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The German Council of Economic Experts Urges Further Reforms (November 13, 2002)

In order to boost the momentum for neoliberal reform, the German Council of Economic Experts proposed a twenty-point program for “employment and growth” in its annual report for 2002-03. It advocated reducing labor costs, limiting unemployment benefits, capping health care costs, and consolidating finances.

Twenty Points for Employment and Growth

With its annual report, the German Council of Economic Experts is presenting a comprehensive twenty-point reform program to strengthen the forces driving the economy. The core of this program for employment and growth is the reform of the labor market, since the present institutional structure is partially responsible for the dire state of the labor market. Politics must get to the root of the problem. It must create better conditions for strengthening the demand for labor, create greater labor market flexibility, and lower entitlement wages and at the same time expand the low-wage sector. The Council of Economic Experts finds the proposals of the Hartz Commission insufficient. For the low-wage sector, the Council of Economic Experts is discussing a three-part package of measures that will increase the attractiveness of jobs for employers and employees alike by fundamentally restructuring entitlement wages and welfare benefits. In contrast to the political proposals currently on the table, this plan would significantly reduce entitlement wages. In general, the reform proposal of the Council of Economic Experts would not lead to additional fiscal burdens, despite the fact that welfare recipients who start working would be allowed to keep a larger share of their cash transfer income than is currently the case, and although contribution rates for unemployment insurance would be lowered. It would pay to work again.

[. . .]

III. A program for employment and growth

18. Since the mid-1990s, the course of economic development in Germany has been disappointing, and Germany has already been called the slowpoke of Europe on multiple occasions. Germany’s gross national product has been growing far more slowly than those of other European Union countries; in comparison with the United States, Germany’s performance

is even poorer. Therefore, firstly, the German Council of Economic Experts is devoting its economic policy remarks to an analysis of the weak points in German economic growth, and, secondly, it is presenting a twenty-point program to strengthen economic growth forces and to overcome the high level of unemployment. The core of this program is the radical structural reform of the labor market, the health system, and public finance and taxation policy.

The approach taken in the coalition agreement between the Social Democratic Party and the Green Party on October 16, 2002, and in the *ad hoc* measures and the *Vorschaltgesetze* (announced laws preceding major reform laws planned for a later point in time) is to merely deal with the symptoms of the German malaise, and this is the wrong approach. What is needed instead is a fearlessly frank diagnosis, for this is the only basis upon which a long-term, holistic therapy can be developed. Only through radical structural reform can Germany make itself fit to face the growing challenges posed by global competition, technical progress, and an aging population.

[. . .]

Component I: Strengthen the demand for labor

24. One of the main hurdles to employment in Germany is the heavy burden of taxes and social security contributions on labor income. For a single person with average earnings, the marginal tax rate can currently reach 67 percent of employee compensation. A large part of the overall marginal tax burden in this income bracket is attributable to the rates of contribution to the social security system. The high marginal tax contribution rate pushes up the cost of labor for enterprises and drives a wedge between total labor costs and employees' net pay. As a result, fewer jobs are available and the employment level drops. The German Council of Economic Experts therefore demands the following:

Lower the marginal tax rate for labor

For employees, the high marginal rate of taxes and social security contributions on labor income lowers the incentive to work; for employers, it is, in effect, a tax on the labor factor that systematically weakens the demand for labor. The high marginal tax rate therefore needs to be reduced.

(Proposal 5, section 428)

[. . .]

Keep pay raises below the growth rate of labor productivity

Wage negotiators, too, must contribute to strengthening the demand for labor. In an underemployed economy, pay raises must remain below the growth rate of labor productivity in

real terms. And the relevant benchmark price level is not consumer prices but rather producer prices.

(Proposal 6, sections 429 et seqq.)

Component II: Lower entitlement wages, expand the low-wage sector

26. Component II focuses on a particularly problematic area of the labor market – the low-wage sector. Unskilled workers, whose rate of unemployment is especially high, are chiefly in this segment of the labor market. Numerous wage subsidies, for example in the form of payroll and reintegration grants, are already used in Germany to enhance the attractiveness of jobs for employees and employers alike. The resulting employment effects are limited, however, and depend above all, as the international evidence shows, on the specifics of a country's social security system and on its labor market structures. Studies and experience to date indicate that labor subsidization programs that do not lower the entitlement wage, and that do not target specific groups, yield no noteworthy employment effects at an acceptable cost. General wage subsidies that do not target specific groups cannot be financed without lowering the entitlement wage owing to the wide income corridor within which jobs are subsidized.

27. With an eye to reinforcing incentives to take up gainful employment and to lowering wage costs in the low-wage sector, the German Council of Economic Experts is considering a comprehensive three-part reform of the present system of wage substitutes and wage supplements. The first part foresees shortening the entitlement period for receiving (contributions-based) unemployment pay [*Arbeitslosengeld*] to twelve months in order to give the older, long-term unemployed a greater incentive to work and at the same time to generally enhance the attractiveness of the labor factor by reducing non-wage labor costs. This step would *per se* ease the burden on the statutory unemployment insurance fund [*Arbeitslosenversicherung*] by 5.5 billion Euros; even after allowing for a corresponding increase in expenditure on (means tested) unemployment aid [*Arbeitslosenhilfe*] and for lower receipts for other branches of the social security insurance system; this measure would still yield net fiscal savings of 1.5 billion Euros.

Limit the entitlement period for unemployment benefits to twelve months

Shortening the entitlement period for receiving unemployment benefits – i.e., a return to the situation that prevailed until the mid-1980s – would increase incentives for the unemployed to take up paid work and cheapen the labor factor by lowering the contributions to the statutory unemployment insurance fund. This would strengthen the demand for labor.

(Proposal 7, section 441)

[...]

Integrate unemployment assistance and social assistance

*The amalgamation of unemployment assistance and social assistance would lower fiscal costs, yield efficiency gains, and enhance the incentive to work.
(Proposal 8, sections 442 et seq.)*

[. . .]

More employment in the low-wage sector requires a structural reform of the social assistance scheme

*In order to improve the incentive of social assistance recipients, the standard rate paid to social assistance recipients who are able to work should be reduced – in return, social assistance recipients should be able to keep a larger part of any income earned on the labor market than is currently the case. Those who cannot find a job on the primary labor market would have to agree to make their labor power available to municipal employment agencies if they wish to retain their current level of benefits.
(Proposal 9, sections 446 et seqq.)*

[. . .]

Component III: Improve coordination on the labor market

31. The overall strategy of the German Council of Economic Experts further envisages improving the coordination between demand and supply on the labor market by reducing labor market inflexibility. The third component shows what wage negotiators and lawmakers can do to increase wage flexibility:

Greater flexibility – responsibility of wage negotiators

*Wage negotiators could create greater flexibility in employment contracts, especially in the field of compensation, by establishing procedures according to which firms would be able to deviate from the standard framework agreement, for example by means of variable wage components with profit-related bonuses or through agreements that take job security into account (opt-out clauses [Öffnungsklauseln]). More widespread use should also be made of lower-than-standard starting pay rates [Einstiegertarife] for unemployed persons taken on.
(Proposal 10, sections 462 et seqq.)*

Change the statutory rules in favor of decentralized wage-setting

The statutory rules need to be changed in key areas in order to create a legal basis for decentralized wage-setting. Job security should be taken into account within the framework of the favorability principle [Günstigkeitsprinzip], and the current prohibitory provisions of Section

77 (3) of the Industrial Constitution Act [*Betriebsverfassungsgesetz*] that apply to enterprises not covered by collectively negotiated wage agreements should be scrapped.
(Proposal 11, sections 466 et seqq.)

Extend the ability to offer temporary employment contracts – relax the tight restrictions on dismissals

Lawmakers should create greater statutory scope for temporary employment contracts covering a longer term – say, four years – and not make this subject to the consent of wage negotiators.

*In connection with job protection legislation, one needs to consider that the current rules protecting employees against dismissal [*Kündigungsschutz*] make it harder for unemployed persons to enter the labor market. These rules should be made less stringent in order to improve the employment prospects of jobless persons. The social considerations regarding redundancy dismissals [*Sozialauswahl*] should be defined more clearly. Legal provisions should be enacted that enable newly recruited persons to voluntarily waive dismissal protection rights in return for an agreed-upon redundancy compensation package in the event that they are subsequently laid off. The relaxation of dismissal protection rights should be extended from firms employing up to five employees to firms with up to twenty employees.
(Proposal 12, sections 469 et seqq.)*

[. . .]

Health policy: pragmatic steps plus conceptual perspectives

(sections 483 et seqq.; Chart 6)

33. In the field of health policy, the German Council of Economic Experts suggests a dual approach: on the one hand, the Council has devised a package of measures aimed at mobilizing efficiency reserves within the existing public health service structure; and on the other hand, it has developed two further-reaching reform strategies aimed at transforming the present system.

A crucial requirement for the necessary dampening of the growth in contribution rates is to introduce immediate expenditure-side reforms to mobilize the presumed efficiency reserves in the present system. Corresponding reform measures should seek not only to tackle the cost-bloating disincentives in the patient-doctor relationship and to redefine the respective roles of the statutory health insurance system [*Gesetzliche Krankenversicherung*] and the private health insurance scheme [*Private Krankenversicherung*], but also, in particular, to modernize the present outmoded pharmaceuticals distribution system and to give individual health insurers [*Krankenkassen*] greater contractual freedom vis-à-vis health service providers.

[. . .]

35. This precarious budgetary development is not only a consequence of the poor cyclical momentum but also of insufficient fiscal consolidation efforts in the past. Therefore, it is also wrong to blame fiscal policymakers' limited room for maneuvering – which many people feel is insufficient, given the present economic situation – on the rules of the Stability and Growth Pact. Furthermore, the current debate on the pact's rules is also taking place at the wrong time, as it is precisely now that the rules need to face their first real test.

[. . .]

Resolutely proceed with budgetary consolidation – uphold the Stability and Growth Pact

In view of the growth target, the course of fiscal consolidation that has been embarked upon needs to be pursued more resolutely than hitherto. The general government deficit for 2002 amounts to 3.7 percent; according to the calculations of the German Council of Economic Experts, the structural deficit comes to around 2.75 percent. This must be eliminated by 2006. That will also allow sufficient scope for the automatic stabilizers to take effect. The rules of the European Stability and Growth Pact are not “stupid.” It was right to adopt the Stability Pact, and it is right to continue to uphold it.

(Proposal 20, sections 532 et seqq.)

Reducing government debt means strengthening growth dynamics and easing the burden on future generations

In the long run, a reduction of government debt will launch the economy onto a higher growth path; income per member of the domestic population will increase. If, as is to be expected, the growth rate is below the capital market interest rate for long-term government bonds, lower government debt will permit tax reductions in the future. This will ease the burden on future generations. The consolidation of public budgets and a sustained fiscal policy are two sides of the same coin.

(Proposal 3, sections 386 et seq.)

[. . .]

Scale back government tasks in favor of private activity and concurrently refocus public spending on investment

With a government spending ratio of almost 50 percent, the state channels nearly half of aggregate income into its own hands. Even if there are good reasons for government intervention, private-sector activity should have priority over public-sector activity in a market economy. Efficiency is generally better achieved through private decisions coordinated via markets than through government action. The government expenditure ratio must therefore be reduced and government spending needs to be concurrently restructured:

– Despite extensive privatization in the past, the scope for privatization at the level of central, state and regional government has not yet been fully exhausted. Greater use needs to be made of market-based financing instruments. This includes the envisaged, agreed-upon highway tolls for trucks and the introduction of university fees, which has not yet been agreed upon.

– Subsidies should be granted for a limited period only and should decrease steadily over time; for reasons of political economy, cuts in subsidies should be made across the board; the reduction of subsidies and the tightening of tax breaks should be accompanied by the lowering of tax rates.

– The reduction of the government expenditure ratio should be coupled with rebalancing the expenditure mix in favor of public investment, especially in the transportation infrastructure as well as in education and science.

(Proposal 2, sections 378 et seqq.)

[. . .]

Cut tax rates further, seek to integrate income tax and business taxes

After the phases of tax reform planned for 2004 and 2005, further cuts in tax rates are required with respect to income tax and business taxes if more employment and higher growth are to be sustainable. Existing tax breaks should be lowered.

In the medium term, a fundamental decision needs to be made regarding the integration of business taxes into the income tax regime.

(Proposal 1, sections 374 et seqq.)

[. . .]

Elements of a growth program for Eastern Germany

The leitmotif of a growth strategy for the Eastern part of Germany must be to bring about a supply-side improvement in the region's attractiveness as an investment location. Essential components of such a program are:

– *the further expansion of the public infrastructure, especially in the field of transportation; this includes the accelerated completion of interregional highway links and an improvement of the road network in Eastern German towns and cities; the resources earmarked as part of the Solidarity Pact II [Solidarpakt II] should be specifically targeted at extending the municipal infrastructure in potential growth centers; the measures to overcome remaining infrastructural deficits should be documented in the "Progress Report on Reconstructing Eastern Germany" [Fortschrittsbericht Aufbau Ost];*

– the strengthening of private-sector investment; the general investment grants paid under the Investment Grants Act [*Investitionszulagengesetz*] should be phased out, however, in favor of promoting innovation networks and individual investment aid projects within the framework of the German Joint Program for the Improvement of the Regional Economic Infrastructure [*Verbesserung der regionalen Wirtschaftsinfrastruktur*];

– the pursuit of an employment-oriented wage policy by the social partners; the alarming employment situation in Eastern Germany can only improve if the process of raising East German pay rates to the Western German level is suspended and geared instead to the different development of productivity.

(Proposal 4, sections 388 et seqq.)

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Source of original German text: Sachverständigenrat zur Begutachtung der Gesamtwirtschaftlichen Entwicklung, *Jahresgutachten 2002/3: Zwanzig Punkte für Beschäftigung und Wachstum*. Wiesbaden, 2002, pp. V-19.

English translation (not including the first paragraph) is an edited version of a translation taken from the website of the German Council of Economic Experts, “Twenty Proposals for Employment and Growth,” Annual Report 2002–03, first chapter: retrieved on May 20, 2008.