Hermann Remsperger: Current challenges facing economic policy-makers

Speech by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at the ZIRP - the Rheinland-Palatinate Initiative, Mainz, 3 November 2003.

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I

Ladies and gentlemen, even if the global economy now appears to be picking up and overall economic recovery seems likely, there is no disputing the fact that economic policy in Germany is facing major challenges. Everything must be done to ensure that Germany once again achieves sustainable economic growth. Comprehensive, systematic reforms are essential if Germany is to meet this objective.

Of course there is no denying that the sluggish economic trend over the past three years was partially caused by global factors. However, we should not overlook the problems of our own making. The very fact that Germany has been suffering not only from a cyclical downturn, but also from an inadequate growth momentum, means that it is not enough merely to expect the emerging improvement of the global economy to rescue Germany from the economic trough permanently and, as it were, “automatically” solve its economic policy problems.

After all, over the past few years, growth in Germany has been noticeably below the average across the euro area. While GDP in the other euro area countries has risen at an average annual rate of just over 2½% since 1995, in Germany it has only increased by 1½% a year. There are, of course, a variety of possible explanations for this. For example, Germany sustained a special type of “exogenous shock” - as the economists say - as a result of reunification. Furthermore, Germany was unable to profit from the convergence process leading up to European monetary union by which interest rates in those countries with previously stronger inflationary tendencies fell to Germany’s level. However, this does not suffice to explain why Germany is lagging behind.

A review of the overall economic state of affairs should also include an intemporal comparison. In the 1970s the average annual growth rate was 2¾% and in the 1980s it was still as high as 2¼%. Since the reunification of Germany, the average rate has been barely 1½%. If, in the period since 1991, Germany had managed to maintain on average at least the growth rate it achieved in the 1980s, real GDP would now be more than one-tenth higher.

The flagging economic dynamism brought with it a noticeable slowdown in investment activity. In recent years the capital stock (excluding housing) has increased at a rate of only 1½%, compared to an average growth rate of 2½% in the 1980s. Such weak capital formation imposes considerable restraints on the supply potential of the German economy.

Thus in order to secure a higher expansion path in the future, it is essential that we not only stop the downward trend of fixed capital formation, but, moreover, reverse it. In particular, in view of the increasingly shorter lifespan of assets and the subsequent greater need for replacement investments to maintain the capital stock, the share of investment in GDP must be raised significantly.

Alongside the falling growth trend, the progressive rise in unemployment is another regrettable feature of the economic development over the past 30 years. Unemployment has risen markedly with every downturn in the business cycle. For example, in 1973 just under 300,000 people were registered as unemployed, rising to over one million in 1975, and subsequently from approximately 900,000 people in 1980 to 2.2 million in 1983.

In the first half of the 1990s unemployment in Germany as a whole rose again from roughly 3 million in 1992 to close to 4.4 million in 1997. Although the number of unemployed subsequently dropped to less than 4 million, the latest jobless figure is once more in the region of 4.4 million.

These figures clearly show that in the subsequent economic upturns, we have been far from successful at reintegrating the additional jobless people in the production process. Simultaneously, the labour supply in Germany rose considerably.

Under the standardised EU definition, the unemployment rate in Germany is now around 9½%, one of the highest in the Community. According to our analyses, the greater part of this is of a structural nature. Hence the need for structural reforms to lower unemployment.

Efforts to increase the effectiveness of the labour market in Germany must be made by parliament, as well as both sides of industry. It is the task of parliament to create the appropriate legal and institutional framework. Management and labour must argue appropriate employment contracts.

Back in spring of this year, with the First and Second Acts Promoting Modern Labour Market Services, the Federal Government acted upon some of the initiatives of the “Hartz Commission”. Alongside the objective of increasing the efficiency of job-placement activities, the burden of taxes and social security contributions for low income groups was cut. In addition, special incentives were created for household services, so as to exploit more fully the potential which is undoubtedly available in this area. Further measures, such as reducing social security benefits for the unemployed, are under way and under currently being discussed in parliament.

Altogether this should undoubtedly improve the effectiveness of the labour market. However, the provision specifying that it is only reasonable to expect people to work for the actual local rates of pay would weaken the incentive to take up work. Moreover, further measures to make the labour market more efficient seem necessary. For example, consideration should be given to extending the favourability principle (Günstigkeitsprinzip) to include the safeguarding of jobs. In future, it should generally be possible, in the interest of employees, to agree on a pay level below the collectively negotiated rates if the very existence of the enterprise is in jeopardy. Similarly, employment protection legislation, which in its current form benefits those currently employed, but simultaneously increases the duration of unemployment, needs to be re-examined.

Not least, the tax wedge on the labour market must be reduced. The wedge between the employer’s labour costs and the employee’s take-home pay in the form of social security contributions and wage tax rose from 43% in 1991 to 48½% in 1997. While it is true that the burden of taxes and social security contributions eased slightly to 47½% in 2002, there is no doubt that the considerable rise in non-wage labour costs since reunification has had a negative effect on labour demand.

In recent years employers and trade unions have agreed on a number of measures to increase flexibility on the labour market with regard to working hours and wages. These include the working hours accounts introduced in many sectors of the economy. They make it possible to adjust the regular working hours more effectively to the needs of the business without payment of overtime bonuses. Moreover, in many sectors it is possible to reduce or increase the weekly working hours within certain limits.

There is now not only a greater degree of flexibility with regard to working hours, but also wages. Remuneration corridors in the chemical industry mean it is possible to lower employees’ earnings in an enterprise for a limited period to below the collectively negotiated rates. The relaxation clauses for the thirteenth monthly salary in the chemical industry, the private banking sector and recently also in the construction sector are another example of increasing flexibility within industry-wide wage agreements.

Equally important issues are sufficient wage flexibility and wage differentiation, particularly for unskilled workers. However, hardly any progress worth mentioning has been achieved in this regard in recent years. To create employment opportunities for unskilled workers with low productivity, the wage scale needs to be brought more into line with productivity.

II

Ladies and gentlemen, the current political discussion in Germany demonstrates almost daily that fiscal and social policy-makers are faced with major tasks. If they are tackled resolutely, Germany will be in a position to overcome its weak growth.

In my opinion, there can be no question of further increasing the general government deficits in order to try to engineer a short-term cyclical stimulus. The real challenge lies in implementing wide-ranging structural reforms to create confidence in the sustainability of public finances, thereby supporting macroeconomic momentum.

However, it is no easy task to implement reforms of this kind in Germany. A broad consensus normally has to be reached between the individual government levels and also between the political parties. A full calendar of elections and the virtually continuous electioneering which they entail, as well as the considerable influence of various lobbies, mean that a great degree of inertia is inherent in the system.

The result can be seen, for example, in the extremely complicated tax and social security system, which is characterised by innumerable piecemeal amendments and supplements. The system has become immensely complex and, as a result, is increasingly perceived as unjust. The epithet “tax and subsidy jungle” indicates the loss of clarity and transparency. This is another reason why the stalemate over reform which has built up over decades must now be broken. The dismantling of the dense web of regulations, which this requires, would also enable us to reduce bureaucracy. A leaner government sector could then be financed with lower taxes, which, in turn, would benefit all.

In my opinion, considerable “deconcentration” of government activity is also desirable. This includes a stricter separation of government tasks together with increased responsibility of each tier of government for both expenditure and revenue. Greater emphasis on competitive elements in the federal system and greater consideration of the different preferences in the individual regions could facilitate more efficient and more focused government activity.

Allow me now to explain in more detail the tasks I see in the three areas of budget consolidation, taxation and social security.

The **consolidation of public finances** constitutes a key task for all government levels. The budget deficits of central, state and local government have risen dramatically in the past two years from €34 billion to €60 billion. The situation is expected to deteriorate considerably this year, with the deficits of general government including the special funds rising to more than €80 billion. In many cases, the statutory borrowing ceilings set by budgetary law will be exceeded.

The social security funds have also slipped into the red. The fluctuation reserves of the statutory pension insurance scheme, which had already been lowered considerably in recent years, will fall even further. The statutory health insurance funds have resorted to borrowing, which is actually prohibited by law.

Last year the general government deficit ratio came to 3.5%, which was well over the 3% limit set by the Maastricht Treaty. It will further increase this year and could even exceed 4%. While it is true that unfavourable cyclical developments and other temporary influences are playing a part in this, this should not blind us to the fact that the bulk of the deficit - which we estimate at approximately 3% of GDP - is structural. Looking at public debt, in 2002 it amounted to 1.3 trillion or 1,300 billion €. The debt ratio increased to 60.8% and will grow further in the current year.

The consolidation of public finances is not an end in itself, but an economic necessity[1]. High deficits entail rising interest payments, which restrict the government’s room for manoeuvre in the future. At a later date spending must be cut or taxes increased to finance them. This poses an even greater problem if, as in Germany’s case, the burden of taxes and social security contributions is already great and considerable further strains on public finances are already expected as a result of the demographic trend.

Government finances that are perceived to be unsound and unsolved fiscal problems give rise to uncertainty about the future course of fiscal policy. This in turn leads to consumption and investment restraint and depresses economic growth.

A reduction of the deficits is also essential if Germany is to fulfil its international commitments. In the run-up to European monetary union, particularly at Germany’s urging, the Stability and Growth Pact was concluded. The Pact laid an important foundation for a successful European monetary union by supplementing and fleshing out the details of the Maastricht Treaty.

Euro area governments are required to reach a budgetary position that is at least close to balance in the medium term - in other words structurally. This requirement, together with the 3% deficit ceiling, is intended to ensure that sound public finances are achieved or maintained. Sound public finances are an important prerequisite for winning and keeping public confidence in a stability-oriented monetary policy, for achieving low inflation expectations and consequently for favourable medium and long-term capital market rates.

A strict interpretation of the Pact therefore means that German fiscal policy must endeavour, also in line with the earlier provisions of the European Commission and the Ecofin Council, to comply with the 3% ceiling for the deficit ratio in the coming year. This ceiling will be overshot in 2003 for the second

[1] J. Stark, H. Remsperger, Regeln in der Budgetpolitik - Zur Kritik am Stabilitätspakt, in: Deutsche Bundesbank, Auszüge aus Presseartikeln, Nr. 40, 16.9.2003, p.10-13.

year running. If it is breached again in 2004, there is a risk of further damage to the credibility of the Pact, which is in the interest of neither Germany nor Europe.

However, judging from the way things stand at the moment, the achievement of this target appears in jeopardy. Although the Federal Government has put together a package of consolidation measures, these will be offset by shortfalls arising from the planned advancement of the third stage of the income tax reform from 2005 to 2004. Furthermore, there is uncertainty about the implementation of the measures announced in the parliamentary decision-making process and their actual financial impact.

If a third year of excessive deficit is to be avoided, it is essential that the announced consolidation measures be fully implemented. If, at the same time, the plan to bring forward the third stage of the income tax reform is adhered to, there must be comprehensive counter-financing. Otherwise - as should also be the case for France -the next procedural steps under the Stability and Growth Pact should be implemented strictly.

Experience has shown that successful and sustainable consolidation should focus primarily on expenditure, in particular non-investment expenditure. All general government benefits must be reviewed. A reduction in subsidies, which distort macroeconomic allocation and therefore inhibit growth, would be especially desirable. Therefore the proposals of the “Koch-Steinbrück Initiative”, which envisage an across-the-board cut in numerous subsidies, are to be welcomed in this respect.

At the same time, the option of completely eliminating out-dated subsidies (such as the home buyers’ grant) should not be excluded. A marked increase in the proposed linear cuts of 4% over three years also appears warranted, as does extending the cuts to include further subsidies.

I have already mentioned that the tax wedge in Germany, which increased noticeably in the 1990s, poses a considerable impediment to growth. As well as relieving the burden of social security contributions, **tax policy**[2], in particular, is faced with the task of lowering the high marginal tax rates in order to improve the incentives for labour supply, labour demand and capital formation. To achieve this, fiscal policy must likewise have a clear strategy and objectives, something which - to put it tactfully - has not always been in evidence in recent times.

An extensive simplification of tax law would take us a big step forward. The widening of the tax assessment base associated with the abolition of current tax loopholes could be used to lower tax rates further. Moreover, in the context of a comprehensive income tax reform, consideration could also be given to a further shift from direct to indirect taxes by abolishing current turnover tax reductions.

A deterioration of investment conditions must concurrently be avoided, not least in view of the current weak growth and low fixed-capital formation. To this end, a reintroduction of the wealth tax must be rejected once and for all and the envisaged restriction of the facility for offsetting corporate losses against taxes must be abandoned.

I am also sceptical of attempts to reform or even extend the existing local business tax. It would appear far more advisable to me - also with a view to simplifying the tax system - to abolish it and replace it by an add-on facility on income and corporation tax for local governments.

As regards the taxation of investment income, the proposed tax amnesty could help to broaden the domestic tax base on a lasting basis through the repatriation of exiled money. However, in order to achieve this, a reliable perspective for the future taxation of investment income is particularly important. In this context the definition of a final tax rate would appear to be the right move.

The **social security system**, which was characterised by a sharp increase in the contribution rate in the 1990s, from 35½% in 1990 to over 41% in 2000, are also in urgent need of reform. This is particularly essential because the social security systems in their current form cannot cope with the demographic developments. While relief can perhaps be expected for the unemployment insurance fund, provided there is a considerable reduction in the high level of unemployment, the pension insurance scheme, the health insurance fund and the long-term care insurance scheme face major structural problems in the longer run.

Rising life expectancy and the persistently low birth rate mean that the population is progressively ageing. Given that the life expectancy of 65-year olds in Germany increased from 78½ years in 1970

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[2] See H. Remsperger, Neue Prioritäten in der Steuerpolitik - Strukturreformen und Entlastung, in: Deutsche Bundesbank, Auszüge aus Presseartikeln, Nr. 28, 25.6.2003, p. 3-5.

to 82½ in 2000, the Rürup Commission assumes a further increase of roughly 3 years to 85½ by 2030. It is also assumed that the birth rate will stagnate at 1.4. Based on this scenario, the elderly dependency ratio - the ratio of over 64 year olds to 15 to 64 years olds - having risen from 21.9% in 1970 to 24.2% in 2000, will shoot up to 45.5% in 2030. This necessitates considerable adjustments in the pay-as-you-go **statutory pension insurance scheme**. Ultimately there are only three possible approaches: increasing the contribution rates, reducing the relative pension level, or raising the retirement age including a shortening of the pension entitlement period.

The reform strategies presented to date point to a mixture of these three approaches. It seems to me that, in the longer term, a curbing of the rate of pension increases and a rise in the standard retirement age will be unavoidable. A further increase in the contribution burden should be avoided as far as possible. Furthermore, a greater role in old age provision should be played by funded private pension schemes, which, in the event of an objectively insufficient ability to save, could be supported by government transfers.

The statutory **health insurance funds** are likewise facing considerable financial problems. Growing health expenditure is not a problem per se. Indeed, in an ageing society this presumably accords with the population’s preferences. However, the structure of the current system does not enable it to meet the challenges it faces.

The measures agreed by the Bundestag and Bundesrat for the statutory health insurance funds are to be welcomed in that they may lead to a lowering of the contribution rates. At the same time, the increased participation by the patients in individual health costs should contribute to a more efficient use of resources. Last but not least, non-wage labour costs will be reduced. However, overall, these measures by no means obviate the need for further reforms.

In particular, I believe it is necessary to decouple social security funding from non-wage labour costs and clearly differentiate between redistributive and earned entitlements. This can be achieved by introducing uniform contributions for all coupled with tax-financed social equalisation. In addition, more measures are needed to enhance the efficiency of health services providers.

On balance, therefore, I see a need for considerable further fiscal policy action and reforms. We should therefore welcome the fact that the Federal Government has taken some important steps forward with “Agenda 2010”, and that a very open discussion on this subject has begun and, in many respects, courageous and encouraging proposals have been made. What is now required is to assemble them in a cogent overall package, to place public finances on a sustainable long-term footing and thereby to incisively improve Germany’s overall economic outlook.

Finally, let me point out that the conditions for growth have already improved at the microeconomic level. First, the profitability of the banks has picked up slightly. Second, many production enterprises have used the past few years to implement restructuring and consolidation measures.

While the indebtedness of enterprises, in particular large companies, rose sharply from 63% of GDP in 1995 to 85% in 2000, this debt ratio has since stabilised. This becomes particularly clear when one considers the new borrowing. In 2000, the new borrowing of “non-financial corporations”, which includes partnerships, amounted to approximately 11% of GDP. In 2002, the ratio was only 1¾%. In the same period, the acquisition of financial assets by these companies fell from 10% to 4.3% of GDP.

As well as shortening their balance sheets, enterprises also introduced many less visible innovations. The restructuring of business areas, the modernisation of product ranges and the review of value-added chains are important elements in laying the basis for stronger future performance.

Given these adjustments at the enterprise level, which form the link between structural change and economic growth, the urgently required reforms in the labour market and fiscal and social policy will be rooted in fertile soil. The ground has long been prepared as far as interest rate policy is concerned. A wind of change bringing plentiful reforms would enable us to reap even greater benefits. Unfortunately there is a risk that the climate for future harvests will be damaged by the collapse of the Stability and Growth Pact. Fiscal policy should do everything possible to avoid further damage to the credibility of the fiscal rules in Europe.