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DEREGULATING THE GERMAN ECONOMY

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PREFACE

The International Center for Economic Growth is pleased to publish *Deregulating the German Economy,* by Juergen B. Donges, as the fifteenth in our series of Occassional Papers, which features reflections on broad policy issues by noted scholars and policy makers.

In this paper, Dr. Donges discusses deregulation in one of the world's major industrial economies, Germany. The experience of Germany shows how important it is to continue the application of thoughtful economic policy at all times. Germany has one of the strongest economies in the world, yet it has not been strong enough to shrug off the weight of excessive regulation: from the 1950s to the 1980s, a decline in growth coincided with an increase in regulation. There are groups favoring regulation in all countries, no matter how developed or prosperous, and it is all too easy for policy makers to fall prey to the view that an economy can support, or even benefit from, a large number of regulations.

Dr. Donges brings his considerable expertise and experience as chairman of the German Deregulation Commission to this important topic, which will be of interest to policy makers and researchers in all countries, developing or developed, concerned with implementing good policy or deregulating an economy.

Nicolás Ardito-Barletta
General Director
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Panama City, Panama
February 1991

ABOUT THE AUTHOR

Juergen B. Donges is professor of economics at the University of Cologne, Germany, and codirector of the Institut für Wirtschaftspolitik in the same city. He is the chairman of the Deregulation Commission set up by the German federal government. Dr. Donges has served as an adviser to economic research institutes and government agencies in various countries, as well as to the World Bank, the United Nations Conference on Trade and Development (UNCTAD), the United Nations Industrial Development Organization (UNIDO), and other international organizations. His many publications focus on trade policy, development economics, economic growth and structural change, and the economics of European integration

JUERGEN B. DONGES

Deregulating the German Economy

In most Western industrial countries, the deregulation of economic activities—particularly the removal of barriers to market entry and exit, the decontrol of prices, and the liberalization of investment decisions—has become an important component of domestic public policy. Deregulation ensures that the liberty of the individual, as guaranteed by every democratic constitution, can also be exercised in the marketplace. Moreover, deregulation improves the functioning of markets and strengthens competitive forces with a view toward enhancing dynamic efficiency and economic welfare. At stake is the elimination of serious microeconomic rigidities stemming from inappropriate interventions by governments or self-regulating bodies. Consequently, deregulation is one of the pillars of the supply-side policies that came into increasing use in the 1980s, after widespread disillusionment with the capability of Keynesian macroeconomic policies both to tackle the problem of the productivity slowdown and high unemployment and to secure international competitiveness of the domestic economy in the context of a progressive globalization of markets and production.

The most radical deregulation initiatives have been pursued in the United States in the late 1970s and early 1980s (Derthick and Quirk 1985; Niskanen 1989). In Europe, Great Britain was the front-runner, combining the deregulation of markets with the privatization of public companies (Yarrow 1986). Germany has joined the deregulation movement only recently;[1] the federal government has taken steps to expose some sectors—such as domestic air transport, cross-border trucking, telecommunications, insurance companies, and stock market activities—to greater competition. Furthermore, rigid labor-market legislation has been relaxed, and retail shopping hours have been expanded. To date, Germany's regulatory reform has been rather limited, even in the reformed areas. Other important sectors that are subject to rigorous regulation—such as the electric power industry, railways, craft trades, many liberal professions, and rental dwellings—remain unscathed. In 1990, however, the federal government announced, in the Economic Report to the Bundestag, its intention to further reduce or eliminate market regulations. The Deregulation Commission, which was set up by the government in 1987, has been requested to make pertinent proposals.[2] Needless to say, deregulatory actions taken in the future will be applied to East Germany too, after reunification with West Germany in October 1990. For a country that has had a centrally planned, socialist economy for forty years, the scope and depth of deregulation—as well as privatization, which is bound to take place—is unparalleled throughout history.

The obvious challenges in East Germany apart, it is not always well understood abroad why there should be a need for extensive regulatory reform in West Germany. After all, the Federal Republic is often thought to resemble the textbook model of a market economy. Its macroeconomic performance has been remarkable both by historical standards and by comparison with other industrial countries.

It is true that since the fundamental monetary and economic reforms of 1948, which paved the way for rapid economic reconstruction, discussion about economic policy in West Germany has been dominated by the market economy philosophy, independent of the rul-

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1. Although the topic of this paper is deregulation in Germany, it should be recognized that the history of the regulations under discussion is entirely *West* German.

2. A first report by the Deregulation Commission (quoted hereafter as DRC 1990) with proposals for deregulation of the insurance industry and the transport sector was submitted in March 1990 (see Appendix).

ing political party. It should be noted, however, that by no means were all regulations abolished after World War II; on the contrary, many regulations that had been implemented early this century (as in the insurance industry) or during the 1930s (as in the energy sector, trucking, and craft trades) were taken over by the Federal Republic. Moreover, new regulations abounded: in retailing, for instance, with strict closing hours; in the labor market, with nationwide mandatory minimum wages, strong protection of workers against dismissal, and considerable severance pay to laid-off workers; and in many liberal professions, with restrictive statutory requirements. Although the German antitrust law of 1957 established as a general principle the prohibition of cartels and other competition-limiting agreements, some sectors have explicitly been excluded: agriculture and forestry, coal mining, iron and steel, transportation, telecommunications, insurance, banking, and public utilities. Over the past four decades, the scope of regulation has broadened considerably in some areas of the German economy. Regulation of the growing service sector has been particularly severe, and this will likely have adverse long-term consequences for the entire economy, because services are key inputs into most sectors of the economy. As Donges and Schatz (1986) have shown elsewhere, only half of the West German economy operates according to market principles. The state interventions in the market may be less comprehensive in Germany than in most other Western European countries, but German governments, as well as other countries' governments, have found it difficult to resist the demands of well-organized interest groups for maintaining or strengthening regulations.[3]

As for macroeconomic performance, it is respectable indeed, but there is no reason for complacency. The rise of regulations was paralleled by a secular loss of dynamism in the economy. The growth rate of potential output followed a downward trend: it was highest in the 1950s (6 percent a year), lower in the 1960s (4 percent), and lowest in the 1970s and the first half of the 1980s (2 percent). The capacity of the economy to adjust to changes in comparative advantage, changes derived from technological advances and the emergence of new competitors on

3. For a detailed overview of the system of regulations in Germany, see Soltwedel et al. (1986) and Krakowski (1988).

the world market, diminished. A one-time full-employment economy, which even had to import labor during the 1960s and early 1970s—as much as nearly 10 percent of the labor force in 1973—has been experiencing a recalcitrant pattern of high unemployment since the mid-1970s. This pattern continued into the second half of the 1980s, with 8 to 9 percent unemployment concentrated on specific groups. Although not all economic problems that afflict the German economy are due to regulations or other state interventions, such as public subsidies and import protection, many are, particularly the delays in the much needed structural adjustment of the economy.[4]

Consequently, it is worthwhile to rethink regulation in Germany. It is necessary to detect the circumstances in which deregulation seems appropriate or will strengthen the capacity of the economy to cope with the challenges ahead, both inward (e.g., the reunification of West and East Germany) and outward (e.g., completion of the single market in the European Community). The purpose of this paper is to clarify some major aspects of regulatory policies and reform. The next section examines the rationales and motivations for regulation. Subsequently, the reasons for deregulation are discussed. Recent deregulatory actions in West Germany are reviewed in the ensuing section, and in the final section the scope for further German deregulation is considered.

The Rationale for Regulations Reassessed

In Germany, as in other countries, two broad categories of regulation have to be distinguished. One category encompasses all regulations that are *basic* for the smooth functioning of the market mechanism and the fruitful coexistence of people in a growing economy. Important examples include private property rights and rights of disposal, commercial law, antitrust law, civil and criminal law, certificates of qualification, safety legislation, social security, and environmental standard

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4. Analyses of the long-term pattern of economic development in West Germany are provided by several studies of the Kiel Institute of World Economics, such as Fels, Schmidt, et al. (1981), Wolter (1984), and Donges, Schmidt, et al. (1988). See also Lipschitz et al. (1989).

setting. In strict economic terms, these regulations are sensible and are applied to everybody. These basic regulations help to save transaction costs and are not to be the object of deregulatory policy, required amendments notwithstanding.

The other category concerns *special* regulations aimed at specific industries, companies, or markets, irrespective of the effects on unregulated activities and the general public. The regulatory instruments that are typically employed are restrictions on market entry and exit, price and profit administration, investment and output controls, compulsory terms of contract, and commonweal obligations (gemeinwirtschaftliche Pflichten). Special regulation is also applied through public ownership, for example, railways, air transport, post and telecommunications, and electric utilities. As competition is reduced, such special regulations can be justified from an economic standpoint only if the social benefits exceed the social costs (costs to the consumer). As this cannot be taken for granted, special regulations must come under scrutiny, and if need be, they should be eliminated or replaced by more efficient regulations.

Market-failure arguments. Much of the specialized regulation is motivated by the notion that in particular circumstances competition is either not possible or, if possible, not conducive to an efficient allocation of resources. These are instances of market failure, which have long been the focus of the normative theory of regulation (Kahn 1970, 1971; Joskow and Noll 1981). According to this theory, the government, or authorized private bodies, can remedy, that is, regulate, the market failure and thus secure maximization of overall economic welfare. The current debate on regulation and deregulation in Germany also revolves around so-called sector-specific peculiarities as sources of market failure. The Deregulation Commission (1990) found five types of peculiarities, of which one is associated with noncompetitive markets and the other four with competitive markets, to be the most prominent in the debate.

The first refers to the existence of *natural monopolies*. These arise when a single firm is able to produce, because of economies of scale or economies of scope, any level or any combination of output at a lower cost than multiple firms can. In this situation, competition is not possible at all and regulation, usually some form of price regulation, is necessary in order to avoid monopolistic behavior. In return, "cream skimming" is prevented by protecting the incumbent firm from potential entry. The industries most commonly believed to be natural monopolies are those that operate transport or communications networks: railways, air traffic control, phone companies, and other utilities.

Second, in competitive markets, a special situation is ascribed to *destructive competition*. This occurs when heavy fixed costs, or high costs specific to the investment (sunk costs), deter firms from adjusting production capacities in periods of low demand, in the hope that demand will pick up soon, and induce each of them to price other suppliers out of the market. In some sense, competition is always destructive—it drives away the relatively less efficient suppliers. This selection is economically desirable; however, economic problems arise when long-term excess capacity in the industry is not scrapped or when, irrespective of whether or not capacity is adjusted, the surviving firms are not the most efficient but are just financially strong enough to buy up the others, whereby industrial concentration increases. Industries thought to face economically undesirable destructive competition include truck transportation and inland navigation. It allegedly also happens, though for other reasons, in the insurance industry, in craft trades, and in the liberal professions, as well as in the labor market that, left alone, is supposed to be subject to so-called dirty competition at the expense of workers. In all these cases market entry regulation, supplemented in the labor market by exit regulation, is considered as the most appropriate tool in remedying the market failure.

Third, competitive markets may also fail when the conclusion of a particular contract has a large information content regarding the quality, safety, and other distinctive features of the good or service being provided and when consumers either are less knowledgeable than producers or can obtain appropriate information only at prohibitively high costs *(asymmetric information)*. Here the problem is seen as the danger that consumers may make rash purchasing decisions, buying the cheapest good or service without recognizing that the quality is lower than desired, which allows inefficient or even fraudulent suppliers to remain in the market undisturbed. The result is adverse selection in the marketplace. The insurance industry is often cited as a case in point:

individuals and small traders are thought to be unable to undertake cost-benefit comparisons for the insurance products they are interested in, which almost inevitably leads to inadequate insurance coverage; insurance companies are thought to be unable to independently calculate cost-covering premium rates, which seduces them, when fixing premiums, into an underestimation of future claims. Advocates of regulation of the insurance industry often state that policyholders will be negatively affected unless government regulation remedies the information asymmetry, preferably through price controls and the setting of standards for the content of the contracts. Curiously enough, this need for regulation has not been claimed for the transport-related insurance and the reinsurance business.

Fourth, in connection with contracts, especially with their interpretation, a market failure may be engendered by what Williamson (1985, 1987) has called *opportunistic behavior* by one of the contracting parties. The main issue to be considered here is that many long-term contracts are written in an incomplete manner because of the impossibility of both specifying all details in advance, including provision for all contingencies, and strictly supervising and enforcing at a reasonable cost the fulfillment of the agreement, including appropriate adaptations of the contract to changing circumstances. In such a situation one of the contracting parties may be tempted to exploit the honesty of the other. In order to avoid opportunism of this kind, some form of conduct regulation seems to be required. The most frequently used examples are insurance legislation and industrial law, including legislation on workers' codetermination in private enterprises.

Last but not least, *externalities* are a familiar source of market failure in the production or consumption of a good or service. An externality can be positive (e.g., public goods) or negative (e.g., pollution and bank and insurance insolvencies). Depending on the variety of externality, benefits conferred, or costs imposed, on the whole community through production or consumption are not reflected in the market prices. Left alone, market forces would supply too little or too much of the commodity in question. To the degree that there is nonrivalry and nonexclusion, there is a prima facie governmental role in providing such public goods as national defense, police, courts of justice, and infrastructure. Such negative externalities as pollution have been used to justify public environmental management of the command-and-control variety. To avoid the potentially negative side effects of bank and insurance failures, various regulatory tools have been established: professional qualification requirements for management, capital and disclosure requirements, limitations on types of investment, prescriptions about portfolio composition, and continuous monitoring of the companies' financial health, among others.

The rationale behind specialized regulation sounds plausible. Economic theory has provided a convenient basis for shaping and implementing regulatory policy. Much of this rationale, however, has been called into question for the following reasons:

- Basic assumptions of traditional theoretical models do not hold unambiguously in the light of new theoretical insights and empirical evidence.

- Many regulations, as actually applied, have high costs, which are imposed on both the regulated sector and other activities and individuals. These costs are ultimately borne by the consumers at large, and the regulations may not yield any net benefits—this is regulatory failure.

- The potential is great for increased competition in areas formerly thought to be subject to market failure.

- Situations that are viewed as examples of market failure are, in fact, often cases of government failure.

To put it in another way, the ability to model a market failure, often making quite restrictive assumptions, does not say anything about the importance of such a market failure in reality; and it does not say anything about whether the kind of regulation chosen is the most efficient, or if it happens to be so, whether it should be retained permanently. The Deregulation Commission (1990) has examined the new theoretical analysis of regulation and has evaluated the evidence from recent empirical research on both the demand and cost functions in regulated sectors and the effects of deregulation where it was under-