

Economic Survey of Germany, 2004

Summary

With the effects of adverse external shocks diminishing, a strong and competitive export industry is helping the German economy out of a three-year period of near stagnation. Domestic demand has been declining over the last couple of years, as poor labour market performance has weighed on consumer sentiment and business confidence. The labour market still suffers from weak economic growth and distorted incentives, with both contributing to problems in taking up work and providing employment. Productivity growth is not high enough to compensate for the adverse effect of low labour utilization on economic growth. Fiscal targets have been missed on account of both cyclical and structural factors. The government has launched a major reform initiative to reinvigorate economic growth. These reforms are welcome, have to be continued and need to be broadened further to reduce government debt, remove fiscal distortions, and improve incentives to supply and demand labour. Furthermore, there remains considerable scope to foster the creation of new enterprises and widen product market competition, thereby also maintaining the strong innovative capacity of the economy. The major challenges are to link fiscal consolidation to public sector reform and to increase the capacity of the economy to create employment and increase productivity growth. To create confidence and to restore Germany's traditional economic strength it is necessary that reforms reflect a coherent vision about the reorientation of economic policy – combining a growth and stability oriented macro-economic policy with structural reforms – and are implemented according to a transparent and predictable roadmap.

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This Policy Brief presents the assessment and recommendations of the 2004 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.

After phased income tax reductions that contributed to the rise in the structural deficit, priority should now be given to balancing the budget within a limited number of years. For the consolidation process to have maximum beneficial effects on economic activity, much will depend on casting it within a consistent framework that links budgetary improvement to public sector spending reform. The efficiency of the public sector should be increased by providing more scope for output performance budgeting. There remains room for a fully financed tax reform reducing the welfare costs of taxation by cutting high statutory tax rates while broadening the tax base by reducing tax expenditures. On current plans the structural balance is projected to improve by $\frac{1}{4}$ percentage point per year, which is clearly not enough to prepare for ageing related spending increases.

Important steps have been undertaken to reform health care and pensions, marking progress in re-establishing fiscal sustainability. Increasing co-payments, reducing the catalogue of fully funded health services and involving health funds in managed care should allow insurance funds to contain contributions. More could be done to reduce the power of special interest groups and increase the scope for insurance funds to play an active purchaser role. Progress in pension reform should continue by announcing soon a phased increase of the statutory retirement age. Fiscal subsidisation of the funded system should be reconsidered.

Major reform steps to make the German labour market more conducive to employment creation have been legislated and are being phased in. Employment protection legislation (EPL) has been eased, including an increase in the employment threshold above which dismissal protection is binding for small firms. Benefit duration for older workers without job search requirements will be substantially reduced. Unemployment and social assistance will be merged. Active labour market programmes are to be evaluated more systematically. These reforms have to continue and should be broadened. In addition, fiscal obstacles to higher labour supply and demand should be removed. The efficiency of placement services must be further increased and job search requirements should be enforced regardless of age. Active labour market programmes which turn out to be unsuccessful should be terminated. The scope for individual agreements on wage and non-wage aspects of a labour contract should be increased. Opening tertiary education to more competition and widening the autonomy of educational institutions with respect to achieving targets should contribute to more effective human capital accumulation.

Competition in product markets should be further strengthened by removing entry barriers and making more progress in reducing administrative overheads. The part of the large German procurement market which falls below EU thresholds should be opened to greater competition, requiring *inter alia* making transparent the multitude of regulations on lower levels of government.

Key indicators show Germany belonging to the countries in the OECD with strong innovation activity even though some weakening in Germany's position relative to other OECD countries has occurred recently. Measures to improve the framework conditions for innovation should include removing disincentives to take risks and to provide capital to new firms and raising the efficiency of the higher education sector. Furthermore, making labour markets more flexible and increasing the scope for competition overall, as well as reducing administrative opacity, would improve the capacity of the German economy to innovate and contribute to higher potential growth. ■

How can economic performance be raised?

With the effects of adverse external shocks diminishing, the German economy is currently recovering, ending a couple of years in stagnation on the back of its traditionally strong, competitive and innovative export-oriented manufacturing sector. However, the economy is far from operating at full strength due to the weakness of final domestic demand. Poor labour market performance continues to weigh on consumer sentiment and business confidence remains volatile. The labour market suffers from weak growth and distorted incentives, with both contributing to problems in taking up work and providing employment. Although monetary conditions should remain supportive for GDP growth in the euro area, a persisting German inflation differential relative to the euro area average would mean that real short-term interest rates risk damping the recovery of demand in Germany to an extent, which may not be compensated by the corresponding gain in competitiveness. Cyclical weakness and the structural problems of the economy impact strongly on public budgets, while uncertainty about how public finances will be put on a durably sustainable path is a further factor undermining confidence. Re-establishing Germany's traditional economic strength requires a comprehensive policy response within a coherent framework.

The German government has responded to this challenge by taking significant steps to reform labour and product markets, and substantial reforms to the social security system have recently been legislated. While not all measures are yet in force, the thrust of these reforms is appropriate and can be expected to improve labour market performance and business dynamism in the medium term. To create confidence it is necessary that reforms reflect a coherent vision about the reorientation of economic policy and are implemented according to a transparent and predictable roadmap. For economic performance to be raised in a durable way, it is indispensable that the reforms be continued and deepened. The main challenges in this respect are:

- Linking sustainable consolidation of general government finances with public sector reform. This would include, *inter alia*, reforming budgetary procedures, including those governing federal relations, reducing distortions of the tax system, reforming long-term care and continuing with health and pension reform, as well as harmonising public and private sector labour and pension regulations.
- Enhancing employment creation through better incentives to supply and demand labour, a more efficient management of labour market policies and greater responsiveness of wage formation to labour market imbalances.
- Strengthening productivity growth by fostering product market competition and the economy's capacity to innovate.

Moving in parallel to address these challenges simultaneously is essential for reaping the synergies across reforms in the different fields. ■

Is fiscal consolidation ambitious enough?

Fiscal consolidation resumed in 2003, with the cyclically adjusted balance improving by ½ per cent of GDP. This improvement did not translate into lower public deficits, however, mainly due to unforeseen cyclical and structural shortfalls in direct and indirect taxes. With economic activity stagnating, the general government deficit deteriorated to almost 4 per cent of GDP, nearly ½ percentage point higher than in 2002. Another fiscal consolidation package is being phased in this year and next, comprising *inter alia* cuts in subsidies and tax expenditures as well as revenue raising measures, including a tax amnesty with preferential taxation of repatriated assets. At the same time substantial income tax reductions will become effective, partly brought forward into 2004

from 2005. With further reductions scheduled for next year, income tax cuts amount to some one per cent of GDP. The overall deficit is likely to decline to close to 3 per cent of GDP in 2005, helped by strengthening economic activity. On balance the OECD projects that the structural deficit will improve by ¼ per cent of GDP both this year and in 2005, less than officially projected due to expected revenue shortfalls. Repeatedly under-achieving fiscal targets undermines confidence. Public finances need to be put back on a sustainable path, which requires a balanced budget within a few years and surpluses further ahead. ■

How can public sector reform make fiscal policy more effective?

While most consolidation measures that are being phased in have a lasting effect, there is a need for more fundamental spending reform in order to address a number of counterproductive features of Germany's public sector. In their present setting, Germany's federal relations make it difficult to find the necessary political consensus for fiscal reforms, often involving complicated mediation processes between the Bundestag and the Länder chamber of Parliament (Bundesrat), whose outcomes are hard to predict. The working of market forces is hampered by a high tax-wedge on labour while persisting subsidy programmes reduce economic efficiency. Parameters of important ageing-related spending programmes are not sufficiently adjusted to predictable demographic changes and make future contribution changes likely. Special tenure and pension schemes for civil servants reduce labour mobility and make it more costly to reduce public sector employment. Measures which address these issues are explained in more detail below.

Against the background of the various fiscal pressures that are impinging on the general government budget, strict prioritisation of public sector spending projects is required for the sustainability of public sector finances. This can be fostered by a simplified output-oriented budgeting framework that presents to parliament budgetary appropriations for programmes, together with analysis of associated costs and benefits. Such a reform should be introduced and embedded in a medium term budgeting framework. Moreover, untangling the responsibilities of the federal government and the states and communities is one of the most pressing tasks in order to increase the speed and transparency of federal decision making. Reducing the degree of co-financing between the

different levels of government and introducing a higher degree of tax autonomy for the *Länder* and communities, as has been proposed in earlier Economic Surveys for Germany, would go some way towards making decision processes at the federal level simpler and more transparent. In this context the setting up of a high level commission to look for a consensus on modifying those constitutional provisions governing federal relations is a welcome development. ■

Does the tax system need further reform?

Despite substantial income and corporate tax reductions, phased in since 1999, average and marginal tax rates on incomes in Germany are relatively high in comparison to major competitors and the new EU accession countries. At the same time, many special rules of taxation and tax concessions imply that the deadweight costs of taxation are high and the tax code is complex. In particular, the tax system disadvantages the financing of start-ups relative to investment in established firms. Also, certain tax rules hamper investment in equity capital and the broadening of equity capital markets. Abolishing such distortions is likely to improve not only the efficiency of the economy but also its capacity to innovate. Further tax reform should therefore focus on reducing the deadweight costs of taxation by cutting both tax expenditures and statutory tax rates and should be fully financed. ■

Should special programmes for the East be phased out?

Self-sustained growth in the new *Länder* is still lacking, unemployment remains persistently high, and productivity is still some 30 per cent lower than in the west. There is evidence that the structural weaknesses of the eastern German economy are unlikely to be remedied by special subsidy programmes. Indeed, the OECD has argued in the past that persistently high subsidisation and inefficient labour market policies have biased the structure of the economy and reduced its adaptability to market forces. Hence:

- The objective of applying the same set of rules for subsidisation to the whole of Germany should be consistently pursued and enforced effectively.
- Regulatory reform should also apply to all of Germany. However, as a second-best solution, some discretion might be given to economically weak areas in Germany to establish pilot projects of regulatory reform. ■

Can the efficiency of health and long-term care spending be raised?

Health care spending in terms of GDP remains among the highest within the OECD while significant room for efficiency improvement remains. Recent reforms have reduced the share of health care services that are fully financed by the public system and have increased the scope for selective contracting between health care providers and insurance funds. Future reform should:

- Further widen the scope for selective contracting.
- Consider reducing the collective role of the doctors' and insurers' associations in bargaining supply conditions.
- Strengthen quality control by securing the independence of the supervising bodies.

Since the end of the 1990s the long-term care insurance has been in deficit, and spending pressures are set to increase substantially, mostly as a result of population ageing. Measures that should be taken to increase the efficiency of the system include:

- Rebalancing insurance payments so as to create incentives to substitute home and ambulatory care for more expensive stationary care.
- Re-channelling of funds in favour of better performing service providers. ■

Should pension reform continue?

From 2005 onwards pension adjustment will be linked to the ratio of dependent employees contributing to the scheme relative to the number of pensioners, and the minimum entry age for early retirement on account of unemployment will be increased from 60 to 63. On the other hand, the government decided to defer to 2010 the decision on whether or not to increase the statutory retirement age above 65. Linking pension adjustments to the ratio of contributors to pensioners, in particular, is an important step to put the public pension system on a sustainable base. Even so, pension contribution rates are set to rise significantly over the next decades due to ageing, driving up non-wage labour costs. Participation in the voluntary funded scheme is hampered by cumbersome regulations, while it is relatively expensive in terms of evolving tax expenditures. Hence, pension reform should be complemented by further measures in order to increase its effectiveness:

- A phased increase in the statutory retirement age should be announced soon.

- The system should be made actuarially neutral around the statutory retirement age.
- The government should evaluate the extent to which tax-subsidies in the funded scheme actually induce households to save more rather than substitute between different savings instruments.

Public sector reform will require a more flexible labour force. Pension rules and the terms of health care insurance are not sufficiently harmonised with the private sector scheme and within the public sector, respectively, which hampers the mobility of labour. Obstacles in this respect should be removed by a number of measures:

- Rules for public sector pensions should be fully harmonised with the general scheme, and a transparent link between contributions and benefits according to individual contribution histories should be established.
- Special tenure for civil servants (Beamte) with a distinct pension plan should be reduced to the minimum or abolished entirely.
- Health care insurance for civil servants should be subjected to the rules prevailing for private sector employees.
- Raising contributions so as to pre-fund retirement outlays should be considered. ■

How should labour market reforms proceed?

The weak capacity of the German economy to create more employment from economic growth stems from a complex interaction of various factors affecting the demand for and supply of labour with the wage setting system. While overall wage restraint has helped to improve competitiveness and contributed to price stability, wage formation is not flexible enough to prevent the various supply and demand constraints from affecting employment. Although work incentives have been improved, benefit programmes still induce older workers to withdraw from the labour market while high social security charges and cumbersome regulations add to the labour costs employers are facing. The education system is not sufficiently meeting skill requirements of job market entrants, increasing structural unemployment. Some significant steps of labour market reform have been made, and first initiatives have been taken to increase the efficiency of the education system. While this marks progress, reform needs to continue and further measures – explained in more detail below – are necessary.

Significant barriers to effective labour supply exist for older workers and second wage earners, in particular women. At present extended eligibility periods for unemployment benefits without obligation to search for a job for unemployed aged 58 and older serve as a channel into effective early retirement. From 2006 onwards the extended duration of unemployment insurance benefits for older unemployed will be cut significantly and older new unemployed will also be subject to job search requirement. While this marks substantial progress, significant age-related extensions of benefit duration and exemptions from job search requirements for the stock of older unemployed will remain. Second earners face larger average effective tax rates than single earners, mostly affecting women with full-time working partners. Households with dependent children find it difficult to reconcile work and family as long as proper child care facilities are lacking. The availability of free healthcare co-insurance for non-working spouses distorts incentives against working. Disincentives to higher labour supply should be removed by the following measures:

- The possibility of stricter application of job search requirements regardless of age should be considered, and the impact of ending the preferential extended duration of entitlement for the older unemployed should be assessed.
- Personal income taxation and child benefits should be reformed so as to minimise distortions of labour-leisure choices across different household situations and average effective tax rates on labour income of secondary earners should be reduced.
- Resources for child support should be reallocated to some extent from cash to in-kind benefits like child care vouchers.
- Introducing charges for healthcare co-insurance for non-working spouses should be considered.

Important steps have been taken to increase incentives for taking up employment. In 2005 unemployment assistance will be combined with social assistance into one single means-tested benefit, and job acceptance criteria will be sharpened. This organisational reform of the Labour Office needs to be properly implemented; and reform widened, in particular:

- The present legislation, which gives the local authorities the option of administering the new benefits and placement services instead of the Federal Labour Agency, should be rethought, as it would compromise the potentially large efficiency gains that could be achieved from having only one agency administering a unified set of placement services and means tested benefits. Instead only one agency should be involved.

- Initiatives to strengthen activation strategies providing counselling advice and support services associated with appropriate sanctioning should be pursued further.
- Active labour market programmes should be rigorously evaluated as foreseen and measures that are not effective should be immediately discontinued.
- First steps to provide labour offices with adequate resources and qualified personnel are welcome and should be pursued further while performance incentives for their management should be extended.

Progress has also been made in increasing the flexibility of labour markets. A number of measures reduce the restrictiveness of dismissal protection, in particular the range of social criteria that employers have to take into consideration in dismissal decisions has been reduced and the threshold number of employees above which dismissal protection legislation becomes binding has been increased from 5 to 10 employees. It remains to be seen whether these changes will reduce the legal uncertainty associated with the present legislation. Measures to increase labour market flexibility should include:

- Evaluating the impact of recent reforms of EPL and considering further easing accordingly. Specifically this might include allowing the option of not adopting dismissal protection provisions as part of the work contract after a probationary period in exchange for higher severance pay and raising further the threshold of applicability of dismissal protection.
- Widening the scope for wage determination at the company level so as to better align wage contracts with labour market conditions.
- Further confining the administrative extension of collectively bargained contracts to minimum wages and a minimum standard of working conditions.
- Discontinuing the practice of conditioning public procurement by Länder on firms paying wages according to local collectively bargained wage rates.
- Evaluating the impact of support for low paid jobs on labour supply and training and considering tighter targeting on benefit recipients.

Germany has low youth unemployment in international comparison, due to a relatively efficient school-to-work transition. However, excess demand for traineeships in recent years has led to serious concerns about rising youth unemployment. A contribution and subsidy scheme has been considered as a possible measure to increase the supply of apprenticeships at times of excess demand. As such schemes would increase non-wage labour costs, which are already high, alter-

native measures were sought to address the market imbalance between supply and demand directly, resulting in a voluntary agreement of the industry to supply 30 000 additional apprenticeship places. This measure should be supported by allowing for a higher degree of flexibility of pay for trainees and reducing training costs to enterprises. Furthermore, efforts should continue to update training requirements and improve the attractiveness of apprenticeships by an increased flexibility in training periods. ■

Which policies can strengthen innovation?

The supply of well trained and highly qualified labour is a key contribution to innovation performance, in particular the generation and diffusion of knowledge. The efficiency of the German tertiary education system is relatively low, as witnessed by long study durations and high drop-out rates. While the government plans to promote a competition based selection of a small number of additionally funded high performance universities, a broader approach is required to raise the performance of tertiary education overall. Within the university sector itself, a greater degree of competition among institutions should be established. Major measures should include:

- Institutional reform in the secondary education system toward a clearer focus on outcomes, as outlined in the *2003 Economic Survey*.
- Better preparation in the non-academic track to direct university entry.
- Bureaucratic allocation of students to universities should be given up and universities obtain more discretion to choose students.
- The allocation of public sector funding should be linked to performance indicators.
- Consideration should be given to allowing universities to levy tuition fees from their students, enabling students to act as purchasers of the universities' services at the institution of their choice. The distributional issue could be addressed by obliging students to pay such fees in instalments only after graduation and provided that their income exceeds a certain threshold.

Universities should be given more autonomy with respect to the use of funds and their personnel management.

Net migration to Germany appears significantly biased toward low qualifications. On average, immigrants have significantly lower qualifications than the domestic

population. The relatively high tax wedge is a disadvantage for Germany to be chosen as a location by internationally mobile high-skilled workers. New immigration legislation that aims at introducing qualification standards for immigrants seeking dependent and self-employment in Germany has been decided. Legislation along these lines that raises the qualification profile of immigrants should be implemented.

Key indicators show Germany belonging to the countries in the OECD with strong innovation activity, as reflected in one of the upper ranks in the number of patents filed per population and above average levels of R&D spending in terms of GDP. Some weakening in Germany's position relative to other OECD countries has occurred over the last one or so decade. While the redirection of resources towards unification-related spending as well as low economic growth has contributed to this development, more fundamental structural issues have also played a role. Germany has benefited less than other high-performing countries from the surge in new technologies, such as ICT and biotechnology, as innovation activities continue to focus on sectors such as machinery and automobiles in which Germany has a long record of strong export performance. Some features of the regulation of capital, product and labour markets are hampering the supply of risk capital, the creation of new firms and the reallocation of labour. In addition, firms are finding it increasingly difficult to recruit highly qualified labour. The government envisages a policy initiative to foster innovation. Several reform proposals addressed above are equally appropriate to improve the framework conditions for innovation. To summarise, the following points are of particular importance:

- Reform the taxation of capital in order to remove disincentives to take risks and to provide capital to new rather than to established firms.
- Raise the efficiency of the higher education sector, *inter alia* by improving access and giving universities more autonomy and incentives to attract students.
- Evaluate government-funded innovation programmes more consistently in order to increase efficiency and eliminate ineffective subsidies.
- Remove hurdles to firm creation by reducing the complexity of the tax system, taking further steps to reduce administrative opacity and further reducing the costs imposed by employment protection. ■

How can reform of product market regulation improve the environment for doing business?

Pro-competitive regulation of product markets contributes to improving productivity performance, stimulating investment and innovation. The government has embarked on a number of reforms designed to move the economy towards a more pro-competitive stance. The telecoms regulator's remit has been extended to the gas and electricity industries, improving the regulatory conditions for non-discriminatory network access for market entrants. Entry barriers to practicing a handicraft have also been reduced by removing the master certificate requirement in many crafts and exempting new craft businesses from contributions to the crafts association for four years. However, deregulation needs to continue as about 90 per cent of establishments in the craft sector remain subject to some entry requirements. Similarly, compulsory contributions to enterprise associations should not act as a barrier to market entry. Fee schedules of professional associations limit price competition among members and are legally binding in some cases. The government intends to allow private contracts to deviate from binding fee schedules for architects and engineers. This should be implemented and further deregulation should be considered. The government has also launched an initiative to reduce bureaucracy in order to reduce administrative opacity, including the planned simplification of complex and non-transparent rules on public procurement, which accounts for 17 per cent of German GDP. Competition for public procurement should be strengthened further by removing the participation of business organisations in the procurement process. To prevent administrative opacity in future regulatory initiatives, regulatory impact analysis should be strengthened. This would help, *inter alia*, to foster the establishment of new enterprises and company growth. ■

For further information

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- **Economic Outlook No. 75**, June 2004. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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