Germany transformed – Economic specialization and institutional adjustment

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DRAFT

THIS IS A ROUGH DRAFT. I APOLOGIZE FOR THE LACK OF EDITING.

abstract

What do the recent trends of the German economic development convey about the trajectory of change and the potential of VoC theorizing to explain and understand institutional adjustment? Has corporate and welfare restructuring prepared the German economy to deal with new challenges? What effects will this have on the coordinating capacities of economic institutions?

This paper argues that the transformation of the institutions governing the German political economy over the last two decades has been largely path-dependent. Despite the weakening of self-governing associations, particularly organised labour and employers, the German production model of a well-protected and cooperative plant level coalition of specifically skilled workers and management is thriving. Its' governing capacity has shifted to the plant-level and institutions are more concentrated on the exposed sectors of the economy. Welfare restructuring reinforced plant level cooperation. Corporate and welfare restructuring combined form a trajectory of transformation that presents a deepening rift between different sectors of the German economy. This process induces a new interplay of firms and institutions, which is both the basis of current competitiveness as well as a major challenge for further economic development of Germany's position in the Eurozone.

1. Introduction

It does not lack a sense of irony that the 'German model', a term of appreciation which had been coined after the response of the German political economy to the oil shock of the 1970s and subsequently served as the role model for European monetary integration, has now bounced back, as Germany has become the best performing country after the initial slump in 2009. Or indeed that after three decades of liberalization of Western industrialized economies, a non-liberal coordinated market economy leads the news on economic recovery.

This is mainly for the fact that in the interim period of the 1990s and first half of the 2000s, the admiration for the German model was more than dead. Low growth, low and decreasing employment levels and little economic dynamism after the shock of unification contributed to the view that only an outright overhaul of the underlying economic institutions, a good dose of deregulation and liberalization and a stronger embrace of the fortunes of financial markets would install new growth potential. Almost 15 years ago Roman Herzog, the former federal president, talked about the mental depression that had befallen Germany, and called for a "Ruck" – a sudden jerk.[1] Soon after, the German model was portrayed as the sick man of Europe in the Economist. Similar phrases remained commonplace until Chancellor Schröder introduced the Agenda 2010 in March 2003, in which he insisted that "either we modernize or we will be modernized by the unremitting forces of the market".[2] This view was shared outside Germany, as pressure from international organisations and other EU governments also mounted. The IMF, for instance, intensified its argument that Europe as a whole is being held back by Germany's unwillingness to grasp the nettle of reform. Similarly, in international benchmarking reports, Germany was singled out as a problem case with regard to the EU's Lisbon economic development agenda.[3]

Much has happened since. Welfare and labour reforms have activated labour markets and reduced entitlements. Firms have restructured and regained competitiveness. Is it due to these measures thanks to the 'modernization' of the Agenda 2010 and the liberalization that occurred that Germany has started to bounce back? Has liberalization prepared the German economy to deal with new challenges? Is there still a German model to speak of or has German capitalism deceased to be useful concept of distinguishing a particular mode of continental European market economies from others?

[1] Berliner Rede von Bundespräsident Roman Herzog am 26. April 1997. http://www.bundespraesident.de/Reden-und-Interviews/Reden-Roman-Herzog-,11072.15154/Berliner-Rede-von-Bundespraesi.htm?global.back=/Reden-und-Interviews/-%2C11072%2C6/Reden-Roman-Herzog.htm%3Flink%3Dbpr_liste.
[2] Regierungserklärung von Bundeskanzler Schröder am 14. März 2003 vor dem Deutschen Bundestag. http://archiv.bundesregierung.de/bpaexport/regierungserklaerung/79/472179/multi.htm
[3] Murray 2003.

This paper advances the argument that intensified plant level cooperation combined with the ongoing restructuring of the welfare state has transformed the German political economy on a distinctive institutional trajectory. While the recent comeback of the German economy owes more to the institutional foundations of the 'old' German model than to the liberalizing policies of the early 2000s, social policy reforms were a necessary component. At the same time, the transformation of the institutions governing the German political economy over the last two decades has been largely path-dependent. Despite the weakening of self-governing associations, particularly organised labour and employers, the German production model of a well-protected and cooperative plant level coalition of specifically skilled workers and management is thriving. Its' governing capacity has shifted to the plant-level and institutions are more concentrated on the exposed sectors of the economy.

Path-dependent plant level restructuring coincided with equally path-dependent but liberalizing social and labour market policies that went beyond the traditional tinkering at the margins of benefit entitlements. Plant level restructuring and policy change together form a trajectory of transformation that presents a deepening rift between the different sectors of the German economy. The key manufacturing sectors increasingly use domestic service industries, just like the off-shore production sites in Eastern Europe, as a low cost suppliers and a source for flexible adjustment. The recent recovery of the German economy has built on a pattern of corporate restructuring which manufacturing firms and their core workforces have established over the last couple of decades. This process induces a potential line of rupture for the political economy and society as a whole is main challenge for further economic development as well as for Germany's position in the Eurozone.

2. Corporate and welfare restructuring in continental welfare states

By now it has become almost common to note the rapid change that continental European welfare states have experienced during the past 10 years both in the area of welfare restructuring as in the area of economic institutions[4]. Gone seem to be the times when scholars agreed that is was largely impossible to render structural reforms in a continental welfare setting, despite the massive problem load these countries face.[5] There exists a broad consensus that Bismarckian welfare states have in fact undergone fundamental restructuring.[6] The overall *reform trajectory* of most continental welfare states after the alleged "golden age of the welfare state" and the oil crisis in 1970s has been remarkably similar. After a phase of preservation of the old institutional logic by means of labour shedding and further increases in social contributions in the 1980s, a phase of negotiated retrenchment set in from the early 1990s onwards. During this second phase, measures

[4] This section in parts borrows from Hassel and Schiller 2009.
[5] Esping-Andersen 1996; Scharpf 2000; Pierson 2001.
[6] Palier and Martin 2007; Vail 2008.

largely aimed at stabilizing or cutting social expenditure while leaving the overall structures of social transfers untouched. The consequent moderate adjustments of social insurance benefits were negotiated with the social partners, which in turn guaranteed a relatively low cost for the current "insiders".

At the same time, a new world of welfare was created through the development of tax-financed benefits.[7] In the context of rising unemployment figures and rising social contributions, this negotiated retrenchment strategy met increasing political resistance. The third phase starting from the mid 1990s therefore saw reforms which challenged the traditional pillars of the Bismarckian welfare states. Reforms included changes in the financing mechanisms or governance arrangements. Finally, in the fourth phase since the early 2000s, reforms are quite different from what has been the traditional reaction of Bismarckian welfare states: e.g. funded pension schemes, activation policies, defamilialization of care or privatization in health insurance systems have been introduced.[8]

In the VoC literature, there has been a period of convergence in theorizing and researching Between the mid to late 1980s and the late 2000s during a phase of relative stability and continuity in advanced industrialized countries.[9] Institutional configurations of national political economies were seen as the main category of distinction between national political economies with a strong emphasis on the interdependence between the mode of corporate finance, innovation and the usage of human resources within firms that are competing on international markets. Non-liberal forms of market economies displayed a number of features that were in stark contrast to liberal Anglo-American countries such as concentrated ownership of firms through block-holding, bank-finance, plant-level cooperation between workers and managers, higher levels and more specific skills in core industries and pathways of specialization in different technologies and industries.

There had always been some level of disagreement on the foundations and origins of diverse economic institutions. Different perspectives emphasised micro versus macro level approaches, the use of rational choice assumptions and large n comparisons in contrast to few historical case studies. In particular, approaches focusing on the role of the firm as a micro-level actor espousing rationally based preferences for market competitive reasons leading to institutional equilibriums were in contrast to macro-level studies of institutions emphasizing power resource approaches in historically unique settings over long period of time. All the while, the commonalities in the discussions tended to be greater than the criticism of each other assumptions.

However since the mid 1990s, advanced political economies have started to display rather strong evidence of institutional change in particular in continental European non-liberal

[7] Palier and Martin 2007: 543.
[8] Palier and Martin 2007: 543.
[9] Hall/Soskice 2001, Crouch/Streeck 1997, Amable 2005.

market economies. In most countries, governments have implemented labour market,[10] unemployment insurance[11] and pension reforms[12], which have altered the patterns if not scale of social spending and the social security position of workers. Labour market regulation was weakened particularly for labour market outsiders by facilitating temporary work, while many regulations for labour market insiders were kept. As the VoC literature has underlined in particular the protection of specific skills which was inherent in generous and far reaching status-securing unemployment benefit systems and strong employment protection had helped workers to invest in specific skills.[13] When government started to address low labour market participation rates and rising long-term unemployment, they tended to dismantle these provisions.

Capital markets and corporate governance regulations have been the subject of intense reform pressure. Beginning in the mid 1990s, many governments liberalized capital markets towards liberal market economies.[14] In some cases, reform was radical and fundamental while in others reform steps were incremental and less radical. Corporate finance moved some way towards equity finance and some big national champions defined themselves as shareholder value firms quite similar to their Anglo-American counterparts.

Also, the structural changes on the labour market towards deindustrialization and labour market deregulation weakened the position of trade unions. Union membership figures declined quite substantially almost across all industrialized countries. Employers' associations lost members and collective bargaining coverage declined. Collective bargaining practices changed too. While centralised collective bargaining survived in most places, the contents of collective agreements were less regulated than before and delegated more decision making rights to a lower level.

Plant based vocational training, another prominent feature of non-liberal capitalism, was in decline and a steady trend towards higher and tertiary education lured school leavers away from mid-level specific skills. In other words, the fundamentals on which non-liberal market economies were supposed to rest were subject to profound changes which were all in the direction of increasing liberalization and deregulation.[15]

The *nature, scope* and *direction* of this ongoing reform process in many continental European political economies has recently been described as a process of "dualization", i.e. it has been described as a process where two distinct institutional worlds of welfare emerge which are guided by very different principles and institutions for different parts of the population.[16] On the one hand, a new welfare world has emerged in which family benefits,

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[10] Bonoli 2010.
[11] Clegg 2010, Clegg 2007.
[12] Häusermann 2010.
[13] Estevez-Abe, Iversen, Soskice 2001.
[14] Culpepper 2010, Höpner 2007.
[15] Particularly Streeck 2009.
[16] Palier and Martin 2007; Palier and Thelen 2008; Swank, Martin et al. 2008.

health care and poverty alleviation are delivered either as universal or targeted benefits and which are mainly financed by taxation and controlled by the state. On the other hand, pensions and employment policies have largely been retained in the social insurance world, even though the meaning of social insurance has changed due to a stronger reliance on actuarial and activation principles. Whereas the insiders continue to be insured relatively well, a growing part of the population is experiencing the development of 'atypical' jobs and types of social protection other than the typical social insurance.

Analyzing changes in industrial relations, labour market policy and welfare reforms in Germany and France, Palier and Thelen conclude that "in all three arenas, significant change have been accomplished within the context of a high degree of formal institutional stability, mostly through a process of institutional erosion which leaves a solid 'covered' core but with a growing number of firms and/or workers outside this core".[17] Similar characterizations of the ongoing reform processes in continental welfare states can be found in other accounts, as well.[18] While the nature and direction of the reforms in continental Europe by now seems to be well-understood, the future implications of this process are still unclear. The open question, therefore, is whether this segmented pathway of reforming is robust and will determine the future shape of the continental welfare world[19] or whether this dual way of reforming is merely a period of transition towards the liberal welfare model.

Not only are future implications of this restructuring process unclear, but the search for explanations for the swift policy changes in continental Europe has also only just begun. Some scholars stress that the new process is driven by new cross-class dynamics and alignments, which are characterized by an intensification of cooperation between employers and workers within the core economy but which is associated with a shrinkage in the system and thus growing numbers of workers outside the core.[20] Due to an erosion and/ or decentralization in industrial relations and increasing tensions within the unions, segmentalistic forms of coordination more and more prevail over solidaristic forms of coordination in Germany and France.[21] In Germany, trade unions were divided within and among themselves. While unions directly representing low-level service sector workers had much less weight than the major industrial unions, the industrial unions were split between the interests of powerful works councils and their own interest of protecting lower income workers in the industry.

According to Carlin and Soskice, works councils representing skilled workers supported flexible low-level service labour markets for two main reasons: (1) it implied cheaper services and therefore increased the real income of their members and (2) it implied that their members would bear less of the cost of prolonged unemployment (Carlin and Soskice

[17] Palier and Thelen 2008: 9.
[18] Bleses und Seeleib-Kaiser 2004; Clegg 2007; Morel 2007.
[19] Palier and Thelen 2008.
[20] Palier and Thelen 2008; Carlin and Soskice 2009.
[21] Palier and Thelen 2008: 5.

2009: 93). The fragmentation within and across the unions made it possible for the SPD to equally move towards the centre in order to compete with the traditionally strong position of the CDU. This coalitional realignment was sealed by the fracturing of the SPD left and the formation of the new left party.[22] It resulted in reforms which relatively well protect the status and privileges of labour market insiders and at the same time provide enough flexibility to stabilize the core.[23]

This paper investigates the current avenues of VoC theorizing using the case of institutional change and economic performance in Germany. It poses the question of what kind of contribution recent patterns of liberalization had on economic institutions and performance and to what kind processes of liberalization alter the configuration of economic institutions in a meaningful way. It thereby assumes that not all kind of liberalization matter to the same degree, but that there is a core of significant fields in the political economy whose level of non-market coordination are crucial for the functioning of the political economy.

On this basis, the paper argues that the transformation of the institutions governing the German political economy over the last two decades has been largely path-dependent. Despite the weakening of self-governing associations, particularly organised labour and employers, the German production model of a well-protected and cooperative plant level coalition of specifically skilled workers and management is thriving. Its' governing capacity has shifted to the plant-level and institutions are more concentrated on the exposed sectors of the economy.

Moreover, the paper points out that despite the dualism in the labour market the recent comeback of the German economy owes more to the institutional foundations of the 'old' German model than to the liberalizing policies of the early 2000s. Policy tools as well as firms' strategies to overcome the crisis were built upon patterns of plant level cooperation that have been pursued by German firms for the last two decades.

Therefore, the paper concludes that coordination and liberalization are not opposites or mutually exclusive not even in the same economic sphere or within the same economic institution.[24] Rather, market and non-market coordination is used and pursued by economic actors interchangeably depending on the management challenge and the business environment at hand. For managers and their workforces, the distinction between liberal or non-liberal forms of restructuring is irrelevant. They are guided by the institutionally determined opportunities of capturing competitiveness and less by principled considerations. If employment laws allow mass dismissals easily, skills are general and trade unions are weak, the costs of rapid downsizing are low. If employment laws are strict, skills are specific and trade unions strong, the costs are much higher. Firms will prioritize internal flexibility rather than changing the law.

[22] Carlin and Soskice 2009: 93.
[23] Palier and Thelen 2008: 51.
[24] See also Herrigel 2010 with a related argument.

Applied to the transformation of the German political economy since reunification two decades ago, the argument is that economic shocks have driven plant-level actors to pursue radical measures of cost cutting and productivity increases by exploiting existing patterns of plant-level cooperation. By focusing on regaining competitiveness for its export sectors the German political economy has further specialized in export-led growth. This had institutional consequences.

Intensified plant-level cooperation led to employment guarantees for core workers which insulated them from previous demands for strong social security provisions. In turn, persisting outsourcing towards low cost countries but also to low cost service sectors have added to liberalization in other parts of the economy, particularly through the use of fringe workers. Manufacturing firms, with the tacit support by their works councils, supported firms in services industries that lobbied for more liberal employment rules for non-core segments of the workforce. When the German government pursued activation strategies on the labour market, core firms and core workers did not veto the proposed measure of liberalization.

Thereby, sustained economic coordination has facilitated and to some extent required liberalization in some areas for cost containment, more flexible corporate finance and numerical flexibility of the workforce. As a consequence of the benefits of coordination, firms actively pursued a strategy of dualization of the workforce dividing employees in core and fringe workers. Continued coordination in the core of the economy is accompanied by liberalization at the fringe. Liberalization occurred not against strong resistance by key beneficiaries of social policy but was accepted and supported as a precondition for sustained coordination.

At the same time, dualization has set in motion a process of further institutional adjustment and fostered dualism. Dualism in medium-level coordinated market economies creates schisms within and between interest group organisations, partly between capital and labour and between small and big firms, but predominantly between manufacturing and service sector which is affected differently by policy adjustments. Long-term structural change is likely to push for further reconfiguration as the service economy trumps manufacturing.

3. Plant level competitiveness and the road towards dualism

When unification hit the German political economy in the early 1990s, firms had already become under competitive pressure from Japan and East Asia as well as from an overvalued exchange rate in EMS. In the aftermath of the unification boom an extraordinary pay hike added to their problems. The subsequent recession in 1992/93 was the worst since WWII and half a million jobs in the manufacturing sector were shed. Within 15 years between 1994 and 2009, the German economy devalued its real unit labour costs vis-a-vis its European competitors by 20%. [25]

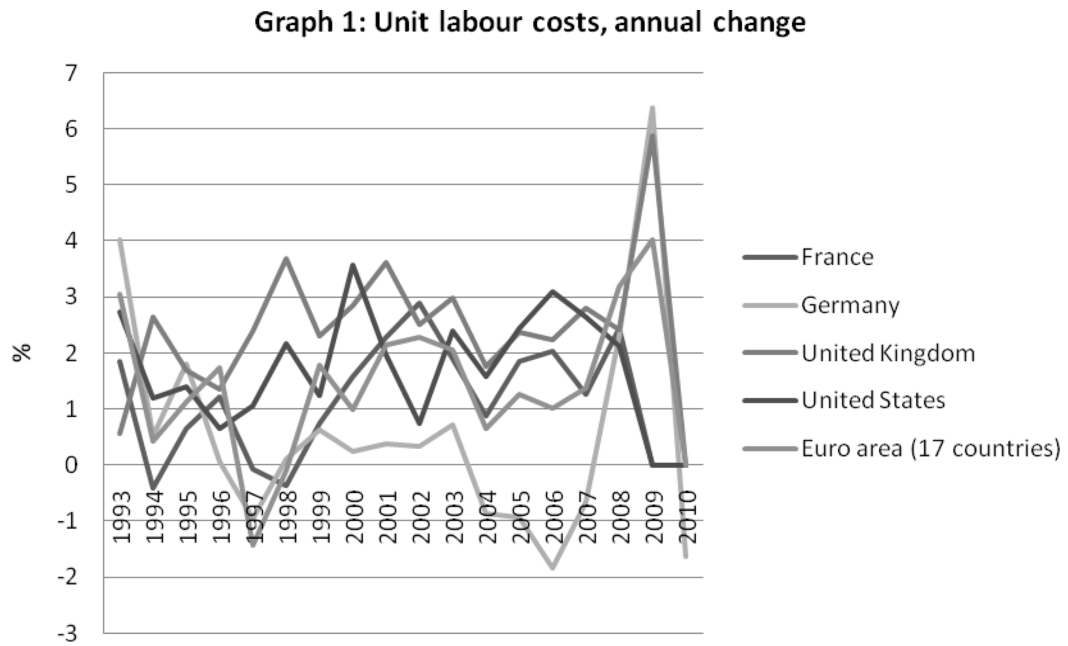
The recovery trajectory of the German economy has built on a pattern of corporate restructuring which manufacturing firms and their core workforces have established over the last couple of decades. When unification hit the German political economy in the early 1990s, firms had already become under competitive pressure from Japan and East Asia as well as from an overvalued exchange rate in EMS. In the aftermath of the unification boom an extraordinary pay hike added to their problems. The subsequent recession in 1992/93 was the worst since WWII and half a million jobs in the manufacturing sector were shed. Within 15 years between 1994 and 2009, the German economy devalued its real unit labour costs vis-a-vis its European competitors by 20%. [26]

Throughout the 2000s, real unit labour costs rose slower than Germany's major competitors including the Eurozone as a whole (Graph 1). Cost cutting was achieved through a combination of plant level restructuring and policy change, which all helped to reduce costs and increase productivity without hurting the skill base and the flexibility of the manufacturing workforce.

Off-shoring particularly to Eastern Europe took off in the second half of the 1990s. Some observers suggested that this way of organising production by slicing up the value chain "has been more important for Germany's lower unit labour costs than German workers' wage restraint".[27] According to estimates, German off-shoring to Eastern Europe boosted not only the productivity of its subsidiaries in Eastern Europe by almost threefold compared to local firms, but it also increased the productivity of the parent companies in Germany by more than 20%. "In any case relocating production to Eastern Europe made globally competing German firms leaner and more efficient helping them to win market shares in a growingly competitive world market. The efficiency gains from reorganising production were particularly pronounced after 2004 leading to a sharp fall in Germany's relative unit labour costs from 2004 to 2008."[28] Marin also suggests that off-shoring to Eastern Europe has led also to lower wages for skilled workers in Germany. "German firms off-shored the skill intensive part of the value chain to exploit the low cost skilled labour available in Eastern Europe. As a result, the demand for this type of labour in Germany was lower, putting downward pressure on skilled wages in Germany. Hence, off-shoring improved Germany's competitiveness by increasing German firms' productivity and by lowering its skilled wages." This view is reinforced by Hans-Werner Sinn's assessment of the Bazaar economy, in which large parts of German manufacturing does not take in the country but is re-imported for assembly.[29]

[25] Marin 2010a.
[26] Marin 2010a.
[27] Marin 2010b.
[28] Marin 2010b.
[29] Sinn 2006.

In order to restructure manufacturing plants without facing trade union opposition, management and works councils used the tool of plant level concession bargaining often coined 'employment pacts', which had been introduced by Daimler Benz in the late 1980s. They settled agreements, which aimed at improving the competitiveness of plant and thereby led to more secure jobs. Both sides compromised: workers accepted pay cuts, longer working time and more flexible working patterns, while management guaranteed investments and promised not to resort to mass redundancies.[30]



Source: OECD

In comparison to concession bargaining in the US, these agreements were broader and less one-sided. They included measures to improve the infrastructure, training, costs and productivity as well as technology. The workforces of particular plants were rated in benchmarking comparisons and collaborated with local management to make the most profitable bid for investments. Promises by management were not legally binding but had a reputation effect for day to day relations with works councils.

One important component of concession bargaining was the distinction between core and peripheral workers through outsourcing processes. Collective agreements were adjusted accordingly in particular by transferring service components into other collective agreements and lower pay. Canteens, security and other service components were removed from manufacturing collective agreements and passed on to service sector trade unions and their collective agreements. Terms and conditions for workers in services components of manufacturing firms thereby worsened drastically as they were shifted from previous metal or chemical sector pay scales to service sector pay.

[30] Hassel and Rehder 1999; Seifert 2002; Rehder 2003; Massa-Wirth and Seifert 2004.

In addition, in the late 1990s, plant-level agreements which provide for terms and conditions which deviate from the industry-wide collective agreement were reached in a third of private sector companies. Another 15% of companies simply violate the agreements, according to a survey by the union-based research institute WSI.[31] After 2004, plant-level bargaining was officially recognized and regulated by an innovative collective agreement in the metal sector (Pforzheim Agreement). In 2006, one in ten firms in the metal sector negotiated an official derogation from the relevant agreement.[32]

The price that companies paid for plant-level agreements was, however, a move towards tighter dismissal protection for the existing workforce, rather than a more flexible regime of hiring and firing. Firms pledged in plant level agreements to refrain from any collective dismissal for a period of several years. The flexibility firms gained from concession bargaining was internal cooperation rather than external adjustments. Unions and employers adjusted collective agreements to allow for plant-level deals. They introduced 'opening clauses' that allow for local bargaining, if the business situation is bad. Pay grades became more differentiated and lower pay grades have been introduced. Even the trademark of German trade unionism, the 35-hour week, has been effectively shattered.

Many companies designed new work arrangements with their works councils at the plant level. It is virtually impossible for unions to monitor and police violations of collective agreements at the plant level. Hardly any employee was prepared to sue a company for breaking an agreement, and unions do not have the staffing capacity to enforce or negotiate agreements in small and medium sized companies. Rather, firms hoped that competitive pressure, stubborn high unemployment, and weaker trade unions would allow them to change the conduct of these agreements and give them internal flexibility in order to reduce labor costs as was needed for regaining competitiveness.

With regard to union cooperation, this strategy worked. While unions rarely blocked workplace deals aimed at providing job security and competitiveness, they usually did not talk about these deals in order to avoid other firms following suit. Protection for the core of the workforce and instability for fringe workers (the insider-outsider problem) were complementary to each other. Firms argued that the only way to protect core workers was to look for other options to lower labor costs – at the expense of other parts of the workforce. Flexibility was thereby achieved in an uneven – segmented - pattern.

Union weakness was expressed in rapidly falling union membership rates[33] and the failure to rally enough support for industrial action. While the manufacturing unions, particularly IG Metall was capable of forcing firms to accept union demands until the mid to late 1990s (Bavaria strike in 1995), the strike weapon was seriously impaired in the strike in Saxony in 2003, which the union lost badly.

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[31] Bispinck and Schulten 2003.
[32] Lehndorff 2010.
[33] Hassel 2008.

The strengthening of employment protection for permanent employees has been moreover reinforced by collective agreements in the manufacturing sector which over time have included clauses protecting long-term employees from dismissals. Repeated rounds of plant-level concession bargaining as outlined above led to higher levels of employment security at least for some groups of core workers.[34] For example, in September 2010 the electronics firm Siemens agreed a deal with its works council which gave unlimited employment guarantees for almost its entire workforce of more than 120.000 employees.[35]

4. Welfare restructuring

Alongside corporate restructuring, fundamental welfare restructuring has taken place during. The "Agenda 2010" reforms of 2003 especially produced a fundamental of German labour market and social policy.[36] Firstly, the 2003 reforms markedly reduced the central role of social insurance and status-oriented benefits. More than two thirds of all unemployed no longer receive benefits related to former earnings, but receive flat-rate benefits based upon a defined minimum subsistence level instead. Secondly, access to active labour market programs is no longer restricted to recipients of earnings-related benefits, but has rather been broadened to include virtually everybody. Furthermore, entitlements to the new benefits are no longer linked to family income, as has been the case with former social assistance. Thirdly, the amount of tax-financed benefits has been increased relative to contributory benefits. Consequently, contributions to the unemployment insurance fund were gradually lowered from 6.5 percent at the time of the reform to 2.8 percent today.[37] Fourthly, the central role of social partners in the administration of the unemployment insurance fund was rolled back decisively. For instance, social partners now lack the opportunity to influence the deployment of active labour market funds at the local level.[38]

This was complemented by policy changes in employment protection and labour market policies. Employment protection for permanent employees has remained strong, while employment protection for 'irregular' contracts (fixed-term, agency and marginal work) has diminished. Over the years, three main types of irregular employment spread in the labour market: fixed-term contracts, temping agencies, and low-level part-time employment. Firms tended to push for these alternatives as flexibility buffers for protecting permanent employment. The move towards opening an irregular employment segment started already during the 1980s, but was greatly intensified during the 1990s and 2000s.

[34] See also Zagelmeyer (2010).
[35] spiegelonline September 22nd, 2010.
[36] Seen on German welfare reforms Hassel and Schiller 2009 and Hassel 2010; for a detailed description of the Hartz reforms and its implication Hassel and Schiller 2010.
[37] Steffen 2008: 34.
[38] Bender, Bieber et al. 2006: 232

Limitations on irregular employment were lifted gradually during the 1990s and 2000s. Marginal employment has until 2003 been confined to workers working fewer than 15 hours per week and less than a low threshold of income as being exempted from social security contributions. Marginal employment status had been introduced during the 1960s when labour markets were tight and employers aimed to entice pensioners, housewives and students to take up few hours of employment without paying contributions. These groups of workers were covered by social insurance through their primary status (as pensioners, spouses or students). Over time, as contribution rates soared employers increasingly used marginal employment to avoid paying contributions for low paid jobs. Regulatory changes aimed to increase employers' tax on marginal employment in order to avoid abuse while retaining the concept of subsidizing marginal employment.[39]

Both, marginal employment and fixed-term contracts are overwhelmingly used by employers in services industries. Only about 10% of marginal employment is to be found in manufacturing, while more than 80% are service sector jobs.[40] Also the prevalence of fix-term contracts vary across sectors. While more than 20% of service sector jobs are fixed-term, the share in manufacturing is below 7%.[41] This reflects the demand for non-standard employment in different industries. While manufacturing industries also benefited from the change in policy, it was the service industries that depended on them. Particularly, part-time and marginal employment regulations were key policy instruments to cut costs in services.

The main facilitator for cost cutting was however the change in labour market policy in 2003. While initially driven by the need to curb public spending, activation policies turned out to become a major programme for subsidizing low skilled employment. Fiscal constraint were the origins of policy change. German unification saw unemployment benefits and spending on active labour market measures in the East explode. Contribution rates for unemployment insurance doubled and subsidies by the federal budget to the labour agency rocketed. Social expenditure as part of total government spending stood at 22 percent in 1990 and increased to 57 percent in 2000.[42]

When the dotcom boom collapsed in the early 2000s public finance problems accumulated on several frontiers. Unemployment rose again in both eastern and western Germany, long-term unemployment took up an increasingly higher share of the unemployed, the costs of reunification increased rapidly, the Stability and Growth Pact started to kick in, tax reforms

[39] With regard to further regulatory changes, the regulation of fixed term employment has been loosened drastically. Using OECD scale of 0 to 4, regulatory tightness of fixed term employment was relaxed from 3.5 in 1990 to 0.75 in 2008. Similarly agency work underwent massive deregulation from 4.0 to 1.75. At the same time permanent employment was stricter regulated from 2.58 to 3.0. See Venn (2009).

[40] Minijobzentrale 2010: Quartalsbericht III.

[41] Statistisches Bundesamt 2010.

[42] OECD 2009.

(the Eichel tax reform) reduced tax revenue particularly for local authorities..[43] All these developments put enormous pressure on the government to restructure social spending.

The welfare reforms Hartz IV cut the maximum duration of unemployment benefit and limited earnings related transfers to to the first year of unemployment (18 months for those over 55). The new benefit for long-term unemployed (exceeding 12 months of unemployment) was a means-tested flat rate payment and set at what was universally seen as a low level of social assistance (it can be topped up temporarily if a claimant previously received considerably higher unemployment benefit). The reform further introduced major in-work benefits for part-time and low paid employees. Since all transfer recipients are required to take any job that is offered to them to prove their willingness to work and since no statutory minimum wage has been set, wages can be set at extremely low levels and be topped up by transfer payments. About 28% of long-term unemployed benefit recipient are employed in work and receive benefits at the same time. In June 2010 this group amounted to 1.4 mio. employees.[44]

At the same time, the benefit system reform has not altered some of the most important obstacle towards a more employment friendly system – the high tax-wedge that burdens low skilled and low paid work. Germany remains the country within the OECD with the highest marginal tax rate for low paid employment. Social security contributions are set as a proportional rate and kick in above a comparatively low threshold. The reason for non-progressive social security rates lies primarily in the set up of the insurance-based welfare state which draws on employers and employee contributions equally. In turn, this is partly the reason for the high number of marginal jobs as described above. While marginal employment is exempted from contributions, full-time employment for low paid workers is taxed at a rate of 36%.[45] Combined with strong pressure on the unemployed to take up low paid employment and a new system of topping up income with partial benefits, the recent reforms have created strong incentives for low skilled workers to take up part-time employment for very low wages and simultaneously draw social security benefits.

As a result of policy change, from 2003 onwards, the trend to ever declining employment rates of men, particularly elderly male, has reversed. Both employment rates overall and the absolute number of people in employment has increased. A study commissioned by the Bertelsmann Foundation in 2010 summarizes: "Germany has reached a historical high point of employment in 2009 and exceeded other countries' employment rates. At the same time, levels of inactivity have declined. Progress was achieved with regard to the labour market participation of women and elderly workers. A particularly dynamic development can be

[43] Their revenue from income tax declined from 21.3 to 19.8 bn and from local business tax from 19.3bn to 15.2 bn Euro between 2000 and 2003. In 2003, 90% of all local authorities in the state of Northrhine-Westfalia were unable to cover their expenditures within their budgets. See Hassel and Schiller (2010: 181).

[44] Datensammlung Erwerbstätigkeit und Leistungsbezug nach dem SGB II, 2007 - 2010, Sozialpolitik aktuell, Universität Duisburg-Essen.

[45] Immervoll 2007.

observed in private services.“[46] . Indeed the employment rate increased by 4 percentage points between 2004 and 2008. Unemployment levels are below average (which is mainly due to short-term working and the effects of the financial crisis. The problem of the German labor market is not inactivity any more.

The structure of the German labour market has dramatically changed over the last two decades. The number of full-time jobs has decreased by 20%, while the number of part-time and marginal employment drastically increased. The rate of part-time employment doubled between 1991 and 2007, the number of marginal employment increased by 2.5 times.

But the economic upswing after 2005 showed a different trend. In particular from 2006 onwards unemployment decreased faster than ever in post-war German history from 4.8 mio. unemployed on average in 2005 to 3.2 mio in 2008. This was the lowest level since 1992. This is even more remarkable given the fact that the German definition of the unemployed is particularly wide. The underlying definition of being ‚able to work‘ includes all benefit seekers who are able to work more than three hours a day. These are more than 90% of all claimants of social assistance in 2005.

During the most recent economic upswing in 2006/2007 890.000 new jobs were created. In contrast to earlier periods the share of full-time jobs has increased again. Of these were 210.000 full-time and 590.000 part-time jobs. The share of ‘proper jobs’ compared to marginal employment are significantly higher than in previous economic upswings.[47] Also long-term unemployment decreased faster than in previous periods of economic recovery.[48] While 1999 1.7% of economic growth was need to create additional employment, this threshold has decreased to 1.3%.[49]

However, many full-time positions today are offered as temporary jobs or agency work. Between 2006 and 2007 agency work increased by 64%. Initial pay rates for agency work stand at 7 Euro and therefore below the rate the unions want to see as a minimum wage.[50]

Survey data show that the unemployed are increasingly willing to take jobs below their skill levels, for lower pay and for worse terms and conditions. Also those in employment are more willing to accept concessions in exchange with job security.[51]

The downside of the activation of the labour market is the rapid increase of low pay. Since the mid-1990s low pay has been rising continuously. Between 1998 and 2007 the share of low paid among all workers shot up from 14.2% to 21.5%.[52] In European comparison, Germany and the Netherlands were the only countries in which the share of low paid

[46] Eichhorst et al. 2009: 4.
[47] Koch u.a. 2009: 236.
[48] Gartner/Klinger 2008: 442.
[49] Gartner/Klinger 2008: 445.
[50] Vanselow 2009: 3.
[51] Kettner/Rebien 2009: 6- 7.
[52] Kalina/Weinkopf 2009: 3.

increased between 1995 und 2000. Only the UK (19.4%), Ireland (18.7%) and the Netherlands (16.6%) have had higher shares of low pay employment than Germany in 2000.[53] Since then the share of low paid has further increased and is only topped by the US in 2005.[54] Low pay is also not confined to the unskilled. The share of skilled workers who are low paid has risen from 58.5% in 1995 to 70.8% in 2007.[55] Also, low pay is gradually diffusing into the core of the labour market. While low pay used to be concentrated in atypical work, it is now to be found in full and part-time employment and standard jobs. The majority of low paid are however women, even though the share of men is rising.

In terms of quantity, marginal employment has been the most important form of irregular employment. In 2007, marginal employment accounted for 7 million employees, with the highest concentration in retail.[56]

Fixed term employment has increased significantly over the last two decades. In 2008 about 2.7 million of the 30.07 million employees were on a fixed term contract reaching a share of 5.7%.[57] This number excludes trainees and students. Also temping agency work increased rapidly. In 2009, 1.6% of all employees worked for temping agencies, an increase of 53% over 2 years.[58] In total, however, fixed term employment and workers working for temping agencies still account for less than 10% of the workforce.[59]

The increase of irregular and marginal employment has to be seen in the context of firms' attempts to increase or maintain job security for core workers. As in many southern and eastern European countries, governments, employers and unions jointly preferred the deregulation of the peripheral labour market over the deregulation/liberalization of employment protection for the core workforce. As a consequence, the dualism of insiders and outsiders on the labour market has deepened both numerically as well as regulatory.

Overall the experience is therefore mixed. More employment and more activity are combined with low pay and insecure employment. Studies have shown that low paid employment usually does not serve as a path into better paid work. In a survey of 30,000 low paid full-time workers in 1998/99 only 13% managed to find better work by 2005.[60]

Activating the long-term unemployed has therefore not solved the structural problems on the German labour market. Germany still has the highest unemployment rate among the unskilled in the western world. The labor market is increasingly segmented in a core and periphery. Underemployment has emerged. In particular women with children work very few hours compared to mothers in other countries. The Hartz-IV reforms have thereby

[53] Bosch/Kalina 2007: 27.
[54] Carlin/Soskice 2009: 77
[55] Kalina/Weinkopf 2009: 6.
[56] Minijobzentrale 2010.
[57] Statistisches Bundesamt 2009.
[58] Eichhorst 2010.
[59] Eichhorst and Marx 2009, 14.
[60] Koch et al. 2009: 249-250.

introduced a form of negative income tax (or in-work benefits) in which low paid employment is topped up by benefits. In absence of a minimum wage, these forms of combined income drive wages at the bottom end of the labor market further down.

5. The effects of dualization and the challenge of the service economy

So far, I have argued that firms reacted to economic shocks by fostering cooperation and off-shoring non-core parts of the production either abroad or by subcontracting to cheaper service suppliers. Government policy has liberalized employment legislation and social policy for non-core workers. Liberalization and intensified plant-level cooperation can thereby go hand in hand together, leading to a segmented and dualist political economy. In this section, I will argue that dualism between different segments of the economy is also complementary and mutually dependent. In other words, Germany's competitiveness in manufacturing sectors does not only depend on collaboration with works councils at the plant level but also on liberalization in the service economy. Moreover, the same institutional set up which protects exporting industries helps to liberalize the service sector.

One example of how dualization feeds directly into cost cutting of manufacturing firms is the development of wages in the service economy. In contrast to other European countries cost cutting in manufacturing in Germany was helped rather than counteracted by service sector pay setting. In many other countries of the Eurozone, pay restraint was achieved in the exposed sectors but not in the sheltered sectors. Therefore pay rises in services outstripped manufacturing sectors.

In Germany (and in Austria) cost cutting in manufacturing was accompanied by even fiercer cost cutting in services.[61] Over time, wages in services fell relatively to manufacturing wages, even though these sectors were sheltered sectors not under international competition. Graph 4 shows the development of service sector wages in relation to manufacturing wages. In all parts of the service sector, wages fell behind manufacturing wages. The graph illustrates how hourly pay in finance, insurance and real estate used to be higher than manufacturing pay up until the late 1980s. Since the late 1980s despite the persisting pay restraint in manufacturing, hourly wages in services grew even less than in manufacturing. Particularly in hotel and restaurant, wages today are less than half than in manufacturing industries while they stood at 80% during the 1970s.

The origins of this particularly severe wage restraint in the service sectors are not obvious. Johnston puts it down to the pattern bargaining of Germanys wage bargaining system: "A similar constraint on sheltered sector wage setters might also exist in countries where inter-industry coordination of wage bargaining remains strong. Austria and Germany provide notable examples: both have pattern bargaining systems where wage-setters in all sectors shadow the metalworking sector. The metalworking sector (IG Metall in Germany and GMT

[61] Johnston 2009.

in Austria), leads negotiations, setting wage increases equal to the increase in the national aggregate labour productivity rate. All other sectoral unions then shadow these increases, using them as a target, but rarely reaching them unless their sectoral productivity levels permit it."[62]

In addition to pattern bargaining which prevents service sectors to ever catch up with wage developments in manufacturing, liberalization policies themselves have contributed to wage decline in services. Atypical employment, such as temping work, part-time, precarious work are all concentrated in the service economy and heavily oversubscribed by women workers. High labour costs have driven retail and restaurant firms to staff predominantly with female part-time workers, who worked in small workplaces with no union representation. As a consequence of fierce competition in services, low unionization and outsider staffing, wages have stagnated or even fallen behind. Three more reasons can account for weak service sector pay: First, in the wake of reunification, collective agreements were hastily transferred to the Eastern states. In manufacturing, trade unions ensured that wage levels were at an appropriate level in comparison to the West. In many services sectors, where unionization was weak, unions settled for very low wages in order to come to an agreement since many employers were rather reluctant to enter collective bargaining. They thereby established a low wage floor for service sector pay. Second, the absence of a national minimum wage which prevents wages from falling to even ridiculously low level has contributed to a downward wage drift. And third a range of subsidies for low wages encouraged service sector workers to accept low wages in exchange for additional transfers. Activation policies in order to increase labour market participation came at the price of low wages concentrated in services.

As a consequence, manufacturing and low skilled service sector firms now work under different institutional regimes. Manufacturing is organized around a skilled high productivity core which is protected against economic insecurity. Low skilled services operate under conditions that are not far from labour markets in liberal market economies.[63]

The capacity of service sector unions, primarily Verdi, to protect and raise wages for instance by campaigning for a national minimum wage is thereby severely limited by the opposition of manufacturing unions against it. The same is true for limits on wage subsidies and the creation of social security exemptions for low skilled jobs. Both are accepted and even encouraged by manufacturing unions, whose members benefit from low cost services.

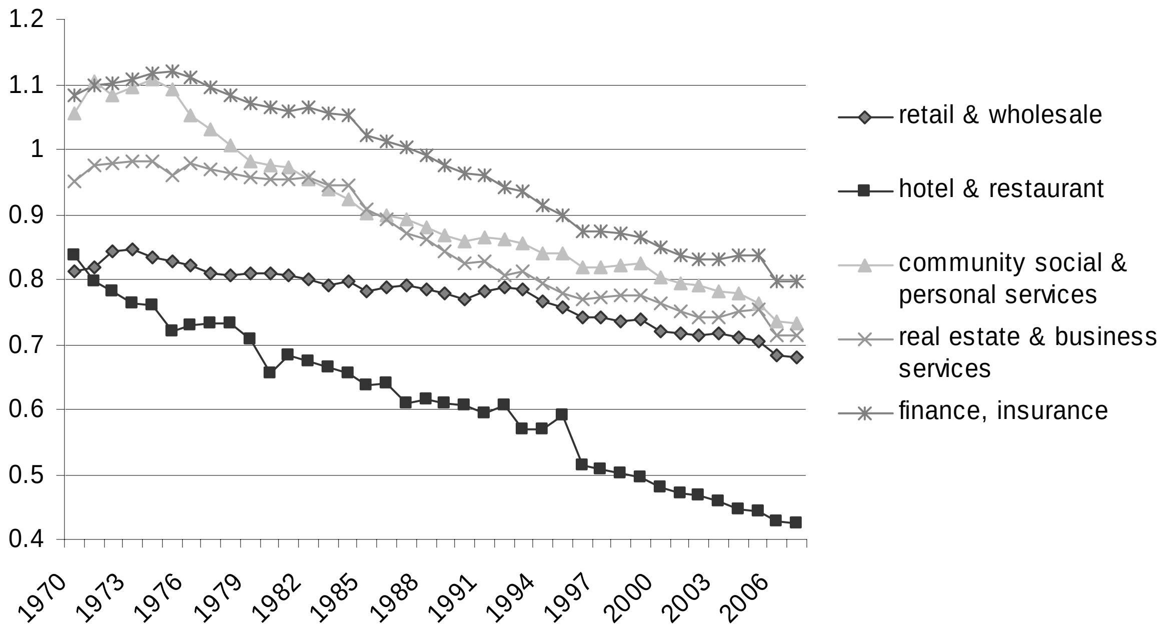
Finally, the wage restraint in manufacturing and wage decline in services are directly linked to weak domestic demand and explain therefore the export dependency of the German

[62] Johnston 2009, 26.

[63] This is reemphasized by the fact that employment protection is annulled for minimal offences against employers. A string of court decisions in unfair dismissal cases have held up the view that a shop worker with 30 years tenure can be sacked for taking food or minimal amounts of money from the till.

economy. The incremental but increasing institutional specialization into a two sector dual economy has led to a development trap of an export dependent equilibrium.

Graph 2 Hourly wage in services as share of manufacturing wages



Source: Klems database.

This in turn creates several problems for the domestic economy. One is the problem of training for young school leavers. Low pay in services reduced the incentives for school leavers to enter three year apprenticeships in the service sector, if the pay for trained workers is hardly above the pay for the unskilled. It also undermines coordination in services as workers do not trust employment security or skill based employment in services. As the economy deindustrializes, either this schism will be reinforced into a dual economy or it will turn into a major source of conflict as service industries have different needs for skills and for their pay structure. Combined with different types of demand for social security and redistribution by service sector employees (particularly part-time women) with higher turnover, this might turn into the biggest challenge.

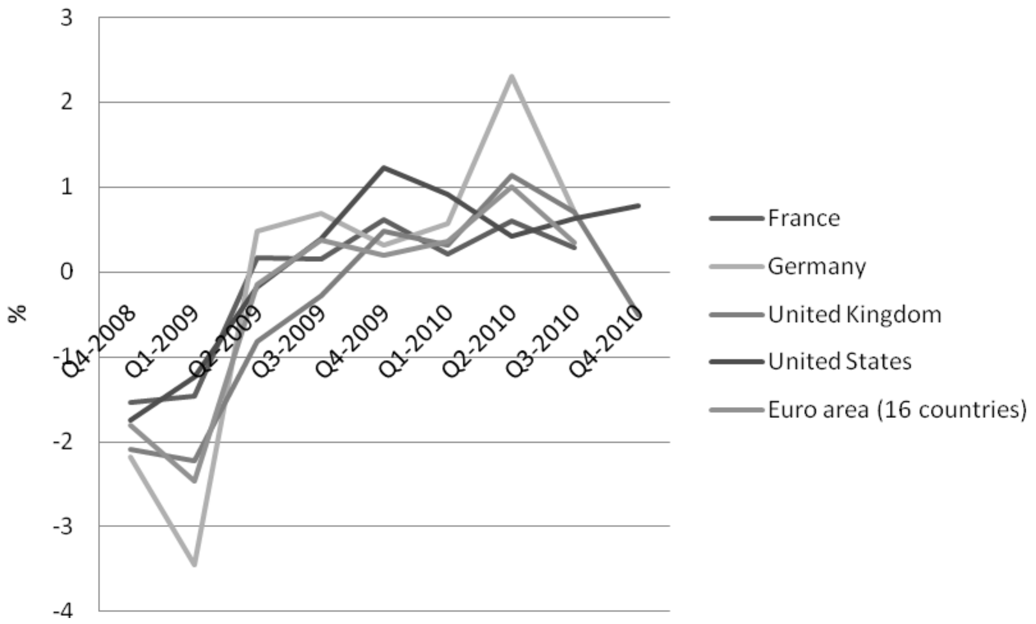
6. Germany's recovery in the financial crisis and its position in the Eurozone

Finally, when taken the trends of the last two decades together it becomes clear how the German economy owes its recovery to the process of fostered coordination in a context of service sector liberalization as outlined in the preceding sections. The German economy was hit by the financial crisis comparatively late. Until fall 2008 the outlook for the German economy was relatively optimistic. The Council of Economic Advisors forecasted 1.8%

growth for 2008 and stagnation.[64] This supported the government's view that the crisis would be confined to the US and other financial centers. However, from the last quarter 2008 the German economy started to shrink. In early 2009, exports and manufacturing collapsed. In the second quarter of 2009 the German economy had shrunk by more than 6% compared to the second quarter of 2008 which was a worse performance than the countries which had "caused" the crisis.[65]

Since then, the German economy has been through an extraordinary development over the last two years. Among OECD countries, it had the steepest decline followed by the fastest recovery (Graph 3). Given the extreme dependency on exports of manufactured goods, the effects have been most dramatically in the manufacturing sector.

Graph 3: Quarterly Growth of Real GDP



Source: OECD.

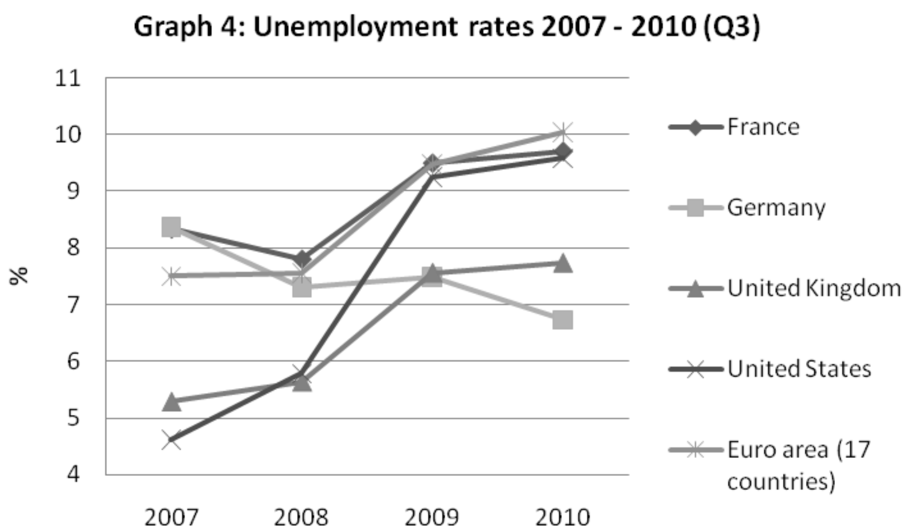
The recovery has been helped by the contribution of the automatic stabilizers of the German welfare system and the two stimulus packages, the first on November 5 2008 amounting to 11.8 bn Euro followed by the second on January 27 2009 of about 50 bn. Euro. In total, the German contribution to global demand stood slightly above the average of the OECD.[66] Of these, the German cash for clunkers programme (amounting to 5bn Euros) subsidized car

[64] SVR 2008.
[65] Bodegan et al 2010.
[66] Hassel and Lütz 2010.

manufacturers worldwide. In particular the cash for clunkers programme protected core skilled workers in export oriented industries.

At the same time, the labour market was relatively protected from the fall-out of the slump. The elasticity of employment relative to GDP was the lowest among the EU (EU 2009) meaning the loss of GDP did not translate into job losses. As a result, Germany was the only major country which emerged from the crisis with lower unemployment levels than before the crisis (Graph 4).

As the OECD points out, the single most important explanation for the gap between the business slump and employment outcomes is the reduction of working hours.[67] Manufacturing firms hoarded their permanent staff, using various measures: they cut back on overtime, used deposits on working-time accounts, reduced working-time and used the public short-time provisions, which were extended as part of the stimulus package. In total these measures were used by about a fifth of all firms. According to a plant-level survey by the trade union research institute WSI, 30% of all firms used working time accounts in order to avoid dismissals. This was by far the most important adjustment mechanism. Other mechanisms were job rotation (14%), extra holidays (13%) and pay cuts (11%).[68]



Source: OECD; note: 2010 refers to Q3.

Labour hoarding enabled German firms to rebuild capacity quickly, when demand on world markets picked up. Unlike in liberal market economies, where downswings are immediately translated into redundancy, labour hoarding stabilized demand and protected the skills of the workers concerned. This was also reflected in the change of unit labour costs. While hoarding labour first pushed up unit labour costs in 2009, it bounced back in 2010. Labour

[67] OECD 2010, Lehndorff 2010.
[68] Bodegan et al. 2009.

hoarding and the use of working time accounts was only possible due to the plant-level agreements German firms had negotiated with their core workforce since the late 1980s.

In the midst of the financial crisis, news from the German economy reported a remarkable recovery of the competitive position of German firms, higher than average growth and the highest employment levels ever. We can therefore see that the two components which contribute to this remarkable development are: first, German firms used flexible adjustment tools which they had developed over the last two decades since the post-unification crisis. Second, public policy, particularly the specific measure of short term working, has contributed to stabilizing employment in the crisis.

However, what has been understated so far in the analysis of the recovery of the crisis is the extent to which wage subsidies for the low skilled, the lack of a minimum wage and wage decline in the service sector has worked as a cost containing environment which allowed export-oriented firms to contain their wages and unit labour costs. The increasingly dualist nature of the German economy has created an export-oriented high skill industry which depends on a domestic environment of low cost services to control labour costs. This model, which is questionable in its social and economic long-run effects, is specific to the interactions of wage bargaining institutions, social and employment policies and training institutions.

Current proposals of the German government for the conditions of bail-out provisions in the Eurozone include a convergence of unit labour costs of Eurozone members.[69] As has been shown above, the factors that determine unit labour costs in Germany are however not remotely exportable or even recommendable to other countries of the Eurozone.

7. Conclusion

Maintaining and regaining competitiveness for manufacturing firms has been a driving force in the restructuring of the German political economy. Firms have responded to economic shocks by restructuring while public policy has complemented manufacturing competitiveness with social policy liberalization which helped to contain costs in the service economy. Both have contributed to deepening dualism.

Dualism entails continued coordination and liberalization. Both are not opposites but complementarities in the transformation of the German political economy. The combination of the two is moreover the most important underlying factor for Germany's recent recovery in the recession following the financial crisis. The competitiveness of German firms not only hinges on wage restraint and plant-level cost cutting exercises in the manufacturing sectors but also on cost cutting on services supplies that facilitate wage restraint.

[69] Financial Times: Debate over competitiveness; February 3 2011.

The drive towards regaining competitiveness has been beneficial for industry and expensive for the taxpayer. Social spending has not declined after liberalizing labour market policies were introduced. This is mainly due to high and increasing levels of subsidies for the low paid. Dualism also had detrimental effects for the development of productivity and quality improvements in vital services such as education and personal care.

Because of the specific nature of institutional and policy foundations of the process, the emerging dualism of the German economy is a business model which cannot be exported to other countries in the Eurozone. Further developments of European economic governance must pay closer attention to the specifics of national political economies rather than suggest one-size-fits-all solutions for balancing regional imbalances.

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