Economic Insight

Lasting economic success cannot be taken for granted

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Executive summary

- On 24 September, this year of European elections will reach its next climax: the election of a new German government. These elections are taking place against the backdrop of a pronounced boom in the German economy.
- The extensive labor market and social reforms of *Agenda 2010* have played a considerable role in the success story of the last few years. The reform package has helped to turn the German labor market around. Since the reform measures were implemented, the number of people in work has increased by more than 4 million, while unemployment has halved.
- The current favorable situation cannot conceal the major challenges facing Germany, which pose a threat to the country's long-term economic success. From 2020, the number of people in work is likely to increase by no more than 0.5% annually. Maintaining economic growth on a par with that seen in recent years will then require considerably faster productivity growth, necessitating high investment in education and physical capital. Such investment, however, is precisely one of the current weaknesses of the German economy.
- To raise growth potential, the government should implement economic policies aimed at improving investment conditions for the private sector and removing bottlenecks in public investment. Ways should also be found of expanding and making better use of the potential labor supply. In this paper, we present some possible areas for action on these three issues.
- The next German government should use the positive economic situation to lay the foundations for the country's lasting economic success from a position of strength.

Boom-time elections in Germany

On 24 September 2017, some 61½ million voters in Germany will decide who is to determine the country's political fortunes for the next four years. The election is taking place against the backdrop of a booming German economy. Real gross domestic product (GDP) has been recording annual growth rates of nearly 2% for the last three years, and this year it has a good chance of surpassing the 2% mark. In many respects, the German economy has outperformed expectations in recent years. Unemployment has fallen more sharply than anticipated, and high inward migration has delivered strong economic momentum rather than increasing joblessness as some had feared. The public finances have also developed unexpectedly positively. The country has recorded a government surplus since 2014 and the public debt burden has fallen noticeably in relation to GDP.

There is no doubt that the *Agenda 2010* measures have played a decisive part in this success story. Extensive labor market and social reforms – the Hartz reforms – were the centerpiece of this policy package. A brief overview of the main objectives and measures of *Agenda 2010* is shown below.

Agenda 2010 has made Germany stronger

Key Targets and Measures	
More efficient job placement	▪ Customer segmentation ▪ Service for employers ▪ Outsourcing of placement services ▪ Case manager for long-term unemployed
More encouragement & individual responsibility	▪ Tighter rules for unemployment registration ▪ Tighter definition of "reasonable work", sanctions ▪ Shortened entitlement to unemployment benefits ▪ Consolidation of unemployment and welfare aid
More flexibility to boost labor demand	▪ Mini and midi jobs ▪ Reduced job protection ▪ Facilitation of fixed-term contracts ▪ Deregulation of temporary employment

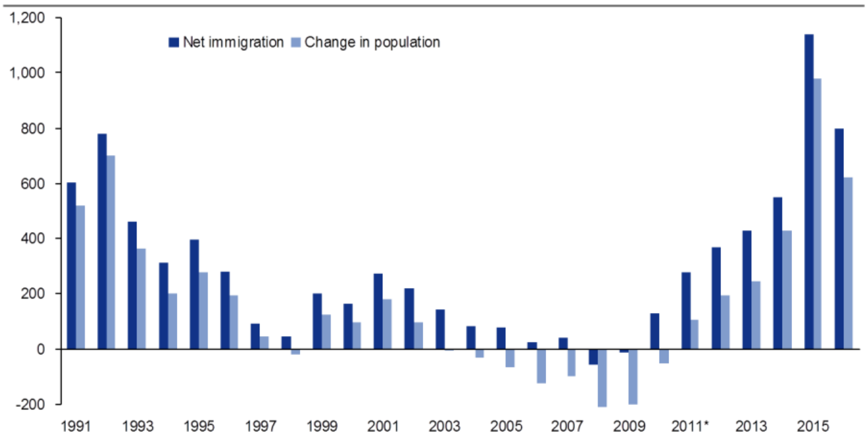
Achievements
✓ Unemployment sharply down (also in respect to permanently unemployed persons)
✓ Employment rising strongly (in particular jobs liable to social insurance)
✓ Improved funding of social insurance systems
✓ High participation rate
✓ Growth more labor-intensive than before

The reform package has made a major contribution to the turnaround in the German labor market. Since the reform measures were implemented, the number of people in work has increased by more than 4 million (+>10%), while unemployment has halved. This despite the considerable impact of the global financial and economic crisis, the European sovereign debt crisis and the large influx of refugees. There is no doubt that the reforms have made economic growth more job-intensive. Since 2005, every 1% of growth in real GDP has created an average of 242,000 new jobs in Germany. This compares to an average of just 104,000 jobs for every 1% of growth between 1995 and 2005.

Development of labor force potential – risk to Germany's growth prospects

The current favorable economic situation cannot conceal the major challenges facing Germany, which pose a threat to the country's long-term economic success if they are not appropriately addressed. The fairly strong GDP growth, averaging 1.9% since 2014, has been generated by a marked increase in the number of people in work (+1.1% per year on average). Without the major increase in labor force potential resulting from inward migration (estimates by the Institute for Employment Research (IAB) put this increase at 1.3 million people from 2013 to 2017), such growth in the number of people in work would hardly have been possible. Germany's economic growth has been strengthened by high net immigration amounting to almost 3 million people over the last four years. Foreign nationals of the main migration countries have made up a substantial share of the positive employment trend. They account of late for a third of the additional jobs liable to social security contributions (year-on-year comparison).

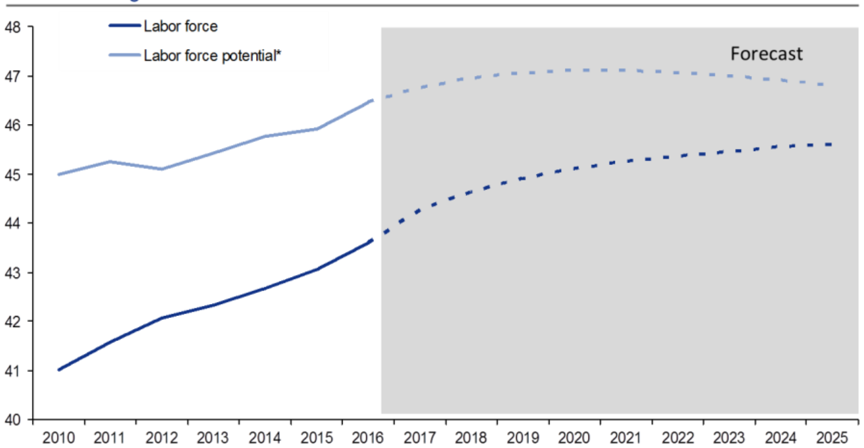
Net immigration amounts to almost 3 million since 2013
In thousands



* Since 2011: Population projection based on census 2011 Source: Federal Statistical Office.

Like the Bundesbank, we expect the increase in labor force potential to tail off over the next few years, before labor force potential begins to fall in absolute terms from 2020. This assumes continued migration of refugees on the same scale as in 2017 and a further slight decline in migration from within the EU (2016: 201,000 people, 2015: 431,000 people). The reason for the expected trend reversal is a growing decline in the number of Germans of working age. The Bundesbank estimates that even with net immigration of 2.5 million people by the middle of the next decade (a realistic assumption), the labor force potential will be no higher in 2025 than it was in 2016 (Monthly Report, April 2017). This will increasingly limit the room for further strong employment growth in Germany. The following chart shows that, based on these assumptions for labor force potential, the likely scope for employment growth in Germany from 2020 onwards is in the region of 100,000 to 200,000 people in the absence of special incentives to raise participation in the workforce.

Labor force potential likely to decline from 2020 onwards
Annual averages in million

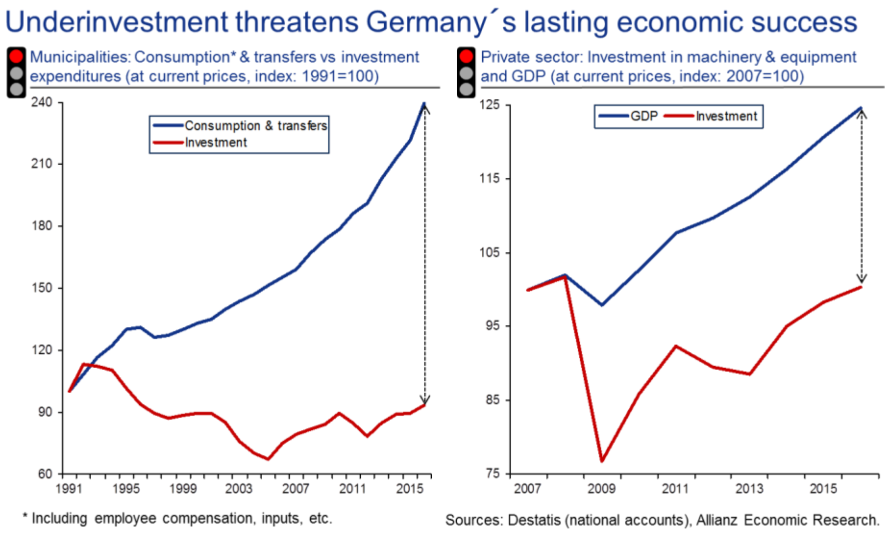


* According to IAB, the labor force potential includes those in work, the unemployed pursuant to ILO and hidden reserves (incl. job-seeking inactive people)

Sources: IAB-Kurzbericht 9/2017, Federal Statistical Office, own forecasts.

With the number of people in work rising by just 0.5% a year at best from 2020, the economic growth rates of recent years can only be sustained with a much-accelerated increase in productivity. Alongside high investment in education, the country will therefore need to invest intensively in state-of-the-art physical capital. Such investment, however, is precisely one of the current weaknesses of the German economy. Both the public and private sector have long undergone a pronounced investment weakness. Two examples illustrate this phenomenon:

- Municipalities: While annual spending on consumption and transfers at municipal level more than doubled between 1991 and 2016, investment spending last year was even slightly down on the level seen in 1991. The share of municipalities in total public sector investment declined from 51% to around 35% over the same period.
- Private sector: Even by last year, private sector investment in machinery and equipment had barely recovered to the level seen in 2007, the year before the collapse of Lehman Brothers. This was despite the fact that nominal gross domestic product in 2016 was almost 25% higher than in 2007.



In the public sector, the reluctance to invest is largely limited to local government level. At national and federal state level, investment has roughly kept pace with government consumption since 1991, despite some large fluctuations. The recent lack of local investment is primarily attributable to years of tight budgets in local government. Cash-strapped municipalities have not only postponed investment but also cut staff, for example in building authorities. This has resulted in bottlenecks in planning and implementing investment projects which are, given the involvement of various federal-level authorities, complex and time-consuming. In principle, however, sufficient funding is available (not least from national government, too).

There are numerous reasons for the weak investment in the private sector. The great uncertainty over the future economic development following the global financial and economic crisis, the government debt crisis in the eurozone and the various geopolitical crises probably go a long way to explaining it. The less companies can weigh up their future economic position, the more reluctant they will be to expand capacity. Relative declines in prices for capital goods and strengthening of the equity base in the corporate sector are other likely contributing factors. Many businesses have increased their equity ratio in recent years in order to maintain relatively favorable access to credit despite the higher regulatory requirements in the financial sector.

Increasing growth potential as the key to success

In order to ensure Germany's long-term economic success, policymakers must take measures to increase the country's growth potential. Should they fail to do so, demographic factors and their effect on the labor force will inevitably trigger a substantial fall in potential growth, significantly clouding the future prospects for the German economy. We believe that the government should use the available fiscal scope to boost growth potential, without breaking the fiscal rules of the Stability and Growth Pact or Germany's public sector debt brake. To maintain or, even better, reduce the public spending ratio, government consumption should rise at a slower pace than economic output.

In our view, measures to boost investment and innovation are key. Economic policy measures should aim to improve investment conditions for the private sector and remove bottlenecks in public investment. Given the demographic challenges, ways should also be found to expand and make better use of the potential labor supply. No list of possible measures for achieving this can ever be exhaustive. In the following, we have concentrated on a few key aspects of each of the action areas: private sector investment, public investment and the potential labor supply.

Private sector investment

- Tax treatment of cost of capital in corporate taxation
- Reintroduction of declining-balance depreciation (potentially time-limited and only for specific areas)
- Tax incentives for research to increase R&D spending in the corporate sector

Public investment

- Improvement of digital infrastructure through co-financing with public funds
- Planning/implementation of investment projects: relieving capacity bottlenecks at municipal level (e.g. under-resourced building authorities: consolidating/creating capacity at a higher level)
- More PPPs, both to tap into the financial strength of the private sector and to reduce capacity bottlenecks in the public sector

Potential labor supply

- Education: resolving deficiencies in the school system (e.g. class sizes, shortage of teachers, aging staff) and at public universities, promoting digital skills (e.g. broadband access in schools)
- Factoring the need for skilled labor into immigration rules
- Promotion of women's participation in the workforce
- Expansion of all-day childcare at primary and secondary schools
- Further education/lifelong learning
- More flexible retirement age

Germany's economy is performing very strongly at present. In the absence of an exogenous shock, we see little reason why this period of high growth should not continue for a few years yet. The new German government following national elections in September should use this time in order to lay the foundations for the country's lasting economic success from a position of strength.

Selected key points from the CDU/CSU and SPD manifestos

CDU/CSU	SPD
Taxes and charges • Phasing out of the solidarity surcharge from 2020, tax relief of EUR 4bn in the next legislative period • Income tax cut of EUR 15bn, reduction of "middle-class bulge" • Threshold for 42% top rate of tax to increase to EUR 60,000 • Individual taxation of investment income (as soon as exchange of information between international tax authorities ensured) • Financial transaction tax • No increase in inheritance tax	**Taxes and charges** • Replacement of income splitting for married couples with family splitting • Abolition of solidarity surcharge for low and middle incomes from 2020 • Income tax: Threshold for 42% rate of tax to increase to EUR 60,000. Linear progressive increase in top rate of tax to 45% for an income of EUR 76,200 • 48% top tax bracket for people earning more than EUR 250,000 (single) • Individual taxation of investment income • Financial transaction tax • Higher taxes on very large inheritances
Research, innovation and the digital economy • Tax incentives worth EUR 2bn to promote research (choice between existing project funding and tax incentives for research) • Increase in R&D spending to 3.5% of GDP by 2025 • Nationwide expansion of fiber-optic network by 2025, roll-out of 5G mobile technology also to be completed by 2025 • Minister of State for "Digital Policy"	**Research, innovation and the digital economy** • Financial support for SMEs to help them recruit R&D staff • Improvement of depreciation options for R&D expenditure • Doubling of central government research funding for universities of applied science • Increase in R&D spending to 3.5% of GDP by 2025 • High-speed fiber-optic cables throughout Germany, promotion of 5G
Family and welfare • Increase in child tax exemption to match adult tax exemption. Initially: increase child benefit by EUR 25 per month and increase child tax exemption accordingly. Second step dependent on economic situation • Legal entitlement to childcare for children of primary school age • New benefits per child for families building a home	**Family and welfare** • Introduction of "family working hours" and family allowance (EUR 150 each per month, up to a maximum of 24 months if both parents work between 75% and 90% of standard full-time hours) • Gradual abolition of nursery school fees • Legal entitlement to day care for children of primary school age • New benefits for families building a home

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