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The evolution of the German model: How to judge reforms in Europe's largest economy

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1 The German problem and the current debate

It has become popular in recent years to criticise Germany for its failure to adjust to economic, social and demographic challenges at hand. The urgent need for "reform" appears with increasing frequency in newspaper headlines, in reports by expert commissions and high-flying economists, and even in newspaper adverts placed by German "citizens' campaigns". Germany has become the "sick man" of Europe, it is argued – or, as the Germans put it, the "red lantern" illuminating the back of a long train.

Few would argue that nothing needs to change. Germany's low – and recently negative – growth rates, its high levels of unemployment and steadily rising public deficits, are a call to action that is difficult to ignore. Even the left-wing of chancellor Gerhard Schröder's Social Democrats, and Germany's tradition-bound trade union movement, no longer simply defend the status quo. The adoption in December of most of Chancellor Gerhard Schröder's Agenda 2010 proposals shows that a degree of "movement" (as the chancellor calls it) is possible in Germany. Yet a pervasive aspect of the current debate on reform remains the sense of "standstill" – that little is changing fundamentally, despite the obvious need for action. Linked, there is a sense that the momentum for change that does exist is too weak to overcome institutional resistance. "All talk and no action" is the perception among ordinary Germans, who see endless rounds of talkshow discussions and expert commissions as having minimal impact on their lives. Conversely, all the talk of radical cuts – for instance in social welfare benefits or in pensions – creates insecurity, even before laws are fully implemented.

This perception of "standstill" is particularly painful for many Germans as it was recognised years ago. Roman Herzog, the former federal president, talked in 1997 about the mental depression that had befallen Germany, and called for a "Ruck" – a sudden jerk – to wake up German society. Similar phrases remain commonplace today. Introducing Agenda 2010 in March, Mr Schröder insisted "either we modernise or we will be modernised by the unremitting forces of the market". Christian Democrat leader Angela Merkel talked in similar terms at her party conference in December, arguing that Germany is facing fundamental challenges that require a complete overhaul of its institutions.

The debate around Agenda 2010 gave arguments in favour of reform renewed energy last year. The chancellor himself suggested in parliament on December 19 that the country had overcome the "German disease" of low growth and inability to reform. In addition, pro-reform pressure groups have pushed themselves into the public arena in an attempt to shape public debate, and thereby put pressure on politicians and other political stake holders. The weekly magazine Der Spiegel has counted 25 such groups. Many of the organisations are themselves closely linked to vested interests, in business or conservative politics. For instance, the campaign organisation Neue Soziale Marktwirtschaft – new "social market economy" – has received €50m from the engineering industry employers' confederation. However, such groups see the breaking up of such interests and the cutting through of long-winded consensus-based decision-making as key milestones on the road to reform. From outside Germany, pressure from international organisations and other EU governments is also mounting. The IMF, for instance, has 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 has been singled out – for instance by the London-based Centre for European Reform – as a problem case with regard to the EU's Lisbon economic development agenda.[1] The international business media has also done its bit in keeping up the pressure on Berlin.

The purpose of this paper is not to argue a case for or against economic reform in Germany. The need for change is clear enough. Similarly, the need for public debate – in Germany and elsewhere – on the country's future goes without saying. Our concern is that the nature of that debate, especially outside Germany, is hindering a more nuanced understanding of the processes of change and reform already underway in the country. It is therefore also hindering the formation of a thorough understanding of the tasks ahead for the key political actors.

Assessing continuity and change is not an easy task in an economic era that champions dynamism and flexibility. Depending on the perspective, a 'reform' can be seen as far-reaching or not going far enough – or indeed going a long way, but in the wrong direction.The positive resonance attached to values such as dynamism and flexibility reflects the increasing use and acceptance in Germany of an Anglo-American yardstick in measuring economic progress. Despite the clear-cut differences between the political economies of Germany, on the one hand, and Britain and the US in particular on the other, the increased use of an Anglo-American frame of reference by German economists, the business community, the IMF and the international media in their assessments of Germany's 'progress' has had a lasting impact.

Inside Germany, those seen as defending elements of the 'German model' are firmly on the defensive, and often attacked as blocking reform. Outside Germany, there are few important voices that point to the particular nature of Germany's political economy as a key factor in assessments of how reform is to be achieved. Yet fewer highlight elements of the model that could be useful in the Anglo-American world; more often, there is an apparent sense of satisfaction when the German model appears to malfunction. Only rarely are the traditional strong points of a consensus-based high-skill, high productivity manufacturing sector worth a mention.[2]

One does not have to agree with the German trade unions' political perspective to welcome as a breath of fresh air their brutal honesty in repeatedly complaining of the dominance of "neo-liberalism" in the current debate on reform in Germany. Irrespective of one's view of the Anglo-American yardstick, it has helped distort the picture of what is going on in Germany. On the one hand, by setting the measuring bar on reforms at – what appears in Germany as – a high-level, much of what has been achieved is ignored. On the other hand, an unrealistic perception has developed of how quickly radical reforms are likely to be adopted and implemented. The mantra that reform is needed

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[1] Alasdair Murray, 'The Lisbon Scorecard III: the status of economic reform in the enlarging EU.' Working Paper, Centre for European Reform, London, 2003.

[2] Rebecca Harding, 'Dynamic Germany - The Role of Policy in Enabling Markets' International Politics and Society, Friedrich Ebert Foundation Bonn 2/2002.

quickly and at all costs smothers arguments about how that reform can best be achieved in the German context. The impression is often created that a "big bang" change is needed; one that will change the way Germany works almost beyond recognition. The view of one US-based academic, that "Germany needs nothing short of a re-invention of the economy if it is to move to a higher growth path" is rather typical.[3] In a similar way, talk in Germany of the (rarely realised) possibility of launching reforms that amount to a 'grosser Wurf' – literally a 'big throw' – also often confuses more than it clarifies.

No political economy changes overnight and, in our view, many facets of the traditional German institutions will remain in place for a long time to come. Even if it were desirable, the 'German model' of consensus-based decision-making is unlikely to be abandoned in the near future (by governments of any political colour), despite the mounting pressures. The aim of this paper is to view the reform process in Germany through a lens that is more German than the one described above; that is, to use a German yardstick to assess what has been achieved in recent years, and what more is needed. The aim is explicitly not to argue that Germany does not need the radical reforms often prescribed by international critics. Rather, it is to make the case that a better understanding of how such reforms could be achieved is available if the "Germanness" of the reform process is appreciated.

We argue that if you scratch the surface it becomes clear that Germany has been, and is, changing more rapidly and radically than is often perceived. Three areas of change – company behaviour, collective bargaining and trade unions, and the treatment of the unemployed – are used to illustrate this. Such changes add up to a gradual transformation of the old German model established during the post-war period, to something that is indeed more Anglo-American – more liberal and less continental – than before. The reforms in Agenda 2010 broadly fit in with this shift.We argue that this is a useful approach in understanding the way Germany needs to change in future, although we also conclude that it remains unclear whether in the longer term this significant-but-gradual reform process will be sufficiently rapid to enable Germany to modernise in ways made necessary by external economic conditions.

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[3] Stephen Silvia, 'Reinventing the German Economy', AICGS Policy Report no. 8, American Institute for Contemporary German Studies, 2003.

2 The German model: a moving target

There have been 'sick men' of Europe before. The UK had this position for most of the 1970s, when Germany dealt more effectively with the impact of the oil crisis. During the 1980s the sickness award was passed around the smaller countries of Europe. The Netherlands, Belgium, Ireland and Denmark were all at one point singled out for poor performance in terms of economic development, employment and public finances.

Until the mid-1990s, the German economy still appeared to be on the rise. The country appeared to have dealt with reunification in a sophisticated manner, to have presided over national and European monetary union and to have kept hold on its traditions of Ordnungspolitik: restrictive monetary and fiscal policy and tight competition laws. Yet trouble was brewing. Since the mid-1990s the critical views of an inflexible, top-heavy and high cost economy have gained ground. Reunification provided a ready excuse in the early 1990s, since it drained the country of many resources. For at least five years, however, the debate has shifted towards structural problems of adjustment that go well beyond the challenges of reunification.

These structural problems, an integral part of the German model, are in themselves well known. In the economic sphere, they include the thicket of laws and other regulations that impose restrictions and high costs, especially on companies. Labour laws, for instance, impose detailed rules on how workers are to be employed, how they are to be dismissed, and on every stage of employment in between. In addition, the system of checks and balances developed after the Second World War as protection against extremist politics have become a further impediment to quick and flexible decision-making.

Looking for the power centre of German policy-making is like undressing a Russian doll; decision-making procedures are multi-layered and interwoven between various spheres of the political economy. A weak and fragmented state spars with powerful and centrally organized interests. The central government in Berlin, as the target – and more recently the source – of the general reform rhetoric, is kept in check by players that pursue highly specific interests.

A reform has to win approval not only by the lower house of the federal parliament, but in the majority of cases also by the upper house that represents the interests of the 16 states, or Laender. This inevitably involves further deal-making, as with Agenda 2010 in December 2003. Reforms are also sometimes conditioned by the constitutional court that has on many occasions influenced and restricted the room for policy making. The court has over the years developed a number of abstract policy principles that reflect judicial reasoning but not necessarily economic wisdom or an understanding of the changing broader environment. For instance, in tax policy the court has developed the principle of taxation equivalence that requires the same treatment for capital income as for wage earners' income. However, many other industrialized countries have successfully introduced differentiated tax rates in order to deal with international tax competition – a route that in Germany is currently forestalled by the court. On a different but equally important issue, the court has granted special pension rights to some groups of former public officials in the eastern Laender with no consideration of the ability of these Laender to pay.

Organized interests are not only centrally co-ordinated but are usually systematically interwoven with political parties and the policy-making process. Both big parties have a workers' wing which is close to the interests of trade unions. While the Social Democrats parliamentary group had until the last election two trade union leaders in its ranks, the general secretary of the employers' federation is a member of parliament for the Christian Democrats. These lobby networks are accompanied by highly organized chambers of industry, skilled trades and professional organisations that not only have monopoly positions – often enshrined in law – but also their own regulatory powers. Doctors' associations, lawyers and architects have their pay rates protected by national regulations and in the case of doctors and notaries, they control their own markets. At the local level, they also often either constitute, or work with, powerful networks of local politicians. Under these conditions, any reform is bound to be slow, piecemeal and will not necessarily address the essential problems. For instance, the 'self-regulation' within the Bundesagentur für Arbeit, the federal labour authority (in which employer and employee representatives until recently had joint decision-making rights at national, Laender and local levels), has slowed the authority's modernisation process. The health reform that was adopted in parliament in the summer was necessary due to the ever rising costs in the system. This is primarily due to the lack of efficiency and cost control. The reform was the result of an extraordinary cooperation between the government and opposition, but in practice it had to neglect most issues that went against the interests of important lobby groups and may hardly lower the costs of the system.

Grand reform projects are therefore not the place to look in order to detect the changing nature of the German model – despite the fact that last year saw more grand reform proposals than any other in post-war history. And yet, the model does change. It has changed because businesses and employees, for instance, have long since adapted to a new environment – one that the political establishment is often still only talking about.

3 Companies – engines of change

Thomas Limberger, chairman of General Electric Germany said recently: "For foreigners, it is extraordinarily attractive to invest in Germany at the moment. Deutschland AG is breaking up."[4] His comments are interesting because they go against the grain of how German business is perceived, especially outside the country. Because of its weak economy and structural problems, Germany is rarely presented as an "extraordinarily attractive" place to invest. What became known as 'Deutschland AG' rested for decades on a low degree of market capitalization of firms, cross shareholding and interlocking directorships that developed over the years into a highly complex and tightly-knit network of relationships between firms. At the centre of these networks were big financial firms such as Deutsche Bank and Allianz insurance which held large portions of corporate stocks in a variety of forms.

In reality, Germany's leading companies recognised at least ten years ago the need, if not to cast aside the German model, at least to adapt it in such a way to allow the use of Anglo-American practices alongside ingrained German ones. Companies realized they needed to act because of changed economic circumstances – a recognition that some German business practices, while perhaps suited to a sheltered domestic economy, were unsuited to the challenges of economic internationalization.

During the 1990s, financial firms shifted their business strategies towards investment banking and specialist financial services, leaving behind their traditional role of monitoring the German manufacturing sector. Firms took active steps towards disengaging from cross-shareholding and interlocking directorships, towards more transparency and shareholder value and towards an active position in the corporate market. The traditionally strong role of representatives of big German banks in supervisory boards of big German companies has thereby diminished drastically. In the 1950s the spokesman of Deutsche Bank executive board, Hermann-Josef Abs, held up to 24 seats on supervisory boards of big German firms. Today Deutsche Bank is one of the leading international investment banks, with more than half of its employees outside Germany. More generally, between 1992 and 1999 the share of chairmen of supervisory boards of 40 large German companies who were bank representatives fell from 44% to 23%.[5] In addition, under corporate governance guidelines adopted in 2002, executives are encouraged to hold no more than five supervisory board seats.

The personnel and financial disentanglement of banks from the industrial sector also changed their position in the corporate takeover market. Hostile takeovers are a core business for investment banks. The traditional role of German banks was to defend companies against such takeover attempts. The takeover of Mannesmann by Vodafone Airtouch in February 2000 was therefore symbolic for several reasons. First, it was the first successful major hostile takeover by a foreign company. Second, there was no political defence against the takeover. And third, the lack of support for the German company

[4] Interview „Das Netzwerk gegen ausländische Investoren ist aufgebrochen" Tagesspiegel 02.09.2003.

[5] See Martin Höpner, ‚Wer beherrscht die Unternehmen'. Frankfurt: Campus Verlag, S. 138, 2003.

from important players in the business community – especially banks and trade unions – underlined the shifts in perception about how business should and can be done in Germany.

Compared to previous hostile takeover attempts in Germany, 'Hausbanks' such as Deutsche Bank were more hesitant to take sides with the management of the target firm. During the Mannesmann takeover Deutsche Bank did not make a public statement to support the Mannesmann defence. Moreover, the trade union IG Metall, which controlled half the seats on the supervisory board, made no move to argue against the legitimacy of hostile takeovers as it had done in previous cases. The acceptance of Anglo-American business practices has had the ironic consequence that former IG Metall boss Klaus Zwickel faces trial for approving "inappropriately large" severance payments for Mannesmann bosses.

The Mannesmann takeover indicated that the times are gone when the Deutschland AG – with its cross shareholdings, house banks, legal hurdles, political pressure and strong union representation on supervisory boards – could prevent such a development. In addition, as in Anglo-American countries, shareholder value strategies have spread across big companies. While market capitalization has remained low, stock option schemes created incentives for managers to take shareholder value seriously. During the latter half of the 1990s when this policy coincided with the stock exchange bubble, young and aspiring German managers experienced that shareholder value was a way to get rich quick. The new generation of leading German managers is now trained in American style business schools and looks down on the old-fashioned forms of checks-and-balances in the traditional German business model.

They also look abroad. In 2000, a third of the biggest 100 companies in Germany applied international accounting standards and a quarter were listed in stock exchanges outside Germany.[6] Both measures indicate that companies have started to look for international investors. Not only the banks have walked out of the housebank system; firms increasingly seek equity finance.

This process was undertaken largely independent of help or encouragement from the government. No 'big bang' legislative reform programme was required although since 1998 a series of laws has liberalised conditions on Germany's capital markets. Four Laws for the Promotion of the German Financial Market aim to provide a more transparent framework for the operation of stock trading. These established a supervisory agency for stock trading at the federal level and set up rules of conduct for the participants. The Eichel tax reform in 2000/2001 changed laws on capital gains tax, enabling companies more easily to shed stakes in other firms. German companies were also enabled to issue financial statements based on international accounting standards (IAS or US-GAAP) rather than on German accounting standards (HGB).

These developments in the German corporate governance sector serve to underline the break with past behaviour with regard to both the aims of public policy and company behaviour. Cross shareholding today is a remnant of the old days due to the weakness of the stock market. It is no longer a principle for a networked business sector. Public policy

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[6] MPIfG, ‚Arbeitsbeziehungen in Deutschland: Wandel durch Internationalisierung', Köln, 2003.

is clearly engaged in facilitating and smoothing the transition of German business and corporate governance practices towards the increased adoption of some Anglo-American practices.

Obviously, convergence towards Anglo-American business practices is not equivalent to a full-blown adaptation to a market-driven corporate governance regime, and many discrepancies between the governance of German and Anglo-American firms remain. In particular co-determination blocks further convergence of German corporate governance structures towards a single board system. However, leaving aside the institutions, the way business practices have evolved over the last decade represents a strong shift towards Anglo-American practices. Convergence is driven by new opportunities of firms in international capital markets, but also by the heightened competition on product markets and an emerging Anglo-American management culture.

4 Collective bargaining decentralises as trade unions lose power

In many accounts by the IMF and the OECD, the regulation of the labour market is seen as a stumbling block limiting the growth potential of the German economy. According to the OECD, Germany is near the top in a ranking of employment protection measures, in 4th place behind Italy, France and Sweden.[7] Recipes for overcoming economic stagnation usually start with proposals to deregulate the labour market, including Germany's labour relations model.

While the core elements of this model are still in place – centralised, industry-wide collective bargaining, co-determination, and sectorally-based union and employers' bodies – the image of strong trade unions holding a firm grip on companies is a distorted view. In fact, the collective bargaining and trade union landscape in Germany has changed much more significantly than is commonly perceived. Companies today are generally much more able to determine wages and working conditions for their employees than they were a decade ago.

During the recession of 1992/93 half a million jobs in the manufacturing sector were shed. Redundancies were negotiated with the help of unions and plant-level representatives. 'Concession bargaining' at the plant level now takes place in the majority of big companies in industry: Longer working time, pay cuts and flexible work organization has spread throughout the economy. Today in a third of companies in the private sector plant-level agreements exist that provide for terms and conditions that diverge from the industry-wide collective agreement. Another 15% of companies simply violate the agreements, according to a survey by the union-based research institute WSI.[8]

Unions try to keep up with these developments by adjusting collective agreements to allow for plant-level deals. They have introduced 'opening clauses' that allow for local bargaining, if the business situation is bad. In the chemical sector, pay grades were widened by introducing a 'pay corridor' reaching down to ten percent below agreed rates, following pressure from tyre manufacturer Continental. Pay grades have thereby become more differentiated and lower pay grades have been introduced. Generally, firms are also less willing to participate in the industry-wide system. The share of firms that belong to employers' associations and are thereby obliged to apply industry-wide collective agreements has diminished to 45 percent in western Germany. In eastern Germany, only 23 per cent of companies are members of associations. The share of employees in the private sector who work in companies that are part of a collective agreement has declined to roughly 60 percent.[9]

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[7] OECD Employment Outlook 1999.

[8] Reinhard Bispinck, Thorsten Schulten, ‚Verbetrieblichung der Tarifpolitik? – Aktuelle Tendenzen und Einschätzungen'. WSI-Mitteilungen, 2003.

[9] IAB, ‚Die Entwicklung der Flächentarifbindung 1995–2001', 2002.

Even the trademark of German trade unionism, the 35-hour week, has been effectively shattered. Studies show that the majority of white-collar employees in the car industry does not work the 35-hour week but has returned to a 40-hour week. In a face-saving exercise, the IG Metall engineering union now negotiates over annual working time accounts, in which an average of 35 hours for blue-collar workers must be reached over a period of two years. In reality, the issue for the IG Metall is not the length of the working week but overtime bonuses. The fight for a shorter working week has long been lost. According to data from the federal statistical office, the share of German employees who work 40 hours or more has steadily increased since 1993. At the same time, the share of those that work between 35 and 40 hours is decreasing.[10]

Many companies design new work arrangements with their works councils at the plant level without even informing the associations. Monitoring and policing violations of collective agreements at the plant level are virtually impossible for the unions. Hardly any employee is 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.

One reason for this development is union weakness. Since the early 1990s, unions have lost more than 4 million members, a third of their membership. Membership as a share of total employment is down to 20%. The number of companies that are union free is steadily increasing. Moreover, unions are concentrated in declining industries and are hardly present in the growing service sector.[11]

Despite – or rather because of – the significance of this trend, unions have been largely unwilling, at least until recently, to publicly acknowledge its existence. Rather, they attempt to publicly display their traditional strength in the still highly organized car industry and by exerting pressure on the SPD. While they rarely block workplace deals aimed at providing job security and competitiveness, they have also not had the honesty to admit that such deals reflect shortcomings in the capacity of the German labour relations model to adapt to new challenges, and in their own authority. The IG Metall's failed strike for the 35 hour week in the Eastern metal industry in mid-2003 showed how little this union in particular is prepared to accept the reality of the changed economic situation.

The weakness of the unions is however dawning on policy makers. Unions had essentially a veto right during the first term of the Schröder government. The government even extended union rights at the workplace. Immediately after Mr Schröder's re-election in September 2002, union pressure was seen as the main reason why the ruling coalition's policy programme contained so few reform ideas. On the government's part, the fact that the initial warning shot across the unions' bows came from the chancellor himself – in his Agenda 2010 speech in March – shows that he saw himself in a powerful enough position to break long-standing taboos built by unions around labour legislation. That he has not backed down, despite intense union pressure, is a further sign of the changing times. On the opposition's part, it has used the issue to attempt to drive a wedge between the

[10] Statistisches Bundesamt, ‚10 Jahre Erwerbsleben in Deutschland'. Wiesbaden, 2002.

[11] Bernhard Ebbinghaus, ‚Dinosaurier der Dienstleistungsgesellschaft. Der Mitgliederschwund deutscher Gewerkschaften im historischen und internationalen Vergleich'. MPIfG Working Paper 03, 2002.

unions and the government – seeing a chance to both embarrass Mr Schröder but also to push him towards further reforms. Such an opportunity would have been unthinkable only a few years ago.

In a wider sense, with unions 'cornered' in only one part of the economy, their legitimacy to speak for workers across all sectors has been increasingly undermined. This is of particular significance in Germany, where unions still fulfil this formal representative role on many official commissions, committees and supervisory boards. Unions have lost considerable power – in the market and in politics. On the surface, their financial resources, legal and organisational structures and personal political links still feed their influence on the government and big companies. In the substance, however, their influence is dwindling due to their inability to adjust to the changing environment.

The labour market that has emerged is less regulated than is commonly assumed. One should recall that big manufacturing companies in the US and UK also have strong union representation. The regulatory power of the unions in these countries does not however extend beyond these plants. It has been a feature of the German model of labour market regulation that agreements were forged that set universal rules for the vast majority of employees. This system is being eroded by company opt-outs and concession bargaining.

Tight labour laws that regulate dismissals and workers' participation still exist. However, they increasingly divide the labour market into those who enjoy them and those who do not. Employment expansion has taken place among workers on temporary contracts, those in temping agencies and in precarious jobs. More than a fifth of young workers under the age of 30 (and not on vocational training contracts) are employed on temporary contracts which forestall employment security and dismissal protection.[12] In September 2003 there were 6.7m workers employed in so-called mini-jobs – low wage jobs that are largely exempted from social security charges. Deregulation is spreading at the fringes of the labour market, and unions have little power to do anything about it.

[12] Statistisches Bundesamt, ‚10 Jahre Erwerbsleben in Deutschland'. Wiesbaden, 2002.

5 Closing in: tougher times for the unemployed

The German welfare state, one of the most generous in the world, is changing radically, and, apart from those immediately affected, few people appear to have noticed.

The German welfare state has always been a mixture of an Anglo-American lean benefit system for the needy poor, and a contribution-based insurance system covering periods of unemployment and old age that links benefits to previous pay. In the past, the focus was firmly on the latter component, centred on the idea of 'Lebensstandardsicherung', or the 'securing of living standards' both now and in the future. Once a certain living standard was reached, say that of a skilled worker, the system guaranteed that that standard was maintained, also during periods of unemployment and in retirement. Following the passage of Agenda 2010, the future now looks very different.

There used to be three forms of income assistance for the unemployed. First, 'unemployment benefit' was for those who had paid contributions towards the unemployment benefit funds. Depending on age and length of service, entitlement could last up to three years. Second, those still unemployed after this entitlement had expired received 'unemployment assistance'. Unemployment assistance was lower than unemployment benefit but still related to previous earnings. It was tax-financed. Finally, there was 'social assistance' for those who had never paid into the unemployment funds. Social assistance was means-tested and funded by local authorities.

The three different systems of benefits for the unemployed produced complex administrative processes. Partly in order to streamline these processes, Agenda 2010 proposed to merge unemployment assistance and parts of the coverage of social assistance into one benefit, called Arbeitslosengeld II (ALG II), essentially for the long-term unemployed. (Social assistance remains for those unavailable for work). The philosophy that underlies the reform had previously been used by the Blair government for activating the unemployed. The state provides opportunities but also asks for commitments and personal effort. It aims to simplify the overly complicated rules for entitlements for social assistance and to increase the incentives to look for work for those on unemployment assistance. These include tougher sanctions for the unemployed. Jobless people face cuts in benefits if they refuse job offers, and increased pressure to be more geographically mobile in order to find a job.

Experts agree that after a year of unemployment the value of previous qualifications is significantly reduced, and the long-term unemployed will only find new work in areas that are markedly worse paid than their previous job. Therefore, the linking in the past of unemployment benefits to previous earnings was seen as creating a disincentive for people to accept a new job. In order to reduce these incentives to remain unemployed rather than taking low paid employment, the maximum duration of unemployment benefit has also been cut. Unemployment benefit is still available, but is limited to the first year of unemployment (18 months for those over 55).

ALG II is a means-tested flat rate payment set at what is universally seen as a low level, that of social assistance (it can be topped up temporarily if a claimant previously received considerably higher unemployment benefit). Those receiving ALG II have usually to prove that close family members are unable to support them, and that most of the recipient's savings are used up. With these measures, the government has effectively, in a single blow, transformed a central element of the country's prized social security system. From 2005, the group of the unemployed that will receive benefits that are linked to previous earnings will become the minority. Given the – by international standards – large share of long-term jobless among all unemployed, the majority of the currently unemployed will receive ALG II. The government commission that designed the plan estimated in April 2003 that this group embraces 2.6m job-seekers.[13] Seasonally adjusted unemployment in December 2003 was 4.34m. Moreover, ALG II recipients will be required to take any job that is offered to them as their contribution to proving their willingness to work.

The reform will have moved Germany a significant distance towards an Anglo-American model of largely means-tested, flat rate jobless benefits – a model long rejected by the German political establishment as anti-social.

Unlike the two other examples above, this reform of the benefit system has been largely driven by politicians, but with economic and financial factors – in particular high structural unemployment, the state's severe budgetary problems and the financial crisis of local authorities – playing a vital role in forcing political decision-makers to act. The reform originally aimed at expenditure cuts of €4.2 bn per year – if the expected efficiency gains can be achieved.[14]

The fact that a SPD-led government could even contemplate – let alone implement – such a major departure from the social security system established under chancellor Bismarck in the nineteenth century is a sign both of how dire the state's financial problems are, and of how far a readiness for change has spread within the political establishment. The changes have the broad support of the CDU and the size of the welfare cuts was not a contested issue in the mediation committee negotiations in December. In the final parliamentary reading on Agenda 2010 on December 19, only 12 government-aligned MPs voted against this measure.

This third example reinforces the message arising from the previous two, namely that Germany has already been changed in a way, and to a degree, that are not immediately apparent amidst the chatter of the reform debate at present.

[13] Bericht der Arbeitsgruppe Arbeitslosenhilfe/Sozialhilfe der Kommission zur Reform der Gemeindefinanzen, 17. April 2003.

[14] Bericht der Arbeitsgruppe Arbeitslosenhilfe/Sozialhilfe der Kommission zur Reform der Gemeindefinanzen, 17. April 2003.

6 Assessment – how to judge reforms

Even without big bang reforms and despite the rhetoric of standstill, Germany has changed. But how far? Critics will say that the difference from the Anglo-American world is still vast. Company behaviour is not uniform and the capital market is still under-developed. Compared to many countries, German trade unions are influential and welfare payments generous.

Those who know both worlds immediately point to the much more dynamic but also harsher realities of Anglo-American societies. They sometimes also argue that the changes described above are more at the margins than at the core. Germany still embodies the European continental social model, where equality is a policy-guiding principle, employee rights are enshrined in economic policy and the dangers of deregulation are usually seen as weighing heavier than the opportunities.

This perspective, while essentially accurate, does not capture the nature of change. The German model is entering a new phase – which combines the European continental social model and Anglo-American approaches in a more dynamic way.

There are two defining characteristics of this reform process. First, traditional German institutions remain in place but are nevertheless undergoing processes of fundamental change. This combination of continuity and change is key: It is as if the institutions are being hollowed out, while their 'walls' and 'ceilings' remain in place. Second, changes in underlying expectations, attitudes and values in business, policy-making and in the wider society are fundamental forces driving Germany away from its traditional model towards one that remains essentially German, but one that draws on a much wider range of social, economic and cultural influences than, say 30 years ago.

One can identify these two characteristics in the examples above. The institutions that underpinned Germany's traditionally cosy relations between business and finance are still in place but have nevertheless been modernised. The German corporate governance model still rests on a dual board, on workers' participation rights and on large shareholders.

The same could be said for collective bargaining institutions. The debate last year in the context of Agenda 2010 on possible legal changes to enable increased workplace negotiations did not result in concrete action. But changing attitudes and expectations have already had a severe impact on these institutions. Globalisation, in particular the internationalisation of companies and of business standards, has forced German managers to adopt more open, international approaches. They have adapted the workings of the traditional corporate governance institutions to their own needs – including the role of employees in codetermination procedures. Similarly, changing attitudes towards work and towards the often conservative role played by centralised unions and employers' bodies have fuelled an approach among the wider population towards trade unions in particular that is largely instrumental and stripped of traditional political motivations.

In a rather typical 'Germany-needs-a-big-bang' style editorial comment by the international business media, one newspaper commented a couple of days after the government and opposition struck their deal on Agenda 2010 to pass a package of twelve laws (ranging from labour market to local government finance reforms): "Mr Schröder's grand reform attempt must be considered to have ended in failure...Those looking for a program to revitalise the German economy will have to keep looking: they won't find it here (in Agenda 2010)."[15]

While one can indeed question whether Agenda 2010 "will revitalise the economy", it is open to debate whether such a broad package can be dismissed as a failure. Even though the steps are modest by international standards, and in many cases have been diluted since the chancellor's initial drafts, they nevertheless represent significant movement. All of the main institutions underpinning Germany's social security system are affected, a process that will add to modernisation pressures. This reform process has knock-on effects on other policy fields such as the pension system, health, tax policy and the labour market. The process of adjustment will continue and it will be small regulatory changes that may have the biggest impact. Of equal importance, Agenda 2010 is underpinned by a significant attitude change on behalf of both the government and the opposition. Both camps appear to have left behind the previously prevailing attitude that Germany could essentially rely on the strength of its exporting manufacturing sector for wealth and growth.

The process of change is far from complete, and remains highly problematic, both regarding internal party battles, and regarding the general anxieties in the public about "reforms". Yet it is fundamentally true that, even compared with only a few years ago, politics is now taking place in a sphere where the need for structural and institutional reforms has been internalised by the vast majority of the important players.

The purpose of this paper has been to point to ways in which Germany is changing even without going through big bangs. We have argued that it is necessary to understand the way German institutions have been changing in order to retain the appropriate context for assessing new developments, such as Agenda 2010. This is particularly important with regard to institutional reforms that will gain in importance in the months and years to come. The government has already appointed a commission that will look into the problematic interaction between the upper and lower house of parliament. Other areas of institutional reform likely to attract attention are the monopolistic structures of chambers of commerce, professional associations, the social partners and the skilled trades chambers that suppress competition and hinder cost cutting and flexible adjustment. It does not seem realistic to expect that government commissions or policy-making will be able to fundamentally restructure these institutional barriers. But internal adjustment of these institutions might allow for far-reaching changes in how they work.

Without such an understanding, the piecemeal compromises that lie at the heart of German policy-making do indeed look inadequate to tackle the modern challenges of globalisation, crises in public finance and an ageing society. That said, we withhold judgement on whether such step-by-step change will move Germany forward quickly enough to meet these challenges.

[15] Wall Street Journal Europe 17.12.03.

There is a prevailing view among economists and others (often arguing from a strongly Anglo-American viewpoint) that a point will come in the not too distant future when the economic and other pressures will become so great, and the country's structural inadequacies so clear, that the only alternatives will be a big bang change (or series of changes) or the relegation of Germany to a permanent position in the second division of industrialised economies.

We do not know when, or whether, such a point will come. It seems by no means inevitable that it will. However, even assuming that it might, we believe it useful to assess Germany's ability to respond to such a turning point through the perspective described above – that reform is happening, before our eyes – rather than on the basis that Germany is essentially 'unreformable'.