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KAS WASHINGTON

Germany: How to Turn Gloom into Growth

GASTVORTRAG

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Excellencies, Dear Colleagues, Dear Friends, Dear Dr. Mr. Wahlers, Ladies and Gentlemen,

First of all, I would like to tell you that I am very happy to be here in Washington, especially this evening. When people from the U.S and my country meet these days, it is an achievement in itself. Of course we are all focused on the Iraq conflict. People in Germany wish it would have been possible to start military action with a unanimous vote in the U.N. Security Council. Even more so, we would have wished the Iraqi regime had met the seventeen, not the only last one but the seventeen, U.N. resolutions of the past 12 years. And we should always be aware of what Saddam and his terrorist regime has done to its own people and to its neighboring states since 1991.

Now, it makes no sense to dispute the past. Now that the allied troops have started their operations, I personally want to leave no doubt on where we stand. We want the allied troops to be successful as fast as possible and we hope very much that the number of casualties will be as few as possible. We pray for those American and British soldiers who have already lost their lives. Our thoughts are also with their families. I am equally saddened by the loss of life of the civilian Iraqi population due to the war that Saddam Hussein is imposing on his own people. I also want to assure all Americans and today's audience in particular, that we Germans have never forgotten what America did for us 55 years ago and again 13 years ago. Germany's unification would not have been achieved without the clear and strong support of our American friends and without the strong commitment of George W. Bush's father and his administration. So President Bush simply deserves, despite all differences in details, the right to be addressed as a friend. I wish my government also shared that view.

I. Germany's economic reality – the facts

Now ladies and gentlemen, today I am asked not to focus on the Iraq conflict but to focus on the economy of my country. Germany's economy is in a deep structural crisis. Our economic prosperity is decreasing, unemployment is rising, the national debt is growing, the social security systems are on the brink of collapse, and between 2000 and 2002, **Germany's competitiveness** compared with other countries **continued again to fall**. This is all taking place against the background of a demographic trend which will impose major burdens on us and, indeed, all the other European countries, as well over the next 15 to 20 years.

The state of the economy in my country, and its economic outlook, are grimmer than the general mood. In saying this, I am not exaggerating or trying to make the situation sound worse than it is. You know how to interpret my comments. You therefore also know that an unembellished analysis of the economic situation is a prerequisite for proposing the right solutions and putting them into

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practice. If we shy away from the facts, we will be in no position to change the facts.

The cause of this trend in Germany is not the cyclical slowdown. If it were, we could accept and deal with it, if Germany's economic substance were in reasonable shape. But the causes of the dilemma are Germany's unresolved structural problems and the present Government's refusal to tackle the long overdue task of structural reform in the labour market, social protection systems, and taxation and public budgets.

On a self-critical note, however, I should say that the measures taken by the Federal Government led by my party, the Christian Democratic and Christian Social Union, up to 1998 also failed, especially in the second half of their time, to take account of the real scale of the structural problems facing Germany.

Without the necessary structural reforms to boost economic momentum and growth, we in Germany will be unable to solve our problems and halt the downward spiral, as the European Commission, the OECD and all the economic experts in Germany and outside have confirmed.

Let me begin by presenting you some facts to illustrate the problem. This will also give you a sense of what needs to be done, right across the economy, to ensure that Germany, one of the world's wealthiest countries, can continue to prosper in the future.

The economic situation, business and growth

Compared with other European countries, Germany has recorded **well below average growth rates** for some considerable time. The average rate of real GDP growth amounted to 1.4% annually between 1999 and 2002, whereas economic growth in the European Union averaged 2.2%. The gap would be even wider if the EU average were adjusted to exclude Germany's poor growth rates. With GDP growth of just 0.2% last year, the poorest rate in 9 years, Germany turned in the worst performance in Europe and according to forecasts, can expect to trail well behind the other European countries in 2003 as well, with minimal growth of just half a percent.
Although Germany is no more dependent on the US economy than other European countries, Germany's growth performance has been particularly poor over the last few years. This is due, first and foremost, to the lack of economic momentum at the domestic level. Although it still achieved moderate export growth, domestic demand dropped sharply in 2001 and 2002. The fall in investments in equipment, -5.8% and -7.4% in 2001 and 2002 respectively, and in construction, -6.0% and -4.9% respectively, is the main reason for this.

Small and medium business in Germany is in a poor state as well. The income situation is unsatisfactory and an analysis of balance-sheet data reveals worryingly **thin capitalization**. According to statistics from the Deutsche

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Bundesbank, the own funds ratio among SMEs currently stands at well below 20%, and is actually less than 10% for one-third of the smaller and medium size companies. This thin capitalization increases companies' vulnerability during periods of cyclical weakness when company profits are low. Reflecting the negative macroeconomic trend, the total number of **insolvencies** also climbed to a new peak of around 38,000 in 2002, a more than **16.4% increase** on the previous year. At the same time, the number of business start-ups fell by around 4%. A further rise in insolvencies is predicted for the current year.

The labor market

Mirroring Germany's gloomy economic trend, unemployment is also increasing. In February 2003, it stood at nearly 4.7 million, which means that with seasonal adjustments, it has steadily risen since December 2000. Unemployment in Germany now stands at 10%, in eastern Germany it is already nearly 20%.

Analyses show that unemployment in Germany is not mainly cyclical, but that more than 80% of it has structural causes. This is why structural reforms are especially necessary in the labour market in order to tackle the causes effectively. For example, the percentage of long-term unemployed, who have been out of work for at least 12 months, is extremely high in Germany compared with other countries. In 2000, according to the figures presented in the OECD Employment Outlook, they accounted for more than 50% of the total jobless figure, compared with only 6.0% in the USA. Unless we can make radical changes here, Germany will be unable to make any significant impact on unemployment.

Finances, budgets, state sector

The public budgets are another problem area. There is general overspending against the revenue received from taxation, and debt is mounting as a result. According to data from the Federal Statistical Office, the government deficit stood at 77 billion euros last year. With a deficit of 3.6% of GDP, Germany therefore clearly failed to meet the deficit criterion set out in the Stability and Growth Pact. It also failed to meet the second criterion, namely keeping the debt-to-GDP ratio below 60%: Germany's figure was more than 61%.

For this year, given that poor economic performance is predicted once more, it is likely that Germany will fail to meet these two criteria again. In light of this development, the European Commission, at the start of this year, initiated disciplinary action against Germany for exceeding the deficit ceiling laid down in

the Stability and Growth Pact, in order to force the Federal Government to get its budget back on track and into line with the stability criteria.

Undoubtedly, German unification and its associated costs were also a factor in the high public debt ratio. We all knew, back in 1989, that the prosperity gap was too wide and the former GDR's economic substance in too poor shape for us to achieve unification at zero cost. But the real dimensions of this political and economic challenges were much bigger than estimated 12 years ago.

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As a result of inadequate or sluggish structural reforms in the fields of statutory pensions, health insurance and the labour market, consumption outlays as a proportion of the public budgets have been steadily rising at the expense of investment outlays. What is particularly worrying is the soaring federal subsidy to the statutory pensions insurance schemes. This is the largest item of expenditure, amounting to more than 30% of the federal budget this year, compared with 20% in 1998. Expressed in euros, 77 billion are being paid out of the federal budget of just 250 billion as an ongoing subsidy to the pensions insurance schemes! If we add on the interest charges accruing on the burgeoning federal debt, amounting to 38 billion euros, which is 15% of total spending, it is apparent that around 47% of expenditure cannot be varied over the short term. The federal budget offers very little scope to implement fresh policy initiatives. The same applies to the budgets of the *Bundesländer* and local authorities. Public spending as a share of GDP has settled at a consistently high level of around 50%.

The corollary is that taxes and contributions in Germany have also reached a level which is harmful to growth. In 2002, the tax ratio was more than 23% and rising, despite the last tax reform. The social insurance contributions, for example, the contributions paid by employers and employees on a 50-50 basis to the pensions, health, nursing care and unemployment insurance schemes, are also increasing. In 2002, they averaged over 41%, and in the current year, this will increase to more than 42%. Labour in Germany is thus becoming more and more costly.

The growing burden of taxes and contributions has had a "positive" impact on some economic sectors. However, I am referring to the shadow economy, which is booming in Germany. It is estimated that in 2002, some 350 billion euros bypassed the regular economy. In other words, the output of the shadow economy in 2002 was equivalent to around 6 million regular jobs.

The expansion of the shadow economy clearly demonstrates that the state has exceeded its boundaries and that in many people's eyes, it is claiming and redistributing far too high a share of the wealth generated in the economy. These people are no longer willing to accept this state of affairs. They find a way out by withdrawing beyond the state's reach, ultimately to everyone's detriment. That is why the development of the shadow economy in Germany is a further sign that action is needed.

Summary:

Without far-reaching and fundamental structural reforms in the labour market, budget, finance and social policy fields, the downward spiral of zero growth, higher unemployment, rising social insurance contributions and higher public deficits cannot be halted, which will result in a loss of prosperity for present and future generations. Citizens' and companies' confidence in policy-makers' ability to bring about reform has been shattered. This is where we must make a start, by mapping out objectives and showing the way forward to achieving these goals.

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II. *Which reforms does Germany need?*

Now, which reforms does Germany need? The core goals of our economic and labour market policies remain unchanged; they are "**employment for everyone**" and "**prosperity for everyone**". Massive efforts will be needed to translate them into reality.

The **social market economy** remains the central political tenet, reflecting the decision to pursue an approach to economic governance which is directed towards fulfilling both economic and social needs. If an appropriate balance is struck between the two aspects, the market economy and the social dimension, it is extremely successful, as the past has shown. Alongside parliamentary democracy and the rule of law, it has been the basis for prosperity and growth in Germany.

The target to be achieved for the German economy is obvious. Germany needs much higher economic growth. We must measure all the reforms which will become necessary over the next few years in terms of their contribution to economic growth.

I would like to examine these much-needed reforms starting with the public budgets.
Public spending as a share of GDP should be reduced to 40% within ten years. We must give our citizens and business room to breathe and engage in independent economic activity again. With almost one euro in every two earned in Germany flowing through the public budgets, this has now reached a level which is almost incompatible with an market economic system. As a result, market mechanisms in Germany can also no longer function in the way that is necessary to achieve a positive outcome. We must therefore have faith in people's individual abilities and initiative again, and the government should confine itself to setting the overall parameters. People, rather than government agencies, generally know what is best for themselves.

Reducing the expenditure-to-GDP ratio by around 9 percentage points is a massive task which can only be achieved over time. It means that for a period of 8 to 10 years, the rise in public expenditure must be 1 percentage point lower

than GDP growth, for example currently by around 20 billion euros annually. With growth of less than 1%, as in 2001 and 2002, there must therefore be an absolute reduction in consumption outlays from the public budgets. This shows the scale of the target. Let me put it another way: from now on, it will no longer be possible to fund whatever we think is desirable from the public purse. We will have to make drastic savings and set new spending priorities.

As you all can imagine, this is one area of a politician's work which is far from enjoyable. You get far more applause at constituency events if you announce generous benefits from the government, a new highway or bridge, or open new social amenities. But there is no alternative, especially if we are to comply with

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the criteria laid down by the European Stability and Growth Pact in future.

There is another reason, too, why Germany must be restored to its role as a pillar of stability in Europe: we can only guarantee the long-term stability of the euro if all the Member States present stability-oriented budgets and do not undermine the European Central Bank's monetary policy by running high budget deficits. There are already signs that as a result of the German Federal Government's failure to implement consolidation measures, other countries are also contemplating easing the terms of the Stability and Growth Pact. We can only counteract this trend if we ourselves set a good example.

But if we roll back the functions of government and cut spending, there must be a corresponding reduction in the taxes and contributions paid by private citizens and business. We cannot demand that citizens make their own provision in future if they do not have the financial resources to do so. Let's be blunt about it: the tax burden in Germany must be reduced. The tax rates in particular are still too high compared with other countries. A top rate of tax below 40% and a starting rate of income tax below 15% are our targets. Given the strain on the public budgets, we will only achieve this if we begin by putting the labour market in order and then expand the basis of assessment for income tax, namely by dismantling tax exemptions. This will offer a further advantage as well: it will make the tax system simpler and more straightforward for taxpayers once more.

Alongside the income tax reform, reforms in the social insurance systems are essential, for three reasons. Without structural reforms in the social security systems, statutory pensions, health insurance schemes as well as unemployment and welfare benefits, it will be impossible to tackle the budget problems faced by the Federal Government, the Länder and the local authorities or reduce social insurance contributions and therefore non-wage labour costs. Reductions here are essential to cut the cost of labour, increase companies' demand for workers, and thus help to bring down unemployment. Structural reforms of the statutory health and pensions insurance schemes are also crucial in light of demographic developments in Germany. We need to future-proof these systems against demographic trends, for otherwise, in 15 to 20 years time, the only way to cover the ensuing costs will be through extremely high contribution rates, which will have again a negative impact on growth.

These structural reforms should be tackled promptly in Germany, for if they are to be socially compatible, they must lead to more individual responsibility and individual provision over time. The mobilization of efficiency reserves, for example in health insurance, will not be enough by itself.

The targets which I have tried to outline cannot be a programme for a single legislative term. I would describe them as a guiding light for government policies. Even with optimum government performance, which we actually do not see, they are unlikely to be achieved in full within less than 8 to 10 years. The path towards these goals will not be easy for anyone. However, if the targets to be reached are defined clearly, and a resolute and reliable course is steered,

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people in Germany will be willing to follow along this difficult path.

The reforms which I have described will be easier to implement if the German economy can be jump-started in the short term. This will boost economic growth and generate extra tax revenue, and also allow spending cuts to be made. It will offer the necessary budgetary scope to press ahead with the consolidation of all the public budgets and with structural reforms in the social security systems. These reforms must be undertaken in a socially compatible way in line with the social market economy as the guiding principle of economic governance. Under these provisions, no one should fall through the safety net provided by the social security systems in Germany.

In the short term, therefore, a labour market reform must begin with legislation which makes labour law more flexible, overhauls the incentive structures, and increases competition in the labour market. The Federal Government is currently in the process of drafting initial strategies which can be implemented swiftly through legislation. It must become more attractive to work and less attractive to stay at home. Those who are able to work should do so. Otherwise they must accept considerable cuts in their social aid. It is one of the major problems of our labour market constitution to create employment incentives, since the gap between earned income and benefits for joblessness is too narrow.

This program will cut the costs of labour for companies, thereby improving their human resource planning. This will significantly boost growth in the German economy within the same year and help ease the difficult situation in the public budgets at all tiers of government.

Summary:
If higher growth and more employment are achieved through the measures described above, these radical reforms will encounter less opposition from the general public in Germany. However, Germany must revert swiftly to a growth-oriented course. Otherwise, there is a risk of a downward spiral which will be difficult to halt. If we are successful in setting a course towards growth and employment in our labour market, social policy, and budget and finance policy, Germany will once again become the powerhouse of the European economy. The potential is already there.

What is lacking at present is the courage at the political decision-making level, especially within the Federal Government, to remove the current obstacles through a package of bold reforms. There is growing pressure for reforms. The general public in Germany increasingly recognizes that the present course is unsustainable, and they are willing to endorse major reforms.
That is why I am relatively confident that Germany will manage to turn itself around.

Ladies and gentlemen, I would like to conclude with a few brief comments on Germany's tax and finance policies.

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Germany needs to revert to a tax system which provides the basis for sustainable economic growth and more employment. Current German tax law, on the other hand, tends to impede growth and employment. In consequence, Germany has to contend with tax evasion, tax avoidance, continuing capital flight, corruption and an increasing burgeoning shadow economy.

At the same time, it must also deal with the challenges of European integration and globalization. First, I would like to set out some general criteria for a growth- and employment-oriented tax system, which may well be applicable to countries other than Germany as well.
Tax laws must be based on the taxpayer's ability to pay, and their key features must be simplicity and clarity, uniformity and justice, practicability and yield, and an abolition of incentives and subsidies which serve no economic purpose.

Above all, promoting sustainable growth also requires a sustained reduction in the tax burden. It is obvious that German income tax rates, which range from a starting rate of 19.9% to a top rate of 48.5%, must be cut substantially to free up economic capacities on a sustained basis. And unlike the U.S., Germany continues to impose a special burden on companies through its so-called trade tax. This special tax was created as a charge on the specific demands made by industry on the public infrastructure. However, as a result of Germany's successful transformation from an industrial to a service economy, it is outdated and its abolition is long overdue. Another obsolete tax is the so-called wealth tax, which still exists in Germany, although it is currently not collected. This is purely a tax on assets. But growth-oriented taxation must be based specifically on ability to pay, not on assets. The wealth tax, too, is outdated and must be abolished once and for all.

Ladies and gentlemen, I hope that with these comments, I have set out some of the policy principles which will lead us back to sustainable growth and employment, and which together with the other European nations could therefore give fresh impetus to Europe too.

We really do need such a fresh impetus for us and others in a world which is becoming more and more unsafe and which affords more and not less transatlantic cooperation, which affords more and not less transatlantic friendship and which depends on good personal relations between those who bear the responsibility for this in business, in science, in the media, and last but not least, in politics.

That is why I am happy to be here and with you especially in these days.
Thank you so much for your attention.

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