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Reactions to Globalization: Germany, France, and the USA in Comparison

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This paper was written by Professor Ganßmann for a workshop of our project on “Reactions to Globalization: Germany, France, and the USA in Comparison”. This is a joint project of the German Council on Foreign Relations (DGAP), Berlin, and the Institut Français des Relations Internationales (ifri) Paris, as well as the Institute for International Economics (IIE), Washington, DC. The project is supported by the Otto Wolff Foundation, Cologne, and The German Marshall Fund of the United States, Washington, DC. We greatly appreciate their generous support. At the German Council on Foreign Relations, Dr. Bernhard May is responsible for the project.

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1. Premises

Globalization is real. Of course, there is globaloney, too, for example, when all the changes resulting from the simultaneity of market openings, deregulations, privatizations and accelerated technical change are taken to be results of globalization. However, a new structure of the world economy - supported by new institutional and technical possibilities - has developed in the last 20 years. Globalization means that the links and interdependencies between the units forming the worldwide economic system have simultaneously increased, lengthened and intensified. Globalization as a process implies that events, decisions and activities in one region of the earth have become increasingly important for agents in other, sometimes very far away regions. Globalization can be observed in two dimensions, extension and intensity. On the one hand, we are observing processes which - in their spatial aspects - take place globally. On the other hand, they imply an increased intensity of relations, mutual influences and dependencies. Globalization has consequences, not just for its active proponents, but for almost everybody, because it generates pressures on the whole environment of the (world) economy, which includes nation states, subnational political and social structures and institutions. In many OECD-countries, globalization has at least contributed to the breakdown of institutionalized, corporatist compromises which were established during the "golden-age"-period of capitalist development from the fifties to the mid-seventies. Sweden in the early 90s is perhaps the most drastic example of the breakdown of one of these - more or less implicit - social contracts. The established procedures of wage formation and, thus, macroeconomic regulation (Moene/Wallerstein 1995) lost the support of the employers' association, requiring a set of painful readjustments and the finding of new compromises before the background of a hugely increased unemployment rate.

The new structure and openness of the world economy is not simply a result of economic forces, but also of political decisions made by nation states. Its dynamic requires not only economic innovations, but also adjustments in the political realm, especially - within nation states - in social policies. So far, it is not clear what new forms of institutionalized compromises (between business and labour, shareholders and stakeholders, welfare state clients and tax payers, etc.) will be established. In Europe, several "models" are discussed, since especially smaller European countries seem to be farther advanced in finding ways to cope with the new constellation. In terms of economic performance,

Switzerland, the Netherlands, Austria, Denmark, and, with a remarkable comeback, Sweden have been doing very well, even given the recent downturn of the world economy. By contrast, the "new economy" of the United States did not last too long. A tremendous increase in income and wealth inequalities (Pigetty/Saez 2003) appears to have been the price paid for lowering unemployment in trickle down fashion in the late 1990s. There is an increasing awareness that the bursting of the huge speculative bubble in financial markets is likely to do a lot of harm in a society in which state guaranteed social safety nets are wide-meshed and - in European eyes - far too fragile.

Although advocates of strictly neoliberal economic policies¹ have not been successful in European elections, alternatives to the neoliberal agenda are not well defined. What worked in the smaller European economies is not easily sorted out and even less easily transferable to the larger ones. In part, as we will see, this uncertainty about adequate responses to globalization is due to the inability to distinguish between real, imagined or anticipated impacts of globalization.

2. The Debate

The effects of globalization on the capacity of nation states to preserve some leeway for autonomous decisions about economic and social policies have been controversial even before the term globalization became fashionable. A proposition widely discussed already some twenty years ago was the so-called compensation hypothesis. The increased openness especially of small economies to world market forces generated (or threatened to generate) internal instability and insecurity of employment. Governments responded with increased social security efforts, thus inaugurating the period of quickly expanding welfare states (Cameron 1978, Katzenstein 1985). However, apart from the problem of sustaining growth in government spending simultaneously with further integration into the world economy, this compensating response to externally generated insecurity is held to be increasingly difficult to maintain under current conditions (Rodrick 1997). With progressive globalization, the welfare state is itself

¹ The neo-liberal project aims „to disable state intervention altogether, restricting its economic functions to a minimum and constraining economic policy by rules or delegating it to organs that are not responsive to the political process. In this view the state must be institutionally constrained so that it is unable to yield to political temptations.“ (Przeworski 1996) Why the term "neoliberal" is used for the very traditional shrink-the-state, free-the-market position of the disciples of Hayek et al. is not rationally reconstructable. Paleoliberal (Alexander Rüstow) would be more adequate.

considered to be part of the problem of non- or maladjustment, responsible for labour market rigidities.

This kind of argument in turn has provoked efforts to show that there is no "one best way" in coping with globalization. As an alternative to conservative supply-side strategies, with their standard components of low inflation, low taxes, balanced budgets, deregulation, privatization and further opening to world markets, the feasibility of well implemented and broadly supported social democratic supply side strategies has been demonstrated (Boix 1998, Garrett 1998). However, recently even the premise of all these arguments, namely, that expanding welfare state programs were a reaction to, or a complement of, increasing openness has been under dispute. Rather than exogenous factors, endogenous structural changes leading to increasing tertiarization and its negative impact on employment in "old" industries or agriculture in the 60s and early seventies are held to be responsible for welfare state expansion and the concomitant political regulation of labour markets (Iversen/Cusack 1998). According to this analysis, outside forces, including the impacts of globalization, continue to be much less important than the endogenous dynamics of structural change. Against this, the Cameron/Katzenstein line of argument is upheld by Minnich (2003:46f.) who finds that „corporatism and globalization both increase equality of income, lending support to the argument that, in the most 'globalized' economies, domestic corporatist institutions mediate international market forces, thus maintaining equality.“

By pointing to these controversies I want to emphasize that there is not much of a common opinion concerning the effects of globalization on labour markets and their sociopolitical environments. This discord mirrors the diversity of empirical evidence: Political responses to globalization are quite different in different nation states. They are strongly influenced by traditions and institutions, including those of conflict resolution between capital and labour. Thus, empirical evidence does not confirm the view that „there is no alternative“ to the neoliberal agenda. It rather suggests that responses to globalization have been diverse and path-dependent. These paths correspond roughly to the patterns suggested by established welfare regime typologies (Titmuss 1958, Esping-Andersen 1990): liberal, conservative and social democratic welfare states have reacted differently to globalization, according to different priorities in terms of social values or ultimate political goals. Iversen/Wren (1998) have argued that there exists a "trilemma" for modern service economies be-

tween the goals of income equality, budgetary restraint and high employment. Liberal welfare states opt for fiscal stability and high employment at the cost of steeply increasing income inequality; conservative welfare states opt for budgetary restraint and income equality but have to tolerate high and persistent unemployment; social democratic welfare states sacrifice budgetary stability for high employment while maintaining a high degree of income equality. However, while this is an elegant post factum stylization of developments observed in the 1970s and 80s it is not clear whether the trilemma is real and the options chosen lead to stable positions. In addition, the role of globalization in the trilemma remains controversial. Thus, Schwartz (2001) has argued that welfare states are in difficulties not because of globalization, structural change and unemployment (either as a consequence of technical change or of Baumol's disease) but rather as a consequence of the politics of deregulation and privatization. They have eliminated non-welfare state sources of social security, such as employment security and wage augmenting rents in public sectors or state sponsored and run monopolies (mainly in energy and telecommunications industries). Because of „stranded investments“ (Schwartz 2001: 35), capital owners suffered income losses, too. All these losses led people to turn to the state for compensation. However, since welfare states have lost income sources, too, and are under pressure to lower taxes and stop cross subsidization, their ability to provide protection has declined.

In such a perspective, globalization is less the true cause of increased general insecurity and more a metaphor for externalizing and anonymizing what is really caused by deregulation and privatization. However, let's look at arguments about the effects of globalization.

3. Fears

One characteristic of the public debate about globalization is that it is rarely based on empirical analysis of observable effects of globalization. The fact that some states have succeeded in combining economic openness and strong welfare programs allows for some careful optimism not only with respect to economic gains, but also with respect to the continuing "possibility of politics". By contrast, the more typical stance in the globalization debate is to highlight the breaks, ruptures and dramatic changes which add up to pessimistic scenarios of things to come.

"As borderless capital moves relentlessly around the globe, ignoring national boundaries, it inevitably creates a competition not only over markets but over public policy. Lower wages and limited social policies in host countries tempt the globalizers to use these advantages, to pressure higher wage countries to lower them, thin the social contract, cut back on environmental protection, reduce social security, and trim health and safety on the job. Leveraging is what this amounts to. It is a term that applies equally to the financial attractions of globalization and to public policies, as one nation's more limited social contract is used as an argument for reducing the social contract in the most highly advanced countries. Alongside international trade in products, services and money is the import and export of public policies. This yields a race to the bottom, a competition over which country can offer the lowest wages and the most limited social policies." (Wachtel 1999: 4)

Evidently, most of these pessimistic scenarios are intended as self-defeating prophecies: Doom is certain if you don't change your ways, so you better change them quickly. Less dramatically, but in more detail, the following negative effects of globalization are feared:

(1) On labour markets of rich countries the increased competition of low-wage-countries on merchandise and service markets results in increased unemployment, degradation of working conditions and decreasing legal protection of employees. This pressure is primarily directed towards the low-skilled who either experience higher unemployment or wage-losses (or both).

(2) State organized social protection systems are under pressure from two angles. On the one hand, wage costs are to be lowered and social security contributions are a primary target for such cost cutting. As they

have resulted in a widening gap between gross and net wages they are not only experienced as a burden by business - which always has an interest in cost reduction - but also by employees. For them, the cost-benefit balance of social security (in all its aspects: old-age-, health-, unemployment-, accident-, long-term-care insurances) has deteriorated. This is the inevitable outcome of a shrinking wage share in national income and/or a growing number of welfare state clients due to high and persistent unemployment. This negative trend in the cost-benefit-balance of welfare state programs is likely to continue given aging populations in the rich countries. On the other hand, nation states have more or less reduced their economic policies to competition for investments. If international investors consider high levels of welfare state provision either as an obstacle to high capital returns or as an indicator of fiscal irresponsibility, governments are under pressure to cut back welfare state programs, with the risk of getting drawn into a race to the bottom.

(3) Globalization involves not only competition in terms of wage costs and, therefore, pressure to cut back welfare state programs, but also competition between tax systems. The distribution of tax burdens can no longer be organized according to ability-to-pay, the principle underlying progressive income taxation, but only according to the ability to avoid paying taxes. The higher the (potential) mobility of tax payers, the lower the tax burden. This leads to the fear that nation states will lose so much of their taxing power that a serious underprovision with public goods is imminent.

(4) Global financial markets threaten nation states with similar losses of sovereignty. Extremely accelerated, voluminous and effectively world-wide around-the-clock transactions reduce the leverage of established economic policy instruments, especially of traditional macroeconomic stabilization and employment policies. Deficit spending to stimulate aggregate demand is difficult in open economies and requires close coordination with monetary policy. But autonomous adjustments of interest and exchange rates are no longer feasible tools of governments, even where they are not yet placed in the hands of independent (and in the Euro-zone: supranational) monetary authorities.

(5) A parallel to the race to the bottom social policy is feared to take place in environmental protection policies (eco-dumping), since high protection standards cannot be maintained if too many other economies operate with lower standards and thus with lower costs (the "how can I be good when everybody else is bad"-syndrome).

Opposed to these propositions are direct counter-propositions on the one hand, arguments for positive, compensating effects of globalization on the other hand. In what follows, I do not want to address fears about eco-dumping (5) at all. Concerning vanishing opportunities to tax (3), I will just point to some counter-evidence. Mainly, I want to discuss the issues of low wage competition and diminishing social protection (fears 1 and 2), a discussion which will have implications for the question of the continuing feasibility of national economic policies. Concerning fears (1) and (2) I will hold against them, first, that unemployment in Germany is as high and persistent as it is not because of globalization but mostly for internal (or Euro-zone internal) reasons (section 4); secondly, that unemployment is not so much the result of excessive welfare state protection, but rather of the economic turmoils following German unification (section 5). It is true that the cost-benefit balance of welfare state programs has deteriorated, in the sense that contributors/tax payers get less for what they pay. However, this is not an effect of globalization (or, as another popular prejudice has it, of ageing) but rather the result of using welfare state programs to cushion the effects of the disastrous deindustrialization in East Germany. Welfare state programs are predominantly financed by West Germans in dependent employment². In pointing out such internal causes of unemployment and fiscal strain I do not want to dispute that globalization is real and exerts pressures on the German labour market and welfare state. But the order of magnitude of these effects is, thus far, quite secondary compared to endogenous factors which are responsible for the internationally almost unique inability of Germany to reduce unemployment to a tolerable level³.

If this reading of the situation is correct, it follows that most of the current public emphasis on the necessities of cost-reducing welfare state reforms, of deregulation, of increasing flexibility to enhance German competitiveness in the global economy amounts to barking up the wrong tree. The specter of merciless market forces unleashed by globalization is rhetorically inflated to push for an extra dose of business friendly supply side policies. Some irony is involved, however. If people believe that the specter is real, they will demand more, not less security. In that way, the embeddedness of the German labour market in welfare

state programs may ultimately be strengthened as a reaction to the perceived – rather than the real – threats of globalization. Thus, a misguided debate may have unintended results. The issue is not simply one of opposing globalization and demands for flexibilization on the one hand and welfare state induced rigidities causing unemployment on the other hand. Rather, the real issue is whether it is possible to use welfare state programs to enable, support and strengthen flexible responses to new market demands ("Flexicurity" is the term coined by the Dutch for such a strategy).

Before turning to unemployment, some brief remarks on taxes and public spending (fear 3): That nation states are losing their capacity to tax is not something everybody fears, of course. However that may be, in view of government revenue and spending shares which, in a slowing trend, are still growing, but hardly ever falling, such fears seem to be misplaced. In OECD countries in 1999, total tax receipts (including social security contributions) averaged 37.3% of GDP, after 35.6% in 1990 and 32.8% in 1980. Germany's tax burden as a share of GDP was 37.7% in 1999, slightly above the OECD and clearly below the EU average (41.6%). German taxes are exceptional only insofar as social security contributions amount to a very high 36.6% of total tax receipts (a share second only to the Netherlands' 39.3%), whereas the German share of corporate income taxes (4.8%) is far below the OECD (8.8%) and EU (8.7%) averages (OECD 2002a: 38f.). The latter numbers are interesting. The rather uniform public opinion that the German tax burden is intolerably high must either be simple disinformation or rest on the rather naive conviction that nominal tax rates correspond to effective tax rates. That is not the case. Apart from social security contributions, German taxes are comparatively low. Remarkably in terms of bias, the contribution of wealth taxes to total tax revenues is considerably higher (above 10%) in the "liberal" regimes of the USA, Canada, Japan and Great Britain than the 2.7% share of taxes on wealth in Germany⁴. While overall tax burdens still seem to be growing, tax avoidance or evasion have become major international sports, with an increasing share of corporate profits accruing not where production and sales take place but where taxes are lowest⁵. In short, the "fear" that nation states lose their capacity to tax is unfounded. Rather, tax burdens are more likely to be shifted from the more to the less mobile and, by implication, from the more to the less well-off.

² Formally, employers pay a considerable share of social insurance contributions. I am assuming, in accordance with most analysts of incidence, that social security contributions are in the last instance paid by wage and salary earners.

³ That France and Italy have a similar unemployment record seems to be due to a spill-over effect: The unemployment generating monetary regime of the Bundesbank in the early 90's was shaped by the internal German situation, but extended in its reach to cover the EMS countries. The European Central Bank has continued the tradition of using high interest rates preemptively.

⁴ 1997 OECD tax data according to *Neue Zürcher Zeitung* Nov. 9, 1999

⁵ From the survey of globalisation and tax in *The Economist* (January 29, 2000)

4. Globalization and Unemployment

A standard explanation of unemployment refers directly to globalization. Newly opening global markets induce national economies to specialize increasingly in products which allow for greatest comparative advantages. Countries with high-skilled but expensive labour forces will produce with higher capital intensities, those with cheaper, low-skilled labour forces will produce with higher labour intensities. The old theorem on the equalization of factor prices explains the adjustment processes resulting from such a competitive constellation. "The import of labour intensive goods from low-wage countries has the same effect on the internal labour market as the direct immigration of labour would have: an expansion of labour supply." (Donges 1998: 3, my translation H.G.). The employment chances of the low-skilled in rich countries are particularly damaged under such circumstances because poorer countries will use their comparative advantage to produce labour intensive goods given the availability of cheap and low-skilled labour, whereas richer countries will use less, but high-skilled labour relative to capital. Demand for the high-skilled will remain relatively high there, so that either the wage distance between high-skilled and low-skilled will increase or the latter will suffer higher unemployment (Wood 1995). Wage dispersion increased especially in the USA and the United Kingdom. Where this form of adjustment was blocked - as it was in Germany - by union power and/or welfare state programs preventing the downward adjustment of reservation wages, the theory predicts higher and persistent unemployment, particularly of the low-skilled.

This straightforward textbook explanation of German unemployment has been very popular among those who are either interested in lower wages or believe that lower wages can lead to increased employment. It seems to go well with the fact that US (and, to a lesser extent, British) unemployment decreased along with increasing wage inequality and stagnating real wages for the low and medium skilled, whereas the German labour market showed no significant increase in wage inequality and unemployment increased or persisted on a high level. However, closer analysis has resulted in evidence which contradicts this textbook wisdom: Non-employment of the low-skilled was found to be as high in the US as in Germany, despite the extensive low-wage labour market segment in the US (Nickell 1998). If one can assume that both countries experience similar pressures from globalization, it re-

mains puzzling that increasing real wages of the low-skilled in Germany did not lead to much higher unemployment for them.

One possible explanation suggests that low skills do not mean the same thing in the two countries. Both Nickell (1998) and Freeman/Schettkatt (1999) have demonstrated that educational attainment levels in the lowest skill segment are significantly higher in Germany than in the USA. This is mostly due to the so called "dual system" in Germany. It combines school attendance with an apprenticeship for the vast majority of those who will work in the lower range of the labour market. The difference in educational systems could thus explain why relative unemployment for the low-skilled in Germany is lower than in the USA. The assumed globalization induced shift of demand in favor of the higher-skilled in rich countries would affect the German low-skilled less than those in the USA.

But such a plausible additional argument does not completely solve the puzzle: Why hasn't the breakdown of US real wages in the early 1980s at least compensated for the low skill differential?

One possible explanation is that the skill-biased-demand-for-labour theory, while theoretically sound, is not relevant because the development of world trade and investment was quite different from what was assumed. There is not much convincing evidence that globalization has resulted in increased competition between high and low wage countries. The lion's share of world trade takes place between rich countries. According to Thygesen et al. (1996: 17f.) the share of exports into non-OECD, non-OPEC countries in 1992 amounted to 2.55% of GDP in the USA, 3.16% in Europe and 3.73% in Japan, with corresponding import shares of 3.39% for the USA, 3.26% for Europe and 2.22% for Japan. A look at more recent world trade data (WTO 2003) suggests that although regional trade blocks such as the EU, NAFTA and ASEAN have led to a stronger integration of some of their less developed members into world trade the overall pattern is still tri-lateral, with much of Asia, Central/Eastern Europe and Russia, and most of Africa and Latin America (except Mexico) remaining outside the global triangle formed by North America, Western Europe, Japan and the Tiger states. A similar constellation holds for foreign direct investments. Most of them take place in the OECD-arena⁶. Thus, 85% of the capital newly invested

⁶ From 1984 to 1994, 95% of all FDIs came from fourteen OECD countries. The positive employment effects of these investments, however, were not considerable, since 4/5 of them are mergers and acquisitions (Bundesbank 1997: 74, 79).

by German business in foreign countries from 1998 to 2001 went to rich OECD countries (Bundesbank 2003: 57). Given the relatively small volume of trade and investment flows between poor and rich countries, it is not likely that they will have more than a secondary amplifying effect on unemployment in rich countries.

Considering the evidence on trade and investment flows one cannot escape the impression that globalization so far is mainly a trilateral affair between the rich countries of North America, EU-Europe and Japan. There are differences in wage costs between these countries, but in the sectors exposed to world market competition, they do not appear to be large enough to derive the considerable differences in unemployment from them, especially if wage costs are seen, as they should be, together with productivity. Higher productivity can compensate for the competitive disadvantage of higher wages. This is the standard (and, I think, correct) argument of German industrial unions whenever the loss of competitiveness of German industry is attributed to excessively high wages. German experience in the 1990s suggests that exchange rates have been a much more important factor for growth than wage costs: The expected positive employment effects of wage restraint in the mid 90s were neutralized by the increased value of the DM, whereas the Euro-weakness against the dollar fed an export boom that clearly improved the German labour market situation -- until the US bubble burst.

To sum up this section: It is likely that external forces influenced the German labour market by adding some upward pressure to given high and persistent unemployment. However, globalization which presumably affects all OECD economies as an external force, with its impact varying with their degree of openness and their structural composition, cannot explain the considerable differences between employment developments in the USA and Germany.

5. Eurosclerosis and Reforms

The German unemployment record could only be attributed to globalization if Germany had particularly maladapted to globalization pressures. Indeed, according to one of the major streams of public (or published) opinion precisely this appears to be the problem. German institutions, especially those regulating the labour market, are held to be too rigid in face of the changing requirements imposed on the German economy by world wide competition, whether it be on product markets or in the race for foreign direct investments.

Although German export firms are doing much better than those serving the domestic market and although Germany has attracted a larger share of foreign direct investments (measured relative to GDP) than any other G7 economy (OECD 2002a: 56f.), this supply-side argument is still emphasized by conservative economists, business leaders and the free market advocates among politicians. Nowadays market liberals can be found in all major German political parties - except perhaps the PDS - from high density among the Free Democrats to one or the other self-styled economic expert among the Greens. They all believe that the major obstacles to a smooth coping with globalization are labour laws, welfare state programs and union power. Nonetheless, a considerable part of the Social Democrats and the representatives of the Christian labour movement among the Christian Democrats have for many years acted as a political blocking coalition, defending welfare state programs and unions. Whatever the outcome of this conflict, the intense debate about "Eurosclerosis", the disease held to be responsible for high German (and French and Italian) unemployment, has been largely ideological, based on strong convictions and little evidence. The Eurosclerosis story is subject to the same criticism as the dramatic globalization scenarios: Just as the effects of globalization are likely to be far too small to explain the unemployment differences between pre-globalization and globalization times, institutional rigidities cannot account for the different employment performances of liberal and non-liberal regimes. European labour market rigidities have existed long before the early to mid 1990s, when the unemployment gap between the USA and the big European economies opened. Even given different speeds and extents of deregulation, its effects cannot possibly explain more than a small fraction of unemployment differences. Empirical estimates of the impact of labour market rigidities on unemployment (for surveys see Gregg/Manning 1997, Nickell 1997) have failed to support the Eurosclerosis argument. Various indicators of flexibility do not correlate significantly with unemployment - except for a positive correlation between the duration of unemployment benefits and the unemployment rate. Thus, the share of the difference in unemployment between the USA and Germany which is empirically explainable by the factors held responsible for Eurosclerosis is at best small, implying that the reforms held to be necessary for higher flexibility will not significantly contribute to a reduction of unemployment. Nonetheless, the Eurosclerosis explanation of labour market problems is upheld by German business

associations and most media, continuing a narrative which first emerged in the late 80s: The flexibility of wages, working times, job entry and exit is held to be too low, the incentives structured by welfare state programs reward passivity and are not conducive to more flexibility, the system of wage bargaining is too centralized, etc. (For a recent list of such complaints see Frankfurt Voice, Deutsche Bank Research, 23.12. 2002).

Against the rigidity stereotype, major unions point to the concessions they have made (or been forced to make) during most of the 1980's and 90's: more flexible working times, more opening clauses in semi-centrally negotiated wage contracts, new patterns of partial early retirement, more jobs without legal protection against dismissal, etc. The unions, however, have little public voice and - in Germany as elsewhere - are under the pressure of eroding membership, partly due to structural economic change, partly due to unemployment, partly due to rapid loss of members in East Germany (where union membership was exceptionally high and members were to a large extent simply taken over by West German unions after 1989).

Compared to the almost frozen lines of conflict between business and labour, there is some movement on the political scene. The familiar order of left and right, of union or business friendly political allegiances has been disturbed recently, not as an immediate effect of the election of 1998, with the Social Democrats forming a new government with the Greens, but after the struggle for dominance in the SPD had been won by Schröder and Lafontaine had resigned in 1999.

The tax and welfare state reform projects introduced since then by the government are difficult to distinguish from what the Kohl government had proposed earlier, only to be blocked by the Social Democrats. Some of these reforms are explicitly intended to adjust German institutions to the new globalized economy, enhancing the competitiveness of German business. Nominal⁷ income tax rates will be reduced. As a „green“ element, some of the burden of social security contributions on wages was to be shifted to energy consumption by means of "ecological" taxes, thus helping to keep the wage bill low despite expected increases in spending on pensions and health. The income replacement value of pensions will be further decreased and private provision for old-age income is encouraged and subsidized. Privatization of publicly owned enterprises will continue. These reforms may have improved supply side con-

ditions for firms, but have neither changed labour market nor general macroeconomic conditions to the extent required to reduce unemployment more than incrementally. Of course, one can always argue that reforms have not gone far enough, but that is always true if the objectives are as open-ended as in the neo-liberal project.

Therefore, if the aim really is to reduce unemployment, it is unlikely that the Schröder government can be satisfied with pushing through the conservative supply side reforms that the Kohl government failed to accomplish. It will need to add an effective Social democratic and Green touch to be reelected. This seems to be far more difficult than expected. The politically much heralded "Bündnis für Arbeit" (Coalition for Work), a revival of the top level corporatist negotiating triangle of the 70's (Konzertierte Aktion), has not come up with any major suggestions on how to get the unemployed back to normal paid work. Although the German government - perhaps imitating New Labour in Britain - tends to underline its positive attitude towards business, it has not yet been able to perform the function expected from the state side in such triangular negotiations, namely, to prevent the deterioration of bargaining games into prisoner's dilemma situations. Business and labour still seem to pursue mainly non-cooperative, loss avoiding (maximin) strategies. After the breakdown of the unification boom in 1992 and the failure of their own high-wage strategy of integrating East Germany, unions tried to exchange wage restraint for employment generating investments. When sufficient investments were not forthcoming, they increased wage demands, only to face a worsening investment situation. Partly, this could be a matter of timing. Unions see profits taking off but by the time they are ready to demand their share, profits have dwindled again, as in 1999/2000. As collective actors business and labour rationally distrust each other to the extent that neither side is willing to enter closer cooperation by making concessions now that can only be rewarded later. At least in theory, the government could help overcome these barriers by backing the necessary agreements with political guarantees. In practice, nothing noteworthy has resulted from such neocorporatist consultations so far. As to the future, the scope of participants and the agenda of „Bündnis für Arbeit“ is not comprehensive enough (Lehmbruch 1999) to create the new „social pact“ (Rhodes 2001) necessary to overcome German self-paralysis.

Insufficient scope also is the problem of the „Hartz-Kommission“, a rather hastily constituted body with

⁷ It is too early to say whether the effective total income tax rate will decrease, too. The current German tax system features high progressive tariffs, but, as compared to the rest of Europe, has low effective direct tax rates, which are regressive because of loopholes open mostly for high income earners.

the task of suggesting labour market reforms. The resulting suggestions are clearly shaped by the idea that German unemployment is mostly a mismatch problem. Mismatch can be tackled by improving labour market services to bring together jobseekers and firms with job openings. However, a short look at German Beveridge curves (Nickell et al., 2001: 52) – relating job openings to unemployment – shows not only that job openings are a rare item, but also that unemployment rose without any indication of a worsening performance of the labour market. „The main message transmitted by the Beveridge curves for France and Germany goes squarely against the cliché that high and persistent unemployment is entirely or mainly a matter of worsening functioning of the labour market. It is precisely in France and Germany that there is no sign of a major unfavourable shift of the Beveridge curve during the period of rising unemployment.“ (Solow 2000:5).

6. Endogenous causes of German unemployment

Pursuing an argument developed by Scharpf (1999), who found that Germany lacks employment opportunities for low skilled service workers, Manow/Seils (2000) again propose that the German unemployment problem is due to rigidities in the labour market at the low-skill end. Once more, rigidities are being attributed to the welfare state (high wage replacement and social assistance rates, high tax wedge between gross and net wages). But, as Howell (2002) has argued, the rigidity thesis would imply that countries as the UK and the USA with their flexible, low wage labour markets – in other words: a good share of working poor - have lower relative unemployment rates of the low- vs. high-skilled. As Howell has shown for the early 1990s, this was not the case. And it still isn't. In 2000, the ratios of low skill over high skill unemployment (defined according to educational achievement: less than upper secondary/upper secondary education) were highest in liberal countries with highly flexible labour markets (Ireland 2.7, Switzerland 2.5, USA 2.2, UK 2.0). Conservative Austria (2.1) was an outlier. There was no specific ordering among „rigid“ conservative (Germany, France, Belgium 1.8, Italy 1.4) and employment oriented social democratic (Finland 1.4, Sweden 1.5, Denmark 1.6) labour market regimes (own calculation based on OECD 2002: 316f.)

In short, the skill-bias and mismatch story of unemployment so popular in Germany does not fit the evidence, neither in the globalization, biased technical change or low productivity services variants.

Why then is unemployment in Germany so high and persistent? At the end of the 1980s, before unification, it looked as if the supply side policies which the Kohl government had gradually adopted from 1982 onward would turn into a success. The share of social expenditures had, for the first time since 1974, sunk below 31% of GDP (BMA 1999, Tab. 7.2). There was even a slight budget surplus in 1989. Productivity and employment growth were quite satisfactory. Unemployment had decreased below 6% for the first time since 1982. Only high interest rates gave some cause for concern. Then came unification. In the ensuing years, state expenditures increased rapidly. The public debt doubled from 1990 to 1996. Taxation was not adequately adjusted to the new expenditure requirements. In effect, the tax burden net of social security contributions (as a share of GDP) was slightly lower in the 1990's than in the late 1970's and 80's. But its distribution changed, so that the main sources for financing German unification were the taxes and social security contributions of middle and lower income households. Income taxes on wages and salaries and social security contributions - which are payable only by those in dependent employment up to an income ceiling - increased in 1991 by 13.2%⁸. With the help of the Bundesbank, interest rates increased, so that the already highly indebted public sector slipped into a fiscal squeeze. When the short lived unification boom collapsed, the resulting recession was not amenable to supply side tools. Given the high interest burden the budget could not be consolidated although the government stabilized state consumption and reduced public investment and employment. Rather, the attempts to slow the increase in the public debt depressed aggregate demand, an effect that was amplified by stagnating or slightly shrinking net disposable wages and salaries. Without policies of stimulating aggregate demand via deficit spending, there remained two possibilities to improve overall economic prospects (and thus reduce unemployment): Aggregate demand could be stabilized or increased either by increased spending out of capital incomes or by increased foreign demand. Relying on exports, a sort of macroeconomic mercantilism, is a German tradition. Although profits quickly recovered from the recession of 1993, the hope that increased profits

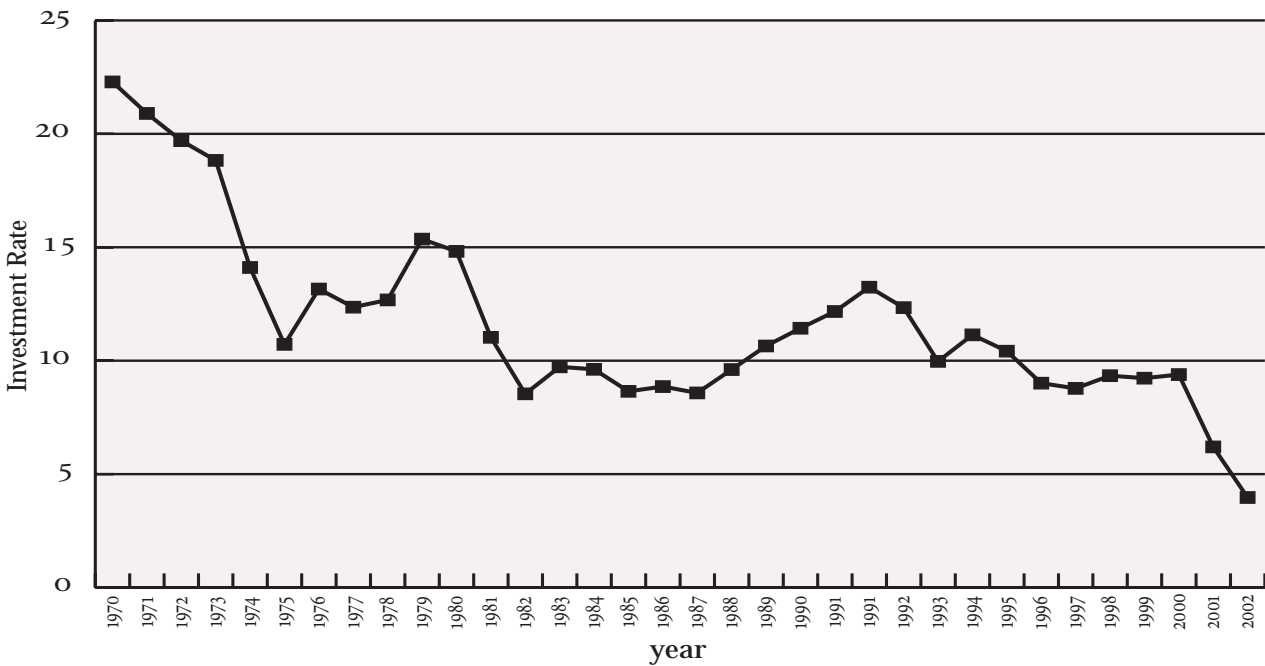
⁸ This caused net real incomes from dependent employment to decrease slightly in 1991.

would translate into increased investment and - via increasing effective demand - into growing employment was not fulfilled. On the export side, restrictive monetary policy together with the crisis of the European currency system (1992) led to an appreciation of the DM, so that exports - helped by wage restraint - started to boom only since 1996. Even under the favorable conditions of 1997/8, however, export growth alone was not sufficient to stimulate domestic demand. The investments required to sustain a rate of growth sufficient to more than marginally reduce unemployment simply did not take place. Thus, German unemployment has more and more become „capital shortage“-unemployment: Investments are too low and slow to create the number of work places sufficient to absorb the unemployed. There can be no doubt that the share of national income going into investments has fallen in the long run, from more than 20% in the early 1970s to a catastrophic all time low

able to increase their returns before taxes by 41% or 5% p.a., whereas total net investment was reduced after the 1993 recession and did not return to earlier levels, remaining about 10% below the 1991 level in 1998. Investments of non-financial corporations were reduced even more, dropping more than 50% in the early nineties, thus exacerbating the recession (Bundesbank, Dec 99: 54f.). German unemployment has to be explained by explaining German investment behavior.

7. Globalization and Investment

If globalization has a significant impact on the German labour market, we will find it in this context. It is hardly the case that German enterprises lost competitive strength internationally by losing markets in zero-sum-fashion to competitors from low-wage countries



of less than 4% in 2002 (calculated according to BMGS 2003 tables 1.8, 1.19).

Schalk et al. (1997: 11) estimated that „capital shortage“-unemployment in West Germany has increased from 3.5% in 1980 to 5 to 6% unemployment in the mid 1990s, where „capital shortage“-unemployment is estimated as the rate of unemployment that will persist when a normal rate of capital utilization is reached. Given the further deterioration of the investment ratio in the last years, the share of unemployment due to capital shortage will have increased considerably. Apparently, investments did not fall as a consequence of falling profits. From 1991 to 1998, German corporations were

in too many industries. Rather, it seems more plausible to assume that the increasing density and speed of international communication and the ease of capital transfers led to larger shares of capital being channelled into financial and/or foreign markets. Partly, this change took place for the simple reason that a regime of flexible exchange rates requires export oriented enterprises to engage in rather voluminous hedging operations (Davidson 1999:102). But - led by US financial markets and exchanges - the great international wave of speculation of the late 1990s made possible gains from purely financial transactions which dwarfed the gains to be made with traditional means of investing capital

in the production and marketing of goods and services at home. Between 1998 and 2001, German capital holdings in the United States more than tripled (amounting to 287 billion €) and grew to be higher than German capital holdings in the EU (271,8 billion €). Of the increase in the US (197,1 billion €, compared to net investments of 372,2 billion € in Germany), more than half went into the financial sector (Bundesbank 2003: 57f). Once the bubble burst, gains proved to be based on mere inflated monetary claims to shares of - worldwide - real production. If they were to be transformed into cash and actual purchases of real goods and services, a large part turned out to be fictitious. Speculative increases in asset values present options on real wealth whose value shrinks once too many want to use these options⁹. But be that as it may, during the speculative boom financial asset values increased dramatically generating returns unattainable by traditional investments. Quite different from the USA, however, in Germany these windfalls did not spill over into the real economy where they would have increased aggregate demand and thus induced strong general growth.

At the same time - and maybe as a collateral of participating in international speculation - German corporations increasingly switched to short term maximizing behavior, thus neglecting the social, ecological or political consequences of their activities. Business associations started a campaign questioning the viability of producing competitively in Germany. Given the background of relocations of some production sites, of foreign investments and of the building of global value creation chains by the global players of German origin, the "Standortdebatte" (location debate) put real pressure both on the shop floor and on the political system. Especially big corporations were able to make their threats to relocate credible. To prevent their use of the exit option, the government - sometimes ill-guided (Thelen 2000) - tried to push through "reforms": Deregulation attempts were to enhance labour market flexibility while cutbacks in welfare state programs were to reduce the part of wage costs which was politically determined. Because of much resistance, not least by the Social Democrats when the party was still in opposition, these reforms took place in small steps only. At the same time, unions had to make concessions, comparatively minor ones with regard to wages, but

significant ones with respect to more flexible working times and employment patterns. But all this was evidently not sufficient to induce business to invest more in Germany again.

8. Perspectives

Given the exit option of business and the possibilities to withhold employment generating investment, the government is in a squeeze, regardless of which party or coalition rules. The risk of increasing unemployment puts politicians under pressure to engage in further cost-saving reforms, deregulation and privatization - all in the name of enhancing competitiveness in global markets. However, the fiscal crisis is real and unabating, partly because the effective corporate tax burden has been steadily reduced, partly because the costs of unemployment remain high despite decreases in individual benefits, and partly because unification still demands considerable public West-East transfers. Given the general - Bundesbank or ECB-lead and Maastrich-treaty imposed - reluctance to increase the public debt, there is no leeway for further tax reductions unless government spending is reduced.

From the side of the electorate, however, expectations are that traditional welfare state financed income maintenance programs are upheld. Globalization or not, cuts can only be gradual if whoever runs the government wants to be reelected. Dissatisfaction because of the deteriorating cost-benefit balance of welfare state programs is already widespread. Despite much emphasis in the media on the necessity of switching to private provision and insurance, however, a vast majority of the population and organized labour continue to hold the state to be responsible for social security. Thus, politicians risk losing electoral support if they tolerate more than incremental deterioration of traditional welfare state programs. But continuing them and being non-responsive to business demands (to lower wage costs, cut back social security contributions, deregulate and privatize) increases the risk that more and more enterprises will not sufficiently invest or even completely choose the exit option, thus destroying the economic feasibility even of reduced welfare state programs. It is no wonder that under these circumstances "third ways" are so popular among politicians.

With or without "third ways", what are the options to get out of this squeeze? Of course, the underlying conflict between a population insisting on continued state organized social protection and enterprises threaten-

⁹ This construction is similar to a model of modern automobile traffic. On average, more than 90% of all cars are parked and merely present mobility options. They are not usable without generating traffic congestions, which proves that complete mobility is impossible.

ing their exodus and exercising pressure by withholding investments can further escalate. Given the German tradition of macroeconomic mercantilism, underwritten by all major political parties, business and unions, it is highly unlikely, however, that such an escalation will lead to a protectionist backlash against globalization. The shared experience of (West-) Germans since World War II is that an open, competitive economy brings huge benefits for all.

Therefore, the escalating conflict will be about welfare state programs and wages. To prevent such an escalation, it should be possible to find a corridor of social compromise by making use of the expected benefits of globalization. Apart from the explosive growth of purely financial transactions in the last 20 years, globalization is a rather slow, gradual process, so there should be enough time to define such a corridor. Globalization and technical progress based on highly skilled labour can generate the additional economic means for social policies likely to be demanded if some or all of the feared negative effects of globalization will become reality: Unemployment of the low-skilled, increased inequality of primary incomes and tax competition limiting the financial leeway of governments. The last two effects imply that financing social policy interventions to compensate the losers of globalization may become increasingly difficult because they involve new patterns of redistribution. Since ambitious redistributive programs that would draw on income from capital to finance welfare state programs are not feasible given the global exit option of capital, the remaining options for financing compensations for globalization losers imply cutting back those transfers which – under current conditions – flow to globalization winners while improving the targeting of transfers to the globalization losers. This is a stony path. One important experience from the era of welfare state expansion was that new programs could be installed only if those not primarily in need, the middle classes, were taken into the boat of welfare state beneficiaries (Goodin/Le Grand 1987). To take from the less needy in order to give to the needy is likely to be much more difficult (Pierson 1994) than the expansionary process of buying the assent of the less needy by including them in programs originally intended for the needy only. However, such difficulties cannot legitimize the return to the politics of benign neglect, to once again letting poverty grow and creating new underclasses. Thus the political task is to convince a sufficient share of the globalization winners that they have to compensate the losers if they want to live in "good" society.

It is unlikely, however, that the means to finance such compensation will come forth voluntarily and equally unlikely that it will be politically feasible for governments to simply increase the tax burden for relevant parts of the population according to ability-to-pay criteria. Instead, governments can propose attractive medium term exchanges, if they can credibly establish win-win-situations of the following type: Political support in terms of infrastructure, research funding and subsidies for qualification and training is granted to potential gainers of globalization, be they firms or individuals, in return for a share of these gains once they actually accrue. These returns can then be used to compensate the globalization losers, but the main emphasis in this exchange should not lie on passive measures. Rather, the number of such losers should be minimized by supporting the growth of a highly qualified work force. Thus, the state would be involved in a dual role: as an organizer of innovative and transformative capacity, which involves strong, reliable long-term support of higher education and research, and – more traditionally – as the welfare state insuring against risks of income loss.

In general, the suggested strategy is analogous to some schemes of financing higher education: The government grants cheap long-term credits to those attending university and demands repayment once the returns for the acquired human capital start to flow in sufficient magnitude. Of course, the risks involved in pursuing such a strategy vis-à-vis globalization are considerable. Nobody can know with certainty which innovations or qualifications will ultimately prove successful. But although nobody anticipated the impact and success of the internet, for example, the general direction of changes towards the „knowledge economy“ or „knowledge society“ is a pretty safe bet. Apart from that, here as elsewhere risk-pooling is a good strategy and nation states still provide the biggest available risk-pools.

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