Economic Myths and Reform Realities for Germany

Manufacturing and a fiscal blow-out won't save Europe's largest economy. Services liberalization and private investment can.

By Michael Heise
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Germany's economy is the envy of much of Europe. The country's exports of goods make up 28% of the European Union's total, it has high average living standards, and it currently boasts the eurozone's lowest unemployment rate. According to Eurobarometer, 86% of Germans are upbeat about their national economy.

Yet this success is creating a new risk: The debate over economic policy is in danger of sliding backward as Berlin feels less of a sense of urgency to continue reforming. Chancellor Angela Merkel's coalition government already has reintroduced early-retirement provisions that had been eliminated by previous reforms. Now Berlin is contemplating a further partial unraveling of the pension and labor-market reforms introduced by previous governments.

With one of the fastest-aging societies in the world and productivity growth barely above zero, Germany's economy won't grow over the longer term unless it keeps improving its efficiency and competitiveness. In addition to complacency, cherished beliefs about the German economic model stand in the way of change. After the 2017 election, the new government will have to challenge some conventional wisdom if it wants to prolong Germany's mini-Wirtschaft¬swunder.

The first myth is that Germany's manufacturing industries will by themselves guarantee a bright economic future. Manufacturing accounts for a much bigger share of Germany's economic output than in most other developed economies. But 70% of Germany's gross domestic product is generated in service industries. A separation between making things and providing services already is difficult, and it will become nonsensical in a world where fully automated manufacturing blends with digital-services provision.

This makes lagging productivity in services a major concern. Germany's investment in areas such as IT improvements, training, management and other intangibles is paltry, and boosting it should be a priority for Berlin. Liberalization is critical. Some services that serve as inputs for the wider economy—legal and notary services, tax consulting and architectural services, for instance—remain heavily regulated, driving up costs and deterring innovation.

If Germany wants to improve its economic prospects it must not only maintain its leading edge in manufacturing but also stimulate competition in professional services. If its regulations were as competition-friendly as in best-performing countries, the OECD calculates productivity would rise by 2%.

Berlin also must counter the myth that after last decade's Hartz labor-market agenda, there is no further need for labor-market reform. Unemployment is below 5%. But with the working-

age population predicted to fall by 4.2 million by 2050 even in a scenario with high migration, more efforts are needed to maintain a stable labor force and the viability of social benefits.

The average German now spends almost two decades in retirement. The share of people over 55 who work has gone up, but very few Germans work beyond their mid-60s. Present retirement provisions give little incentive to work after reaching retirement age, as working income is partially deducted from the pension, and unemployment insurance needs to be paid. The government is planning changes. They need to come soon.

Germany can also boost its female labor force, especially since young women on average are more educated than men. Although the share of women who work is high, the vast majority are in part-time jobs, which limits their pay, productivity and career prospect. Among Germany's married mothers, only one in four has a full-time job. The OECD reckons that if women were to close the labor-market gap to reach parity with men, per capita GDP would jump by 20% in the coming decades. More daycare and after-school facilities for children would help, as would flattening the steep marginal tax rate for second earners. Immigration won't cure the demographic weakness, but it can help if the challenges of language and professional training are met in an efficient way.

The third myth, and perhaps the most controversial, is that Germany doesn't need to boost its investment. Public-sector investment has been stuck at around 2% of GDP since the 1990s, one of the lowest shares in the EU. Although Germany's infrastructure is still ranked world-class by some measures, roads and school buildings are beginning to crumble in many places. The country also needs to roll out fast broadband and modern transport.

No one has this issue entirely right. Foreign commentators have suggested the government should borrow to fund such public works. The government rightly prefers balanced budgets in times of solid growth. But politicians and the public also remain suspicious of attempts to boost public-works spending through private investment. Half of Germans are opposed to private investments in infrastructure and only one in four considers them a good idea. That's a missed opportunity.

If the country wants to maintain and improve the plumbing for growth, it will have to rely on both government and private sources of funding. Despite cheap borrowing costs for the government, many infrastructure projects—including the new Berlin airport—have turned out to be enormously expensive for the taxpayer as cost and time schedules have been overrun. Boosting the efficiency of infrastructure investment and transferring risks away from the taxpayer are the real advantages of private-capital participation.

Over the past decade, Germany went from being the sick man of Europe to its economic champion. This success won't be sustained unless Berlin dares to tackle some of the issues that will undermine Germany's competitiveness and wealth, and stops clinging to outdated beliefs about what constitutes economic strength.

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