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THE RISE AND FALL OF THE GERMAN MIRACLE

ABSTRACT: *The fast recovery of Germany's economy after World War II—the so-called "German miracle"—can be explained by the market-oriented economic policies pursued in the 1950s, based upon the ideas of Ordoliberalism. The slowing growth rates and increasing economic difficulties since the 1970s seem to have resulted from the extension of interventionist and redistributionist policies beyond those sanctioned by Ordoliberalism. The roots of the German economic decline are political: already in the 1950s, a broad consensus existed about the need to integrate market-oriented economic policy with a highly redistributory welfare state in a "social market economy."*

After the catastrophe of National Socialism and World War II, West Germany's economy recovered surprisingly quickly in the 1950s—the period of the "German miracle." But although Germany still has the strongest economy in Europe, it is widely acknowledged that today the German economy suffers from considerable structural problems, manifesting themselves in slow growth, high unemployment, a huge government debt, and severe financial crises in the social security system (e.g., Sachverständigenrat 1999, 43–117). Several years ago, in *The Fading Miracle: Four Decades of Market Economy in Germany*, Herbert Giersch, Karl-Heinz Paqué, and Holger Schmieding suggested that the German miracle was due to sound market-oriented economic

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policies, which allowed for the working of the spontaneity of markets, whereas its fading can be traced back to the post-1950s growth of regulation and corporatism. In this essay we want to discuss this proposition in the light of more recent developments. To this end we will discuss the characteristics specific to German capitalism, both in the successful period of the 1950s and 1960s on one side, and in the more difficult years since the mid-70s on the other. This will require us to analyze two overarching German ideas about the role of the state in market economies: the doctrine of "Ordoliberalism," and the notion of a "Social Market Economy."

West Germany's "Economic Miracle"

After the end of the national socialist dictatorship, industrial production in West Germany recovered slowly, in 1947 reaching only 33 percent of the 1938 level (Statistisches Bundesamt 1956, 141). The main problem was not a lack of capital—the capital stock of 1945 surpassed that of 1936 by 20 percent (Hardach 1993, 45)—but the restrictive institutional framework for economic transactions which was the heritage of the centrally administered Nazi economy. This included both the rationing of many consumer goods, raw materials, and energy and investment goods; and the fixing of prices, wages, and rents. The level at which prices were frozen reflected the burst in the money supply that had paid for both the massive German rearmament in the second half of the 1930s and for the war. The huge expansion of the money supply had, as early as 1936, made price controls necessary to prevent inflation (Giersch, Paqué, and Schmieding 1992, 19). Due to this "repressed inflation," the postwar Reichsmark became worthless, leading to the dominance of barter transactions among privately owned firms (Buchheim 1991, 60).

Both the three Western Allies and the Germans knew that reforms were inevitable. One year before the founding of the Federal Republic of Germany in 1949, Ludwig Erhard, as the director of the (U.S. and British) Bizonal Economic Administration, got the consent of the majority of the Bizonal parliament to carry out his radical plans for the reinstitution of a market economy (Giersch, Paqué, and Schmieding 1992, 32ff.). In June 1948 a currency reform was enacted by the Western Allies, and important steps were taken for the liberalization of markets. A new Deutschmark replaced the Reichsmark,

and immediately a money economy replaced bartering (ibid., 36ff.; Buchheim 1998). This also marked the beginning of the modern German tradition of an independent central bank. The independence of the central bank from the rest of the government was deemed an institutional safeguard against the recurrence of such disasters as the post–World War I hyperinflation and the pre-1948 repressed inflation.

The currency reform was directly accompanied by Erhard's decision to abolish the system of central planning in the Bizone by lifting price controls on almost all manufactured goods and some foodstuffs, and by rescinding rationing and the central allocation of resources (Giersch, Paqué, and Schmieding 1992, 37ff.). Although basic foodstuffs, most raw materials, wages, and rents were exempted from this liberalization for the moment, Erhard's 1948 guidelines on economic decontrol enunciated a clear commitment to a market economy and the beginning of a broad program of liberalization; and in the following years, the conservative government of Chancellor Adenauer turned the German economy step by step into a free market (ibid.; Ambrosius 1977, 171ff.). At the same time, reforms in the tax system reduced tax rates and favored the accumulation of capital through tax exemptions (Giersch, Paqué, and Schmieding 1992, 38). Finally, a law against restraints on trade ended a tradition of cartelization that went back to the legal approval of cartels that had begun in 1897 (Kartte 1969, 15–23).

As yet, however, Germany was not integrated into the international economy. The Deutschmark was not convertible, and trade with the rest of Europe was coordinated by bilateral agreements. Although the Marshall Plan was intended to spur multilateralization (Hardach 1994), its effect was more that of political stabilization than of economic recovery (Giersch, Paqué, and Schmieding 1992, 97ff.).

The strenuous transition to currency convertibility, which lasted until 1958, was facilitated by the founding of the European Payments Union (EPU) as a multilateral clearing system in 1950. In the 1950s, Germany was transformed from being an extreme debtor to a creditor nation (Kaplan and Schleiminger 1989). Due to the U.S. insistence on a general liberalization of international trade, which led to the creation of GATT and the OEEC (later OECD), Germany became a pacemaker of the European trade-liberalization movement. By 1958, 94 percent of private German imports from OEEC countries (representing 82.6 percent of all German imports) were free of quantitative restrictions (Giersch, Paqué, and Schmieding 1992,

Figure 1: German Unemployment, 1950–1998

Year	West Germany	Germany
1950	11.0	
1952	9.5	
1954	7.6	
1956	4.4	
1958	3.7	
1960	1.3	
1962	0.7	
1964	0.8	
1966	0.7	
1968	1.5	
1970	0.7	
1972	1.1	
1974	2.6	
1976	4.6	
1978	4.3	
1980	3.8	
1982	7.5	
1984	9.1	
1986	9.0	
1988	8.7	
1990	7.2	7.2
1992	6.6	8.5
1994	9.2	10.6
1996	10.1	11.5
1998	10.5	12.3

Source: BMA 1977, 2.10; 1998, 2.10.

109). Parallel to its external liberalization, the German economy became increasingly export-oriented (ibid., 13ff.).

During the 1950s, annual German real GNP rose by an average of 8.2 percent, and there was a continuous decline in unemployment from 10 percent to 1 percent (Giersch, Paqué, and Schmieding 1992, 2ff.; see Figure 1). This is particularly remarkable given that the German labor market had to absorb 9,000,000 refugees from the former German territories (Bethlehem 1982). After some volatility directly

after the currency reform, increases in the consumer price level remained below 4 percent until the end of the 1960s (Giersch, Paqué and Schmieding 1992, 12). In short, the economic benefits of the establishment of a market economy were tremendous. Real wages rose an average of 6 percent in the 1950s (ibid., 71ff.), the general standard of living increased enormously, and unemployment was virtually eliminated.

Ordoliberalism and the Social Market Economy

Giersch, Paqué, and Schmieding (1992, 68ff.) characterize the development of West Germany's economy of the 1950s as the outcome of a "supply-side miracle."[1] But what were the economic ideas behind the German market-oriented policy after the war? Erhard's 1948 reforms were based upon "Ordoliberalism," the doctrine of the Freiburg School of Law and Economics. In the aftermath of the global economic crisis after 1929, trust in the workings of market economies was shattered throughout the world. In Germany, where ideas of economic liberalism had never been very popular, Hitler encountered no resistance in transforming Germany's already cartelized economy into an even more centrally administered economy geared to producing armaments and waging war, leading economically both to the elimination of unemployment and the emergence of inflationary pressures (Giersch, Paqué, and Schmieding 1992, 19–22). The Ordoliberals, who were in clear opposition to National Socialism, were a group of economists and legal scholars, many of whom had been forced to leave Germany in the 1930s, but some of whom were still teaching at German universities; foremost among the latter group was the economist Walter Eucken in Freiburg. Since the late 30s they had attempted to develop an innovative conception of the market economy that became the intellectual basis of the economic recovery after Germany had lost the war.[2]

Rejecting Marxist central planning (and therefore implicitly also the Nazi variant of central planning), corporatism and its tradition of cartels, and interventionism (the predominant form of economic policy in the 1920s, which had led to massive rent-seeking behavior by interest groups), the Ordoliberals advocated a genuine market economy (Eucken 1952). But they also rejected minimal statism; in their opinion a laissez-faire economy would fail to ensure the proper

working of markets, due to an inherent tendency for the cartelization and monopolization of markets (Eucken 1952, 30ff.). Normatively the Ordoliberals wanted to realize individual freedom and solve the problem of scarcity (in modern terms: efficient allocation). Unlike classical liberals, they were convinced that achieving these goals required restricting not only the power of governments, but also that of private agents, especially firms and large interest groups (ibid. 169–79). Therefore the Ordoliberals demanded legal protections of competition against restraints on trade, as well as a central bank, but one insulated from politics as an institutional safeguard against inflation (Bernholz 1989).

But the most important general idea of the Ordoliberals was that both the smooth working of the price system and the protection of individual freedom against the power of the state and of private agents can be achieved best by establishing an institutional framework (a set of general rules) for the markets, within which economic processes should take place with as little government intervention as possible. Therefore economic policy should take the form of appropriate general rules for the proper working of markets. Discretionary, interventionist economic policy should be avoided as far as possible (Eucken 1952, 334–38). Ordoliberals advocated a "strong" state to establish a set of general rules but they rejected discretionary regulations, which hamper the proper working of markets. It was especially important to them that economic policies should not interfere with the smooth working of the price system (Röpke 1942, 252–58).

Ordoliberalism is no "third way" between capitalism and socialism; it should be seen as a specific form of liberalism. The difference from laissez-faire liberalism lies in its insistence that markets can fulfill their positive functions only if the state establishes a clear institutional framework within which spontaneous market processes take place. In that respect the Ordoliberal approach has many parallels to F. A. Hayek's emphasis on the importance of general rules (the "rule of law") for the emergence of spontaneous order (Hayek 1960). But in contrast to the Ordoliberals, Hayek was much more skeptical about the capability of the human mind to design the required set of rules for this institutional framework. Given the experience of Germany in the 1930s, the Ordoliberals had little confidence in the spontaneous emergence of appropriate institutions, such as that displayed by Hayek in his theory of cultural evolution (Hayek 1973).

Ordoliberalism is one of the early precursors of modern institu-

tional economics, especially the "property rights approach," "law and economics," and in particular "constitutional economics" (Buchanan 1987)—which, in separating the "choice of rules" from "choice within rules," can be seen as very close to the Ordoliberal idea that after setting down an institutional framework of rules of the game, the state should refrain as much as possible from intervening in the game (Vanberg 1988; Leipold 1990).

The Ordoliberal view gave Ludwig Erhard clear theoretical guidelines for his step-by-step policy of transforming the centrally administered economic system of Germany into a genuine market economy during the 1950s. Although socialist ideas of different kinds were popular after the war in West Germany, the rapid success of Erhard's reforms in reducing unemployment and increasing standards of living for wide parts of the population led to an increasing acceptance of the market economy. This development was supported by the coinage of the term *social market economy* for this specifically German form of capitalism. The basic idea of the "social market economy" (Müller-Armack 1956; Giersch, Paqué, and Schmieding 1992, 31ff.) was the claim to integrate the concept of the market economy with the welfare state. The Ordoliberals were, in fact, very reluctant about welfare statism, arguing that the best social policy would be not political redistribution, but market productivity leading to higher wealth for everyone (Eucken 1952). But "social security" as a central task of the state enjoyed great resonance in Germany, dating from Bismarck's introduction of a state-based social security system in the 1880s, so the idea of combining a market economy with the welfare state had great appeal—even leading the Social Democratic Party in 1958 and the trade unions in 1963 to accept the concept of the social market economy (Giersch, Paqué, and Schmieding 1992, 155).

The result of this development was a double one. On one side, already in the 50s a relatively clear decision was achieved in West Germany in favor of a market economy and against socialism, bolstered by the negative experiences of East German socialism. But since German economists never really succeeded in developing a consistent concept of a "social market economy," in which redistributive social policy could be reconciled with a market economy, this broadly accepted concept was characterized by a broad vagueness, deep tensions, and clear contradictions (see, e.g., the critical appraisal in Wiseman 1989) between the aim of a genuine market economy, as

advocated by the Ordoliberals, and the strong German tradition of a welfare state with redistributory intentions and corporatist elements.

Inflation, Unemployment, and the Failure of Keynesian Macroeconomics

In the 1960s, Germany saw both a continuation of the "economic miracle" of the 1950s and a transition to the growing economic difficulties that became apparent in the 70s. The average real growth rate was still 4.4 percent annually and the labor market was characterized by a chronic shortage of labor (Giersch, Paqué, and Schmieding 1992, 11), producing an average rate of unemployment until 1973 of around 1 percent (BMA 1998, 2.10) despite a strong influx of foreign labor. Unemployment was so low because wage increases lagged behind productivity gains, and an undervalued currency led to soaring exports (Giersch, Paqué, and Schmieding 1992, 126ff.).

But this situation also raised the rate of inflation, which had remained between 1 and 4 percent in the 1960s but rose to 7 percent in 1973–74. Given the Bretton Woods fixed-currency system, Germany's export boom implied high currency surpluses in the 1960s (Holtfrerich 1998, 407ff.), and the Deutsche Bundesbank increasingly had to face the problem that the influx of capital expanded the domestic money supply, importing inflation. Since the revaluations of the Deutschmark in 1961 and 1969 were not sufficient to overcome the undervaluing of the German currency, repeated speculative attacks led to the decision by Germany and other countries in 1973 to switch to floating exchange rates. This breakdown of the fixed currency system made it possible for the Deutsche Bundesbank to control the domestic money supply and allowed it to pursue a restrictive monetary policy so as to regain price-level stability (Giersch, Paqué, and Schmieding, 1992, 176–84). (By the beginning of the 1980s, the Deutsche Bundesbank, supported by a great fear of inflation in the German population, won its reputation for pursuing monetary stability, safeguarded by its political independence.)

This transition period up to 1973 was also characterized by the spread of Keynesian macroeconomic demand management, which had been popular in the United States since the beginning of the 1960s. At the same time, the conservative coalition government of the Christian Democrats and the liberal Free Democrats was replaced by

a coalition of the Christian Democrats and the Social Democratic Party (SPD) in 1966, and finally by a coalition government of the SPD and the Free Democrats in 1969, under chancellors Willy Brandt (1969–1974) and Helmut Schmidt (1974–1982). After an independent Council of Economic Experts was established in 1963 and a Law for the Promotion of Economic Stability and Growth was enacted in 1967, the deficit spending policies necessary for pursuing Keynesian aggregate demand management became conceivable in the pursuit of price stability, full employment, foreign-trade balance and adequate economic growth (Giersch, Paqué, and Schmieding 1992, 148). Together with a general change of the political climate in Germany, leading to a more critical attitude to the market economy and a greater emphasis on "social justice," it was thought that the government should exert a much more active role in steering and controlling the German economy than under the previously dominating Ordoliberal concept of the market economy. In addition to discretionary anticyclical Keynesian aggregate demand management to fine-tune business cycles (Scherf 1986), there was a general tendency to extend regulations in many fields, especially in the labor market, so as to protect consumers and workers and to expand the redistributive German welfare state. But the limited success of such policies soon became apparent.

After 1973, the state of Germany's economy worsened for several reasons. One problem was that the economic boom at the end of the 60s and the beginning of the 70s, prolonged by inflation that could not be fought before the transition to floating exchange rates, had led to a distorted and hence unsustainable structure of production (Giersch, Paqué, and Schmieding 1992, 133ff.). Presumably more important was the increasing cost of labor. In the 60s, trade unions were moderate in their demands for higher wages, and there was no rise in real unit labor costs. The situation changed dramatically in 1969–70, when the trade unions—spurred by wildcat strikes and the expectation of rising inflation rates—switched to a more aggressive posture (Giersch, Paqué, and Schmieding 1992, 156ff.). Salaries in the public sector rose by 11–12 percent in 1974, and other industries followed with wage increases above 10 percent (Scherf 1986, 37). Furthermore, the unions also used wage negotiations as a means for redistribution, especially in the lower wage classes. As a consequence of wage increases that exceeded productivity increases and inflation rates, the real unit labor cost increased by 1.6 percent annually between 1969

and 1974 and at a slightly lower rate in the second half of the 1970s (Giersch, Paqué, and Schmieding 1992, 132, 198). This encouraged the substitution of capital goods for labor. The first and second oil crises in 1973 and 1979 brought about an additional rise in production costs through enormous price increases for raw materials, especially crude oil. Counteracting this worsening in the terms of trade would have required sacrifices in real wages to avoid rising unemployment, but these did not take place.

As a consequence the German economy suffered deep recessions 1975 and 1982, in which unemployment rose from 1.3 percent in 1974 to 7.5 percent in 1983 (BMA 1998, 2.10). Since then, as can be seen in Figure 1, German unemployment rates have increased sharply in recessions, but have declined only to a small extent in the boom periods, leading over several business cycles to a terraced pattern of mounting unemployment that can be observed until today. Correspondingly, the average growth rate fell to 2.2 percent between 1973 and 1980 (Giersch, Paqué, and Schmieding 1992, 4). The German government attempted to fight the economic crises by applying the newly introduced macroeconomic instruments, but Keynesian investment programs financed by budget deficits, due to political and economic time lags, were partly procyclical, and rising public spending could not be reduced enough in the boom phases of the business cycles (Scherf 1986). This led to the additional problem of major budget deficits, which have persisted in Germany up to the present.

The Crisis of the Welfare State

Eventually it came to be thought that many of the problems of the German economy, especially the high rate of unemployment, were not susceptible to macroeconomic solutions. Since a high proportion of unemployment in the 1980s and 1990s seemed to have not cyclical but structural causes (Giersch, Paqué, and Schmieding 1992, 201ff.), it was suggested that economic policy should focus on solving problems on the micro level, implying a turn to so-called neoliberal or supply-side policy. This development can be seen as reflecting the influence on German thinking of Thatcherite and Reaganite reforms, but it can also be interpreted as a renaissance of the old Ordoliberal market-oriented concepts of the 1950s.

The basic insight was that the economic problems of late twentieth-

century Germany were a consequence of failing incentives on the supply side of markets caused by overregulation, state intervention, high taxes, and a welfare state that had been extended too far. The central problem was seen as state failure, not market failure. From the Ordoliberal perspective, the state had not confined itself to its proper task: establishing an institutional framework for ensuring the preconditions of a smoothly working market economy. Instead, it had vastly extended the range of its activities, systematically impairing markets and producing observable negative effects on growth and employment.

By extending the thick net of labor regulations in the 60s and 70s, German labor markets lost much of their flexibility (see generally Soltwedel et al. 1990; OECD 1999, 98–148; Paqué 1999). In part, this was due to the corporatist system of industry-wide collective bargaining that was largely guaranteed by the German constitution. The collective bargaining system allowed the trade unions to impose minimum wages above market-clearing equilibrium wages, and to impose wage uniformities that reduced occupational and regional wage flexibility (Monopolkommission 1994, 360–80).

These rigidities were aggravated by many regulations, such as the strict rules of the German Dismissal Protection Law, which made German employers reluctant to offer new jobs because of the high cost of dismissals (Rüthers 1996, 51ff.; Geue and Weber 1998, 306). Another problem might have been the introduction of a far-reaching system of labor codetermination in large firms in 1972. Although trade-union wage demands became more moderate in the 1980s, indirect labor costs had reached 81.80 DM for every 100 DM in direct labor costs (Institut der Deutschen Wirtschaft 1999b). Unemployment became increasingly persistent, and more and more of the unemployed remained jobless for long periods (Eekhoff 1998, 7ff.).

Many German labor-market regulations were conceived as instruments for the protection of "socially weak" groups and can therefore be interpreted as being part of the redistributive welfare state. But the German system of social security for the middle class was also expanded to an unprecedented extent. The benefits of German statutory old-age insurance, health insurance, and unemployment insurance were considerably increased, and the eligibility of recipients broadened. Consequently, social security "contributions" rose from 8–10 percent of GNP in the 50s to 17 percent during the 80s, reaching 19.3 percent in 1997 (BMA 1998, 7.6). This was the main cause of soaring indirect labor costs, and the benefits for which these contributions paid created negative incentives

for their recipients to take up the low-paying jobs (Eekhoff 1998, 196ff.) that are often the first steps out of poverty and toward long-term employment.

Even as employment was being discouraged, unproductive industries were being subsidized. In 1997 the total volume of industrial subsidies reached 291 billion DM, or 8.1 percent of GNP and 36.5 percent of total tax revenue. The main sectors profiting from subsidies were agriculture, mining, transportation, and housing (Boss and Rosenschon 1998; Giersch, Paqué, and Schmieding 1992, 216ff.). In slowing down necessary structural changes by propping up unsustainable jobs, German internal subsidies substituted for external protectionism (Giersch, Paqué, and Schmieding 1992, 227).

As a consequence of these policies, public spending increased rapidly after the 1960s, leading both to higher taxes and growing budget deficits. The public-sector share of the GNP (including social-security expenditures) rose from less than 30 percent in the 50s (Giersch, Paqué, and Schmieding 1992, 219) to 50.1 percent in 1982 (Institut der deutschen Wirtschaft 1999a, 86). Since a growing proportion of the rising tax burden was met by direct taxes, especially progressive income taxation (Giersch, Paqué, and Schmieding 1992, 219), there can be no doubt that in the late 60s and especially in the 70s, supply-side conditions had worsened considerably, especially in light of the simultaneous growth of labor-market regulation and welfare-state benefits.

Yet the policies of the social-liberal coalition cannot be seen as a real break with the past. The basic principles of the German social-security system are today in many respects still surprisingly similar to those of the system that Bismarck introduced in the 1880s: health insurance, accident insurance, and pensions for the disabled and elderly (Frerich and Frey 1993, 95–101). For more than a hundred years this system of obligatory insurance has been extended step by step to encompass more recipients and to give them more benefits. This state-based system of social security was explicitly reconfirmed in the early 50s, and while the extension of the system in the late 60s and 70s was a considerable further step that overstrained the German economy, it was not a break in the development of the German welfare state. The same is true for the labor market. The system of collective bargaining among trade unions and employer associations dates back to the beginning of the Weimar Republic, was reestablished in the Collective Agreements Law of 1949, and was reconfirmed by the new German constitution. The Dismissal Protection Law was enacted in 1951, and was only intensified by the so-

cial-liberal coalition in 1973. In the same way, the 1976 expansion of labor involvement in management has to be seen as part of the German tradition of works councils dating back to the Weimar Republic and especially to the "parity codetermination" in the German coal, iron, and steel industries that began in 1951 (Frerich and Frey 1983; Hentschel 1983).

The Intractability of German Economic Problems

Since the Social Democrats were not willing to reduce their commitment to state intervention, the Free Democratic party changed its coalition partner in 1982, leading to the long phase of the conservative-liberal government under Helmut Kohl, lasting for 16 years. Only after Kohl's electoral defeat in 1998 was a new coalition of Social Democrats and the Green party formed, led by Helmut Schröder.

The new conservative-liberal government that took office in 1982 promised to resolve the unemployment problem in Germany by strengthening economic growth through a more market-oriented economic policy animated by Ordoliberal, supply-side economics. But while neoliberal thinking became increasingly dominant in policy discussions, and Keynesian demand management virtually disappeared in the 80s (Giersch, Paqué, and Schmieding 1992, 195), the new coalition fully participated in the broad social consensus around the need to maintain the German welfare state. Reforming the welfare state and labor-market regulations was understood as part of an overall need for a policy of liberalization and deregulation, but this policy was rather slow and cautious. In comparison with changes undertaken by the Reagan, Thatcher, and New Zealand administrations, the Kohl government was timid. Corrections to the German system of social security were deemed necessary, but the government never planned major reforms.

Therefore it is no surprise that several problems have remained unsolved despite many reform attempts, some of which were carried out while others were not.

For one thing, German old-age insurance is a pay-as-you-go system that is at the mercy of demographic changes. Since in Germany, as in many other industrialized countries, the number of children has declined considerably since the end of the 60s and the life expectancy of pensioners has risen, it has been known for more than 20 years that the ratio of pensioners to contributors will increase dramatically in the fu-

ture, leading either to considerably reduced pensions for the current generation of employees or to soaring rates of "contribution." These problems have been aggravated by high unemployment and the extension of benefits to newly entitled groups. The rate of pension exactions has already reached nearly 20 percent of gross income, with employers and employees each paying half. To cope with demographic changes, pension extractions will have to reach 30–35 percent in 2030 (Börsch-Supan 1998, 139), leading to even higher indirect labor costs and the further discouragement of job creation. The relatively timid reforms of the Kohl government, which never questioned the pay-as-you-go system, will at best alleviate the problem temporarily (see Siebert 1998; Börsch-Supan 1998; Sachverständigenrat 1999, 180–83).

A second major problem is the skyrocketing cost of the German health-care system. New laws are regularly enacted to limit expenditures, but no sustainable solution has been found (see generally OECD 1997, 67–117). Despite the fundamental problems with the pay-as-you-go pension system, an additional pay-as-you-go insurance system for long-term health care was enacted in 1995 despite wide support among economists for an actuarially sound capital-funded system of private insurance (Eekhoff 1998, 164–74).

Similarly, while many attempts have been made to reform the tax system, only marginal changes, such as a slight reduction in the top marginal income-tax rate, have been enacted. All proposals to extend the tax base by eliminating the many exemptions have failed, as have efforts to end the investment and employment disincentives produced by Germany's highly progressive taxes on middle- and higher-income earners and its corporate tax rates, which compare unfavorably to those of other countries. Rising public debt now makes such reforms even more difficult (Eekhoff 1998, 238–49; Sachverständigenrat 1998, 220ff.; OECD 1999, 49–69).

At the beginning of the 1980s the Kohl government did pursue small measures of privatization and deregulation, and it managed to reduce the share of the economy devoted to the public sector from 50.1 percent in 1982 to 45.8 percent in 1989 (Institut der deutschen Wirtschaft 1999a, 86). But while more than two million new jobs were created in the 1980s (Sachverständigenrat 1994, 257), unemployment remained high throughout the decade due to demographic changes and the failure to enact major liberalizing reforms, and economic growth remained sluggish, averaging 1.9 percent between 1980 and 1989 (see Giersch, Paqué, and Schmieding 1992, 4 and 207ff.). Only the policy of the

Deutsche Bundesbank turned out to be a full success, reducing inflation to nearly zero in the 1980s (ibid., 12).

The conservative-liberal reforms were too inconsequential to prepare Germany for the new and unprecedented challenges of the 1990s: German reunification, European integration, and globalization.

The Mixed Results of German Reunification

At the end of the 1980s East Germany's centrally planned economy was bankrupt. Consequently, reunification can be seen as a rational economic strategy for the East Germans. Less than eight months after the fall of the Berlin Wall on November 9, 1989, East Germany's economy was incorporated into West Germany's social market economy through the German Economic, Monetary and Social Union (July 1, 1990), followed by political integration in October 1990.

The East German economy suffered from very low productivity due to a systematic neglect of investments, and its products were not competitive in Western markets. This became immediately visible through the quick introduction of the German Mark in East Germany (Giersch, Paqué, and Schmieding 1992, 256ff.). The politically chosen and economically inaccurate conversion rate of 1:1 for rents and wages, and the pressure for equal wages in East and West Germany, led to rapid wage increases and therefore a cost explosion for East German firms in the beginning of the 90s, preventing the East German economy from adapting itself to the conditions of the Western market. As a result, most East German industries collapsed (Franz 1999, 381ff.), and subsequent privatization policy failed to diminish East German unemployment, despite large subsidies for the maintenance and restructuring of enterprises. The German government tried to revive East Germany by transferring huge sums to its infrastructure, and partly through tax exemptions for East German investments. Moreover, East Germans were incorporated at once into the West German system of old-age, healthcare and unemployment insurance. The results have to be seen as mixed (Sachverständigenrat 1998, 210ff.). Large parts of East Germany have received an entirely new infrastructure and the standard of living of the East German population is much higher than before 1989. On the other side there is still very high unemployment—18 percent in 1998 (Franz 1999, 382)—which, despite an intensive application of labor-market policy measures and huge transfers and subsidies, seems to be

persistent. East Germany will have a long way to go before its economic inferiority to West Germany disappears (e.g., Sachverständigenrat 1999, 72–84).

Neither the rapidity of the reunification process, the politicized currency conversion rate and wage increases, or other problems can be discussed here in detail (see Sinn and Sinn 1992; Gerling 1998; Hunt 1999). What can be said is that within a few months, the whole system of West Germany's social market economy, with its dense net of regulations and its complex redistributory welfare state, was slipped over East Germany, which meant additional impediments to investment, especially because the administration for this system had to be built up from scratch. Meanwhile, paying for reunification has put great financial pressure on both the German budget and the social-security system, aggravating the already existing problems dramatically. Taxes had to be increased and the public-sector share rose above 50 percent of GNP during the 1990s (Eekhoff 1998, 238). The central problems facing Germany are the same now as in the 80s: reform of the old-age insurance and the health-care system, of labor-market regulations, of taxes; and reductions in budget deficits and public debt. But this is no real surprise, since reunification distracted attention from the problems of the West German social market economy for years, delaying the necessary reforms, even as it increased their urgency because of the financial strain of the huge transfers to East Germany.

The Challenge of Globalization

Due to liberalization in many countries and technical progress in transportation and communication technologies, the mobility of individuals, firms, and especially capital have increased rapidly. As a result states, which can be seen as offering complex bundles of public goods (including law, regulations, infrastructure, social security) and taxes, find themselves in competition with one another as locations for investments and therefore jobs. Those countries that succeed in producing especially attractive conditions for the establishment of new production sites are able to induce the influx of capital, helping to foster economic growth, reduce unemployment, and increase tax revenue (Kerber 1998). Since Germany has not been able to carry out real reforms, the international competitiveness of Germany as a location for foreign investments is deemed unimpressive, leading to a comparatively low level of foreign

direct investment in Germany. Among German economic-policy elites, it is increasingly suggested that fundamental reforms of Germany's social market economy are necessary for regaining competitiveness (Sachverständigenrat 1995; Siebert 1995).

Yet with the rise of the European community, many of the policies that determine the institutional framework within which the market process takes place are made at the international level. In some respects, the EC stands for a strictly market-oriented approach, as exemplified by both the Single European Market Program and the widely successful liberalization and deregulation program. On the other hand, the EC has many powers that it already uses or can use to impose further regulation and intervention. The Common Agricultural Policy, the huge EC programs of research and technological development, and the EC structural funds, with their broad distribution of subsidies, are examples. Thus, even while there has been deregulation and privatization in specific sectors (e.g., telecommunication) and while, as a consequence of the Single European Market Program and the general process of globalization, a huge restructuring has taken place as German industries have adapted themselves to European and global markets, German firms also have become increasingly mobile, implying the danger of exporting jobs to other areas, such as the Middle East and Eastern Europe, where wages are low. This makes it especially disadvantageous that Germany has been unable to solve its huge tax, social-security, public-debt, and labor-market problems. At the beginning of the 1990s, Giersch, Paqué, and Schmieding (1992, 273) pointed out that Germany "lagged well behind the Anglo-American world in its efforts to give its economy a more supply-friendly incentive structure through tax reform and a less stifling system of regulations." This is still true, despite the fact that the OECD has repeatedly demanded reforms, especially in regard to the flexibility of labor markets (OECD 1996, 98–148; OECD 1999, 93–100; Sachverständigenrat 1999, 165–80).

In some respects the problem is political. The need to assemble coalition governments, and the fact that the second chamber of parliament is usually dominated by the opposition, implies that major reforms require great political consensus (unlike, say, in the United Kingdom). This problem is aggravated by politically strong interest groups and the quasi-corporatist German system of collective bargaining with strong unions, which until recently blocked all major reforms of the labor markets. In addition, the German population has been very reluctant concerning fundamental reforms, especially in regard to the traditional

system of social security. Only recently has awareness that fundamental reforms might be inevitable spread widely.

There seems to be considerable empirical support for Giersch, Paqué, and Schmieding's view (1992, xi) that market-oriented policies accounted for the postwar "German miracle," while subsequent overregulation and the overextension of the welfare state, funded by high taxes, with their disincentive effects, weakened economic growth. The high growth rates in the 50s and early 60s can be traced back to the unleashing of market forces by the postwar establishment of a market economy through internal and external liberalization. The economists also have good arguments that the decline in economic growth and the inability of the German economy to solve the aggravating problem of high unemployment has had its cause in the massive deterioration of supply-side conditions since the beginning of the 70s, especially through the extension of the regulatory and redistributive state. Despite the turn of the Kohl government to a more supply-side oriented policy at the beginning of the 80s, market-oriented reforms were too slow and unambitious to solve the many problems that had piled up in the previous decades.

But does this mean that the German attempt to integrate a real market economy, in the Ordoliberal sense, with elements of a more interventionist state—leading to the concept of the "social market economy"—was wrong from the outset? It is much more difficult to answer this question. Both the corporatist system of collective bargaining and the state-based system of social security were already in place during the "economic miracle" of the 50s, and it is not undisputed why these institutional arrangements have been the cause of economic problems since the 70s but not before (see, e.g., Giersch, Paqué, and Schmieding 1992, 71ff. and 154ff., for the difficulties in explaining moderate union behavior in the 50s and 60s). And even if one rejects the idea that the German welfare state might have fostered the overall efficiency of the German economy by providing social peace, it is possible to argue that the welfare state might have been politically necessary to gain the consent of the population to the establishment of a market economy in Germany.

Finally, there is the view that consent is not only strategically but normatively important: that the preferences of the people should be systematically taken into account. From this perspective the deep-rooted preferences in Germany for the safeguarding of a relatively high minimum income for each member of the society or for other "social"

aims should be taken seriously. This leads back to the crucial, and open, question of the extent to which the welfare state is compatible with a free-market economy.

NOTES

1. A different assessment can be found in Abelshauser 1983; also see Giersch, Paqué, and Schmieding 1992, 40ff.
2. For discussions of Ordoliberalism/the Freiburg School of Law and Economics see Vanberg 1988 and 1998), Peacock and Willgerodt 1989a and 1989b, and Streit 1992. Translated articles of Eucken, Böhm and Röpke can be found in Peacock and Willgerodt 1989b; most important, but not translated into English, is Eucken 1952.

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