

Preface

What ever happened to Germany? Europe's biggest and the world's third-biggest economy, the world's first welfare state, is in a state of despair. Dubbed an "economic miracle" after World War II, the country seems to have been abandoned by fortune and now seems to lack the wherewithal to encourage its return. From 1995 to 2005, Europe was the world's slowest-growing continent, and, next to Italy, Germany was the slowest-growing country in Europe. Once a locomotive, it was the laggard of the continent, if not of the world. In recent years, Germany has had the lowest net investment share of all developed countries next to Japan, bankruptcies have climbed to alarming records, capital has been fleeing to cheaper locations in Eastern Europe and Asia, the extent of unemployment has become ever more menacing, and yet the world's poor continue to arrive at its doorstep. Although Germany will remain Europe's biggest economy for many years to come due to its sheer population size, one European neighbor after another is overtaking Germany in per capita income. Germany has become the sick man of Europe, unable to keep abreast with Austria, Denmark, Ireland, Finland, Great Britain, or the Netherlands. The *Wirtschaftswunder*, the much-admired German economic miracle of the postwar period, seems to have moved on to other places. No miracle has been sighted in Germany for years now.

As the German economy threatens to erupt, the population continues to dance on the volcano. In tourism Germany remains the world champion, and its cruise ships plough the oceans more defiantly than ever. The pension system is defended, although not enough children are being born to finance it in the future and no real policy changes are being made to address this fact. The population is shrinking faster than that of any other developed country. Young couples have traded in baby carriages for second cars. Everyone wants to be in love and dreams of happiness, but there are no babies in these dreams. It is simply unquestionably accepted that pensions come from the government, just as electricity comes out of the wall socket.

Smart politicians know better than to awaken voters from their dream of a fairytale world provided for by an inexhaustible welfare state. Those who are stupid or honest enough to do so stand no chance of political survival. Gerhard Schröder, who took a step in this direction with his Agenda 2010, was immediately punished. He is no longer chairman of his party and no longer chancellor. With his Agenda 2010, Schröder made the first move away from expanding the welfare state further toward a more market-oriented approach since the 1950s. When they saw that more market orientation meant fewer transfer incomes, the Germans quickly lost their appetite for reforms. Many voters moved away from the Social Democrats to the Linkspartei (Left Party), a new party that includes the frustrated former finance minister Oskar Lafontaine and former communists from East Germany. And even the new chancellor, Angela Merkel, who nearly lost the election because her campaign program was too market-oriented, seems to have forgotten her goals. She quickly understood that success can be more easily claimed if a “rich people’s tax” is introduced and if pensions and public health insurance are cross-financed with general taxes so as to please the median voter. Now that she is an elected official, not a candidate, she has become more timid, and there are no signs that she is planning to implement the kind of changes that Germany’s current economic situation requires.

Of course, Germany’s economic problems cannot be solely blamed on recent administrations. Previous administrations bear even greater responsibility for the current mess. The social-liberal coalition of the 1970s got the ball rolling by raising the public debt, and the government of Helmut Kohl mishandled the economic unification of the country with absurd promises and unrealistic policy programs. Present-day politicians are not to blame for the scale of the problem. However, they must be faulted for their abysmal failure to rectify past mistakes.

Germany needs a radical cultural and economic revolution—a revolution as courageous as the one that occurred in Great Britain under Margaret Thatcher, though not identical to it. After 50 years of progressive entanglement, Germany is ripe for this. Who knows, maybe Angela Merkel has a streak of Maggie in her.

Germany’s institutions must be transformed, uncomfortable questions must be asked, and radical rethinking must start. Can the power of the unions continue to be tolerated? Why is the welfare state permitted to pay such generous benefits for idleness? How long can the languishing economy of Eastern Germany be endured, and at what stage will it be simply too expensive to finance a West German standard of living there? Can the ratio of debt to gross domestic product continue to rise? Must the government tax away two-thirds

of even a low-earning worker's returns to additional effort? Why is Germany's population ageing so quickly, and can anything be done about this? Should the childless receive a full government pension? Are immigrants a burden, or a blessing? Are the Germans prepared for competition from Poles, Czechs, Slovaks, and Hungarians, whose countries joined the European Union in 2004? Where is the new Europe headed, and what tricks does the European Union have up its sleeve? These questions demand honest answers, and then Germany needs courageous economic and social reforms with which to buy back its future.

The necessary reforms will be painful, and it will take years before these produce any notable results. This explains why German politicians, forever with an eye on the next election, have balked at undertaking reforms with the requisite rigor.

If the pragmatism of politicians is lamentable, it is at least understandable. What is less comprehensible is the failure of many German intellectuals to recognize a B-grade movie when they see one. Preoccupied with the intricacies of Goethe, Kant, Grass, and Habermas, they neglect the most basic laws of economics. They rest their faith in the primacy of politics, behaving as if optimal economic conditions can be willed into existence, with or without the market.

Democracy in the television age eschews the deep debate of real issues for superficial discussions of flavors of the day. On talk shows, eloquence wins over expert knowledge, and he or she who masters the economics of sound bites wins the favor of acolytes and audiences alike. Serious analysis that gets to the bottom of problems does not see the light of day as stations vie for ratings. The country is on the brink of decline, and still nothing is more important than the outcome of a soccer game, an image of a stout Angela Merkel taking a bath in the sea, or the sex life of Boris Becker.

I never saw as many German flags in my life as during the World Cup soccer championship hosted by Germany in 2006, except in the summer of 1990, when Americans celebrated German unification even more enthusiastically than the West Germans did. While older Germans did not participate in the soccer jubiliations of 2006, for the first time since World War II a generation of young Germans showed an innocent, unencumbered affection for national symbols, enthusiastically supporting their young and dynamic team. The nation is being reborn as a soccer team. As much as I endorse this shift in orientation, given Germany's problematic past, I wish that some of that enthusiasm and sense of coherence could also revitalize the German economy.

Unfortunately, as long as lobbies and political parties pursue their special interests, it will be impossible to find common ground. Unions and

employers still fight over minuscule wage increases. The political mainstream is paralyzed by the rise of the Linkspartei. Each group balks at advancing radical market-oriented reform proposals for fear of being demonized by its political adversaries. The Social Democrats do not dare to continue Schröder's reform path, because they are afraid of losing voters to the new party. The Christian Democrats stay put, because they fear losing votes to the Social Democrats should they sympathize with Thatcherite ideas.

Time passes and no progress is made. Meanwhile, Germany's star continues to sink. The worldwide boom from which Germany is currently profiting gives the illusion that Germany's economy is afloat, but in fact the boom is merely extending Germany's tenuous paralysis as reforms are delayed even further.

Germany may still have a future as one of the world's top economic powers. But this will require a concerted effort to overhaul its welfare state and its economic system (that is, the laws and institutional rules that define the scope of the economic decisions made by firms and private households). The reforms debated in Germany these days are not nearly enough. Nothing short of a new order, in which old taboos are discarded and powerful interest groups are shown the door, will suffice. It is possible that this reconstruction will not occur until Eastern Germany's economy has fallen apart altogether. But there is no time. If Germany wants to secure its economic future, it has to act now. The figures and facts are on the table. All that remains is to do something to set them right.

This is an abbreviated and edited English version of the eleventh edition of my book *Ist Deutschland noch zu retten?* My intent in the German edition was to help stimulate a discussion among the broader German public of the economic issues facing their country.

Sadly, however, Germany's problems are not unique: They are characteristic, albeit on a lower scale, of many other European Union countries. In dealing with its pension system, Germany faces demographic and economic problems that Spain, Italy, and the Netherlands will also be confronting in the coming decades. In fact, the whole Western world, including the United States and Japan, faces similar problems. And the labor-market problems resulting from the increasing difficulties of the welfare state to cope with international low-wage competition by the formerly communist countries are not limited to Germany either. France, in particular, exhibits many of Germany's symptoms and threatens to be the next to succumb to the disease that I describe in this book. The French riots of 2005 and the mass demonstrations against a minimal adjustment of labor-tenure clauses show how badly distorted the French labor

market is and how little the French public understands how the market economy works.

In this English-language edition, it is my hope that studying the German example will also lend insight into the problems facing these other countries, particularly those in Europe. The European welfare state was built after the German model that Chancellor Bismarck introduced in the 1880s. It has come under threat and needs to be overhauled to be able to cope with the forces of globalization and demographic change. Using the German example, I try in this book to explain how this could be reasonably done while respecting Europe's social values and preferences. Whether German politics will follow my recommendations remains to be seen. In any case, some solutions will have to be found, for the historical end of the traditional European welfare state has come, and once again the German solutions may define the direction in which the whole continent will have to move.

My objective in this book is to inform the reader about the state of the German economy, about how a well-functioning market economy operates, and about obvious defects of a welfare state of the German type. But I will try to avoid making prophecies. I am neither a guru nor an evangelist. I am an economist and, as such, I can only describe institutional conditions that, on the basis of past experience and the insights from economic theory, would generate a healthier economy. I do not want to take my readers to a new dream world; I want to wake them up to reality. Successful policy decisions require facts and sound economic explanations. I want the economic arguments to be heard, and I hope that hearing them will enable the reader to separate the wheat from the chaff in the public debate. Only broad public support for tough economic reform will derail the demagogues and the dreamers who now monopolize public discussions. I want a better Europe for my three children—a continent that will give them a future.

I revised the book in Wassenaar, where the polder model, which paved the way for a recovery of the economy of the Netherlands, was initiated in 1982. The Netherlands Institute for Advanced Studies (NIAS), where I am kindly hosted, provides the right *spiritus loci*. Final revisions were made in Munich and in Italy after the annual CESifo Summer Institute in Venice, whose proud republic fell into an irreversible decline.