REINVENTING THE GERMAN ECONOMY

Stephen J. Silvia

The American Institute for Contemporary German Studies
The Johns Hopkins University

AICGS POLICY REPORT #8

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FOREWORD

The German economy has remained stagnant for three years, raising troubling questions about the long-term vitality of this erstwhile European powerhouse. Exports have lagged and high unemployment rates continue to plague the country. Various government schemes have had little success in improving the situation and in the next decade Germany will continue to be challenged by the aftereffects of unification and the deepening of European integration (particularly the introduction of the euro). It will also likely be strained by the eastward expansion of the European Union. The aging population and low birthrates are putting the welfare state under strain, and judging by present demographic trends, the situation is only likely to worsen in the next decades.

The government of Gerhard Schröder has its work cut out for it. It must strike a balance between maintaining a social safety net for its citizens, while promoting economic growth. With the Agenda 2010 program, a critical first step has been taken. Its success, however, will depend on the ability of the present and subsequent governments to continue with often-painful reforms. It remains to be seen whether the Schröder government will stay the course or back down due to the resistance of large segments of the population.

In this Policy Report, Stephen J. Silvia goes beyond the daily headlines and political debate, providing a broader perspective on Germany's economic problems as well as prescriptions for solving them. The report builds on discussions at two workshops held in Washington and Berlin in February and May 2003. The workshops brought together analysts of German economics and politics and representatives from the business and labor communities from both sides of the Atlantic. Although participants identified reasons for concern, many also expressed optimism about the long-term prospects for Germany's economy. Success will depend on sustained commitment to a comprehensive reform program that goes beyond piecemeal measures. In the short term, Silvia argues, the German government must focus on job creation. Over the long term, German political and economic structures must also "reinvented" in order to meet the demands of the twenty-first century.

AICGS would like to thank Professor Silvia for his stewardship of the Study Group, and the members of the Study Group—Klaus Deutsch, Rebecca Harding, Dorothee Heisenberg, Christian H. M. Ketels, Amy Medearis, Werner Meissner, Wolfgang Schroeder, and Hermann Simon—for their insights and contributions to this project. AICGS is grateful to the German Marshall Fund of the United States for its generous support of this project and publication.

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August 2003

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Professor Silvia is a political scientist who teaches International Economic Policy, with a focus on trade and investment relations. Professor Silvia's research specializes in comparative political economy, comparative industrial politics, and comparative economic systems, with a focus on Germany and the European Union. He also writes about German politics and political parties. He has taught at Yale and Tufts Universities, and has been a resident scholar at Harvard University, the *Freie Universität Berlin* and the *Institut für Sozialforschung* in Frankfurt/Main. Professor Silvia has published widely in scholarly journals including Business in the Contemporary World, Comparative Politics, German Politics, German Studies Review, *Gewerkschaftliche Monatshefte*, The Industrial and Labor Relations Review, International Journal of Political Economy, New German Critique and West European Politics.

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I benefited immensely from the input of the study group and outside speakers, but I am the single author of the report. As a result, the opinions and the shortcomings of the report are all my own.

1. INTRODUCTION

Everyone agrees that the German economy is broken. For the first time since the Second World War, the economy has been essentially stagnant for three straight years. Except for the brief unification boom, growth has been sub-par for two decades. The labor market has not cleared since the early 1970s, despite numerous schemes to reduce the number of unemployed. Germany's share of worldwide exports and patents has slipped since the early 1990s. In particular, two traditional German export sectors – pharmaceuticals and electro-technical goods – have stumbled badly. Germany has been a laggard in the transition to a service-based economy.

Extraordinary challenges continue to confront Germany. Difficulties encountered in the two grand integration projects of the 1990s – German unification and the deepening of the European market (including the introduction of the euro) – have widely exceeded initial estimates. These endeavors will continue to burden the German economy for many years to come. A third momentous integration project – the eastward expansion of the European Union, although not without opportunity, will undoubtedly place additional strains on the German economy in the years to come. Moreover, thirty years of declining birth rates have eroded the viability of Germany's elaborate pay-as-you-go welfare state and sent payroll taxes skyrocketing. In the coming decades, Germany's accelerating demographic implosion will only exacerbate the welfare state's problems.

There is a widespread (if not unanimous[1]) consensus that the immediate causes of Germany's poor economic performance are principally structural shortcomings that have been compounded by policy mistakes. The state share of the German economy has become too large, crowding out more productive economic activity. The cost of employing people – in particular, non-wage costs – has become too high. Government regulations in the labor and product markets dampen competition and the efficient allocation of resources. A myriad of policy mistakes have expanded and extended the cost of German unification.[2]

Yet the German economy is not a total write-off. Germany's economic foundation, although weathered and deteriorating in places, still has much to offer. The economy is open. Local customers are demanding. The physical infrastructure remains excellent. The workforce is highly educated. The quality of suppliers is unsurpassed worldwide. Local rivalries spur innovation among firms. Numerous vibrant industrial clusters remain productive.[3] Germany is still the home of hundreds of world-class firms, including many small-to-medium sized enterprises that have been "hidden champions" in global markets.[4] Islands of innovation still exist not only in traditional manufacturing, but also in some cutting-edge sectors, such as software, biotechnology, and environmental engineering.[5]

The debate about tackling the woes of the German economy has moved quickly. Before the September 2002 election, many prominent German politicians were in denial. Some faulted external forces beyond their control, most often a soft international economy and the European Central Bank, for Germany's poor economic performance; others blamed their political opponents.[6] By early 2003, however, rising unemployment and plummeting popularity in opinion polls forced the previously reluctant government to act. In mid-March, German Chancellor Gerhard Schröder introduced a series of measures that has become known as "Agenda 2010," designed to improve the economy. The measures include healthcare reform, the liberalization of employment protection laws, and a reduction of unemployment insurance coverage.[7] Pension and education reforms are slated to follow.

Agenda 2010, if it becomes law, would move Germany in the right direction. Yet it represents, at best, just the first of many steps needed if Germany is to regain its footing as an economic powerhouse. The purpose of this report is to rise above the din of daily headlines and political debate to provide a broader perspective on Germany's economic problems, prescriptions, and prognosis. It argues that Germany needs nothing short of a reinvention of the economy if it is to move to a higher growth-path. Piecemeal reforms, even well meaning ones like the Agenda 2010, are insufficient because they do not change expectations or the incentive structures of the German economy. Any reinvention of the German economy must make employment creation (rather than unemployment reduction) the immediate goal. Over the longer term, German policymakers need to focus on transforming the competitive infrastructure of the German economy – which remains at a high level, but has been eroding badly in recent years – to make it compatible with the economic demands of the twenty-first century. German political structures must also be reinvented to promote constructive competition, particularly at the state and local levels, as a means to promote policy innovation.

This report consists of three parts. First, it presents a brief profile of the German economy. Second, it investigates the sources and solutions to Germany's more immediate economic problems. Third, it analyzes Germany's underlying economic and political infrastructure with the objective of identifying means to improve competitiveness. The report concludes with a summary and a discussion of Germany's economic prospects in the twenty-first century.

2. A PROFILE OF THE GERMAN ECONOMY

Two interrelated immediate problems have plagued the German economy for decades: slow growth and weak employment generation. Another set of underlying problems – less discussed in the current reform debate, but just as important – has begun to erode the competitive prowess of Germany. Let us look at all of these in turn.

2.1 Economic Growth

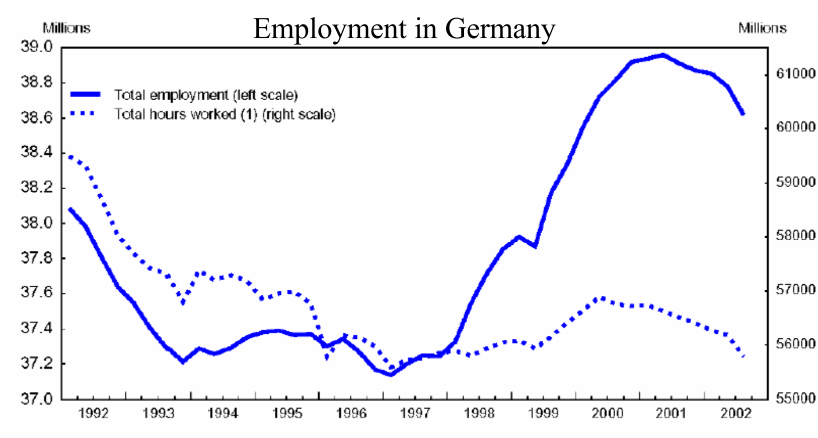
Germany has languished at the bottom of the growth table of the more affluent countries for decades. Standardized data from the Organization for Economic Cooperation and Development (OECD) show that from 1980 to 1989, the real gross domestic product (GDP) of western Germany grew at an average annual rate of 1.9 percent. During the same decade, the yearly growth rates for the eleven other current participating countries in the euro area, the United Kingdom and the United States averaged 2.3, 2.4 and 3.0 percent, respectively.[8] German unification produced a short-lived boom. Real German GDP growth exceeded five percent in 1990 and 1991. The old pattern of sluggishness reasserted itself thereafter, however. Germany's real GDP expanded by only 1.4 percent annually between 1992 and 2002, lagging far behind the euro eleven (2.1 percent), the U.K. (2.6 percent) and the U.S. (3.2 percent).[9]

A growth gap also exists within Germany between east and west. Eastern Germany initially made great progress toward eliminating the disparity with the west. In 1991, eastern German per capita GDP was only one third of that of western Germany. By the mid 1990s, this ratio narrowed to just under two thirds. Since then, however, eastern Germany's relative position has actually slipped slightly. In 2002, the ratio of east-west per capita GDP stood at 62.7 percent.[10]

2.2 Employment

Germany has experienced considerably difficulty in generating employment for some time. Employment as a share of the labor force declined on average by 0.3 percent per year between 1980 and 1990. The decline accelerated to 0.7 percent annually from 1991 to 1995. Employment as a share of the labor force, on average, remained unchanged between 1996 and 2002. This stands in contrast to most other affluent OECD members; they shifted during the latter half of the 1990s to employment-intensive growth.[11] Germany was able to increase the total number of employed by 1.7 million between 1997 and 2000 (i.e., from the trough to the peak of a business cycle), but this was accomplished while actually reducing the total number of hours worked. Total hours worked in the German economy declined between 1992 and 2002 by over 6 percent (see figure 1).

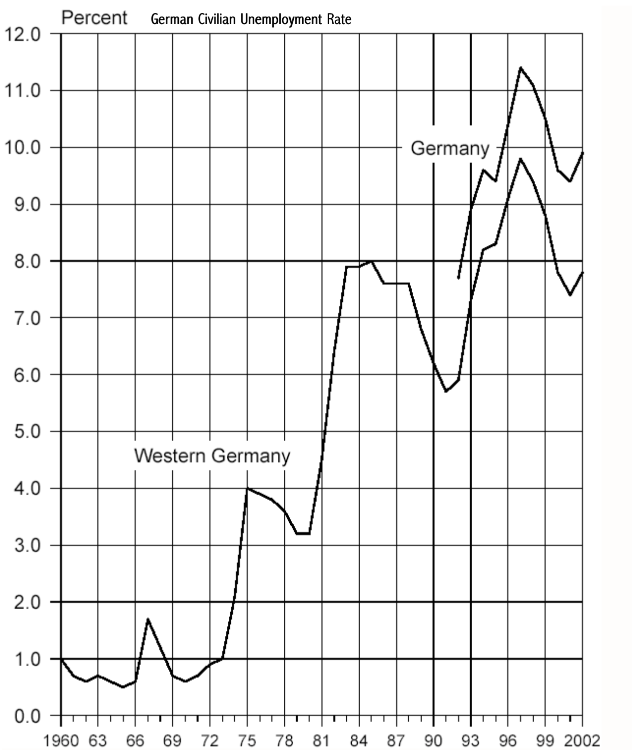
Figure 1



1. Annualised figures.
Source: Deutsche Bundesbank, Federal Labour Office and OECD.

Gerrmany's weak capacity to generate jobs has played a principal role in producing a progressively higher unemployment over the last three decades (figure 2). In 1970, only 149,000 employees – that is, 0.7 percent of the civilian labor force – were unemployed.[12] In the three full business cycles that followed, western Germany added roughly one million to its unemployment rolls at the low points of each cycle. This performance suggests a growth in the structural sources of joblessness. Unemployment is rising once again in Germany. In June 2003, the German government reported that 4.4 million were officially unemployed. This amounts to a seasonally adjusted jobless rate of 10.6 percent. In eastern Germany, unemployment reached 18.7 percent. An additional 1.7 million (i.e., approximately 5 percent of the labor force) throughout Germany are currently participating in an active labor-market or retraining program.

Figure 2



Source: Siebert 2003, p. 5

2.3 Competitiveness[13]

Germany remains strongly competitive, but its relative position has been eroding for at least a decade. Germany has been "reaping the benefits of past investments in assets and strong clusters," but these resources are deteriorating rather than being replenished.

The investment ratio and investment in research and development (R&D) have fallen significantly in Germany. During the 1960s, investment in Germany amounted to 26.5 percent of GDP. This ratio has fallen to 19.4 percent for the years 2000 to 2003. German company R&D spending as a percentage of GDP in 1999 was 1.5 percentage points lower than it had been in 1989. Out of the top fourteen OECD countries, only Italy, the Netherlands, and the United Kingdom also experienced declines. Despite Germany's reputation for technical prowess, it placed only exactly in the middle of the field regarding the share of researchers in the workforce of the top thirteen OECD members. Alarmingly, between 1991 and 1999, the share of researchers in the German workforce actually declined. The only other top OECD country to experience a decline was Italy. Germany's poor showing in the 2002 PISA international comparison of primary and secondary education provides further evidence of neglect of the educational infrastructure.

The results of Germany's waning investment in R&D and education are already manifest. By the end of the 1990s, Germany had slipped to twelfth place regarding the share of its patents that are most frequently cited. It ranked behind Finland, Israel, Japan, Sweden, Taiwan, and the United States in U.S.-registered patents per capita. Of the top thirteen patent recipients, Germany placed twelfth in terms of compound annual growth rate of U.S.-registered patents between 1990 and 2001. German productivity performance has also been slipping. Between 1995 and 1999, German labor productivity grew by only 1.8 percent. This record places Germany in the middle range among OECD members and is well below Germany's performance in the first three decades after the war, which fluctuated around 3 percent. Between 1990 and 1998, German total factor productivity only improved by 1 percent per year on average.

Germany's deteriorating record in R&D and productivity makes it plain that more than the current government proposals of budget cuts and liberalization are needed to set Germany back on a sound economic footing.

2.4 Other Issues

Several other issues have also contributed to the poor economic performance of the German economy. German unification remains costly. Annually, the equivalent of 3 to 4 percent of Germany's GDP is transferred from west to east. Since 1990, these transfers have totaled well over 500 billion euros. They have also contributed to the expansion of German public debt from €460 billion in 1989 (i.e., 42 percent of GDP) to €1.2 trillion in 2002 (i.e., 61.1 percent of GDP). Using a DGII model, the European Commission estimates that the burden of unification accounts for one-third of the growth gap between Germany and the rest of the European Union.[14]

The financial architecture of the German economy is far from secure. Germany is overbanked at the retail end and underserved at the investment level. Although some progress has been made, Germany has thus far failed to develop an equity and venture capital culture comparable to that of the United Kingdom, the United States or even the Netherlands. This has recently contributed to liquidity crunches, in particular for small and medium-sized enterprises. Moreover, the *Landesbanken*, which stand accused of widespread cronyism in personnel policy and lending practices,[15] distort the distribution of capital throughout the economy.

Significant barriers remain to competition in German product markets. Although far less often discussed, permit requirements, excessive product approvals, and restrictions on marketing, pricing, and shop hours are no less distorting than labor market regulations.[16] Similarly, opaque corporate governance and barriers designed to hinder unfriendly takeovers of publicly traded corporations have protected inefficient firms at the expense of both consumers and shareholders.

Finally, increasing numbers of voices from across the political spectrum have identified the structure of federalism in Germany – in particular, the distribution of power and responsibility between the federal government and the German states – as a source of Germany's economic woes.[17] The German federal system contains a plethora of veto points that reform opponents have used to block change. Furthermore, the

German system of fiscal federalism, which transfers funds collected at the federal level to the states based on relative income, dangerously severs the linkage between expenditure and taxation, precluding a transparent system of political accountability.[18]

The list of problems hobbling the German economy is long and eclectic. There is no single silver bullet that can resolve the situation that has built up over several decades. Nonetheless, setting a small set of clear objectives frames and prioritizes policies. The remainder of this report undertakes just such an exercise.

3. POLICY RESPONSES

Any successful renewal of the German economy must accomplish three objectives: (1) raise the capacity to create jobs, (2) regenerate the competitive foundation, and (3) restructure the process of political decision-making to promote innovation. Let us discuss each objective in turn.

3.1 Employment Creation

For decades, successive German governments of varying political stripes and the German trade union movement have attempted to reach full employment primarily by taking people out of the labor market. Such schemes over the years have included paying immigrant workers to go home, retraining measures, early retirement programs, and working time reduction. These efforts have proved ineffective in reducing unemployment largely because paying for them has increased the cost of hiring, thereby reducing the relative demand for labor. The German welfare state retains, at its core, the same structure as the classical pay-as-you-go system that Prince Otto von Bismarck introduced to Imperial Germany over a century ago. Payroll taxes provide the preponderance of funding for workers' retirement, sickness and accident compensation, and unemployment insurance programs.

Economists call the difference between the cost of employing someone for an employer and an employee's take-home pay that results from the introduction of payroll taxes and other charges the "wage wedge." The greater the wage wedge, the smaller the incentive employers have to hire. Germany's wage wedge equals slightly more than 50 percent of employee pay. This gap ranks among the highest in the world. It exceeds the OECD mean by a full 20 percentage points. Only Belgium has a higher wage wedge than Germany among the most affluent OECD members (see figure 3).[19]

Figure 3 The "Wage Wedge" in Comparative Perspective

What has produced such a large wage wedge in Germany? The rising costs of financing retirement and unemployment. In 1972, the German government spent €56.8 billion, or 12.4 percent of its federal budget, on pension costs. By 2002, pension expenditures had risen to €249.3 billion, or 29.1 percent of the German federal budget. In 1970, an employer and employee paid a total of 11.1 percent of earnings to fund the pensions of retirees. By 1990, the total contribution to fund pensions had risen to 15 percent as a result of declining birth rates and rising life spans. The government of Helmut Kohl decided to fund many of the expenses of German unification through the pension and unemployment systems. This enabled it to reduce the size of the immediate tax burden imposed by German unification, but it came at the price of expanding the German wage wedge. By 2002, the total contribution to the pension system had risen to 19.5 percent. Only a reduction in the minimum reserve requirements and since 1999 partial reliance on funds collected from an "ecological tax" on electricity and fuel consumption have kept the contribution rate designated to fund pensions from exceeding 20 percent of the gross wage.

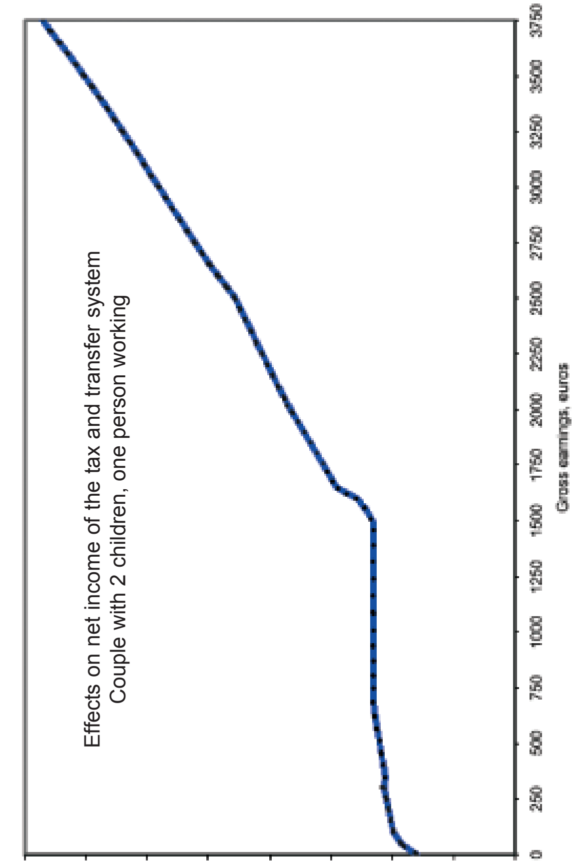
The remaining portion of non-wage costs consists of: healthcare, including hospice care for the elderly, which recently has amounted to roughly 15 percent of direct wages; unemployment insurance, which costs employers and employees together roughly 10 percent of the gross wage; and a handful of other benefits that are mostly enshrined in law and often supplemented through collective bargaining agreements, such as vacations and holidays.[2]

Employment protection legislation also dampens the demand for labor in Germany. In cases of major layoffs, the Works Constitution Act (*Betriebsverfassungsgesetz*) gives works councils the right to codetermine with management which employees receive pink slips and to negotiate "social compensation plans" (i.e., severance packages), many of which can be quite lavish. The procedure for choosing the persons to be laid off is called "social choice" (*Sozialauswahl*). Age (versus seniority with the employer), marital status, number of children, and employer needs are the prime criteria. In practice, the age criterion has created a disincentive for hiring older workers, since social choice requires a firm experiencing hard times to lay off a younger worker, even one with more seniority, before laying off an older worker. As a result, many firms simply do not want to chance hiring older workers, since they would have such a hard time dismissing them. In the 1990s, the Kohl government radically expanded early retirement for employees in their early fifties by subsidizing through unemployment insurance a gradual transition into retirement. Employers used the program so extensively that it became too costly to sustain as originally constituted, but a modified version still exists. Many collective agreements also promote early retirement and rely in part on unemployment insurance to finance them. These schemes have both greatly contributed to two developments weighing down the German economy today: the disproportionately large number of unemployed who are fifty or older and the expansion of the state share of GDP.

Supply-side conditions are also a critical component of the explanation for the failure of the German labor market to clear. Several German labor market policies set the German "reservation wage" – that is, the wage at which a typical unemployed person is indifferent between continuing to receive unemployment benefits and accepting a job – at a high level. Germany currently provides three levels of assistance to those without gainful employment. "Unemployment income" (*Arbeitslosengeld*) amounts to 67 percent of net income for a married principal breadwinner and 60 percent for a single person without children. Currently, an unemployed person below the age of 55 may receive unemployment income for a maximum of 12 months. Those 55 and older may receive unemployment income for up to 32 months. A worker who has exhausted the unemployment insurance benefits, but remains jobless, qualifies for "unemployment assistance" (*Arbeitslosenhilfe*). Unemployment assistance provides 57 percent of a married breadwinner's last net wage (53 percent for a single person without children) and does not expire so long as a person continues to search for work. The search requirement has been rarely enforced in practice, although there is talk of doing so in the future.

Finally, "social assistance for income support" (*laufende Hilfe zum Lebensunterhalt*, or HLU, a.k.a. *Sozialhilfe*) exists for all those, employed or unemployed, whose income falls below a specified subsistence level. This means-tested benefit is far more modest than either unemployment insurance program. At the end of 2000, 2.7 million Germans received HLU; 37 percent of these were able to work, but were not employed.[3] Nonetheless, the HLU program, as currently structured, provides a very weak incentive for participants to enter the labor market at the lower end of the pay scale. For a family of four in the HLU program receiving a net monthly income between €700 and €1500, the reduction of HLU benefits for each additional euro earned is 100 percent (see figure 4). For a single person, the HLU withdrawal rate is at least 85 percent and at times 100 percent, up to slightly more than €800.

Figure 4



The German system of wage determination also affects the reservation wage. Collective bargaining contracts set wages, either directly or indirectly, for roughly 80 percent of the work force. Only foreign nationals working in the construction industry are subject to a statutory minimum wage. A declaration of general applicability (*Allgemeine Verbindlichkeitserklärung*, AVE; a.k.a. *erga omnes* declaration) permits the extension of the coverage of an existing collective bargaining contract per government decree to *all* businesses in a bargaining district of an industry, including firms that are not member of the employers' association that signed the contract. There are important differences between a system relying on AVEs versus one that relies on a minimum wage. Collective agreements cover much more than wages, set much higher wage rates, and vary from sector to sector. An AVE is not implemented automatically. An employer or trade union must ask the government for an AVE, and the only contracts that can be declared generally applicable are those that already cover a majority of employees in the bargaining district for the sector in question. Although AVEs have never directly set compensation for more than 5 percent of the labor force in western Germany, their very existence dissuades employers from setting compensation significantly lower than the rates found in collective agreements. The impact of the AVE has been to truncate the lower part of the demand curve for labor, producing high unemployment among unskilled workers. The same cannot be said for eastern Germany, however. High unemployment and low membership in employers' associations have made it legally impossible to use AVEs. Employers there can and do pay wages significantly below the collective bargaining rate.

The German systems of unemployment insurance, social assistance, and collective bargaining have had a big impact on the reservation wage. A recent study has calculated the German reservation wage to be 1.2 times the previous wage.[4] In other words, the typical unemployed German requires a new job to pay 120 percent of the person's previous wage before he or she is willing to accept it. The effective marginal tax rate of 100 percent on earnings at the lower end of the scale, which was discussed earlier, helps account for the unusual results.

The proposals contained in the Schröder government's recent Agenda 2010 go some way toward addressing the large wage wedge and the reservation wage. Agenda 2010 includes a cut in the maximum duration of the unemployment income program for employees above 55 from 32 to 18 months and a reduction in the level of unemployment assistance to that of HLU. If enacted, these changes would not only give the unemployed a greater incentive to find work more quickly, but also help to reduce the state share of the economy. The government has already passed legislation reducing payroll taxes on "mini jobs" paying up to

800 euros per month in the household services sector. The Federal Economics and Labor Ministry has also produced a parallel set of proposals that include amending the rules governing mass layoffs and reducing the number of skilled occupations that legally require a "master's license" (*Meisterbrief*) as a prerequisite to employment from almost 100 to less than 50.

The Schröder government has not put on the table a proposal to change the collective bargaining regime. Some have suggested amending German law to give works councils and firms belonging to an employers' association the unilateral authority to reach side agreements that would allow them to undercut a regional collective agreement.[5] Current law permits reductions below contractual rates only with the approval of the relevant trade union and employers' association. An alternative means to end the truncation at the lower end of the German labor market so as to open more employment opportunities for low-skilled workers would be to introduce an earned income tax credit. Either an earned income tax credit akin to the program in the United States or the addition of progressivity to payroll taxes would reduce the effective cost of job creation for employers without having to go through what would undoubtedly be a contentious effort to change collective bargaining legislation. An earned income tax credit would also maintain Germany's commitment to providing a decent standard of living to all. Since an earned income tax credit supplements rather than replaces earnings, this sort of program should actually help to reduce the state share of the economy by shrinking the pool of unemployed. It would also have the added benefit of reducing the marginal tax-rate for families with a breadwinner engaged in low-wage employment to something significantly below 100 percent, thereby reducing the hesitation to reenter the labor market.

Promoting employment in these ways would help spark a round of labor-intensive growth that could become self-sustaining. This was the experience both in North America and several European countries during the 1990s. A second round of pension reform designed to simplify and to improve the incentives for participating in the new program permitting defined contributions should also help in the long run to reduce both the wage wedge and the state share of the economy.

To promote employment creation, Germany should also take advantage of the introduction of the euro and the current political mood, which is highly supportive of challenging established "taboos," to pursue a much more thoroughgoing liberalization of its product and financial markets. Product market liberalization should include an end to all restrictions on setting and changing prices, and a substantial reduction of subsidies. Firms in protected and subsidized sectors will certainly resist, but the benefits to consumers and the economy as a whole far outweigh any particularistic losses. Market pressures, the Basel II package of new banking supervision regulations, and European Union initiatives are all pushing the German financial system toward the elimination of special privileges for publically owned banks at the state and local levels. Recent scandals involving *Landesbanken* have added to the pressure. German politicians at the state level must show the political fortitude to dismantle this system, which at times has resembled a teutonic version of crony capitalism, now before an accumulation of bad loans and stranded investments undercut the foundations of the entire financial architecture.

Finally, Germany can enhance its economy immensely by adopting a liberal policy toward immigration. Immigration would not only inject new talent and energy into an economy, it also would help to counterbalance the demographic implosion currently underway in Germany. Highly restrictive measures, such as the so-called "green card" program of temporary visas for skilled employees in the information technology sector, are wholly inadequate. The green card program is not competitive with similar programs in other countries, such as the U.S. H1B visa. As a result, Germany will only recruit second-tier foreign workers who could not go elsewhere. To be sure, policymakers must remain sensitive and realistic regarding the capacity of German society to absorb foreign workers. Still, a well-crafted program would both enhance German competitiveness and help to address Germany's mounting demographic challenge.

3.2 Restoring Competitiveness

The key to restoring the underlying competitiveness of the German economy is a renewal of the education system at all levels. The system as it stands today is non-transparent, non-accountable, and does not take performance into account when distributing resources. This must change. Germany must set nationwide standards of achievement for primary and secondary levels of education and develop effective means to evaluate school performance regularly. A combination of testing and periodic review would be best. Action plans that would reward the high performing schools and assist the low low performing ones would set a standard of continual improvement for education in Germany. The talents of women are currently badly underutilized in Germany. The introduction of all-day schooling would help not only to improve the performance of pupils, but also would permit more women to participate in the labor market.

Recent steps to upgrade and modernize the apprenticeship system should continue. Additional efforts must be taken to ensure that training curricula are revised to keep them up to date and that training for new occupations is added in a timely way. The option of moving from vocational training to university should be expanded and made easier. Recent difficulties in finding enough places for apprentices at firms should be addressed by enhancing the skill-sets apprentices bring to the workplace, thereby making them more attractive to employers, rather than by the introduction of a training levy on non-participating firms. On the other side of the coin, the subsidization of training should be avoided, since ensuing distortions would cost more than the benefits that would result.

There is widespread recognition that German higher education is badly broken. Overcrowded, underfunded universities suffer from suffocating bureaucracies that respond to statutes rather than to the needs of students and faculty. German universities inadequately prepare students for employment in the twenty-first century and have increasingly been falling behind in research. Fortunately, Germany will not be able to continue to produce this inferior product for much longer, because a wave of liberalization is underway.

Numerous European Union programs have made the pursuit of higher education outside of a student's home country and mutual recognition of European degrees far easier. German students have been increasingly using these programs to escape their inferior universities for superior ones elsewhere in Europe. Prominent countries have been pushing for the elimination of barriers to cross-national trade and investment in education as a part of draft Chapter on the General Agreement on Trade in Services (GATS) within the Doha Round of trade negotiations of the World Trade Organization. North American universities have already begun to take advantage of the broken system by setting up branches in Germany. Further liberalization would only accelerate this trend, unless German universities respond. The construction of these exit and entrance options will ensure that more Germans get a quality education from non-German universities and put pressure on German universities to reform.

The recent reform in higher education introducing internationally comparable degrees as an option at German universities is a step in the right direction. Still, much more needs to be done to make German universities more performance-oriented and to provide them with the necessary resources to improve. The introduction of tuition would help on both these fronts. Tuition of €1,000 to €2,000 per semester would not only encourage students to pursue their studies seriously and expeditiously, but also empower students when dealing with university administrators. Students would become "customers" who could take their euros elsewhere.

Some object to the introduction of tuition out of principle. Yet since students will benefit materially as a result of their education, it is only fair that they pay at least part of the cost. A system of financial aid and lending could be used to enable capable students from less affluent families to attend university. Tuition would empower students by giving them leverage to change programs to make them more suited to their needs. Tuition would also provide universities the necessary resources for reducing class size and upgrading facilities to bring the German system of higher education back up to a world-class level.

Personnel policy must also change at German universities. The vast majority of professors' pay should no longer be based on a bureaucratic scale. Performance in both teaching and research should determine salary. It is stunning that the country that pioneered over a century ago a system of close ties between business and universities has let it deteriorate as far as Germany has. Unlike many other countries, university rules governing employment and intellectual property make it very difficult for German scientists to commercialize research. Freeing scientists from these restrictions will entice many more to stay in Germany rather than move to other countries with fewer barriers and could even attract greater numbers of foreign nationals to teach in German universities.

A comprehensive reform of the education system would go some way toward renewing Germany's competitive foundation. Educational reform will produce an environment conducive to training skilled personnel and producing world-class research and development.

3.3 German Political Structures

Since the mid 1990s, Germans have grown increasing critical of their federal arrangements. Many have decried them as all too conducive to gridlock, thereby precluding the enactment of needed reforms.[24] Federalism as it has evolved in Germany since 1949 has been premised on "a distinct aversion to conflict."[25] Instead of following the model of the United States Constitution, which contains power by pitting three powerful and autonomous branches of government against one another in a series of contained conflicts, the Basic Law keeps power in check by dispersing it. The federal government and the *Länder* governments are both involved in the drafting of federal legislation, the collection and distribution of taxes, and the administration of federal laws in a complex division of labor *within* each functional and geographical sphere. Dispersion forces the various branches of government to consult and to coordinate if they are to get things done, promoting cooperation over conflict. In other words, German federalism is not arranged like a "layer cake" consisting of fully autonomous political units with distinct functional and geographical jurisdictions. Germany's interwoven system of federalism resembles a "marble cake" instead.[26] All too often in recent years, the opposition party in the *Bundestag* has held a majority of seats in the *Bundesrat*. The result has been "reform gridlock" (*Reformstau*).

It is beyond the scope of this report to present a detailed blueprint for revamping German federalism. Nonetheless, the adoption of a few principles should go some way toward alleviating reform gridlock. The federal government should cede more sources of tax revenue and full autonomy over a wide range of governmental tasks to the states. Uniting the authority to tax and to provide services would give German voters for the first time a transparent opportunity to express a preference regarding the public services for which they are willing to pay. These changes would also permit states to experiment with tax structures to see which generate more business activity, which ultimately maximizes the tax yield. Healthy experimentation among the states would permit testing and the opportunity to spread best practices, as they arise, nationwide. Devolving more programs to the state level would also help to alleviate reform gridlock at the federal level, since less federal legislation would have financial implications for the states and thus would not take the form of an "approval law" (*Zustimmungsgesetz*), which is subject to an absolute veto in the *Bundesrat*.

4. CONCLUSION

Germany can only return to a higher growth if it reinvents its economy. Job creation should displace unemployment reduction as an immediate principal objective. This can be done by shrinking the wage wedge, cutting the reservation wage, and adopting an earned income tax credit to enhance the employment opportunities for low skilled employees. Germany must also focus on shoring up its competitive foundation through a top-to-bottom reform of its educational system. Finally, Germans should reform their federal system by devolving more tasks to the states, giving states more autonomy over setting taxes and promoting a system of experimentation.

The German government should seize this moment of reform fervor to implement these changes, many of which are long overdue. The reception of Agenda 2010 thus far shows that real progress can be made, despite the substantial role interest groups play in German governance. Time is of the essence. The negative example of Japan demonstrates that the reliance solely on incremental fixes at the margins and perpetual protection of sacred cows can result in years of stagnation that are destructive to the economy and corrosive to society.

ENDNOTES

[1] See, for example, Heiner Flassbeck's commentary in the *Frankfurter Rundschau*, 15 March 2003.

[2] For example, Organization for Economic Cooperation and Development, *OECD Economic Surveys: Germany* (Paris: OECD, 2003), pp. 9-21.

[3] Michael E. Porter and Christian Ketels, "German Competitiveness," Institute for Strategy and Competitiveness, Harvard Business School, November 2002, p. 1.

[4] Hermann Simon, *Hidden Champions: Lessons from 500 of the World's Best Unknown Companies* (Boston, MA: Harvard Business School Press, 1996).

[5] Rebecca Harding, "Dynamic Germany: The Role of Policy in Enabling Markets," *Internationale Politik und Gesellschaft*, no. 2 (2002), pp. 122-134.

[6] For example: *Frankfurter Rundschau*, 3 December 2002 and 10 March 2003; and *Die Welt*, 28 February 2003.

[7] For the details of Agenda 2010, see: *Süddeutsche Zeitung*, 15 March 2003; and http://www.bundesregierung.de/Themen-A-Z/-,9757/Agenda-2010.htm.

[8] All economic data, unless otherwise noted, is from: Organization for Economic Cooperation and Development, *OECD Economic Outlook* (Paris: OECD, various years).

[9] The gap remains essentially the same even after additional factors are taken into account, such as differences in population growth and statistical methodologies. See: Horst Siebert, "Germany's Social Market Economy: How sustainable is the Welfare State?" *AICGS German-American Dialogue Working Paper Series* (Washington, DC: AICGS, 2003), p. 2.

[10] Statistisches Bundesamt, *Statistisches Jahrbuch 2002. Für die Bundesrepublik Deutschland* (Wiesbaden: Metlzer-Poeschel, 2002).

[11] Organization for Economic Cooperation and Development, *OECD Economy Surveys: Germany*, vol. 2002, Supplement No. 4 (Paris: OECD, 2003), p. 26.

[12] This report uses German national labor-market data. German methodology defines unemployment relatively broadly. For any given year, German national data report an unemployment rate between 1 to 2 full percentage points higher than the standardized unemployment rate calculated for Germany by the OECD.

[13] The data and citations in this section, unless otherwise noted, come from: Christian Ketels, "Reinventing the German Economy: The Company Perspective," presented at the Reinventing the German Economy Workshop, American Institute for Contemporary German Studies, The Johns Hopkins University, 21 February 2003.

[14] Siebert 2003, p. 6.

[15] For example, *Die Welt*, 9 July 2003.

[16] Alan B. Krueger and Jörn-Steffen Pischke, "Observations and Conjectures on the U.S. Employment Miracle," Princeton University, Industrial Relations Section, Working Paper no. 390 (August 1997); and Organization for Economic Cooperation and Development, *OECD Economic Surveys: Euro Area* (Paris: OECD, 2001), pp. 11-12 and 170-177.

[17] For example, *Die Welt*, 22 May and 9 July 2003.

[18] Organization for Economic Cooperation and Development, *OECD Economic Surveys: Germany* (Paris: OECD, 1998), pp. 70-96.

[19] Eckhard Wurzel, "The OECD Economic Survey: Germany," OECD Breakfast Series, Washington, D.C., 15 April 2003.

[20] Industriegewerkschaft Metall, Abeitlung Wirtschaft – Technologie – Umwelt, *Lohnnebenkosten – ein Verteilungskonflikt* (Frankfurt/Main: IG Metall, March 2003), p. 8.

[21] OECD 2003, pp. 83-84.

[22] Björn Christensen, "Reservation Wages, Offered Wages, and Unemployment Duration – New Empirical Evidence," *Kiel Working Paper*, no. 1095, Institut der Weltwirtschaft, January 2002.

[23] For example, Siebert 2003, p. 6.

[24] For example, <http://www.buergerkonvent.de>.

[25] Uwe Thayson, *The* Bundesrat*, the* Länder *and German Federalism*, German Issues no. 13 (Washington, DC: American Institute for Contemporary German Studies, 1994), p. 8.

[26] Konrad Hesse, *Der unitarische Bundesstaat* (Karlsruhe: Müller, 1962); and Uwe Leonardy, "The Working Relationship between *Bund* and *Länder* in the Federal Republic of Germany," in Charlie Jeffery and Peter Savigear, eds., *German Federalism Today* (New York: St Martin's, 1991), p. 52.

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#8. Silvia, Stephen J. *Reinventing the German Economy*. Washington, D.C.: AICGS, 2003.