PART I

Regulatory Reform in Germany

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Consolidating Economic and Social Renewal

PART I

Chapter 1

Performance and Appraisal

Introduction

Germany is the world's third largest economy after the US and Japan in terms of GDP, and as one of the top exporters of merchandise products, one of the world's most important trading nations. It has a high GDP per capita income of some EUR 25 900 and enjoys high standards of social welfare. It is also the largest economy and most populous country in the EU, with 82.3 million inhabitants. Re-unification has boosted Germany's strategically central location in Europe, which promotes especially strong east-west ties with other European countries. Manufacturing industries with a strong export orientation (including automobiles, chemicals, machinery, shipbuilding, electrical engineering, and household equipment) remain the backbone of a diverse economy. The services sector has overtaken manufacturing, but is still mainly focused on domestic markets. A distinctive feature of Germany's industrial structure is the important place taken by established family-owned medium-sized companies, the *Mittelstand*.

As with other OECD countries, Germany can lay claim to its own distinctive approach to governance. This has grown out of the concept known as the social market economy, which was developed after the war to rebuild society as well as the economy, though some of its roots go back much further in German economic and political thought (Box 1.1).

Box 1.1. **Germany: key features of the governance and regulatory framework**

Historical background

After the Second World War, Germany put in place a comprehensive governance framework for managing the country's social, political and economic development, known as the social market economy. The country wanted to avoid the mistakes of the pre-war period. Very broadly it aimed to promote freedom as a political objective, prosperity as an economic objective, and solidarity and fairness as a social objective. These objectives and the means of attaining them were seen as organically linked. In pursuit of them, careful balances need to be struck: between co-operation and competition, between fairness and efficiency, and between the role of the State and the role of the market. All elements of the economy, politics and society (especially employers, employees, and the government at all its levels) were called on to be stakeholders in the process and to share responsibility for achieving the objectives. This led to an emphasis on consensus-building, co-operation, and negotiation as a practical means of pulling together for the common purpose.

The legal State

The "legal State" (*Rechtsstaat*) is a central element of the framework, articulated through a comprehensive codified legal architecture rooted in the Basic Law (the Constitution). The importance of the system of law is revealed by the culture of policy making and policy implementation, in which lawyers play an unusually prominent role both in the government and in the private sector.

Box 1.1. **Germany: key features of the governance and regulatory framework** *(cont.)*

The competition law and policy

A core element of the legal architecture is the competition law, which has a central place in the functioning of the economy. Some OECD countries have historically given the State an important role in the ownership and management of economic assets, and may question the extent of the role which competition should play in ordering economic behaviour. By contrast, Germany historically makes a clear distinction between the State and the market, generally emphasises the private ownership of economic assets, and promotes efficient competition (that is, market conditions under which no firm has the power to coerce others) between private companies as the key to a well-functioning economy. Companies should be held to social as well as economic account: they are responsible to stakeholders in the community, and private economic power must function fairly.

Reflecting and underpinning these relationships, competition law sets the legal framework within which entreprises must operate. In doing so it defines the important place occupied by co-operation and negotiation as an adjunct to market forces (the feature that is less prominent in the political economy of countries which rely primarily on market forces for the allocation of resources). The competition law protects relationships which help to promote desirable outcomes, and rules to promote competition are moderated by rules to accommodate efficient co-operation.

The external dimension of competition

Competition has an external as well as an internal dimension: strengthening the German economy so that it can be competitive in international trade, and promoting open international markets in which competition can take place. An important part of the post-war vision has been to sustain and develop Germany as a major trading nation.

Co-operative federalism

Germany has been a federal State from the start. Co-operative federalism is a key part of the governance system embedded in the Basic Law. Its objectives are to support a well-functioning democracy, to ensure a harmonious political balance, and to promote broadly equivalent living standards across the federation. Powers and tasks are carefully allocated between the federal (*Bund*), State (*Land*) and community (*Gemeinde*) levels of government.

The sixteen *Länder* each have their own Constitution and Parliament, administrative agencies and courts. The Basic Law assigns the federal government responsibility for matters considered to be relevant to the country as a whole, and the *Länder* are responsible for all other issues, where they are not explicitly assigned to the federal government. In particular, they are responsible for education and health. They also have significant administrative responsibilities, notably income tax collection. However in practice responsibilities are not always clear, and overlap: for example all three layers of government are involved in health care.

The two chambers of parliament reflect the close political relationship between the federal government and the *Länder*. The first chamber (*Bundestag*) represents the federal level, and the second chamber (*Bundesrat*) represents the *Länder*. The *Länder* have a major role in law-making at the federal level. The *Bundesrat* has the right to reject draft *Bundestag* legislation, or propose amendments to it, including the annual federal budget. About three-quarters of all federal statutes are addressed directly to the *Länder* and local governments. This drives a highly consensus-driven federal policy-making process, in

Box 1.1. **Germany: key features of the governance and regulatory framework** *(cont.)*

which the *Länder* seek to influence draft legislation rather than have to reject it formally at a later stage in the *Bundesrat*. The *Länder* are responsible for implementing the legislation addressed to them directly as they see fit (federal supervision is restricted to verifying the legality of the enforcement). This independence promotes strong diversity in regulatory management and practices between the *Länder*.

The communities also play an important role in promoting a democratic balance, and are heavily involved in their local economy. The Basic Law guarantees the communities the right to regulate on their own responsibility all local community affairs, within the limits set by the law. The communities can justify a wide range of activities as a consequence of this. They have a traditionally high level of involvement in multifunction public utilities. Over 800 local utilities cover activities such as electricity, gas and water services, many of which are partly or wholly owned by the communities.

The governance and regulatory framework today

There has been an evolution over time from the original framework. Economic conditions have changed. For example the original concept assumed there would be full employment, and environmental concerns have risen up the agenda. However its main principles have so far survived. The solidarity principle continues to underpin key policies and governance structures. Examples include the State-federal fiscal relationship to promote parity of living conditions, and a generous health care system. The basis on which re-unification was carried out also reflects this principle. The west German social welfare system was extended to the east. Massive aid was, and still is, given aimed at bringing the economy and infrastructure of the east up to the standards of the west. Decision-making is still based on seeking and achieving consensus. The State-federal relationships, the political partners in government, and the social partners play a critical role in this. Consensus-seeking remains a necessary component of decision-making in a federal State where the centre is not as strong as in some other countries, and where coalition governments are the norm. The basic structure of the competition law, comprehensive from the outset, has not fundamentally changed.

All that said, recent reform policies such as Agenda 2010 aspire to promoting the development of a new balance between solidarity and individual responsibility.

The German economy was a strong performer in the first three decades or so after the war – very competitive and with excellent growth relative to most other OECD economies. This highly successful period was underpinned by the massive rebuilding of the economy which installed modern capital stock and the latest technologies. Combined with a well-educated and productive labour force, and a creative will to succeed, it yielded impressive results. The disciplined and comprehensive principles of the original social market economy governance system provided an effective institutional and regulatory setting which harnessed stakeholders to the task of rebuilding and wealth creation.

Today, however, the economy faces important difficulties. Growth slowed sharply and more markedly than in several other European countries in the second part of the 1990s, following a steep acceleration immediately after re-unification as incomes rose in the newly liberated eastern *Länder*. Productivity growth has also slowed, and employment growth is weak. The fiscal deficit has grown steadily. The burden and consequences of re-unification are a major, even perhaps the most important, factor in these developments (Box 1.2).

However re-unification has not been the only factor affecting Germany's performance. At least three other factors can be identified. First, there has been a long term slowdown in growth, predating re-unification in 1990. Productivity growth has slowed too over time. In the second half of the 1980s real GDP growth was below that of the EU average. There was also a pronounced long term increase in unemployment, starting in the early 1970s, with a trend loss in manufacturing employment, but without a fully countervailing trend growth in services employment (as happened in the US). This suggests that, leaving aside re-unification which was undoubtedly a shock to the economy and difficult to absorb, some negative economic developments were already at work, reflecting deep-seated problems such as a poorly functioning labour market and an expanding welfare State. Many of these trends and problems were not unique to Germany, but re-unification brought the issues into sharper relief than elsewhere.

Second, the external environment has been difficult: the world economy has worsened significantly since 2000, which has highlighted Germany's potential vulnerability as a major exporter. Though export performance has been strong, this has been necessary to compensate for a weak domestic demand which has helped to slow growth and reduces

Box 1.2. **Re-unification: the impact on the German economy**

Re-unification with eastern Germany in 1990 was extremely costly, and remains a heavy burden on public finances. Growth in the eastern *Länder* has stagnated at relatively low levels, a sizeable productivity gap with the western *Länder* persists, and unemployment in the eastern *Länder* is twice as high as in the west. It is inevitable that overall German performance suffers.

Re-unification, whichever way it might have been carried out, would likely have made a significant dent in overall German performance and continued to exert a drag on the economy for some time afterwards. It was a unique, unprecedented event for an OECD country. There was no blueprint to guide policy makers at the time, but a strong political imperative to act quickly and forcefully, as well as a need to act in accordance with deep-seated values that had moulded west German economy and society after the war, not least of which was the principle of solidarity. This made some key initial choices very expensive, and has also delayed the economic adaptation of the eastern *Länder.* Massive budgetary transfers were made to the east, necessary to pay for the application of west Germany's generous social security system and for aid to eastern firms hit hard by exposure to the highly competitive west German business environment. Transfers on this scale had no precedent in OECD countries.

Many of the achievements which followed have been impressive, including a radical privatisation programme that established viable new market structures and the development of new firms in sectors previously dominated by State-run enterprises, new infrastructure established on a large scale, and a huge environmental clean-up. But the economic convergence process stalled in the second half of the 1990s. Some post re-unification decisions have been relatively unhelpful to the adaptation process, for example the amount of subsidies to promote capital intensive investment and investment in construction and the length of time these subsidies were granted. This distorted eastern manufacturing production structures, and diverted investment away from higher productivity growth areas, though other factors also played a role in the difficulties of adaptation, such as the loss of traditional markets.

Germany's resilience to external shocks such as exchange rate movements. Also, while the convergence of real interest rates to lower German levels in the run-up to the European Monetary Union implied some investment stimulus for several European countries, such as Italy and France, Germany did not benefit from this convergence effect.

Third, re-unification absorbed the government's attention away from the need for important and necessary governance and regulatory reforms (which started to be carried out in many other OECD countries). Some important specific reforms were carried out, notably the complete market opening of the electricity and gas sectors. But at the same time Germany chose not to make any fundamental changes to its regulatory governance: indeed this was transplanted to the east. The regulatory governance reforms that have been made in recent years have tended to be somewhat narrowly focused on reducing bureaucracy and improving efficiency within the public administration, rather than looking out to identify broader regulatory quality reforms. Other fundamental reforms – particularly reforms that might have helped to strengthen the economy, such as labour market reforms – were also neglected or crowded out.

A further factor may now be added which can be expected to have a major and negative impact on Germany's future economic prospects if it is not effectively handled: a rapidly ageing population.

The German government is well aware of these challenges and has now implemented, or is launching, a number of necessary reforms. These include labour market and pension reforms, and the recent launch of "Agenda 2010" (which covers a wide range of issues from benefit and health reforms to support for new SMEs). It is now accepted that wide-ranging reforms are needed. Yet questions remain about the capacity of the regulatory governance system to provide effective support for these. Could it be impeding flexibility and new ideas? Is there adequate scope for new players to come into the market? How far can all relevant stakeholders make their voices heard? Is innovation encouraged? Has the system deteriorated toward less competition and more protection? Is the internally-driven, relatively slow and incremental approach to reform losing valuable time for achieving important results?

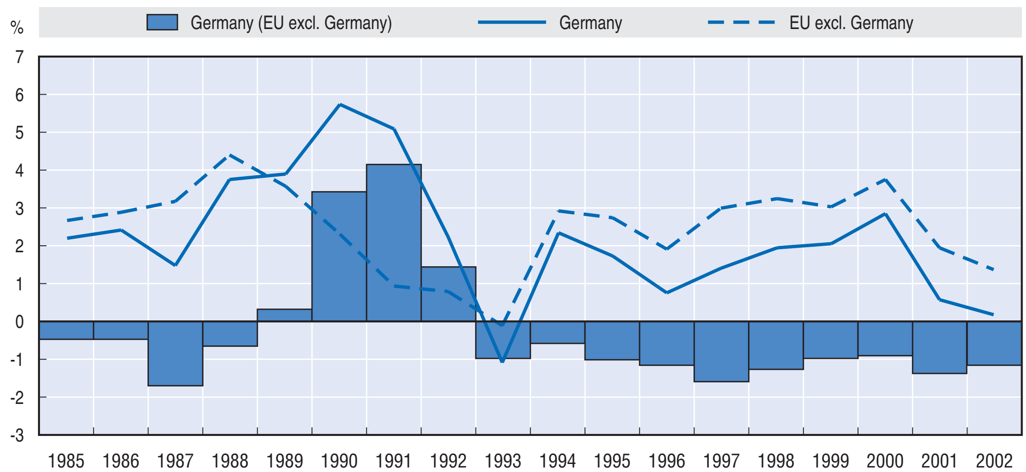
This part of the report is structured as follows. It starts by considering the key issues that are shaping the overall development and performance of the German economy and the particular characteristics of the economy that have a strong link with regulatory reform. It then considers the contribution which regulatory reform has already made to performance, before addressing the question of where further regulatory reform might continue to boost performance and the achievement of policy goals. It ends with the important conclusions that can be drawn from this analysis. This second part provides a more detailed analysis of regulatory quality, competition policy, market openness, and reforms in the electricity, gas, pharmacy and telecommunications sectors. The second part of the report does not analyse all the important issues and reforms that are mentioned in the first part. However the OECD's recent Economic Surveys of Germany provide much of this additional analysis.

Setting the scene: the macroeconomic context

Germany's average growth performance has deteriorated over the last decade relative to some other EU and OECD countries

Figure 1.1 shows the evolution of German real GDP growth compared with the EU. Over the last fifteen years and with the exception of 1990 and 1991 (when growth accelerated steeply reflecting the buoyant demand associated with re-unification) growth in Germany has slowed relative to some other European and OECD countries. Independently of comparison with others, Germany's per capita growth slowed from 2.2% in the 1970s to 2% in the 1980s and to 1.1% between 1991 and 2002.

Figure 1.1. **Real GDP growth in Germany and the EU 1985-2001**[1]



1. Growth rates for western Germany for 1984/85 to 1990/91 and for Germany from 1991/92 onwards.

Source: OECD Analytical Database.

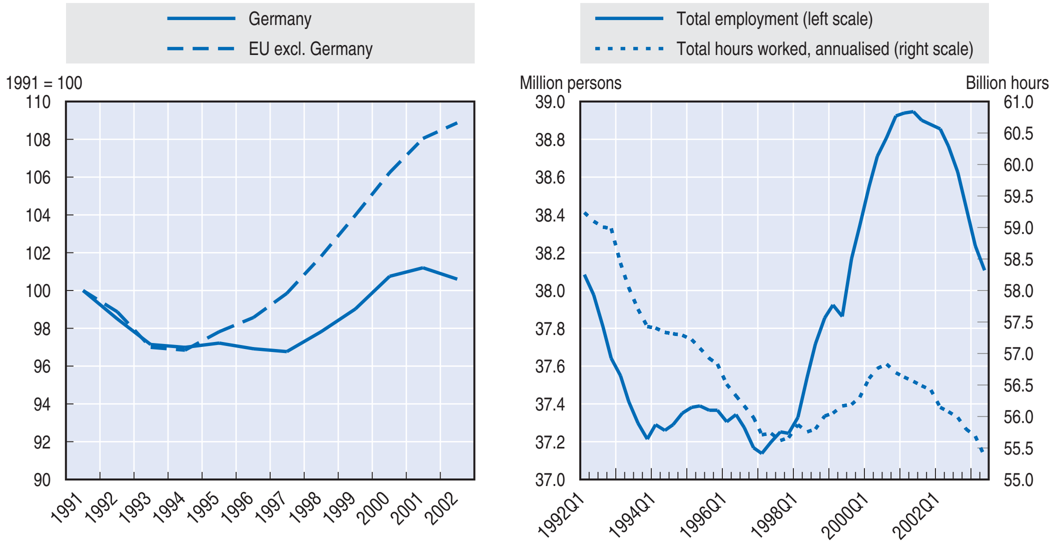
This underperformance has persisted into the new century. The economy stagnated in 2001 and 2002, and this has continued into 2003. The persistence of this relatively low growth performance points to underlying structural challenges that need to be tackled. Not only is growth weak, but unemployment is high, there is a large structural fiscal deficit, and demand is weak. However inflation is low, and export performance remains strong.

Weak employment generation is a major factor in reduced growth

A decomposition of real per capita growth into the growth contributions of labour – in terms of total hours worked per inhabitant – and labour productivity – in terms of real GDP per hours worked – indicates that weak employment performance is a key factor in the weaker growth. There are several reasons for the weak labour input. A sharper reduction in the working age population than in most other OECD countries is one factor. But decreasing employment rates and a reduction in average working hours as well as rising labour taxes are the most important factors. Figure 1.2 shows the employment trend compared with the EU. The growth rate of employment declined during the 1990s. It also shows the trend in hours worked, which has also declined.

The negative interaction of low employment generation and rising taxation of labour has reduced disposable incomes and braked private consumption. Domestic demand remains very weak.

Figure 1.2. **Total employment and hours worked in Germany and the EU 1990-2002**



Source: OECD Analytical Database and *Quarterly National Accounts*, domestic concept.

Labour productivity growth has been good, but not enough to reverse the weak GDP growth trend and investment is an issue

Labour productivity has risen faster in recent years than in other European countries. It grew by an average of 1.9% p.a. between 1995 and 2001, faster than France, Italy and Spain (1%), and nearly as much as the US (2%). But this was not enough to offset the adverse effect on GDP growth of a weak labour input. The quality and quantity of investment has been an issue holding back stronger productivity growth.

As regards quality, one key issue is that investment to rebuild the new States has not always been well-directed in support of productivity growth. Subsidies in favour of capital intensive production distorted the new States' manufacturing production structure, and construction investment in the early 1990s diverted investment away from areas associated with higher productivity growth.

As regards quantity, investment has also been an issue. Equipment investment boomed at the beginning of the 1990s, but a wide negative growth differential then opened up relative to other EU countries. The OECD's 2003 *Economic Survey of Germany* suggests that subdued investment in machinery and equipment since the mid 1990s accounts for roughly one quarter of the GDP growth differential between Germany and the EU.

Re-unification has imposed a heavy burden on the economy

Re-unification has also been a major factor contributing to the weak growth trend. The heroic aim in 1990 was to achieve rapid economic and social convergence of the east with the west. Re-unification was carried out on the principle of extending the complete west German legal, economic and social system to the new *Länder*, immediately and without any transition or adaptation. Exposure to, and integration with, the highly productive and competition-based environment of the west German economy was a harsh experience for the enterprises and workforce of the east. Mitigating the immediate pain of such exposure, the solidarity and fairness principles embedded in the political economy of west Germany were diligently applied. In particular, the generous west German social security system was fully extended to the east. Massive budgetary transfers to the east were needed to pay for this, and for financial aid to help the eastern firms cope with their competitive disadvantages. But social spending inevitably accelerated. The budget transfers to the east and active labour market measures reduced the pressure to adapt wages to reflect the lower productivity levels of the east. Subsidies to promote investment, which were intended to help firms compete, did not always support productivity growth. And, more directly, the cost to the German budget of welfare and other support to the east was huge. Re-unification proved more complicated, costly and lengthy than first anticipated.

Though achievements are impressive, the east is not yet on a self-sustained growth path

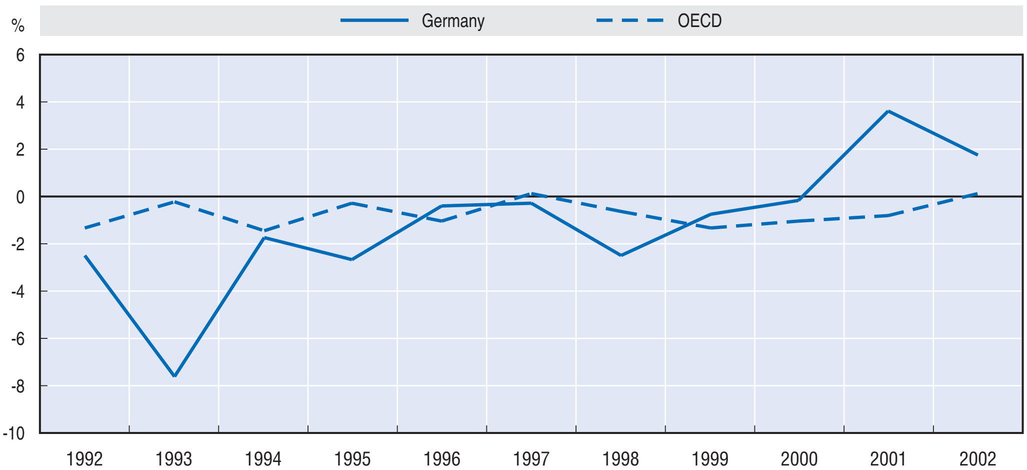
Despite a good start in the early 1990s and considerable progress, the process of economic convergence slowed down in the middle of the 1990s and is still some way from being complete. Growth in the east persists at low levels, a substantial productivity gap remains, and unemployment levels are much higher than in the western *Länder*. Though the capital stock of the new States has reached the level of the old States, capital intensity is uneven: high in some areas but inadequate in others. Self-sustaining growth in the east has not yet been achieved. The gap between east and west continues to impose a large burden on the economy as a whole, and the annual level of west to east budget transfers is around 4-5% of west German GDP. Special aid is planned to continue until 2019.

Export performance is important, remains strong, and needs to be sustained

A positive contribution from exports is, self-evidently, a key contributor to growth for a major exporter. Export-oriented economic policies have been an important feature of Germany's development, and German GDP growth has traditionally been fuelled by its export performance. This has, overall, been well sustained in recent years. Germany's market share of world exports fell in the early 1990s and the merchandise trade balance dropped sharply (as goods destined for the export market were diverted to the reconstruction of the eastern States). But it has since recovered, and the trend in Germany's market share of world exports has been upward since 2000. Competitiveness deteriorated in the early 1990s but improved in the second half of the 1990s, helped by lower costs from more moderate wage settlements and pricing by firms closely to the market. For several years now German GDP growth has been accounted for largely by net exports, as exports have been maintained while imports have weakened substantially, reflecting the weakness of the country's domestic demand (Figure 1.3).

The world economy has worsened significantly since 2000. For growth to be sustained against the vagaries of the external environment, Germany needs not only a strong and dynamic export sector, but also strong domestic demand. The weak growth trend has been partly due to weak domestic demand. This has reduced Germany's resilience to external shocks such as exchange rate movements and oil price rises (especially as Germany has to import all its oil as well as most of its gas, the price of which is indexed to the price of oil). Germany needs to consider how it can reduce its exposure to the world business cycle and improve the resilience of its export sector. The overall trade balance suffers from an important structural deficit in services trade (outgoing tourism, business services and to a lesser extent, transportation).

Figure 1.3. **Export performance for total goods**[1]



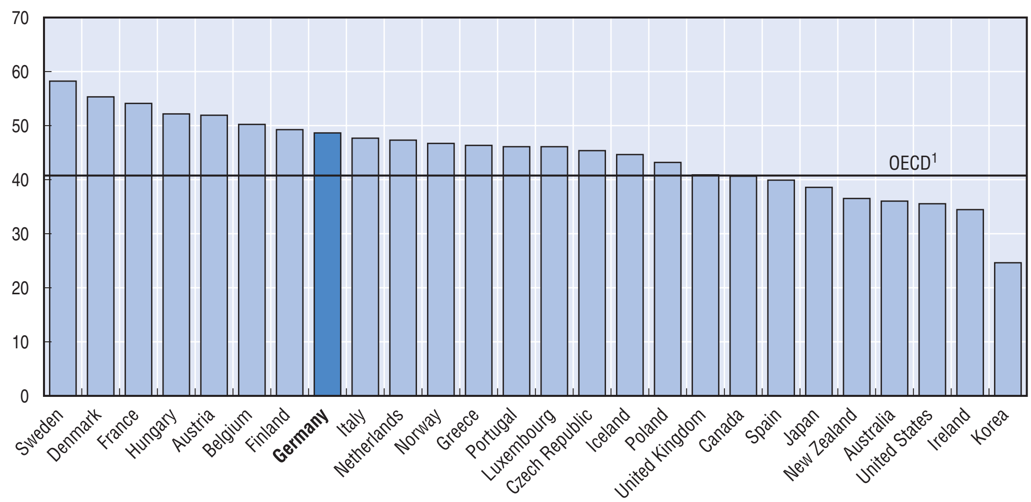
1. Export performance of country X is export volumes of X divided by potential export volumes of X, *i.e.*, divided by a weighted sum of imports of the countries to whom X exports. Estimate for Germany in 2002 and for OECD in 2000 to 2002.

Source: OECD Economic Outlook Database and Sources and Methods.

Public, and especially social, spending is high

Germany has one of the higher shares of public spending as a percentage of GDP among OECD countries, at 45% well above the OECD average (Figure 1.4).

Figure 1.4. **Public spending in 2002 as a percentage of GDP**



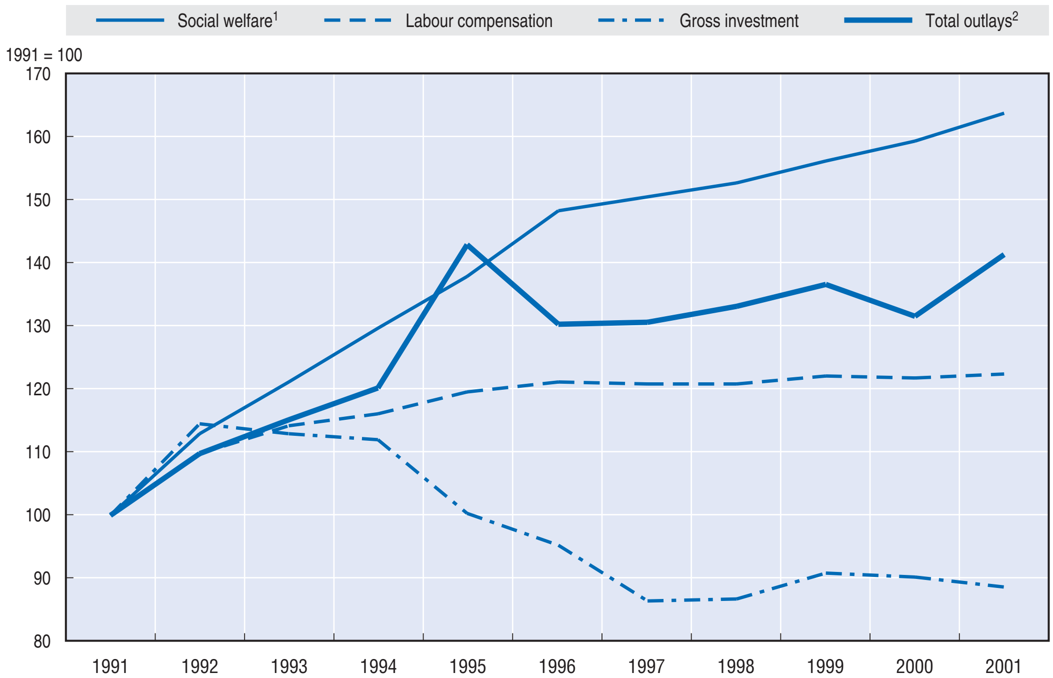
1. Weighted average.

Source: OECD, *OECD Economic Outlook*, No. 71, June 2002.

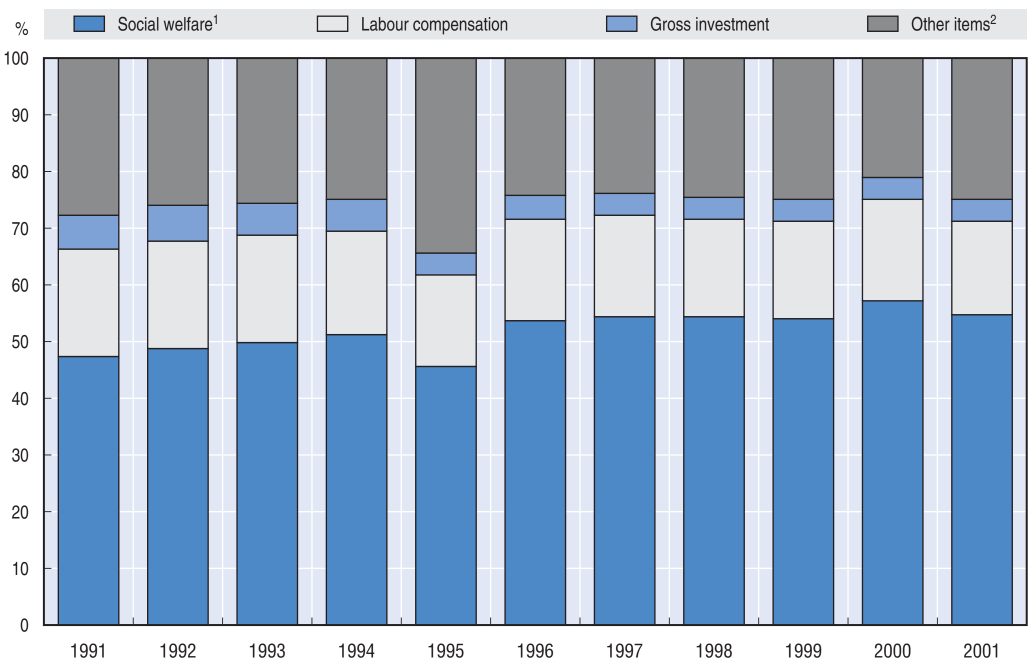
Social spending accounts for over half of the total. It accelerated as the west German social security system was extended to the east. In terms of GDP German spending currently ranks second in the OECD behind Sweden (Figure 1.5). This reflects in part the traditional importance attached by Germany to values of solidarity which underpin its

Figure 1.5. **German trends in general government spending**

A. Nominal



B. Total outlays



1. Both benefits and benefits in kind.
2. In 1995, debt relating to re-unification was taken over by the federal government. This was recorded as a flow in the national accounts, boosting temporarily general government spending.

Source: Federal Statistical Office, OECD.

welfare system. Although social security spending declined in the 1980s, it did not revert to the lower levels of the early 1970s. Social security contribution rates were 26.5% of the wage base in 1970, rising to 35.8% in 1990, and with a further, marked increase thereafter.

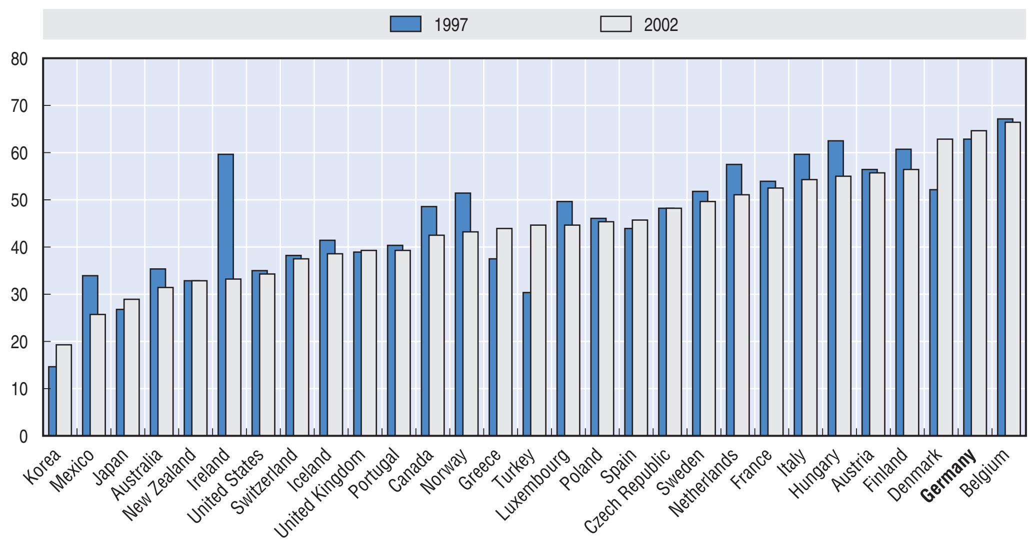
Figure 1.5 also shows that other categories of public spending (notably investment) are much smaller. Streamlining social spending is unavoidable if fiscal consolidation is to be successful.

Today's structural fiscal deficit is largely the result of this significant public expenditure, linked to the rise in unemployment and an increase in the number of people dependent on social assistance. The deficit has grown steadily, and is now at 3.5% of GDP. This breaches the EU Maastricht ceiling as well as the government's own target.

Public spending imposes a heavy burden of taxation and social charges, which discourages participation in the labour market and impedes investment

A recent OECD study on tax policies ranked Germany's tax wedge on labour (the difference between what an employer pays and what an employee receives) second among OECD countries in 2002 (Figure 1.6). This is largely due to high social charges. The government aims to reduce social charges, and new legislation on health care reform goes in this direction. Meanwhile the current tax levels give a strong incentive for firms to save on their use of labour. Germany also still ranks relatively unfavourably as regards business taxation, which discourages investment. Despite significant reforms, there remains considerable scope to improve business taxation. The tax system is also extremely complex. The tax reform measures implemented since 1999 do mark progress in several respects. Tax rates have been lowered and, at the final stage of the reform (the government brought the reform forward in 2004) the burden of personal and corporate income taxes will have been reduced substantially.

Figure 1.6. **Marginal tax rates on labour**[1]



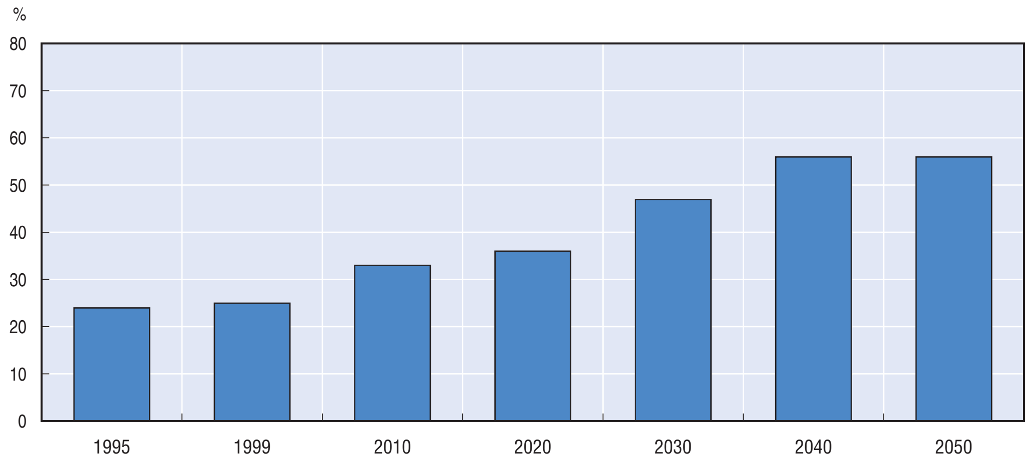
1. Tax wedges – between labour costs to the employer and the corresponding net take-home pay of the employee – are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, minus benefits as a percentage of labour costs. To determine total labour costs, employer social security contributions and – in some countries – payroll taxes must be added to gross wage earnings of employees.

Source: OECD, *Taxing Wages*.

A rapidly ageing population will put further pressure on public spending

Germany faces a rapid rise in the proportion of elderly in the population over the next three decades. According to Germany's own recent population projections the old age dependency ratio (over 65s as a percentage of the working age population) will rise from 25% in 1999 to 56% in 2040 (Figure 1.7). This is more severe than in the US and in many other European countries. It has a number of important consequences. Germany faces one of the sharpest increases in public pension provision among OECD countries, and the health needs of an ageing population put an upward pressure on social spending. A budget surplus may be needed to cope with this in the future. The implications for labour inputs to the economy, already weak, are also severe.

Figure 1.7. **Projected evolution of the old age dependency ratio**[1]



1. Number of persons aged 65 and over as a percentage of number of persons aged between 20 and 65 years. The projections assume a net immigration into Germany of 100 000 persons annually.

Source: Federal Statistical Office.

The problems are acknowledged: the government is promoting a wide range of important reforms

The government is committed to addressing economic weaknesses. It has a fiscal consolidation programme and all levels of government have agreed to establish a domestic stability pact. The objective is to balance the budget in the medium term. The government has also adopted the findings of a labour market reform commission (the *Hartz* Commission). Pension and health reforms have been made. The Agenda 2010 reform platform (Box 1.3) seeks further important changes and the Master Plan is a new attempt to reduce bureaucracy. Specific problems in the network industries have been acknowledged and a regulator for the gas and electricity sectors is planned. The momentum must be sustained, however, and many areas need further stronger action.

Regulatory Reform: its contribution so far

Regulatory reform (Box 1.4) is an important part of governments' toolkit for improving economic performance and meeting public policy goals.

Germany started out with a governance and regulatory system which was considered at the time to be complete and carefully balanced, and which served the country extremely well in the post-war reconstruction period. The legal State tradition promotes reliability. By

Box 1.3. **Agenda 2010: the main proposals**

Agenda 2010 was launched in spring 2003. This is a wide-ranging reform programme which covers employment, pensions, health, education and local finances as well as public administration reforms. The main elements are:

Labour markets

- **Reform of the unfair dismissal law.** Including: more flexibility in use of the threshold level for unfair dismissal for small businesses; introduction of greater legal security for social selection for dismissals caused by factors relating to the company; supplementing unfair dismissal protection by adding the settlement option and greater flexibility for starters of business in concluding employment contracts.
- **Cutting the unemployment benefit entitlement period.** Including: the duration of entitlement will be limited to twelve months; employees above 55 can claim unemployment benefit for a period of 18 months.
- **Combined services for unemployment and social welfare.** Including: introduction of a new benefit to be paid as a fixed sum for basic needs, such as maintenance, statutory health insurance, social nursing care insurance and retirement pension insurance; rejection of reasonable job offers reduces the benefit; relief of burden of costs for federation, States and municipalities; introduction of a special scheme for young recipients of social welfare.
- **A new employment office.** Including single source service to unemployed and recipients of social welfare; active role for job centres in finding work; performance-based judgements of job centres. Creation of new job centres for all types of support services.
- **Publicly subsidised jobs in east Germany.** Including introduction of a special scheme for a total of 100 000 young recipients of social welfare benefits or unemployment benefits aged between 15-25 who are unemployed in the long run, especially in weak regions.
- **Wage setting.** Fostering plant level agreements on wages and working conditions.

Pensions

- **Adjustment of the retirement pension insurance.** Including future pensions being based on the portion of income giving rise to the insurance obligation; raise of age limit; introduction of a permanence factor; broad discussion with participants on the basis of the Rürup Commission.

Health

- **Health reform.** Including: maintenance of the solidarity principle; opportunity for sickness funds to conclude individual contracts with doctors in some sections of medical care (*e.g.,* integrated care); improved opportunities for the merging of sickness funds; expansion of quality assurance; review of list of benefits provided by GKV; taking out of sickness allowance from parity financing of the GKV; introduction of principle of resident doctors; selective introduction of individual charges for medicines and doctor's consultation; permission to use mail order pharmacies; loosening ownership restrictions on pharmacies and price restrictions on non-prescription drugs.
- **Prevention law.** Including: prevention is to be considered the fourth pillar of the health service; illness to be actively averted; more health promotion.

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Box 1.3. **Agenda 2010: the main proposals** *(cont.)*

SMEs

- **New law for craft trades.** Including limitation of master's certificate to 62 craft trades in sectors where risk is involved; abolition of owner's principle.
- **New support for SMEs.** Including: support for founders of new business (small business act); a special bank for financing SMEs; introduction of so-called micro-loans; introduction of "Capital for Work" scheme; introduction of an Initiative to Reduce Bureaucracy; introduction of subordinated loans; strengthening of equity capital provision.

Infrastructure

- **Loans for housing modernisation and improvement of communal infrastructure.**

Local government

- **Reform of local authority finances.**

Training and schools

- **Training offensive.**
- **Reform of the school system.** Including; introduction of national education standards; improvement in training and development for teachers; early years support; more care for small children.

Tax reform

- The government intends to bring forward the third stage of tax reform.

emphasising specific and comprehensive regulations and the importance of the rule of law, Germany's public administration has earned wide recognition for its reliability, legality and honesty. Competition law and policy is a considerable and enduring strength.

These firm and tested foundations have tended to limit the scope for, and interest in, extensive reforms, at least until very recently. A well-tried and coherent existing regulatory governance system was already in place (which was not the case in many other OECD countries). Re-unification has also been a highly distracting burden. The big changes that have taken place in recent years have often emerged from outside Germany: through the EU legislative process (for example, network industry liberalisation, public procurement rules), or through globalisation and technological change (for example, the market and regulatory evolution of the financial sector).

Germany's own reform initiatives have tended to focus on the public administration (how to reduce bureaucracy and improve efficiency), though there has been a growing focus too on the importance of quality regulation and the related need to improve regulatory systems such as Regulatory Impact Analysis (RIA). Most recently, in response to the increasingly pressing needs of the economy, deeper economic reforms have been launched (covering among other issues the labour market, pensions, health, and SMEs).

Competition law and policy: a particularly clear, coherent and comprehensive legal framework, and a respected competition authority

Perhaps the best example of an enduringly well-conceived part of the original framework is competition law and policy. These occupy a central place in Germany's economic and political framework. Chapter 3 gives more detail. The law was enacted to be a foundation of the post-war political economy. Though it only took effect in 1958, it can take at least some of the credit for sustaining the economic success that had taken root after the war. The independent institutional culture of the main competition law enforcement body, the BKartA, is also a considerable asset. Legal transparency and certainty are key strengths. The competition rules and their objectives are clear: notably, the rules about horizontal cartels send a clear message about the importance of competition while permitting efficient co-operation. Instruments for deterring anti-competitive behaviour are well-developed (for example significant fines can be imposed against anti-competitive cartels). The recently introduced leniency programme to encourage firms to reveal the existence of cartels looks promising. All-in-all, Germany's competition law and institutional framework are particularly strong and effective compared with many other OECD countries.

As discussed later, competition policy needs to refocus more clearly on some of its original aims, and develop further its capacity to deal with new challenges, such as the liberalising network sectors. The supporting legal and institutional structure for it to do this may need a few adjustments but it remains broadly sound.

Box 1.4. **What is regulation and regulatory reform?**

There is no generally accepted definition of regulation applicable to the very different regulatory systems in OECD countries. In the OECD work, regulation refers to the diverse set of instruments by which governments set requirements on enterprises and citizens. Regulations include laws, formal and informal orders and subordinate rules issued by all levels of government, and rules issued by non-governmental or self-regulatory bodies to whom governments have delegated regulatory powers. Regulations fall into three categories:

- Economic regulations intervene directly in market decisions such as pricing, competition, market entry, or exit. Reform aims to increase economic efficiency by reducing barriers to competition and innovation, often through deregulation and use of efficiency-promoting regulation, and by improving regulatory frameworks for market functioning and prudential oversight.
- Social regulations protect public interests such as health, safety, the environment, and social cohesion. The economic effects of social regulations may be secondary concerns or even unexpected, but can be substantial. Reform aims to verify that regulation is needed, and to design regulatory and other instruments, such as market incentives and goal-based approaches, that are more flexible, simpler, and more effective at lower cost.
- Administrative regulations are paperwork and administrative formalities – so-called "red tape" – through which governments collect information and intervene in individual economic decisions. They can have substantial impacts on private sector performance. Reform aims at eliminating those no longer needed, streamlining and simplifying those that are needed, and improving the transparency of application.

Regulatory reform is used in the OECD work to refer to changes that improve regulatory quality, that is, enhance the performance, cost-effectiveness, or legal quality of regulations and related government formalities. Reform can mean revision of a single regulation, the scrapping and rebuilding of an entire regulatory regime and its institutions, or improvement of processes for making regulations and managing reform. Deregulation is a subset of regulatory reform and refers to complete or partial elimination of regulation in a sector to improve economic performance.

Source: OECD (1997), *OECD Report on Regulatory Reform*, Paris.

Market openness: policies to promote an open international trading environment are strong

As a major exporting country, Germany has long attached importance to the promotion of an open trading environment. Chapter 4 reviews this in more detail. Germany's policy of non-discrimination in the international context is anchored in its membership of the WTO and the EU. It therefore has obligations to ensure compliance of its domestic regulations with the Most Favoured Nation (MFN) and National Treatment (NT) principles. But it is also proud to have started this process from the beginning of the last century. Important steps have been taken to streamline customs procedures, which can be a significant cost to business and attract growing attention, now that tariff barriers in OECD countries are low or non-existent. These include the consolidation of a currently fragmented set of different IT systems with the ultimate aim of eliminating paper-based procedures. German customs authorities regularly meet business associations to promote dialogue. National standards are another very significant potential cost of operating in different markets, and Germany works in close co-operation with the international and EU standardisation bodies. The German standards body (DIN) is a key player in this context. Conflicting national standards are systematically replaced by international standards where these exist.

Some issues could be better handled. Efforts to assess the impact of regulations do not explicitly consider trade and investment issues (the impact of domestic regulations on trade, as well as the impact of trade regulations on trade). As will be seen later, the complexity of German rules and the consensus-based approach to rule-making involving established stakeholders do not promote an easy environment for foreigners, who may be unintentionally excluded from the consultation process and other regulatory mechanisms.

Reform of the administration: a succession of initiatives to improve efficiency and reduce bureaucracy

A succession of reforms of the administration have been initiated since the 1990s to improve efficiency and reduce bureaucracy. These are considered below.

The New Steering Model

German variants of New Public Management have been taken forward to promote the modernisation of the public sector, under the banner of the "*New Steering Model*". Private sector management principles were introduced in the 1990s to promote a clear division of responsibilities between politicians and the administration, and to set up contract-based management, integrated departmental structures and output control. The evidence, however, suggests that implementation of the New Steering Model has encountered serious difficulties, and that the early reform enthusiasm is over.

The Lean State programme

The *Lean State* programme, started in 1995 and completed in 1998, aimed to reduce the number of tasks performed by the State and to reduce bureaucracy. An independent advisory council appointed by the government, made up of political and academic experts, trade unions, and State and local government representatives, tabled proposals in 1997. Key elements were public sector modernisation, debureaucratisation and deregulation. A steering committee was established to promote the recommended measures. This resulted in new government requirements obliging regulators to work with quality checklists in the review of draft laws, and the adoption of a law to expedite planning and approval procedures. Other recommendations, however, have not been followed through.

The Modern State – Modern Administration Programme

The *Modern State – Modern Administration* programme launched in 1999 and completed in January 2002, aimed to promote a new conception of the State as the “enabling State” (Box 1.5). It emphasised improved regulatory quality and efficiency. It had four main aims: the enhanced effectiveness and acceptance of legislation; improved co-operation between the different levels of government and with the private sector; a competitive, cost-efficient and transparent administrative system; and highly motivated employees.

Box 1.5. **The “Modern State – Modern Administration” programme**

The 1999 federal government reform programme *Modern State – Modern Administration* has the overall objective of introducing and promoting a new conception of the State as “the enabling State”. At the core of this concept is the ambition of a more restricted role for the State and the encouragement of self-regulation and private initiative. At the same time the State would continue “to have the duty to protect the freedom and security of its citizens as its core task for which it remains solely responsible…”.

The programme sets out four principles and four reform areas, to be carried forward by a number of specific projects:

- *A new distribution of responsibility,* promoting the devolution of social responsibility and strengthening society’s potential for self-regulation.
- *Responsive public services,* stressing values such as participation, transparency of government activities, accessibility, communication .
- *Diversity of public bodies,* encouraging better co-operation between the different tiers of administration, diversity within the federation and more weight to the principle of subsidiarity.
- *Efficient administration,* calling for efficiency and effectiveness in the public sector, use of competition, benchmarking and performance-based remuneration, and reduction of administrative burdens.

The programme identifies four key areas of reform:

- Enhanced effectiveness and acceptance of legislation.
- Improved co-operation between the different levels of government and with the private sector.
- A competitive, cost-efficient and transparent administrative system.
- Highly motivated employees.

Key projects supporting regulatory quality management include:

- Preparation of RIA manuals (finalised in 2001, however new guidelines are being considered).
- Review of the Administrative Procedure Act providing the legal basis for online access to government services using qualified electronic signatures.
- Publication of a report of 80 suggestions from business to reduce administrative burdens and how to implement these suggestions.
- Preparation of a Freedom of Information Act (not yet proposed to Parliament).

The latest initiative – the Initiative to Reduce Bureaucracy – is a further effort to reduce bureaucracy and help SMEs

The 2003 *Initiative to Reduce Bureaucracy (Initiative)* has further broad and ambitious goals to reduce bureaucracy (Box 1.6). It aims to strengthen civil society, reduce burdens on SMEs, support growth and employment, consolidate public budgets, and modernise the federal administration. The operational focus is on administrative burdens, particularly on SMEs. The details of the Initiative were outlined in a Cabinet decision of July 2003.

These initiatives show that important efforts have been made over time to reduce bureaucracy and administrative burdens imposed on businesses, especially smaller ones, partly reflecting successive governments' support of the *Mittelstand*. However the impact of the earlier initiatives several years on is not always clear. The goals of the Initiative to Reduce Bureaucracy are commendable but previous reforms also sought to tackle similar issues. Following through on recent reform initiatives will be important as this appears to have been a weakness with past initiatives.

Box 1.6. **Federal government initiative to reduce bureaucracy**

The Federal government initiative to reduce bureaucracy – the Initiative to Reduce Bureaucracy – Promoting Small Business, Creating Employment, Strengthening Civil Society was launched by the government in February 2003.

The operational focus is on administrative burdens, particularly for SMEs and for citizens. The objective is to reduce burdens, and improve public sector efficiency. In this respect, it appears to the OECD Secretariat that the Initiative differs little from preceding policies and policy Statements in this area. However it is clearly premature to assess results at this stage.

The Initiative is an umbrella project into which new bureaucracy-reducing projects are continuously integrated. Immediate activities of the Plan – mostly consisting of projects already initiated by individual ministries or as part of previous programmes – include, among others:

- a review of selected federal legislation;
- simplification of official statistics and statistical reporting requirements for SMEs;
- the e-government initiative BundOnline 2005; and
- special assistance for SMEs and start-ups; *e.g.*, streamlining regulations for public procurement.

The Initiative also envisages an overall strategy for reducing bureaucracy. Based on inputs from ministries – each must identify projects where the plan's objectives can be implemented – the strategy was presented to the Cabinet, in July 2003, containing 54 projects, and adopted by it. The Initiative emphasises, that "specific bureaucracy reduction goals" are to be set for each individual measure. However the Initiative in its current version does not include such targets or measures, nor how to develop methodologies that would enable quantitative measurement of, for example, administrative burdens imposed on businesses. The Minister of Economics and Labour has commissioned work on methodologies to improve the assessment of regulatory impacts.

A Steering Committee of State Secretaries from the ministries of the Interior (chair), Finance, Justice, Economic and Labour as well as the Chancellery chief-of-staff is charged with implementing the Initiative. The Committee does not report to the Committee of Permanent Secretaries responsible for directing and implementing the Modern State – Modern Administration programme.

Regulatory policy: important elements of this have already been developed

Regulatory policy – that is, an explicit policy that aims to improve the quality of the regulatory environment on a continuous and dynamic basis – is a key part of good governance in a modern society and economy. Elements of a potentially effective regulatory policy already exist in Germany, building up over time. The "Joint Rules of Procedure of the Federal Ministries" were first established in 1958. These set out in detail the steps for preparing and presenting policy proposals for the cabinet, as well as principles for the organisation of federal ministries, the co-ordination between them and with other official bodies. Recent revisions strengthen the requirement on ministries to explain the main regulatory impacts of draft laws and regulations. The "Blue Test" questions to promote regulatory quality (precursors to a more fully-fledged Regulatory Impact Analysis system) were issued in 1984. A 1996 amendment to the Joint Procedures made it mandatory for regulators to assess all draft laws on the basis of a checklist. Most recently, work has been carried out to develop the RIA framework to suit the German context. A handbook of RIA methodologies and concepts, and guidelines to exemplify these, have been developed and tested. But this work is not yet linked to real world procedures and institutions. The Ministry of the Interior is preparing an operational RIA guide and there is an urgent need to close the gap between proposals and their application in practice.

Though there is no single central unit responsible for promoting regulatory quality across ministries, a number of central regulatory co-ordination and management units have been established by the federal government, supported by ministries with horizontal responsibilities. As discussed later, these disparate elements need to be brought together and strengthened.

Labour market reforms: important and much-needed recent initiatives

Germany's recent initiatives to promote employment and get the unemployed back to work are summarised in Box 1.7. The *Job-AQTIV* Act promotes a range of measures to improve the efficiency of labour market policies and encourage the unemployed into activity. The government has also said that it will act on the proposals of the *Hartz* Commission.

Network industries: rapid liberalisation of some key sectors

The network industries play a key role in the costs and efficiency of other sectors, as well as making a major direct contribution in their own right to GDP. Efficient, good quality telecommunications, energy and other services are important for the competitiveness and economic performance of other sectors, and consumers gain from the significant price reductions that generally accompany liberalisation. Like other countries in the OECD, Germany has been pursuing policies of liberalisation. It has implemented a distinctive and radical approach in the electricity and gas sectors with a full market-opening (*i.e.,* giving all consumers, not just the larger ones, the right to choose a supplier) ahead of most other OECD countries and beyond the requirements of the EU directives. However as discussed later, achieving sustained competition in these sectors also requires re-regulation to ensure network access and to create a level playing field for market participants.

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Box 1.7. **Labour market reforms**

A. The *Job-AQTIV* Act

The *Job-AQTIV* Act (Activation, Qualification, Training, Investment, Placement) came into force in 2002. Its measures are:

- *Profiling of job seekers:* the newly-unemployed and applicants for vocational training are profiled with respect to their professional strength and potential. An "agreement of integration" may then be made, which specifies the rights and duties of the job seeker and the support they will get.
- *Job-rotation:* companies filling certain temporary vacancies receive a government grant.
- *Temporary work agencies:* conditions for temporary work through sub-contracting have been revised to make this easier.
- *Employment-promotion measures in infrastructure:* regional and local investment in infrastructure is subsidised on condition that firms give work to the unemployed.
- *Promotion of a low-wage sector:* the social security contributions of employees in low-income jobs are subsidised.
- *Modification of unemployment benefits:* sanctions on the unemployed if they refuse an employment offer or fail to co-operate in other ways have been sharpened.

B. The "*Hartz-Kommission*" proposals

The federal government set up this commission, made up of 15 representatives of the social partners and the government, following the discovery of irregularities in the operation of the Federal Employment Office. The commission was asked to make proposals for a comprehensive reform of the Federal Labour Office. It was also asked to assess and make proposals on labour market policies and placement strategies. Its report was released in August 2002. Major recommendations are:

- *Reorganisation of labour offices:* local labour and social welfare offices should be merged into "Job Centres" and provide "one-stop-services" for all unemployed. The budget responsibility and flexibility of these Job Centres should be widened, and a performance-orientated bonus system for placement officers introduced, as well as electronic tracking of key information. Placement of the unemployed should be out-sourced to newly-created autonomous "Personal Service Agencies (PSA)", commissioned by the Job Centres. Financial sanctions should be applied if a job-seeker refuses a placement.
- *Responsibilities of the unemployed:* employees who have been given a redundancy notice should immediately register at the labour office to start placement activities, or face a cut in benefits. Other measures to put greater responsibility on the unemployed are also proposed, including wider sanctions for non-co-operation (such as temporary suspension of benefit payment) and acceptance of a wider potential range of jobs.
- *Temporary work agencies (TWA):* legal restraints on TWAs should be further reduced, and the relationship between TWA contracts and placement contracts improved.
- *Employment of disadvantaged groups:* young job seekers should be made an "activating offer" such as a traineeship. Measures to encourage the creation of new apprenticeship places should be taken and personal vocational training shall be guaranteed.

Box 1.7. **Labour market reforms** *(cont.)*

- *Older unemployed:* those aged 55 years or more who have been made redundant and take up a job that is paid less than their last one should receive the difference out of social security benefits. Employers' social security contributions should be temporarily subsidised and the age limit for temporary employment lowered. But a "bridge system" should also be set up to provide older unemployed willing to leave the labour market with benefits until they retire at 60 on a "cost neutral" basis.
- *Self-employment and small jobs in the low wage sector:* to reduce illegal work, measures should be put in place to enable the unemployed to earn more with reduced taxes and social security contributions. Other measures to promote small jobs and home services jobs should also be taken.
- *Job creation in SMEs:* SMEs creating new permanent jobs should obtain equity and loan capital subsidies up to EUR 100 000 for each newly employed (a proposal aimed especially at companies with low equity capital resources in east Germany).

The electricity sector: full market opening

In line with the German tradition, the key task of working out the details of network access by third parties has been entrusted to the private associations covering the electricity and gas markets, under the public oversight of the competition authorities. In the OECD context, it is a very distinctive approach marked by the striking absence of a specific regulator with *ex ante* powers.

The telecommunications sector: a good start to liberalisation and some very good results

The telecommunications sector is a major contributor to innovation across the whole economy (Box 1.8).

Germany made a good start with liberalisation. Today it has in place a high quality, technologically advanced telecommunications infrastructure with high penetration rates for both fixed lines and wireless. Broadband access is widely available via DSL lines. Market entry is relatively easy, and local operators are providing effective competition to the incumbent in a large number of German cities. Prices for households as well as businesses

Box 1.8. **The contribution of open telecommunications markets to growth and innovation**

The OECD growth study underlines that the diffusion of ICT does not just depend on the cost of the hardware, but also on the associated costs of communication and use, once the hardware is linked to a network. Increased competition in the telecommunications industry is particularly important in driving down costs, as it leads to more entrants, greater technology diffusion, improved quality and a higher rate of innovation. Countries that moved early to liberalise their telecommunications industry now have much lower communication costs, and hence a wider usage and diffusion of ICT technologies, than those who followed later.

Source: OECD (2001b), *The OECD Growth Project: the New Economy Beyond the Hype*, Paris.

have come down substantially. Germany has one of the largest number of Internet users, and the Internet market is growing rapidly.

Pension reform: the foundations for a multi-pillar system have been laid

After a series of partial reforms to the public pension system in the 1990s, reforms in 2001 created the foundations for a multi-pillar pension system (Box 1.9). These foundations need to be strengthened, with some urgency given the time it takes to phase in new arrangements.

Box 1.9. **Pension reform**

The reform targeted a reduction in the public pension replacement rate and a cap on the contribution rate, revised the indexation of the pay-as-you-go (PAYG) pension, the phase-out of early retirement programmes and the creation of incentives for individuals to opt for compensating occupational and individual pensions.

These measures should maintain the relatively high overall pension incomes over the next decade. However, as demographic pressures mount, there is considerable uncertainty as to whether the targeted reduction in replacement rates will ensure financial balance of the public pension system up to 2020 without additional measures. The uncertainty as to whether the system is sustainable in the later decades under the current framework is even higher. Given the long time needed to phase in pension reforms, these issues need to be addressed urgently.

The government should review the statutory retirement age in the light of life expectancy increases, and ensure that the phasing out of early retirement programmes does indeed raise the effective age of retirement. Public opinion might also be influenced by considerably lengthening the time horizon of official projections, in order to better highlight the risk of falling replacement rates in the PAYG system unless further action is taken.

Regulatory reform: the challenges

Overall prospects for the German economy remain uncertain. There is still no self-sustained growth in the new States, and the gap with the west remains large. The population is ageing rapidly. A more rapidly growing economy would compensate for these structural weaknesses. Three issues are of particular importance in achieving stronger growth. First, impediments to increased employment need to be reduced. Second, productivity needs to grow faster. Third, the fiscal deficit needs to be eliminated.

Where can regulatory reform help?

Regulatory reform is never the whole answer to tackling economic and other issues. But it can provide essential support to other policies and help remove important blockages. Product and labour market reforms, for example, can provide valuable help in boosting employment and productivity growth. Recent OECD studies show that imperfections in labour and product markets reinforce each other. So the removal of barriers to trade and competition in potentially competitive product markets can complement labour market reforms aimed at increasing long-run employment levels. And product market innovation can be stimulated by a more flexible labour market. The interaction with financial markets is also important (Box 1.10).

In Germany's case, regulatory reform can make an important contribution to the three targets for achieving stronger economic growth: removing impediments to increased employment, increasing productivity growth, and reducing the fiscal deficit.

The following sections review the need for further reforms which would support stronger economic growth. They cover labour and product market reforms (including the network industries), competition policy, public expenditure management and regulatory governance, before concluding with a section on the political economy of reform.

Labour markets: recent reforms are a major step forward but more is needed

The OECD Surveys explore the reasons for Germany's weak labour inputs in more detail, as well as proposing areas for further or stronger reforms.

One important factor will be highlighted here: collective wage bargaining, which is an enduring feature of Germany's governance framework. Collective wage bargaining has positive elements, including low transaction costs, and when it works well, the promotion of modest wage settlements that help to sustain a low inflation rate and maintain international competitiveness. In the past few years, the scope for more flexible wage determination at the company level has been widened by incorporating "opening clauses" into collective wage agreements. The 2002 wage round saw an important agreement of this type in the chemical sector (it allows part of workers' remuneration to be based on the level of a company's profits). But collective wage bargaining remains a generally inflexible system which does not easily take account of productivity differences between sectors and between different parts of the country. Policy initiatives to support more differentiated collective bargaining outcomes are lacking. Consideration should be given to widening the scope for wage determination at the company level so as to better align collective wage contracts with labour market conditions.

Box 1.10. **The cross over effects of regulation in product, labour and financial markets**

Product, labour and financial markets interact with each other in a number of ways. Regulation in one of these markets may stimulate or restrict performance in the other markets. A number of studies have been carried out on these cross-over effects. For example, imperfectly functioning financial markets that restrict the availability of venture capital may limit innovation, which adversely affects competitiveness and slows job creation. Product market regulations affect wages, employment and employment security (for example wage premiums are found to be weaker in more competitive industries, so employment growth is stronger). OECD analysis using product market regulation data suggests strongly that employment rates are increased by product market regulatory reform aimed at increasing competition. It may explain just over 1% of the difference in employment rates between countries (in some cases much more). Conversely labour market regulation affects product markets. A regulatory environment that promotes competition positively affects productivity, and innovation/R&D are stronger in more open markets. There is some evidence that labour market reforms may enhance innovative activity and hence output growth.

Source: OECD (2001), "The cross-market effects of product and labour market policy", *OECD Economic Outlook*, Paris.

Product markets: exposure to greater competition would strengthen important sectors

The Mittelstand should should remain competitive

Rules favouring SMEs are rooted in two traditional concerns: maintaining quality for the consumer, and protecting the *Mittelstand* against the encroachment of larger firms. The competition law thus pays special attention to protecting smaller firms against dominance in a bargaining relationship. The law controls discrimination and "unfair hindrance" by dominant firms, associations and cartels. It also permits SMEs to combine and co-operate, under certain conditions (for example SME purchasing co-operatives may be exempted from the cartel prohibition). SMEs are, in short, a favoured class for protective treatment under the competition law.

The issue, already debated in Germany for some time, is whether the advantages of these arrangements outweigh the competition effects and impair performance in terms of productivity, costs and prices. For the *Mittelstand* to remain competitive, it should not be over sheltered.

Some sectors are still heavily regulated: a concern to promote quality may be impeding competition and innovation

An important set of heavily regulated *Mittelstand* sectors are the retail trade, craft services and professional services, and pharmacies. The question is whether the right balance has been struck between necessary regulation to protect and promote important goals and values, and market freedom. The government is aware of this issue, and has recently made some important changes.

The retail trade in Germany is traditionally highly regulated compared with many other European countries. For example, opening hours are still more restricted than in many other European countries, and there are restrictions on discounts outside the sales seasons as well as prohibition of below cost pricing (an important case concerning the latter has recently been upheld by the courts). However opening hours rules are now being relaxed. It is also noteworthy that productivity in German retailing is above the European average.

The crafts sector is also highly sheltered and entry is difficult and costly. For 94 crafts and services, a master's certificate is required in order to operate independently and to own a company in the field (a system that can be directly traced back to the medieval guilds). Professional services have been regulated to prevent competition: rules of the professional associations that limit the competitive freedom of their members, for example on fees, are exempted from the competition law. The Agenda 2010 programme, together with the Initiative to Reduce Bureaucracy, suppressed the master's certificate requirement for 53 out of 94 trades. Nevertheless, a master's certificate may still be obtained in these trades.

Business structure restrictions on pharmacies – pharmacies must be owned by pharmacists, and pharmacists may own one pharmacy at most – do not appear to promote consumer interests, as economies of scale cannot be exploited. Mail order trade in pharmaceuticals is also currently restricted. The experience of other OECD countries suggests that with adequate protection in place, this market can be safely opened up. Current health sector reforms address some of these issues: for example mail order retailing will be allowed and pharmacists will be able to own up to four pharmacies (regionally restricted).

Public procurement rules do not encourage adequate competition

Public procurement rules raise a number of issues. Calls for public procurement published at the EU level are the lowest in the EU, accounting for slightly less than 1% of GDP, compared with an estimated total contract value of just over 17% of GDP. The aim is not to evade the EU threshold rules (which are the same for Germany as for other EU countries and which Germany observes) but rather to encourage bids from SMEs. A large number of procurement contracts acts are therefore deliberately split up to make bidding by SMEs easier. The fact that such contracts are then not required to be published at the EU level because of their small size (they are published domestically) makes it harder for foreigners to learn of opportunities.

The German public procurement legal framework is also extremely complex. As in most other EU countries, EU directives are implemented in such a way that EU and national law coexist: above a certain contract value EU law applies, and below it national law applies, which can vary between the sixteen *Länder*. The level of the EU threshold varies by type of procurement. Also, EU legislation has been integrated into a web of different German laws and rules – the competition law, the ordinance on public procurement, and the procurement codes. Legal protection for bidders varies according to the value of the contract. Above the EU threshold every domestic or foreign bidder can appeal to the public procurement tribunals. Legal protection below this threshold is inadequate. The manner in which EU law has been integrated into German law results in a lack of transparency.

Finally, public procurement committees (made up of federal and *Länder* representatives and business associations representing important domestic clients) create the procurement codes. This is likely to reinforce the closed nature of the process.

Network industries: substantial further progress is needed for effective liberalisation

Court appeals on regulatory decisions in the network sectors are widespread but the process is slow: this needs urgent attention

The use of the courts to challenge regulatory decisions in the network industries is widespread. Delays in the courts hamper enforcement against denial of network access. If an *ex post* approach is to work, speed is vital so that market participants are not discouraged. Even with *ex ante* regulation (as in telecommunications) challenges are numerous (Box 1.11). Although judicial review is important and a right that must be protected, it should not be allowed to become a mechanism to routinely block or delay the application of sound regulatory decisions. Regulators need adequate and clear statutory authority to implement and enforce their decisions. The new Telecommunications Act helpfully proposes a two-stage rather than a three-stage appeals process.

A stronger policy framework for network sector regulators needs to be developed

Germany has experimented in the last few years with different paths for the oversight of liberalised network sectors: a regulator for telecommunications, none for electricity and gas. Neither approach has been wholly successful. Though it is now acknowledged that *ex post* competition law oversight is not enough for network sectors, the regulatory story in telecommunications has been controversial. What is the solution? It is not to go backwards and rely mainly on *ex post* surveillance, but rather to go forwards with a regulatory approach as an essential adjunct to the competition law that seeks to draw lessons from regulatory experience so far. Such analysis is beyond the scope of this project, but several

Box 1.11. **Problems with the enforcement of regulatory decisions in telecommunications**

Regulatory decisions in telecommunications often take a long time to be implemented. Even though the law says that RegTP decisions stand pending appeal, the telecommunications incumbent (DTAG) can and has successfully used the courts to suspend the obligation to comply, and in practice RegTP refrains from implementing decisions pending a decision by the courts. Many rulings have been contested over months or even years. About 210 court cases are pending today. Germany's confidentiality rules add to the delays. Key data cannot always be submitted by RegTP to the courts to justify its decisions. Examples of problems which have arisen:

1. *Leased lines.* DTAG's prices are relatively low but delivery times had been among the longest in Europe until 2002. RegTP imposed a number of requirements on DTAG in response to complaints. But DTAG appealed and the court's decision suspended the obligation to implement RegTP's decision, on the grounds that DTAG is obliged to offer competitors only those conditions which it offers itself internally, and that RegTP had the burden of proof for showing this.
2. *Internet access.* This is now one of the major generators of traffic over the telephone networks. RegTP has been blocked in its efforts to require DTAG to offer an appropriate wholesale interconnection product to Internet access providers. DTAG has successfully appealed to the courts (the case is ongoing). The courts have defined non-discrimination as follows: DTAG can only be obliged to offer products to competitors that it uses itself. This is a severe and arguably inappropriate test, because an incumbent running the network may not always need the same product as competitors seeking connection to the network. Competitors fear it could mean that every regulatory decision to oblige DTAG to provide an interconnection product could be denied because DTAG does not use it internally.
3. *Line sharing.* The enforcement of a requirement on DTAG for line-sharing took over two years to be resolved.

important issues need careful review. These include the issue of regulators' powers (are they strong enough and appropriate for the task? Are they quite clear?); staff competences (a careful mix is needed that will enable regulators to deal effectively with the regulated entities for which they are responsible); and independence (ensuring that the State's roles relating to ownership, policy making and regulation are carefully separated, and that regulators have the operational independence they need for their job).

Some concerns, for example, have been expressed in the telecommunications context over the independence of the ministry and RegTP *vis-à-vis* DTAG, in which the government still has a 42.3% share. Is there a conflict between the government's interests as a shareholder and regulator? DTAG's current debt problems and falling share price may be increasing pressure for a tolerant regulatory attitude toward the anticompetitive conduct of what the government may also consider to be a national champion.

The electricity and gas sectors: stronger structural reforms and a regulator are needed

Though the *electricity sector* was fully opened to competition in 1998, the approach of negotiated access has not yet succeeded in securing effective and sustainable competition. There have been no new competitive domestic entrants into generation so far (though this has to be appreciated against the background of overcapacity in generation at the start of liberalisation, and the addition of considerable new capacity from renewables enjoying a guaranteed price regime). Market concentration has become an issue. Intense merger activity since liberalisation has resulted in vertical as well as horizontal consolidation. The four major utilities are responsible for transmission and system operation and there is evidence of problems with market power. Distribution and supply remain tied up with traditional regional and local companies, and vertical integration dampens competitive procurement. Electricity prices have risen (after falling considerably following market opening) not least because of the imposition of environmental taxes. Compared with other OECD countries, industrial prices are now around average but small consumer prices are high. The renewed rise in electricity prices is mainly due to government-imposed burdens such as the eco-tax. Private consumer switching of suppliers is low as in most other countries where private households are free to choose their supplier.

The *gas sector* was also opened to full competition in 1998 but *Ruhrgas* remains the dominant company. It imports 60% of gas consumption, and controls a large part of the high pressure pipelines within the country and about half the storage facilities. Gas prices are high compared with other OECD countries.

There is a need to tackle structural issues more forcefully. The basic problem is discriminatory behaviour which is facilitated by the industry's structure. Vertical as well as horizontal integration opens the door to cross-subsidisation of activities. An effective separation of activities, and especially the network from other activities, is needed. If ownership separation of activities is not feasible, effective accounting separation, which does not exist today, is essential. Key issues in the Associations Agreements are the proposed pricing principles and rates of return for network access (and a linked issue of regulatory accounting), which may be encouraging companies to set higher access fees than necessary.

Just as important, there is a need to rethink the regulatory framework, which after five years, and despite valiant efforts by the BKartA, has not yet delivered effective and sustained competition. Providing effective network access is perhaps the most decisive factor in stimulating competition, and here the competition law needs the assistance of pro-active *ex ante* regulation by an independent regulator. The new EU internal market directives require the nomination of a regulatory authority. The Ministry of Economics and Labour proposes giving this task to RegTP as from July 2004.

The original telecommunications incumbent is regaining lost ground and needs to be controlled more effectively

Despite important achievements, competition in telecommunications remains fragile. DTAG, which has not yet been fully privatised, is regaining lost market share and consolidating its lead in important new markets such as DSL broadband services. It has, in effect, slowed the roll-out of cable broadband services, and has successfully challenged the regulator's authority on key issues such as pricing and leased line provisioning (Box 1.11 above).

A difficult and puzzling issue is the controversial stance taken by RegTP on some important regulatory issues which contradicts the position taken by many other regulators in OECD countries (Box 1.12). Also, regulation of DTAG, which is still partly government-owned is shared between the regulator, the competition authority and the ministry. The approach sometimes appears lenient. This may reflect an over-strong political interest in the sector's regulation, which should be managed independently of short-term political considerations.

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The new telecommunications law should be very helpful in clarifying the regulator's powers, among other issues.

Other network industries need a stronger approach both to liberalisation and regulation, in order to secure effective competition

The *postal sector* is moving towards competition, but slowly. The development of a more competitive postal market has been delayed by the government's decision in 2001 to prolong the monopoly of *Deutsche Post AG* (DP) on domestic letter delivery below certain weight thresholds (recently reduced) to the end of 2007. The government has instead decided to follow the EU liberalisation schedule. Where competition has been introduced the playing field is far from level. DP is for example exempt from sales tax, including on revenues generated in competitive markets (to compensate, somewhat arbitrarily, for its universal service obligation). The experience of postal market liberalisation combined with an effective regulatory framework in some other OECD countries has been very positive.

There has been some progress in introducing an appropriate regulatory framework in the *rail sector*. From mid 2002 the Federal Railways Office (which had been mainly concerned with technical and safety issues) was granted greater powers in relation to third party access, though not the power to regulate route charges. The dominant incumbent, *Deutsche Bahn*, has been forced by the BKartA to introduce a non-discriminatory route pricing structure. The Acts on railway reform and revision of the General Railway Act in 2002 have been helpful. The government expects further improvements to flow from

Box 1.12. **RegTP's controversial decisions**

1. DSL broadband services. Following complaints, RegTP investigated DTAG's pricing, and found some elements below cost, but did not take action because a predatory effect had not been proven. Complaints continued and DTAG eventually raised its prices. The sequence of events suggests that DTAG engaged in a predatory strategy to secure the long term broadband services market for itself (with initial price cuts to deter competitors, and once this had worked, price increases to recoup the initial losses). RegTP explains that it sought a balance between roll-out and competition: encouraging broadband roll-out by allowing DTAG to charge low prices, but also placing obligations on DTAG to allow equal access to its lines by competitors. The outcome suggests this was a flawed strategy, as DTAG has now asserted its dominance in this market. DTAG has been accused of "price dumping" in other markets too.
2. Fixed to mobile termination charges. RegTP's stance – they are not regulated – contradicts the view of the EU Commission and of a growing number of regulators that fixed to mobile termination charges are excessive.
3. Local loop unbundling. Local loop unbundling (LLU) is an important method of providing high speed broadband services (such as high speed Internet access and video on demand). Though Germany was the first European country to require a form of LLU it lost its lead. In fact the EU has taken action against Germany for failing to implement the EU regulation on LLU, noting the lack of any published reference offer for LLU. A key issue is pricing by DTAG. Competitors have argued that they were being squeezed by DTAG's prices for access to unbundled local loops, which was more than what they could charge their own customers. The price squeeze problem has now been addressed by RegTP (among other measures it has reduced the access price payable to DTAG).

implementation of the "Future of the Railway" Task Force recommendations, and of the EU infrastructure package. The intention in this context is to introduce rules ensuring non-discriminatory access to the rail network and to separate, in line with EU requirements, the network from train operation. However the government still considers that regulation of prices for third party network use is unnecessary given the likely pressures of competition on the track operator.

It is not yet clear whether all the changes, when they have been made, will be enough to ensure effective and sustained competition. This will need effective separation of the track from train operation. Also, the Federal Railways Office should have the power to regulate route charges, and ownership separation of the network from potentially competitive activities should be considered in the context of privatising *Deutsche Bahn*.

The *water sector* has a good performance in term of public access to water supplies and sewage treatment facilities, but efficiency is an issue. German drinking water charges are among the highest in the EU. Though the introduction of competition in the provision of water services is more difficult than in other network industries, there is scope for improving efficiency through the greater use of benchmarking, expanding the geographical coverage of individual water works, and the use of competitive tendering for water contracts.

Competition law and policy: a need to refocus more clearly on some of its original aims

The right balance needs to be restored between the promotion of competition and support of market relationships

The competition law's motivating ideas have become diffuse and in some respects have weakened over time, through legislative fine-tuning of the rules, and the special-interest character of some of the changes (quality for the consumer, protection of the *Mittelstand*). A key goal of the law is to protect market relationships and structures where these are expected to contribute to an efficient market outcome. Germany may want to consider whether this is still working effectively. Could the pursuit of this goal be encouraging (however unintentionally) the status quo, and making new entry and innovation difficult?

To redress the balance between competition and co-operation and to give more weight to the former, controls over means of doing business and in some cases over terms of entry into professions, services and crafts need review. The current system raises costs and limits entry unnecessarily. For example constraints on discounts and pricing – some of them in the competition law itself – probably tend to keep price levels too high and prevent marketing innovations. However changes are underway in the law on discounts.

The competition law alone is not enough for the network sectors: a difficulty which is now being addressed

As an agent of effective change in liberalising network sectors, the competition system faces difficulties. At a very general level, competition law enforcement (the responsibility of the BKartA) and policy (the responsibility of the ministry) are not strongly linked in practice (although the BKartA ultimately reports to the ministry). This can weaken the link that needs to exist between them in managing the development of competition as well as its counterpart, re-regulation, in these sectors.

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The BKartA's enforcement tools are not well suited for applying competition law and for promoting competition in infrastructure sectors where competitive markets have not yet taken root, and which have a network monopoly core. Enforcement of the competition law in these sectors has proved difficult. The normal *ex post* process for tackling misconduct is ineffective. The usual methods of analysis and proof are hard to apply: notably, there are no comparable markets with which to compare prices. Court delays are also a major issue (see above). Germany is in a state of transition as regards the use of regulators to meet needs in these sectors which cannot reasonably be addressed by the BKartA alone. As already discussed, a regulator was established for telecommunications when the sector was liberalised, but not for electricity and gas.

The government now recognises the problems raised when the competition law is not supported by regulation. Its original "hands off" approach to regulation of the electricity and gas sectors stood out in marked contrast to nearly all other OECD countries. The experiment of self-directed industry regulation supported by competition oversight of these sectors is now giving way to a solution in which the competition law will have the necessary support of *ex ante* regulation.

Public expenditure management: a pressing need for reforms to contain costs and improve efficiency

Fiscal consolidation is now a priority. Recent developments reinforce this. Consecutive tax reductions over the last couple of years were not reflected in proportionate cuts to government spending. Against this background weak economic growth has increased the deficit. But the issue is also structural and longstanding. Social assistance and unemployment-related benefits contain considerable scope for reform to reduce disincentives for improving labour supply and encouraging job searching. Increasing social assistance, disability, sickness and unemployment benefits reduce incentives to be part of the labour force, and contribute to a disfunction of labour markets. Financing the expenditure necessitates an increase in public contributions which increases taxation and non-wage labour costs, with adverse implications for labour supply and demand. And the costly active labour market measures are often ineffective in improving the chances of re-employment, as well as discouraging wage adjustment in the new States. Instead of remaining in the labour force on terms that better reflected realities (such as productivity levels), those who have lost jobs have often instead been absorbed into social welfare.

Spending pressures are likely to persist, due to the continuing fiscal burden associated with re-unification and the substantial deterioration of the old age dependency ratio. A number of measures have already been taken. Not least, the domestic Stability Pact agreed in 2002 is an important step toward securing a higher degree of fiscal discipline across the different levels of government.

Public expenditure needs more cost-efficient management

Efforts are needed for the more cost-efficient management of public funds. The same outputs can be achieved with less funding, which can reduce the government's financial needs and hence the tax burden (the high-spending health sector is a potential candidate). Or the same funding can be put to more effective use, for example by improving the quality of public services (the education sector is a potential candidate). The goal of greater efficiency can therefore be made to work hand-in-hand with Germany's longstanding and legitimate concerns about solidarity through social welfare.

The government has already taken some measures in this direction. Steps have been taken toward the introduction of modern resource accounting for public expenditure at both federal and *Länder* level: ensuring that all costs are taken into account (the costs of administrative services used not to be included), relating expenditure to outcomes, and including assets and liabilities. This does not yet go as far as some other OECD countries (Box 1.13) and needs to be reinforced.

Box 1.13. **Linking expenditure to outcomes: the UK approach**

The UK introduced a new fiscal framework in 1997. The core is that ministries (departments) now operate under three-year plans for discretionary expenditure, subject to Departmental Expenditure Limits (DELs). The finance ministry is committed to this funding and in exchange, departments are held accountable for achieving policy targets specified in Public Service Agreements (PSAs). A department's DEL is dependent on having agreed PSAs in place to determine performance against allocated resources. The relevant minister is responsible for meeting PSAs, and progress is monitored by the finance ministry. PSAs start with an overarching departmental aim, followed by objectives and then quantitative targets against which performance can actually be measured. They also include "value for money" targets that allow inputs to be related to outcomes. PSAs are cascaded from departments to agencies, local authorities and other non-departmental public bodies.

The quality of targets is work-in-progress, as departments seek to move away from input and process targets, to output and outcome targets.

Resource accounting has also been introduced.

The evaluation of public expenditure is another important target for reform

The federal court of auditors as well as the *Länder* courts in their annual reports have stated repeatedly that there is not enough evaluation of the effectiveness of public sector spending. Is the money well spent? Does it deliver acceptable outcomes? Both *ex ante* and *ex post* evaluations are needed. Though key infrastructure bottlenecks have been removed in the new *Länder*, others remain, especially some decayed regional transport networks whose renewal would help to foster growth. Such areas need early attention to avoid further decay and preempt a future need for even higher funding. Money has instead tended to go on less growth enhancing areas such as the central administration. Evaluation can help to identify the costs and benefits of alternative projects.

The federal-State fiscal relationship, especially co-financing, also needs reform: it works against containing costs and demand

Complex institutional arrangements are in place to promote inter-governmental co-operation and revenue-sharing, with the aim of creating broadly equivalent living conditions across the federation, and accommodating the regional governments' financial needs. However optimal efficiency in resource allocation is not achieved, for a number of reasons. The relationships are complex, in terms of responsibilities as well as funding (Box 1.14).

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Box 1.14. **Co-operation and revenue sharing between the different levels of German government**

The power to raise taxes rests mainly with the federal government. Revenues, however, are predominantly shared between the different layers of government. Superimposed on this primary system of tax-sharing is a secondary redistribution system aimed at meeting the constitutional objective of broadly equivalent living conditions. This involves both vertical transfers from the federal government to the *Länder* and horizontal transfers between the *Länder*, aimed at accommodating the regional governments' financial needs. Similar arrangements exist between the *Länder* and the communities. Special vertical transfers go from the federal government to the new *Länder* to promote the catching-up process (the "Solidarity Pact"). Also, certain spending projects are co-funded between the federal government and the *Länder*, and the *Länder* and the communities.

The fiscal relationship between the different levels of government is complex and does not encourage cost-efficiency. This applies in particular to activities that are co-financed by the three layers of government (federal, State and community). Co-funding grants extended by the federal government to the Lander and local governments accounted for some 0.8% of GDP (EUR 17.4 billion) in 2002. The *Länder* also co-finance projects in their communities with their own resources, so the overall figure for co-financed public expenditure is even higher. Broadly, three schemes involving the federal government can be distinguished. "Joint Fiscal Tasks" are jointly decided by the federal government and all States, and cover fields such as university construction, subsidies to improve regional economic structures, and financial aid for R&D. "Investment Aid" can be granted for major investment projects by the *Länder* or communities to promote balanced economic development. And grants for the "Disbursement of Funds" support social transfers by the *Länder*.

Co-financing is perhaps the most important issue. Efficiency and cost control of co-financed projects is impaired by the fact that the *Länder* and communities are likely to opt for spending projects so long as the perceived benefits exceed their own partial budgetary costs. So an effective cost-benefit analysis of a project cannot take place, because the total costs of a project are not taken into account. The potential for a distorted view is large: the federal budget contribution is usually 50% (it can be up to 90%, but only in exceptional cases of financial assistance for significant investment by the Lander/municipalities). Split responsibilities for a project not only seriously impede effective project evaluation but also project control.

Health expenditure is high but outcomes are only average: reforms should be developed further to improve efficiency

Health expenditure relative to GDP increased in the 1970s, was roughly constant in the 1980s and rose again in the 1990s (partly as a consequence of re-unification). Within the OECD, Germany has a relatively high spending-to-GDP ratio. Access to health services is excellent, but various indicators of health outcomes are close to the OECD average, suggesting scope for efficiency improvements. A number of steps have already been taken (Box 1.15). Reforms to improve efficiency and reduce costs are important, against the background of an ageing population which is making increasing demands on the health system, and continuous improvements to medical technology which are also stimulating a growth in demand.

Box 1.15. **Health sector reforms**

Recent steps to improve incentives in the health care system include the introduction of a diagnosis-related payment system (DRG) for hospital care, currently in preparation. This could be a significant source of savings by cutting the average length of hospitalisation, provided that efficient systems of cost information and for monitoring the quality of services are also put in place. The freedom for health funds to contract selectively with health care providers has been widened and more freedom given to consumers in choosing their insurer. Recent reforms introduced financial incentives to implement disease management programmes for selected chronic conditions. This is a positive step, but further reform should encourage the health funds to develop into active purchasers of health services on behalf of their patients, and to offer differentiated products. To this end the current arrangements which favour collective bargaining between the funds and health provider organisations should be re-examined. A more comprehensive risk equalisation system would mitigate the risk of cream skimming.

The education system is also costly: comprehensive reforms are needed to improve outcomes

Germany spends more than most other OECD countries on secondary education. But student performance was found to be poor in the recent international PISA study. The study also suggests that successful education systems are those that combine standardised targets for educational outcomes with decentralised flexibility and responsibility on how to achieve them. The German school system tends in the opposite direction. It is characterised by tight regulation on schools (for example no freedom to select teachers) and the absence of nationwide uniform educational standards. This points to the need for a comprehensive change in the regulatory framework. Nationwide standards, combined with regular evaluation, should be introduced. At the same time schools should be left more freedom to determine suitable ways of reaching their targets.

Tertiary education is also costly for public budgets, and suffers from long study duration and high dropout rates. Recent initiatives to shorten tertiary education and improve incentives for university teachers to deliver high quality teaching need to be widened. Tertiary studies with a shorter duration should be introduced on a broader scale. Consideration should also be given to allowing universities the right to levy tuition fees. Distributional aspects could be addressed by adjusting student support schemes. Reform should also promote greater competition between universities and public funding of universities should be linked to performance.

Regulatory governance: a number of important issues need attention to promote a more dynamic framework

Regulatory governance also needs to be strengthened and developed, in order to provide effective support for more specific reforms. The enduring strength and completeness of Germany's post-war governance framework, as well as the distraction of re-unification, has masked the need for it to adapt. It is also very difficult to make changes to a system which works on the basis of a carefully crafted, coherent and balanced set of components. Germany's regulatory functions are an integral part of a much wider governance approach which supports a set of core societal values: the importance of the rule of law, the need to balance co-operation alongside competition, co-operative federalism, and the search for consensus in decision-making. Important changes, poorly handled, might risk destabilising the whole structure. The challenge is nevertheless to move forward and accommodate the development of a more dynamic regulatory governance system: one that makes the search for regulatory quality a permanent and continuous feature of the system. The traditional German system is more static than dynamic, and tends to adapt relatively slowly to new circumstances. The OECD Secretariat considers that reform initiatives launched over the course of the last few years appear to have difficulty making effective headway over time, and engendering any deep changes to the existing system seems difficult. But if the more specific reforms needed to promote faster growth are to succeed, they need the support of a more dynamic and adaptable regulatory policy environment, in which questions are constantly asked about the appropriateness of regulations for their purpose, costs and benefits, as well as outcomes, and which can help to speed up decision-making without losing important stakeholders along the way.

The following sections identify specific areas of the current system that raise concerns and need change.

Organised interests slow up the decision-making process: a more efficient process needs to be developed

Organised interest groups take part in the long-standing traditions and practices of elaborate, consensus-driven decision-making. Over time, this has led to an increasing interlinkage between the players taking part, who should ideally be independent of each other. Many players at different levels of the system and with different degrees of legitimacy – organised labour, organisations representing industry or the *Mittelstand*, a *Bundesrat* dominated by parties in opposition to the government – are increasingly capable of blocking or stalling the political decision-making process. The consequence is that urgent reforms, to which everyone agrees in principle, must go through a lengthy process and may also end up as the lowest common denominator that can be shared by all (Box 1.16).

A more efficient rule-making process is needed. This issue has been the subject of much debate in Germany, with no conclusive results, partly because the changes needed to make a real difference could go too deep (even, possibly, constitutional change). An independent committee set up by the government in 1994 issued proposals, but these were never followed through – perhaps because they became caught up in the very processes they were intended to reform.

Some other OECD countries have a similar strong tradition of consensus-driven decision-making, but back this up by putting the development of major legislation in the hands of official government-appointed preparatory committees. Though this is not a German tradition, recent years have seen the development of government-appointed preparatory committees, including the *Hartz* Commission for the labour market, and the *Rürup* Commission for the health sector and pensions. This is a positive development if it can be accommodated without undermining the consensus-building process which is a major pillar of Germany's governance system.

Transparency and accessibility in rule-making are an issue and outsiders are disadvantaged

Transparency is one of the central pillars of effective regulation – that is, regulation that will be suited to its purpose. It is a challenging task and involves a wide range of practices, including standardised processes for making and changing regulations, consultations with interested parties, effective communication of the law and plain language drafting, publication and codification to make the law accessible, controls on administrative discretion, and effective implementation and appeals processes.

As matters currently stand, there are no government-wide obligations on ministers on how to conduct public consultations. German consultation procedures are generally governed by traditions internal to individual ministries. A consequence of this discretion is that draft regulations are not made systematically available for public consultation. For example there is no single Web-based public access point for draft regulations, as in many other OECD countries. Laws must be published when they are agreed and before they enter into force, but not drafts.

The consensus-building process is driven by established, somewhat informal networks of stakeholders. The early start to informal consultation and the sustained participation and involvement of these stakeholders means that the latter have a major influence on the final legislation. Conversely, it excludes any influence by others, raising important accessibility and cost issues for outsiders, for example parties which do not belong to the organised bodies such as the Federal Association of German Industry (BDI). Those who are not selected as consultation partners or who are not familiar with the workings of the regulatory process risk being systematically, albeit unintentionally, disadvantaged.

Box 1.16. **Is the German governance system slow in promoting change?**

A number of reform examples suggest that the German governance system may be slow in promoting necessary changes. Changes are eventually made, but valuable time may be lost, with costly consequences for the economy. Reforms to the regulatory governance system itself appear to be victims of this problem:

1. *Regulatory governance reforms*. The Lean State programme was initiated in 1995. It took two years for a committee to be set up to promote the implementation of recommended measures. Many measures have not yet been implemented. The process of developing the RIA framework has been slow too. An RIA handbook and guidelines were commissioned in 1998, and the practical implementation of the new system is still "work in progress". A substantial revision of the guidelines is being prepared for 2006, including a report on methodologies due in 2004.
2. *Freedom of Information Act*. Launched as part of the *Modern State – Modern Administration* programme in 1999, and originally scheduled for finalisation in 2001, this is still subject to internal government discussions.
3. *Telecommunications reforms*. The failure to formulate and implement effective rules for competition promptly and effectively is the most serious weakness of the current telecommunications regime. The implementation of EU law has often been slow and reluctant.
4. *Electricity and gas reforms*. These sectors were liberalised five years ago under a regulatory regime which was somewhat unusual in the OECD, and which has not been able to deliver effective and sustained competition. The need for change – which is now being implemented – might have been foreseen sooner.
5. *Pension and labour market reforms*. A strong case can be made that action might have started much sooner. Though pension reform is proving slow to engage in many other European countries so Germany is not alone on this issue, labour market reforms have already been engaged for some years elsewhere (for example in the UK).

The evaluation of rules is weak: costs and benefits are not systematically assessed and are often unclear

German principles for good regulation promote a high legal quality. But the law-driven culture also means that there is only limited use of evaluation and quantitative, evidence-based assessments to help regulatory decision-making. The traditional focus on administrative burdens and the many projects over time to reduce the number of rules is laudable. But a more systematic and quantitative evaluation of rules and their costs and benefits might have sidestepped some of this effort by avoiding the adoption of burdensome rules in the first place. This point applies well beyond simpler administrative burdens, to whole regulatory frameworks and high-level decisions. For example in telecommunications, the government's aim to minimise regulation should be carefully tested in relation to the current state of competition and the effectiveness of today's *ex ante* regulatory regime. This requires improved information, regular market monitoring, and the development by RegTP of performance indicators. Another example is the electricity and gas sectors where evaluation of policies could have been (and still could be) helpful.

This is not to say that Germany lacks any evaluation system: it was among the first OECD countries to start down the RIA path. RIA is perhaps the most important regulatory tool available to governments, as its aim is to ensure that the most efficient and effective regulatory options are systematically chosen. It is, however a challenging process which needs to be built up over time. It combines good habits of consultation with a rigorous review of the impact of prospective rules through a clear and balanced assessment of costs and benefits.

Cumulative initiatives starting with the 1984 *Blue Test* questions underline a significant effort to help regulators prepare effective RIAs. But the equally longstanding problem is that procedures are not sufficiently carried out, due to lack of operational guidance, lack of expertise at the centre of government to guide ministries, a reluctance among regulators to use RIAs, and the absence of monitoring and sanctions for non-compliance. In short, a culture that puts a priority on the deployment of RIAs at the outset of the rule-making process does not yet exist.

The legal culture of the administration does not support the promotion of regulatory quality: this needs to be encouraged

The pre-eminence of lawyers in the administration goes back to ensuring fairness, balance and a firescreen against capture by special interests. These are important goals. The *Rechtsstaat* tradition promotes law-trained civil servants, even for posts with a high economic content. But at the same time it discourages an economic perspective on issues and a full appreciation of the importance of evaluation which includes quantitative cost-benefit analysis, key components for ensuring regulatory quality. A number of economic research institutes offer policy advice to the government. But this advice may not always be well-digested by civil servants who lack themselves an economic training and outlook. Nor does it encourage the development of economic and other missing competencies within the administration itself. There is an application gap between the ideas and tools developed by academics and the practical rules and guidelines needed to make the ideas and tools operational.

Reflecting the general strength of the legal tradition, most business and consumer representatives also have a legal background.

Successive reform initiatives aimed at improving the efficiency of the administration underline these weaknesses. The reforms have tended to look inwards, and have overlooked the need for reforms aimed more directly at improving prospects for the economy, at least until recently. There appears to be no assessment of the impact of reforms either.

The regulatory system is complex and likely to promote costly regulatory outcomes: it needs streamlining

The regulatory system is complex, characterised by an increasing number of federal regulations, often expressed in complex legal terms. As noted, most federal rules are addressed to the *Länder* for implementation as they see fit. The way that regulations are implemented across Germany therefore varies from State to State.

Germany's public administration has a tradition of steep hierarchies covering narrowly defined administrative responsibilities. This has fostered specialised administrative competencies, but it also feeds specialised, sectorally-based approaches to regulation. Framework procedures are often overruled by specific procedures for particular policy areas, for example planning, and establishing a business. There are signs that specific procedures are proliferating.

The combination of a law-driven administration, in which cost-benefit analysis has difficulty making headway, and the complexity of the regulatory governance system may be driving unnecessarily costly regulatory outcomes. An example is the tax system, which is probably the most complex in the Europe.

Self regulation needs careful evaluation to ensure that it is the most appropriate approach

The *Modern State – Modern Administration* programme emphasised the need to strengthen society's potential for self-regulation. There are already clear formal obligations on regulators to consider alternatives to regulation, such as self-regulation, including a checklist in the federal government's Joint Rules of Procedure to identify opportunities for self-regulation. The federal government has also recently commissioned some research which proposes guidelines for "regulated self-regulation", that is, what to consider when establishing regulatory regimes based on self-regulation. The current checklist already includes a number of pertinent questions to shed light on whether self-regulation would be the right approach, the necessary framework role of the State, and how the State might need to remain involved. One important conclusion of the research is that the advantages of this approach are high when the defined policy objectives are *not* considered to be fundamental to the public (which therefore implies that the reverse also holds true). Caution is therefore needed in applying self-regulation to important sectors.

Self-regulation is part of the German tradition. Many activities are already subject to regulatory frameworks which have been developed and are managed by representatives of the sector, albeit under the umbrella of a comprehensive and efficient competition law and authority. These include professional services, the electricity and gas sectors, and public procurement.

This raises an issue: there are problems with these areas which a rigorous application of the current procedures (if not the more recent proposed guidelines) might have helped to identify. For example, the holders of the masters' certificates which are required for entry into many services and crafts are active in setting the rules and standards for their trade, and new entry is difficult. A similar problem exists in the electricity and gas sectors where market entry is difficult. Existing systems of self-regulation as well as proposed new ones should be subject to the same analysis.

A central regulatory quality system needs to be developed: this would help to drive forward a dynamic regulatory policy

As noted, elements of a potentially effective regulatory policy already exist. But there is no single central unit responsible for promoting regulatory reform across ministries. Existing arrangements could be developed in this direction, including closer working arrangements to promote an organised approach and avoid fragmentation, the development of analytical expertise, and the implementation of a broader range of regulatory quality standards. Many other OECD countries have now set up central units (Box 1.17).

Box 1.17. **Central regulatory quality units: OECD experiences**

Experience across the OECD suggests that central oversight units are most effective if they are:

- independent from regulators (*i.e.,* they are not closely tied to specific regulatory missions);
- operate in accordance with a clear regulatory policy, endorsed at the political level;
- operate horizontally (*i.e.,* they cut across government);
- staffed by experts (*i.e.,* they have the information and capacity to exercise independent judgement); and
- linked to existing centres of administrative and budgetary authority (centres of government, finance ministries).

Central oversight units can carry out three different roles. Firstly, bodies may be *advisory*, *i.e.,* increasing regulatory capacities by publicising and disseminating guidance and by providing support to regulators. The second role, *advocacy,* refers to the promotion of long-term regulatory policy considerations, including policy change, development of new and improved tools and institutional change. Thirdly, bodies promoting regulatory quality may have a *challenge* function *vis-à-vis* new regulatory proposals. Such challenge may be in the form of an assessment putting pressure on the proponent regulatory body to improve performance in accordance with a set of given criteria. Or it may in the form of a "veto", where the reviewing body acts as a gate-keeper in the regulatory process.

Experience suggests that most regulatory policies have relied primarily on advocacy and advice. Advisory and advocacy functions are helpful preconditions for creating a fruitful and non-confrontational environment for regulatory quality. However leadership in the form of regulatory oversight bodies challenging as well as setting and enforcing targets for regulatory quality may be needed to go beyond the limits of reforms that are primarily driven by self-assessment.

The political economy of reform: strengthening the role of marginal stakeholders

The political economy of reform – how to manage the process of reform and encourage support for it – is a challenge for all countries. In Germany's case the challenge is sharpened by the fact that current stakeholders in the decision-making process are both longstanding and have interlocking interests. One answer is to seek ways of involving new or currently marginal stakeholders. Three important categories of stakeholders may not be

Box 1.18. **Strengthening the role of marginal stakeholders in the reform process**

Consumers face a paradox. They are protected – maintaining quality for the consumer is the driver of considerable regulation. But at the same time they appear to have relatively little influence in the rule-making process. There is no strong national consumer protection authority. Competition policy recognises how consumers benefit from it, but consumer policy is not closely linked. In the context of the EU Green Paper on consumer protection, Germany has argued against new and stronger consumer protection structures. Germany also does not support mutual recognition of consumer rules in the EU because it would threaten what it believes to be its higher-level protections. Consumers have particular problems making their voices heard in the network industries. For example the interests of residential and small business consumers of telecommunications services appear to be weakly represented. Consumer organisations may need more government support and even funding to help them participate effectively in the rule-making process.

In principle foreigners face the same issues and potential difficulties as domestic firms in dealing with the German administration. In practice they may find it harder, confronted with the precision of the German approach, the extent of regulations, and the complex federal-*Länder* architecture and division of responsibilities.

New and small firms are also likely to find it difficult to afford the time and money necessary to participate in the rule-making process.

playing a strong enough role in the current system and could lend new perspectives and perhaps valuable support to new initiatives – new firms, foreigners and consumers. A rebalancing of existing stakeholder interests would also be helpful, for example in the wage bargaining context, and in the federal-State relationships.

A second part of the answer is to consider how governance structures and policy areas might be rearranged so as to be less overlapping and intertwined. This would include reform of the mixed State-federal financing. Competition and benchmarking between the *Länder* could also be encouraged. A central regulatory unit to help mitigate overlap and encourage the adoption of general rules, for example on RIA and consultation, would be valuable.

Third, it is important to sustain the momentum of reform. Some past reform initiatives seem to have petered out. Reform results should be monitored and the public should be kept informed, to maintain broad support.

Last but not least, communicating the benefits of reform needs to address the legitimate concerns of stakeholders who fear they will lose out. Successful reform in the long run requires a broad constituency and effective co-ordination. This is likely to be especially true in Germany's consensus-driven society.

Conclusion

Germany faces the need for important structural adjustments to its economy. It must find a path to stronger growth which will enable it to manage the problem of a rapidly ageing population and help close the gap in performance between its eastern and western States. Though re-unification has imposed a heavy burden, more than was expected initially, it is not the only factor behind the slow growth. Deep-seated governance and structural issues have come to prominence with the pressures of re-unification.

The governance and regulatory framework which has evolved from the original social market economy blueprint after the war has a number of strengths, including a very reliable administrative culture based on the careful application of the rule of law, and a strong and comprehensive competition law and policy. Trade policy and regulation is also generally strong, and helps to sustain Germany's good export performance. Governance and regulatory structures seek to maintain a careful and necessary balance between different stakeholders and levels of government, and to promote solidarity across the federation. These goals remain important to Germany's overall wellbeing. But the system is static, predicated from the start on the idea that an effective balance has been achieved. It is not a system that accommodates or promotes change very easily. With re-unification the understandable instinct was to stay with it. Re-unification distracted from reflection on the possible need for reform in the context of wider changes in a global economy, and of certain underlying weaknesses in Germany's own economic development over time. It was a massive task in its own right and absorbed attention and energy. But while Germany was engaged in this heroic venture, unique in the OECD, many other OECD countries, including many large as well as small European neighbours, were actively updating their regulatory governance systems, as well as developing specific reforms in important areas such as labour markets and public expenditure management. Valuable time has been lost.

The German government has, in the last year or so, shown that it is keenly aware of the need for important specific reforms. There is perhaps less awareness of the need to take a more rounded view of the regulatory governance system itself, which is a necessary motor for ensuring that these reforms are timely, efficient and effective, whether they are reforms to labour markets, network industries, or to promote SMEs. This report therefore argues not just for the determined pursuit of specific reforms, but also for important adjustments to regulatory governance traditions so as to ensure that necessary change can take place more quickly, at least cost to the economy, and with the participation of all relevant stakeholders. As matters stand, the regulatory framework can be slow to adapt to change and can impose unnecessary costs. It can also, unintentionally, exclude stakeholders who may help to bring new ideas to the debate and support change.

Germany's first economics minister anticipated some of today's problems. He defined the social market economy as a framework which fosters the development of all agents' productivity. But he also warned of the risk that degeneration might take place towards a system in which the vested interests of various groups would undermine the capacity of the economy to generate wealth. A regulatory governance renewal is needed which puts the system back on the original track of harnessing all stakeholders to the common purpose of generating wealth, and at the same time encourages a more dynamic reform process.

Perhaps the most difficult operational challenge is to generate an engine of reform which will deliver the changes needed to regulatory governance. The federal, State and local levels of government provide a multitude of platforms for independent reform initiatives and ideas, but these are only brought together by the slow consensus-seeking decision process. It is too early to judge whether Agenda 2010 and the reforms of federalist structures which are currently under consideration will improve Germany's capacity to undertake and implement reforms more rapidly. Last but not least, and as in many other OECD countries, more attention also needs to be paid to the political economy of reform so that momentum and public support can be sustained.

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APPENDIX

Appendix Tables

Table A.1. **Sectoral regulatory reform in Germany**

Industry	Key legislation/regulatory framework	Regulation on prices	Regulation of entry and exit	Other regulations	Remaining regulations on prices, entry, exit	Other remaining regulations
Telecommunications	Fully open to competition since 1.1.1998. Competition-oriented regulation in principle covers all telecommunications markets.	Sector regulator (RegTP) controls the market on *ex ante* and *ex post* basis.	Free entry and exit. (Proof of reliability and professional qualification); access regulation (interconnection, essential services).	Carrier-selection and pre-selection for local calls introduced by law since 1.12.2002, implementation of CbC 1.5.2003, pre-selection in summer.		Universal service obligation exists but without practical impact.
Electric power	Market liberalised in 1998. All customers free to choose supplier. Conditions for network access determined by Associations Agreements. *Ex post* control through BKartA/courts. Introduction of regulatory authority planned.	No *ex ante* regulation. Abuse control by BKartA/courts on the basis of competition law and/or the Act Against Unfair Competition. Tariff approval (small consumers via low voltage electricity networks) by State agencies (relevant for retailers, who are also entitled to special contracts).	Supply of electricity does require specific approval (however, specific activities are not included); reasons for non-approval are legally fixed. No specific regulations for exit.	Minimum quotas for "green" electricity purchased at regulated prices, compensated by fee on some consumers.		Universal service obligation exists but without practical impact.
Natural gas	Market liberalised in 1998. All customers free to choose supplier. Conditions for network access determined by Associations Agreements with quasi legal status. *Ex post* control through BKartA/courts. Introduction of regulatory authority planned.	No *ex ante* regulation. Abuse control by BKartA/courts on the basis of competition law and/or of the Act Against Unfair Competition.	Supply of natural gas does require particular approval (however, specific activities are not included); causes of decline for approval are legally fixed. No specific regulations for exit.	Notification of long-term natural gas supply contracts (longer than 2 years).		Universal service obligation exists but without practical impact.
Insurance and banking	Liberalisation of insurance market in 1994. Abolishment of insurance monopolies and *ex ante* control of insurance products. Phasing out of State guarantees for State-owned banks by 2005.	None.	Comprehensive licensing requirements and on-going financial supervision in compliance with globally accepted core principles including minimum capital requirements and professional qualifications. Supervisory powers include withdraw of licence.	On-going financial supervision in compliance with globally accepted core principles. New Federal Financial Supervisory Authority effective 1 May 2002 for banking, insurance, securities/asset management supervision with involvement of the Central Bank in the on-going supervision of banks.		Some agreements among health insurance funds are not covered by the competition law.

Table A.1. **Sectoral regulatory reform in Germany** *(cont.)*

Industry	Key legislation/regulatory framework	Regulation on prices	Regulation of entry and exit	Other regulations	Remaining regulations on prices, entry, exit	Other remaining regulations
Railways	State monopoly transformed into joint stock company in 1994. Partial unbundling of infrastructure and train services in 1999. Currently guidelines of EU (first railway package) and results of task force of government "Future of railways" are put into practice.	Supervision by Federal Railway Office (mainly technical issues and track access and abuse control by BKartA *ex post i.e.*, prices for track access).	Proof of professional qualification. Free entry and exit.			
Air transport	National carrier privatised in 1997.	Unregulated pricing subject to abuse control by BKartA *ex post*.	Free entry and exit within EU.	Bilateral treaties on air traffic.		
Road transport	Partly liberalised market for occasional bus services; abolition of contingents for freight transport in 1998.	Prices fixed by the operator of regular bus services (approved by competent authority) and occasional bus services; prices for taxi services fixed by competent local authority. Liberalisation of freight rates in 1994 for road haulage.	Proof of professional qualification, financial and personal liability for carriage of passengers and road haulage. Restricted entry for taxi services.			
Postal services	In 1989 the integrated post and telecom operator was transformed into three enterprises (telecom, post, and bank); transformation into joint stock companies in 1995 with partial privatisation afterwards. Partial monopoly rights (to date for letters up to 100 g) were granted in return for universal service obligations; market opening for letter above 100 g and outgoing letters to foreign destinations.	RegTP is regulator and supervises price setting of dominant carrier(s) (letters *ex ante* regulation; other postal services *ex post* regulation).	Entry for the delivery of letter post items up to 1 kg is subject to a licence (licences are not restricted, except for the exclusive right area, now set at below 100 g). Some competition for Deutsche Post AG for letter services with added value. Free entry and exit for parcel and courier services where many companies entered the market long ago.			

Table A.1. **Sectoral regulatory reform in Germany** *(cont.)*

Industry	Key legislation/regulatory framework	Regulation on prices	Regulation of entry and exit	Other regulations	Remaining regulations on prices, entry, exit	Other remaining regulations
Pharmacy	Regulated sector.	Uniform prices for drugs that may only be sold by pharmacies (including prescription-only drugs).	Proof of professional qualification and citizen of a European Union State. Free exit and limited entry as neither pharmacy chains nor non-pharmacist owners are permitted.	Pharmacies restricted in products that may be carried; some restrictions on advertising. Subject to retail restrictions on opening hours, with modifications.		
Retail sector	The Gifts Ordinance and the Discounts Act were lifted on 31 July 2001. Opening hours recently further liberalised (takes effect from 1 June 2003). Act against Unfair Competition to be revised: regulation of special sales to be abolished.	Ordinance on proper price quotation. Act against Restraints on Competition forbids sales below purchase costs.	Free entry and exit; notification in register of companies and register of commerce. Construction license demanded outside town centers, even if change of use of an existing building for retail is intended.	Some locations are exempted from opening hours limit (gas station, railway stations). Ordinance on Packaging requires outlets to charge deposit for certain types of packaging and to recollect used packaging.		

Source: OECD.

Table A.2. **Potential impacts of regulatory reform in Germany**

Industry	Industry structure and competition	Impact on output, price, and relative prices	Impact on service quality, reliability and universal service	Impact on sectoral wages and employment	Efficiency: productivity and costs
Telecommunications	State monopoly in long distance and international services replaced by competition, mostly local monopolies in local connections, but some competition is developing.	Significant decline of prices for long distance and international calls, some decline for local calls.	More freedom of choice for customer.	Positive employment effects (since 1998).	Acceleration of productivity and declining unit costs.
Electric power	Regional legal monopolies replaced by oligopoly. Entry mostly on retail level and for renewables.	Prices have decreased, in particular for industrial customers.	More freedom of choice for customers, but relatively low rate of switching in reality. However, many customers have renegotiated prices.		Higher level of productivity.
Natural gas	Regional legal monopolies replaced by oligopoly at retail level, duopoly remains at import level and generally monopoly in transport.	Prices have developed in line with prices in other European countries. No relative decline.	More freedom of choice for customer; customers have renegotiated prices. However very low rate of switching in reality.	Wages still above average; employment decreased.	Increase in productivity.
Insurance and banking	Competitive market, with trend towards consolidation and mergers.		Improvement of service level due to ICT applications.	Negative employment effects.	Increase in productivity.
Railways	Increasing intramodal competition in the freight market; increasing competition for the provision of (subsidised) local passenger services; beginning intramodal competition for long distance passenger services.	Output by and large constant in the freight market with probably declining prices and declining market share of rail transport; output increase for local services even prior to public tenders, with partially shrinking subsidies per train kilometre; output by and large constant in the market for long distance passenger services. Successful entry of one competitor.	Improvement of service level due to ICT applications. Service level is generally good, so is reliability. Significant improvements of service level for local services.	Negative employment effects.	Increase of productivity.
Air transport	Competitive market.	Decreasing prices and new entry of several carriers.	Service level is good, as well as reliability.		
Road transport	Many small suppliers. Competitive market for road haulage.	Decreasing prices.			
Postal services	Partial monopoly.	Prices slightly falling in real terms.	Limited choice for customer, apart from courier services.	Decreasing employment.	Productivity increase.
Pharmacy	Potentially competitive.				
Retail sector	Competitive market.		Increased service level due to liberalised opening hours.		

Source: OECD.

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