

Wurzel, Eckhard

**Article**

## Why Germany needs structural reform

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## WHY GERMANY NEEDS STRUCTURAL REFORM

ECKHARD WURZEL\*

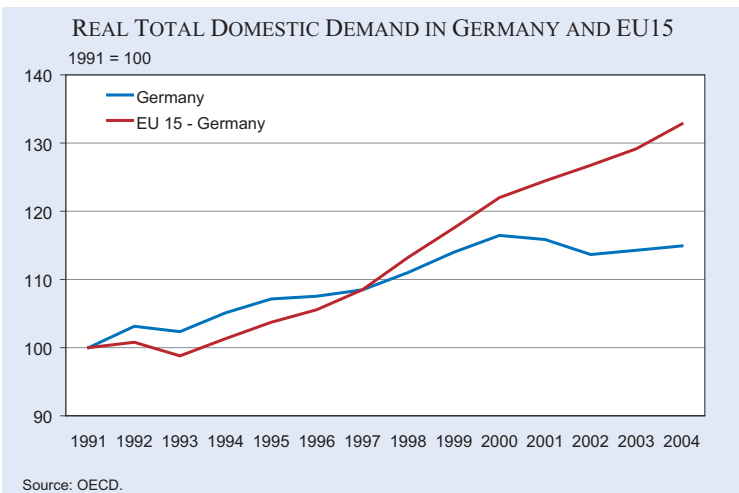
Observers of the German economy are facing an apparently contradictory picture. On the one hand, economic growth persistently undercuts that of the European Union by a significant margin, on average by some 1/2 percentage point relative to the other EU 15 countries over more than a decade. Domestic economic activity is notoriously weak (Figure 1), which is reflected in sluggish private consumption and investment, and progress in cutting high levels of unemployment appears to be lacking.

On the other hand, since the middle of the 1990s there has been a secular increase in the economy's external competitiveness, as reflected by measures of Germany's real effective exchange rate vis-à-vis its main trading partners. While the appreciation of the euro within the last couple of years interrupted this trend with respect to export destinations outside the euro area, German competitiveness within the euro area continued to rise owing to the country's relatively low inflation rate (Figure 2).<sup>1</sup> German industry is very successful in opening new export markets, in central and eastern Europe as well as in Asia, and since the beginning of the decade Germany's share in world exports has increased significantly.

How do these two apparently diverse observations fit together? Does the weakness of domestic activi-

ty underline the need for structural reform, or are we – on the contrary – dealing with a highly competitive economy with no need for an institutional overhaul? Indeed, the success on external markets indicates that Germany's export sector is able to address the challenges posed by a rapidly changing international environment.<sup>2</sup> In the same vein, the German economy is a main innovator, and research and development intensive industries contribute a larger share to exports than in OECD countries on average.<sup>3</sup> Nevertheless, the observed gains in competitiveness on the one hand and weak overall growth and employment due to weak domestic activity on the other hand are to a considerable degree two sides of one and the same coin. They reflect adjustment processes in the overall economy in response to adverse economic shocks, in particular those that occurred at the beginning of the

Figure 1



Weak domestic economic activity but strong export performance

\* Eckhard Wurzel is Senior Economist and Head of Desk for Germany and Austria at the Economics Department of the Organisation for Economic Co-operation and Development (OECD).

<sup>1</sup> Other indicators also point to a trend increase in Germany's international competitiveness. See Nerb, G. (2005), *Wie schätzen deutsche Industriefirmen ihre Wettbewerbsposition ein?*, ifo Schnelldienst 13/2005.

<sup>2</sup> The dichotomy between strong export performance and weak GDP growth plays a pivotal role in Hans-Werner Sinn's recent analysis of structural shortcomings in the German economy. According to Sinn a pathological boost of value added in Germany's export sector coexists with a strong increase in the import content of German exports, which is crucially related to high labour costs. See Sinn, H.-W. (2003), *Ist Deutschland noch zu retten?*, Econ, Berlin; and Sinn, H.-W. (2005), *Die Basar-Ökonomie – Deutschland: Exportweltmeister oder Schlusslicht?*, Econ, Berlin.

<sup>3</sup> According to key input indicators Germany belongs to the countries in the OECD with strong innovative activity, although Germany's relative stance appears to have weakened somewhat in the 1990s. Also, the growth in multifactor productivity, which is related to technical progress, decelerated in the 1990s. See the special chapter on innovation in: OECD (2004), *Economic Survey of Germany*, Paris.

Figure 2



1990s, subject to an institutional framework that is not yet sufficiently well geared to support rapid adjustment in favour of higher trend growth and employment.

### Unification

At the beginning of the 1990s, the introduction of the German Mark in the former GDR at conversion rates far above the purchasing power of the old GDR currency, social transfers to the eastern states associated with the extension of the west German social security system to the east, massive industrial subsidies, and buoyant wage increases all combined to produce a temporary boost in domestic absorption that pushed up prices for domestically produced goods relative to foreign goods. Rapidly rising government debt added to this effect while high interest rates put upward pressure on the nominal exchange rate. High wage settlements were sustained until 1995, with early retirement programmes, job creation schemes and related measures effectively insulating collective wage setting from massive losses in employment in the eastern states.<sup>4</sup> Rising social charges contributed to the upswing in unit labour costs. Overall, these factors triggered a real appreciation of the DM that accompanied the swing in Germany's current account from a sizable surplus into deficit. Other events that occurred over the 1990s and in the present decade, such as the transition to the European Economic and Monetary Union or the rapid economic development in China,

<sup>4</sup> By the middle of the 1990s employment in the eastern German manufacturing sector had almost halved in comparison to 1990.

have added to pressures to adjust to a rapidly changing environment.

### Unemployment

Mounting unemployment, excess capacities and – in the first half of the 1990s – falling international competitiveness with associated losses in export market shares triggered market adjustments that have continued for more than a decade. Wage increases have moderated significantly since the middle of the 1990s.

While real wages per hour – net of employers' social security contributions and deflated by the private consumption deflator – increased on average by 2<sup>1</sup>/<sub>2</sub> percent annually between 1992 and 1995, since 1996 they have risen on average by 3<sup>3</sup>/<sub>4</sub> percent annually. Cost cutting programmes by business entailed further reductions in employment while hiring remained subdued. Indeed, measured in terms of the number of hours worked, as opposed to headcount, employment has trended down since the beginning of the last decade, with the volume of employment in 2004 undercutting the level that prevailed in the 1993 recession by almost 6 percent. Over-capacity in the construction sector – largely induced by subsidisation of projects in the eastern states – triggered a trend decline in construction investment that is still continuing. Equipment investment is driven to a considerable extent by the objective to streamline production processes rather than to widen capacity, as surveys among enterprises confirm. Similarly, there is empirical evidence that offshoring of production is motivated to a significant degree by the need to cut costs.<sup>5</sup>

### Regulation

Economic adjustment along these lines helps to restore and preserve competitiveness. However, output and employment foregone can be considerable if raising competitiveness relies largely on prolonged periods of retrenchment. By contrast, structural change can become the vehicle that generates higher income and employment if the regulatory envi-

<sup>5</sup> For a recent survey among enterprises see: Deutscher Industrie- und Handelskammertag (2005), Going International, Berlin.

Unification policies resulted in high costs in terms of debt, unemployment and subdued growth

ronment fosters the reallocation of resources and the expansion of activity in new areas. Wanted is a regulatory environment in which the economy can quickly transform gains in competitiveness into higher overall activity, for example by utilising resources that are saved via off-shoring for the development of new lines of production at home. Germany's subdued growth performance is characterised by lacking job creation while productivity growth is not high enough to compensate for the deficiencies in labour utilisation.<sup>6</sup> There is considerable scope to improve the regulatory environment in various areas so as to raise the capacity of the economy to generate employment and raise productivity growth.

The need for regulatory reform will not diminish in the future. Raising the growth potential of eastern Germany remains a major challenge. While fast growth in various industrial branches of the economy cannot be ignored, a broader self-sustained upswing of economic activity has not yet been achieved, and a large part of total absorption in eastern Germany is still being financed via transfers. Total factor productivity (TFP) in manufacturing has been estimated to stand at around 70 percent of the west German level.<sup>7</sup> Since, on the other hand, production technologies in industry were found to come close to those in the west, the gap in TFP is likely to reflect structural weaknesses of the east German economy that are unlikely to be remedied by subsidising capital accumulation, but require regulatory reform.<sup>8</sup>

### Ageing

More generally, Germany's economic and social system will be profoundly affected by demographic ageing. Germany belongs to the OECD countries with the most significant deterioration in the age distribution of its population. According to the current population projections of the Federal Statistical Office, the old-age dependency ratio, defined as the ratio of persons aged 65 and older to those aged between 20 and 64, will rise to 53 percent in 2040, from somewhat below 30 percent at present. *Ceteris paribus* this development will be associated with

marked reductions in the labour force and potentially adverse consequences for labour productivity growth for the years and decades to come. At the same time, the fiscal pressure on the social security system and government finances more generally, including those of the states and municipalities, is set to increase.

### Initiatives taken

Notwithstanding sizeable challenges, past economic adjustment toward viable market structures in the new eastern states and restructuring in the overall German economy provide a platform from which higher growth and employment can be achieved. In eastern Germany, new infrastructure has been established on a large scale and tremendous environmental damage inherited from the GDR has been remedied. Moreover, several reform initiatives that became effective over the last couple of years are significant steps in the right direction. This is true, *inter alia*, for policies aiming at more efficient job placement of the long-term unemployed, improving the sustainability of the pension system, increasing the efficiency of the health care system, and raising competition in the crafts sector. However, in several fields, including those where reform steps have been taken, more needs to be done to raise Germany's economic potential.

### Federalism

Policy formation – fiscal and non-fiscal – is often subject to complex and opaque interactions between the federal government and the states and communities. Increasing the consistency of policy initiatives and the speed with which they can be designed and implemented requires reform of the system of federal relations. Responsibilities for related tasks are often split between the federal government and the states and communities. Moreover, the high degree of co-financing of spending across government levels allows regional governments in principle to condition their approval of federal fiscal legislation in the second chamber of Parliament (*Bundesrat*) on concessions in federal legislation that does not formally require their approval, as experienced in the past. There is an urgent need to untangle the responsibilities of the different levels of government and reduce the degree of co-financing. One example of a task of high importance for the future success of the

Needed are regulatory and federalist reforms to permit flexible adjustment

<sup>6</sup> See OECD (2003), Economic Survey of Germany, Paris.

<sup>7</sup> See: Beer, S. and J. Ragnitz (2002), "Wachstum des Ostdeutschen verarbeitenden Gewerbes vor allem durch höhere Wettbewerbsfähigkeit der Unternehmen", *Wirtschaft im Wandel* No. 13/2002.

<sup>8</sup> See Wurzel, E. (2001), The Economic Integration of Germany's New Länder, OECD Economics Department Working Paper No. 307, <http://www.oecd.org/dataoecd/60/57/1899874.pdf>

German economy, that will require streamlining the federal decision structure, is raising the efficiency of the education system.

### Labour market

There are still significant hurdles to higher labour supply, and a perception that economic growth is not strong enough to prevent higher labour supply from translating into higher unemployment, in particular among older people. By contrast, in OECD countries where participation rates of older workers are high so are their employment rates, indicating that there are few inherent barriers to higher employment of older people. Germany's tax wedge on labour is among the highest in the OECD, requiring reform in the social security system to reduce it. Reducing tax and non-tax disincentives for spouses to take up work, lowering benefit withdrawal rates for the long-term unemployed, and removing financial incentives for early withdrawal from the labour force would improve labour supply conditions. More efficient activation of the unemployed requires further reform of the Public Employment Service, including revisions in the allocation of responsibilities across different public administrations. The potentially high costs of adjusting the regular work force to labour demand conditions, implicit in Germany's relatively strict employment protection regulation for regular employment, favours non-standard forms of employment. Fostering employment flexibility while developing incentives to invest in training would suggest more symmetric reform of employment protection legislation. Similarly, further progress is necessary in allowing firm-specific and regional conditions to impact on negotiated wage rates.

### Competition

Product market competition is a driver for innovation and investment. Rents accruing to incumbents due to a lack of competition reduce resources elsewhere, notably for the development or marketing of new products. Also, prices that are higher than under more competitive conditions – for example for energy or household services – diminish the purchasing power of private households, weighing on consumption. While the German economy is traditionally very open with respect to international trade, there exist significant impediments to competition on some domestic markets. Barriers to entry in the

crafts sector have been recently reduced but warrant further deregulation. Regulation of professional business services, such as those of architects and engineers, is very restrictive by international comparison. Incidentally, Germany's share in internationally traded business services is relatively low, and competitiveness indicators point to much weaker sectoral performance than in industry.<sup>9</sup> It might not come as a surprise that branches that are sheltered at home tend to under-perform on external markets. Fostering competition in network industries, such as in telecommunication, energy supply and in postal services, should also rank high on the policy agenda, notwithstanding the significant progress that has already been made in recent years. Streamlining administrative regulation in a number of fields is called for, and would help to increase labour productivity as firms can shift resources to productive uses. This would promote firm entry, as administrative costs are particularly burdensome for small enterprises.<sup>10</sup> Further significant reductions in tax concessions and subsidies also belong to a range of measures that need to be addressed to improve the allocative efficiency of the economy.

### Budget consolidation

Lasting budgetary consolidation is unavoidable if fiscal pressure stemming from society's ageing is to be coped with and the wherewithal for higher outlays is to be created in areas that are vital for the development of the productive potential of the economy. Over the last 15 years, general government debt relative to GDP increased by some 28 percentage points. While unification played a major role in this development, both in terms of spending increases and debt take-over, the marked increase in indebtedness points to the need to respond to new fiscal pressures by more stringent prioritisation of government spending. By 2004, almost 57 percent of general government outlays consisted of social spending, up from 48 percent at the end of the 1980s, whereas investment accounts for only 3 percent of spending. A more rigorous approach to evaluating public sector spending projects against alternatives is called for in various areas, such as health care, education, active labour market measures, and infrastructure investment. Redefining federal fiscal relations and

Germany's tax wedge on labour is among the highest in the OECD

<sup>9</sup> See Nerb, quoted above.

<sup>10</sup> For an evaluation based on enterprise surveys see: Institut für Mittelstandsforschung Bonn (2004), *Bürokratiekosten kleiner und mittlerer Unternehmen*, Deutscher Universitäts-Verlag, Wiesbaden.

reducing industrial subsidies stand as examples of policy requirements that could generate significant savings in public budgets while improving the functioning of the economy.

### **Conclusion**

Important challenges facing Germany, such as high unemployment, adverse demographic developments and the impact of globalisation, are common issues within a wider set of OECD countries, notwithstanding the fact that reunification played a special role in shaping Germany's recent economic history. Indeed, several other industrialised countries went through periods of intense structural and fiscal reform that were triggered by sub-par economic performance. The new German government will need to firmly anchor and broaden the path of the regulatory reforms that Germany has recently embarked on.