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The tax shift that could give Germany a lift

By Lars Calmfors
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The stagnation of the German economy is the most pressing macroeconomic problem in Europe. It is not a problem only for Germany but for the European Union as a whole. The German economic crisis will do little to encourage Britain, Sweden and the accession countries to join the euro.

There is a broad consensus that Germany has a long-run growth problem because of supply-side rigidities that have contributed to excessive real labour costs. This has resulted in unacceptably low levels of long-term growth and equilibrium employment. The recent proposals of Gerhard Schröder, the German chancellor, are therefore a welcome first step to make labour markets more flexible. There is an urgent need to reduce the generosity of unemployment, health insurance and pension benefits and to soften job protection legislation that helps unions maintain high real wage levels. Relative wages must to a larger extent reflect local conditions, and that means a more decentralised wage-bargaining system.

But it is simplistic to focus only on supply-side rigidities. There is also a serious cyclical problem caused by a shortfall of demand. This is very much related to a misaligned real exchange rate because the D-Mark was converted to the euro at the wrong rate. The effective revaluation of the D-Mark in the early 1990s was a proper response to the post-unification boom. But the revalued exchange rate, which later became the conversion rate to the euro, today gives Germany unnecessarily high labour costs relative to the other eurozone countries.

This disadvantage was to some extent offset by the earlier weakness of the euro, which helped maintain German competitiveness against countries outside the eurozone. But the appreciation of the euro over the past six months means that the competitiveness problems will now hit Germany with full force.

If monetary union had not existed, the obvious way to reduce Germany's relative costs would have been a devaluation. As this is no longer possible, the real exchange rate versus the other euro countries has instead depreciated through lower nominal wage growth. Over the past six to seven years, annual nominal wage increases in Germany have been more than half a percentage point lower than the eurozone average. But this is a very slow way of adjusting which requires a painful period of high unemployment.

The adjustment process is slow because nominal wages are rigid downwards. Europe's experience shows that it is difficult to reduce nominal wage growth below 1.5-2 per cent. The problem is exacerbated by low inflation in the whole eurozone. It would help if the

European Central Bank had an inflation target of, say, 2.5 per cent, instead of somewhere below 2 per cent.

So what should Germany do? One possibility is to simulate the effects of a currency devaluation through a so-called internal devaluation - a reduction of the payroll taxes paid by employers. Cutting the payroll tax rate by 5-10 percentage points would at a stroke boost Germany's competitive situation and shortcut the adjustment process. It would be hard to finance a payroll tax rate cut on this scale through public spending cuts. So to avoid a further deterioration of the government budget, it would have to be paid for by higher taxes on employees, such as income tax, social security contributions or value-added tax. Such a tax shift would accomplish a similar switch of expenditure from foreign to domestically produced goods as a devaluation of the D-Mark would have done.

In Scandinavian countries, "internal exchange rate" changes have for a long time been considered as an alternative to a conventional devaluation and they have at times been used. In a currency union, this measure is the only quick way of adjusting real exchange rates. It is also an instrument that does not con- travene the rules of the stability pact.

A possible drawback of an internal devaluation is that it could take some time before the positive effects on output and employment are felt. Therefore it might not be appropriate to counteract a short-term lack of demand in this way. But it is a suitable instrument to correct a fundamental misalignment of the real exchange rate.

One should not view an internal devaluation as a substitute for structural reform. Germany needs both. Supply-side reform is needed to raise the long-run growth potential. A fast reduction of payroll taxes is required to speed up the necessary adjustment of the real exchange rate. If Germany is to get out of its unemployment trap, its government should seek to build a consensus for such a two-pronged approach.

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