Analysis

Germany – reviving the sick man of Europe

- *Good news about Germany's economy is currently as hard to find as a needle in a haystack*
- *However, much could be done to improve Germany's prospects*
- *Much of the requisite action would take the form of supply-side reforms*
- *So as to be able to spot when or if this starts to happen, we have included a list of "Watch fors"*

Germany's economy is lagging its competitors

Germany is falling behind in international competition. Economic output is barely higher than in 2019, and has been falling for several months. High costs for energy and labour, together with a shortage of skilled workers, are leading industry to cut production and invest abroad. But:

1. Is the situation really that bad?
2. What are the problems, and
3. How might they be solved?

Immediate prospects

The economy stands to improve somewhat this year, given that inflation pressures have decreased significantly and real disposable incomes will rise. However, even with cyclical recovery, the economy's long-term growth potential is low. Various estimates put it at just 0.5% which, if correct, will exacerbate distribution problems and state funding constraints. (Figure 1)

The 'green' impulse has not materialised

At the same time, disillusionment is spreading around the green and digital transformation. The hoped-for impulse to growth has not materialised. While the transition is important for competitiveness in the long term, in the near term it is costly and burdensome, for businesses, the government, and households. It would take higher investment and innovation to renew the capital stock and improve resource efficiency and sustainability, as well as to cope with the demographic decline in the workforce.

The investment ratio has been declining

The investment ratio in Germany, however, has been declining over the long-term. This has been happening in other countries too, but it is particularly problematic for Germany's capital-intensive manufacturing. Currently, real equipment spending is below even pre-pandemic levels.

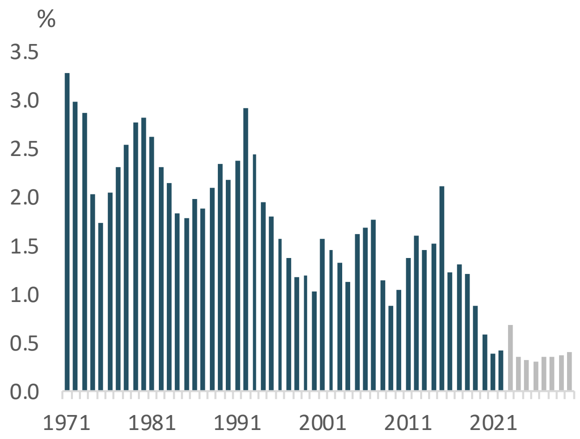
Investment is going abroad

At the macroeconomic level, the savings of the German economy greatly exceed domestic investment, leading to considerable capital exports, not only in financial investments but now also in direct investments. At the same time, foreign investment in Germany is decreasing. (Figure 2)

Business conditions are deteriorating

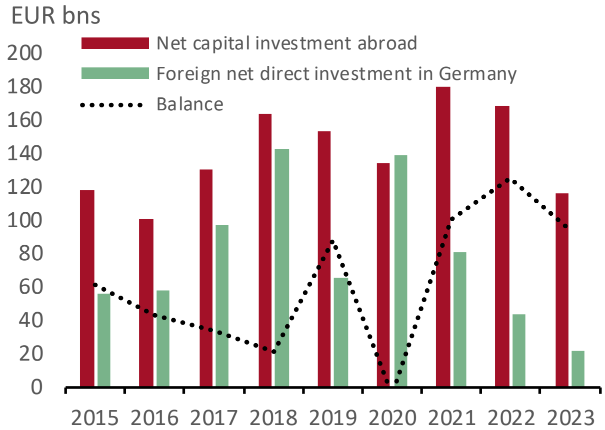
Reversing this trend will require strong companies and favourable investment conditions, aided by measures to increase the country's attractiveness for investment and innovation activity. In the eyes of companies, however, Germany's business conditions are deteriorating. This stands in marked contrast to strengths in other areas, such as political stability, good vocational training of

Figure 1: Potential output growth



Source: German Council of Economic Experts
Note: Grey bars represent projected values

Figure 2: Direct investment in the capital account



Source: Deutsche Bundesbank

the workforce, and capable research networks. The list of locational disadvantages is long, including high taxes and levies, high labour costs, expensive energy, and bureaucratic hurdles.

In addition, there are productivity-crushing deficits in digitization, which are becoming increasingly important in the age of generative artificial intelligence and its potential impact on future growth. Rising labour productivity is needed to counteract the impending decline in the workforce.

Infrastructure

Better infrastructure is needed …

For investment and business conditions to improve, public infrastructure investment is needed, including in security, education, transportation, digitization, and energy. However, the reflexive demand for more money, and calling for a relaxation of the debt brake or new special budgets, is in general not the answer.

… and funds need to be used more effectively

What is crucial is that funds are used effectively, and that barriers to investment are removed. This requires strengthening planning capacities, including through the use of private providers, and simplified decision-making processes. Also, follow-up costs of public investments need to be budgeted for. Had adequate maintenance expenses and reserves been accounted for in the past, public infrastructure would be in a much better condition today.

Supply-side reforms

But most important is supply-side reform, including …

All that said, however, the most important contribution to improving growth will have to come from supply-oriented reforms that improve capital stock and productivity growth by fostering investment and innovation activities of companies. Ideally, measures should cause only minor revenue losses, or even generate additional income.

… tax reform …

In the area of corporate taxes, depreciation allowances could be used to promote investment activity in the short term, until a comprehensive tax reform is financially feasible. Short-term revenue losses would be offset by long-term gains in tax income.

… retirement-age policy …

Additional state revenues and reduced expenditures could be expected if more people were employed full-time, and vacant positions in the economy were filled. One possibility would be to review, and possibly restrict, early retirement without deductions (somewhat inaccurately known as retirement at 63) and to adjust pensions to increasing life expectancy.

… benefit incentives …

Also, in the area of wage replacement benefits, it is questionable whether the financial incentives are sufficient to bring job seekers into the labour market. The large number of basic income recipients of working age may be due to low incentives. Increasing the employment of transfer recipients would benefit the labour market, reduce state expenditures, and increase tax revenues.

… contribution rates …

Notwithstanding positive labour market developments, the contribution rates to social security have increased to a historic high of 41.5% of earned income for childless people. Such high rates increase labour costs for companies and reduce the net incomes of employees, especially in lower- and middle-income brackets. Measures to limit these contribution rates could strengthen international competitiveness.

… and tax incentives.

Better tax incentives are necessary to reduce the high part-time rate in Germany and create more full-time jobs, especially for women. This requires improved childcare and financial incentives. Mitigating tax progression and lower transfer withdrawal rates could help even in small steps that should be feasible.

The Growth Opportunities Act of the federal government is a first step, but only a minor one in the reform catalogue. It is quantitatively scarcely noticeable and does little to improve the incentive systems in the labour market or lower the burdens for employers and employees.

Conclusion

If Germany is to regain its former growth trajectory and shed the image of the "*sick man*" it will need fundamental reforms. Public investments and subsidies alone are not enough to revitalize growth and remain internationally competitive. Germany needs a growth-oriented Agenda in 2030 that increases investment, innovation, and incentives to work.

Such a turnaround could yield considerable returns and improve resilience to external shocks. If Germany invests, produces, and develops more again, workers, self-employed individuals, and the state will benefit from higher incomes.

Creating the political consensus does not seem impossible: but there are few signs of it yet.

Watch for

- Growing signs of political discontent at the performance of the economy.
- Constructive policies for improving infrastructure.
- The beginnings of talk about serious structural reform.
- Any movement towards consensus on reform of tax, benefits, and retirement age.■

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