



The growth potential of Germany

Only more working hours can overcome Germany's economic slump

Dr. Michael Heise on Global Economics

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Future economic performance depends on an old-fashioned factor: labor. Without additional employees, longer weekly working hours, and better incentives for full-time work, German growth is likely to remain weak. The problem is that increasing labor input requires nothing less than an economic policy U-turn — and time is running out.



The growth trend of the German economy has been declining for decades. Current calculations, such as the joint diagnosis by economic research institutes, show that growth adjusted for economic fluctuations and achievable in the medium term will average just 0.3% per annum in the coming years until 2030.

This would have consequences: if this rate of so-called potential growth cannot be increased, there will be further shortfalls in tax revenues and social security contributions, and tough cuts will be necessary in other spending categories in view of the necessary expenditure on infrastructure and defense.

The government has already set the right goal

To get out of this 0.3 percent dilemma, the government has rightly set itself the goal of increasing medium-term growth. Although no exact figure is mentioned in the coalition agreement, various parties involved in the negotiations spoke of 1 percent by the end of the decade. Admittedly, such a target does not seem particularly impressive in numerical terms. In fact, however, it requires nothing less than a reversal of the trend in the development of the volume of working hours and investment activity.

This becomes clear when you look at the drivers of growth: labor, capital, and technological progress. Current calculations predict a more or less sharp decline in the trend volume of working hours in Germany by 2030. The “production factor labor” therefore tends to represent negative growth. Calculations using the modified EU method show a negative contribution of the volume of working hours to potential growth of -0.2% per year on average.

Retirement of the baby boomers

This is based on the assumption that the working population of around 63 million people will decline slightly in the coming years, partly due to the retirement of many baby boomers. The large number of people retiring also means that labor force participation, i.e., the number of people of working age who are actually available for the labor market, is hardly increasing at all.

If efforts to increase labor force participation and significantly reduce the unemployment rate are unsuccessful, a reversal in the trend in working hours can only be achieved by increasing the number of hours worked per employee. Annual working hours per employee in Germany have been declining for many decades and,

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Page 2

at around 1,340 hours, are well below those in other countries (for comparison: USA 1,680 hours). In the long term, this reflects a reduction in weekly working hours and a significant increase in the proportion of part-time employment, particularly among women.

How can a turnaround in working hours be achieved?

There are basically several ways to adjust the economic policy. First, it would be important to increase the employment rate among older people and recipients of basic income support ("Bürgergeld") – instruments such as the active pension ("Aktivrente") and stricter reporting requirements for basic income support recipients at job centers should serve this purpose. However, it is questionable whether these measures alone will have a significant effect.

There are also starting points in terms of average working hours. Longer weekly working hours would be one possibility. Another important factor is improving incentives for full-time employment, especially for women. In middle-income groups, the change is often not financially attractive because progressive taxation reduces the increase in income and social benefits are lost. The issue of childcare is also important for increasing full-time employment in Germany.

In addition to increasing the supply of labor, it is also necessary to increase the demand for labor. There are still a large number of unfilled vacancies – officially reported vacancies alone number 660,000. In the long term, however, it is necessary for growth to increase the demand for labor in companies. This in turn requires better business conditions, otherwise the massive decline in employment, which is particularly evident in industry, will continue.

And if the turnaround fails?

Increasing the volume of work is the key factor for more growth in the coming years. If the downward trend in the volume of working hours in Germany cannot be stopped, it will not be possible to raise medium-term growth back to 1%. It is possible to promote the accumulation of capital stock by improving the economic environment for investment and structural reforms, but these are longer-term processes.

Measures such as depreciation allowances and increased government infrastructure spending are aimed at boosting private investment. But even if they are successful, investment will only slowly improve productivity and the growth of capital stock: The institutes' projections assume an end to the decline in investment

and a slight increase. Nevertheless, the contribution of capital to production output will hardly increase. It will take many years of higher investment to restore significantly faster growth in the national capital stock. From this perspective, there is no way around expanding the total volume of working hours.

Can technological progress help?

Many are placing their hopes in the growth effects of technological progress, a key area of research that has recently been recognized with Nobel Prizes for significant research achievements. Nevertheless, projections of the German economy's growth potential estimate that technological progress, which increases production and income based on a given level of labor and capital input, contributes an average of just 0.2% per annum to growth.

This contribution can certainly be increased significantly in the medium term, but in the short term, the options available to policymakers are limited. Greater digitalization, targeted research funding, and better financing conditions for innovative start-ups are all important prerequisites for high levels of innovation, but they are not simple and quick-acting policy levers.

Conclusion: The "autumn of reforms" should not be wasted

The sobering conclusion of numerous analyses is that there is little prospect of higher growth until the end of the decade. According to the figures in the joint economic forecast, production potential will increase by an annual average of only 0.3% in the years up to 2030. The contributions of capital (0.3%) and technological progress (0.2%), which cannot be easily changed in the short term, contribute to growth, while the volume of labor is developing negatively and thus contributing to a decline in production (-0.2%). A reversal of this trend is necessary if the federal government wants to achieve potential growth of 1% in the foreseeable future.

There are many starting points: better employment conditions for companies, greater labor force participation among older people (pension policy and tax policy) and welfare recipients (social policy and employment policy), and fewer part-time workers (tax and social policy, daycare and other childcare services for families) would be measures that could take effect relatively quickly. It would therefore be important for the so called "autumn of reforms" to produce something substantial after all.

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