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A change of partners?

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From *The Economist* print edition

Angela Merkel would like to head a new coalition. That would be just the start to answering Germany's long-term problems



AP

SAARLAND, the smallest German state without the excuse of being just a city, is a thumbnail caricature of Germany. It was here, among the woods and hills, that Goethe in 1770 claimed to discover that "passion for reflection on economic and technical matters" that occupied much of his life. For decades the thick coal seams underneath it made Saarland a pawn in the power-games of Germany and France. And because of that history, the sort of industry that Germany is known for—cars, steel and machines—looms even larger in its economy than in the rest of the country.

After 2000 that was a blessing. Orders poured in, and Saarland—though once a bit of a joke to Germans in the *Reich*, the locals' rueful name for the rest of the country—outpaced Germany's growth. Though the coal was becoming too costly to mine, Saarland upgraded old industries like steel and ventured into new fields, such as information technology. But when the global financial crisis broke, hitting Germany's export-dependent economy harder than most, the self-described "rising state" tumbled even further. Like the rest of Germany, Saarland is now praying that the recovery will be sufficiently swift and strong to stave off mass unemployment.

The crisis and its aftermath have provided unsettled political weather for Germany's federal election, to be held on September 27th. The chancellor, Angela Merkel, who is running for re-election, promises to lead Germany "cleverly out of the crisis". Her main challenger, Frank-Walter Steinmeier, the foreign

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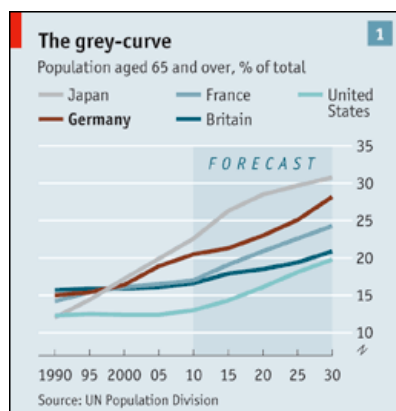
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minister, is trailing largely because voters doubt he would be any smarter in this respect. In surveys of voters' opinions about the economic competence of the two biggest parties, Ms Merkel's Christian Democratic Union (CDU) handily trumps Mr Steinmeier's Social Democratic Party (SPD).

But a second glance at Saarland tells you that crisis-management is not all that matters. Saarlanders are older than other Germans; despite its economic success, the state's tiny population of 1m is shrinking through a falling birth rate, mortality and emigration. The rest of Germany is not far behind. It is among the world's fastest-ageing countries (see chart 1). This year western Germany will pass a demographic milestone: the number of people of working age will shrink for the first time, as has already happened in the formerly communist east. Politicians have had little to say about this in their quest for Bundestag seats. In Saarland, for example, the hottest issue seems to be whether towns, to save money, may have to close their swimming pools. But the consequences of an ageing population will be longer-lasting than those of the economic crisis and at least as far-reaching. So Saarland's towns are wondering whether it is worth spending money on swimming pools when the number of children is falling. The greying of Germany raises the stakes for almost everything the next government will do.



This is not what Germans call a *Richtungswahl* (turning-point election). Unlike the Americans or the Japanese, they are not pining for change. Germany profited handsomely from booming world trade, creating 1.6m jobs between 2005 and 2008. When the crisis hit, the government deflected the pain, at least until after the election. Ms Merkel and Mr Steinmeier—both exuding sobriety and competence, but hardly setting passions alight—have governed together in a “grand coalition” for the past four years, which gives their contest the feel of sibling rivalry. Relieved they have not suffered more, Germans seem ready to give Ms Merkel a second term without inquiring too insistently how she might use it.

Yet the election will not be a coronation. The main choice voters face is whether to extend Ms Merkel's cranky partnership with the SPD or to heed her plea for a change of coalition: she would rather govern with the smaller Free Democratic Party (FDP). That would not be a trivial change. The SPD and FDP stand almost at opposite poles of Germany's political spectrum. The SPD preaches “solidarity”, which entails strong worker protection, minimum wages and robust social welfare. The FDP champions “freedom”, which goes along with sharply lower taxes, less regulation and friendliness to private enterprise. Ms Merkel's CDU and its Bavarian sister party, the Christian Social Union, stand uneasily in the middle. All four accept the tenets of Germany's “social market economy”. Both the Social Democrats and the Liberals have mellowed, which means that the next government is unlikely to bring in radical change, no matter what its makeup. But a government with liberal leanings is more likely to keep Germany vigorous as it ages, and is what Ms Merkel says she wants.

Voters do not share her tastes. Less than a third favour a “black-yellow” partnership of the CDU and the FDP. With the crisis easing, voters are paying more attention to the SPD's solidarity agenda. Mr Steinmeier outscored Ms Merkel in their only televised debate (a muted affair, to which the opposition was not invited), mostly by coming across for the first time as someone who could do her job. But he has little chance of winning outright, and virtually none of forming a left-wing coalition in the Bundestag. Hence the possibility of another grand coalition.

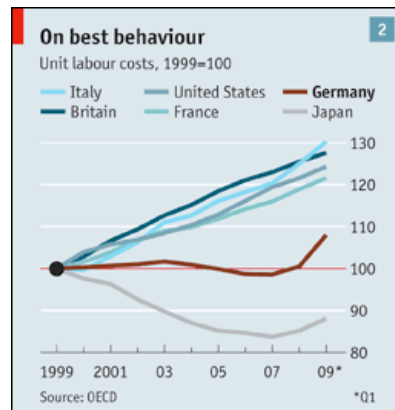
Lucky for some

The muddy political choices reflect the murky mood of the electorate. On the eve of the election Germany deems itself a successful country, lucky to have escaped the worst of the recession. It is among Europe's most competitive economies and second only to China as an exporter of goods. But the fruits of success seem to be distributed unevenly. Relative poverty and inequality have risen faster in Germany than in any other OECD country since 2000, says Gustav Horn of IMK, a

union-linked think-tank. And since 1999 Germans' wages have risen less than anywhere else in the euro zone. Even before the recession Germans were grumbling about the pay of corporate fat cats. Now executive pay sometimes seems to be the most emotive campaign issue.

These discontents are reverberations from German unification in 1990, which saddled the country with gargantuan costs and led to a decade-long quest to regain competitiveness. The private sector did much of the work: enterprises restructured and trade unions accepted low pay rises and more flexible contracts. The grand coalition's predecessor, a left-leaning partnership between the SPD and the Greens, enacted tough reforms of the labour market, including "Agenda 2010", which chopped unemployment benefits. Ms Merkel's government topped that up by raising the pension age (gradually, from 65 to 67, starting in 2012), cutting corporate tax rates and almost balancing the federal budget before the crisis knocked it askew.

The reforms pushed more people into work and reduced the price of labour (see chart 2), which helped firms take full advantage of the boom in world trade. Long-term unemployment dropped by 40% in 2007 and 2008, the first big retreat in absolute numbers since the 1960s, notes Joachim Möller, director of IAB, the federal employment agency's research unit. Most Germans credit the government's anti-recession measures, such as "cash for clunkers" and subsidies for firms to hold on to workers, for the fact that unemployment has risen only mildly so far. In fact, this "German miracle" may owe as much, if not more, to Agenda 2010.



But Germans are tired. Sure, Saarland created lots of jobs during the boom years, says Eugen Roth, head of the trade union confederation in the state and an SPD official. But too many of these were the insecure, low-paid positions encouraged by the reforms. In Saarlouis, for example, Ford is employing temporary workers alongside assembly-line veterans; in a crisis, they will be first to go. A chastened SPD has been trying to make amends. The grand coalition extended unemployment benefits for older workers, and broke a contract between generations by promising the retired that their pensions would never fall. Such reversals scare economists, many of whom say their priority for the new government is that it

do no more harm.

But that will not be enough. The next government will have to fend off the credit crunch and redesign the regulation of banks, which may be in worse shape than officials have yet let on. Germany can no longer count on exports alone to turbocharge its economy, but it is not clear what else, if anything, will. Nothing comparable to the telecoms boom of the 1990s is on the horizon, notes Klaus Deutsch of Deutsche Bank Research. Politicians of all stripes tout green technology, but that is speculative, and it is not clear how the government can best nurture it. Hard choices loom in energy among dangerous nuclear power, dirty coal and expensive renewables.

Germany's leaders will handle all this wearing fiscal manacles. Next year's federal deficit is expected to be a record €86 billion (\$126.5 billion). The next government, whatever its makeup, will reduce this: members of the euro zone are supposed to limit public-sector deficits to 3% of GDP, and a new constitutional amendment directs the federal government to cut its structural deficit (ie, adjusted for the business cycle) to 0.35% of GDP by 2016. The ageing process makes debt more toxic. The shrinking of the labour force will whittle away at potential growth, consuming the means to pay for it.

A "generation balance" drawn up by Bernd Raffelhüschen and Stefan Moog for the Market Economy Foundation in Berlin weighs the cost of today's spending commitments for tomorrow's taxpayers. The debt of the public sector was 65% of GDP in 2007; adding in unfunded future costs of pensions, health care and other schemes, the state's implicit debt jumps to 250% of GDP. Recent cuts in income tax and social-security contributions softened the crisis but greatly increased the long-term burden. To cope, Germany will have to make the most of its dwindling workforce.

Wasting human capital

By 2020 Germany will lack 2.4m workers, which will cost the economy more than

€1 trillion, reckons McKinsey, a consultancy. This sounds a pleasanter problem to deal with than unemployment, more often the spur to reform. There are no real culprits (you cannot denounce childless couples) and the solutions sound cheery: encouraging breeding, improving schools, promoting research and the like. But generational challenges demand reforms almost as daunting as Agenda 2010.

Germany wastes human capital like unmeasured water. Despite the reforms, 53% of unemployed people have been jobless for more than a year, more than double the OECD average. A high proportion of women work, but a German obstacle course keeps them from working too much: school hours are short, kindergarten places are scarce and second incomes in families are taxed at high rates. As a result the total number of hours worked in Germany is among the lowest in the OECD.

Around a quarter of children are born into immigrant families, providing a lift to Germany's depressed fertility rate, but they underperform. Children with "migrant backgrounds" drop out of school at more than double the rate of native Germans. Germany's ranking in international tests of reading and maths would jump several places if the scores of migrant children were not counted. Too few Germans of any sort reach the top of the education ladder: 23% of young Germans get university degrees, compared with an OECD average of 36%.

These are the laments of a society that has changed faster than the institutions that are supposed to serve it. The school system is a holdover from an era that deemed motherhood a full-time job, an attitude that France, for example, shed long ago. Only now are Germans getting used to the idea that "guest workers" from Turkey and elsewhere, who arrived from the 1950s onwards, are going to stay. Traditional attitudes have found a home in Ms Merkel's CDU. Although it proclaims that Germany is an "integration land", the party's election programme gives priority to "qualification over immigration", rules out dual citizenship and calls for deporting foreign criminals. On such matters, the SPD is more progressive.

And so, one suspects, is Ms Merkel, for whom being a woman and a one-time physicist seems to matter more than party dogma. Her star appointment was Ursula von der Leyen, a mother of seven, who as family minister introduced "parents' pay", a benefit to encourage middle-class women to bear more children without abandoning their careers. In concert with the states she started a scheme to build pre-schools for all children of parents who want them by 2013, which will help women into the workforce. Ms Merkel brought the government's "integration co-ordinator" into the chancellery and put together an "integration plan" to impart Germany's language and values to immigrants and upgrade their skills.



Overpampered as well as overhatted

Reuters If Germany is going to defuse the "time bomb" of immigrant dropouts and head off a ruinous skills shortage, it will have to overhaul education. Ms Merkel knows it. But the two main parties are at odds over how to tackle it. The CDU champions the traditional three-tier high-school system, in which pupils are separated early (usually at ten) according to ability. The SPD wants children to study longer together, reckoning that slower ones will benefit. Everyone accepts the goal of raising investment in education from 4.8% of GDP to 7%, but there is no convincing plan to pay for it. The SPD wants schooling to be free, from kindergarten to university; the CDU is more open to charging fees.

Disagreement does not cause deadlock because the *Länder* are free to experiment. Hamburg, for example, which is governed by an unusual coalition between the CDU and the Greens, plans to extend the number of years children study together in mixed-ability primary schools from four years to six. But experiment is risky, as *Länder* governments are discovering. Saarland's CDU government introduced university tuition fees and shut 100 primary schools because there are fewer children to fill them, but that was a big part of the reason the government lost its absolute majority in state elections on August 30th.

Boosting brainpower is not enough. Reform in its narrow sense, of saving on welfare, is unavoidable. The costs of the social-security system are set to soar, in the short term because of the slump and in the long run because the country is

ageing so fast. The unemployment-insurance contribution, laboriously scaled back from 6.5% of gross pay to 2.8%, may soon rise, followed perhaps by the health contribution, now 14.9%. That will jeopardise the government's goal of holding total contributions to 40% to encourage employment.

The grand coalition and its SPD-Green predecessor installed checks on the future rise of pension costs (and, in moments of timidity, weakened them). Germany's greying argues for encouraging individuals to rely less on state-funded pensions and more on their own savings, as the FDP advocates. But the real mess is health care. The "generation balance" puts the implicit debt of the health system at 99% of GDP, but that does not include the cost of improvements in medical technology. If you include just half that cost the debt more than doubles, says Mr Raffelhüschen.

The grand coalition dealt with this half-heartedly. Payroll contributions and taxes now flow into a single fund, which distributes the money to insurers according to the number and needs of the patients they enrol. Insurers are supposed to compete for patients; those with high costs may charge a modest additional fee. But real competition has yet to start and may never really happen, since services are uniform and the extra fees are nominal. "The root of the problem still has to be dealt with," says Michael Braun of Mercer, a consultancy. Strife between the CDU and the SPD has prevented a more-coherent solution. A black-yellow coalition might do better.

Too broad a church

A government of determined reformers would not stop there. *Kündigungsschutz*, a system of worker protection that makes each dismissal a judicial adventure, should be loosened, though it is hard to see the cautious Ms Merkel agreeing. One way to reduce the economy's reliance on exports might be to liberalise the *Meisterzwang*, a system of guild protection that restricts competition in some 41 crafts, an idea that the small-business-friendly FDP may resist. The welfare system imposes a steep implicit tax on low-skilled workers, discouraging them from taking jobs. Germany's federal system, which gives states little scope to raise their own revenues and mandates massive transfers among them to even out living standards, is crying out for further reform.

Merely to mention such ideas is to despair of them. Germany has an astonishing capacity to rise to big occasions, such as unification; but in ordinary times it seeks consensus among myriad power centres, which makes progress slow, if it happens at all. A black-yellow government would resist rolling back reform and block some bad ideas, like a generous economy-wide minimum wage. But it would not change the rules.

"I worry about a potential total blockade of the decision-making system," says Hans-Olaf Henkel, a leader of Konvent für Deutschland, a reformist group. Fewer decisions are now subject to veto by the Bundesrat, the legislative chamber that represents the states. But with more states being governed by coalitions, the Bundesrat's deliberations could become more tortuous.

The roots of consensus are deep. In the 16th century Catholics and Protestants sought ways to co-operate rather than warring. One ingenious device was the *Simultankirche*, a shared church where the two faiths worshipped separately. Germany itself feels like a secular *Simultankirche*, in which the relative strengths of the sects may change without disturbing the basic arrangements among them. Unfortunately, it will be surprising if this month's elections break that pattern.

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