FOR AGENDA

SM/04/353
Correction 1

October 21, 2004

To: Members of the Executive Board

From: The Secretary

Subject: **Germany—Selected Issues**

The following factual corrections to SM/04/353 (10/8/04) have been provided by the staff:

Page 5, para. 4, line 2: for "stipulates" read "generally requires"

Page 60, para. 97, line 6: for "With some simplification," read "Simplifying for exposition,"
line 11: for "and there was no link to demographics." read "and there was only a weak link to demographics."

Page 65, para. 110, line 1: for "Basic Law" read "Constitution (Grundgesetz)"
line 4: for Basic Law" read "Constitution"
footnote 42, line 2: for "(see para. 39)" read "(see para 143)"

Page 66, para. 111, line 7: for "Basic Law" read "Constitution"
footnote 44, line 2: for "as a "fraction" in Parliament" read "as a parliamentary group."

Questions may be referred to Mr. Decressin (ext. 37140), Mr. Brunner (ext. 39671), and Mr. Braumann (ext. 38504) in EUR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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OVERVIEW

1. A cyclical recovery is underway in Germany, but the longer-term growth prospects remain a concern. A combination of fiscal adjustment and structural reform is needed to improve the longer-term growth outlook, and this Selected Issues Paper illuminates different aspects of the challenges confronting Germany and the associated policy requirements.

2. **In a cross country study involving 21 OECD economies, Chapter I investigates the steady decline in capital accumulation in Germany in recent decades.** It finds that capital accumulation was very strong in the early years after World War II, consistent with rebuilding. With marginal benefits diminishing as the capital stock was restored to levels comparable with other advanced countries, part of the more recent slow down could thus have been expected and is commonly referred to as "convergence". However, the path along this convergence has had wide swings, which are related to wage booms in the 1970s and immediately following unification in the 1990s, and to increases in taxes on capital and wages. Sharp wage increases are found to boost capital formation in the short run as employers substitute capital for labor at a rate that adjusts to the higher relative price for labor (thereby boosting unemployment and causing an underutilization of labor). Higher taxes on factor inputs, be they capital or wages, are both seen to lower capital accumulation. In the long run, capital formation is seen to depend on the growth of total factor productivity and labor supply. Hence policies should aim at keeping factor price distortions to a minimum, and especially promote flexibility in labor markets together with proper incentives for a higher degree of labor utilization.

3. **Chapter II focuses on the German labor market, assessing participation rates, employment, and unemployment from a cross country perspective.** Participation is found to be low among elderly workers (who are bridging into retirement with generous unemployment facilities), women (in the West), and youth. Employment rates are especially low among the elderly, notably in the East, where lower productivity workers were essentially priced out of the market through high wage floors (high reservation wages) linked to the adoption of generous entitlement provisions from the West following unification. Moreover, while the overall unemployment rate is higher than in comparator countries, the gap in participation (i.e. labor utilization) is larger than in unemployment, suggesting that policies directed at increasing participation rates offer the greatest potential for increased labor supply and output growth. Labor market and entitlement reforms in Agenda 2010 are estimated to boost steady state employment by some 1½ percent. In light of the impending demographic changes, especially the decline in the working-age population, additional steps will be needed to boost longer-term participation rates and labor utilization. The paper concludes with several options to deepen reforms in this direction.

4. **Chapter III considers the link between pensions and growth.** The key to this link is embedded in German law, which generally requires that social transfers need to be financed with payroll taxes. Higher payroll taxes, however, reduce labor supply, and therefore reduce growth. Staff simulations show that the coming demographic shifts are likely to reduce GDP growth below what is currently expected because of an adverse cycle of

rising nonwage labor costs and low incentives to work. The Agenda 2010 reforms to begin addressing the pressures from aging are a step in the right direction, but are not expected to be enough to contain payroll taxes sufficiently and prevent a growth slowdown. An important policy option to lessen the pressure from aging is to increase the effective retirement age—thereby supporting growth and enhancing the distributional equity between generations.

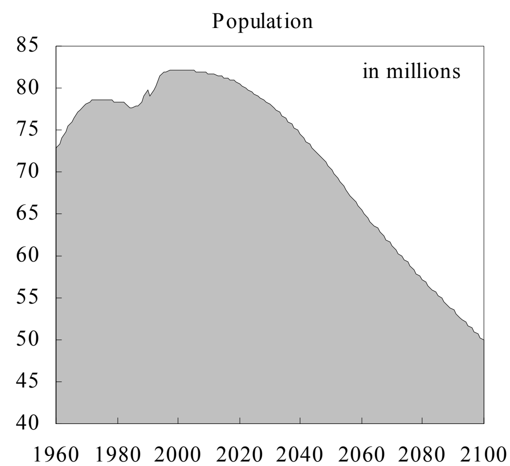
5. **Chapter IV offers perspectives on Federalism and Germany's Political Economy of Fiscal Adjustment.** It shows that the evolution of the structural fiscal balance is closely linked to the support for the government in the upper house of parliament (the Bundesrat—representing the Länder governments). Also, it explores the course of structural reforms, which are key to boosting growth and redressing long-term fiscal imbalances, and finds that these are subject to frequent policy reversals. In order to limit the political economy biases to fiscal policy, the chapter explores options to strengthen budgetary institutions, notably more transparency; stronger budgetary rules; and more room for Länder governments to mobilize revenue and tailor spending to local circumstances—thereby inducing a degree of competition in the federalist framework that is now dominated by the need for consensus.

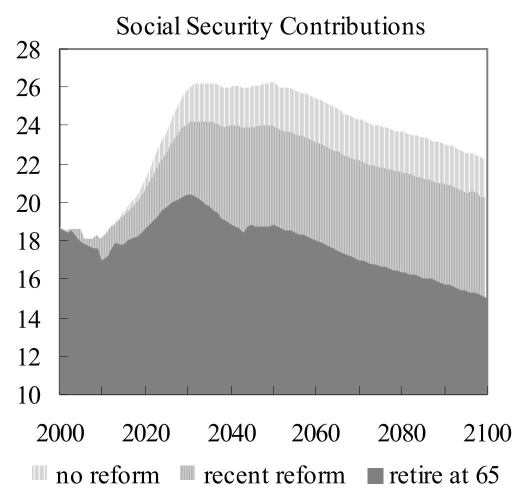
6. **Chapter V examines whether purchasing power parity (PPP) holds over the long run in Germany and Switzerland.** Using data for the past century, it finds that PPP, characterized by a relatively stable REER, holds for Germany but not for Switzerland. The Swiss trend appreciation reflects high equilibrium private and public saving rates and a degree of pricing power in monopolistic domestic markets that is not present in Germany. Calculations of the German *fundamental equilibrium exchange rate* suggest that the current REER is close to its equilibrium level. How to reconcile this external, and quite competitive, equilibrium in Germany with dormant domestic demand and low labor utilization is a challenge that requires further research.

- Economic effects of aging without reforms,
- The impact of the entitlement reforms of 2004,
- The impact from raising the retirement age.

C. Economic Effects of Aging Without Reforms

93. **Current demographic projections suggest that Germany's population could decline by 40 percent during the 21st century**. More important for fiscal policy, the ratio between the working age population and dependents (children and elderly) will worsen sharply after 2010, as the process of aging accelerates. The labor force will then decline, even if labor force participation increases. As large cohorts of baby-boomers begin to retire, the demands on the social security system will escalate. This age-related shift is projected to continue to about 2035, when the dependency ratio stabilizes at close to 50 percent, nearly twice the present rate.





94. **The decline in the labor force will inevitably reduce trend GDP growth.** Capital and labor are the key inputs in the production function. As the supply of labor shrinks, output growth slows. Employment is projected to decline by an average of 0.4 percent a year during the 2010s, and by 1.0 percent a year during the 2020s. In current benchmark scenarios, capital and total factor productivity are assumed to grow at around 2 and 1 percent a year, respectively. With these assumptions, which reflect recent experience, potential GDP growth would be about 0.5 - 1.0 percent per year.

95. **However, the burdens of aging may reduce potential GDP growth to around zero if they are financed with ever-higher payroll taxes.** Increasing payroll tax rates would reduce net (after-tax) wages, and depress labor supply. This effect would magnify the demographic decline of the labor force mentioned above. As a result, GDP growth will slow further, and in turn reduce investment and capital accumulation. The ensuing shortfall in social security revenue may trigger another round of payroll tax hikes, employment declines and growth reductions. This downward spiral could paralyze potential output. According to the calibrated model, German potential GDP growth could decline to around zero for most of the 2020s.

96. **With unchanged policies, the model thus suggests that higher payroll taxes could shave off 1 percentage point of GDP growth per year.** As shown in the figure, social security contributions may need to rise by up to 7 percentage points of GDP through about 2035 to cover higher pension and health outlays. This would leave real GDP in 2030 some 20 percent below the level it could attain if contributions had remained unchanged. Similarly, after-tax real wages would also forgo a gain of some 20 percent. This result should also be seen in the context of income distribution. A shrinking working population will transfer more funds to an expanding dependent population. This will lower Germany's productive efficiency, but also make income distribution more uneven among generations.

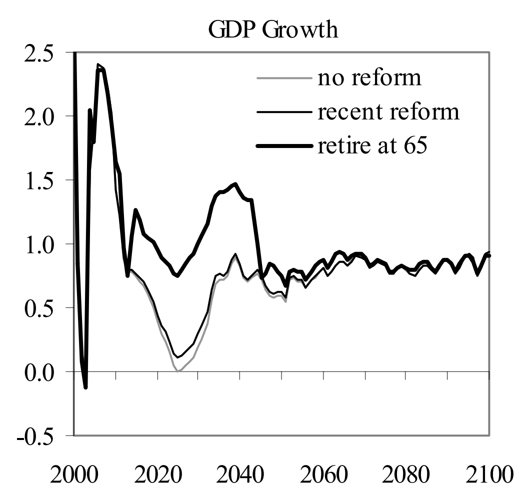
D. The Reform of 2004

97. **The recent pension reform dampens somewhat the growth in benefits.** Following the recommendations of the Rürup commission, a series of measures was implemented in February 2004 to limit the increase in benefits. The annual raise in pensions was suspended for 2004, and more importantly, a "sustainability factor" was added to the pension adjustment formula. This factor slows benefit growth if the population ages and the dependency ratio increases. Simplifying for exposition, the pension formula now reads:

$$\Delta\, benefits = \Delta\, gross\ wages \times \left(1 - \alpha\,\frac{D_{t-1}}{D_{t-2}}\right),$$

where D is the old-age dependency ratio and the sustainability factor α is equal to 0.25 according to the law. The indexation of benefits to gross wages thus becomes less than unity as the dependency ratio increases. A higher value of α would slow benefit growth further. Until now, α was zero, and there was only a weak link to demographics.

98. **This reform is estimated to raise GDP growth by 0.1 percent per year compared to the no-reform scenario.** Slower benefit increases translate into smaller increases in payroll taxes, and a somewhat smaller decline in the labor supply. Nevertheless, with social security contributions still increasing by 5 percentage points of GDP, the active generation continues to bear a large transfer burden. The figure below shows the effects of the recent pension reform on income distribution. The horizontal axis shows that with no reform (α=0), the average real pension over the coming 20 years would be around 16 percent higher than today. The vertical axis shows that average real net wages would decline by about 3 percent (2004 levels are set at 100). The recent reform (α=0.25) slows down somewhat the growth in real pensions (still an increase of 14 percent), and preserves average



- The presentation of all fiscal accounts should be moved to an ESA 1995 basis and they should be better integrated. Presently, it is difficult for the electorate to understand how the federal budget and the budget of each Land fit within the objectives for the general government deficit. Not only is there no aggregation of these budgets, they are also prepared on the basis of accounting standards that differ significantly from ESA 1995.

- The golden rules governing Bund and Länder budgets could be replaced with rules that are more consistent with the Stability and Growth Pact (specifically, aiming for balance over the cycle). Also, the Internal Stability Pact could be strengthened in various respects.

108. **In addition, reforms of intergovernmental fiscal relations could improve the prospects for fiscal consolidation and structural reform**. At present, these relations are too complex and the mechanisms that are in place could be redesigned to provide stronger incentives for prudent fiscal management. Potential measures are:

- Making revenue allocation across Länder more transparent by folding all redistribution into the formal equalization mechanism (the Finanzausgleich).

- Providing additional scope for the Länder to follow independent, deficit-constrained expenditure and tax policies. At the same time, the interregional equalization mechanism could be simplified and redesigned to support Länder fiscal adjustment efforts.

B. The Political Economy Infrastructure

109. **The power to shape economic policy is shared between the federal government (Bund) and 16 Länder governments**. Federal parliament is composed of two chambers. The members of the lower chamber (Bundestag)—which selects the Chancellor, the head of the federal government—are chosen in general elections that take place every four years. The members of the upper chamber (Bundesrat) are designated by the state (Länder) governments: at least three and up to six per Land, depending on the population. Members for each Land have to cast their votes en bloc. Länder governments are chosen in Länder elections that are staggered throughout the term of the Bundestag.

110. **According to Germany's Constitution (Grundgesetz), both the Bund and Länder can shape economic policy but in practice the initiative in policy making has largely been taken over by the Bund, with the Länder ensuring the administration of the laws and their enforcement** (Spahn, 2000). One key reason is the concern—raised in the Constitution—for establishing the same living standards across Germany.[42] However, all

[42] The interpretation of the "same living standards" wording is subject to considerable debate (see para. 143).

laws proposed by the Bund that affect Länder interests—either financially or administratively—in any event need the approval of both the lower and upper chambers of parliament.[43]

111. **Accordingly, Germany's federalism is highly cooperative rather than competitive**. In other federations, e.g., the United States, Canada, and Switzerland, lower levels of government have considerable tax and expenditure powers. In Germany, the federation develops the economic policy framework for all Länder, with the latter implementing and administering the specific policies, including through their own budgets. For instance, reflecting a very strict interpretation of the call for same living standards across Germany in the Constitution, tax law is virtually identical across Länder. Also, revenue is typically shared or apportioned among different layers of government, with an equalization mechanism ensuring that all Länder have very similar revenue per capita.

112. **With this strong consensus approach, broad support within the population is almost always necessary to achieve important economic reforms**. There are two key reasons. First, a majority of the members of the upper chamber (Länder representatives) need to approve all major reforms. However, the membership of the upper chamber changes frequently as a result of Länder elections that are staggered throughout the four-year general election cycle. The outcome of the Länder elections then represents, to varying degrees and over time, a view on the policies followed at the national level. Second, electoral rules favor coalition governments. Elections for the lower chamber and federal government feature direct voting for roughly half of the seats. The remainder is distributed across parties with a view to securing a representation that is broadly in line with the proportion of votes cast for the various parties.[44] As a result, no single party has been able to command an absolute majority in the lower house of parliament over the past three decades. Instead, the country has been governed by coalition governments, headed either by the Christian Democrats (CDU) or the Social Democrats (SPD). Coalition governments are also the rule rather than the exception in the Länder.

C. The Role of the Political Economy Infrastructure in Fiscal Adjustment and Structural Reform

113. **The government's political support can have significant implications for fiscal adjustment and structural reforms**. This section explores how the political infrastructure in Germany might have influenced economic policy. Furthermore, it analyzes empirically the

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[43] The exact distinction between laws that require approval of both chambers and those that do not is subject to some debate in Germany and a Bund-Länder commission is investigating the matter.

[44] Parties need to have either three direct seats or 5 percent of the votes cast to be represented as a parliamentary group.