No Way to Escape Imbalances in the Eurozone? Three Sources for Germany's Export Dependency: Industrial Relations, Social Insurance and Fiscal Federalism

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Over the last two decades, the German political economy has increasingly relied on export specialisation as a strategy for economic recovery. This export-led development strategy turned out to be a mixed blessing. While on the one hand, specialisation in high-quality manufactured goods has preserved Germany's competitive edge, vis-à-vis many other industrialised countries, it has, on the other hand, led to an increasing dependency on exports as the engine for growth. There has been no equally strong evolution of a domestic service economy beyond manufacturing-related services. The issue of export dependency becomes increasingly important in light of the financial crisis and global imbalances, vis-à-vis Greece and the Eurozone but also globally. Weak aggregate demand depresses both domestic employment and endangers the still fragile construction of the Eurozone.

The paper argues that Germany finds itself in an export-dependency trap due to imbalances between domestic services and export-driven manufacturing. It analyses three sources for the over-reliance on export-oriented manufacturing and weak employment in domestic services: firstly, the industrial relations system, secondly, the social insurance financing of the welfare state and thirdly, fiscal federalism. All three are fundamental pillars of the German political economy and locked into political coalitions that are not easily changed.

INTRODUCTION

On March 14th 2010, French finance minister, Christine Lagarde, openly criticised Germany's large trade surplus in an interview with the Financial Times. Lagarde said: 'Those with surpluses could do a little something…When you look at unit labour costs to Germany, they have done a tremendous job in that respect. I'm not sure it is a sustainable model in the long term and for the whole group. Clearly we need better convergence…It takes two to tango.'[1]

The implication was that other countries would be financially and economically in better shape if Germany did not focus its economic development entirely on exports, but were to boost domestic demand to help deficit countries to regain competitiveness. More recently, at the end of May 2013, the European Council published its country-specific recommendations, urging Germany to increase wages and lower high taxation for low-paid employment.[2]

During the post-war period, from 1957, Germany's current account balance had two dips into deficit: during the second oil crisis, 1979-1982, and after the double shock of German reunification and the EMS in 1990. During the 1970s, the current account balance surplus was about 1 per cent of GDP, which went up to 3-4 per cent during the 1980s. Between 1991 and 2001, the current account had a deficit of about 1 per cent of GDP. The reasons for the deterioration of the current account during the 1990s were connected to high government deficits due to reunification and catch-up consumption, which reduced savings. Labour productivity in Eastern Germany was also far below Western standards and the Deutsche Mark was overvalued. When the world economy slowed down in the early 1990s, the demand for German exports declined, while imports remained up. The balance, therefore, turned negative for a whole decade. It was only after 2002 that the current account surplus shot up: from

2005 till 2011 the surplus was between 5 and 7 per cent. Balance of trade makes up about 90% of the current account balance. Trade, particularly exports, therefore, play a key role.

GRAPH 1 HERE

Source: OECD statistics.

Germany is not the only country with an increasing current account surplus. Within the EU Luxembourg, the Netherlands, Norway, Slovenia, Sweden and Switzerland have seen similar surpluses and Austria, Slovakia, Ireland and Hungary had a surplus of 2 per cent in 2012. While some countries have obvious market niches, such as banking industries (Luxembourg and Switzerland) or oil (Norway), others have manufacturing exports creating a surplus. In particular Austria, the Netherlands, Sweden and Slovakia have similar export driven economies. These are, however, small open economies[3]. Germany is the only big OECD country that behaves that way. Other big industrialised countries have long experienced both processes of deindustrialisation and current account deficits. Moreover, Germany has had particularly low growth in domestic demand during the period in the run-up to the financial crisis (graph 1). In combination, the German political economy has become an extreme version of an export-led economy.

Paradoxically, European monetary union has accelerated the trend. The conservative Bundesbank, which served the function of disciplining wage setters in the German industrial relations system,[4] lost its role precisely at the moment the German economy experienced a long period of radical wage restraint and stagnating unit labour costs. With the introduction of monetary union in 1999, monetary policy did not respond to German wage setting anymore and was out of sync with the economic developments in most regions within the Eurozone.[5] Why was wage setting restrained so determinedly during the 2000s, when it was clear that the European Central Bank (ECB) would not respond to any higher wage settlements by unions? What are the reasons for the German political economy's strong focus on exports and the simultaneous neglect or even downplaying of the domestic service economy?

The arguments presented in this paper build on the standard understanding of wage bargaining institutions in the broad political economy literature on neo-corporatism and social pacts, by emphasising the role of competitive bargaining (micro-corporatism). In addition it argues that the financing mechanisms of the welfare state help reproduce the institutional foundations of the German political economy and thereby systematically reinforce the imbalance. The strong lines of defense in the German export strategy not only reflect the comparative advantage of the German economy, but also the underlying structural and institutional complementarities that do not easily allow for a stronger focus on domestic demand. This paper offers a theoretical explanation for the exceptional position of the German political economy. While focusing on an extreme case, it aims to broaden our analysis of combining private sector organised interests (industrial relations) and welfare finance (fiscal federalism) in order to understand the trajectory of adjustment of advanced political economies.

The paper focuses particularly on the economic development since the early 1990s up until the financial crisis in 2007/2008. The fall of the Berlin Wall and the introduction of the Euro have put the German economy under hefty pressure, which has prompted a strong reaction by the business and policy community. The argument, therefore, concentrates on these responses in a particular economic environment. While institutions are long-term and stable, their effects vary with the economic and political environment. After the financial crisis, the situation changed again as the affected countries used fiscal stimulus to stabilise their economies. Because of the changes in the global economy and the responses by governments, the situation has shifted towards stronger domestic demand. Nevertheless, the analysis in this paper suggests that the comparatively stronger export focus and weaker demand will remain a feature of the German economy due to a specific constellation of institutional factors.

THE ARGUMENT: THE POLITICAL FOUNDATION OF AN EXPORT-LED ECONOMY

Recent advances in the comparative political economy literature have addressed how national institutions foster economic specialisation and contribute to global imbalances of trading deficits and surpluses. Coordinated market economies (CMEs), such as Germany, are based on long-term job tenure and close relationships in industry. They invest in specific skills, which are insured by some welfare state policies such as unemployment insurance or pensions. They specialise in manufacturing industries that produce for world markets and tend to have trade surpluses. They benefit from prudent monetary and fiscal policy and put strong emphasis on wage control, in order not to endanger their competitive position.[6] Liberal Market Economies (LMEs), on the other hand, are more likely to have current account deficits but higher levels of domestic demand (see also graph 1).

Contributions in the literature have focused largely on the role of wage bargaining institutions for explaining this phenomenon. The discussion of the Eurozone crisis has analysed that long-term wage restraint contributed to the imbalances within the Eurozone and that the capacity for wage restraint varies with the wage bargaining institutions of the Eurozone Member States.[7]

Baccaro and Pontusson have expanded the argument by emphasising the shift of advanced economies from being wage-led during the Fordist era to increasingly profit-led in the global economy. Export-oriented CMEs are particularly likely to adopt a profit-led economic growth model. However, a comparison between Sweden and Germany reveals that Sweden has remained much more demand-driven during the last two decades. Baccaro and Pontusson argue that the key explanation of the two cases lies in the different characters of their export industries. Because Swedish exports are high-quality service exports, they are less price sensitive in comparison to German manufacturing exports. In other words, Germany had to repress labour costs and, by implication, domestic demand comparatively more in order to remain competitive in world markets.[8]

This paper builds on these insights but expands them beyond the industrial relations features as the main (and only) explanation for the focus on export-led growth. It argues against the functionalist claim by Baccaro and Pontusson (that costs had to be repressed because of Germany's competitive position) but adds two institutional arguments: firstly, that in the industrial relations arena, German wage bargainers are much more segmented. A highly-coordinated manufacturing sector operates alongside large segments of liberalised services. The restructuring of the export-oriented manufacturing sector has aimed to keep the high level of quality intact, while substantially lowering labour costs. This has been supported and facilitated by a number of policy changes in the labour market and social policies.[9]

Secondly, policy changes are also shaped by the capacity of the state: fiscal federalism and the decentralised structure of the German state have further fuelled policy adjustments that repress the domestic service economy and support export manufacturing. The strong dependency of the federal government on social security contributions (as opposed to tax revenues) has ring-fenced the conservative nature of the Bismarckian welfare state's financing structure, hindering the evolution of a high-quality service economy. It is the latter aspect of state capacity that is new in the comparative political economy and welfare state research literature.

The basic premise is that political economies are shaped by two distinct but interacting arenas: the corporate and the political, which are governed by different rules and actors. In the corporate arena, the changing competitive pressure of large firms in the dominant economic sector is in the centre of the analysis, and the restructuring of big firms is the driver for change. When adjusting to economic shocks or political upheavals (the fall of the Berlin Wall), firms use the tools of their institutional setting to protect their competitive position. They will use the scope of internal restructuring to improve their position.

The factors influencing state capacity have largely been neglected in political economy research. While Iversen and Soskice point out the role of electoral rules for the prospects of centre-right and centre-left governments and their capacity for redistribution,[10] and Martin and Thelen introduce the size of the public sector as a mechanism for coordination,[11] the role of the welfare-finance nexus for policy-making as such has not been systematically included in the analysis.

Some authors have argued that policy responses in Germany have primarily been driven by fiscal exhaustion.[12] Increasing claims and social spending, when dealing with the impact of the oil crisis, during the 1970s, and reunification, have overstretched the fiscal capacities of the state. The response to the financial crisis has now led to the establishment of an institutionalised long-term austerity regime.[13]

My main claim is that CMEs with federalist structures and insurance-based welfare states in the context of an export-led economy are more prone to repress wages and thereby dampen domestic demand because a) high insurance contributions put even more downward pressure on labour costs and b) fiscal decentralisation backs up political coalitions supporting insurance-based welfare. Compensation-focused policies, in turn, give an additional boost to manufacturing industries, at the expense of a high-quality service economy.

The theoretical argument points to a configuration of particular institutional features: a particular kind of coordination (in the form of industry level industrial relations) coincides with an insurance-based welfare state and a decentralised state. I argue that these three institutional features form the strong foundation of the German political economy. All three of them contribute to the specialisation of the German economy in export-oriented manufacturing and depress the evolution of a high-quality service economy.

INDUSTRIAL RELATIONS

This section will summarize a standard account of the German wage bargaining system and add the specific process with which German wage bargainers have kept wage increases below the Eurozone average. Standard accounts of the role of wage setting institutions in CMEs, such as Germany, assume an interaction between large wage setting actors and the monetary policy by the central bank. As central banks signal that they are prepared to punish any inflationary wage settlements, wage setters who fear high interest rates restrain themselves when setting wages and avoid punishment by settling on moderate wage increases.

The adjustment process that occurred in Germany during the 1990s and 2000s only partially fits the standard interpretation: the reunification boom of 1991/92 was accompanied by an exceptionally large wage hike, followed by a response by the Bundesbank and a steep recession. Subsequently, however, a period of profound corporate restructuring took place, during which firms, with the cooperation of plant-level union representatives, cut labour costs substantially. Restructuring was based on plant-level concession bargaining, in which labour conceded pay cuts, holiday cuts and more flexibility, in exchange for commitments by management to ensure long-term job security.[14]

Moreover, firms strategically distinguished between core and peripheral workers and aimed at cutting the costs for peripheral workers, while assuring the cooperation of their core workforce. Service components were outsourced, such as canteens, security and maintenance, and were transferred to other collective agreements, which provided lower pay for these workers.[15] Plant-level agreements were negotiated to increase flexibility and cut costs. Regional collective agreements responded to these developments and included new provisions to take plant-level bargaining into account.[16] Collective agreements in manufacturing strengthened employment protection from dismissal for core employees and, in turn, reinforced the emphasis of plant-level negotiations on job security.[17]

The role of unions and works councils in this process is highly disputed. While union representatives see the increasing dualisation in German firms as mainly politically-driven and induced by management blackmail to relocate if they do not cooperate with a more dual labour force, it is clear that most plant-level deals have been negotiated without much public discussion. In any case, protection for the core workforce and instability for fringe workers has emerged simultaneously and been seen by management as a mechanism to protect core workers, while lowering overall labour costs.[18] Declining union membership and the lost strike of the metal sector union, IG Metall, in Saxony in 2003, put the union leadership under increasing pressure.[19]

It is not disputed that policy changes since the mid-1980s have facilitated the process: this includes the liberalisation of fixed-term employment, the introduction of temping agencies and the exemption of small jobs from social security contributions. These incremental policy reforms, towards more exceptions from the standard full-time, unlimited employment relationship, allowed management in all sectors to integrate non-standard jobs in all areas of the production process.

Moderate wage increases and fierce cost cutting in manufacturing were also helped by the fact that wages and costs in the service economy were held down even more. Compared to other countries in the Eurozone, growth of labour costs in the service sector fell short of cost developments in manufacturing. 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 those in the manufacturing sectors.[20] In Germany, it was the opposite, as can been seen in graph 2.

GRAPH 2 HERE

Source: based on Klems database.

Hourly pay in finance, insurance and real estate was higher than manufacturing pay, right up until the late 1980s. Since then, hourly wages in services have relatively declined, compared to manufacturing wages. This is despite the persistent pay restraint in manufacturing industries. In the hotel and restaurant sectors, wages today are less than half of those in manufacturing industries, compared to 80 per cent during the 1970s.[21] Only in Germany and Austria did cost cutting in the service sectors go even further than in manufacturing.[22] Therefore, service sector wages fell relatively to manufacturing wages, even though these sectors were sheltered and not under international competition.

Union weakness in the service sector and the structure of pattern bargaining in Germany are factors that can explain the relative wage disparity between manufacturing and service sector wages.[23] Indeed, wage settlements in manufacturing are frequently seen by wage bargainers in other sectors as the upper limit of negotiations, rather than an orientation point. Other factors are the high share of atypical employment, female employment and low-skilled employment in many areas of the service economy.[24] The lack of a national minimum wage also put more pressure on service sector pay than on manufacturing pay. Finally, social policy provisions that offer additional top-up benefits for low-paid, part-time employees have generated large numbers of employees on very low pay who receive additional benefits. According to a recent government statement, about 20 per cent of employees in the retail sector earn less than €8.50 per hour and almost 5 per cent receive additional social benefits.[25]

Low wages in the service economy thereby serve as a facilitator for wage restraint in manufacturing, as they contribute to price stability for services. In contrast to the expectation of a cost explosion in the service economy, due to low productivity increases, service-sector prices in many areas have not outstripped manufacturing prices. The standard of living for employees in the manufacturing sector has, therefore, been protected, while it has declined for those in services. Moreover, job security and training have been concentrated in manufacturing. Low-skilled service sector employees work under conditions that are now more similar to those in LMEs. The wage restraint in manufacturing and wage decline in services feed into each other and together make up a system of weak domestic demand and export dependency.

SOCIAL INSURANCE

In the service economy, employment creation has increasingly depended on the low-wage service sector. As Iversen and Wren [26] and Scharpf [27] have pointed out, the conservative welfare state, with relatively egalitarian wages and a small public sector, has faced difficulties in creating these jobs. While in liberal countries, wage inequality has allowed for a demand for low-paid services, and Nordic countries have employed many service sector jobs in the public sector, job growth in the central European countries has been restricted. However, recent experiences have shown that particularly Bismarckian welfare states have managed to overcome the trap of the service economy. It is my argument here that the German path towards employment in the service sector has pushed down wages (and domestic demand) even further because of the insurance-based nature of the welfare state, as will be explained below. This remains the case even though the German welfare state has shifted in its benefit structure more towards a more liberal, universal model.

The role of social insurance has long been a key component of the German political economy and welfare state. The role of insurance mechanisms for protecting specific skills has been analysed as providing an individual level of reassurance when investing in them.[28] There is, however, a flip-side to social insurance with regard to its underlying financing mechanism. As in the case of labour market dualisation, which could be accommodated in the manufacturing sector but greatly exposes the service economy to liberalisation, social insurance financing creates negative effects for domestic demand and for the service economy.

Politically, social insurance was part of the political exchange that underpinned German corporatism, as it traded real wage increases for social expenditure.[29] Rising contribution rates meant that German workers paid for the expansion of the welfare state by foregoing wage increases.

Over three decades, employees paid on average 0.5 per cent per annum of their gross wage as a foregone wage increase. Between 1970 and 2000, contributions to social security schemes increased by 15 percentage points (0.5 percentage points per year). At the same time, real wage increases in Germany were about the EU average (membership of 2000), and real unit labour costs tended to increase more slowly than the EU average. With regard to *real* wage developments and social expenditure levels, Germany stood roughly in the middle of the EU countries (2.2 per cent p.a., 1970-2000).

The expansion of social expenditure started in the 1960s. Social expenditure, as a share of the Gross National Product, increased from 21 per cent in 1960 to 24.5 per cent in 1970 and almost 30 per cent in 1980 (graph 3). The government cooperated as long as the increases in spending were financed not through taxes but through contributions. Indeed, while social expenditure soared in the 1970s and 1980s, the share of government financed through general taxation, actually decreased.[30] In other words, the increase in social expenditure was not at the general taxpayers' expense, but was increasingly rolled-over to payroll taxes. However, this model was criticised from all sides from the mid to late 1990s onwards, as employment rates had substantially declined. The government realised that high and increasing contributions to social security were detrimental to employment and particularly crowded out jobs at the lower end of the labour market. Business was getting increasingly uneasy about rising labour costs.[31]

GRAPH 3 HERE

Source: Hassel[32] based on Streeck and Trampusch[33] for Contribution Rates, bda-online Entwicklung der Sozialleistungsquote.

Payroll taxes as such are not the problem. In an EU comparison, German payroll tax levels are below average. Based on Eurostat's statistics on labour costs, the German statistical office estimates payroll taxes at 33 per cent, which is below the EU average of 36 per cent.[34] This picture changes, however, when one looks at the effective tax-rate of labour income, which includes taxation and payroll taxes. Here, the rate stood at 39 per cent on average in 2007, which was above the EU average of

34.4 per cent.[35] In addition, the focus of taxation is skewed towards the lower end of the pay scale. According to the OECD, Germany is the country with the highest effective tax rate for low-paid workers. In 2005, an average income was taxed at 42.5 per cent (income tax and payroll tax) which was higher than the effective tax rate of Denmark.[36] Low income, with less than 67 per cent of average pay, was taxed at 36.4 per cent. This compares to 26.2 per cent on average in the OECD for average pay and 21.9 per cent for low pay. Again, employers' contributions are similarly attributed at 20.7 per cent, only just above the average of the OECD.[37] In other words: a German worker with a low wage has to earn 15 per cent more than a low-paid worker in another OECD country to have the same net pay.

Moreover, with the exception of marginal employment, the full level payroll tax kicks in from the very first Euro earned and the rates are not progressive for all jobs that are not in the category of marginal employment. On the contrary, they are linear until they reach a limit and are, therefore, regressive by nature. 'As a result many of the low-paid jobs in particularly price-elastic areas are squeezed out of the private sector due to the more than 40 per cent of social security charges'.[38]

TABLE 1 HERE

Source: OECD Statistics.

The welfare reforms of 2003 did not solve this problem, but rather shifted it to the benefit system. Since add-on benefits were introduced for workers on low pay even workers in the low-paid service economy, who, in principle, could have a living wage, are pushed into either part-time jobs, which are exempt from social security charges (mini-jobs) or can draw additional benefits. The lack of a minimum wage has played an important role in this dynamic. Until 2015, Germany was the only country in the EU that had neither a statutory minimum wage nor a high coverage (above 90 per cent) of collective agreements. A minimum wage would have stopped employers from exploiting add-on benefits in order to push wages down further. Without a minimum wage, there was a strong incentive for workers in low-paid jobs to agree to a low wage, as benefits would make up the difference anyway. This has had a further dampening effect on the wage structure as a whole. As a consequence, the share of *working poor* in Germany (full-time employees with less than 66 per cent of average pay) is now the highest in the EU.

High effective tax rates for low-paid employment were already problematic during the 1980s. At the time, rather than introducing a progressive tax structure, the government responded by introducing exemptions from payroll taxes for very small and low-paid jobs (marginal employment). Introducing exemptions, however, has paved a path for employers and employees alike to take advantage of low-cost employment. Employers had a pool of very flexible workers at low costs, while employees, who had social insurance through their spouses or other occupations, could avoid paying social security contributions. This path, thereby, solved the cost problem of labour-intensive service jobs, but simultaneously initiated a trend towards labour market segmentation, which by now includes more than 7 million workers in marginal employment (less than 450€ monthly pay). As the phenomenon spreads and creates low-cost employment opportunities for firms, competition forces them to take advantage of them. As mentioned earlier, employment in the retail sector now relies heavily on non-insured marginal work. All attempts to stop the leakage of non-insured work have not been successful so far.[39] Rather the opposite has taken place: while the overwhelmingly regressive and overly heavy tax burden on the low-paid has remained, the threshold of wages to be exempt from taxes and social security contributions under the category of marginal jobs has been steadily increased.

FISCAL FEDERALISM

So far the political and institutional dynamics, explaining the institutional change of the German political economy, have been largely framed as developments based on the coalition politics of management and labour and on insider-outsider cleavages[40] or as neoliberal politics.[41] In this last section on fiscal federalism, I will bring in an institutional element that has additionally framed the path towards an increasing *schism* between the export economy and the domestic service industries. The argument has two components and is only indirectly related to the standard literature on fiscal federalism. It refers to the tight linkage between social insurance, the welfare-finance nexus and the political capture of the federal budget by lower level regional entities through fiscal federalism.

Table 1 shows the position of Germany in a comparative perspective on the extent of fiscal decentralisation and the importance of social insurance for the federal budget. Fiscal decentralisation is mirrored by large shares of social security contributions in government revenues. This feature is shared by Belgium and France. This does not imply that France or Belgium should be equally locked in an export-dominated economy. Rather the reverse: the dampening effects on domestic demand only play out in the context of an export-led manufacturing sector. In Germany, wage bargainers in the exporting industries control wage setting, and service sector unions are too weak to push for higher wages. In Belgium and France, strong public sector unions were able to compete with manufacturing sector wages. In combination, the effect of fiscal federalism amplifies wage restraint in the German case. The implication is that export manufacturing plus fiscal decentralisation poses an additional hurdle for the transition to a more balanced economy.

TABLE 2 HERE

Source: Eurostat and OECD Statistics.

The specific interaction of the welfare state and fiscal federalism in Germany does not establish clearly-separated spheres of fiscal responsibility, legislative competency and political accountability between different layers of government, but meshes them between regional and national units.[42] Rather than leading to a competition of jurisdictions, as in other forms of interstate federalism, Germany's intra-state federalism provides incentives for shifting costs and responsibilities between the different levels of government and between the different budgets of the central state, the regional states (*Länder)* and the welfare state. This results in a common pool-resource dilemma and provides incentives to claim political credit for new spending programmes, while at the same time avoiding the blame for corresponding increases in taxation or public debt.[43] Furthermore, increasing social insurance contributions offered relief in a situation of severe fiscal stress, as was the case with German reunification.[44]

This construction has several consequences: firstly, in contrast to many other federalist countries, federalism in Germany was not a powerful impediment to social spending, but instead its catalyst.[45] Secondly, the presence of various separate independent social insurance budgets provides incentives, not only for easing the burden of the central state budget, but also providing opportunities for balancing budgets among the social insurance schemes, by shifting costs from one social insurance budget to the other by means of contribution level adjustments or insurance conditions.[46] The easy access to social security budgets and the low level of political conflict around the adjustment of social insurance contribution rates has led in the past to the comparatively high payroll taxes and the high rate of taxation for the low-paid (see previous section).

Payroll taxes are politically (and legally) framed by the equivalent principle which links contributions to benefits. As contributions are a share of gross wages, benefit levels are similarly related to individual pay. This mechanism still stands despite the fact that in reality social benefits decreasingly reflect contribution rates. Messing with the tax rates, in order to make them less regressive, would violate the equivalence principle and, therefore, run into legal and constitutional problems as well as political ones. In the past, the normative foundation of social insurance based on contributions has been highly appreciated by policymakers and the electorate alike, which has prevented any changes to the contribution structure.

The other effect of German fiscal federalism is the weakness of the federal government in tax policy. Almost all tax policies affect the German Länder and are, therefore, subject to the co-decision procedures in the Upper House (Bundesrat). Social security budgets, on the other hand, are under the sole control of the federal government.

The federalist decision-making rules only allow limited autonomy for the federal government.[47] Tax cuts are built on the precondition that social security contributions remain stable. A lowering of social security contributions at the lower end of the labour market is, therefore, politically a very difficult policy choice. The federal government of any party, therefore, tends to hold on to the existing contribution rates in order to preserve its financial autonomy vis-à-vis the federal states, even though this is highly damaging for the labour market (and for domestic demand and, thereby, growth in general).

The second part of the argument affects the role of financing for social and other public services. Public-service delivery is almost exclusively located at the level of local government; private-service provision is usually carried out by large non-profit organizations. The structure of fiscal federalism in Germany dries out large-scale, local social services, as local authorities are particularly weak financially. Moreover, throughout the key periods of the 1990s and 2000s, when the German political economy increasingly specialised in export manufacturing, the financial resources of local governments became increasingly depleted.

The fiscal relationship between the federal government, regional states and local authorities is complex. There are no direct fiscal relations between the federal government and the local level, but only between the federal and regional level and the regional and local level.[48] Nevertheless, local finances are highly dependent on federal policy-making, as local authorities have to implement federal laws on social assistance, childcare or other social spending programmes. Local authority finances today have the effects of pro-cyclical amplifiers, as high unemployment increases their spending on social assistance, while tax revenue and local investment decline.[49] Cuts in unemployment benefits (which are centrally financed through social security contributions) have led in particular to higher spending by local authorities. From the mid-1990s, the federal government cut spending at the expense of local authorities.[50]

Even though the federal government responded several times to massively increasing costs at the local level,[51] social spending kept rising and local authority budgets went into deficit. In 1992, deficits reached a record of €8.2 billion and in 2003, a total of €8.4 billion.[52] Ten years later, in 2013, the finances of local authorities were in a similarly bad state. In North Rhine-Westphalia about half the local authorities were operating with emergency budgets in 2010.[53] The volume of short-term loans for local authorities in the region has shot up from €3 billion in 2003 to more than €20 billion in 2011.

The financial strain felt by local authorities contributes to the low spending on childcare and early education in Germany. In 2009, Germany spent 0.5 per cent of GDP on childcare and pre-school, compared to an OECD average of 0.7 per cent. This amounts to an increase of 0.1 percentage points during the entire decade.[54] This does not reflect the strong prominence childcare was given in policy debates, but rather the opposite: the difficulties in investing in early childhood education in a federalist system.

CONCLUSIONS: WAGE SETTING, WELFARE FINANCE AND FISCAL FEDERALISM

The coincidence of German reunification and the onset of EMU created an exceptional challenge to the German political economy. The two decades after 1989 can therefore be seen as a quasi-experimental study on the adjustment trajectory for the German economy under pressure. It emerges that the focus on exports is the dominant adjustment strategy in time of crisis, partly due to opportunity but also partly due to the lack of alternatives as a more demand-driven strategy was foreclosed by the institutions of the German welfare state. This paper has analysed the underlying dynamics in the interplay between wage bargaining, welfare finance and fiscal federalism. It argues that under these exceptional conditions, the move towards high current account surplus was particularly pronounced but that this is also a general pattern of economic adjustment.

The control of labour costs in the German industrial relations system shifted over time from the dominance of coordinated wage setting institutions to competitiveness-driven plant-level adjustment. Export sector manufacturing firms in particular cut labour costs by using and establishing new forms of peripheral labour at the expense of core labour. Peripheral labour was hired on fixed-term contracts, temping agencies, marginal employment or through subcontractors. Policy changes, from the mid-1980s onwards, encouraged and facilitated the increasing dualisation of the labour force. Employment in the service economy was particularly affected by dualisation and liberalisation. Peripheral employment exploded, as effective and marginal taxation of low-paid employment was disproportionally high. Wages in the service economy declined relative to manufacturing wages. Low or negative real wage increases and low price inflation in the service economy helped to facilitate a long-term wage restraint in manufacturing.

Service sector employment was additionally oppressed by the comparatively high effective taxation of low-paid employment. Given the generally regressive nature of social security contributions, the average and marginal taxation of employment in the service sector hurt employment prospects. As a consequence, marginal employment and other forms of atypical employment emerged as particularly strong in the service economy. Domestic services are very often poorly paid, of low quality and insecure. In 2003, fundamental and far-reaching welfare reforms were implemented.[55] Long-term unemployment benefits were cut, welfare-to-work mechanisms were introduced and pressure on the unemployed to take up any kind of employment was vastly increased. However, the structure of social security contributions was not touched. Despite reform proposals to lower the high tax rates of low-paid employment, social security rates for the low-paid have remained the highest in the OECD (table 1).[56]

A key factor that can help to explain the persistence of a damaging payroll tax, while the dualisation of the labour market has simultaneously advanced rapidly, is the politically important role of social security contributions, both in the context of the social partners' role in welfare corporatism and the German fiscal structure. The role of social partners in the governance of insurance-based welfare programmes is well known: unions and employers' associations are involved in the administration of all social insurance schemes: unemployment, pension and health, and are very reluctant to fundamentally change its structure.[57]

The second political factor is rooted in the revenue structure of the federal government: firstly, social security contributions amount to a high share of revenue, secondly, they are the only major kind of revenue which the federal government controls unilaterally and thirdly, they compensate for the problems relating to the high degree of decentralisation in the German fiscal system.

There are two main implications from this study for the comparative analysis of political economies: firstly, future research should aim to systematically include an analysis of the fiscal-welfare nexus and the way it shapes policy choices. This research is still in its infancy. As in the welfare state literature, the political economy has not systematically paid attention to welfare finance and fiscal federalism.[58] Most of the political economy research is focused on policy outcome preferences by either employers, workers or the electorate. The fiscal constraints of policy-making and the autonomy of the state vis-à-vis policy-seekers have only rarely entered the equation. That the revenue structure resonates with some key insights into different groups of advanced political economies, however, is shown in table 2. Liberal and Nordic market economies not only have a far higher share of central government control over taxation, but also a much lower role for social security contributions. In contrast, the conservative welfare states of Continental Europe are characterised by a far higher degree of regional control over taxation and the stronger role of social security contributions.

Secondly, in many ways Germany is an extreme case. It has one of the lowest shares of total taxation in central government (after Belgium) and the highest share of social security contributions. This corresponds with the high level of effective taxation on the low-paid and the rapid process towards dualisation. Germany has a very high share of employment in manufacturing and a strong focus on plant level interest representation in trade unions. Trade unions in Germany are highly selective in their membership and have weak representation of labour market outsiders.

Both arenas, the corporate and the political arena, are dominated by rather extreme constellations of actor preferences: federal governments have an interest in controlling higher shares of revenues and, therefore, protect social insurance. Trade unions and employers have a similarly high stake in insurance-based welfare. This reinforces a specific evolution of the welfare state and the institutional underpinnings of the German economy. Whether and to what extent this institutional framework has been adjusted by the economic pressures arising from the financial crisis, and more recently from demographic changes, remains to be seen. The minimum wage has put in a wage floor in the service economy. The high employment levels in the labour market and the shortage of young, skilled workers have started to push up wages across sectors. Both developments translate in higher domestic demand. But under the current institutional conditions, the barrier for generating higher domestic demand remains higher than in other, comparable countries.

ENDNOTES

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GRAPH 1: CURRENT ACCOUNT BALANCE AND CHANGE IN DOMESTIC DEMAND, 1997-2007

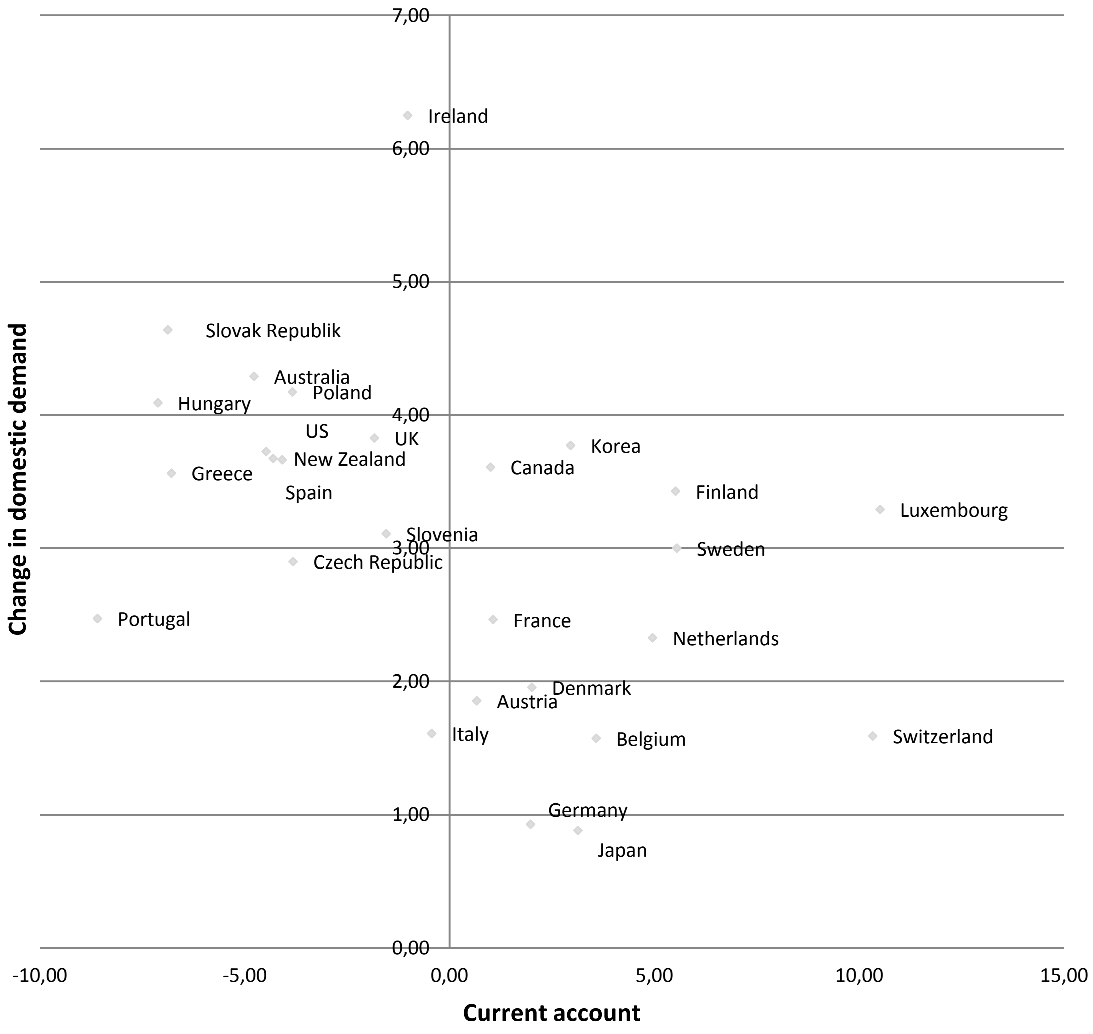


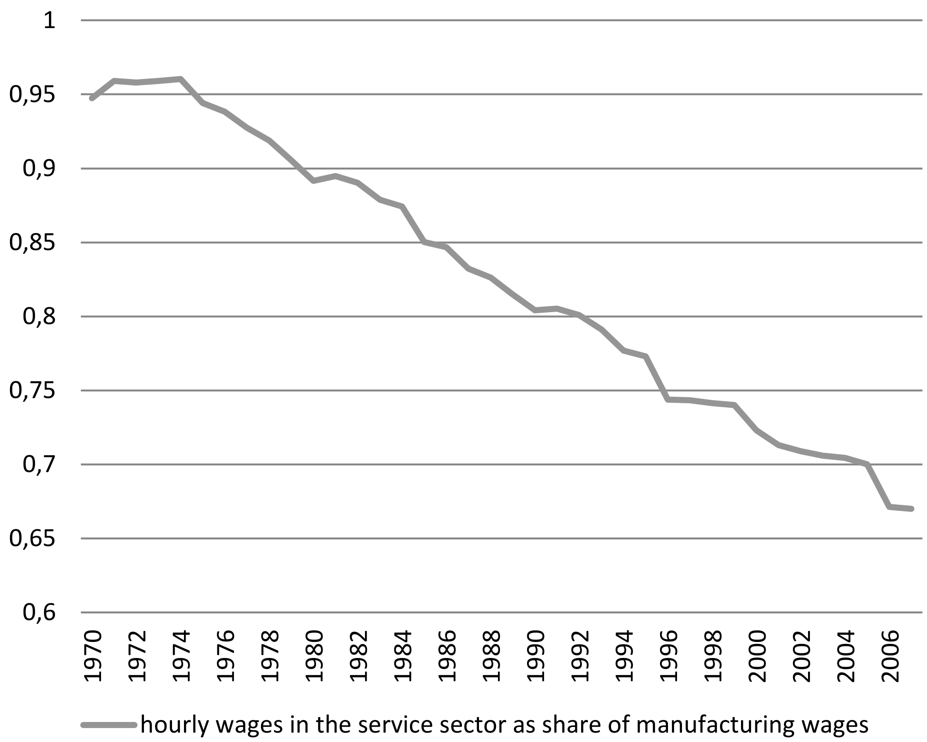
TABLE 1: TAX WEDGE ON LABOUR IN SELECTED EU COUNTRIES

	Average tax wedge on labour (Percentage of total labour compensation)		Marginal tax wedge on labour (Percentage of total labour compensation)	
	At 67 per cent of average worker earnings	At 100 per cent of average worker earnings	At 100 per cent of average worker earnings	At 200 per cent of average worker earnings
Belgium	50.27	43.74	66.5	69.57
Germany	**47.30**	**41.00**	**54.18**	**44.31**
France	45.50	41.98	52.01	59.67
Austria	44.36	39.56	60.04	41.86
Italy	42.99	38.44	53.59	61.54
Sweden	42.49	39.26	63.33	67.10
Netherlands	41.69	38.55	50.25	52.00
Denmark	38.94	33.26	49.42	62.96
Finland	38.26	37.38	58.05	58.05
Greece	37.57	41.64	52.12	58.68
Spain	33.83	33.42	48.19	37.00
Portugal	32.92	29.94	47.07	55.56
United Kingdom	29.70	26.93	38.83	47.70
Ireland	16.00	9.41	33.18	48.90

TABLE 2: CENTRAL GOVERNMENT REVENUES AND SOCIAL SECURITY CONTRIBUTIONS

	Central government as per cent of total taxation (2007)	**Social Security Contributions as share of total revenue (2007)**
Ireland	81.33	16
United Kingdom	94.54	18
Average	**87.94**	**17**
Denmark	73.05	2
Finland	51.50	28
Norway	*66.86*	21
Sweden	52.86	25
Average	**61.07**	**19**
Austria	52.26	34
Belgium	29.60	31
France	36.06	38
Germany	30.07	38
Italy	52.72	30
The Netherlands	58.33	35
Average	**43.17**	**34**

GRAPH 2
HOURLY WAGES IN THE SERVICE SECTOR AS SHARE OF MANUFACTURING WAGES



GRAPH 3
SOCIAL SPENDING AND SOCIAL INSURANCE CONTRIBUTIONS