

## Economic Survey of Germany, 2006

**What strategy is needed to raise economic performance?**

**How should the consolidation of government finances best proceed over the medium term?**

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### Summary

The German economy appears to be in a position where it could now realise a shift from a regime where demand tended to undershoot supply to one in which more expansionary supply conditions and resulting improved growth prospects feed through into more buoyant demand. The challenge in this context is to make improvements in a variety of areas – long-term growth, employment creation, public finance sustainability – while at the same time preserving what could well be a genuine recovery in short-run activity extending beyond the export sector. A well-integrated strategy is necessary, with policies interacting positively with each other, including further progress in areas with a potential to boost aggregate growth and labour income. Both domestic and international factors can contribute to assuring a dynamic expansion, although only domestic factors are subject to policy measures which the German government can choose. Internationally, continued strong world growth and favourable monetary conditions are important. Domestically, product market reform (the in-depth chapter of this Survey) is precisely an area that has the potential to boost long-term growth and labour income and reduce public deficits through a strengthening of the tax base.

**Fiscal consolidation on the spending side needs to be linked to public sector reform.** While significant progress has been made in recent years in curbing spending, deficit targets have repeatedly been missed and the debt-to-GDP ratio is high. A credible consolidation policy is needed that links expenditure control with public sector reform covering federal fiscal relations, removing distortions in the tax system and making the key government services more efficient. VAT will be increased in order to rapidly reduce the structural deficit by compensating for revenue losses from past reductions in direct taxation. A considerable part of increased revenues will be used to lower social security contributions. It is important to make clear that further consolidation focus on the expenditure side.

*This Policy Brief presents the assessment and recommendations of the 2006 OECD Economic Survey of Germany. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

**The efficiency of the education system needs to be increased.** Securing the supply of highly skilled workers is crucial for the generation and absorption of new technologies. Schools should be regularly evaluated against country-wide or state-wide standards, while leaving schools more freedom in determining suitable ways to reach their targets. Allocation of government funding to universities should be more strongly oriented toward output indicators. All universities should be made independent entities and given the opportunity to introduce student fees coupled with a loan scheme and income-contingent repayments.

**Continued labour market reform is necessary to boost employment.** Major steps in labour market reform were implemented over the last three years. Many measures are steps in the right direction. However, reform needs to be deepened and broadened to create the momentum for sustainable improvements in employment. Further institutional reform of the Public Employment Service is required to better activate the unemployed. Hurdles to labour force participation of older employees and females need to be further reduced. Moreover, more flexible employment contracts are necessary, while at the same time avoiding labour market segmentation. Wage rigidities need to be reduced further to fight very high unemployment rates among the low-qualified.

**Regulation of domestic markets for goods and services needs to become more competition-friendly.** While Germany's outward policies are largely open, and the general competition legislation and enforcement framework is, in most respects, effective, measures need to be taken to reduce the administrative burdens on entrepreneurship and reduce the involvement of the government in business sector activities, notably through accelerated privatisation. Policies favouring small enterprises need to be revised, exposing them to competition of larger firms and avoiding disincentives to grow. In network industries, non-discriminatory access of market entrants needs to be improved. Regulation of professions is among the tightest in the OECD, requiring deregulation in order to reduce barriers to entry. Similarly, qualification-related entry requirements in the crafts sector should be abolished. ■

**What strategy is needed to raise economic performance?**

German economic performance continues to be marked by strong exports, reflecting many years of trend improvement in external competitiveness, but persistently weak domestic demand. To some extent these two trends are linked. Wage moderation, while strengthening competitiveness, has meant weak household income growth, holding back consumption; and lower inflation than in other euro area countries has raised the real interest rate in Germany, while the absence of exchange rate movements due to the single currency is likely to have supported exports. Signs of a pick up of domestic demand have emerged, and soft data on business confidence and incoming orders signal that the recovery may become broader in the near future. However, hard data from quarterly GDP statistics indicate that this process was not yet firmly established until the end of 2005. Overall, the OECD projects that real GDP will grow somewhat above potential in 2006, at around 1.75%, after growth of 1.1% in 2005 (working day adjusted). Continued structural reform can contribute to stronger domestic activity and would improve the capacity of the economy to turn favorable external impulses into higher growth and employment.

The adjustment process of the German economy during a long period of relatively low growth, beginning in 1993, was characterised by a slow, but successful restoration of international competitiveness. Current information on export performance does signal that price competitiveness is by and large restored, lifting the external pressure on wages and prices. The German economy could well be in a position now to realise a shift from a regime where demand tended to undershoot supply which was itself weakening because of inadequate framework conditions, to one in which more expansionary supply conditions and resulting improved growth prospects feed through into more buoyant demand. The challenge confronting Germany in this context is to make improvements in a variety of areas – long-term growth, employment creation, public finance sustainability – while at the same time preserving what could well be a genuine recovery in short-run activity extending beyond the export sector.

To meet such a multifaceted challenge a well-integrated strategy is necessary, with policies interacting positively with each other. Labour market reforms can be particularly difficult to implement, especially as there is a risk of impacting negatively on household confidence. This is why they need to be part of a global package, where further progress is achieved in areas with a potential to boost aggregate growth and labour income.

- Over the medium term, fiscal consolidation – in quantitative and qualitative terms – will have to take place in such a way that potential growth prospects are preserved, with the implication that the bulk of adjustment has to fall on the spending side (including the elimination of distorting tax expenditures) and needs to be linked to public sector reform.
- Despite courageous reforms, a lot remains to be done to reduce unemployment and boost employment creation.

### How should the consolidation of government finances best proceed over the medium term?

- Product market reform is precisely an area that has the potential to boost long-term growth and labour income and reduce public deficits through a strengthening of the tax base. ■

Germany's general government deficit amounted to 3.3% of GDP in 2005, above 3% for the fourth year in a row. While the structural balance improved, considerable spending restraint over the last years was largely offset by weak revenues reflecting both discretionary tax reductions and weak domestic demand. The new government has underlined its commitment to fiscal consolidation and public spending reform. Substantial cuts in spending and tax expenditures are to be phased in over the next four years, generating one half of the overall deficit reduction package. The remaining half of the envisaged consolidation is intended to be brought about by an increase in the standard VAT rate by 3 percentage points in 2007 with one third of additional revenues to be used for reductions in social security contribution rates. At the same time, there are plans to phase in fiscal measures of about ¼ per cent of GDP p.a. to raise medium-term growth and stimulate the economy in the short term. This package foresees inter alia higher spending on innovation and infrastructure, a temporary increase in depreciation rates and tax concessions for refurbishing private homes. Overall, the general government deficit is estimated to be [around 3% of GDP in 2006 and around 2¼ per cent of GDP 2007].

As regards fiscal consolidation, relying to a relatively large extent on revenue increases raises important issues. Consolidation driven by expenditure cuts (including the abolishment of distorting tax expenditures) tends to be more durable and favourable to growth. The increase in VAT, however, should be placed in the specific context of German consolidation which started some years ago with strong emphasis on expenditure control, in association with cuts in direct taxation that increased the structural deficit. Hence, it will be crucial to pursue a credible consolidation strategy via public sector reform, designed to generate positive confidence effects.

**Federal fiscal relations urgently need reform.** Overlapping responsibilities between the federal government and the states are often associated with inefficient resource allocation and can slow federal legislation. At the same time commitment mechanisms at the level of the federation and the states for ensuring strict implementation of consolidation plans can be made more effective. *The new coalition government should use its broad support in both houses of Parliament for fundamental reform of federal fiscal relations.*

- The decision powers of the inter-governmental Finance Planning Committee should be strengthened. Fiscal targets and monitoring indicators need to be formulated in terms of national accounting conventions. Spending paths should be derived and monitored for each government individually.
- Bailing out of states with high deficits by the federal government should be terminated. Solidarity Pact II transfers to the new states should be conditioned on spending adjustment by the new States in favour of investment projects removing bottlenecks for higher growth.

- Inter-governmental co-funding is widespread, resulting in insufficient spending control. Co-funding of regional projects by the federal government should terminate in all areas where substantial spill-over effects between governments cannot be established. This implies, inter alia, that federal investment aid for the states should be abolished and spending responsibilities together with appropriate financing fully transferred to states and municipalities.
- Several administrative tasks, such as tax collection or planning of long-distance motorways, are commissioned by the federal government to the states. In important areas this poses severe principal-agent problems leading to cost shifting and a loss in administrative efficiency. *The range of federally commissioned tasks should be reduced by reallocating tasks to either the federation or the states, respectively.*
- Additional tax revenues generated in a state are almost entirely redistributed between states via fiscal equalisation mechanisms. *Inter-governmental transfers in the fiscal equalisation system should be re-designed so as to reduce the disincentive effects for developing the states' own tax base and tax collection efforts. To this end, transfer claims should be computed on the basis of notional rather than actual revenue. Also, more use could be made of lump sum transfers.*
- The states have only very limited legislative power with respect to taxation, even for taxes whose revenues fully accrue to them. *The states and the municipalities should be given more scope in generating own tax revenues, raising accountability of fiscal policies vis-à-vis electorates.*

**Public-Private Partnerships can be beneficial but need to be handled with care.** The government aims at engaging in more public-private partnerships (PPPs) to finance infrastructure investment, based on an evaluation of costs and benefits over the life cycle of the investment project. While PPPs can be associated with efficiency gains there is a considerable risk that this approach is mainly used for accounting purposes and public sector spending obligations are shifted into the future without backing by a proper multi-year budgeting framework. *The federal government, the states and the municipalities should only engage in PPPs if there is convincing evidence that efficiency gains outweigh higher financing costs of the private sector.*

**Distortions in the tax system need to be eliminated on a broad front.**

Notwithstanding significant reductions in corporate and income taxes over recent years, effective tax rates on company profits and on households' wage earnings remain relatively high by international comparison. Progress has been made in reducing tax concessions, but more needs to be done to make the tax system less distortionary in a wide variety of areas.

- Tax expenditures should be further reduced, widening the scope for reductions in statutory income and profit tax rates.
- Reducing carbon-dioxide emissions through subsidies to renewable energies costs much more, at the margin, than achieving this via the carbon tax. In addition, coal-based generation plants are exempt from the carbon tax. *Subsidies should be brought in line with what is justified on account of measurable*

external effects. The planned harmonisation of energy taxation – terminating the exemption for coal – is welcome. ■

### How can reform of the education system help reap benefits from technological change?

Securing the supply of highly skilled workers is crucial for the generation and absorption of new technologies. Improving the skills of low-skilled workers is one way to reduce benefit dependency and to cope with the effects of increasing internationalisation of trade and investment.

- An evaluation should be carried out to see whether fees in early education discourage attendance of early education facilities. Consideration should be given to provide subsidies to early education and childcare through a voucher system, with vouchers to be used in accredited early education facilities.
- While the states have taken measures to move towards national performance standards, there is not yet a coherent reform programme covering all relevant aspects of education policy. *Schooling attainment should be regularly evaluated in all schools against country-wide or state-wide standards, while leaving schools more freedom in determining suitable ways to reach their targets. Consideration should be given to postponing selection of pupils into different types of secondary schools to a later age. Hurdles for the mobility of teachers across states should be abolished.*
- A new programme provides additional funding until 2011 to highly performing universities. While this is a step forward toward more performance-oriented funding, incentives for universities to raise research performance and teaching quality need to be improved on a broader and more sustained basis. *Allocation of government funding should be more strongly oriented toward output indicators, with funding by the federal government playing a significant role. Administrative allocation of students to universities should be terminated and more choice should be given to students and universities. All universities should be made independent entities and given the opportunity to introduce student fees coupled with a loan scheme and income-contingent repayments. This should not be used as a substitute for public funding.*
- Access to university should be widened, ensuring that non-academic tracks of secondary education prepare better for entry to university. ■

### Which further reforms are necessary for the labour market?

Major steps to strengthen employment performance were implemented over the last three years, focusing on reducing work disincentives associated with unemployment-related benefits, and better activation strategies for the unemployed. However, a range of issues still needs to be addressed to achieve success.

#### **Obstacles to labour force participation need to be further reduced.**

Government plans to phase increases in the statutory retirement age from 65 to 67 years are welcome. Other distortions that create impediments to higher labour force participation of older people and spouses also need to be addressed:

- Channels into effective early retirement outside the public pension system have gained importance, undermining efforts to activate older employees. New legislation cutting extended eligibility periods for unemployment

insurance benefits for the older unemployed marks important progress in reversing this trend. Moreover, exemptions for older benefit recipients to search for employment should not be prolonged further. Subsidies for the old-age part-time work scheme (Altersteilzeit) should be removed.

- Policies to improve the compatibility of child rearing and labour force participation of spouses should rank high on the policy agenda. This reinforces the case in favour of strengthening early education and childcare in accredited facilities. The Government plans to extend childcare support. Financial support for child-minding costs should be more focused on families where both spouses are working.
- Average effective tax rates on labour income of second earners in households should be reduced while free health insurance for non-working spouses should be phased out.

**Work incentives for the long-term unemployed can be improved further.**

The introduction of the new means-tested income replacement scheme (ALG II) for the long-term unemployed and welfare recipients marks progress toward more effective activation of benefit recipients who are able to work. Job-search requirements have been tightened and progress has been achieved in subjecting active labour market measures to evaluation. But several issues remain to be addressed:

- Financial incentives for welfare recipients to pick up work remain low. One option of reform is to lower withdrawal rates of income replacement for welfare recipients who are able to work (unemployment benefits II.). At the same time, replacement rates should be revisited to preserve incentives to take up employment.

**Figure 1.**  
**MARGINAL IMPLICIT TAXATION OF GROSS INCOME UNDER UNEMPLOYMENT BENEFITS II<sup>1</sup>**  
 Marginal implicit tax rate, per cent



1. Taken into consideration unemployment benefits II (Arbeitslosengeld II), housing benefits (Wohnkostenzuschüsse, Wohngeld), child benefits (Kinderzuschlag, Kindergeld), income taxes, social charges for employees. Regulation for western Germany as of fourth quarter 2005. For a married couple with gross monthly income between € 1 600 and € 1 700, the marginal implicit tax rate is strongly negative.

Source: ifo Institute for Economic Research.

- Within such a reform option, preferential taxation of small jobs paying very low earnings, which hardly benefit the unemployed, might be terminated.
- Different schemes exist supporting self employment out of unemployment. *These should be merged in favour of better targeting.*
- The wide application of new work provision schemes at municipalities or welfare associations (*Arbeitsgelegenheiten*) is likely to fail in its present form to ease the transition into non-subsidised employment or to function as willingness-to-work tests. *To avoid generating new unemployment traps the remuneration associated with these schemes should be revisited so as to preserve incentives to take up work on the primary labour market. Welfare institutions participating in the scheme should bear part of its costs.*

**Reorganisation of the Public Employment Service needs to continue.**

Successful public employment service (PES) institutions are outcome oriented. While major steps have been taken to strengthen the placement function of the PES, further measures seem necessary:

- Counsellor-to-client ratios have improved significantly over the last couple of years, but are still below target. *Further administrative reform is required to free resources for activation and placement.*
- Financing and decision powers with respect to getting the long-term unemployed into jobs remain dispersed between municipalities and the Federal Labour Office and differ across municipalities. *Consideration should be given to concentrating responsibilities for benefit and employment policies at one level of administration. Allocation of responsibilities to the Federal Labour Office might be preferable. If instead responsibilities for ALG II-related policies are assigned to the municipalities, this should be accompanied by a financial mechanism, which provides incentives for municipalities to engage in efficient job placement.*
- The obligation for local employment offices to establish subsidised temporary work agencies proved to be costly without improving placement outcomes in general. *This policy should be terminated. Regional Labour Offices should utilise external placement services on a competitive basis.*

**Higher flexibility in wages and work conditions is warranted.** Firm-specific agreements between employers and employees have become a main driver for a higher degree of flexibility in work conditions and wages. Yet, wages need to be better aligned with skills, particularly at the low end of the wage distribution, and responsiveness to differential labour market conditions across firms and regions needs to increase further. Increasing the cost of unskilled labour through the introduction of statutory minimum wages risks counteracting policies that aim at reducing high unemployment rates among the low qualified and at improving employment chances for new labour market participants. Suggested policy action includes:

- Administrative extension of collectively bargained contracts should only be applied if negative consequences for the labour market can be avoided.

- Consideration should be given to widening the scope for wage determination at the firm level so as to better align collective wage contracts with labour market conditions.

**Employment protection needs to become more symmetric.** Strict EPL tends to increase unemployment duration in particular for the low qualified and marginal groups in the labour market. At the same time, reaping the benefits of deepening international integration in goods and factor markets reinforces the need to allow for more flexible labour allocation. Recent legislation in favour of more flexible employment contracts gave preference to non-regular forms of employment, which may contribute to widening labour market segmentation. Plans by the new government to exempt the initial phase of an employment spell from dismissal protection while dropping the option to offer fixed-term contracts are welcome. *Germany's employment protection procedures should be reviewed further to reduce the legal costs associated with dismissals.* ■

### How can reform of product market regulation help strengthen economic performance?

A pro-competitive stance of product market regulation can raise consumer welfare through higher real wages, employment and productivity growth, and strengthens resilience to adverse shocks. While external policies are open, there is considerable scope for making regulation of domestic goods and service markets more competition-friendly. Substantial administrative overhead raises barriers to entrepreneurship, and progress with privatisation has been relatively slow. In some industries sector-specific regulation remains highly restrictive.

**General competition law should not be used to protect small enterprises.** Competition law is generally effective and the Federal Cartel Office is a strong and independent enforcement agency, although fining procedures appear to be lengthy. In the area of abuse of dominance, however, competition law in some cases protects small and medium-sized enterprises (SMEs) against aggressive competition by larger firms even if such competition enhances consumer welfare. *Fining procedures need to be made more efficient. The Cartel Office should strengthen the analysis of economic effects of conduct, and not emphasise the protection of small firms on the grounds of them being small.*

**Government sector involvement in business sector activities needs to be scaled down further.** Government ownership of enterprises remains considerable and is concentrated in the network industries, giving rise to concerns over conflict of interest. State aid to business has also been generous in international comparison. Many government support programmes target SMEs and are linked to firm-size limits, which may generate unintended incentives for firms not to grow. *Privatisation of public sector enterprises should be accelerated. State aid to enterprises should be phased out, except where there is evidence that the aid offsets efficiency losses resulting from market failure.*

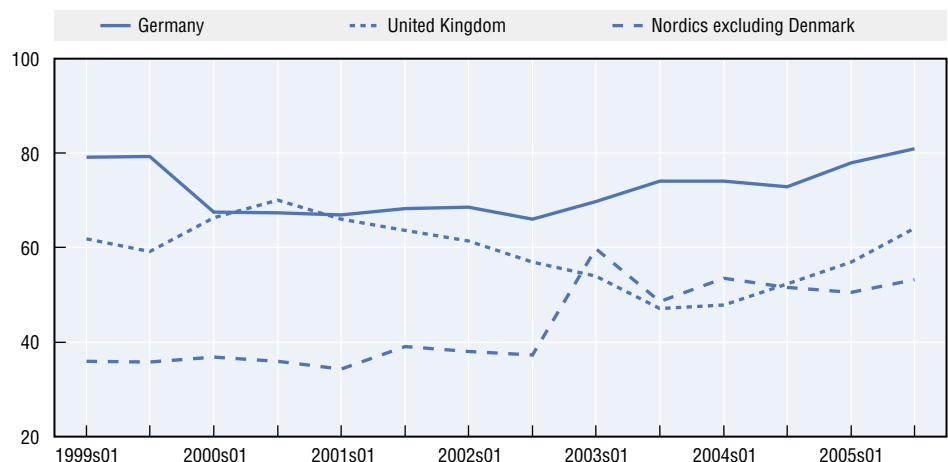
**Administrative burdens impede firm entry.** New firm creation as well as potential foreign market entrants and innovative firms are still particularly subject to the adverse consequences of high administrative burdens, although

efforts to reduce administrative overheads have already been made and the federal government has announced initiatives to this end. Business conduct regulation is input-oriented, favouring insiders, and dispersed responsibilities across different regulatory units add to administrative burdens. Entry barriers remain high in public procurement. Regulatory impact analysis is not yet firmly established, although some states have started to reconsider the appropriateness of existing regulations and have introduced a screening process for new regulations. *Attempts should be made to replace regulation defining inputs by regulation that sets output targets. Related auditing competencies should be bundled within one agency only. Expert groups to assess the regulatory burden for enterprises and households of existing regulation should be established at all layers of government. Regulatory impact analysis should be incorporated in the legislative process at the federal and state level.*

**Notwithstanding significant reform regulatory challenges in network industries remain.** Germany moved relatively early in opening network industries to competition, notably in the energy sector and the railways industry. However, the regulatory framework conditions introduced were not conducive to sustained competition, notably in the energy sector, where regulation largely relied on voluntary agreements between market participants. The introduction of a single sector regulator (FNA) for telecom, energy and railway industries provides an opportunity to accelerate the pace at which genuine competition develops. A single network regulator may potentially reduce risks of regulatory capture and the FNA is formally independent from the government. In the energy sector ex-ante regulation as well as legal and operational separation of network from potentially competitive activities have been introduced.

- In the energy sector, the FNA appears to be overly restricted in assessing the costs of network providers. It should be carefully monitored whether network access prices in the energy sector are determined according to the costs of the most efficient providers. Countries which have introduced ownership unbundling of key potentially competitive activities from the network

**Figure 2.**  
**EVOLUTION OF**  
**ELECTRICITY PRICES**  
**FOR LARGE INDUSTRIAL**  
**CONSUMERS**  
**Euros/megawatt hour**



Note: All prices exclude all taxes. 2005s01 refers to the first half of 2005.

Source: Eurostat, New Cronos.

activities reap bigger effects from liberalising energy markets. It should be considered to extend the separation of network from potentially competitive activities to ownership separation between electricity transmissions network operations and electricity generation. Electricity generation companies and wholesale gas suppliers should be prevented from acquiring further stakes in distribution networks.

- In telecommunications markets, some regulatory decisions favouring competition have been introduced with some delay in comparison to other European countries. *In telephony delays in the implementation of decisions by the network regulator should be monitored and further delays prevented.* Resale of unbundled local loop connections has become a major means of obtaining access to the local loop for competitors. Current regulation excludes the option of introducing compulsory resale of unbundled local loops to competitors until July 2008. *This deadline should be brought forward.*
- Competition in railway services has developed slowly and incentives for implementing more aggressive cost saving measures are weak. *Railway network access charges should be more effectively regulated. The federal and state railways regulators should oblige the incumbent operator to rent out rolling stock at non-discriminatory conditions. Competitive tendering of regional rail service contracts should be made compulsory. Further reforms should aim at achieving more effective separation of the network from transport services.*

**Regulation impedes competition in the liberal professions and the crafts.**

Regulation of (liberal) professions is among the tightest in the OECD. Some professions have rules with respect to exclusive assignment of tasks and the setting of prices for some services. Moreover, associations are often involved in determining the content of regulation, which is likely to strengthen the power of incumbents at the expense of new entrants. *Legally-set price schedules should be phased out as soon as possible and should not be replaced by recommended fee schedules. Conduct regulation needs to be reconsidered.* In the crafts, most existing businesses remain tied to a qualification requirement or a track record of professional experience, generating considerable entry costs. *Qualification-related entry requirements for company owners in the crafts sector should be abolished.*

**Restrictions on opening or expanding large retail outlets should be reduced.**

Large surface retailers have helped lower consumer prices and boost productivity performance in several OECD countries. In Germany permission for new large scale retail centres may be denied if their adverse impact on established retailers in adjacent municipalities exceeds certain thresholds. *Consideration should be given to taking more fully into account consumer benefits that arise from easing restrictions concerning the setting-up of large retail outlets. ■*

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