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# AICGS POLICY REPORT

REVIVING THE GERMAN  
ECONOMY: A DOMESTIC  
IMPERATIVE AND A  
WINDFALL GAIN FOR  
THE TRANSATLANTIC  
PARTNERSHIP

Jens Dallmeyer  
Antje Stobbe

## AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES

THE JOHNS HOPKINS UNIVERSITY

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ISBN 0-941441-83-0

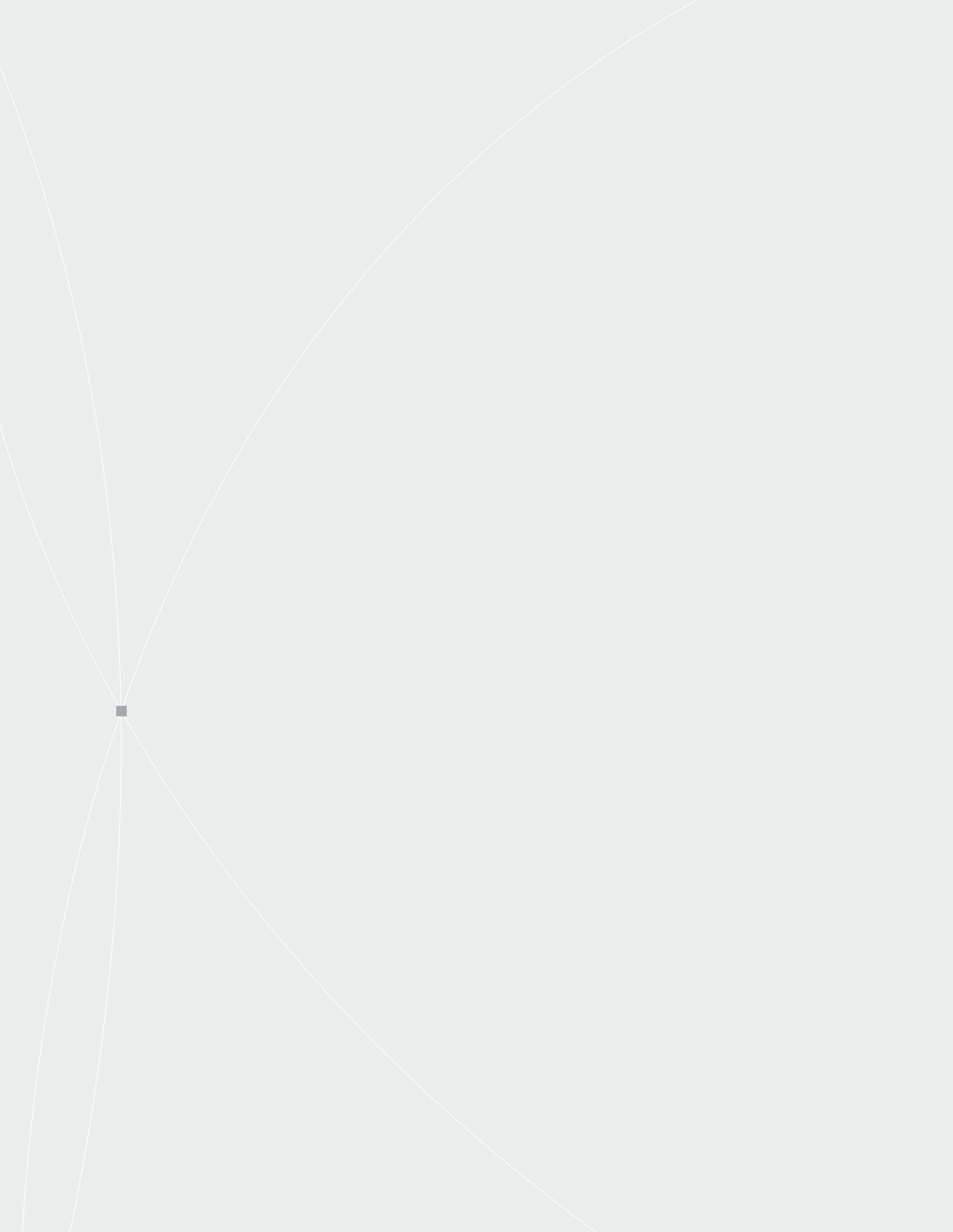
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## FOREWORD

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If any lessons were learned in 2003 on either side of the Atlantic, it was that we should not underestimate how important transatlantic ties are despite frictions and clashes over policies and politics. But we should also have learned that we should not overestimate how much margin for error we have in dealing with our differences. There is too much at stake to tamper with the fundamentals shared in the promotion of a set of values and mutual prosperity. Yet we are also aware that we are in a state of transition in the development of a shared perception of what constitutes security and stability in the post-9/11 environment.

The challenges facing Germany, Europe, and the United States in forging a common agenda are that much more complicated by the increasingly intricate interplay between domestic and foreign policy debates. The concerns in Europe about increasing American deficit spending are mirrored by American concerns about sluggish economic growth in Europe. European criticism of Washington's single mindedness in its policy priorities is matched by American criticism of the cacophony of European voices unable to generate shared policies or perspectives.

This latest publication in the Institute's Policy Report series presents an analysis of these issues, examining in particular how Germany is facing its economic challenges at home while serving as a crucial player within the European effort to bolster its economic and political capabilities. It offers a candid assessment of the reforms now being implemented in Germany, their potential for success, and the steps still ahead for Europe's largest economy. It also provides a helpful framework in which the need for collaboration on both sides of the Atlantic can be better understood.

We are grateful to the two authors, Jens Dallmeyer and Antje Stobbe, who have produced a valuable and instructive perspective on Germany's economic, social, and political challenges emerging in an increasingly competitive global market. We are also grateful to Deutsche Bank Research for its generous support of this study and its publication.



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The views expressed in this publication are those of the authors and do not necessarily correspond with the views of Deutsche Bank Research or Deutsche Bank AG.

## EXECUTIVE SUMMARY

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Transatlantic relations—between Germany and France on the one hand and the United States on the other—were severely strained in the run-up to the Iraq war and thereafter. Many pundits voiced concerns over the potentially long-lasting damage to the transatlantic relationship, speculating about the impact of the conflict on not only foreign policy relations but also on economic relations.

This paper will show that transatlantic economic relations are sound, with economic integration having reached unprecedented levels. For transatlantic relations to be based on a more equal footing, however, it is essential that Europe in general and Germany in particular step up efforts to bolster their economic potential. For Europe the main task will be to improve integration and to realize a truly single market. For Germany, trailing the field with respect to growth in Europe, a whole set of structural issues needs to be prioritized on the economic policy agenda. This paper will examine this agenda and set it against the policy measures defined by the German government's Agenda 2010.



# 01

CHAPTER ONE

## THE IRAQ WAR FAULT-LINE BETWEEN GERMANY AND THE UNITED STATES: PUTTING THINGS INTO PERSPECTIVE

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### **Transatlantic Relations: The Pendulum is Swinging Back and Forth**

Ample analysis has been published about the causes and nature of the serious transatlantic rift that developed in the run-up to the war in Iraq and how to go about healing it. At this point in time it is still difficult to gauge clearly in what direction transatlantic relations are heading. In the aftermath of the terrorist attacks of September 11, 2001, the bond between Europe and the United States strengthened practically and emotionally when western Europe and Russia, proclaiming “unlimited solidarity,” supported the United States in its fight against international terrorism. However, the pendulum swung back: in the run-up to the Iraq war a rift emerged between the United States on the one hand, and a group of countries dubbed “Old Europe” on the other.

While the latter, including Germany and France, opposed military intervention in Iraq, the countries of the “New Europe,” the UK, Spain, and a number of eastern European countries, supported the United States in its efforts to overthrow the regime of Saddam Hussein without a UN mandate. The rift was thus not only a transatlantic one, but also one that led to a divide within Europe between parties opposing and favoring the U.S. military strategy. In the end, Europe did not manage to close ranks behind a coordinated foreign policy strategy.

In early 2004, signs of rapprochement can be observed, and normalization, at least on an operating level, is in the offing. This is even more true since the United States realized it is more difficult to “go it alone” than initially thought and that its concepts for a postwar order in Iraq were insufficient.<sup>1</sup> In fact, there are serious difficulties in establishing law and order—leave alone economic prosperity—in postwar Iraq. Although the United States’ attempt to involve the

UN again and bring other nations’ troops into Iraq does not mark an abandonment of U.S. military hegemony, it signals a rise in willingness to cooperate.

But careful observation of the pendulum’s amplitude should not distract attention from a fundamental difference in how the United States and the European countries—largely independent of the fact whether they belong to the “old” or “new” faction—view themselves after the terrorist attacks of 9/11. A study by the Chicago Council on Foreign Relations and the German Marshall Fund<sup>2</sup> impressively captures this difference in perception. In the United States 91 percent of the respondents regard international terrorism as a “critical” threat to their country’s vital interests, whereas in Europe only 46 percent share this assessment. These fundamentally distinct public opinions are in keeping with how the United States has repositioned its foreign policy strategy since 9/11, mobilizing resources for a unilateral model of military hegemony. However, this shift was no knee-

jerk reaction to an unforeseen event but the result of a long-prepared and carefully formulated strategy. This was already evident in a paper written by National Security Advisor Condoleezza Rice laying out a foreign policy strategy in the run-up to the presidential elections in 2000. In this paper she makes it clear that the task of dealing “decisively with the threat of rogue regimes and hostile powers, which is increasingly taking the forms of the potential for terrorism and the development of weapons of mass destruction” should be one of the key foreign policy priorities of a potential future Republican administration.<sup>3</sup> After 9/11 this priority received a new dimension, singling out the global threat to be dealt with, i.e. global terrorist activity.<sup>4</sup> Shortly after the attacks President George W. Bush made it clear—and this view resurfaced in the National Security Strategy—that the United States sees itself at war and would not hesitate to strike back: “War has been waged against us by stealth and deceit and murder. This nation is peaceful, but fierce when stirred to anger. The conflict was begun on the timing and terms of others. It will end in a way, and at an hour, of our choosing.”<sup>5</sup> In the end, a fundamental division in the partners’ respective positions has emerged. The United States sees itself at war, whereas Europe does not.<sup>6</sup> This split might be covered up until the next conflict emerges, but certainly has not been eliminated.

It is self-evident that antagonism is not a helpful approach to transatlantic relations. But what is it that holds the transatlantic alliance together in the absence of the Soviet threat and against the backdrop of apparently different foreign policy strategies?<sup>7</sup> Why are good transatlantic relations beneficial? One reason is that conflicts of any kind divert time and energy from promoting essentially the same set of values (freedom, democracy etc.) shared by the European nations and the United States, values that are of heightened relevance in a world where terrorism has achieved a new dimension. As the National Security Strategy puts it: “...no nation can build a safer, better world alone. Alliances and multilateral institutions can multiply the strength of freedom-loving nations.”<sup>8</sup> Another reason is that due to the high degree of transatlantic economic integration, serious frictions could impair economic welfare on both sides of the Atlantic. The fundamental insight alone that cooperation is beneficial both to the promotion of common values and to

economic prosperity suggests that more and more diplomatic effort is needed to overcome different interests and philosophies in a number of policy areas. Several authors have voiced concerns that the conflicts over foreign policy could fundamentally hamper cooperation in transatlantic and global economic policy issues, e.g. WTO issues, international capital market regulation, and the policies of the International Monetary Fund. And while it is fairly straightforward to forecast that real economic integration [trade, foreign direct investment (FDI)] will also in the future function as an inherent stabilizer of transatlantic relations, economic policy cooperation is, in fact, already less intense and might indeed suffer from transatlantic disputes in the future.

We currently observe a priority shift in economic relations corresponding with the re-orientation of U.S. foreign policy: economic relations and prosperity are described as instrumental to national security. “A strong world economy enhances our national security by advancing prosperity and freedom in the rest of the world. [...] We will promote economic growth and economic freedom beyond America’s shores. [...] We will use our economic engagement with other countries to underscore the benefits of policies that generate higher productivity and sustained economic growth.”<sup>9</sup> The United States appears to have clear-cut expectations about the policies its allies should pursue: “A return to strong economic growth in Europe and Japan is vital to U.S. national security interests. We want our allies to have strong economies for their own sake, for the sake of the global economy, and for the sake of global security.”<sup>10</sup>

Three conclusions follow from this analysis:

1. The United States has a clear-cut position on key priorities (anti-terror, growth) that guide transatlantic relations. This is true not only for foreign policy and security issues in general, but also for economic relations. In all these fields it is palpable that the United States is seeking to guide the international community according to its priorities.
2. At the same time, Europe does not have a coordinated answer to all of these questions. As the “Old” vs. “New Europe” discussion in the run-up to the Iraq war showed, the position of European

governments towards security issues and global terrorism is not homogenous. This is less relevant with respect to economic coordination but even here there is room for improvement with respect to integration policy (see chapter 2).

3. The third issue to be raised is actually a question: How does Europe—and Germany in particular—want to act in response to the expectation of economic revitalization stated in the National Security Strategy? We would argue that this is not a matter of reacting to expectations but, rather, acting in Europe's and especially Germany's very own interest to strengthen its economic potential. There is some "homework" to be done on the part of the European Union and the German government—in order to strengthen transatlantic relations in economic terms and for Europe to become a more accepted partner of the United States.

Despite these distinctions, it is essential not to over-emphasize the differences between Europe and the United States. There is a great deal of common interest in a large number of policy areas, particularly with respect to economic ties—a fact that is often ignored when stressing the risk of the United States and Europe drifting apart. Thus, on the one hand, there is a lot at stake. On the other hand, transatlantic relations have a strong basis to build upon, and sound economic relations can serve as an inherent stabilizer of transatlantic relations.

### Economic Ties are Strong

Transatlantic integration is very high; the transatlantic economies are often referred to as the most integrated trade and investment network in the world. Economic integration received a substantial push in the 1990s, when dynamics were in place which pulled the allies closer together. Industry deregulation, technological convergence, financial market liberalization, and common business values have been the most important drivers. Globalization was the buzzword of the decade. U.S. corporations invested more funds overseas in the 1990s (over \$750 billion) than in the four decades from 1950 to 1989 combined.

Although emerging markets in other parts of the world have increased substantially in importance as a destination for trade and foreign direct investment, Europe is still one of the most relevant target markets for the United States. About 21 percent of U.S. exports went to the EU in 2002 (Western Europe: 23 percent), with Europe ranking as the second most important U.S. export market after Canada. Conversely, Europe shipped about 24 percent of its exports to the United States.<sup>11</sup> However, trade is just one facet of economic integration. German exports to the United States amounted to just 3.2 percent of GDP in 2002, which largely understates real economic integration with the United States. This is because foreign direct investment, especially cross-border merger and acquisition (M&A) activity, has considerably gained in importance over the last decades, and companies often sell their goods in the target market through foreign affiliates. In 2000 the value of European affiliates' sales in the United States was more than four times larger than the value of European exports to the United States, i.e. \$1.4 trillion (for the UK the number was five-fold in 2000, for Germany four-fold). U.S. foreign affiliate sales amounted to \$2.9 trillion in 2000 (almost three times U.S. exports in that year, \$1.1 trillion). Almost half of that figure (\$1.4 trillion) accrued to Europe.

A more comprehensive set of indicators<sup>12</sup> will show the extent to which the two regions are integrated, beginning with the U.S. perspective:

- FDI: Europe was the most important destination of U.S. foreign direct investment in the 1990s. The share of U.S. FDI in Europe has grown steadily over the last decades, reaching almost 50 percent of total U.S. FDI in 2000/2001. In the 1990s the UK was the most important target market for U.S. companies and attracted 20 percent of U.S. FDI (\$175 billion); the Netherlands ranked number 3 after Canada (\$65.7 billion). Switzerland, Germany and France are the other European countries that rank 6-8 on the top-ten list of U.S. target countries.
- Foreign assets: the foreign assets of U.S. corporations amounted to more than \$5.2 trillion in 2000, of which 58 percent was invested in Europe, especially in the United Kingdom (\$1.3 trillion), the Netherlands, and Germany.

■ **Earnings:** Europe is also top of the list with respect to earnings of U.S. companies. In 2001, U.S. foreign affiliates earned about half of their total global income in Europe, with the UK being the largest single market (13 percent of global income between 1990-2001).

Second, there is evidence that the United States is the most important target market for European companies:

■ **FDI:** Three-quarters of all FDI in the United States in the 1990s originated in Europe (\$659 billion), with the bulk of the inflows taking place in the second half of the 1990s (about \$111 billion annually)—to a large extent through M&A activity.

■ **Foreign assets:** More than two-thirds of all foreign assets in the United States were held by European firms (\$3.3 trillion in 2000).

■ **Earnings:** European multinationals earn the largest share of affiliate income in the United States (\$26 billion in 2000, five times more than at the beginning of the 1990s).

Two observations are noteworthy: (1) Increasing mutual foreign direct investment between Europe and the United States provides a sound basis for transatlantic economic relations. For U.S. companies, investment in retail and service activities in Europe (banking, insurance, consulting etc.) was most attractive in the recent past. Notably, financial services and business services are those areas in which the EU stepped up its deregulation efforts.<sup>13</sup> European companies targeted a broad spectrum of companies in the United States for M&A activity. Generally, it is not surprising that European corporations invested heavily in the United States in the second half of the 1990s as this reflects the heightened attractiveness of the United States as a business location in the wake of the “new economy revolution.” Without doubt, due to deteriorating economic conditions since 2001 not only in the United States but also in Europe, cross-border M&A activity received a heavy setback and foreign direct investment in the United States and Europe, respectively, suffered accordingly. However, this should not be interpreted as an indica-

tion of declining transatlantic economic integration but, rather, as a result of the downturn and substantial correction on both sides of the Atlantic after the high-tech bubble burst. There is fertile ground for continuing economic integration. Quinlan argues that the key drivers that helped integration in the 1990s are still largely intact today.<sup>14</sup> There is no room for complacency, however. European governments in particular ought to bear in mind that their economies are in fierce competition with the more developed emerging markets of Asia and central European countries that soon will be part of an enlarged EU. Improving the framework conditions for business investment should thus be high on the political agenda of policymakers. The following chapters will explain in greater detail the most pressing issues on the European and German reform agenda.

(2) There are a number of conflicts on the economic policy level between Europe and the United States driven by intra-industry competition, different regulatory frameworks, and—to a certain degree—differences in the underlying value systems. Bilateral trade flows are, to a large extent, based on intra-industry trade with a substantial share being intra-firm trade of multinationals. Thus the United States and the European countries are trading partners on the one hand, and rivals on the same target markets on the other. Trade disputes are high on the political agenda and receive fairly extensive public attention—a recent example being U.S. steel tariffs.<sup>15</sup> However, the economic weight of disputed issues, i.e. in trade policy, is, in fact, fairly small. Quinlan has calculated that trade amounts to less than 20 percent of transatlantic commerce and that U.S.-EU trade disputes pertain to less than 1 percent of total transatlantic commerce.<sup>16</sup> Moreover, the WTO’s dispute settlement statistics document that the balance of charges and countercharges is fairly equal.<sup>17</sup> But with economic integration becoming deeper, traditional trade issues also are losing importance. Potential conflicts arise in areas such as competition law, investment rules, standards, and taxation. These problems are rather complex to solve and leave a lot of room for negotiations. Their spillover into domestic issues often makes it difficult for policymakers to push ahead with decisions.<sup>18</sup> This underlines the hypothesis that even with economic integration functioning as a stabilizer for economic

relations, strong diplomatic efforts and constructive engagement from both sides are needed to overcome conflicts of interest. Although solving these conflicts requires a substantial coordination of efforts, the closely knit economic network that emerged in the 1990s should prevent transatlantic economic relations from becoming as substantially impaired as is currently the case with foreign relations. The shared economic interests are overwhelming.

### Europe Needs to Step Up its Efforts and Unequal Partners Have to Work on a Common Agenda

Although economic integration is a sound basis for transatlantic relations, there is a substantial gap in overall economic performance between the United States and Europe, particularly with respect to growth, employment, and innovative capacity. Europe is, in fact, trailing the United States substantially in terms of realized and potential growth rates. From 1996 to 2002, EU GDP expanded at an annual rate of 2.3 percent, whereas the United States grew by 3.3 percent on average. The same gap can be observed with respect to potential growth, which is estimated at 2.5 percent for the EU and at 3 to 3.5 percent for the United States (1996-2002). The gap would be even larger if Germany were taken for comparison, as it trailed the field in Europe in terms of growth in recent years. Several authors stress that U.S. economic outperformance actually has a psychological impact on transatlantic relations to the detriment of the slow-growing European core countries and thus has strategic implications.<sup>19</sup> The following statement sheds light on the way the United States sees itself in this respect: "As the prototype of this "new economy," the United States has seen its economic influence grow—and with it, its diplomatic influence. America has emerged as both the principal benefactor of these simultaneous revolutions [the collapse of the Soviet Union and the IT revolution] and their beneficiary."<sup>20</sup> However, it is not only the imbalances in economic performance that are relevant, but their repercussions on other political fields, namely, foreign and security policy. As Grant puts it: "The

continuing under-performance of the European economy has strategic costs. A strong European foreign and security policy requires robust economic growth: not only the instruments of hard power, but also those of soft power—such as development assistance—cost money [...]"<sup>21</sup>

Against this backdrop, the transatlantic policy agenda should include several important issues:

- Improving economic performance should be high on the agenda of European policymakers, not only for Europe as a whole but also for individual countries, especially the growth laggards such as Germany and France. For Germany it is especially important to work on becoming more attractive as a business location by tackling the structural weaknesses that have piled up in the last decade.
- For Europe as a whole it is essential to become more integrated and effective on an institutional level.
- Working on a common economic agenda and establishing a more constructive environment for transatlantic dialogue should be a high priority for the transatlantic partners. This is not only important because strained transatlantic relations need to be reinvigorated, but also because the increased level of economic integration in the 1990s has resulted in the partners being confronted with a set of conflicts whose resolution requires a great deal of diplomatic effort. "While there is no one solution or magic formula for reinventing the transatlantic partnership in an age of globalization, there is a pressing need for a more integrated approach, an overarching vision and a political commitment to address the very real challenges posed by the emergence of a new transatlantic economy."<sup>22</sup> In this respect, it is of major importance that even with Europe better defining its identity and strengthening its economic position, this needs to happen in cooperation with and not in opposition to the United States.



# 02

CHAPTER TWO

## THE EUROPEAN DIMENSION: THERE IS NO PROSPEROUS GERMAN WAY

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### **Germany: Key Constituent of Europe, but Nothing Without Europe**

The underlying issue for Europe is to foster its economic growth potential, not only for its own well-being but also in order to become a more accepted partner in transatlantic relations—with the prospect of reaping benefits in other policy areas. Currently, Europe is still far away from its “Lisbon goal” of becoming “the world’s most competitive and dynamic knowledge-based economy”<sup>23</sup>—a goal originally intended to be achieved by the end of this decade. Thus, promoting the framework conditions for economic growth and integration within the EU should receive high priority on the agenda both of EU politicians and national policymakers alike. “Only a deeper integrated, externally and internally open Europe that consequently utilizes its economic potential will be able to continue to be an attractive business location for the production of goods and services.”<sup>24</sup>

The causes of low growth in Europe—especially in the larger countries such as Germany and France—are complex. On the one hand, institutions such as the European Commission, the European Central Bank, and the International Monetary Fund have identified numerous areas requiring structural reform. These have to be tackled on the national level. Germany, for example, needs to set its priorities by eliminating supply-side rigidities, especially on the labor market, overhaul the structure of its welfare system, and prepare for the demographic problems ahead (see chapter 3 for a more detailed analysis). On the other hand, there are key policy areas that are and should increasingly be designed and coordinated on the EU level, not by individual member states. This is particularly true for economic integration policy and the completion of the single market. As the benefits of the single market have not yet been fully reaped, the economies of the member states would profit from further integration and a deepened international division of labor: more efficient production of goods and services through an improved allocation of capital and an enlarged range of products tailored to the consumer’s choice at lower prices are just two examples of the benefits of economic integration.

However, there is a fine line to be drawn between the principle of subsidiarity, i.e. leaving sovereignty and responsibility for certain policies in the hands of member states, and the principle of coordination. More and more, the latter has recently been extended to fields such as education, technological innovation, and social and employment policy. While it is desirable that national reforms converge substantially in certain fields in order to fully realize the potential of the single market, greater policy coordination runs the risk of increasing regulation and bureaucracy on the EU level to the detriment of economic growth. In certain areas, e.g. social and employment policies, the potential for coordination might thus be overestimated. The expected benefits should, therefore, be carefully weighed against the costs before coordination processes are set in motion.

For Europe as a whole, the ultimate target should be to strengthen growth. At the same time, Europe needs to improve its ability to speak with one voice—this is essential not only with respect to economic policy but also important in other fields such as foreign and security policy, not least because of its repercussions on the economy. Europe as a whole is

highly dependent on the member states playing a constructive role in the reform process. As one of the largest economies within Europe, Germany should aim at speedily upgrading supply-side conditions at home to become an important driver of political and economic reform in Europe. At the same time, national economic policies are crucially dependent on rapid, efficient progress on the European reform agenda, with the member states being an integral part of the European community, profiting from increasing European integration and well-coordinated policy initiatives. This chapter will focus on the European reform agenda, and the issues to be tackled in Germany will be examined in chapter 3.

### Some Key Issues on the European Reform Agenda

In December 2003, the European Council launched another European growth initiative based on 13 infrastructure projects. These are supposed to be funded largely by the European Investment Bank. However, past experience from the 1994 growth initiative, when a package comprising fourteen projects was launched, shows that its overall success with respect to igniting growth was fairly limited. Moreover, a number of national budgets are over-stretched already as the recent discussion on the Stability and Growth Pact (SGP) centering on the German and French budget deficits impressively shows. Thus it is questionable whether the new initiative really addresses the right issues. A European reform agenda focusing on promoting market integration, reducing tax burdens and over-regulation, as well as improving supply-side conditions, is more to the point. As the reform agenda is comprehensive, this paper will touch briefly on a number of issues that will play a crucial role in fostering growth.

■ **Stability and Growth Pact (SGP):** Germany and France will most likely exceed the 3 percent of-GDP budget deficit criterion again in 2004, the third year in a row. Both countries have been reluctant to pursue the substantial structural fiscal adjustment as required by the SGP. The most recent debate on France facing sanctions under-

lines the risk of the SGP being "hollowed out" at its first serious stress test. However, members' compliance with the Pact, which was designed by the founding fathers of European Economic and Monetary Union (EMU), has several important functions. It provides a framework to ensure the sustainability of member states' fiscal policies, thus giving the European Central Bank (ECB) sufficient leeway to pursue a stability-oriented monetary policy. Moreover, it signals to financial market participants the member states' political backing for a joint monetary policy and is thus an indispensable prerequisite for the credibility of EMU, the euro, and Europe's ability to adhere to agreed-upon policy rules in general. Currently, all these functions are at risk. Maintaining a sound fiscal position is absolutely essential for European countries to deal with the fiscal challenges ahead, especially in terms of demographics. Compliance with the Pact should thus be stepped up. The structural deficit (i.e. the budget deficit adjusted for the impact of economic cycles) could be included as a guideline—as suggested by the European Commission—to increase transparency of the member states' fiscal policy stance and improve incentives to pursue an anti-cyclical fiscal policy. However, the 3 percent deficit criterion, as a rule that is simple to measure and transparent, should not be dropped.

■ **Completion of the single market:** Although there were positive measurable effects on growth and trade from the single market program "Europe 1992," the integration of the goods markets is far from complete. Technical market barriers are still prevalent in a number of sectors, which, according to estimates, made up about 28 percent of value added in the EU in 2000.<sup>25</sup> Moreover, there are still a number of sectors (public procurement, network industries, and the defense industry), in which integration has not taken place. Structural barriers in the form of taxes or consumer protection laws also play a part in hampering the completion of the single market. The *Internal Market Strategy 2003-2006* published by the European Commission in May 2003 points in the right direction with respect to the completion of the single

market; timely and thorough fulfillment is required, however, to reap the full benefits of this strategy.

- Establishment of a Single Market in Business Services: Promoting the single market in business services is an action point of the Single Market Strategy. So far, a single market in business services has not emerged. This is, on the one hand, due to the very nature of services—the required proximity to the customer or the limited tradability of services. On the other hand, member states have in many cases followed protectionist strategies in favor of large suppliers and heavily regulated parts of the service sector. The Single Market Strategy rightly aims at developing common principles for the development of a single market in tradable business services. Barriers to the establishment and cross-border provision of tradable (regulated) business services in particular need to be removed and these efforts should include the complete value chain.
- Completion of the single financial market: The degree of integration of the EU financial market strongly varies among its sub-segments. While the money, bond, and foreign exchange markets are more or less fully integrated and substantial progress on the equity markets and in the institutional fund business can be observed, a number of financial market segments remain fragmented. The retail market, the mutual fund sector, and the life insurance business are examples. The Financial Services Action Plan (FSAP) has addressed a broad set of issues to promote the single financial market, especially with respect to capital market law, improving framework conditions for corporations, financial market supervision, and the integration of retail markets. The initiatives to strengthen the capital market, such as efforts to improve the communication of listed companies, in particular, should contribute to a more efficient allocation of capital and lower costs of capital. However, important tasks remain. One is financial supervision. The institutional integration of national supervisory authorities is an indispensable prerequisite for a single financial market as it eliminates the frictions caused by differential supervisory behavior.

Another relates to establishing appropriate framework conditions for the retail market in Europe, particularly with respect to banks, insurance, and mutual fund companies. These efforts require activities beyond the existing tasks defined in the FSAP, which focuses mainly on the wholesale market for financial services.

Europe has achieved a lot in the past decades with respect to integration—a common monetary policy, the introduction of the euro, and the removal of trade barriers are just a few examples. However, frictions in important markets (business services, financial services, transport, etc.) have remained an important obstacle to integration and are a detriment to higher actual and potential growth in Europe. The EU should thus strive to complete the single market in the fields mentioned above. Member states would profit from the benefits of integration and potentially see positive effects on growth. But there are also a number of highly important tasks on the member states' agendas if Europe wants to gain a competitive edge. As far as Germany is concerned, this will be discussed in the following chapter.



CHAPTER THREE

03

## GERMANY'S DOMESTIC REFORM CHALLENGES

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The symptoms: three years of stagnation, rising unemployment, surging deficits in the fiscal and social security accounts, and political inability to achieve sweeping reform. To start on a positive note, there is no longer a lack of awareness that the former *Wirtschaftswunderland* Germany is in dire straits. Not only international critics (who until recently liked to fret about the “sick man of Europe”) but also the vast majority of the German people, politicians, and business community would concede that the country’s economic, social, and political systems have performed poorly in recent years. The country seems ill-prepared to face the huge current and future challenges stemming from continued globalization as well as technological and demographic change.

This change of awareness has been triggered by the rapid and continued deterioration over the last three years in areas where Germany’s structural problems have been concentrated on:

- Economic stagnation: After a good economic performance in 2000, the German economy has virtually stagnated ever since. Real GDP growth was a meager 0.8 percent in 2001, 0.2 percent in 2002 and minus 0.1 percent in 2003, including two “mini” recessions in the last two years. This poor performance seems to mark the natural continuation of Germany’s declining growth trend over the last decades: Average real GDP growth fell from a very strong 4.5 percent per annum in the 1960s to 2.8 percent in the 1970s, 2.3 percent in the 1980s and a mere 1.6 percent in the 1990s (excluding the post-reunification year 1991). Even in the global economic boom years of 1995-2000, German growth averaged just 1.7 percent, compared to 2.5 percent in the whole euro area and 3.8 percent in the United States.
- Rising unemployment: Unemployment has also risen continuously over the last decades. Official national unemployment figures will average clearly above 4 million, or 10 percent of the workforce in 2003 and 2004, close to the highest level since German reunification but still leaving out a “hidden reserve” of presumably another one to two million people who have dropped out of the statistic for various reasons.
- Surging budget deficits and public debt: Budgets at all layers of government suffer from massive shortfalls of tax revenues and higher spending on social security benefits due to the weak economy and high unemployment. As mentioned above, in 2004 Germany will violate the 3 percent of the GDP threshold for the general government deficit for the third year in a row. The public debt ratio has also risen back above the Maastricht ceiling of 60 percent of GDP.

■ Under-funding of public pension and health systems: Closely related to the above symptoms, the public “pay-as-you-go” systems for pensions, health, and long-term care are confronted with huge and rising financing gaps. This has led to higher contribution rates and thus lower disposable household incomes as well as higher overall labor costs.

■ Political inability to achieve sweeping reform: Apart from the 2001 pension reform and some moderate measures at the end of the Kohl era in the late 1990s (quickly reversed when Chancellor Gerhard Schröder took office in late 1998), the German government has shied away from unpopular labor market, fiscal, or social security reform in the last couple of years.<sup>26</sup> Most of the initiatives that were actually implemented were largely designed to plug current financing gaps within the existing structures. Willingness to expose the systems themselves to a fundamental critical review is still insufficient. At least until 2003 there seemed to be a political inability or unwillingness to undertake sweeping reforms without taboos. Forced by the problems outlined above, the federal government has initiated some key reforms, largely comprised in the so-called “Agenda 2010” that Chancellor Schröder announced in March 2003.

Except for the last point, these painful problems and their political implications have become so obvious in recent years that they now seem to form the base and driving force of the ongoing reform process. However, there still are very different opinions among the German public, political parties, unions, and other interest groups about the actual size of the problems, their real driving forces, and, consequently the appropriate therapy. Even though the reform process finally gained momentum in the course of 2003, Germany still seems to face “... not only an implementation problem, but also ‘knowledge’ problems in the sense of recognition and understanding.”<sup>27</sup>

### **The Causes: Rigid Markets Combined with an Outdated Social Model and a High Degree of State Intervention—Plus Huge Demographic Challenges Ahead<sup>28</sup>**

There is no doubt about it—the core of Germany’s structural problems is its weak growth performance. The protracted economic weakness is not only an eye-catching symptom but has directly or indirectly aggravated and exposed the need for reform in virtually all policy areas such as the labor market, the public pension and health system, and public finances in general. All these systems were designed and worked fairly well when Germany enjoyed strong or even rising trend growth. But the permanent expansion of the “welfare state” over the past decades has eroded the economic base it was built upon as it contributed to reducing Germany’s growth potential. In this regard virtually all the symptoms, causes, and cures relevant for Germany’s reform agenda are related to its growth problem. Therefore, we will concentrate on the latter in the following analysis, which draws intensively on previous work published by Deutsche Bank Research in its publication series “More Growth for Germany.” This paper highlights the main obstacles to growth and evaluates the current reform process against what is necessary for Germany to return to a prosperous and sustainable growth path.

The diagnosis must start with the insight that the German economy is suffering not only from a cyclical downturn but a long-term growth problem. Of course, the U.S.-led global slowdown, the equity market crash, the high degree of geopolitical uncertainty after 9/11, and the strengthening of the euro triggered a cyclical downturn in Germany as in many other countries after the boom year 2000. And if the current U.S.-led global upswing holds and an overshooting of the euro exchange rate can be avoided, Germany also seems headed for a temporary, cyclical recovery in 2004. However, this external vulnerability and dependency only reveals the real problem of the German economy—its inability to generate sustained growth of domestic demand and economic activity. It is this weakness of potential or trend growth that matters for the German reform agenda, not the

economy's propensity for short-term cyclical fluctuations in response to macroeconomic policies or external shocks. Estimates of Germany's potential growth rate currently range between 1 percent and 2 percent, which is very low in both inter-temporal and international comparison.<sup>29</sup> Why is that?

- **Low labor input:** Empirical analysis by DB Research and other institutions reveals that the limiting factor and bottleneck for Germany's trend growth is the insufficient use of labor. The weak contribution from this production factor was the main reason for the slowdown in German growth over the last three decades. According to IMF estimates it is to blame for more than half of the growth weakness in the 1990s.<sup>30</sup> The problem lies not with labor productivity per hour worked (which is still impressively high) but with the low level of labor input as such. The latter results from the adverse combination of weak population growth (around 0.2 percent per annum compared with 1.1 percent in the United States), a very low participation rate in the labor market,<sup>31</sup> and a marked and persistent decline of hours worked per employee. Due to the shortened working week, the rising number of holidays, earlier retirement, mounting unemployment (especially among low-skilled workers) and the still comparatively high proportion of non-marketized housework (which of course does not show up in official statistics), the number of hours worked per head of population (the more relevant measure here) dropped from around 950 in the 1960s to below 700 by the end of the 1990s—by almost one quarter. In the United States, by contrast, hours worked rose by around one quarter to around 850 in the same period.
- **Labor market rigidities and the costs of the “welfare state”:** Ultimately, the low labor input in the German economy has two root causes. First, the highly developed, strongly re-distributive, and non-transparent welfare system results in high taxes and social security contributions, which, in turn, drives a wedge between gross and net wages. Together with very generous reservation wages and social standards for the unemployed, it also reduces the incentives to work. Second, and closely related are the severe structural rigidities in the labor market such as the centralized, collective wage-setting process; the resulting lack of differentiation of wages between different regions, sectors, companies, and workers' qualifications; excessive dismissal protection; and a lack of time flexibility of labor input. In spite of reasonable wage moderation in recent years, these rigidities have led to high gross real wages and discouraged the creation of new jobs. The resulting rise in official unemployment in the last three decades is the clearest evidence that the German labor market does not function like a market should—matching supply with demand, or, more precisely, getting all potential workers into jobs, thus increasing the economic use of the labor factor. The ever rising size of the “black” economy (estimated at more than 16 percent of “official” GDP, almost twice the U.S. share)<sup>32</sup> and of unofficial employment as well as the already mentioned low marketization of housework are further proof of the defunct German labor market.
- **Capital productivity on the decline:** With labor intensity falling sharply, the capital intensity of economic activity in Germany has surged in recent decades. As labor became increasingly expensive relative to capital, businesses increasingly substituted the factor capital for the factor labor. The major motivation of business investment was rationalization. The result is fully in line with textbook economics—the capital stock and labor productivity have risen rapidly in past decades while capital productivity and the return per unit of capital declined. Consequently, the pace of capital investment and accumulation of capital stock has slowed down markedly, and the contribution of capital to growth has fallen in recent years. The extreme slump in business investment in the current stagnation phase appears to be a largely cyclical phenomenon, however.
- **Erosion of innovative capacity:** Owing to its high labor costs and its aging and soon shrinking population, Germany's growth potential and prosperity in an increasingly globalized world economy will be ever more dependent on its power to innovate. At first sight, Germany is still well placed in terms of its innovation input, framework conditions, and output. This picture is painted by classic innovation indica-

tors such as R&D-specific labor input, research and development (R&D) spending, and publication and patent output. But closer inspection reveals grave weaknesses in terms of human resources, funding, and attitudes toward structural change.<sup>33</sup>

■ High level of government interference: Germany's economy is still subject to excessively high state intervention in terms of regulations, taxes, and social contributions as well as public spending. In 2003, spending of all public households still adds up to more than 48 percent of GDP, i.e. almost every second euro goes through the government's coffers. As discussed above, the high level of taxes and social contributions (41.5 percent of GDP in 2003) reduces the incentives to work and invest. This effect is exacerbated by the still high nominal income tax rates and an extremely complicated tax system which is hostile to incentives and damaging to growth, even though at 23 percent of GDP the overall national tax burden is the same as in the prosperous 1960s (unlike social security contributions, which have risen massively). Extremely high subsidies (estimates range up to more than 150 billion or one third of tax revenues per annum), especially in traditional sectors like agriculture, mining, transport and housing (these four account for roughly 65 billion alone), result in a severe misallocation of capital and other resources. The persistent expansion of public consumption and social spending has come at the cost of public investment, e.g. in key areas like education. The lack of fiscal consolidation combined with the fiscal rules of the Stability and Growth Pact have left hardly any leeway for discretionary spending or macroeconomic stabilization policy in the current period of stagnation. No doubt, the combined effect of all kinds of state interference in the German economy is a heavy, though naturally hard to quantify, drag on growth dynamics.<sup>34</sup>

■ Reunification burden still heavy: After sparking a rapid boom in the early 1990s, the political and social blessing of Germany's reunification in 1990 has proved to be a protracted drag on the pan-German growth performance as well as on the fiscal and social security accounts—mostly due to politi-

cally motivated economic policy mistakes. With GDP growth in eastern Germany lagging behind the anemic pace in western Germany, the process of catching-up has stalled in recent years; labor productivity has doubled but is still only 70 percent of the level in western Germany. Unemployment in the eastern states is still disproportionately high (around 17.3 percent of the labor force versus 8.0 percent in western Germany at the end of 2003) and is one of the major reasons for the weak labor input in Germany as a whole. According to unofficial estimates, net fiscal transfers from west to east still totaled some 83 billion in 2003 (gross: 116 billion or 4 percent of west German GDP) and will stay at a high level, financing not only investment (especially in infrastructure) but also consumption via wage subsidies and transfers for at least another fifteen years. Economic activity in eastern Germany is not only suffering from the ongoing correction of the heavily subsidized boom in housing and business investment, but also from the fact that it has to cope with most of the structural problems prevalent in western Germany.<sup>35</sup>

■ Demographic challenges ahead: The protracted weakness of growth and related symptoms have occurred even before the huge demographic change will begin to take its toll. Even faster than in many other industrialized countries (especially compared with the United States) the German population will not only grow older but will also shrink significantly over the next decades. According to official projections, the German labor force (defined as people aged 15-65) will probably start shrinking in 2015. Without corrective measures, the adverse effect on the growth potential induced by low labor input (as discussed above) will intensify; trend GDP growth would probably fall below 1 percent per annum and, in a worst-case scenario, could even turn negative. The financing problems of the pay-as-you-go public pensions and health care systems would escalate as the ratio between people paying contributions and those getting benefits deteriorates substantially. This demographic challenge to Germany's growth potential threatens to intensify virtually all the other structural problems as well.<sup>36</sup>

■ Social and political causes for the *Reformstau* (reform deadlock): Is it possible that the German people have deliberately chosen lower growth and employment in exchange for higher stability and social security? What are the deeper causes behind the *Reformstau*, which, until recently, made it impossible to implement the long-recognized prescriptions for a more dynamic economy? In a recent DB Research analysis on this issue, ten potential causes were listed, five of them on the individual, psychological level. (1) the reluctance of Germans to seize new opportunities due to their still high level of personal wealth; (2) the tendency of the media to “sing the blues” and help depression and lethargy spread; (3) Germans’ relatively high sense of risk aversion; (4) their strong preference for a well-developed welfare state that lulls individual responsibilities and initiative; and (5) people’s relatively low interest in politics which leaves politicians subject to vested interests. Moreover, there are five additional causes that are to be found in the institutional and political sphere; (1) the strong political influence of lobbyists and interest groups; (2) self-interested career politicians focused on keeping power (these two problems are certainly not specific to Germany); (3) most members of parliament coming from the public sector, tending to mistrust market solutions and favor government intervention; (4) frequent elections on all levels of government that lead to myopic policies; and (5) Germany’s paralyzed federal system with blurred responsibilities and complex financial transfers that hamper independent regional policy and block reforms.<sup>37</sup>

### The Cure: Germany’s Return to Growth—A Reform Agenda<sup>38</sup>

In principle, these structural problems have been identified, analyzed, and translated into economic policy recommendations for many years now. Again and again, German and international economic research institutions (including, for instance, the IMF,<sup>39</sup> the OECD, the Deutsche Bundesbank, and the German *Sachverständigenrat*<sup>40</sup>) have presented their reform proposals based on intense economic

analysis and experiences in other countries that faced similar problems in the past. However, their advice has been either benignly ignored or overtly dismissed (usually as “neoliberal” or “unsocial”) by politicians, because in their view, the implementation of potentially unpopular reforms would mean losing power in the next elections. In this regard, 2003 indeed seems to have brought some change for the better. Under the ever mounting pressure of the real problems, the presentation of “Agenda 2010” by Chancellor Schröder in spring 2003 finally triggered a public political debate and dispute about the reforms necessary in Germany.

This section will discuss some key elements of the reforms needed to tackle the structural causes of Germany’s persistent weak growth. The next section will use this benchmark to assess the key measures actually included in the current reform process.

The only promising cure of the German “growth disease” is a courageous, consistent, and sustained combination of sweeping, market-oriented structural reforms, especially in the following areas:

■ The Labor Market: Given that the insufficient use of the factor labor is the bottleneck, a fundamental reform of the labor market to boost employment is the sine qua non for solving Germany’s growth problem. Given the myriad causes of the rigidities and imbalances in the labor market, a full package of measures will be required to raise participation rates and working hours, mainly for increasing the flexibility of labor input, reducing all kinds of labor costs, and correcting flawed incentives. Most importantly, the legal framework for the excessively rigid and centralized collective wage-setting process should be made more flexible and allow for decentralized, company-specific wage agreements (“opening clauses”). Working hours should also become more flexible; in light of demographic developments, reforms need to aim at increasingly longer annual and lifelong working times. Special, possibly still collectively agreed upon, solutions must be found for low and unskilled workers, which represent a large share of structural unemployment. The necessary expansion of the low-pay sector must be

compatible with the social security (especially unemployment aid) and tax system to ensure that working in the official economy pays off after taxes and social contributions. The reform of the Federal Employment Service responsible for placement, training, and administration of the unemployed should be intensified and more closely geared to market-based solutions. The strong legal protection against termination of work contracts needs to be eased to encourage hiring, especially for small and medium-sized companies. Participation rights of trade unions and worker councils in business decisions should be critically reviewed. To significantly reduce unemployment, continued wage restraint on the part of the collective bargaining partners (trade unions and employer associations) will remain crucial. For several years, wage increases should not fully exploit the productivity-based scope for redistribution. Such a pro-job wage policy could be made politically more attractive if profit sharing by employees were increased, perhaps by means of occupational pension plans.<sup>41</sup>

■ Social security systems: Most of non-wage labor costs are caused by the two main pillars of the German “welfare state”: the statutory pension insurance (GRV) and the public health insurance system (GKV), with current contribution rates of 19.5 percent (plus additional tax funding) and on average 14.4 percent of gross pay, respectively. Half of the contribution rates are paid by employers. While the goal of higher employment and growth would call for a marked reduction of contribution rates, without corrective action both systems are headed for a massive financing crisis in the longer term due to future demographic changes—even at the currently high contribution rates. The acute financing problems will probably require further emergency measures in the short term but the bigger challenge is to make these systems able to withstand future challenges. Regarding the statutory pension scheme, key priorities of reform will have to be (1) a further reduction of guaranteed benefits (pension level to below 40 percent of gross wages compared to 48 percent in 2001), ideally by means of a flexible demographic sustainability factor in future pension adjustments; (2) a significant increase in the official retirement age of

sixty-five, which currently entitles pensioners to draw maximum benefits, combined with the option to flexibly choose the actual retirement age by applying more appropriate deductions and bonuses on pension benefits than today; (3) strengthening, in general, the principle of equivalence between contributions and pensions, and fostering the transparency and credibility of the system by the introduction of individual pension accounts; (4) encouraging today’s generation of actively employed persons to save privately for their own pensions.<sup>42</sup>

■ Regarding the public health insurance system, it seems clear that the overall costs for society will continue to increase because of rising life expectancy and advances in medical technology. However, to promote higher employment it is essential to avoid an institution where rising health care costs continue to boost total wage costs for employers. Therefore, any reform should aim at decoupling health insurance from the relationship between employer and employee, at least with regard to future increases in insurance premiums. At the end of the day, what do the risks to personal health have to do with having a job? A stronger orientation to the equivalence principle with a risk-appropriate, funded, privately organized health insurance system would make more sense than the current system with its desperate efforts to cap spending by administrative budget and cost-cutting measures. Parallel to correcting flawed incentives on the demand side of medical care, substantial productivity and efficiency gains are required and possible on the supply side (hospitals, doctors, pharmacies) and also among insurance providers, simply by allowing for more transparency, competition, and responsibility on all sides. A similar approach seems adequate for the separate system of mandatory public long-term care insurance. As a general rule for all areas of social security, the financing of non-insured benefits should be paid from general tax revenues. Certainly, these or similar market-oriented reforms would be highly interdependent and complicated and pose problems in the transition period. But to reduce or at least stabilize the burden of non-wage labor costs, they seem inevitable.<sup>43</sup>

- **Fiscal consolidation and tax reform:** If the government wants to get the German economy back on a higher growth trend, two out of the three options to solve the structural public financing problems are no longer viable. In light of the already high levels of budget deficits, outstanding public debt, as well as taxes and social contributions, it can neither increase debt issuance nor public revenues without harming the economy. This leaves only one real option for the inevitable fiscal consolidation—determined cutbacks on public expenditures. Apart from decisive efforts to make the activity of the public sector itself more cost efficient, e.g. by avoiding double work on different levels of government and by fully exploiting the outsourcing potentials to the private sector, the top priority should be to reduce the jungle of subsidies. Subsidies do not only absorb around one third of tax revenues but also heavily distort incentives and thus the allocation of resources in the whole economy, thereby reducing growth potential via many different channels. The sweeping reduction of subsidies to households (like own-home premiums or tax allowances for commuters and night-workers) should go hand in hand with a fundamental income tax reform aimed at further lowering nominal tax rates, broadening the tax base by eliminating virtually all tax exemptions, and massively simplifying the whole tax system. In a move away from the current synthetic tax system (which in principle treats all sources of income equally), the reform could also introduce a final withholding tax (or definitive tax, with a uniform lower rate) on interest and other kinds of capital income to encourage saving and investment and to avoid investors' evasive reactions. Other sensible, also growth-friendly elements of a big tax reform would be a partial shift from direct to indirect (consumption-based) taxation and a general realignment of the legislative powers and tax autonomy of the different levels of government, including the replacement of the current, largely degenerated municipal trade tax.<sup>44</sup>
- **Market liberalization, education, and other reforms:** There are numerous other fields where sweeping reforms are urgently needed to boost Germany's economic performance and competitiveness and to weather the challenges from demographics and globalization: educational reform, the enhancement of innovation capacities, and further liberalization in key industries. However, since the focus here is on the most pressing labor market, fiscal, and social security reforms, we would like to refer to earlier analyses by DB Research on these other issues.<sup>45</sup>
- **Trying to turn the demographic tide:** Given that the future aging and shrinking of the German population will multiply virtually all the structural problems, the natural question is what the government or, rather, society as a whole could possibly do to tackle the demographic change, i.e. the underlying problem per se, and not only its manifold consequences. With life expectancy set to keep rising over the next decades, political decision-makers in Germany should certainly analyze and implement appropriate measures to boost birth rates (for instance by improving the financial situation of families and extending child-care facilities) and, to some degree, immigration. However, whatever measures are taken they will at best ease the demographic challenge in the long run; and they would make the adjustment needs in the short and medium run even more acute. The major responsibility of public authorities, though, is to raise people's awareness and to decisively and quickly implement the inevitable structural reforms required to meet this unprecedented challenge. In particular, radical labor market reforms as discussed above will be indispensable in making the German economy more resilient in handling these demographic shifts.<sup>46</sup>

### **The Current Reform Process: Germany is Slowly Moving in the Right Direction**

Since Chancellor Schröder delivered his "Agenda 2010" speech on March 14, 2003 Germany's sluggish reform drive has accelerated enormously and reached an unprecedented pace in the final months of 2003. Numerous measures have already passed the legislative process or are in the pipeline for 2004. The parliamentary adoption of reform laws is complicated by the fact that many, though not all, measures

need approval not only by the *Bundestag* (the lower house of parliament where the governing coalition of SPD/Greens holds the majority) but also by the *Bundesrat* (the upper house, which is controlled by the opposition parties of CDU/CSU and FDP). Therefore the whole reform process is subject to intense political fighting and bargaining as well as high uncertainty about the actual outcome of specific reform initiatives, as demonstrated in the political showdown before Christmas 2003. However, against the backdrop of the normative discussion above, the following section will describe and assess the current stage of reform in the different policy areas and provide an outlook for 2004.<sup>47</sup>

■ **Labor Market Reform:** Some measures already entered into force at the beginning of 2003, especially those aimed at improving job placement services, tightening the eligibility criteria for unemployment assistance, and fostering temporary (PSAs: Personnel Service Agencies), independent (“Ich-AG”, i.e. “Me plc”), and low-wage employment (tax incentives for “Mini- and Midi-Jobs”). According to still rather tentative evidence, some of these measures (but not the Ich-AGs and the PSAs) already seem to have had some effect. Although the economy contracted in the first half of the year and picked up only moderately in the second, unemployment stopped rising in summer and has declined slightly in recent months, at least according to official statistics. The following key measures were adopted only in late 2003: (1) reduction of the unemployment benefit duration from a maximum of thirty-two months to twelve months for all unemployed (eighteen months for those aged above fifty-five, but valid only from 2006); (2) reforms of job protection legislation, especially allowing for new hiring without dismissal protection for small businesses (up to ten employees), and for the agreement of dismissal payments; (3) merger of unemployment assistance (which so far was paid after insured unemployment benefits ran out) with the significantly lower social assistance (which provides subsistence support) into a new scheme covering all who are able to work (final legislation still due in 2004); (4) related measures to increase the incentives to seek and

take a new job (especially the reduction of acceptability requirements for long-term unemployed); (5) service-oriented reorganization and streamlining of the Federal Employment Service. Overall, these extremely unpopular labor market reforms seem to be well targeted and a major step forward. The most important single feature is the much stronger incentive for the older unemployed to find jobs, which should contribute to a significant reduction in long-term unemployment and a higher participation rate of people aged above fifty-five. However, for the labor market as a whole, the effects will probably be rather small and remote, given that the government so far has not dared to tackle the structural rigidities of the centralized wage bargaining system.

■ **Public healthcare:** Regarding social security reforms in general, the government has committed to a two-step approach—an immediate “emergency program” is to be followed by a medium-term concept to adjust the systems to the demographic challenge. Regarding healthcare, a set of emergency measures has already been agreed and passed, having been given the nod by the opposition. They entered into force at the beginning of 2004 and aim at reducing insurance contributions (by two and a quarter percentage points by 2007) mainly through cutbacks and the exclusion of some services and by widening the scope of co-payments by patients. While it remains to be seen whether, and when, public health insurers will use this relief for a reduction of insurance premiums and thus non-wage labor costs, it is clear that the measures agreed so far fall short of what is needed—regardless of the future demographic trend. The absence of any significant supply- or demand-side reforms to enhance the competition and thus efficiency of healthcare provision is clearly disappointing. Discussions on the next, inevitable reform step have already begun; an expert panel installed by the government (the Rürup Commission) has presented two proposals for systemic reform on the revenue side—uniform premiums (*Kopfprämien*) for all insured in the public system (combined with tax-financed subsidies for those in need) versus extension of the current system to freelancers and civil servants

(*Bürgerversicherung*). While the former would bode well for future economic and labor market performance (as higher health care costs would no longer boost non-wage labor costs), the latter seems politically more attractive as it would at least partly maintain the strongly redistributive nature but also the flaws of the current system. It is not yet clear, however, when the government will address the next step of health care reform—possibly only when insurance premiums start rising again.

- Public pensions: Much earlier than expected by the government, the 2001 pension reform (which introduced some modest cuts in the statutory system and complicated incentives for private provision) proved insufficient to plug the existing gaps. To avoid a further rise in the contribution rate from the current 19.5 percent, the government in autumn 2003 launched another emergency program, including the postponement of the next round of pension increases and other implicit cuts. Also, on the basis of proposals from the Rürup Commission, the government wants to present “as soon as possible” a proposal for the long-term stabilization of the public pension system centered on the introduction of a “sustainability factor,” which would take into account the ratio of pensioners to contributors in future pension adjustments. Other key elements already under discussion are a potential hike not only in the actual but also the official retirement age to sixty-seven, a reform and extension of the tax incentives for private pension plans, and a change towards taxation of pensions only in the benefits phase. For the fundamental reform of the public pension system, the approval of the *Bundesrat* is mandatory and indeed necessary given the long-term nature of this issue. The CDU/CSU announced its own reform concept in December (based on work by their so-called “Herzog Commission” of experts). Similarly to health care reform, a reasonable compromise seems likely to be reached, although the magnitude and timing of the next step remain uncertain. Given that cuts in pensions are highly unpopular among the electorate, the obvious risk is that the next reform steps again will be based on overly optimistic assumptions about future growth and

employment dynamics, keeping the public pension system under construction for many years to come.

- Tax Reform: A three-stage income tax reform was passed back in 2000, mainly aimed at lowering nominal marginal tax rates. In the third and final phase the bottom marginal tax rate will have dropped from 22.9 percent to 15 percent and the top marginal rate from 51 percent to 42 percent — a marked improvement even though the solidarity surcharge for eastern Germany (5.5 percent on the tax obligation) will remain in place. In another last-ditch political effort, the government and the opposition parties agreed to partly bring forward this final stage from 2005 to 2004, with the bottom rate initially declining to 16 percent and the top rate to 45 percent. Around 30 percent of the resulting additional shortfall in tax revenues for 2004 (around 9 billion) will be covered by higher borrowing; the rest is financed by cuts in subsidies (for home-owners and commuters) and higher privatization proceeds. Given the cuts in subsidies and higher health care costs, the earlier tax relief will provide an only marginal economic stimulus (0.25 percent of GDP at best) and lead to another violation of the 3 percent deficit ceiling in 2004. Besides the urgent reform of municipal finances, one big issue on this year’s tax policy agenda will be the reform pertaining to capital income, where the government seems to prefer the pragmatic solution of a final withholding tax on interest income —and possibly dividends, capital gains, and other kinds of income as well—to create a level playing field for all financial market instruments. In order to actually discourage tax evasion, the withholding tax rate would of course need to be fairly low (with the bottom marginal income tax rate of 15 percent valid from 2005 being a good orientation), especially as the government wants to combine it with the already adopted temporary amnesty scheme for tax offenders who have not reported investment income. In our view, the marked reduction of marginal tax rates, combined with a sensible and consistent reform of capital income taxation would already be a big leap forward, even though it would hardly make the German tax system less complicated, or opaque, and thus less unfair. However,

recent discussions in both political camps have slightly raised the chance for a fundamental tax reform in the next couple of years, aimed at a further reduction of tax rates combined with a sweeping abolition of exemptions under a completely redesigned and simplified system. Several proposals for fundamental, even radical, tax reform are in the making or have already been presented. It is certainly much too early to celebrate anything at this point, but at least a common view seems to be building among key politicians that the current tax system has become too obscure to be reformed. Especially the politically extremely unpopular elimination of tax exemptions and other subsidies would be much easier if the old universe of tax legislation were abandoned and replaced by one new, simple, and competitive tax law.

To sum up, the labor-market, social-security, and fiscal reforms implemented in 2003 mark an encouraging step in the right direction but they still fall short of what will be needed to visibly raise Germany's growth potential, let alone to meet the demographic challenge. Most of the measures will only have an impact after significant time lags, and some could even pose a short-term drag on growth. To really make a difference, much bolder and more market-oriented reforms are necessary in virtually all policy areas. The goal should not be to simply adjust the traditional German welfare state to a less affluent economy (though inevitable in the short term) but to boost prosperity and to ensure that Germany will again take the role of the economic powerhouse that Europe so urgently needs.

However, the public reform discussion kicked off by the "Agenda 2010" appears to have strongly improved the political and psychological basis for the outstanding elements of Germany's reform agenda. Public awareness of the challenges has increased markedly, and many politicians now dare to raise unpopular truths and address them, except for a few remaining taboos. Although an intense political competition about the best way out of the crisis has developed, there is a remarkable consensus about the ultimate goals of reform. Even with regard to actual decision-making and implementation, the reform process reached remarkable momentum in 2003. Nonetheless, there is a great risk that the reform process could falter again if and when a cyclical economic recovery temporarily eases the political pressure from the above problems.





CHAPTER FOUR

04

## CONCLUSION: CONSTRUCTIVE ENGAGEMENT NEEDED FROM BOTH SIDES

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Transatlantic relations need active, constructive engagement from both sides. While fundamentally different attitudes to global security issues after 9/11 and the different perceptions of the respective national threats and vulnerabilities need to be accepted on both sides, careful attention should be paid to avoid deep damage in other policy areas. As Miller puts it, managing the difference between America preferring primacy and Europe preferring order is a great challenge for transatlantic relations in the years ahead.<sup>48</sup>

Economic relations could continue to play the role of an inherent stabilizer of transatlantic relations: economic integration has increased substantially in the 1990s and provides a sound basis for other policy areas. While trade issues are of major importance in this context, the economic (not the political) relevance of trade-related policy disputes for transatlantic relations often seems overstated in the press and wider public. However, with real economic transatlantic integration increasing, conflicts of interest are even harder to solve as they relate to a substantially wider set of issues, such as standards, taxation, and consumer protection. Not only these economic issues in a narrow sense but also the broader challenges from globalization, demographic change, or environmental issues are highly relevant for both transatlantic partners, and they require a good deal of willingness to cooperate on both sides if relations are not to be substantially impaired.

Currently, transatlantic relations are unbalanced. And this imbalance is not only caused by different approaches to foreign and security policy but also by the widely differing economic performance. If Europe and especially Germany want to increase their weight in transatlantic relations, they have to work hard to increase their economic potential. Moreover, in

economic as well as foreign and security issues, Europe needs to improve its ability to speak with one voice in order to become a more reliable and accepted partner. We have identified an agenda comprising the most pressing economic issues for Europe and Germany to revive their growth potential. In this context it is essential to stress that the European and the national agenda are highly interdependent: pushing ahead the European reform issues, especially integration policy, helps to improve factor allocation within the European Union and thus raise productivity. At the same time, member states need to tackle a number of important reforms on the national level that have been identified as causes for disappointing growth in Europe.

Although Europe has achieved a lot in the past decades with respect to integration, frictions in important markets (business services, financial services, transport, etc.) have remained an important obstacle to integration and are a detriment to actual and potential growth in Europe. Completing the single market in the areas mentioned above and reducing frictions—such as a complex tax framework or overly strict regulation—should thus be a high priority on the European reform agenda. Moreover, the European Commission—with the help of the member states—should for the

sake of credibility maintain the Stability and Growth Pact. Stepping up compliance is an important issue as it demonstrates—among others—Europe’s willingness to adhere to a self-established set of rules in a coordinated manner.

Germany’s reform agenda primarily aims at boosting growth and employment and at ensuring the sustainability of its fiscal and social security system in spite of the rising challenges from demographic change and globalization. Germany’s persistent weakness of growth potential is largely caused by the insufficient use of the factor labor. Therefore the most urgent reforms are to tackle the structural rigidities in the labor market and to reduce non-wage labor costs by pursuing sweeping, market-oriented reforms in the public pension and health-care systems. The inevitable fiscal consolidation should go hand in hand with a comprehensive tax reform, combining further income tax cuts with a rigorous elimination of exemptions and other subsidies.

In light of continued stagnation, rising unemployment and surging financing gaps in the public budgets and social security system, the reform process in Germany accelerated rapidly in the course of 2003. While the reform initiatives adopted so far still fall short of what is needed to achieve the above goals, they certainly are a remarkable step in the right direction. The public awareness of the need for change has clearly risen. The great political challenge will be to maintain the pace of reform in the years ahead—not only for the sake of Germany’s economic well-being, but also for the sake of European integration and the transatlantic relationship.

## NOTES

- 1 See "They Say We're Getting a Democracy: How America Should Promote its Values in the Arab World, and How it Shouldn't," *The Economist*, European Edition, 2003. Wetzel, Harald, (2003): "Kriegsbilanz schlecht geplant," *Financial Times Deutschland*, p. 13.
- 2 See Chicago Council on Foreign Relations; German Marshall Fund, *Worldviews 2002: American and European Public Opinion and Foreign Policy*, [www.worldviews.org/detailreports/compreport.pdf](http://www.worldviews.org/detailreports/compreport.pdf) (18.12.2002).
- 3 See Rice, Condoleezza (2000): Campaign 2000, "Promoting the National Interest," *Foreign Affairs*, Vol. 79, No. 1 p. 47.
- 4 See Krell, Gerd (2003): *Arroganz der Macht, Arroganz der Ohnmacht. Der Irak, die Weltordnungspolitik der USA und die transatlantischen Beziehungen*. HSFK-Report 1/2003, Hessische Stiftung Friedens- und Konfliktforschung, p. 22.
- 5 *The National Security Strategy of the United States of America*, 2002, p. 5. Quote by President Bush, Washington D.C. (The National Cathedral), September 14, 2001.
- 6 See Miller, Steven, E. (2003): *Primacy or Order? American Power and the Global System after Iraq*. Paper prepared for the Workshop on The Future of Transatlantic Relations of the Bertelsmann Foundation's Transatlantic Strategy Groups, Schloss Reinhartshausen, Frankfurt, Germany, July 17-18, 2003, p. 10.
- 7 See Rice, Condoleezza (2000): op. cit., p. 47.
- 8 *The National Security Strategy of the United States of America*, 2002, p. vi.
- 9 Ibid., p. 17.
- 10 Ibid., p. 18.
- 11 See Krell, Gerd (2003), p. 11. However, the number is significantly smaller (8.7 percent) when intra-EU trade is included.
- 12 Here and in the following paragraphs data is taken from Quinlan, Joseph P. (2003): *Drifting Apart or Growing Together? The Primacy of the Transatlantic Economy*. Washington, D.C.; Center for Transatlantic Relations.
- 13 See Thiel, Elke, Barbara Böttcher and Klaus Günter Deutsch (2004): "Growth and Prosperity in Europe - An Agenda," Deutsche Bank Research, EU Monitor, *Reports on European Integration*, No.8.
- 14 See also Quinlan, Joseph P. (2003): op. cit., p. 22.
- 15 There are further issues that stirred dissent: trade in agriculture, genetically modified foods (GMOs), the Kyoto agreement on global climate change, and the International Criminal Court (ICC) to name a few.
- 16 See Quinlan, Joseph P. (2003): op. cit., p. ix.
- 17 See Krell, Gerd (2003): op.cit., p. 14, Table 7.
- 18 See Hancock, John and William B.P. Robson (2003): "Building New Bridges: A Case for Strengthening Transatlantic Economic Ties," p. 6f.
- 19 This position is put forward by Grant: "The Americans believe that they are superior even in economics, the principal area where the Europeans have succeeded in pooling their interests." Grant, Charles (2003): *Transatlantic Rift: How to Bring the Two Sides Together*. Centre for European Reform. p. 25f. See also Quinlan, Joseph P. (2003): op. cit., p. 22. Quinlan argues that in the United States, there is mounting sentiment that Europe will always lag behind the U.S. economy and that Europe needs America more than America needs Europe.
- 20 Rice, Condoleezza (2000): op. cit., p. 46.
- 21 Grant, Charles (2003): op. cit., p. 3.
- 22 Hancock, John and William B.P. Robson (2003): op. cit., p. 2.
- 23 Zielsetzung des Europäischen Rates, Treffen in Lissabon, March 2000.
- 24 Thiel, Elke, Barbara Böttcher, and Klaus Günter Deutsch (2004): "Growth and Prosperity in Europe - An Agenda," Deutsche Bank Research, EU Monitor, *Reports on European Integration*, No.8. The insights in this chapter draw on the article by Thiel, Böttcher, and Deutsch, op.cit., p. 7.
- 25 Messerlin, Patrick A. (2001): *Measuring the Costs of Protection in Europe: European Common Commercial Policy in the 2000s*, Washington D.C.; Institute for International Economics.
- 26 The tax reform 2000 and the introduction of incentives for private pension provisions ("Riester-Rente") in 2001 were steps in the right direction but were politically unpopular.
- 27 Ackermann, Josef, (2003): "A successful year of reform in 2003!" speech at the New Year's Reception of the city of Frankfurt/Main, published in Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt.
- 28 For references regarding this full chapter please see Deutsch, Klaus Günter, Jörn Quitzau, and Norbert Walter, (2002): "Germany's Return to Growth: A Reform Agenda," Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt; Bergheim, Stefan, and Marco Neuhaus (2002): "Bottleneck Labour - An Empirical Growth Analysis," Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt; International Monetary Fund, (2003): *Germany: 2003 Article IV Consultation - Staff Report*, IMF Country Report No. 03/341, Washington, D.C.
- 29 See Denis, Cécile, Kieran McMorrow, and Werner Röger (2002): *Production Function Approach to Calculating Potential Growth and Output Gaps - Estimates for the EU Member States and the US*, *European Economy*, Economic Papers No. 176; European Commission. However, around 0.4 percentage points of the U.S. lead results from different statistical approaches. See also: Deutsche Bundesbank, (2001): *Problems of International Comparisons of Growth - A Supplementary Analysis*, Monthly Report, Frankfurt.

- 30 International Monetary Fund, (2002): *Germany: Selected Issues*, IMF Country Report No. 02/240, Washington, D.C.
- 31 Especially among older people; only 41 percent of the 55-64 year-old Germans are employed, 17 percentage points less than in the United States.
- 32 Source: Schneider, Friedrich (2002): *Der Umfang der Schwarzarbeit des Jahres 2002 in Deutschland, Österreich und der Schweiz - Weiteres Anwachsen der Schwarzarbeit*, Salzburg.
- 33 See Hofmann, Jan (2003): "Innovation in Germany: Mind the Gap!" Deutsche Bank Research, *Current Issues - More Growth for Germany*, Frankfurt.
- 34 See Boss, Alfred (2003): "The Public Sector - A Clamp on Growth," Kiel Institute for World Economics, published in Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt; Quitzau, Jörn, (2002): "Tax Policies for Increased Growth and Prosperity," Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt.
- 35 See Boss, Alfred (2003): op. cit.
- 36 Gräf, Bernhard (2003): "German Growth Potential: Facing the Demographic Challenge," Deutsche Bank Research, *Current Issues - Demography Special*, Frankfurt.
- 37 Bergheim, Stefan, Marco Neuhaus, and Stefan Schneider (2003): "Reformstau: Causes and Remedies," Deutsche Bank Research, *Current Issues - More Growth for Germany*, Frankfurt.
- 38 Title of an article by Deutsch, Klaus Günter, Jörn Quitzau and Norbert Walter, (2002): Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt.
- 39 See for instance International Monetary Fund, *Germany: 2002 Article IV Consultation - Staff Report*, IMF Country Report No. 02/239, Washington, D.C., and similar reports from earlier years.
- 40 See for instance Sachverständigenrat, "Zwanzig Punkte für Beschäftigung und Wachstum," *Jahresgutachten 2002/2003*, Wiesbaden.
- 41 See Deutsch, Klaus Günter, Jörn Quitzau and Norbert Walter (2002): "Germany's Return to Growth: A Reform Agenda," Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt; and Viktor Steiner, (2004) "Labor Market Reforms for More Growth," Freie Universität Berlin, DIW Berlin, IZA Bonn, published in Deutsche Bank Research, *Current Issues - More Growth for Germany*, June 2003.
- 42 See Bräuninger, Dieter (2003): "On the Statutory Pension Scheme Reform," Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt.
- 43 See Deutsch, Klaus Günter, Jörn Quitzau, and Norbert Walter (2002): op. cit.
- 44 See Quitzau, Jörn (2002): op. cit; Boss, Alfred, (2003): op. cit.
- 45 See for instance Foders, Federico (2003): "Education Policy for Growth and Employment," Kiel Institute for World Economics, published in Deutsche Bank Research, *Current Issues - More Growth for Germany*, Frankfurt. Schaaf, Jürgen, (2003): "Germany's Entrepreneurial Environment: Boom and Gloom for High-tech Companies," Deutsche Bank Research, *Frankfurt Voice - More Growth for Germany*, Frankfurt; Hofmann, Jan, op. cit.; Deutsch, Klaus Günter, Jörn Quitzau, and Norbert Walter (2002): op. cit.
- 46 See Bräuninger, Dieter, Bernhard Gräf, Karin Gruber, Marco Neuhaus, and Stefan Schneider (2002): "The Demographic Challenge," Deutsche Bank Research, *Frankfurt Voice Special Edition*, Frankfurt; Bernhard Gräf, op. cit.
- 47 For this full chapter see Fickinger, Nico and Manfred Schäfers (2003): "Herbst der Reformen - Deutschland verändert sich," *Frankfurter Allgemeine Zeitung*, p.7; International Monetary Fund (2003): *Germany: 2003 Article IV Consultation - Staff Report*, IMF Country Report No. 03/341, Washington, D.C.
- 48 See Miller, Steven E. (2003), p. 24.

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