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## U.S.-EUROPE ANALYSIS SERIES

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### Reform in Germany: Prospects for the New Government

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Foreign commentators and the international press have been skeptical about Germany's new "grand coalition" government, seeing the September election result as a "vote against reforms" and the expression of an apparently innate German desire to stick to the status quo. According to *The Economist*, "this hung vote looks like being a setback for the reform process in Germany."<sup>1</sup> *Le Figaro* fears that "after the vote, Germany may become ungovernable."<sup>2</sup> On the other side of the Atlantic, the *Los Angeles Times* opined that the "[r]esults boost alternative factions and weaken the push for reform."<sup>3</sup> While it is true that the elections did not bring about a clear winner and made forming a traditional coalition government difficult, the new government will by no means be a weak one. Indeed, for the time being at least, the reforms in Germany are likely to benefit from the current power configuration in the Bundestag.

Despite press reports to the contrary, the results were not a clear signal against reforms. The only party in favor of the status quo, the leftist *Linkspartei*, won just 8.7% of the vote nationwide, although it did fare better in Eastern Germany. Polling in the spring and summer of 2005 that predicted a clear victory for a Christian Democrat-Liberal coalition led by Angela Merkel took place at a time when her policy proposals were already well-known. If German voters were opposed to a reformist platform, this would have been visible in the polls. Analysts of the German political scene have, in recent months, failed to point out that all of the main political parties—apart from the *Linkspartei*—supported reform. While they may differ in the scope and the intensity of the reforms they advocate, these parties all understand the necessity of such measures. Moreover, although the results of the elections were confusing in many ways, public opinion polls showed large majorities were in favor of reforms. For example, the 2004 online

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<sup>1</sup> "A surprise that leaves Germany in limbo," *The Economist Global Agenda*, September 21, 2005.

<sup>2</sup> Pierre Rousselin, "Blocage en Allemagne," *Le Figaro*, September 19, 2005. For a compilation of press reports in this vein, see euractiv.com, "German Elections - Media fear 'ungovernability' and 'economic paralysis'", September 19, 2005 at <http://www.euractiv.com/Article?tcmuri=tcm:29-144554-16&type=News>

<sup>3</sup> Jeffrey Fleishman, "German Vote Split, Parties Seek Coalition," *Los Angeles Times*, September 19, 2005.

poll *Perspektive Deutschland* showed that 85% of the 450,000 participants were in favor of reforms.<sup>4</sup>

Reforms in Germany in recent years have stalled on two specific and interrelated questions that are quite distinct from public opinion. Institutionally, German politics in the past few decades have seen a redistribution of power within the federalist system. The German states (*Länder*) have given up their fiscal prerogatives in return for more veto power at the federal level. As a result, the German Upper House (the *Bundesrat*), whose members are appointed by the *Länder* governments, now weighs in on 60% of all federal legislation. German voters have tended, via state elections, to give the national opposition party control of the *Bundesrat*, which has led to numerous political deadlocks. Thus, for example, the Social Democrats blocked the tax reform plans of Chancellor Helmut Kohl's government, whereas the Christian Democrats blocked the federalism reform of Chancellor Gerhard Schröder's government.

Similarly, with regional elections scheduled throughout federal legislative periods, both the Kohl and the Schröder governments routinely came under fire from their respective opposition parties for "unsocial" measures, even if that party had agreed to these measures in the *Bundesrat*. The 2004 controversy in state elections about the "Hartz IV" welfare reforms, for example, saw the Christian Democrats doing precisely that. These types of actions often convinced the central governments to refrain from proposing reforms and in some cases led them to drop reform proposals entirely for fear of losing voters. Schröder scaled down his reform ardor in the middle of his first term when his party lost several regional elections. Helmut Kohl reached a reasonable pace in reform only late in his final mandate and was then unable to implement them.

Merkel's grand coalition breaks the institutional deadlock in that for the first time in years, a single coalition will control both the Lower and the Upper House—the Kohl government did not have a majority in the Upper House from April 1991 to fall 1998 and Schröder lost his majority in the Upper House in April 1999 after just a few months in power.

### **A Common Agenda**

Moreover, most of the reforms initiated by Schröder in recent years were the outcome of cross-party negotiations, a result of having to pass through the Christian Democrat-controlled *Bundesrat*. Because of this, the now formalized grand coalition shares a common agenda on most of the legislative measures that will emerge in the coming months. Cabinet members of both parties, notably the Social Democratic Ministers of the Budget, Peer Steinbrück, and of Foreign Affairs, Frank-Walter Steinmeier, have worked across party lines on many important issues in the past:

- *The reform of German federalism.* A joint *Bundestag-Bundesrat* commission led by Bavarian Prime Minister Edmund Stoiber (a Christian Democrat) and Franz Müntefering (a Social Democrat) worked on the issue in 2003 and 2004, but could

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<sup>4</sup> *Projektbericht Perspektive-Deutschland 2004/05*, accessible at [http://www.perspektive-deutschland.de/files/presse\\_2005/Projektbericht\\_Perspektive\\_Deutschland\\_2004\\_05.pdf](http://www.perspektive-deutschland.de/files/presse_2005/Projektbericht_Perspektive_Deutschland_2004_05.pdf)

not reach a final agreement because of differences on education policies—the *Länder* wanted to regain full responsibility on the issue. According to the chairmen’s statement, however, all other issues were either solved or close to being solved suggesting that a blueprint for future reform may already exist. In the coalition agreement, the two parties agreed to implement the constitutional changes necessary for such a reform (they have the required 2/3 majority in the *Bundestag*). Responsibility for education policy is given to the *Länder*, as are many other policies. For example, with regard to environmental regulations, states will be able to deviate from federal law. In exchange, the power of the *Bundesrat* to veto federal legislation would decrease from 60% of legislation to somewhere between 35% and 40%. Similarly, the *Bundeskriminalamt* (Federal Criminal Office) will now be able to act preemptively in terrorism cases. The coalition agreement emphasized that the federalism reform would only be passed as a whole package.

- *Reduction of Subsidies.* In 2004 a commission chaired by Hesse’s Prime Minister Roland Koch (a Christian Democrat) and Peer Steinbrück, then Prime Minister of North Rhine-Westphalia, applied the so-called ‘lawn mower’ method, suggesting a wide-ranging but nonetheless modest cut in subsidies and tax breaks on everything from tax credits on savings to agricultural subsidies to aid to the coal industry was needed. With subsidies estimated by the commission at 127.3 billion euros a year, the aim was to save 15.8 billion euros from 2004 to 2006 and 10 billion euros every subsequent year thereafter. Although the federal government did not adopt the commission proposals at the time, the current coalition agreement states that “we will be courageous and diminish subsidies.” According to analysts’ calculations, the report calls for subsidies to be decreased by 18.4 billion euros annually.
- *The reform of the welfare state.* Labor market reforms in recent years have been based on ideas shared by both major parties. The so-called “Agenda 2010” would not have been possible without the Christian Democrats’ support. Chancellor Merkel acknowledged the merit of this reform in her inaugural speech, thanking her predecessor for his efforts on the matter, and indicated her willingness to follow the course he had set. Other issues that have often been opposed for political reasons—but which in fact enjoy cross-party support—are the streamlining of the tax system, a reduction of social charges on labor, and the introduction of more market mechanisms in health care. All of which are listed in the coalition agreement.

### **Clouds on the Horizon**

Despite these positive signs, however, a few clouds already loom on the horizon. Most pressing, are high labor costs and low consumption, the key brakes on economic growth. Whereas during the election the Christian Democrats called for reducing social charges on labor by 2% and funding it with 2% increase in the consumption tax rate, the coalition agreement now calls for a 3% consumption tax increase with only a 1% reduction in social charges on labor. In other words, the initial aim of making labor cheaper and more attractive—and thus eventually increasing consumption through a more dynamic economy—seems now to have been sacrificed in favor of fiscal consolidation.

In monetary affairs, the decision by the European Central Bank (ECB) in December 2005 to raise interest rates by one quarter percent—the first increase in 5 years—has been criticized by German commentators and the Organization for Economic Cooperation and Development (OECD) as being premature, given that inflation is still low and economic growth has just begun to take off. While an increase in interest rates might have an adverse effect on slowly recovering business investment in Germany, the German economy as a whole is much less directly linked to rate changes than its Anglo-Saxon counterparts. The rates charged by banks to individual customers are fixed and do not vary with the central bank's decisions. The increase in itself thus is unlikely to deal a fatal blow to the German economy. But the ECB's decision to increase rates, especially if it becomes the first of many such decisions, might spark a discussion in Germany, a country traditionally in favor of central bank autonomy, on the political supervision and the aims of the ECB.

The key factor in determining whether the reform agenda can weather these potential storms will be the new Chancellor herself. Angela Merkel has never been a free-market radical in the mold of Margaret Thatcher, but her desire for reform appears genuine. Her commitment to leading an "honest campaign" has actually been singled out as one of the most important reasons that the Christian Democrats lost their early lead in the polls. In assessing Merkel, the emphasis should be on the way she differs from other Christian Democratic luminaries. She is a female Ph.D. in physics from Eastern Germany in a party largely made up of male lawyers from Western Germany. The party's coherence depends on agreements forged at a time when Ms. Merkel was still living behind the Iron Curtain. All of this means that the new Chancellor desperately needs a strong economy in order to maintain a grip on the party—which is a strong indication that reforms will take place. In all likelihood, Angela Merkel's leadership of the party—and thus her control of the Chancellery—will not last for long. Many of her lieutenants and particularly Lower Saxony's Prime Minister Christian Wulff (seen as an up-and-coming conservative politician) may themselves decide to move to Berlin in the not-too-distant future.

Merkel will have some momentum for reform in her first months in office, but only because she needs a success and because the state of public finances does not give the government much choice. While regional elections will be held again in the spring of 2006, the government will probably be stable until then, if only for the simple reason that none of the parties has a viable alternative at the federal level. The smaller parties have begun to eat away at the larger ones' support: from 1980 to 2005 the combined vote of the Christian Democrats (including their Bavarian sister party, the Christian Social Union) and the Social Democrats declined from 87.4% to 69.5%. They are more likely to try to regain the voters they lost to the smaller parties than appeal to the voters of their coalition partners. Intra- and inter-party power struggles are likely to come to the fore again as the 2009 general election approaches. Either a government break-up followed by new elections, or one of the coalition parties leaving the government to ally itself with the Greens and the Liberals is possible. However, such a move would probably have to be preceded by similar coalitions in some of the *Länder*, which means there would be ample warning.

All in all then, excessive worries at this point about the state of German politics should be seen for what they are. The German population, albeit in a confusing way, has expressed its desire for

comprehensive reforms, and Angela Merkel's government is likely to deliver on a significant number of them.