



OECD Economic Surveys GERMANY

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OVERVIEW



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Summary

- **Main findings**
- **Key recommendations**

Main findings

In the face of recent crises, the German economy has proved remarkably resilient. Unemployment has reached post-unification lows even as job losses mount across Europe, reflecting ambitious reforms in the past decade and Germany's status as a "safe haven" in the euro area crisis. Germany is set for a recovery, backed by a strong manufacturing sector and a robust labour market. Domestic demand has contributed substantially to growth, but the current account surplus remains large. While income inequality is lower than in most OECD economies, the share of low-paying jobs has risen considerably. Potential growth is estimated to fall on account of demographic changes over the next 20 years.

Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies

The tax system depends heavily on the taxation of labour, which weighs on growth prospects. The government's plans to raise pension entitlements, if implemented, will make it more difficult to lower the relatively high labour tax wedge further and are not targeted at alleviating future poverty risks among the elderly. The exemption of housing from capital gains tax biases household investment decisions in the context of rising prices and benefits high-wealth households. Public investment is low and government spending on key services to support inclusive growth, notably childcare services, needs to rise further. On unchanged policies, targets for CO₂ emission reductions will be missed.

Improving financial sector resilience

The German banks have weathered the euro area crisis well but remain vulnerable. Potential risks arise from the low interest-rate environment and large derivative exposures. These potential risks are aggravated by high leverage of the country's largest banks and persistent perceptions of government guarantees to banks. Lending growth remains weak. The upcoming EU-wide stress tests and the Asset Quality Review will provide guidance on action needed to shore up the banking system.

Strengthening the contribution of the services sector to economic growth

The contribution of the services sector to value-added growth in Germany has been relatively small over the past 10 years. Product market competition has become sharper overall. Nonetheless, in some domestically oriented service sectors, notably some network industries and professional services, regulation protects incumbents from competition. While export oriented manufacturing is exposed to international competition and responds with productivity-increasing innovation and human capital accumulation, service sector productivity is lagging.

Making economic growth more socially inclusive and reducing disparities in well-being

Inequality and relative poverty in Germany have risen since the mid-1990s, as elsewhere, although income inequality has not increased since 2004 and has remained lower than in most OECD countries. Poverty risk has increasingly affected employees with relatively low employment protection or limited access to unemployment insurance, as well as many part-time and self-employed workers. Youth who have not graduated from upper secondary education face poor lifetime employment prospects and education outcomes continue to depend strongly on socio-economic background.

Key recommendations

Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies

- Make the tax system more supportive of inclusive growth. Broaden tax bases by updating property tax valuations and extending capital gains taxes on residential real estate, except for owner-occupied housing. Lower social security contributions, especially for low-pay workers.
- Focus additional pension entitlements on reducing future old age poverty risks. Fund such spending from general tax revenue. Prioritize spending on growth-enhancing items such as infrastructure and childcare.
- Phase out tax expenditures for activities that damage the environment while avoiding harming international competitiveness, and better align environmental taxation with negative externalities. To this effect maintain high support for international solutions.

Improving financial sector resilience

- Ensure that banks are adequately capitalised. Introduce a leverage ratio requirement as a complement to capital ratios in line with international agreements. Give consideration to introducing a leverage ratio requirement for systemically important banks before 2018.
- When transposing the European Union's Bank Recovery and Resolution Directive into German law, aim for enabling the authorities to include bank debt as comprehensively as possible in the future bail-in instrument. Clarify the priority for financial stability objectives over creditor rights when resolution legislation is applied.
- Micro- and macroprudential regulation should address remaining risks emanating from Landesbanken. The *Länder* should continue restructuring the *Landesbanken*, including through privatisation.

Strengthening the contribution of the services sector to economic growth

- Reassess regulation with respect to unintended entry barriers and abandon price regulation in some professional services.
- Strengthen the regulator's powers in the railways and broaden rights to issue SIM cards in mobile communications.

Making economic growth more socially inclusive and reducing disparities in well-being

- Provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic backgrounds. Provide more support for disadvantaged youth to complete formal upper secondary education, in particular mainstream VET. Continue reducing the assignment of pupils to special needs schools and make sure assignment to such schools does not reflect the socio-economic background of pupils.
- Reduce the gap in employment protection between permanent and temporary workers. Introduce a minimum wage, set by an expert commission, across all economic sectors. Better target the preferential tax treatment of *minijobs* towards low-wage workers.

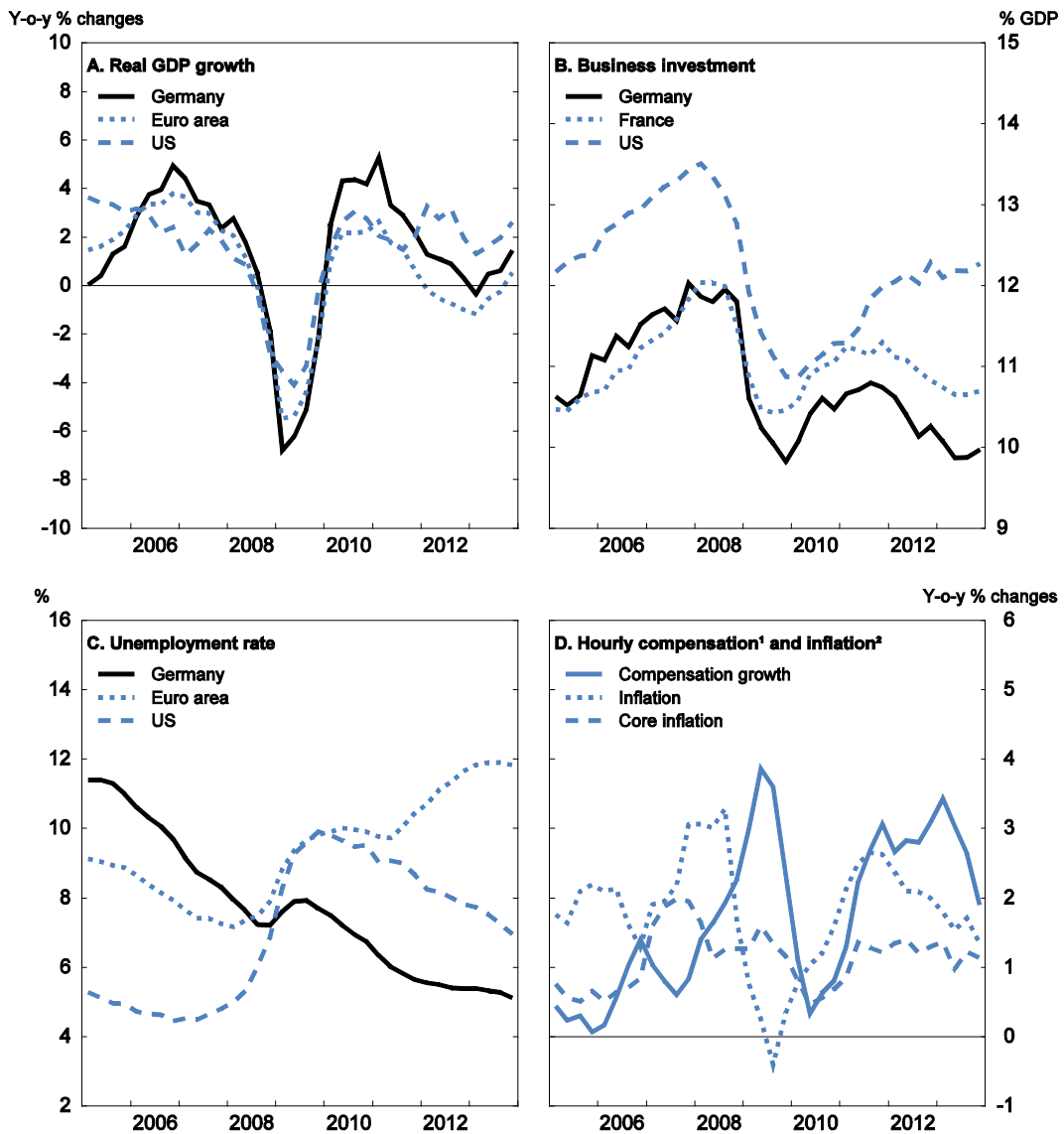
Assessment and recommendations

- Economic growth is strengthening but medium-term prospects need to be improved
- Strengthening financial sector resilience
- Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies
- Strengthening the contribution of the services sector to economic growth
- Further labour market reforms can partly offset the impact of demographic change on labour supply
- Making economic growth more socially inclusive

Economic growth is strengthening but medium-term prospects need to be improved

The German economy has continued to outperform most euro area economies, backed up by a large, competitive and innovative manufacturing sector, a robust labour market and its status as a “safe haven”. Its real GDP per capita has risen above pre-crisis levels. Nonetheless, economic recovery from a drop in output at the end of 2012 has been slow, as euro area financial tensions have diminished only gradually (Figure 1).

Figure 1. Key economic indicators



1. 3-quarter moving averages of working days adjusted nominal labour costs for the industry, construction and services except activities of households as employers and extra-territorial organisations and bodies.
2. Harmonised consumer price index (2005=100), seasonally adjusted. Core inflation excludes energy, food, alcohol and tobacco.

Source: OECD Economic Outlook database and Eurostat.

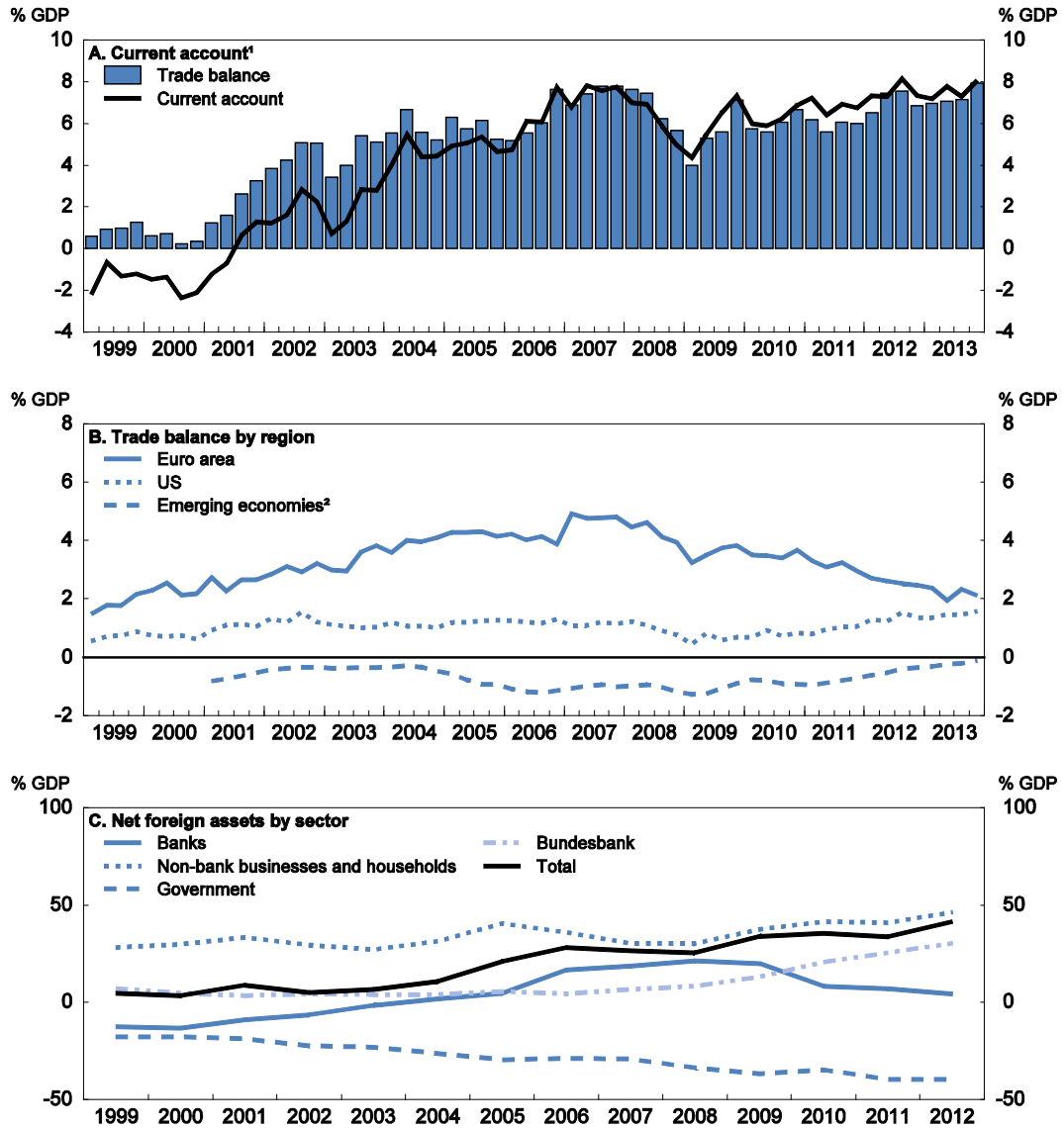
Weak demand from the euro area and decelerating demand from emerging economies damped export growth over the last two years. Domestic demand growth has held up partly because of strong labour market performance with unemployment now being below its equilibrium rate. Real wage growth has boosted consumer confidence. Financial instability and weak growth in the euro area appear to have constrained domestic demand growth. Indeed, business investment spending has been damped by uncertainty about the evolution of the euro area debt crisis and related policies (Federal Ministry of Economy and Technology, 2013). Surveys indicate that German businesses are increasingly willing to shift investment abroad (DIHK, 2013) and to create new production capacity closer to the more dynamic, more distant markets. Inflation remains subdued, reflecting the decline of import prices and a still negative output gap, which the OECD estimates to amount to $\frac{3}{4}$ per cent of GDP in 2013. The output gap may however be larger, as the estimate does not include the impact the recent increase in immigration (see further below) may have on potential output.

Reflecting these developments, the current account surplus has remained close to record highs (Figure 2). The structural surplus could be slightly larger because of the larger negative output gaps in major trading partners in the euro area (Ollivaud and Schweltnus, 2013). The goods trade surplus with other euro area countries has fallen from 4% to 2% of GDP. As a counterpart to current account surpluses, net foreign assets have continued to increase. The Bundesbank accounts for most of the increase in recent years, reflecting the build-up of the Target 2 claims, while the banking sector reduced its foreign assets, notably with respect to euro area crisis economies.

The recovery is projected to continue on the basis of further gradual expansion of domestic demand. Private consumption will continue to be underpinned by solid labour market performance while gradual recovery in the euro area is expected to strengthen investment spending, reducing the current account surplus somewhat (Table 1). GDP may rise above its potential level in 2015 while unemployment is expected to edge down by a small amount. Budgetary measures planned by the new government may reduce the budget surplus somewhat (see below).

Risks surrounding the outlook remain substantial. As demand growth from emerging economies has weakened, the economic recovery is likely to depend to a larger extent on a recovery in Europe than in the previous expansion phase. Renewed financial tensions, notably within the euro area, could lower exports and investment and push up unemployment, which would also weaken growth of private consumption. Renewed financial tensions could also affect German financial intermediaries. Such tensions could have an adverse impact on lending and raise financial risks to taxpayers, especially among banks with relatively weak capital buffers. On the other hand, improving confidence in the euro area recovery could boost GDP growth beyond projected levels. Progress in creating a banking union in the euro area, including a common fiscal backstop, would help reduce feedback loops between government finances and banking sector health in the euro area and contribute to financial stability, with economic benefits for Germany, including by strengthening its attractiveness as a location to invest. Germany should therefore support efforts to build such a banking union as soon as possible.

Figure 2. The current account, the trade balance and net foreign assets



1. Net current account, seasonally adjusted.

2. 12-month moving average of trade balance with BRIICS countries: Brazil, Russia, India, Indonesia, China and South Africa.

Source: Deutsche Bundesbank, OECD Economic Outlook database and DataStream.

Table 1. Macroeconomic indicators and projections

Annual percentage change in volume terms unless specified otherwise

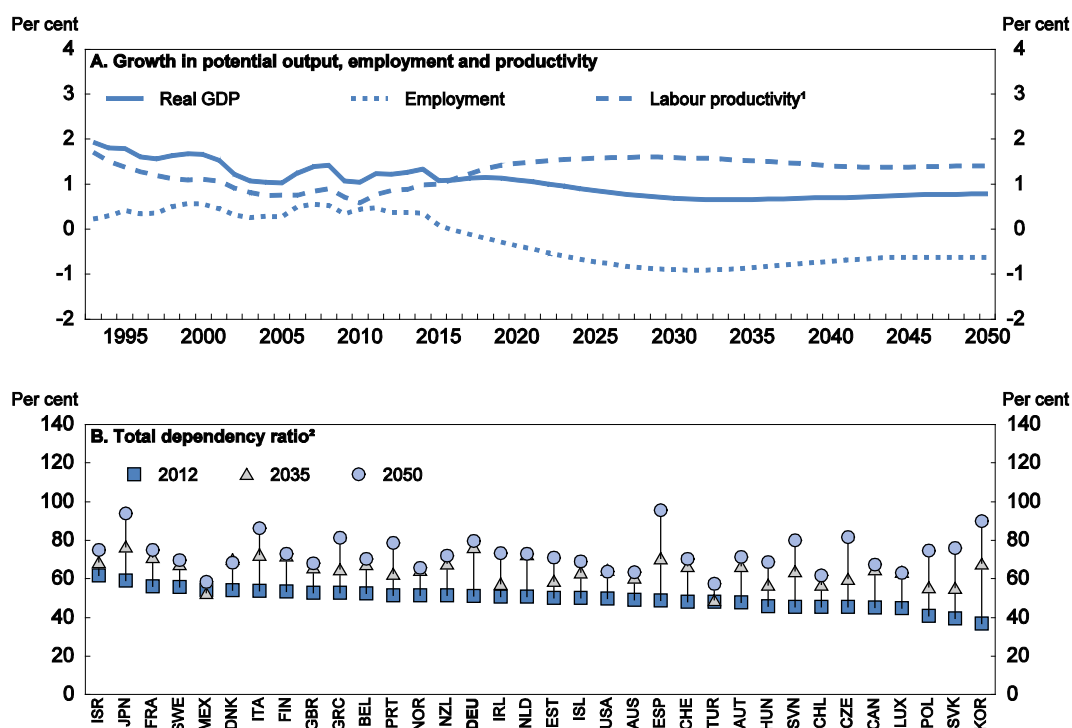
	2010 Current prices (EUR billion)	2011	2012	2013	2014	2015
GDP without working day adjustment	2 495	3.3	0.7	0.4	1.9	2.3
Working-day adjusted GDP	2 490	3.4	0.9	0.5	1.9	2.1
Private consumption	1 435	2.3	0.7	1.0	1.4	2.0
Government consumption	487	1.0	1.0	0.7	1.6	1.7
Gross fixed capital formation	432	7.1	-1.3	-0.5	5.7	4.8
Housing	132	9.1	1.9	0.9	6.9	4.2
Business	259	6.8	-2.2	-1.7	4.7	5.4
Government	42	2.6	-7.1	2.0	7.7	2.5
Final domestic demand	2 354	2.9	0.4	0.7	2.2	2.5
Stockbuilding ¹	-2	-0.1	-0.6	-0.1	-0.6	0.0
Total domestic demand	2 352	2.8	-0.2	0.5	1.6	2.5
Exports of goods and services	1 183	8.1	3.8	1.0	5.1	4.6
Imports of goods and services	1 045	7.5	1.8	1.0	4.8	6.0
Net exports ¹	138	0.7	1.1	0.0	0.4	-0.3
Other indicators (growth rates, unless specified)						
Potential GDP	..	1.2	1.2	1.2	1.3	1.2
Output gap ²	..	0.3	0.1	-0.6	0.1	0.9
Employment	..	2.3	1.0	1.0	0.6	0.4
Unemployment rate ³	..	6.0	5.5	5.3	5.0	4.9
GDP deflator	..	1.2	1.5	2.2	1.3	1.7
Harmonised index of consumer prices	..	2.5	2.1	1.6	1.1	1.8
Core HICP	..	1.2	1.3	1.2	1.3	1.8
Household saving ratio, net ⁴	..	10.4	10.3	10.0	9.9	9.7
Current account balance	..	6.8	7.5	7.6	7.9	7.4
Government financial balance ⁵	..	-0.8	0.1	-0.1	-0.2	0.2
Underlying government primary balance ²	..	0.8	1.4	1.2	0.8	0.7
Government gross debt (Maastricht definition) ⁵	2 057	80.1	81.0	78.4	76.4	72.3
Government gross debt (national accounts definition) ⁵	2 146	85.8	88.5	85.9	83.9	79.8
Government net debt ^{5, 6}	1 232	50.5	50.5	49.1	47.8	45.8
Three-month money market rate, average	..	1.4	0.6	0.2	0.1	0.1
Ten-year government bond yield, average	..	2.6	1.5	1.6	1.7	2.2

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of the labour force.
4. As a percentage of household disposable income.
5. As a percentage of GDP.
6. Gross debt (national accounts definition) minus assets.

Source: Federal Statistical Office and *OECD Economic Outlook 95 database*.

In the absence of further structural reforms the potential growth rate is expected to decline in the next 20 years as a result of population ageing (Figure 3). While past pension reforms have reduced the budgetary impact of demographic change, lower GDP growth will reduce the capacity of the economy to finance public services which contribute to well-being, notably health and long-term care services, for which demand is likely to rise. Against this background, the challenge is to strengthen medium-term growth prospects, broaden its sectoral basis and make the economy more resilient to financial sector shocks.

Figure 3. Potential growth and ageing effects



1. Labour productivity is calculated as real GDP divided by total employment.
 2. Total dependency ratio is population aged under 15 or 65 and over divided by population aged 15-64 (working age).
- Source: OECD Population Statistics database and OECD Economic Outlook 93 long-term database.

The new government which took office in December 2013 has presented a programme for the next 4 years. It foresees some steps which will help raise labour supply and improve human capital utilisation, strengthening potential growth. These steps are welcome and address some of the recommendations made in previous *Economic Surveys*. Some of these measures will also improve well-being and help make economic growth more socially inclusive. Key aspects of the government programme are discussed further below. However, the programme also includes measures raising pension spending. These measures make earlier retirement more attractive and are not targeted at alleviating future poverty risks among the elderly.

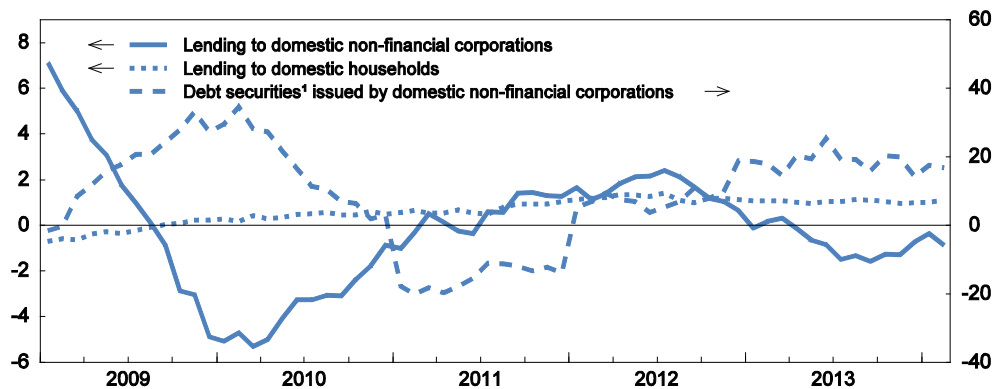
Strengthening financial sector resilience

Funding conditions for non-financial firms are favourable. Nonetheless, despite low interest rates and the “safe haven” status of German financial assets, domestic lending growth has been negative (Figure 4). Business surveys point to weak demand for loans notably among firms. According to the ECB’s SAFE survey and the survey of the German ifo Institute of Economic Research, access to finance is comparably easy for German firms. However, the euro system bank lending survey suggests that the tightening of the supply conditions of bank lending that took place in 2008 and 2009 has not been

significantly reversed. Corporations have increasingly gone to the bond markets, thereby taking advantage of low interest rates. Credit supply standards could become more binding as the recovery gains momentum if loan demand picks up strongly and banks do not soften their lending standards in line with improving economic developments.

Figure 4. Growth of bank loans and corporate bond issuance

Year-on-year percentage changes



1. Outstanding amounts.

Source: Deutsche Bundesbank.

Although German banks have reduced their claims on euro area periphery economies in recent years, financial ties with the euro area remain strong. Some banks may also suffer losses related to other cross-border activities, such as shipping and foreign commercial real estate. While these exposures are modest relative to the sector as a whole, they are concentrated in a few banks (Deutsche Bundesbank, 2012a and 2013a). Recognising risks and losses early on through transparent and conservative valuation of assets helps reallocate loanable funds to their most productive use (e.g. IMF, 2002; Bouis et al., 2013). The euro area bank asset quality review will be useful in this regard. Moreover, low interest rates in Germany and elsewhere reinforce incentives for risk taking. The housing market does not seem to be a risk for the financial sector at present, although developments need to be monitored carefully. House prices may have risen above fundamentals in some urban centres, but overall price increases still appear aligned with fundamentals (Deutsche Bundesbank, 2013a).

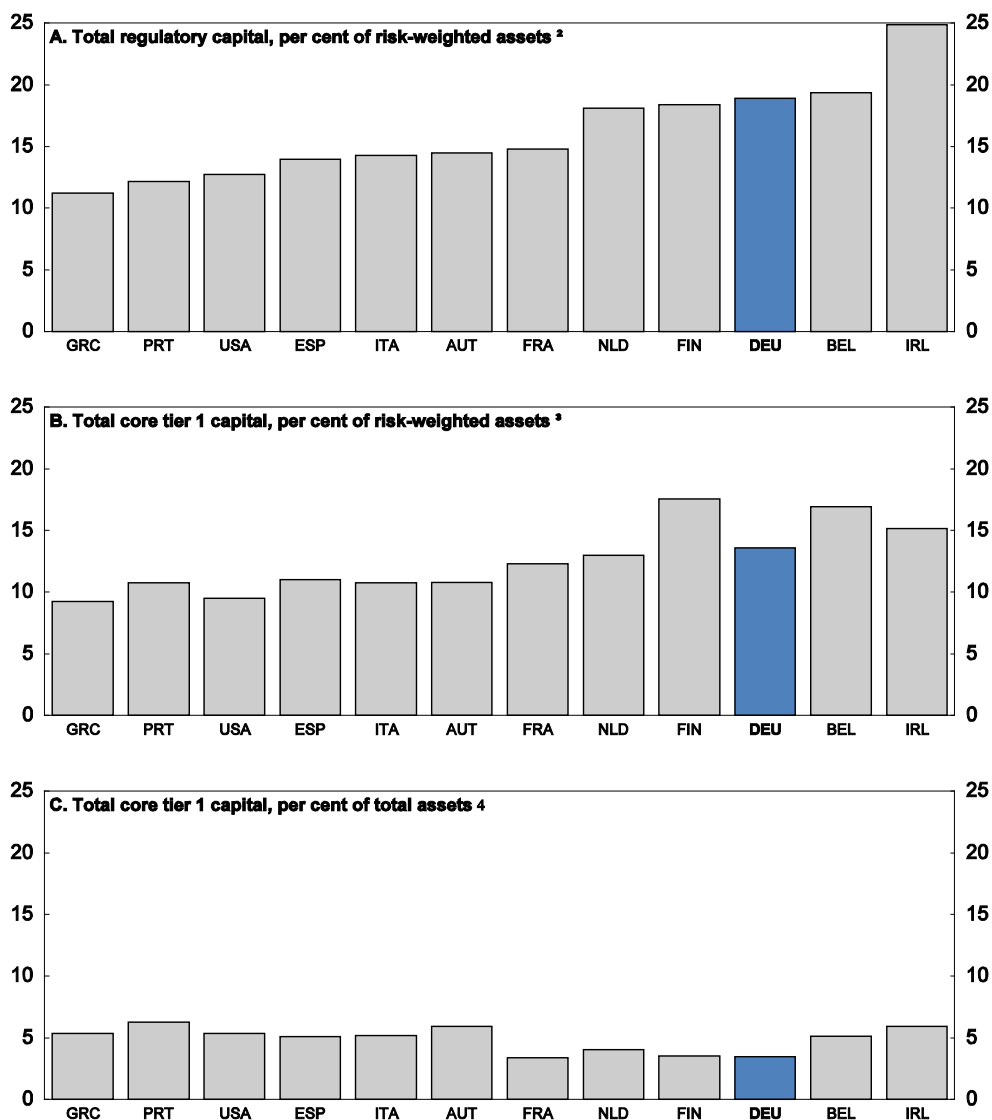
The government has taken important steps ahead of the future EU resolution regime to lower financial risks to the economy and to government finances. Legislation was introduced in 2011 giving the authorities more extensive powers to resolve non-viable banks. More recently the supervisor has received further powers to require banks to cooperate in preparing contingent restructuring and resolution plans. Further reforms include strengthened macroprudential regulation and managerial liability. The new macroprudential framework is timely, as Germany's cyclical position is stronger than the euro area's. It includes a new Committee for Financial Stability with voting representatives from the Bundesbank, the Federal Financial Supervisory Authority, and the Ministry of Finance. The Committee can issue recommendations to public sector agents on the basis of the comply-or-explain principle. The large banks will fall under direct bank supervision by the European Central Bank when the Single European Supervisory Mechanism is introduced in the fall of 2014.

German banks have raised their capital ratios in recent years and mostly meet European Union and Basel III capital requirements, reflecting improved profitability, which is close to pre-crisis levels (Deutsche Bundesbank, 2013b). Some banks have strengthened capital ratios ahead of the euro area asset quality review and stress tests and ahead of stricter Basel III rules. However, Core Tier 1 capital relative to total assets (as measured by IFRS) remained below 3% in some of the biggest, internationally active banks in 2013. Stock market assessments of net worth of the largest private banks, where available, were similarly low. This is of particular concern, as these banks are particularly interconnected and may be too big to fail. The central importance of the German banking system argues

for a strong capital position. While average regulatory and Core Tier 1 capital relative to risk-weighted assets of the banking system are higher than in many OECD economies, Core Tier 1 capital relative to unweighted assets is relatively low (Figure 5). Basel III envisages a leverage ratio requirement, to be calibrated in 2017 based on the experience during the previous observation period. The authorities could consider introducing a leverage ratio requirement for systemically important banks before then to complement capital ratios (which weight assets by risk). More generally, to durably limit risks emanating from financial intermediaries it is also important to ensure high ethical standards in the industry and strengthen corporate governance.

While higher capital requirements raise the private funding costs for banks, historic experience and empirical evidence suggests that these higher costs mostly reflect the reduced value of implicit government guarantees for banks and the reduced scope to deduct capital costs from taxable profits. These do not raise funding costs from a social point of view. The damping impact on domestic lending growth and activity is therefore likely to be limited in the long-run and is offset by the benefits of improved stability and lower risks for taxpayers (Admati et al., 2010). In the short term, stricter capital requirements may result in lower lending as banks may shorten balance sheets to meet stricter requirements. To mitigate the risk of reduced lending growth in the short term, the authorities could require profits to be retained or define additional required capital in nominal terms, rather than relative to the balance sheet.

Figure 5. Capital ratios and leverage ratios ¹



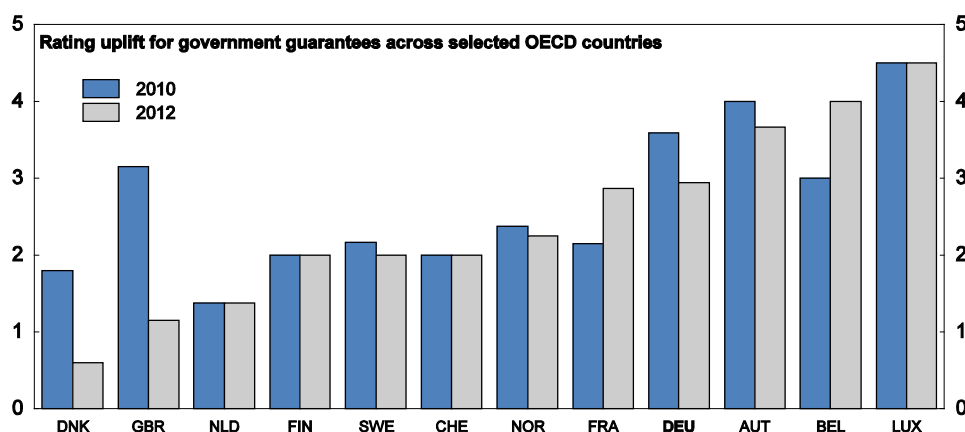
1. Averages, weighted by individual banks' total assets.
2. Total regulatory capital is defined under the latest regulatory guidelines at period-end. For European banks, this excludes transitional capital adjustments when available. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
3. Total Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
4. Based on quarterly data as of December 2013; where these are not available the most recent available data are taken, extending back to December 2012. The leverage ratio relates banks' Core Tier 1 capital to total assets, in book values. Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Data for total assets are adjusted to reflect the International Financial Reporting Standard (IFRS).

Source: SNL Financials, Bloomberg, DataStream and OECD calculations.

Effective resolution tools are important to remove failing banks from the market

With the implementation of the Bank Restructuring Act 2011, Germany moved ahead of many OECD countries in giving authorities more powers to facilitate the reorganisation of weak banks and the resolution of non-viable banks (Financial Stability Board, 2012). This framework establishes a mechanism which allows the authorities to ensure that bank debt absorbs losses in banks which need to be restructured and recapitalised (“bail-in”). However, this mechanism applies only if systemically important activities are transferred to a bridge bank. The EU Bank Recovery and Resolution Directive will require a more flexible bail-in tool from 2016. When transposing the directive Germany should aim for enabling its authorities to include bank debt as comprehensively as possible in its future bail-in instrument. Germany is one of few countries in which resolution authorities have the power to depart where necessary from the general insolvency principle of equal treatment of creditors of the same class. German legislation respects the protection of creditors’ rights as a fundamental feature of financial markets. However, with respect to resolution legislation some financial market experts have criticised that the objective of financial stability is given priority over the protection of creditors’ rights only under certain conditions (Hellwig, 2012). The Bank Restructuring Act may not have succeeded in convincing market participants that banks would not be bailed out. Indeed, perceptions of implicit guarantees of bank liabilities by the government are high compared to other European economies with high sovereign credit rating (Figure 6).

Figure 6. Perceived government guarantees for major banks across countries



Note: Average uplift, calculated as the difference in notches between all-in credit rating and the adjusted stand-alone credit rating, which already factors in parental and co-operative support; hence the difference reflects regional government and systemic support only. Sample consists of 123 large European banks.

Source: S. Schich and S. Lindh (2012), “Implicit Guarantees for Bank Debt: Where Do We Stand?”, *OECD Financial Market Trends*, vol. 2012/1.

To limit incentives for excessive risk taking in investment banking, parliament has approved legislation which requires banks to separate certain trading activities and other risky activities from deposit-taking. Separation of risky proprietary trading activities and asset positions from deposit banking can mitigate the too-big-to-fail problem, making it easier to wind a failing bank down. It also helps remove cross-subsidisation from the implicit guarantees of being part of a large insured deposit bank with access to central bank lending (Blundell-Wignall and Atkinson, 2011).

The large German banks have built up particularly large derivative positions relative to GDP in international comparison over the past 15 years in the context of strong global growth of such positions. The interconnectedness of these positions exacerbates systemic risk. However, market participants pointed out that banks are in the process of entering into netting arrangements across a variety of deals with the counterparties to reduce their gross derivative exposures and hence the systemic risk resulting from this interconnectedness. Recent empirical work at the OECD suggests that, in contrast to primary securities, derivative positions raise default risk (Blundell-Wignall and Roulet, 2012). A large share of the

large banks' derivative business appears to serve the purposes of tax and regulatory arbitrage, for example to change the risk weights applied to primary assets in the bank balance sheet (OECD, 2011a). In these cases derivatives trade is of no social value. It therefore is particularly desirable to avoid cross subsidisation of this business. Owing to their interconnectedness and their significance in raising default risk, separating derivative business from retail banking, which supplies the key payment and lending services, may also be particularly useful for stability reasons. These arguments suggest that derivatives should play an important role in determining separation requirements (Blundell-Wignall and Atkinson, 2013).

Reforming the public banking sector further

Germany's public banks account for more than 40% of banking sector assets, mainly in the local savings banks and the regional *Landesbanken*. The savings banks are sectorally diversified but locally specialised. This "regional principle" has brought economic benefits in terms of keeping coverage of the population with basic financial services high and in terms of access to loan finance for small and medium-sized businesses. It has encouraged regional economic development in relatively poorly developed regions (Hakenes et al., 2009). Savings banks appear to be at least as efficient as commercial banks (Kötter, 2006; German Council of Economic Experts, 2008; Altunbaş et al., 2001). They operate a bottom-up mutual guarantee system covering all liabilities. Such guarantees create moral hazard, although cooperative and savings banks have created internal auditing procedures to mitigate that risk and over the last 40 years few savings banks have required support from the guarantee system.

By contrast, the *Landesbanken* have frequently received financial support from the *Länder* governments (German Council of Economic Experts, 2008) to compensate heavy losses. Since the outbreak of the global financial crisis the *Landesbanken* have reduced their balance sheets and made efforts to shift their business model towards lending to bigger SMEs. Nonetheless only 20% of their assets consist of loans to the domestic non-financial private sector. A substantial share of assets consists of securities, foreign loans, as well as loans to other banks and to the German government sector. Some *Landesbanken* are majority-owned by the *Länder*, the rest by the savings banks. One *Landesbank* has a minority private stake. Their limited relationship to the regional economy makes it more difficult for the *Länder* owning these banks to control their activities. Some observers (Hellwig, 2010) have argued that the *Landesbanken* finance their regional governments in a non-transparent way, which generates conflicts of interest. The track record of some *Landesbanken* with regard to technical efficiency and allocation of lending is also relatively poor, in part reflecting poorly defined business models (OECD, 2010).

Most *Landesbanken* have close financial relationships with the savings banks. These links are encouraged by regulatory settings which provide privileged treatment to savings banks' loans to *Landesbanken*. Moreover they are integrated in the mutual guarantee schemes of the savings banks. If financial problems were to recur among the *Landesbanken*, they could spread to the savings banks. During the global financial crisis, such spreading was limited by government bail-outs which are undesirable and are being curtailed by EU legislation. The *Landesbanken* may also pass on systemic financial risks because of their significant role in interbank lending. Since savings banks cannot generally raise capital externally any losses the savings banks may suffer from financial exposure to *Landesbanken* could result in contraction of their balance sheets to meet capital requirements. These arguments suggest that the *Länder* should continue restructuring the *Landesbanken* including through privatisation. Those *Landesbanken* whose business models generate excessive risks could be subject to additional micro- and macroprudential requirements. Such steps could also help encourage *Länder* governments to push needed restructuring of *Landesbanken*.

Recommendations on strengthening the resilience of the financial sector

- Ensure that banks are adequately capitalised. Introduce a leverage ratio requirement as a complement to capital ratios in line with international agreements. Give consideration to introducing a leverage ratio requirement for systemically important banks before 2018.
- When transposing the European Union's Bank Recovery and Resolution Directive in German law, aim for enabling the authorities to include bank debt as comprehensively as possible in the future bail-in instrument. Clarify the priority for financial stability objectives over creditor rights when resolution legislation is applied.
- Micro- and macroprudential regulation should address remaining risks emanating from *Landesbanken*. The *Länder* should continue restructuring the *Landesbanken*, including through privatisation.

Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies

Fiscal policy is expected to remain broadly neutral in 2014 and 2015. The coalition agreement foresees new spending commitments of about 0.4% of GDP in 2014 and an additional 0.2% of GDP in 2015 which may be partly offset by other budgetary measures and by declining interest payments. Public debt relative to GDP will continue to fall, as the general government budget is expected to remain close to balance, both in headline and structural terms, and legacy portfolios acquired from banks in the global financial crisis are being reduced. Fiscal policy should remain neutral, as the output gap is expected to close in 2015 and public debt is still high. Appropriately the government has committed to reducing the public debt burden below 70% in 2017, a target which will be reached with a neutral fiscal stance provided the reduction of legacy portfolios from banks continues.

More generous pension entitlements to be enacted in 2014 account for most of planned higher spending. In particular, higher pensions will be paid to women who gave birth before 1992, and workers with long contribution records will be able to retire on a full pension 2 years before the legal retirement age (see Chapter 3 for the details of the plans). In the medium term, these measures will be funded by payroll contributions, which are projected to be 0.4 percentage points higher as a result of the planned measures by 2030. The tax burden needed to finance these measures will tend to damp employment. Moreover, the reforms do not address future old-age poverty risks. Further pension spending pressures may arise if these poverty risks materialise and existing means-tested benefits for the elderly are considered insufficient. Funding increased redistributive spending for the elderly from general tax revenue rather than from social security contributions could be more employment and growth friendly (see also further below) and share the burden more broadly and equitably among all tax payers.

Other spending projects of the new government, amounting to about 0.2 percentage points of GDP annually, are mostly devoted to transport infrastructure investment, improvement of formal childcare facilities and education. These spending plans are broadly aligned with growth and welfare-enhancing priorities. Over the past 15 years, budgetary constraints have damped government investment spending, which has dropped below estimated depreciation of government-owned capital (Table 2). According to an estimate by the German *Länder*, making up for the past shortfall of replacement investment in transport infrastructure alone would require an overall spending effort of 1½ per cent of GDP. Ensuring investment keeps up with future maintenance could, in addition, require raising spending by 0.2% of GDP per year (Daehre Kommission, 2012). These estimates cover transport infrastructure that is financed by all level of governments. Higher public spending to improve the availability of full-day childcare facilities would have large benefits by raising female labour supply and educational achievements of children from disadvantaged backgrounds later in life.

Room to fund higher spending on growth-enhancing policies could be made by reducing fiscal support for activities that damage the environment (OECD, 2012b). For example tax breaks for company cars and commuting allowances should be reconsidered. Furthermore, exemptions and reduced tax

rates in the VAT should be removed, although necessary compensating measures for low income households would reduce the net revenue of this measure. There also is scope to redirect family support away from measures which have proven harmful to labour supply and provide little benefit in terms of reducing poverty risk (see below). Efficiency gains could also be made on the revenue side through the re-allocation of the tasks of administrating and collecting tax revenues from the *Länder* to the federal government (OECD, 2012a). The current assignment of tax administration responsibilities reduces incentives for effective tax collection. While the *Länder* bear the costs, each *Land* keeps only part of the revenues from raising tax collection effort, because the federal government receives up to 50% of revenues of major taxes and because the financial equalisation among the *Länder* redistributes revenues from *Länder* with high tax revenues to *Länder* with low tax revenues.

Table 2. Government financial indicators

	% of GDP			
	1997	2007	2012	2013
General government current receipts ¹	45.0	43.5	44.3	44.2
Government current disbursements excluding interest ¹	42.8	40.4	41.8	41.9
Gross government interest payments	3.4	2.8	2.4	2.2
Social security benefits paid by general government	18.5	16.5	16.1	16.0
Government fixed capital formation	1.9	1.5	1.5	1.5
Government consumption of fixed capital	1.8	1.7	1.7	1.7
Government financial balance ¹	-2.0	-0.4	-0.2	-0.1
Government gross debt (Maastricht definition)	59.7	65.1	81.0	78.3

1. Cyclically adjusted. Per cent of potential GDP.

Source: OECD Economic Outlook 95 database.

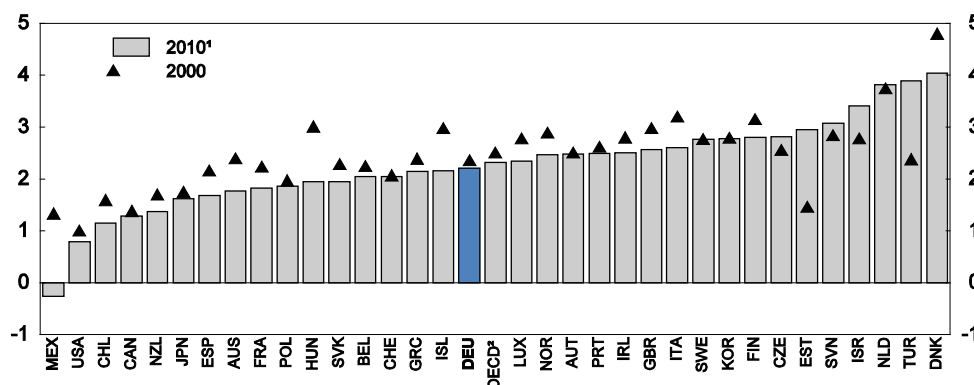
Tax reform can raise potential growth, make it greener and socially more inclusive

Revenues are heavily dependent on the taxation of labour income (OECD, 2012a) despite a reduction of social security contributions by 0.6 percentage points in 2013. The effective labour tax burden is particularly high for low-wage earners. As recommended in the *2012 Economic Survey*, the tax system should be made more growth friendly by reducing the tax burden on labour income, especially for workers on low pay. Such a reform should also include measures on the expenditure side of the social security system. More revenues could be raised from real estate taxes, including by updating underlying valuations although the scope for higher taxes is reduced by municipal fees.

More effective environmental taxation would also raise more revenue. At 2.2 % of GDP in 2011, revenues from green taxes in Germany are in line with the OECD average. Energy taxes in Germany are raised primarily for budgetary reasons and therefore do not always consistently reflect all environmental externalities. For instance, diesel is taxed at a lower rate than petrol, although it has a higher carbon content and emits more local pollutants harmful to human health. Parts of the energy-intensive industries are exempt from energy taxation or benefit from tax reductions which are motivated by competitiveness considerations and these exemptions are not always aligned with participation in European carbon emissions trade (OECD, 2012b). Nominal energy tax rates have remained virtually unchanged since 2003 although some are, especially concerning motor fuels, significantly above rates in other European countries. This has resulted in a declining share of taxation in fuel prices. The motor vehicle tax could also be revised to further encourage the adoption of energy efficient cars. The emission-based highway toll for heavy goods vehicles, which has helped increase the uptake of low-emission freight vehicles, could be extended to light duty vehicles or to passenger cars. The new government is considering introducing such tolls for foreign-registered passenger cars, which will generate a considerable administrative burden.

Figure 7. Revenues from environmentally related taxes

As a percentage of GDP



1. 2009 for Canada, Greece and the Slovak Republic.

2. Unweighted average.

Source: OECD/EEA database on Instruments used for environmental policy.

There is also scope for removing tax advantages and exemptions in the taxation of capital gains and bequests. Households are fully exempt from capital gains tax on housing property held for more than 10 years, including on dwellings not inhabited by the owner. Housing ownership is highly concentrated in wealthy households (Deutsche Bundesbank, 2013c) who therefore benefit the most from this exemption (Frick and Grabka, 2009; European Central Bank, 2013). The tax exemption risks biasing investment decisions towards residential housing, especially in the current low interest rate environment which may encourage expectations of rising prices.

Wealth held in enterprises benefits from preferential inheritance tax treatment under certain conditions. This tax regime generates incentives for wealthy households to transform private into business property (Bach and Beznoska, 2012a). The conditions for such transformations have recently been tightened. Compared to wealth taxes, inheritance taxation has relatively small distortionary effects on economic activity and entails lower administrative costs (Bach and Beznoska, 2012b). To avoid liquidity problems for businesses their inheritance tax payments can already be stretched over ten years. Over this period the government's claim could be subordinated to other claims in the business' balance sheet.

Recommendations on fiscal policy

Key recommendations

- Make the tax system more supportive of inclusive growth. Broaden tax bases by updating property tax valuations and extending taxation with negative externalities. To this effect maintain high support for international solutions.

Other recommendations

- Maintain the fiscal stance in line with budget rules and continue reducing the public debt-GDP ratio.

Strengthening the contribution of the services sector to economic growth

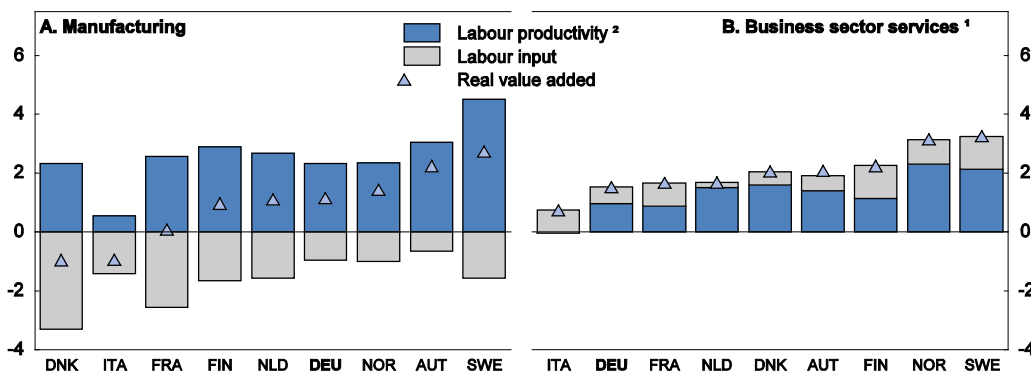
As in all high-income OECD countries, services contribute most to economy-wide value added although the manufacturing sector remains relatively large and accounts for the economy's export orientation. More than 70% of manufacturing value-added was export-oriented in 2008. The business services sector is mostly oriented to serving domestic demand, with 25% of its value-added

export-oriented. According to OECD trade in value-added data, a large share of German exports to neighbouring European countries, notably France, the Netherlands and Austria are inputs to final exports from these countries to outside Europe. Strong performance of firms in these countries therefore also supports competitiveness of the German economy.

Hourly labour productivity has developed favourably in manufacturing in the past decade, whereas in business services it has been weak in international comparison (Figure 8). Competition-friendly product market regulation has a marked impact on productivity performance in the services as well as in downstream industries that use services as inputs, including manufacturing (Barone and Cingano, 2011; Bourlès et al., 2010). Over the last 5 years Germany made considerable progress in making product market regulation more conducive to competition. However, the regulatory protection of incumbents remains substantial in sectors which are not exposed to international competition, notably in some services.

Further efforts to increase competition and productivity in the services sector would have a positive economy-wide impact on potential growth and broaden its sectoral basis. Thereby it could also strengthen demand for foreign goods and services, generating positive international spillover effects. While the effect of structural reforms of the services sector on the current account position is ambiguous from a theoretical point of view (Fournier and Koske, 2010) empirical studies suggest that they contribute to lowering current account surpluses (Ollivaud and Schweltnus, 2013; Coricelli and Wörgötter, 2012). This can happen also in the short term if boosting service sector reforms stimulates domestic investment (OECD, 2013a).

Figure 8. Real value-added and productivity growth in manufacturing and services
Average annual growth rates, 2000-11 or latest year available



1. Business sector services comprise the following ISIC Revision 4 categories; wholesale and retail trade, repair of motor vehicles and motorcycles; transportation and storage; accommodation and food service activities; information and communication; financial and insurance activities; professional, scientific and technical activities; administrative and support service activities. They exclude real estate activities.
2. Labour productivity is calculated as real value added divided by total hours worked.

Source: OECD STAN database.

Regulatory barriers hold back competition in network industries, professional services and the crafts

Machine-to-machine communication is expected to be the market's main growth driver in the future, and automated communication will increasingly make use of mobile telecom infrastructure. In Germany only mobile spectrum holders (and, for testing purposes, manufacturers) can issue SIM cards, including for machine-to-machine applications (CEPT, 2013). A large potential lies in breaking up this exclusive right. Permitting third parties to issue their own SIM cards would enable businesses and consumers in all sectors to seamlessly switch providers. This would increase competitive forces and reliability (OECD, 2012e).

Competition in the railway sector has slowly increased. Further efficiency gains in the railway market and downstream industries could be reaped. Vertical integration generates incentives for the incumbent to give its own transport service providers preferential access to the rail infrastructure which is owned by the incumbent. After almost 20 years of market liberalization the incumbent still provides most freight, short and long-distance passenger transport services. The regulator has undertaken numerous interventions against the apparently discriminatory behaviour of the incumbent (FNA, 2012). The authorities should strengthen the regulator's powers by granting it more investigative and interventional competences, which will help ensure a level playing field between the incumbent and market entrants. A further liberalization in the railway market on a European scale would stimulate cross-border transport, where growth potential for long-distance passenger and freight transport is considerable.

In some professional and other services, regulation in different forms has been accumulating over time to meet different objectives, like consumer protection or other societal preferences. These regulations should be examined with respect to the establishment of unintended entry barriers. It should be assessed whether the objectives can also be achieved in a more proportionate and equally effective way. For instance, in the crafts, it should be examined if the entry conditions could be further liberalised without jeopardising the dual vocational education system. Price regulation for some professions could be abolished without compromising consumer protection. Certain exclusive rights could be opened to a broader range of providers. The economic impact of deregulation would be significant as professional services account for around 10% of GDP.

Making support for renewable energy more cost effective

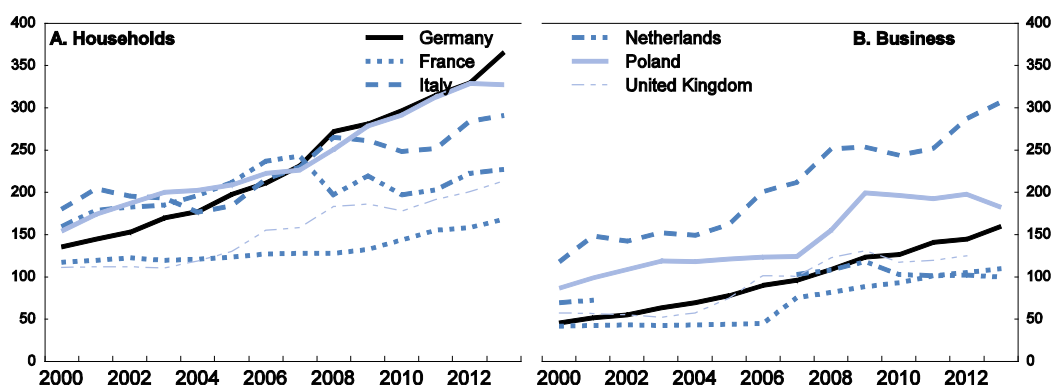
Globally, net carbon emissions will need to be reduced to close to zero in the second half of the century to limit climate change to manageable levels. Appropriately, the government has targeted a reduction of CO₂ emissions of at least 80% by 2050, although they rose in 2012 after many years of decline. Lower prices for CO₂ emission certificates in the European Emissions Trade System (ETS) have reduced the cost of high-emission lignite and coal-based power generation, which has crowded out low-emission gas-fired power plants. In the context of uncertainty about long-term climate policies, low CO₂ prices can reinforce investment decisions in high-emission technologies creating lock-in effects, which may prove costly to unwind at a later stage when more demanding targets will need to be reached. Government projections as of 2012 indicate that the objective of reducing emissions to 40% below the 1990 level by 2020 will be missed on current policies. This outlook reinforces the need to apply tax instruments more consistently to price CO₂ emissions in sectors not covered by ETS (see above).

Government support for renewable energy thus remains necessary to meet its targets, especially given the decision to phase out nuclear power generation by 2022. The German system of renewables support, based on guaranteed subsidised feed-in tariffs funded by a surcharge on electricity prices, has provided reliable incentives for long-term CO₂ emission-reducing investments. It has compared favourably with support systems in other OECD economies (OECD, 2012a and b; IEA, 2013). However, the costs have risen strongly recently and are set to reach 0.8% of GDP in 2014. This reflects the rapid expansion of renewables production, in part encouraged by generous feed-in tariffs in some cases, as well as low wholesale electricity prices, which have increased the gap between guaranteed feed-in prices and market prices. These costs have been born by the electricity consumers. Households now face electricity prices which are considerably higher than in most neighbouring economies (Figure 9). Firms can be partially exempt from the surcharge if they use electricity intensively and face international competition. At the same time such firms have benefited from very low wholesale prices.

Reform options to limit costs of renewable support would be to link feed-in prices for all new plants to market developments, as recommended in the *2012 Economic Survey*. In particular, costs could be more effectively controlled by substituting guaranteed feed-in tariffs by tendering renewable production capacities (OECD, 2012b; IEA, 2013). Moreover, the burden of the costs of renewables support could be broadened, phasing out exemptions, which are granted to businesses on the grounds that they face international competition. The government envisages a number of steps in the right direction. It proposes reducing tariffs and introducing tenders in 2018. It also envisages broadening the range of electricity users paying the surcharge. The government should also support initiatives to reduce the supply of emission certificates in the European Union's trading scheme.

Figure 9. Electricity prices in households and business

USD/MWh converted using PPPs



Source: IEA (2014), *Energy Prices and Taxes, Quarterly Statistics*, 1st Quarter 2014.

Further labour market reforms can partly offset the impact of demographic change on labour supply

Labour force participation increased between 2010 and 2013, partly driven by the continuing rise among older workers and women. Labour supply has also increased on account of higher immigration flows, mostly from Central and Southern European countries. Nevertheless, shortages in numerous specific skills, notably in medium level skills, are holding back employment growth (OECD, 2013b). The number of hours worked per person employed is one of the lowest among OECD countries. One key factor is the relatively low incidence of full-time female labour participation. Only 62% of employed women work full-time compared to 74% OECD-wide in 2012, even though overall female labour market participation is above the OECD average. Women with school-age children have a particularly low propensity to work full-time.

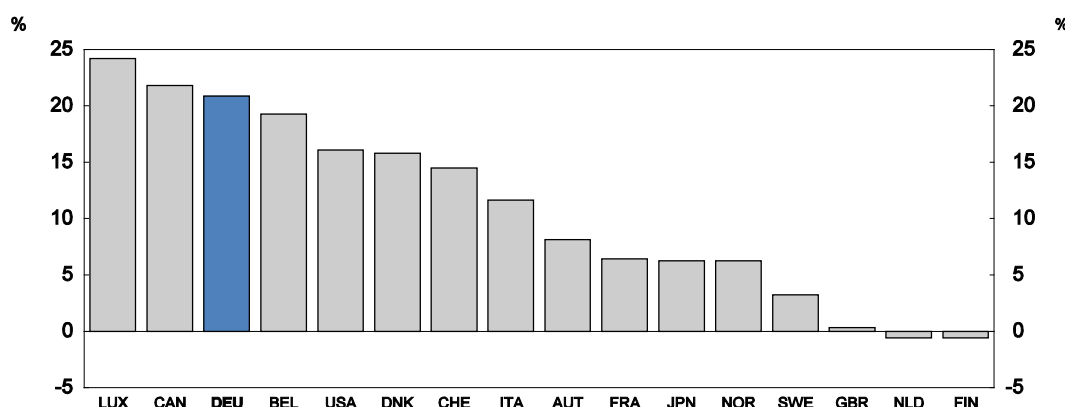
The mix of tax and benefit policies favours single-earner over dual-earner couples and thereby provides disincentives for full-time employment of women. The difference between the tax rate on the main earner and the secondary earner is one of the largest among OECD countries (Figure 10). This is due to both the joint taxation of couples and the free health insurance of married spouses who do not have their own health insurance coverage. As recommended in previous *Economic Surveys*, the joint taxation should therefore be reformed, although full mandatory individual taxation of couples is not possible in Germany for constitutional reasons. Consideration should also be given to ending free health insurance for non-working spouses while ensuring that low-income households are compensated. The childcare subsidy paid to families who choose not to use childcare and to care for their one- and two-year-old children themselves discourages labour market participation and should therefore be abolished, as suggested in the *2012 Economic Survey*.

The effective age of retirement has been increasing over the past 10 years, largely following the phasing out of early retirement and special unemployment benefit schemes for older workers. The employment rate of workers aged 55-64 increased from 52.3% at end-2007 to 62.0% at end-2012, 6 percentage points above the OECD average but below the best performing countries, where older worker employment rates are above 70%. There is still room, therefore, for improvement through reforms to eliminate remaining financial disincentives to work longer, to promote greater training opportunities, and to improve the health of workers at all ages. Government plans to allow individuals with contribution records exceeding 45 years to retire 2 years before the legal retirement age (currently 65 years) without pension deductions should be reconsidered. If implemented, they provide an incentive to retire earlier.

Germany is making progress in expanding childcare and has guaranteed access for all parents, if only for a few hours per day. However, enrolment rates remain low and access to full day care is limited, including for pupils more than 5 years old, who usually attend school only in the morning (OECD, 2012c;

OECD, 2014). Enrolment rates for children below 3 years of age reached 28% in 2012, much less than coverage implied by current estimated demand of 39% (Federal Statistical Office, 2012). Attendance of formal childcare for very young children is particularly low among children from low income households or with a migration background. While 33 % of children without a migration background attend childcare at the age of zero to 3 years, only 16 % of children with a migration background do so (Federal Statistical Office, 2012). A sufficient availability of formal childcare would encourage labour supply decisions particularly strongly among single parents and second-earners in low income households (Rainer et al., 2011) and thereby contribute to reducing child poverty. Moreover, children attending early childcare reap large cognitive and non-cognitive skill gains (Heckman and Raut, 2013). There also is scope to improve the quality of childcare and early childhood education, with a view to provide more education benefits especially for these children. While it is welcome that parents have a legal claim for a public care unit for children aged one year or more since August 2013, efforts should continue to expand affordable and high quality early childcare provision and to expand the supply of full-day care, including for pupils over 5 years old (OECD, 2012c and 2014). Efforts are also needed to encourage the participation of children with weak socio-economic background in early childcare and early childhood education. Additional resources should be made available to increase the staff-child ratio, to provide more integrated education and care, and to ensure childcare workers have better qualifications (OECD, 2012c and 2014), as planned by the government.

Figure 10. Difference in average tax wedge between primary and secondary earners
2012



Note: The bars show the difference between the tax wedge of a worker if the spouse does not work and the tax wedge on the spouse's earnings if the spouse also decides to work. The main earner earns the average earnings and the secondary earner earns 67% of the average earnings in a family of a married couple with two children. The tax wedge is labour taxes (income taxes plus employee and employer social security contributions) in per cent of labour costs. For second earners, it also includes possible changes in family-based benefits and taxation as a result of the second earner entering employment.

Source: OECD (2013), *Taxing Wages*.

Labour migration can help meet future labour demand and address skills shortages caused by a shrinking working-age population (OECD, 2012a). Recent reforms have put Germany among the OECD countries with the fewest restrictions on labour migration for highly skilled occupations. However, the recommendations of the *2012 Economic Survey* to set up an institution tasked with designing, assessing and coordinating labour immigration policy remains relevant. The recent initiative to allow employers to retain foreign graduates of the dual system is a positive step. However, the government could expand its efforts to support German language and preparatory training for recruiting young people into the apprenticeship system (OECD, 2013b).

Difficulties in the recognition of professional and vocational qualifications obtained abroad hold back earnings prospects of immigrants. The Federal Recognition Act, entered into force in April 2012, has proved effective; the first official data, published in October 2013, show that in most cases equivalence of foreign professional qualifications was established and recognition granted. Differences across the *Länder* in the recognition of such qualifications continue to limit the capacity of immigrants to move to

locations where their skills are in highest demand (OECD, 2013b). It is welcome that the new government is considering steps to further facilitate the recognition of qualifications obtained abroad, including non-formal qualifications. This should include easing and harmonizing the recognition of professional and vocational qualifications from abroad across *Länder*.

Recommendations to strengthen potential growth and to mitigate the impact of demographic change on living standards

Key recommendations

- Reassess regulation with respect to unintended entry barriers and abandon price regulation in some professional services.
- Strengthen the regulator's powers in the railways and broaden rights to issue SIM cards in mobile communications.

Other recommendations

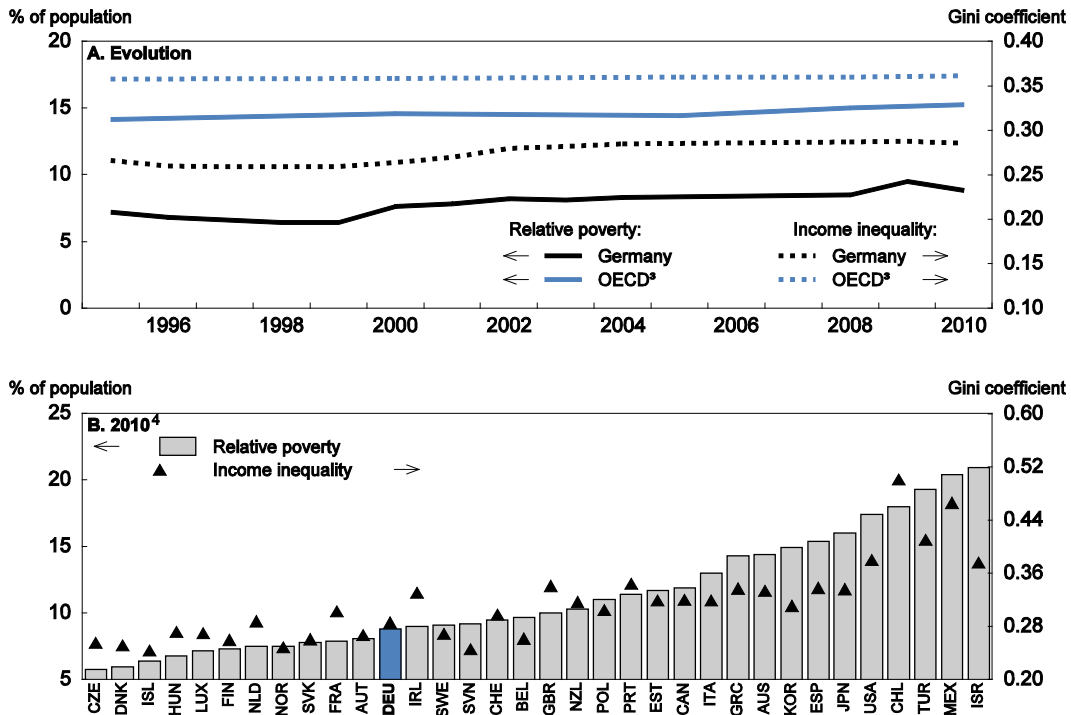
- To reduce barriers to full-time work by women, expand the supply of full-time childcare, reform joint taxation of couples and give consideration to ending free health insurance for non-working spouses while ensuring that low-income households are compensated.
- Expand support for German language training and foster immigration. Continue to improve the recognition of foreign qualifications.

Making economic growth more socially inclusive

Inequality and relative poverty in Germany are below levels observed in many OECD countries. They have risen since the mid-90s, as elsewhere, although income inequality has not increased since 2004 (Figure 11). Past increases in inequality were driven by gains by high income earners and the rising share of dependent and self-employed low-income workers. German households enjoy a relatively high level of economic welfare according to the OECD well-being framework. However, differences in self-reported health status vary strongly between high and low-income households and the link between socio-economic background and education attainment is also relatively strong (OECD, 2011b).

Sustained employment growth and a large drop in unemployment since 2005, largely brought about by labour market reforms in the mid-2000s (OECD, 2012a), have not resulted in a marked decline of relative poverty. At the same time the share of low wage earners and workers in non-regular employment has increased. These developments suggest that low-wage earners have not been able to take a commensurate share in the economic gains of these reforms. Indeed upward mobility of low-income and low wage workers has fallen (German Council of Economic Experts, 2013).

Figure 11. Relative poverty¹ and income inequality²



1. Relative poverty is measured as the percentage of the population whose equivalised household disposable income (after taxes and transfers) is below 50% of the median income.
2. Income inequality is measured as the Gini coefficient using household disposable income. It ranges from zero (perfect equality) to one (where one individual receives all).
3. Population-weighted average for 20 countries.
4. 2011 for Chile; 2009 for Hungary, Ireland, Japan, New Zealand, Switzerland and Turkey.

Source: OECD Income Distribution and Poverty database.

Avoiding labour market duality

Poverty risk has increasingly affected workers in non-regular employment, in particular employees with relatively low employment protection or limited access to unemployment insurance, as well as many part-time and self-employed workers (Table 3). In part, this is because successful past labour market reforms have put more unemployed workers into jobs, but many workers are paid low wages, suffer from low wage mobility, face higher risks of repeated unemployment spells, and 3% of the labour force have to rely on in-work benefits. A high incidence of low-pay and part-time work also raises future old-age poverty risks, as many low-pay workers may not accumulate pension entitlements above the level of subsistence benefits.

Table 3. Exposure to poverty of workers in non-regular, part-time and self-employment

	Risk of poverty		Share of total workers (in %)		
	1998	2008	1998	2008	2011
Total employment	4.6	6.2	100.0	100.0	100.0
Dependent	4.4	6.0	89.6	88.4	88.7
Dependent permanent full-time	3.1	3.2	73.2	66.1	66.5
Dependent non-regular					
Temporary	10.8	16.5	5.8	7.9	7.9
Marginal (<i>minijobs</i>)	13	23.2	4.7	7.4	7.5
Temporary agency		8.5		1.8	2.2
Part-time	9.9	15.3	10.9	14.1	14.1
Self-employed	6.7	7.7	10.4	11.6	11.3
Self-employed without employees	9.3	10.3	5.1	6.5	6.3

Note: The table refers to individuals aged 15-64, not in education or training. The risk of relative poverty is assessed on the basis of the mean equivalised disposable household income, at the 60% threshold. Non-regular employment consists here of temporary employees, workers in marginal employment (*minijobs*) and temporary agency workers. Overlaps among the different forms of non-regular employment and part-time employment exist.

Source: Federal Statistical Office.

A general minimum wage can be an effective instrument to raise wages at the bottom of the wage distribution while preserving employment prospects (Garloff, 2010). This applies especially in the context of precarious employment, in which workers are more likely to accept wages below their marginal product, for example because they receive wage subsidies or because their bargaining power is weaker than that of the employers. Minimum wages can also raise incentives for individuals to work and improve their skills (Acemoglu and Pischke, 2001). At present minimum wages are set for individual economic sectors, generally at the initiative of the social partners and on the basis of extending collective bargaining agreements. Such minimum wages apply to construction and several service sectors. Setting minimum wages on the basis of the extension of collective wage agreements incurs the risk of harming employment prospects of outsiders and generates barriers for firms entering the market (OECD, 2006, 2008b and 2012f). However, an extensive evaluation study commissioned by the German Ministry of Labour in 2011 covering all sectors with minimum wages failed to find any substantial negative effects on employment and market entry.

The government's plans to introduce a general minimum wage are welcome. The minimum wage will be phased in between 2015 and the end of 2016 at an initial level of EUR 8.50. The government plans to create a commission of representatives from the social partners to propose future adjustments of the general minimum wage. However it should be ensured that the minimum wage is not set too high initially to avoid substantial negative employment effects. At EUR 8.50 it would amount to about half of the median wage, placing the German minimum wage at a level similar to those of other European countries, such as Belgium, the Netherlands and the United Kingdom, but below France. It would affect about 15% of all employees nation-wide and 23% in Eastern Germany. Some researchers have argued that a minimum wage of EUR 8.50 may significantly harm employment prospects of workers with little experience or low skills and in some regions (Brenke, 2014).

The mandate of the commission should be to set the minimum wage at a level which balances potential employment losses against the social benefits. The social partners alone may not sufficiently take the interests of the unemployed into account. It could therefore be desirable to involve independent experts or government representatives in the commission's decisions. Moreover, given the introduction of the nationwide minimum wage, cautious use should be made of higher sectoral minimum wages set on the basis of collective agreements.

Marginal employment contracts up to EUR 450 (so-called *minijobs*) benefit from tax subsidies, are only partially covered by the mandatory public pension system and are fully exempt from unemployment insurance. *Minijobs* were intended as a stepping stone to regular employment and to avoid high marginal tax rates for low-wage earners, but have proven little effective as such (Freier and Steiner, 2007; Körner et al., 2013; Fertig and Kluge, 2007). The tax subsidy is not targeted to low income individuals, as many *minijobs* are taken up by second earners to avoid high taxation in the context of the joint income taxation of couples. Also, they can be held in addition to a standard job. Some workers on *minijobs* are exposed to a rising risk of relative poverty once they retire or in case of losing their job (Hohendanner and Stegmaier, 2012) because they acquire low pension entitlements and are not entitled to unemployment insurance benefits. The preferential tax treatment of *minijobs* should be better targeted towards low-wage workers.

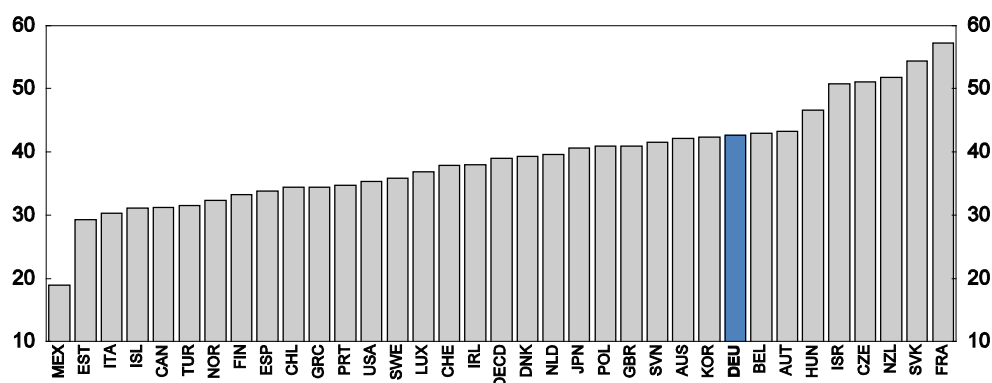
The gap between employment protection of permanent workers with long seniority and temporary workers is large in Germany. While employment protection for permanent workers is among the most stringent in the OECD, temporary contracts were broadly liberalised in 2002. International evidence shows that this often generates hurdles for the transition from temporary to permanent employment. It can result in workers getting trapped in frequent moves between temporary work and unemployment and diminish access to firm-provided training, which in turn raises income inequality and lowers wage mobility (Koske et al., 2012). Nonetheless, permanent employment has contributed strongly to employment growth in Germany in recent years. Thirty nine per cent of workers on temporary contracts moved to a permanent contract within one year (Walwei, 2013). The large gap in employment protection between workers on permanent and temporary contracts should be reduced to further improve the transition of workers in temporary employment relationships into permanent jobs (de Serres et al., 2012).

Poverty risks are particularly concentrated among households affected by unemployment spells, despite relatively high unemployment benefit replacement rates, in part because long-term unemployment is unusually high in comparison to other low-unemployment OECD countries. There is scope to make active labour market policies better targeted to improve the employment prospects of the long-term unemployed (Heyer et al., 2011; Kluge, 2013). For example hiring subsidies could be more targeted and be combined with incentives to acquire education qualifications.

Providing more education support for the disadvantaged

Considerable progress has been made in enhancing both the quality and equity of the education system (OECD, 2013c and 2014). In particular education outcomes in Germany have improved in all three PISA domains, and are above the OECD average. These improvements were mostly due to better results among students coming from a lower socio-economic background and immigrant backgrounds. Nevertheless, the link between socioeconomic background and performance remains strong (Figure 12) and childcare and early childhood education (see above) would be particularly effective in reducing this link. As recommended in the *2008 Economic Survey*, the impact of socioeconomic background on education attainment could be lowered further by reducing stratification of the school system. There is also scope to provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic background (OECD, 2013c). Efforts should also continue to reduce the share of individuals who do not obtain at least upper secondary education degrees, many of them with weak socio-economic background. Plans to strengthen support for disadvantaged youth to complete school and make the transition from school into vocational education and training (VET) are welcome. In this context, comprehensive support and training programmes (education chains) are focused on bringing participants quickly into mainstream VET programmes. In 2013 the *Länder* have jointly made proposals to improve school based training programmes in the transition system. Some of these policies to make economic growth more socially inclusive also require additional public funding.

Figure 12. Impact of socio-economic status on the average difference in performance in mathematics¹
2012



1. The average difference in mathematics score between students whose socio-economic status differs by one unit of the PISA index of economic, social and cultural status. The lower the value the smaller the difference in performance (or the more equal performance between advantaged and disadvantaged students).

Source: OECD (2013), *PISA 2012 Results: Excellence through Equity, Giving Every Student the Chance to Succeed?*, vol. II.

A relatively large share of pupils with learning difficulties is placed in classes or schools for children with learning difficulties or disabilities, which undermines their career prospects in many cases (OECD, 2009 and 2012d). Pupils are more likely to be assigned to such schools if their socio-economic background is disadvantaged, including if they have an immigrant background. In this context, the initiative by the Länder to promote integrated education is welcome (Kultusministerkonferenz, 2010).

Making health and old-age pension insurance more inclusive

The segmentation of health insurance into a private sector, which covers about 10% of the population, and a public sector, which covers the remaining 90%, raises equity and efficiency concerns (OECD, 2008a; German Council of Economic Experts, 2006). Low and middle income earners and individuals with poorer health status are generally covered by public health insurance, where contributions are independent of health risks and are proportional to wage income up to a ceiling. Employees with a wage income above EUR 53 550 per year can opt out of public insurance and choose private insurance instead. High income earners with good health status have incentives to choose private insurance because private insurance premia do not depend on income and because insurers can adjust the terms of contracts they offer to new insurees in line with their perceived health risks. Moreover, private insurers do not participate in the central health fund, the purpose of which is to redistribute insurance contributions of public insurers on the basis of risk-adjusted transfers, thereby reducing selection on the basis of risk. Private insurers can therefore compete on the basis of risk selection rather than on the basis of efficiency.

Private insurance can also result in poverty risks for some individuals when they experience a drop in income. These risks affect older workers because insurance premia tend to increase with age and because they cannot return to the public insurance system. They also affect the self-employed, who do not generally have access to public insurance and may face high income uncertainty. While special tariffs are available for persons in private insurance having difficulties to pay, they can be fairly expensive or provide only limited coverage. While the dual health insurance system in Germany has a long tradition, it generates difficulties in today's labour market, in which employment histories often include changes in employment status and earnings.

The German Council of Economic Experts (2006) and the *2008 Economic Survey of Germany* therefore suggested integrating private health insurance providers in the central health fund. The German Council of Economic Experts (2006) also suggested imposing the obligation to contract on all insurers and limiting the cost of mandatory health insurance for all low-income households with government transfers. This would imply that all insurance companies provide mandatory health insurance packages to all individuals on equal terms, as public insurance companies already do. Such a reform would remove incentives for risk selection and reduce poverty risks. However, it would give rise

to substantial transitory challenges. In particular, it requires dealing with the reserves accumulated in the private health insurance system.

The mandatory public pension system covers employees only, although about one quarter of the self-employed are covered by alternative mandatory pension schemes. The self-employed workers who are not covered often include those most vulnerable to poverty risks (German Council of Economic Experts, 2011). This coverage gap raises the risk that self-employed workers have to rely on social assistance benefits during retirement. It also generates incentives for firms to outsource work to self-employed workers in order to avoid pension contributions, raising precarious self-employment and weakening government finances.

Recommendations to make economic growth more socially inclusive

- Provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic backgrounds. Provide more support for disadvantaged youth to complete formal upper secondary education, in particular mainstream VET. Continue reducing the assignment of pupils to special needs schools and make sure assignment to such schools does not reflect the socio-economic background of pupils.
- Reduce the gap in employment protection between permanent and temporary workers. Introduce a minimum wage, set by an expert commission, across all economic sectors. Better target the preferential tax treatment of *minijobs* towards low-wage workers.

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Chapter summaries

Chapter 1. Strengthening financial sector resilience

The German banks have weathered the euro area crisis well thanks to the solid fundamentals of the economy and the “safe haven” status of German financial assets. Nonetheless, lending growth has fallen in real terms in recent years, reflecting weak demand. The banks are vulnerable to any sharpening of financial market tensions in the euro area and the low interest rate environment. Large derivative exposures among the country’s largest banks, high leverage and market perceptions of strong implicit government guarantees add to these risks. While the public savings banks have performed well and help sustain activity in relatively poor regions, performance among the public *Landesbanken* has been weak both before and after the global financial crisis. In some respects, the government has moved ahead of many other OECD countries with reforms to reduce risks in the financial sector. Nonetheless, further steps to make the banks more robust would reduce financial risks to the government and improve incentives for banks to take advantage of low interest rates to finance strong, sustainable economic growth. Such steps should include reducing high leverage, ambitious implementation of EU requirements for the reform of resolution legislation and addressing governance problems in the public banking sector.

Chapter 2. Raising the potential of the domestically oriented sector

Germany’s manufacturing sector, which plays an important role for exports, has been performing well over the past decade in terms of labour productivity growth and international competitiveness. However, the services sector has had much slower growth rates. Competition often appears to be hindered by protection of incumbents. Reforming and deregulating the domestically oriented sectors, including network industries, crafts and professional services would release hidden growth potential and prove beneficial to the economy as a whole. It could also help strengthen domestic demand and reduce dependence on exports.

Chapter 3. Making economic growth more socially inclusive

While past labour market reforms have been successful in terms of employment, the relative poverty risk and income inequality have remained broadly unchanged in recent years. Some social groups remain particularly vulnerable, including individuals in non-regular employment, the unemployed and the low skilled. If in employment, their jobs tend to be unstable and wages and income mobility low. Continued efforts are needed to foster economic growth in a more inclusive manner, such that the most vulnerable groups benefit from and contribute to economic growth more strongly and such that the gaps between the rich and the poor in terms of income and wellbeing are reduced. These efforts should include enhancing the labour market outcomes of the most vulnerable and increase upward income mobility among disadvantaged individuals; strengthening skills at the lower end of the skills distribution; revising the tax and benefit system to improve incentives and to ensure efficient and well-targeted redistribution; and to make health and old-age pension insurance more inclusive.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Germany were reviewed by the Committee on 25 February 2014. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 9 April 2014.

The Secretariat's draft report was prepared for the Committee by Andrés Fuentes Hutfilter et Andreas Kappeler, as well as André Eid, seconded from the German Ministry of Economic Affairs and Energy, under the supervision of Andreas Wörgötter. Research and editorial assistance was provided by Seung-Hee Koh.

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