

Political Parties, Economic Policy-Making, and European Monetary Union

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Abstract: In addition to its economic and symbolic significance, European Monetary Union (EMU) has important domestic political implications. This paper explores the impact of EMU on political parties, focusing in particular on the impact of EMU on the current German Social Democratic-led government. I argue that EMU prevents major political parties from capturing and maintaining the support of key constituent groups because it limits their ability to pursue redistributive policies. This has had three major effects. First, it leads to greater voter volatility as voters see little difference in the economic benefits which might be associated with one party or coalition of parties from coming into office than others. Second, EMU contributes to greater labor militancy as major parties of the left are unable to pursue economic policies that protect the income of workers and unionized labor. Finally, the shrunken policy space for economic policy leads parties to focus on single issues or personality in order to win elections, which tie voters less strongly to specific parties and hence, further contributes to volatility in elections. While the specific consequences depend on a country's institutional arrangements and party environment, I argue that all major parties of the left and right face economic constraints as a result of the limitations imposed by EMU and will have greater difficulties capturing and maintaining the support of their traditional constituencies.

Paper to be presented at the EUSA 8th Biennial International Conference, March 27-29, 2003, Nashville, TN. Panel 11-G, "The Political Economy of the Euro."

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The move by the members of the European Union to complete European Monetary Union (EMU) has significant economic, political, and symbolic implications. EMU contributes to monetary stability and fiscal restraint, reduces transaction costs between members states, and eases the flow of money and goods across borders.¹ EMU has also created a concrete symbol for a European identity -- the Euro -- and is viewed by some analysts as a major step towards a united Europe². Beyond its economic and symbolic significance, EMU also has important domestic political consequences as member governments adjust their economic policy-making to the constraints imposed by EMU.

This paper explores the impact of EMU on political parties, focusing in particular on the impact of EMU on the current Social Democratic-led government in Germany. I argue that EMU prevents major political parties from capturing and maintaining the support of key constituent groups because it limits their ability to pursue redistributive policies. This has three potential effects. First, it leads to greater voter volatility. Because the major parties of the Left and Right must pursue more similar economic policies in the EMU environment, voters see little difference in the benefits which might be associated with one party or coalition of parties from coming into office than another. As a result, voters are more likely to either abstain from voting, switch their votes from election to election between the major parties, or vote for parties of the far-Left or far-Right, which promise to redistribute income to workers and the lower middle classes through immigration and protectionist policies. Second, EMU is likely to contribute to greater labor militancy. Leftist parties are less able to pursue economic policies that protect and benefit workers or unionized labor. To ensure that their concerns and demands are not taken for granted, labor unions must undertake action, such as strikes. Such labor militancy will adversely affect the electoral prospects of major leftist parties. Finally, the shrunken policy space for economic policy leads parties to focus more attention on non-economic issues or on the personalities of individual candidates in order to win elections. Such issues tie voters less strongly to specific parties, and hence, further contribute to volatility in elections. While the specific consequences depend on a country's institutional arrangements and party environment,

¹There have been many studies of the political economic effects of EMU, including Jeffrey Frieden et al., *The New Political Economy of EMU*. (Lanham, Md.: Rowman & Littlefield, 1998); et al.; Michael Emerson et al. *One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union* (Oxford: Oxford University Press, 1992); Daniel Gros and Niels Thygesen, *European Monetary Integration: From the European Monetary System to Economic and Monetary Union* (New York: Addison Wesley Longman, 2nd Edition, 1998); Erik Jones, *The Politics of Economic and Monetary Union*, (Lanham, Md: Rowman & Littlefield, 2002.

²Tomaso Padoa-Schioppa, *The Road to Monetary Union in Europe: The Emperor, the Kings and the Genies*. (Oxford: Clarendon, 1994); see also Jones op. cit., especially Chapter 8.

all major parties of the left and right face economic constraints as a result of the limitations imposed by EMU and will have greater difficulties capturing and maintaining the support of their traditional constituencies.

The paper is divided into five sections. The first section discusses the means by which political parties seek to build electoral coalitions by pursuing economic policies designed to create income effects for particular groups of voters. The second section explores the impact of monetary union on the ability of parties to pursue these policies. The third section explores the constraints imposed by EMU on the Social Democratic-led government in Germany. The fourth section examines the electoral consequences of this limited maneuvering room. In the final section, I draw some implications about the impact of monetary union on European party politics.

Political Parties, Constituents, and Economic Policy-Making

Political parties are not merely reflections of underlying social cleavages, but strategic actors that seek to achieve and maintain political power. To gain power, party leaders must build electoral coalitions and maintain the support of that coalition.³ Since there are limited resources in society and a variety of groups, parties will pursue economic policies that target specific groups for support. Economic policies, and in particular redistributive policies, are particularly important to voters. Politicians can manipulate the market by instituting policies that redistribute income to certain constituents. In doing so, parties capture and consolidate political support. They also limit competition from other parties or even prevent new parties from emerging.

The use of market mechanisms to build and maintain electoral coalitions is universal. Even in non-democratic societies, politicians manipulate markets in ways that help build support for and maintain leaders in power.⁴ In democratic regimes, the need to build and maintain electoral coalitions is even more important since parties in power cannot rely in the last instance on maintaining themselves in office by force but must win votes. Parties in democratic government will pursue economic policies that seek to promote business confidence in order to ensure economic investment and growth.⁵ But economic growth is a public good and such policies do not help to build and maintain electoral coalitions. As a result, parties will advocate and adopt different mixes of economic

³There is a vast literature on the organization and maintenance of parties and party systems, and on party competition including Maurice Duverger, *Political Parties: Their Organization and Activity in the Modern State*, (London: Methuen, 1954); Anthony Downs, *An Economic Theory of Democracy*, (New York: Harper and Row, 1957); Giovanni Sartori, *Parties and Party Systems*, (Cambridge: Cambridge University Press, 1976); and S.M. Lipset and Stein Rokkan, eds. *Party Systems and Voter Alignments: Cross National Perspectives*, (New York: Free Press, 1967).

⁴Robert Bates, *Markets and States In Tropical Africa*, (Berkeley: University of California Press, 1981).

⁵Charles Lindblom, *Politics and Markets*, (New York: Basic Books, 1977).

policies depending on the redistributive consequences of those policies and the effects of securing the support of particular groups. They can use various policy tools including macroeconomic policies, tax policies, social welfare policies, industrial and competition policies, regulatory policies, and industrial relations policies to do so.

In Europe, many of the major parties of the Left and Right cemented their support in the late 19th and early 20th centuries with rise in the political power of the working class and the extension of male suffrage.⁶ They did so by advocating policies designed to redistribute income and provide benefits to particular groups. Whereas leftist parties captured traditional working class populations by advocating social equality and the extension of workers' rights, conservative parties appealed to middle class populations (i.e., farming, small shopkeepers) through regulation and subsidies designed to aid specific sectors. In the post-WWII period, as these traditional groups declined in number, parties often sought to broaden their bases of support in order to win electorally.⁷ For example, as the percentage of the industrial working class declined, socialist and social democratic parties pursued counter-cyclical demand-management policies and universalistic welfare policies.⁸ This enabled them to appeal to working class by ensuring full employment, while at the same time appealing to middle class voters, who benefitted from universalistic social welfare policies.⁹ Similarly, conservative parties of the center right often supported social welfare policies designed to benefit working class as well as middle class voters, as well as regulatory policies that helped business.¹⁰

The economic conditions in the early post-war period facilitated the consolidation of broad based electoral support for the major parties of the center-left and center-right. During the 1950s and 1960s, unemployment was low and growth was high, which enabled them to expand social welfare and income subsidy programs without undermining economic stability. But with the oil shocks of the 1970s and the collapse of the Bretton Woods system, unemployment rose, growth declined, and inflation increased, making it more difficult for governments to pursue economic policies that would

⁶S.M. Lipset and Stein Rokkan, eds. *Party Systems and Voter Alignments: Cross National Perspectives*, op. cit.

⁷Otto Kirchheimer, "The Transformation of the European Party System," in J. LaPalombara and M. Weiner, eds. *Political Parties and Political Development*, (Princeton, NJ: Princeton University Press, 1960), pp. 177-200.

⁸Adam Przeworski and John Sprague, *Paper Stones. A History of Electoral Socialism* (Chicago: University of Chicago Press, 1986); Herbert Kitschelt, *The Transformation of European Social Democracy* (Cambridge: Cambridge University Press, 1994).

⁹Not all countries instituted universalistic welfare state policies. The types of policies depended on the political institutional and party arrangements within the country. See Gosta Esping-Andersen, *The Three Worlds of Welfare Capitalism* (Princeton, NJ: Princeton University Press, 1990).

¹⁰Christian Democratic parties, in particular, supported social welfare policies.

appeal to these broad constituencies and maintain their loyalty. Low growth and high social expenditures led to fiscal crises in many western European states, requiring governments to adopt austerity programs. Changes in the international political economy, in particular the liberalization of capital markets and increased global competition in product markets, also narrowed the ability of governments to pursue demand management and redistributive policies without risking capital flight.¹¹ European economic integration in the 1980s also constrained political parties from implementing income redistribution policies necessary to maintain their support. The single market program and introduction of qualified majority voting, for example, made it more difficult for parties in government to protect small and medium sized firms or national champions.

In order to maintain price stability and foster growth in this new economic environment, some parties began pursuing supply side policies designed to increase the productivity of capital and labor. While leftist parties sought to invest in human capital to increase productivity of workers, parties of the right sought to alleviate the burdens on the business and widen the middle class. But these policies did not provide the same benefits to traditional constituencies. For example, leftist policies to promote educational opportunity do not necessarily benefit those currently in the workforce. Parties of both the Left and Right had to make judgement calls about which support to encourage.¹² For example, policies that reduced inequalities in society might appeal to working class constituents but not to middle class voters.

The changes in the international political economy made it more difficult for parties to maintain and consolidate their support. Ties between voters and their traditional parties weakened during the 1970s and 1980s leading to greater voter volatility.¹³ There was also more labor militancy in some countries as parties were no longer able to meet the demands of their traditional constituents.¹⁴ These problems were exacerbated in the 1980s and 1990s as countries moved towards linking, and then

¹¹Mitterand's decision to nationalize industry after coming to office in 1981 is a prime example.

¹²Jones, op. cit., p. 72.

¹³Mogens Pedersen, "Changing Patterns of Electoral Volatility in European Party Systems, 1948-1977," in Hans Daalder and Peter Mair, eds., *Western European Party Systems - Continuity and Change* (Beverly Hills, CA: Sage, 1983), pp. 29-66; Michal Shamir, "Are Western Party Systems Frozen? A Comparative Dynamic Analysis," *Comparative Political Studies*, 17:1 (April 1984), pp. 35-79; Russell Dalton, Paul Beck and Scott Flanagan, eds., *Electoral Change in Advanced Industrialized Democracies - Realignment or Dealignment?* (Princeton, NJ: Princeton University Press, 1984); Maria Maguire, "Is There Still Persistence? Electoral Change in Western Europe 1948-1979," in H. Daalder and P. Mair, eds., *Western European Party Systems - Continuity and Change* op. cit., pp. 67-94; and Peter Mair, *Party System Change*, (Oxford: Clarendon, 2000).

¹⁴See especially David Cameron, "Social Democracy, Corporatism, Labour Quiescence, and the Representation of Economic Interest in Advanced Capitalist Society," in John Goldthorpe, ed. *Order and Conflict in Contemporary Capitalism* (Oxford: Oxford University Press, 1984).

fixing, their currencies.

The Impact of European Monetary Union (EMU) on Economic Policy-Making

Monetary union further constrained political parties from undertaking economic policies that consolidated the support of their underlying electoral constituencies. Monetary union can be viewed as a evolutionary process designed to increase monetary stability that began with the Werner Plan in 1969.¹⁵ In the late 1970s and 1980s, members of the European Community sought to coordinate their currencies and fiscal policies through the European Monetary System, which was anchored by the German D-Mark.¹⁶ But under the exchange rate mechanism, countries could still leave the system and competitively devalue their currency. This occurred, for example, in the early 1990s, when some countries could not abide by the Bundesbank's restrictive monetary policy.

EMU took monetary union a step further by irrevocably fixing currencies and creating an independent European Central Bank (ECB). With the creation of an independent central bank, national governments ceded sovereignty over monetary policy to the ECB, thereby restricting their ability to stimulate demand by lowering interest rates or competitively devaluing. In order to qualify for EMU, countries also had to have stable currencies and sound finances. The Maastricht Treaty stipulated that member states had to have a consumer price inflation rate within 1.5% and a long term interest rate within 2% of the Europe's top three inflation performers; a fiscal deficit at or below 3% of GDP; and outstanding public debt at or below or declining towards 60% of GDP. Member states participating in the Eurozone also accepted much tighter fiscal discipline under the Stability and Growth Pact, which was approved in 1997. The Stability and Growth Pact was first proposed by former German Finance Minister Theo Waigel out of concern that countries with loose fiscal policies, such as Italy and Greece, would weaken the Euro. Under the Pact, countries taking part in EMU agreed to work toward balanced budgets by 2004. They also agreed not to exceed a deficit in any one year of more than 3% of GDP. Countries that exceeded these limits could be fined .5% of GDP by the European Commission.

EMU limits government's economic policy making options, regardless of the party in power. Governments no longer control monetary policy since a single interest rate is now set for the entire 12 member Eurozone by the ECB, which has a mandate to maintain price stability. Governments are also limited from spending their way out of a recession as a result of the deficit limits imposed by the

¹⁵Frieden et al., op cit., pp. 166-7.

¹⁶For a history of monetary union see Loukas Tsoukalis, *The Politics and Economics of European Monetary Integration* (London: Allen and Unwin, 1977) and Daniel Gros and Niels Thygesen, *European Monetary Integration: From the European Monetary System to Economic and Monetary Union, 2nd Edition*, (New York: Addison Wesley Longman, 1998). For an account of EMU, see Kenneth Dyson, *Elusive Union: The Progress of Economic and Monetary Union in Europe* (London: Longman, 1994) and Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford: Oxford University Press, 1999).

Stability and Growth Pact. While the impact of EMU on individual governments will differ based on the political economic structure and institutional arrangements within a country and countries will still have some choice about the mix of policies they pursue,¹⁷ all parties in government are under pressure to reduce budget deficits and restructure welfare policies in order to compensate for the loss of monetary tools and ensure that they stay within the Pact's limits. For leftist parties, this poses a particular dilemma because it has become difficult to maintain benefits and protection for working and lower middle class voters, whom the parties have traditionally sought to court. Even parties of the right have greater difficulties pursuing policies designed to maintain the support of traditional constituencies as they are forced to cut subsidies.

As the economic policy options for parties in government have become more tightly constrained, parties in power pursue policies that are more similar to one another than in the past. The parties have fewer opportunities to manipulate the market in such a way as to redistribute income to their traditional voting constituencies. As a result of this, we should expect changes in the behavior of these voting constituencies. In particular, three major changes are likely to occur.

First, we should expect greater voter volatility. Parties have a more difficult time providing redistributive benefits to their electoral constituencies. Socialist and social democratic parties, for example, have built strong electoral constituencies by providing labor protection in the workplace and social welfare programs, both of which are now harder to pursue. The weakening of these policy links between voters and specific parties will lead voters to more easily switch their party affiliation and open space for new political parties. As political parties pursue supply side policies, structural reform and austerity measures, voters will no longer see much difference between the economic benefits provided by the major parties of the center left and right. New parties on the far left or far right may seek to exploit these similarities between the major parties by promising to stop the current fall of wages through stricter immigration laws, protectionist, or anti-EMU policies, thus drawing the support of these voters. Yet in some cases, electoral laws and party competition will make it difficult for new parties to emerge. In this case, voters may more readily switch their votes between center-left and center-right parties from election to election based on retrospective evaluations of specific government performance¹⁸ or they may simply abstain from voting. The specific consequences depend on the institutional and political context within which political parties operate including the fragmentation of the party system, the electoral system, and the incorporation of social actors into the policy process. But all major parties who come to power will face difficulties maintaining traditional constituency support and limiting competition from other parties. They need institutional links with specific groups of voters but the limits imposed by the Stability and Growth Pact make it difficult to do so.

¹⁷For the differential impact of monetary union, see Jones 2000. See Peter Hall and David Soskice, *Varieties of Capitalism*, (Oxford: Oxford University Press, 2001) for the impact of integration and globalization on countries with different political economic structures.

¹⁸Morris Fiorina, *Retrospective Voting in American Elections*, (New Haven, CT: Yale University Press, 1981).

A second and related consequence is the growing importance of single issues and personalities in campaigns. As the economic policy space shrinks, parties will have to find other issues in which to mobilize voters from election to election. While economic issues may remain the most important issues to voters, parties have less room to differentiate themselves on economic policy proposals. As a result, they may choose other issues that have more temporal relevance to voters in order to try to mobilize support in a particular elections. However, such issues will not create the same links between voters and parties since they do not have the same redistributive income effects. Such issues may also change more readily from election to election, leading to less electoral stability.

A third consequence of the limited economic policy options for parties is the potential increase in labor militancy. EMU threatens unionized labor in several ways. It limits the ability of leftist parties from redistributing income and reducing social inequalities. Parties cannot increase spending in order to spur growth and reduce unemployment while still remaining within the limits imposed by the Stability and Growth Pact. Indeed, they may be forced to implement austerity measures and undertake structural reforms such as increasing labor flexibility and cutting social welfare expenditures. Such measures will decrease wages and non-wage benefits for workers. Since parties of the center-right are also likely to undertake such policies, labor unions are faced with limited options to make their demands heard. They may choose to work with government and business to moderate wages and influence the specific measures undertaken or they may choose to engage in labor militancy in order to ensure that their demands are not taken for granted and their power undermined.

Thus, the policy constraints posed by EMU, and particularly by the Stability and Growth Pact, have far reaching consequences for political parties. They make it increasingly difficult for parties in government to pursue the types of redistributive policies designed to capture and maintain the support of traditional electoral constituencies. This weakens the institutionalized ties between voters and specific parties and contributes to voter volatility and the importance of single issues and personality in campaigns and elections. And finally, they may lead to increased labor militancy which may further undermine the ability of parties to meet the criteria set by the Stability and Growth Pact.

Germany and EMU: Social Democrats Between a Rock and a Hard Place

In order to examine the impact of EMU on the ability of parties to pursue policies that attract and maintain their electoral constituencies, I examine the economic policy-making of the German Social Democratic Party, which came to power in coalition with the Green Party in 1998. Germany is an important case study not only because it is the largest economy in the EU, but it was also once the economic model of Europe with highly skilled employees, high productivity, a well-developed infrastructure, consensus policy-making, and social peace.¹⁹ Beginning in the late 1980s, it appeared to lose its attractiveness for international investments because of its high levels

¹⁹For a discussion of *Modell Deutschland*, see Peter Katzenstein, *Policy and Politics in West Germany: The Growth of a Semi-Sovereign State*, (Philadelphia: Temple University Press, 1989) and Peter Katzenstein, ed., *Industry and Politics in West Germany* (Ithaca, NY: Cornell University Press, 1989).

of taxation and rigidities in the labor market and welfare system. Yet the pressure for economic policy adjustment in Germany was limited, in part, because it was the anchor currency for EMS and the Bundesbank made its monetary policy based on economic conditions in Germany. Moreover, there were favorable conditions in the global marketplace for Germany's exports.²⁰ But in the past ten years, German GDP has only averaged 1.3% growth, compared to a Eurozone average of 1.9%.²¹ The costs of reunification, coupled with the global economic slowdown and the constraints on deficit spending by the EMU, have worsened the economic crisis in Germany. In 2002, it breached the Stability and Growth Pact's 3% budget deficit limit and it may do so again this year. At a time of slow growth and high unemployment, the Social Democratic Party must undertake austerity measures to comply with the limits imposed by the Stability and Growth Pact. What happens in Germany in response to this economic crisis is likely to have significant consequences not only for the German economy and the Social Democratic-led government, but for the entire Eurozone and, in particular, for the willingness of EU member states to abide by the constraints imposed by the Stability and Growth Pact.

Germany's two largest parties of the left and right, the Christian Democratic Union (CDU) and the Social Democratic Party (SPD), attract the majority of German voters. Each has a group of more or less constant supporters. The most loyal voters of the CDU have traditionally been Catholic voters and middle aged and older voters, who are self employed farmers, shopkeepers, and professionals. The core of the SPD is skilled blue collar and unionized workers.²² In the post-WWII period, both parties have supported Germany's social market economy, which is a capitalist market economy, supported by a social welfare state designed to provide greater security to the population. Both have also supported Germany's consensus style decision-making in which representatives of labor unions and business associations advise the government on policy. However, the SPD is viewed as more sympathetic to the promotion of workers' right and of social welfare policies and hence supported by blue collar, industrialized and unionized workers, whereas the CDU has pursued policies that benefit Germany's large number of small and medium sized enterprises and more generally, the business community. Both parties have led the government in coalition with smaller parties in the post-war period. However, the SPD was out of power for most of the 1980s in part because of its lack of appeal among non-unionized, middle class voters.²³ While labor union families remain the most loyal supporters of the SPD, the number of union

²⁰Karl Kaltenthaler, "German Interests in European Monetary Integration," *Journal of Common Market Studies*, Vol. 40, No. 1, 2002, pp. 78-9.

²¹*London Business School Economic Outlook*, November 11, 2002, p. 15.

²²Lewis J. Edinger, *West German Politics*, (New York: Columbia University Press, 1986).

²³Hans-Georg Betz, "The Evolution and Transformation of the German Party System," in Christopher Allen, ed. *Transformation of the German Political Party System: Institutional Crisis or Democratic Renewal?* (New York: Berghahn, 1999), pp. 44-46.

members has been declining from a peak of 11 million to 7.7 million.²⁴

After 16 years in opposition, the Social Democratic Party came to power in 1998 in a coalition with the Green Party. In order to regain power and win the election, the SPD had to come up with an approach that could appeal to a broad center left constituency, as well as draw voters away from the Christian Democratic and Liberal Democratic (FDP) parties. This strategy required protecting the rights and benefits of unionized families, while at the same time, appealing to the modernizing tendencies of middle class, and professional and salaried employees, many of whom were floating voters. It meant balancing the party's traditional concerns with full employment and social equity with the need for economic flexibility and greater economic growth. Thus, in its 1998 party program, the party emphasized innovation and jobs.²⁵

The dual emphasis was also reflected in the dual leadership of the party. Gerhard Schröder, the Chancellor candidate, advocated the modernization, supply-side approach designed to maintain business confidence and ensure business investment in the German economy. He advocated decreasing the tax burden on individuals, corporations, and small and medium sized firms, increasing flexibility in the labor market, and reducing non-wage costs to business. He supported improved financing for innovative and high technology efforts, and he advocated greater individual responsibility in social security provisions.²⁶ This was designed to appeal to middle class and professional voters. Oskar Lafontaine, the party chairman, represented the left wing of the party. The former premier of the Saarland, a coal mining and heavily unionized area, Lafontaine argued that the way to deal with Germany's economic problems was not market liberalization but rather the stimulation of demand through the lowering of interest rates, a redistribution of income, and greater government management of the economy.²⁷ He advocated lower taxes for low and middle income individuals, higher wages, a tax increase on gas and energy sources, a shortened work week, increases in social welfare programs especially for families, and a looser monetary policy. These policies sought to gain the support of working and lower middle classes, as well as those in the left wing of the party.

The SPD's dual emphasis on innovation and social justice worked as a vote maximizing strategy. In the September 1998 election, the SPD received 41 % of Germany's 60.5 million votes. It maintained its traditional supporters – 48 % of the blue collar workers and 61 % of unionized

²⁴ <http://www.dgb.de/dgb/mitgliederzahlen/mitglieder.htm>

²⁵ SPD Parteivorstand, *Arbeit, Innovation and Gerechtigkeit*, (Bonn: SPD, 1998).

²⁶ SPD Parteivostand, op. cit.; also *Aufbruch und Erneuerung. Deutschlands Weg ins 21. Jahrhundert*, Koalitionsvereinbarung zwischen der Sozialdemokratischen Partei Deutschlands und Buendnis 90/Die Grünen," Bonn, 20.10.1998, <http://www.spd.de/politik/koalition/index.html>.

²⁷ See Oskar Lafontaine and Christa Müller, *Keine Angst vor der Globalisierung. Wohlstand und Arbeit Fuer Alle*, (Bonn: Dietz, 1998).

blue-collar workers.²⁸ Not only was the SPD able to attract union voters, but it also attracted large numbers of salaried employees. Some 1.6 million voters, who normally voted CDU, voted for the SPD.²⁹

Many analyses of the 1998 election suggest that the election was less a win for the SPD than a loss by the CDU. Germany's economic problems had increased during the 1990s as a result of the high costs of reunification, rapid technological change, and increased globalization. Unemployment in 1998 was 12.3% or 4.2 million people, considerably higher than the EU average of 9.9%. In eastern Germany, it was as high as 21%. One out of every four DM or 21.4% of GDP was being spent for interest payments.³⁰ Economic growth was sluggish. Germany had the highest industrial wage and non-wage costs in Western Europe. The tax burden on corporate firms in Germany was 56.23% in 1998, the highest among the G-7 nations.³¹ High taxes make it difficult for companies in Germany to have adequate money for innovation and research. Foreign investment had been declining during the 1980s and 1990s with German companies investing more money abroad than foreign companies were investing in Germany. A number of German firms had already invested overseas to take advantage of lower taxes. Siemens, for example, went to Hungary to do research on diesel turbines in rocket engines.³² The Kohl government was unable to implement major economic reforms and voters increasingly believed that the Kohl government could not effectively solve Germany's increasing economic problems.³³

Thus, once in power, the SPD had to show it could deal with these economic problems. But promoting economic growth and ensuring social justice under the constraints imposed by EMU proved quite difficult. Schröder needed to consolidate labor union support by pursuing policies which redistributes income to unionized workers. Labor unions, which had seen their wages and benefits decline under 16 years of CDU/FDP rule, believed that their interests would be met by the SPD. Indeed, they argued that they needed to make up for the low wage increases and the cuts in benefits they had received during the CDU/FDP governments. The SPD had for years

²⁸AICGS, "Election 1998, Germany in the Year of Decision," p. 1, www.aicgs.org/wahlen/elect98.shtml.

²⁹Ibid.

³⁰For statistics on the economic trends in Germany, see Bundesministerium der Finanzen, *Arbeitsplaetze Schaffen – Zukunftsfähigkeit gewinnen. Jahreswirtschaftsbericht 2000 der Bundesregierung* (Berlin: BMF, 2000).

³¹Bundesministerium der Finanzen, *Steuerpolitik der Bundesregierung*, Working Paper, (Berlin: BMF, 2000), p. 10.

³²Personal Interview, Berlin, July 2000.

³³AICGS, "Election 1998," op. cit.

campaigned on increasing worker representations in companies and maintaining the nationwide wage bargaining system, which characterizes its industrial relations, and promoting programs designed to benefit the working class. The labor unions expected the party to deliver.

Initially, the Schroeder government pursued economic policies that would consolidate support of traditional working class and lower income voters. It reduced taxes on low income families, rolled back some of the modest welfare and labor reforms implemented by the former center-right government, and increased taxes on businesses. Lafontaine, the government's finance minister, also argued that monetary policy must carry a bigger responsibility for reducing unemployment and called on the European Central Bank to cut interest rates. He suggested that the budget deficit constraints in the EU's Stability and Growth Pact were too severe. He and French Finance Minister Dominique Strauss-Kahn wanted to increase the political control over the management of the single currency by strengthening the committee of EU Finance Ministers. Schröder's policies of reducing non-wage costs and a more flexible labor market policy as a way of adapting to a more international market and spurring growth seemed to take a back seat to Lafontaine's approach of using the state to solve unemployment problems and pushing social equity. This antagonized many middle class, white collar voters who had supported the SPD during the campaign. Relations with the business community were also tense. Even within the government and the party, officials wondered whether the government could survive its four year term.³⁴

EMU undermined the viability of policies of the left, which had traditionally been used to maintain the support of the working class. It became clear that the European Central Bank would not bow to political pressure by Lafontaine to lower interest rates, even though Germany could have benefitted from a lower interest rate. Thus, one of the major planks in Lafontaine's approach to job creation -- monetary policy -- was scuttled. Schröder also would not support Lafontaine's proposal to further tax some businesses. Companies including Daimler-Benz were already threatening to take their investments out of Germany, which would only have added to Germany's economic downturn. Unable to move forward with his policy proposals, Lafontaine resigned in March 1999.

In reasserting his position within the party and government, Schroeder could now set the direction of economic policy. Many within his party and in the EU recommended he undertake austerity measures and structural reforms. The Commission, for example, suggested that countries reduce their budget deficits and restructure their welfare policies in order to ensure that countries could compensate for the loss of monetary tools. It told Germany, for example, to reduce its government deficit in coming years by cutting subsidies, transfers to households, and government consumption.³⁵ Similarly, a number of officials in the ministries and Chancellery believed that

³⁴Personal interview, Berlin, July 11, 2000.

³⁵European Commission, *Commission Recommendations for the Broad Guidelines for the Economic Policies of the States and the Community Members*, 11/144/98-N, (Brussels: European

radical reform of the labor market was necessary to spur growth. However, Schroeder did not view these measures as politically viable since it would anger traditional labor union supporters. "If we started with the labor market reform, then we would have a problem, so the strategy is to do less here," said one Chancellery official.³⁶ The majority of the population also supported social welfare programs and were unlikely to support major cuts.

To demonstrate that he was combating unemployment, Schroeder pushed corporate tax reform and an austerity budget. Tax reform had more visible consequences that could be designed to apply broadly to companies and individuals, while reform of the social welfare system and other structural reforms had more middle and long term consequences and would likely lead to short term cuts in benefits. Lower taxes also meant cuts in the budget in order to stay within the limits imposed by the Stability and Growth Pact. Within 18 months of Lafontaine's resignation, the Schröder government agreed to reduce net borrowing by the federal government to zero by 2006 to stay within the guidelines imposed by the Stability and Growth Pact. His government passed budget cuts of \$16 billion including a 7% cut in ministry budgets. It also passed the largest corporate tax cut package in the history of the Federal Republic, which abolished capital gains taxes on the sale of equity stakes by corporate shareholders. And it reduced income tax on top earners and made some cuts in pensions. This was viewed by business and party officials as a paradigmatic shift for the party, aimed at capturing and maintaining middle class support, particularly among white collar employees and high tech professionals, and promoting business confidence. At the time, one member of the Federation of German Industry (BDI) called these moves "quite astounding."³⁷ One Social Democratic Party member suggested that the party had gone farther than he ever thought possible.³⁸

These reforms did not solve the unemployment problem. Unemployment began rising in early 2001. Many of the unemployed have now been unemployed for more than a year. At the same time, employers are complaining about not being able to find enough workers for over one million job vacancies.³⁹ The number of job vacancies, coupled with the high long-term unemployment, suggest that unemployment is not due to cyclical fluctuations in the business cycle but to other, structural factors. Economists, academics, business associations, and even members of the Schröder's government point in particular to the need for greater labor market flexibility as well

Commission, May 6, 1998), p. 9

³⁶Personal interview, Berlin, July 5, 2000.

³⁷Personal interview, Berlin, July 14, 2000.

³⁸Personal interview, Berlin, July 11, 2000.

³⁹*The Economist*, June 29, 2002, p. 51.

as for the reduction of wage and non-wage costs.⁴⁰ Among industrial countries, Germany continues to have the highest industrial wage and non-wage labor costs and the toughest job protection measures.⁴¹ While these were offset in the past by high rates of productivity, other countries surpassed Germany in productivity growth during the 1990s.⁴² These high wage and non-wage costs mean employers won't risk hiring additional workers. Workers may also choose to remain unemployed since benefits are generous rather than taking lower paying, service sector jobs, thus suggesting the need to lower unemployment benefits. But moderating wage and non-wage costs, creating greater labor market flexibility, and lowering unemployment benefits threaten the SPD's traditional electoral constituency – unionized labor.

Union officials and members of the left wing of the SPD were already unhappy with the tax reform and budget austerity measures. "The close relationship between big industry and the SPD cannot go on indefinitely," said one DGB official.⁴³ Some went further suggesting that Schroeder had forgotten the goals of social democracy. One party member said Schroeder did not understand solidarity and social justice; instead, "[t]hey are more concerned with equal opportunity."⁴⁴ While labor union officials said they saw the need for reform to spur growth, they did not want to see a decrease in the protection of workers rights and benefits, or movement away from sector wide collective bargaining agreement, or cuts in social welfare programs, which would increase inequalities. These policies have been the means by which the party has captured and maintained this constituency.

Though union members comprise fewer than one in five workers in Germany, the party still depends on their members. Labor union members have influence within the party organization and even within some of the government's ministries. Regional party associations within the party, for example, have substantial power, particularly in choosing candidates for parliament and delegates

⁴⁰ See, for example, Bundesverband der Deutschen Industrie, *Fuer ein attraktives Deutschland*, (Cologne: BDI, 2000); also Philip Manow and Eric Seils, "The Employment Crisis of the German Welfare State," in M. Ferrara and M. Rhodes, *Recasting European Welfare States*, (London: Frank Cass, 2000), pp. 137-160. Manow and Seils argue that high non-wage labor costs and especially rising social insurance stymies job growth particularly in the service sector and adversely affects the competitiveness of German industry.

⁴¹*The Economist*, June 29, 2002, p. 51.

⁴² Michael Huelshoff, "The Storm Before the Calm: Labor Markets, Unemployment and Standort Deutschland," in Carl Lankowski, *Breakdown, Breakup, Breakthrough*, (New York: Berghahn, 1999), p. 102.

⁴³Personal interview, Berlin, July 14, 2000.

⁴⁴Personal interview, Berlin, July 11, 2000.

to the national conventions.⁴⁵ And approximately two-thirds of SPD parliamentarians are labor union members.

Most importantly, the SPD has relied on labor union members as its most loyal constituents. The German economy continues to be dominated by its industrial sector, and skilled industrial workers and public service employees are particularly well organized. Labor union members can affect the SPD electoral chances in several ways. First, they can do so by abstaining from voting. This undermines the ability of the SPD to win against center-right parties since the SPD and CDU attract similar percentages of the vote.

Second, the labor unions can undertake more militant action. Labor unions are guaranteed the right to strike by the German Basic Law. While they have tended not to strike too frequently, as the union members are threatened by rising unemployment and less able to win policy concessions from the SPD, they may use strike to achieve their goals. For example, while the labor unions agreed in 2000 to hold down wage increases to an average 2.5%, since then they have become more militant in their demands. Germany's most powerful labor union, IG Metall, which represents 2.7 million workers, started a wave of strikes in May 2002, demanding wage increases of 6.5%, which was considerably above the inflation rate. The union reached an agreement with business to raise wages to 4%. The public service union in the fall of 2002 was unwilling to accept a 3% pay hike and threatened work stoppages. But such aggregate wage agreements make it harder for Germany to bounce back from its economic recession. The wage agreements are seen as particularly problematic for smaller and new firms. Yet for the unions, pushing for higher wages may be one of the only ways to protect their interests. They are compelled to undertake more militant action or allow the SPD to continue with its market-oriented policies. As Berthold Huber, the head of IG Metall in the state of Baden Württemberg, said, "Neo-liberalism has meant nothing more than a redistribution of wealth in favor of industry. What people are saying now is that they want a fairer share."⁴⁶ Labor union militancy, however, makes it more difficult for the SPD to hold on to its middle class voter base, who may choose to vote for the Greens or CDU instead. Higher wages also exacerbate the unemployment problem by increasing the cost of workers and decreasing the willingness of employers to hire new workers. It may also lead to capital flight, the cost of which in Europe is significantly reduced under EMU. As a result, higher wages can increase unemployment, which puts more pressure on the budget deficit.

Third, labor unions can keep the government from moving forward with reform. Germany has traditionally had consensus policy-making. Labor unions are consulted on major policy initiatives that affect employees, which basically gives unions significant influence over policy. This may prevent the government from passing measures which adversely affect the union's

⁴⁵ Gerard Braunthal, *The West German Social Democrats, 1969-1982*, (Boulder, CO: Westview, 1983), p. 29.

⁴⁶ Edmund Andrews, "Germany Braces for Strikes as Union Takes Off Gloves," *The New York Times*, May 2, 2002, p. W1.

interests.

The need to maintain labor union support in order to win elections, coupled with the need to build consensus for policies in Germany, made it impossible for Schroeder to pass further economic reforms designed to stimulate investment and growth. Indeed, in the run-up to the fall 2002 elections, Schroeder moved to extend codetermination rights of workers in smaller firms, giving them more say in the workplace. Schroeder did set up a commission in February 2002 to come up with ways of dealing with unemployment problem. The commission, which was headed by Peter Hartz, the personnel director of VW, issued its report in August 2002 shortly before the fall elections. The commission unanimously recommended labor market and unemployment insurance reforms, including providing greater incentives to the unemployed to seek work. But as the federal election last September neared, there were no new initiatives. In fact, the party lost important state elections in Sachsen-Anhalt in the spring of 2002, coming in third behind the CDU and the former east German communist party, the PDS.⁴⁷ Throughout the spring and summer, Schroeder's SPD party remained behind the CDU in the polls. The SPD, which lost votes in the fall 2002 national election, was able to retain power at the national level only because of an increase in Green Party support and a disappointing result for the CDU's potential coalition partner, the FDP. The SPD/Green coalition now has a bare majority of 306 seats in the 603 seat lower house.

Electoral Consequences of EMU: Elections of 2002 and 2003

In the EMU policy environment, the SPD has had difficulties pursuing policies that benefit and consolidate the support of its strongest and most loyal constituents, the working class and, more specifically, unionized workers, while simultaneously dealing with Germany's high unemployment problem. The austerity and supply side measures required to stay within the limits of the Stability and Growth Pact and to spur investment are at odds with the party's need to consolidate working class support. Because the party faces increased difficulties pursuing policies that benefit the working class, ties between the working class and party have become strained. We should, therefore, expect some changes in voter behavior. In particular, one might see increased voter volatility as the SPD finds it increasingly difficult to convince workers of its ability to pursue policies that benefit them. If we examine the federal election of 2002, there is some some evidence of these trends.

First, voter participation in Germany's federal elections in September 2002 declined to 79.1% compared with 82.2% in 1998. While this is high by American standards, it was the third

⁴⁷ "State Elections in Sachsen-Anhalt," American Institute for Contemporary German Studies, April 21, 2002, <http://www.aicgs.org/wahlen/sa402.shtml>. While local politics was key in this election, voters also blamed the SPD for dismal economic circumstances in the state.

lowest turnout in Germany's post-war national elections surpassed only in 1990 and 1994.⁴⁸ This suggests that more voters are abstaining from voting than in the past. Second, the SPD lost 2.4% of the vote overall, and did poorly among workers, traditionally its strongest supporters. Among workers, the party lost 5%, while the CDU gained 8%. Even more telling, were the losses from unionized workers. The SPD lost 7% and the CDU gained 9%.⁴⁹ The loss of its traditional supporters suggests that the SPD has been less able to show workers that putting the party in power results in economic benefits for the working class. Third, while economic issues were the major issue for voters, it was not the major reason why voters voted for the SPD. In 1998, 42% of voters believed the SPD could best create new jobs; by 2002, only 24% of voters believed SPD could best create jobs compared with 38% for the CDU.⁵⁰ Clearly the SPD did not win on economic issues. Instead, the SPD's victory has been attributed to Schroeder's own popularity, his handling of the August floods in eastern Germany, and his strong anti-war stance. Among young voters, for example, for whom Iraq was a particularly relevant issue, SPD vote share went up. But issues like the war against Iraq are only temporal issues and not ones that are likely to tie voters to the SPD for the long term. In the next election, war may no longer be an issue. Indeed, a few months after the federal election, in state elections, war was not a relevant issue.⁵¹

The results of the federal election were mirrored in two state elections earlier this year, the first since the national election in the fall. The SPD had crushing losses in state elections in Hessen and Lower Saxony. There was a record shift in the states between the major parties. The CDU made double digit gains in Lower Saxony and the SPD suffered double digit losses in both states. The SPD won 33.4% of the vote in Lower Saxony, down from 44.5% from the previous election, whereas the CDU won 48.3%, up 12.4% from the previous election. In Hessen, the SPD won only 29.1% of the vote, down 10.3% with the CDU at 48.8%, up 5.4%.⁵² More telling, the SPD lost among core its core support groups in both states. The party received 21% from labor union workers in Lower Saxony and only 12% from this group in Hessen.⁵³ As a result of the elections, the opposition has gained a majority in the Bundesrat, the upper house of the legislature.

Conclusions

⁴⁸Forschungsgruppe Wahlen, "Bundestagswahl 22. September 2002," p. 1, www.forschungsgruppe-wahlen.de.

⁴⁹*Ibid.*

⁵⁰*Ibid.*

⁵¹American Institute of Contemporary German Studies (AICGS), "State Elections in Lower Saxony and Hessen, February 2, 2003, p. 1, www.aicgs.org/wahlen/e2003.shtml.

⁵²*Ibid.*

⁵³*Ibid.*, p. 2.

What do these results portend for the SPD and German politics more generally? Can the SPD still pursue policies designed to consolidate support among its traditional labor union constituency? Must it push forward with austerity measures and labor market reforms in order to survive economically in an EMU environment? More importantly, what implications can we draw from this case study about the impact of EMU on party politics in Europe?

The economic choices of the SPD are highly constrained. With growth at only .2% last year and unemployment at 4.71 million in February 2003 (the highest level since Schroeder came into office), Schroeder must show that he can promote economic growth. But the limits imposed by the Stability and Growth Pact mean he cannot cut taxes or boost public spending to revive growth. Germany's deficit rose to 3.75% of GDP last year, well over the Stability and Growth Pact limit of 3%. It became the second country, after Portugal to breach the deficit limits. While the current interest rates of the ECB may further dampen growth in Germany, Schroeder also does not have the option of devaluing the currency or cutting those rates. David Mackie of JP Morgan Chase suggests, "if interest rates were being set on the basis of conditions in Germany alone, they would be 1.72% lower than the current European Central Bank rate of 2.75%." ⁵⁴ Germany's currency may have been overvalued at the time that currencies were irrevocably fixed, but there is no longer a way to devalue the currency and the ECB does not seem likely to decrease the interest rate substantially in the near future.

The EU Commission declared in January that Germany must take steps to trim its deficit by May 21, 2003. If it does not, the ECOFIN may impose a plan on Germany. The Commission also said that Germany has to curb the rise in its debt which at 60.9% of GDP last year exceed the Stability and Growth Pact limit of 60% of GDP. The Commission is taking a hard line in part to ensure the credibility of the Euro. Pedro Solbes, the EU's monetary affairs commission, said that "Sound public finances are part of the solution, not part of the problem. We can't spend our way out of a downturn in Europe."⁵⁵ Moreover, governments that have implemented austerity measures to balance their budgets and stick to the Stability and Growth Pact limits, believe large states including Germany must also stick to the terms. ⁵⁶

But if the German government continues to tighten its fiscal belt, it may further depress growth in 2003. It is already widely expected that Germany will breach the deficit ceiling for 2003 because growth is expected to be less than 1%. And even if it does undertake structural reforms, the positive consequences of those reforms will not be immediate. And yet, he has little choice but to implement further austerity measures and undertake more radical reforms. These policy

⁵⁴"Europe Isn't Working," *The Business*, January 12, 2003, p. 10.

⁵⁵*The Financial Times*, January 9, 2003, p. 6.

⁵⁶France is also close to breaching the limit. The Commission directed France to trim its deficit by .5% this year.

measures that are likely to further anger labor unions and the leftist members of the party, although it may help consolidate middle class support. Not only is unionized labor declining in Germany, but a January 2003 survey of voters in Germany suggested that many voters in Germany are frustrated with the ability of unions to stymie the party's reform efforts. The survey showed that 58% believed labor unions had a large or very large influence on government policy compared to only 31% in 1999.⁵⁷ In light of this, Schroeder announced on March 14, a package of radical reform aimed at lowering non-wage labor costs, loosening Germany's job protection laws, reforming the social welfare and health care system, and reducing the tax burden on companies with turnover of less than 17,500 euro a year.⁵⁸

If he is successful in pursuing these policies, it will have several consequences. First, it signals an end to consensus policy-making in Germany between labor and business associations and government. Already there is some evidence of consensus policy-making breaking down. This month, the Alliance for Jobs, a tripartite forum created by Schroeder to bring together labor union government and employers associations to deal with unemployment could not reach any agreement. After abortive talks, Schroeder said, "the positions of the unions and employers are too far apart to be brought together. The government now has a responsibility to act."⁵⁹ By breaking the traditional ties to the unions and the tradition of consensus policy-making, the party may have more freedom to act. At the same time, however, it lead to a second consequences, namely, increasing voter volatility in Germany. As a result, it will be harder for the SPD to count on labor union support. Labor union members are more likely to abstain from voting or switch their votes from election to election. Third, it is also likely to increase inequalities in the society and further anger labor unions, leading to greater labor militancy. The social peace that has characterized Germany for most of the post-war period may come to an end as unions find that they cannot depend on the SPD to protect their interests.

If, on the other hand, the current government fails to pass these reforms and narrow the deficit, it would likely further erode support for the Stability and Growth Pact and encourage other countries to also engage in deficit spending. This, in turn, would undermine the Euro's credibility in financial markets and push interest rates higher, which would make it more difficult for many countries to recover. It may also lead countries to call for reform of the Stability and Growth Pact or scrap it entirely. Within Germany, it is likely to lead to a loss of support for the SPD, as it cannot win without the support of the middle classes.

⁵⁷Institut für Demoskopie, Allensbach, "Wachsende Kritik am Einfluss der Gewerkschaften auf die Regierungspolitik," (February 2003), Nr. 2.

⁵⁸"Regierungserklärung von Bundeskanzler Schröder am 14. März 2003 vor dem Deutschen Bundestag," www.bundesregierung.de/regierungserklaerung.

⁵⁹Haig Simonian, "Demand for Reform May Push Schröder Off Fence," *Financial Times*, March 14, 2003, www.news.ft.com

As long as it remains in effect, the Stability and Growth Pact will limit the policy options of political parties in government. Whereas in the past, parties in government could use fiscal policy to ensure full employment and provide a degree of social security, this option has become increasingly constrained. This is not to say, however, that all political parties will converge on the same economic policies. While monetary policy has converged, the national responses to it have differed. First, the effect of EMU on the various Eurozone economies differs depending on the structure of the economy and the political-institutional framework. Some countries have not been saddled with the same public deficits that Germany has had as a result of reunification. Moreover, some countries have more consistently been able to pursue wage restraint as a result of corporatist bargaining, which has given the government more flexibility. All these affect the policy options of political parties in governments.

Second, parties still have different voting constituencies and have some leeway to determine the mix of policy responses to EMU. For example, in debating tax reform in 2000, the CDU pushed for greater consideration of small and medium sized firms, while the SPD was more interested in ensuring that tax reform was spread more evenly and that among businesses, large corporations that employ more unionized workers, would benefit. Thus, the space for economic policy making has narrowed but not closed.

Third, a country's political-economic conditions also affect the policy mix and timing of policy adjustment. Some governments in Europe passed austerity measures in the 1980s and 1990s and have come close to balancing their budgets. Germany with its consensus policy-making has found it more difficult to do so. To understand the varying effects better, more research needs to be done in order to see how the effects of EMU are filtered through the domestic political institutions and affected by party competition. But regardless of the specific effect, the choice of rules for EMU has led to a narrowing of the economic policy space for political parties, and has made it more difficult for parties to pursue economic policies that consolidate the support of traditional constituencies.