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Economic survey of Germany, 2002

Summary

In the wake of the unification boom Germany has been for a number of years an economy characterised by weak domestic demand and lower growth than in many other OECD countries. Low employment growth and a high share of structural unemployment are highlighting the need for comprehensive labour market reform. These developments have been shaped by long drawn-out adjustment to the exceptional unification shock as well as increased vulnerability to adverse external shocks. Growth has been very low since 2001, and the projected recovery relies strongly on the expansion of world trade. The budget deficit is likely to exceed 3½ per cent of GDP in 2002. The high structural deficit needs to be addressed by structural measures over a number of years, but a start has to be made already in the 2003 budget. The federal government has committed itself to strict fiscal consolidation and is now designing a consolidation package. Furthermore all levels of government have agreed to establish a domestic stability pact. The recent pension reform is a step in the right direction, but more may have to be done to pre-fund ageing related expenditure increases and increase the labour force participation of older workers. A more rigorous approach to evaluating public sector spending projects should be implemented to target expenditure cuts, which are necessary to put the budget on a sustainable consolidation path and to create room for lowering taxes. Boosting potential growth and employment requires deeper structural reform, especially on the labour market. Further measures to improve job placement – including some of those proposed by the *Hartz Kommission* – need to be implemented quickly. The positive momentum for reform should be used to implement measures that are likely to improve labour utilisation. This requires, *inter alia*, reducing the tax wedge,

- Why is the economy not growing faster?
- How should the budget be consolidated?
- What are important issues in public sector reform?
- How should health care reform proceed?
- What action is required to improve secondary and tertiary education
- Is further action required to cope with rising pension claims?
- What labour market reforms are necessary to promote growth?
- What should be the next steps in regulatory reform?
- What progress has been made in financial market reform?
- What are some major issues in sustainable development?
- For further information

This Policy Brief presents the assessment and recommendations of the 2002 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.

promoting a higher degree of wage responsiveness to market conditions, and reviewing the complex employment protection procedures. Over the last years Germany emerged amongst the pioneers in product market reform and market opening in Europe. Nevertheless further steps in opening up markets should be considered. Consumers could benefit from a further liberalisation of retail legislation and a consolidation of past reform successes in the general competition framework and network industries. Unless more comprehensive progress is made in promoting competition on energy markets the government should consider installing independent sector regulators. Access to the railtrack needs to be guaranteed on a non-discriminatory basis and the postal monopoly rights need to be terminated. Considerable progress has been made reducing air pollution, greenhouse gas emission and limiting waste production. However, further environmental progress will come with sharply rising economic costs, if not offset by more consistent application of economic instruments. Progress on all these scores is essential to facilitate the changes required for Germany to strengthen economic growth, support social cohesion and maintain an attractive environment. ■

Why is the economy not growing faster?

While in the beginning of the 1990s economic growth in Germany was stronger than in most other OECD countries on account of the unification boom, growth has faded since then. This reflects in part imbalances in labour markets and in the construction sector that themselves arose from unification, as well as a variety of adverse external shocks. But the difficult adjustment process and the prolonged weakness of domestic demand also point to the need to overcome structural rigidities that impair the resilience of the economy and in particular to strengthen its capacity to create employment. Insufficient incentives to take up work and hire labour together with a high tax wedge driving up labour costs, in combination with adverse macroeconomic factors, contributed to weak job creation which bears on consumer demand. This combination of factors has weakened Germany's growth potential and resilience to outside shocks. Burdened with a legacy of high social expenditures and a shrinking tax potential, the government is now confronted with high structural deficits. There is thus a pressing need for structural measures to strengthen the budget over the medium term. At the same time, with growth too low and overly dependent on external

demand fundamental reforms in labour markets and continued reform in product markets are necessary and urgent to strengthen growth and reduce unemployment. The German government is committed to addressing these problems; it is putting forward a fiscal consolidation programme and has adopted the findings of a labour market reform commission with many proposals going in the right direction. Nevertheless, more will be needed.

The German economy has barely grown in 2001-02 and employment has fallen. Domestic demand has been particularly weak and fell in 2001 for the first time since the post-reunification recession in 1993. Despite earlier tax cuts, consumer confidence declined steeply and private consumption weakened as labour market prospects deteriorated and disposable incomes were depressed by a number of temporary inflationary shocks. At the same time, fixed investment in machinery and equipment collapsed – reflecting a deteriorating international environment, falling capacity utilisation and stagnating profits – and the downsizing in construction continued. Although growth for 2002 as a whole is likely to be even weaker than in 2001, some recovery is occurring and growth may pick up to 1½ per cent in 2003 and 2½ per cent in 2004, so long as the global situation improves and real incomes grow again on the back of low inflation. The output gap will nevertheless not close over the projection horizon. There are significant risks in these projections, most importantly as regards the development of global demand and hence German exports. Domestically growth may turn out lower, if deficit reduction is implemented mainly via revenue increases. Forceful reform actions on the other hand could invigorate confidence and strengthen growth.

Monetary policy was eased during 2001 as policy rates were lowered by an accumulated 150 basis points by the European Central Bank. Subsequently, there was a significant downward shift of the yield curve, so that by autumn 2002 market rates across all maturities were down to their lowest level since 1999. On the other hand, the euro has appreciated somewhat. OECD projections build in a further 50 basis points cut in short-term interest rates. In sum, monetary conditions should remain supportive for GDP growth. However, the recent sharp fall in German inflation to among the lowest in the euro area means that real short-term interest rates risk dampening the recovery of demand in Germany to an extent, which may not be compensated by the corresponding gain in competitiveness. ■

How should the budget be consolidated?

Fiscal policy was expansionary in 2001, as new business and income tax reductions were phased in. Since the series of tax reductions over the last couple of years was not financed by corresponding reductions in government spending, the structural deficit increased by nearly a percentage point and weak economic growth lifted the general government deficit to 2.8 per cent of GDP. Accordingly, the deficit overshoot the federal government's consolidation target by a wide margin. With economic activity still weak the general government deficit is likely to exceed 3½ per cent in 2002 largely on account of unforeseen tax shortfalls. Structural balances will improve in 2003, aided by cuts in government employment and increases in indirect taxes. The government is designing a consolidation package, whose volume, if fully realised, would contribute to further reducing the structural deficit. While the government has reinforced its commitment to continue fiscal consolidation and balance the general government budget, this objective is unlikely to be met in the short run. One-off measures to eliminate the deficit over a short horizon would risk being self-defeating by further weakening domestic demand. There is a need, rather, for lasting consolidation measures on the spending side so as to redress durably present budget imbalances and to create room for further tax cuts. Over the medium term structural surpluses necessary to pre-fund ageing related spending increases should be aimed at. ■

What are important issues in public sector reform?

For fiscal consolidation to be successful, streamlining social spending and improving resource allocation within the public sector are unavoidable. At present social welfare spending accounts for more than 50 per cent of general government outlays, while compensation for public sector employees represents 17 per cent of spending and gross investment and subsidies account for 4 and 3 per cent, respectively. Against this background, a more rigorous approach to evaluating public sector spending projects is called for in areas like health care, education, active labour market measures and infrastructure investment. Across the board cuts may be simpler to implement, but risk to reduce the growth potential of the economy. The introduction of a cost accounting and controlling framework for public sector services

at various levels of government should be reinforced. To enhance spending effectiveness, outcome-oriented evaluation methods should be applied, and this entails estimating the full costs and benefits of the action taken over a long-term horizon.

While the German fiscal federal system – largely based on inter-state co-operation and revenue sharing – has been successful in promoting a uniformly high standard of living, it generates incentives to overspend. As well, the process itself is in part administratively heavy while shared responsibilities are not supportive of proper project evaluation. The volume of co-funding should therefore be scaled back, and linked more closely to proper cost-benefit criteria. Progress has been made involving all layers of government in a domestic stability pact with agreed spending caps for 2003 and 2004. However, the pact is lacking an enforcement mechanism for budgetary discipline. Moreover, its budgetary objectives should be cyclically adjusted and based on national accounting standards.

Aggregate growth in the new states is stagnating at a low level and the economic convergence with the old *Länder* is stalling, despite high-growth pockets in the industrial sector. Against this background, special funding of considerable magnitude is foreseen to facilitate infrastructure investment in Eastern Germany until 2019. Incentive mechanisms are needed to ensure that such infrastructure investments are directed to areas that contribute most strongly to growth: making federal funding conditional on the new states producing comprehensive evaluations of the longer-term benefits and the full costs of infrastructure investment projects, would be one such mechanism.

Some changes have recently been introduced in the government sector to improve the quality and cost efficiency of public services. Working time flexibility has increased in recent years, and an element of performance-related remuneration has been established in some administrations. Reform needs to be continued, however, so as to further improve work incentives and give the public authorities more flexibility in adapting the appropriate level and composition of the labour force. In particular, more flexibility of public sector pay schemes with respect to function and region should be allowed and the application of tenured contracts limited. ■

How should health care reform proceed?

As in most OECD countries, health expenditures have shown a long-term tendency to increase in relation to

GDP. Within the OECD, Germany is one of the countries with a relatively high spending-to-GDP ratio. While the access to health services is excellent, various indicators of health outcomes are close to the OECD average, suggesting scope for efficiency improvements. Recent steps to improve incentives in the health care system include the introduction of a diagnosis-related payment system (DRG) for hospital care, which is presently in preparation. While this could imply a significant source for savings by cutting the average length of hospitalisation, it needs to be insured that efficient systems of cost information and for monitoring the quality of services are in place once the DRG comes into operation. The freedom for health funds to selectively contract with health care providers has been widened and more freedom given to consumers in choosing the insurer. Up to now, however, health funds have offered relatively homogeneous products and have competed mainly on the basis of risk selection strategies. Recent reforms introduced financial incentives to implement disease management programmes for selected chronic conditions. While this is a positive step, further action is required to establish a basis for the health funds to evolve into active purchasers of health services on behalf of the patients, and to offer differentiated products to their subscribers. For this purpose the current arrangements favouring collective bargaining between the funds and the organisations of health providers should be re-examined. A more comprehensive risk equalisation system would mitigate risks of cream skimming while supporting the desirable trends outlined above. ■

What action is required to improve secondary and tertiary education

Germany is spending more than most other OECD countries for secondary education while performance of students has been found to be poor in the recent international PISA study. The study also suggests that successful education systems are those that combine standardised targets for educational outcomes with decentralised flexibility and responsibility on how to achieve them. The German school system is characterised by tight school regulation, segmentation of educational paths and the absence of uniform educational standards. Hence, a thorough change of the institutional landscape of secondary education towards more outcome-oriented regulatory framework is required. Nation-wide standards for schooling attainments that are regularly evaluated should be introduced, while leaving schools more freedom in determining suitable ways to reach their targets. Tertiary education is likewise

costly for public budgets, while suffering from long study duration and high dropout rates. Recent initiatives to shorten tertiary education and improve incentives for university teachers to deliver high quality teaching need to be widened. Tertiary studies with a shorter duration should be introduced on a broader scale. Furthermore consideration should be given to allowing universities the right to levy tuition fees while distributional aspects could be addressed through a proper adjustment of student support schemes. Moreover, reform should move on quickly implementing a higher degree of competition between universities. Funding of universities out of the general government budget should be linked to the universities' performance. ■

Is further action required to cope with rising pension claims?

After a series of partial reforms to the public pension system in the 1990s, reforms in 2001 created the foundations for a multi-pillar pension system. The reforms targeted a reduction in the public pension replacement rate and a cap on the contribution rate, revised the indexation of the pay-as-you-go (PAYG) pension, the phase-out of early retirement programmes and the creation of incentives for individuals to opt for compensating occupational and individual pensions. These measures should maintain the relatively high overall pension incomes in the next decade. However, as demographic pressures mount, there is considerable uncertainty whether the targeted reduction in replacement rates will ensure financial balance of the public pension system up to 2020 without additional measures. The uncertainty, as to whether the system is sustainable in the later decades on present parameters may be even higher. Due to the long time needed to phase in pension reforms, there is urgency in addressing these issues. The government should review the statutory retirement age in the light of life expectancy increases and ensure that the phasing out of early retirement programmes does indeed raise the effective age of retirement. Public opinion might also be influenced by considerably lengthening the time period of official projections, in order to better highlight the risk of falling replacement rates in the PAYG system unless further action is taken. ■

What labour market reforms are necessary to promote growth?

Achieving stronger growth in the context of population ageing requires, in particular a substantial

improvement in labour market functioning, and fundamental reforms across a broad front are warranted. Consideration should be given to widening the scope for wage determination at the company level, so as to better align collective wage contracts with labour market conditions. Germany's employment protection procedures appear to be complex and should be reviewed in order to promote employment while striking a proper balance between flexibility and security. An example could be to offer an option to open work contracts to specify severance pay in case of redundancy in return for a less stringent dismissal protection.

In 2002 new legislation came into force designed to improve the activation of the unemployed and to increase the efficiency of the public employment service (PES). Several initiatives are steps in the right direction, but as yet incomplete. Furthermore, the federal government set up a commission (*Hartz Kommission*) to make suggestions for a reorganisation of the PES and labour market reform more generally. Placement activities of the PES have been found to be inefficient. An option for more fundamental reform should allow more private sector delivery of PES services, as is already usual in other OECD countries. Furthermore, profiling should be made standard practice and active labour market measures should be used in the first place to facilitate job search activities. Also, the employment-generating potential of temporary work agencies (TWAs) should be better exploited. Timing restrictions on temporary work contracts (*Synchronisationsverbot*) should be abolished for TWAs. Furthermore, consideration should be given to abolishing the compulsory equalisation of work and pay conditions between temporary employed and regular staff after the thirteenth month of employment. However, TWAs should not be subsidised and no preferential terms should be given to public TWAs. Other legislation that has been introduced, such as the legal right to claim part-time employment and the widening of the workers' co-determination, need to be monitored with respect to its impact on labour costs, and modified if necessary.

The German tax-benefit system discourages low-wage earners from taking up work. Effective tax rates for low-wage earners need to be reduced, job search requirements strengthened and incentives to leave the labour force removed. Such reform would entail *inter alia* establishing verifiable criteria for whether benefit recipients are actively engaged in job search as has been proposed by the *Hartz Kommission*. Currently potential sanctions are not very effective because the proof of misconduct has to be provided

by the PES. Hence, benefit recipients should be required not only to produce evidence that they are actively searching but also why they are unable to accept a valid job offer and benefits should be reduced or withdrawn in case of non-compliance with the rules. Unemployment assistance should be combined with social assistance into one single means-tested social assistance benefit. ■

What should be the next steps in regulatory reform?

Strengthening of competition and efficiency in product markets can also contribute to improved growth performance. Over the last years Germany emerged amongst the pioneers in product market reform and market opening in Europe. The power of the German competition authority (*Bundeskartellamt*) to sanction violations of the competition law is well developed, but some scope for improvement remains. In view of the increasing complexity of competition cases the authority's investigative power could be strengthened by increasing the level of admissible fines imposed in cases of non-compliance with information requests. The effectiveness of the recently introduced leniency programme should be monitored with a view of possibly increasing the associated costs of non-participation and benefits of participation. Furthermore, it should be examined whether resources available to the Federal Competition Authority suffice, both to cover merger activity and promote competition in newly deregulated areas. Moreover, competition can be further enhanced by stepping up privatisation efforts, including at local levels of government.

As has been outlined in the last Survey, considerable progress has been made in recent years in introducing more competition in network industries and this has had positive effects on the economy through lower prices, better-quality services for consumers, and increased competitiveness for enterprises. But major challenges remain.

- In the telecommunications sector a number of pro-competition measures have been introduced. Nevertheless tight sector-specific regulation continues to be necessary as the incumbent still dominates the telecommunication infrastructure. In the mobile phone sector developments in joint market dominance, roaming charges and charges for connecting fixed and mobile lines need to be closely monitored by the regulator. More generally, ways to facilitate the

emergence of competing networks such as cable TV and UMTS networks should be explored.

- The approach of opening the markets for electricity and gas without establishing an independent sector regulator has led to uneven progress in promoting competition. Eliminating entry barriers remains a challenge. In this respect framework agreements (Association Agreements) have been expanded and the regulatory framework is to be strengthened with the adoption of a new energy law proposal. However, if the remaining access problems cannot be resolved in the electricity sector, the government should consider introducing a sector regulator. In the gas sector only a limited number of consumers have obtained more favourable contracts and, given the scale of access problems, the government should reconsider its decision not to install a sector regulator. Vertically-integrated conglomerates are an impediment to non-discriminatory network access. Hence, further unbundling of energy generation, distribution and transmission beyond accounting and management separation would reduce regulatory challenges, but is currently hampered by widespread public ownership in local utilities.
- In the railways sector the regulatory framework has been improved as the Railways Office was granted additional regulatory powers to remove technical barriers for network access. Monitoring is necessary to see if these changes are sufficient. The decision of the authorities to separate infrastructure and the provision of transport services by strict organisational unbundling is supposed to secure non-discriminatory access to the network in general. However, ownership unbundling should be considered in the course of privatising Deutsche Bahn.
- Liberalisation of postal services is relatively advanced in comparison with many other EU countries. Postponement of complete market liberalisation in the postal sector implies higher costs for consumers and reduced competitiveness of enterprises. Hence, the termination of the monopoly rights of the Post Office should be accelerated. Moreover, the privatisation of the Deutsche Post should be completed so as to exclude conflicts of interest between ownership and regulation.

There is still scope to enhance competition in retailing. While legal provisions restraining discounts and promotional offers were abandoned in 2001 the effects of this reform were more modest than foreseen since related provisions are still in place. To remedy this situation the prohibition of time-limited discounts outside the sales periods should be given up. More-

over, the current regulation against setting prices below costs should be reconsidered. These measures should be complemented by further deregulation of shop opening hours as emphasised in previous *Surveys*. By giving consumers more choice, such reforms might contribute to improving the general consumption climate in Germany. ■

What progress has been made in financial market reform?

Worldwide turbulence on increasingly integrated financial markets has reinforced the importance of a sound regulatory framework in this area. The integration of financial market supervision provides a more coherent framework for the supervision of institutions and products across financial sectors and supports international co-operation in the field. The government should ensure that all benefits of a unified financial supervisor materialise. The recent establishment of a legal framework for take-overs with stringent information requirements and time schedules is an improvement over the previous voluntary approach. It also improves the protection of minority shareholders. It can be improved further by ensuring strict management neutrality. Also, relaxing certain information requirements related to future business plans should be considered if they are economically costly. Corporate governance will be strengthened by the Fourth Financial Market Promotion Act. New provisions for security trading enhance investor protection via better detection and prevention of market manipulation. This includes the obligation for the corporate management and the supervisory board to immediately report share trades. Such reporting requirement should be extended to stock options and employee share schemes. ■

What are some major issues in sustainable development?

Sustainability is vital for long-term economic, social and environmental development. It is receiving a lot of attention in Germany through the mechanism of the national sustainability strategy. Considerable resources are being provided for measures aiming at ecological improvements and risk prevention. There have been substantial reductions in air pollution and greenhouse gases in the past decade, leading to improved health and environmental quality, but the costs of further improvements may be rising, depending on the

instruments that are applied. Command-and-control measures aimed at point sources of air pollution are likely to result in increased costs relative to benefits. In this light, there should be a further alignment to externalities of the taxes on vehicles and fuels (both in the transport and electricity-generation sectors) in order to ensure a cost-effective approach. Any such moves would need to be revenue neutral as in the ecological tax reform. An expansion of road pricing could also contribute to a reduction in localised pollution problems. Ideally, abatement costs should be equalised across sectors and balanced with benefits. In the area of waste management, waste production has been reduced but the balancing of costs and benefits is a matter of concern. The government has set ambitious and arbitrary targets and transferred the responsibility for its implementation to manufacturers and retailers. However, costs are high and one company dominates the recycling market. The government's commitment to review costs and improve

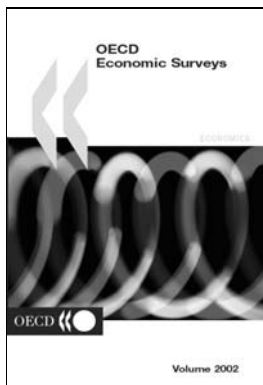
competition in recycling is welcome but it is still necessary to ensure that price-based mechanisms result in a better cost-benefit ratio. This would ensure that the packaging tax payments of producers and consumers do not exceed the total of the private costs and the environmental externalities of other methods of waste disposal. Indeed, in both air and waste policy, it is necessary to ensure that the costs they impose on society are better related to the benefits they provide to society. ■

For further information

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