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DEREGULATING THE GERMAN ECONOMY

Juergen B. Donges

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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
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Panama City, Panama
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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-

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

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 undertaken (drawing on the experience of the United States to a large extent).[5] Key insights include the following.

Industries with natural monopoly characteristics are not all subject to economies of scale and scope over the entire range of their output. More often than not it is possible and efficient to separate the networks, where regulation is justifiable, from other operations, which can be opened to competition. Examples of the latter are found in the telecommunications industry, which was long considered to be the most prominent case of a natural monopoly as a whole. Competitive areas are the production and sale of terminal equipment and the supply of long-distance services and value-added network services (such as teletext, data exchange, or electronic mail). In the electricity industry only the transmission of electricity through high-tension mains, not its generation and distribution—except deliveries through low-tension mains—may constitute a natural monopoly. In railways, transport service can be supplied by a number of competing carriers. In all the above cases, economies of scale by one company are exhausted at an output level that is a relatively small portion of the size of the market; sometimes, economies of scope are appreciable, but not sizable enough to deter new competitors from entering the market.

Even where a natural monopoly exists, there is not always a compelling need for heavy regulation, especially barriers to entry. If competition *within* the market is not possible, competition *for* the market frequently is. A competitive environment can be established through franchise bidding schemes in all areas where the activity can be clearly specified. All interested firms would be allowed to bid on the right to provide a particular service under certain conditions fixed by the contracting authority, and the license to undertake the activity would be awarded to the highest bidder or to the one requesting the lowest subsidy. The competitive incentives can be kept strong if the contracting out is repeated periodically. It must be recognized that some activities—such as road passenger transport and electricity delivery to households—require relatively large investment, and the time period for the contract must be long enough to allow the licensed firm to

5. For an overview, see Pera (1989), in addition to Soltwedel et al. (1986), Krakowski (1988), and Horn, Knieps, and Müller (1988).

recover its assets if it has to leave the market because a rival wins the contract when it is due for renewal.

A great potential for increased competition in industries subject to regulation lies in the *contestability of markets* (Baumol, Panzar, and Willig 1982). If market entry is free, the incumbent cannot adopt monopolistic investment, output, and price decisions, because of the risk of being driven out by new competitors. Rapid technical change, especially the dissemination of modern information and communication technologies, has increased the contestability of industries. At the same time, the importance of sunk costs as entry and exit barriers has declined. The whole transport sector is a case in point.

In a number of regulated sectors, competition by new entrants can be sustained without becoming destructive. Short-term and long-term marginal costs do not differ as much as claimed by the advocates of price and entry regulation; differences are in line with those observable in other, nonregulated industries. Road transportation, inland navigation, insurance activities, craft trades, and liberal professions are all characterized by a competitive structure that ensures efficiency. In the labor market, free entry and exit set effective boundaries to temptations of undertaking dirty competition at the expense of workers and competing firms.

The problem of asymmetric information, and of opportunism rooted therein, can be alleviated significantly through spontaneous solutions generated in the marketplace. One example is the advice provided by brokers and agents, lawyers, consultants, and other specialists. There is also continuous reporting about the quality of a good or service by consumer associations and the media. Competing for reputation induces suppliers to strive for good quality. Intense competition among suppliers in any case effectively protects consumers against cheating, even consumers who are not able or not willing to look for more information. To make this consumer protection even more secure, the government can complement the market solutions by requiring that suppliers accurately and regularly inform the general public about, for example, performance and financial status, meet mandated minimum quality standards, assume product liabilities, and so forth (such measures must not be misused as entry barriers). In especially sensitive areas, such as insurance, consumer (policyholder) protection can be further strengthened by enforcing strict requirements as to management competence, financial integrity, and continuing solvency.[6] Fraudulent activities may nevertheless occur; however, it is not for the regulatory authorities to fight them, but for criminal prosecution, as in every business.

Negative externalities can be internalized in a number of cases. This holds for environmental problems such as air and water pollution. There are basically two ways of using price incentives to control emissions: one is to implement some kind of emissions tax, the other is to create markets for the trading of rights to pollute between firms within the global pollution ceilings placed by the authorities. Thereby, environmental goods are no longer free goods that everybody can use excessively. The costs that producers would impose on the public will be adequately reflected in their own costs, providing a stimulus to reduce those costs. Both approaches increase the economic efficiency of pollution control; the emissions-trading approach may be the more efficient in achieving the desired environmental quality, since the fixing of an emissions tax to obtain the same result can present difficulties given the insufficient information on the tax-responsiveness of polluters.

Public concerns. These insights are so important and pervasive that much caution should be exercised when specialized regulation is requested on the grounds of market failure. It seems that the advocates of regulation are aware of the pitfalls of the traditional reasoning, as they frequently emphasize public concerns in defense of the current regulatory status quo. The economic rationale for specialized regulation is

6. The recent financial debacle of both savings and loan associations and insurance companies in the United States serves as a warning example for deregulation of the German insurance industry. Serious policy mistakes in the United States led to instances of moral hazard; deregulation elsewhere must not make the same mistakes. Especially harmful were the decisions to lower the companies' own capital requirements (thereby giving managers incentive to engage in risky and speculative investments) and to raise the ceiling on deposit insurance (thereby reducing the incentive for depositors to watch the business and financial soundness of their bank or insurer). See President's Council of Economic Advisers (1990) and U.S. Congress (1990) for details.

supplemented with, or replaced by, a public interest rationale. In Germany, frequent reference is made to

- regional and distributional objectives to justify the regulation of the transport sector and the telecommunications industry, including enforced cross subsidization to allow these industries to supply specific outputs or to service selected groups of consumers at below-cost prices

- ensuring a regular supply to justify electricity, coal mining, and agriculture regulation

- protecting bank depositors and insurance policyholders to justify banking and insurance regulation

- protecting individuals and businesses from bunglers and dolts to justify the regulation of craft trades and many liberal professions

- protecting the general public from technological risks to justify the regulation of technical inspection services, especially those on the safety of motor vehicles and industrial installations

- ensuring road traffic and air transport safety to justify trucking and airline regulations

- guaranteeing the reliability of network structures to justify the regulation of telecommunications and electric utilities

- securing "social peace" in industrial relations to justify labor market regulation

It goes without saying that political motivations for specialized regulation are legitimate in a democratic society. Many Germans, to be sure, do not object to prevailing regulations because they support the goals that regulators are apparently concerned about. There is a strong belief that such regulations have been beneficial, and many people are even skeptical of deregulation initiatives, if not in outright opposition to them. The heated discussions that recently took place in connection with a modest liberalization of store hours, the reorganization of the federal post office jointly with some deregulation of telecommunications, and the partial relaxation of labor market regulations are cases in point. The well-organized interest groups, which are the special beneficiaries of regulation, are quite clever in disguising their true goals by vigorously arguing that the public interest is served by regulation. Clearly, policy makers, who want to be reelected, tend to accommodate their constituents' concerns by maintaining specialized regulations or by reversing them only slowly.

Costs of regulations. Irrespective of whether specialized regulations are justified by instances of market failure or by public interest, the regulation may do substantial harm to large groups of the population rather than being advantageous to them. Four points should be noted:

First, when competition is restrained, the regulated sector usually has less diversity of goods and services than both firms and consumers would like, higher costs and prices than under conditions compelling an efficient utilization of resources, slower technological innovation and structural change than is necessary, and fewer new firms and jobs created than would otherwise be the case.

Second, specialized regulations can have undesirable side effects. Most commonly they arise in the form of illegal or underground activities such as the trading of operating licenses on black markets, disguised discounts on mandated prices, and the appointment of straw men to get licenses for regulated activities. Instances can be found in road transportation and craft trades. Another undesirable side effect can be observed in the labor market, where a number of regulations regarding wage-setting and dismissal procedures have come to artificially inflate labor costs, especially for low-skilled or wrong-skilled workers. Consequently, job seekers find employment with difficulty and can remain unemployed for long periods of time.

Third, it cannot be taken for granted that specialized regulation is consistently effective in attaining established objectives, be these industry specific or in the public interest. A striking experience with regulatory failure has been the German Federal Railway (Deutsche

Bundesbahn). Although this public company has been sheltered from intermodal competition by subjecting the trucking industry to entry regulation and the national airline (Lufthansa) to minimum fare regulation, it has continuously lost share in the domestic transportation market, both freight and passenger transport, over the past decades, and year after year it has required subsidies amounting to billions of deutsche marks (DRC 1990, ch. 3).

Finally, regulations generate excess costs. On the one hand, there are direct government outlays for the pursuance of the regulation; these outlays, which mainly represent salaries to be paid to the administrative staff, have to be borne by the taxpayer. On the other hand, interest groups invest resources—lobbying, financial contributions to political parties—to get a favorable regulation, which then generates producer rents and labor rents in the regulated sector; these investments are a waste of resources.

It is difficult, perhaps impossible, to quantify accurately these effects of specialized regulations. Certain problems in regulated sectors might have emerged anyway as a result of changes in the macroeconomic environment and technological developments. Moreover, the information on the demand and supply functions at the firm level is often fragmentary, and the available general equilibrium models are generally not suited for isolating the effects of a specialized regulation on both the affected sector and the global economy from the impact of other policies. Nevertheless, what we found in the academic literature on the subject, what we learned in the hearings of the Deregulation Commission and what we, and anybody else, can experience in reality is straightforward: the regulatory policy represents, at best, a mixed blessing for the economy. Doubtless, the economywide impact of specialized regulations is harmful and must not be belittled; not every single regulation needs to cause concern, but the whole regulatory system with its cumulative effects clearly does.

Reasons for Deregulation

The case for deregulation of economic activities in Germany rests upon the recognition that much of the prevailing specialized regulation is unnecessary, excessive, or inefficient and is incompatible with a forward-looking, market-oriented policy that enhances the dynamic forces in the hitherto regulated sectors as well as the rest of the economy. Such dynamic forces will be necessary in the 1990s for a number of reasons.

Notwithstanding a good macroeconomic performance in recent years, deeply rooted structural weaknesses prevail. These are partly sector-specific (agriculture, coal mining, iron and steel, and shipbuilding for example) and partly regional (the continuing imbalance between the leading south central and the lagging northwest regions of the Federal Republic).

Labor unemployment remains relatively high. It is concentrated on specific groups such as young (up to 25 years old) or senior (55 years and older) workers, low-skilled labor, women, and the handicapped. Long-term unemployment (one year and longer) accounts for one-third of total joblessness. At the same time, many firms have difficulties filling job vacancies, particularly those requiring highly skilled workers.

There is an irresistible and growing sensitivity in German society to environmental issues. Consequently, more resources will have to be devoted to ecologically sound production and products. This calls for enhancing economywide efficiency.

The reunification of Germany will require a great deal of capital in the formerly socialist East to modernize ill-equipped industry, repair decayed dwellings, improve overall housing conditions, build up an efficient economic infrastructure, and rehabilitate a polluted environment. Much of this capital is to be provided by West Germany. In addition, considerable public financial transfers to the East will have to be effected in order to establish a social security system and to provide adjustment assistance to trade-impacted firms. A government German Unity Fund, which is to finance fiscal transfers amounting to DM 115 billion during the period 1990–94, has already been set up. January 1991 estimates are that the budget deficit will reach DM 150 billion in 1991 (roughly 6 percent of GNP) as a result of German unity.

The completion of the single market in the European Community (EC) by the end of 1992 will imply that sector-specific barriers to entry be eliminated or reduced to an agreed common minimum level (Donges 1990). This will expose firms in currently regulated sectors to greater competition; the power of dominant firms will be more easily contested. The creation of a European Economic Space, to be negotiated between the EC and the European Free Trade Association, would strengthen competitive pressures.

Beyond the Single European Market, and eventually, the European Economic Space, international competition will be accentuated because of worldwide changes in comparative advantage. The newly industrializing countries are in a position to further diversify their export assortment to include an increasing variety of high-technology products. Other developing countries, and now also the reform-ready Eastern European countries, which shape their development strategies around export-led industrialization, will exploit comparative advantage through interindustry specialization in their trade with Germany and with other industrial countries. Adjustment pressures to imports from lower-wage countries will, therefore, not abate.

The globalization of markets and production has acquired a strong momentum through the liberalization of international capital flows, which has substantially increased capital mobility, and through technological advances, which have significantly reduced information and transaction costs, thereby amplifying the scope for a profitable geographic separation of a company's research and development activities from its production. As a result, countries increasingly compete with one another not only as suppliers of goods and services, but also as locations for internationally mobile resources.

With these challenges ahead, the German economy must strive for a flexibility of product and factor markets and a capacity for a high rate of sustained growth. Deregulation could help to accomplish this. Admittedly, the effects of deregulation, especially the dynamic and economywide effects, can generally not be forecast. The reason for this lies in the nature of competition—what Hayek (1968) called a *process of discovery*—the channels through which deregulation works and spills over to the rest of the economy are intricate. Nevertheless, the experience with deregulation in other countries is, on balance, encouraging (Horn, Knieps, and Müller 1988; OECD 1989): the allocation of resources improves, installed production capacities are expanded and new ones created (along with new jobs), labor productivity increases, creative innovation is spurred, consumers' choices are widened, and costs and prices are driven down. Despite deregulation, the regional, social, and other public interest objectives commonly associated with regulatory action (as mentioned above) can be achieved, though using different, more appropriate policy instruments. Germany could experience a repeat of such experiences, and if it were only because of the fact that in nonregulated markets, competition, especially competition of new entrants, has invariably enhanced efficiency, boosted international competitiveness, and fostered growth.

Recent Deregulatory Measures

The Kohl government has taken, over recent years, several steps toward deregulation. The most important measures are in the areas of telecommunications, transportation, insurance, retailing, and the labor market.

The telecommunications sector has been reformed through the Post Office and Telecommunications Reform Act of 1989.[7] The former Federal Post Corporation (Deutsche Bundespost) has been divided into three entities—Post, Postal Bank, and Telecom. The latter now faces private sector competition for all telecommunication services, except basic telephone service, and customer equipment. Barriers to entry for value-added networks were lowered; for instance, a private consortium (headed by Mannesmann, a leading German mechanical engineering company) got the license to run its own network for cellular telephones in competition with Telecom's infrastructure in this field. Licenses for other networks, such as low bit rate satellite systems, are to be issued soon. It should be noted, however, that the telecommunications act has continued the state monopoly over the basic network and normal telephone service, in which Telecom makes 90 percent of its turnover, and that it is vague with regard to cross subsidization of competitive services from monopoly profits. Moreover, strict standards requirements prevail, which may favor domestic suppliers and discriminate against

7. This act broadly incorporates the proposals made by a special reform commission that the federal government established in 1985 (see Govemment Commission for Telecommunications 1988).

foreign producers. Apart from this, a fair amount of power still rests with the Post Ministry, so that the potential for political interference with the functioning of the market is great.

In the transportation sector trucking and airlines have been gradually opened, partly under pressure from EC law. In the trucking industry, the common quotas for free cross-border road haulage within the European Community were increased by 40 percent in both 1988 and 1989. Domestic road freight transport, however, has not yet been deregulated; nonresident carriers are not allowed to operate on the domestic market. With regard to scheduled air passenger transport, the entry of new carriers into intra-European regional routes was eased in 1983. In 1987 the so-called fifth-freedom rights have been expanded, permitting airlines to pick up or set down passengers en route between non-large airport cities of EC member states. Moreover, the scope for providing discount fares to passengers was broadened in 1987. Also, the traditional 50:50 predetermination of capacities in bilateral agreements between EC member states has been relaxed, although future increases in capacity continue to be subject to regulation (since October 1989, the rule is 60:40). In domestic air transport, access to routes continues to be reserved for national carriers, thereby ignoring the "eighth freedom of the air." New carriers competing with Lufthansa have been admitted since 1987, although the Federal Ministry of Transportation remains responsible for route licensing and fare setting.

Following the second council directive for non–life insurance of 1988, industrial, non–life insurance was partially opened to competitors from other EC countries in 1990. Nevertheless, the market for non–life insurance of private persons and the market for life insurance—the overwhelming portion of the insurance business—continues to be subject to severe regulation. The fifth amendment to Germany's antitrust law of 1989 has only slightly altered the preferential status that this law confers on the insurance industry: agreements between insurance companies are no longer exempt from cartel prohibition.

In retail trade, the 1956 Closing Act was liberalized in 1989, but only modestly. Shops are no longer required to close at 6:30 P.M. from Monday through Friday and at 2 P.M. on Saturdays, except at 6 P.M. on the first Saturday of each month. They are now allowed to remain open until 9 P.M. on Thursdays (Dienstleistungsabend), but on the first Saturday of each month during the summer they must close at 4 P.M. Options for consumers have improved slightly at best.

The labor market has been made somewhat more flexible (Employment Promotion Act of 1985, extended to 1995 in 1990). The scope for temporary and part-time contracts has been widened, as has the cost-effective employment of workers lent out by specific firms. Working time restrictions for young people also have been removed. Furthermore, newly created firms are now exempted from comprehensive severance pay obligations (Sozialplan) in cases of significant dismissals of staff. Nevertheless, the hard core of the regulatory system—the extensively binding features of collective wage agreements, the strong protection of labor against layoffs, the special treatment of handicapped workers, the restrictions on working on Sundays, and the state monopoly for employment exchange—has not yet been touched.

There are a few more deregulatory measures that all go in the right direction, but the pace of deregulation has been slow when compared with actions undertaken elsewhere. The measures adopted have generally fallen quite short of the proposals that various official commissions have made at various times.[8] Deregulation has yet to make substantial headway in unified Germany.

The Task Ahead

Although deregulation has thus far been only gradual and selective in West Germany, it is important to keep the momentum and speed it up as quickly as possible. Deregulation is not an end in itself, but an effective means of freeing individual creativity, stimulating private initiatives, and widening the range of options for consumers. Given the

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8. See, for instance, the annual reports of the Council of Economic Experts regarding energy (1983), road freight transportation (1985, 1988), telecommunications (1985, 1987, 1988), retail closing hours (1987), and the labor market (1987, 1988, 1989). The Monopolies Commission, in its main biennial reports, dealt with electrical utilities (1977), the insurance industry (1988), and the transport sector (1990). The Coal Commission (1990) made proposals for reforming Germany's coal industry policies.

growing interdependence in the world economy, Germany should catch up with the deregulatory moves that have taken place, or are currently under way, in other industrial countries that compete with Germany for both market share and the attraction of internationally mobile resources. In the medium run, Germany cannot afford to have more microeconomic distortions than those persisting abroad; otherwise, future growth potential would be impaired. Now that unification of both Germanys has become reality, this author would have preferred to see West German regulators resist the temptation to transfer existing specialized regulations eastward. As the formerly socialist country has already begun to convert its economy to market mechanisms, that is, to carry out a radical economic reform, it is counterproductive to "import" specialized, anticompetitive regulations from the West; for many East Germans, among whom the belief in the omnicompetence of the state still runs deep, such regulations will slow their familiarization with the operation of a market economy and hinder their ability to seize the welfare-increasing opportunities of the new system. Unfortunately, the entire regulatory system has been carried over to the east by virtue of the Treaty of Unity. Nevertheless, the government elected on December 2, 1990, is to consider at least temporary exemptions from specialized regulations in East Germany (for instance, in the labor market, craft trades, and liberal professions).

The Deregulation Commission has drawn up a number of guidelines for regulatory reform (DRC 1990, ch. 1):

- A specialized regulation is to be removed, relaxed, or modified if it is unable to correct a market failure, to further an overriding public interest, to reduce transaction costs systematically, or to assign property rights adequately.

- A specialized regulation is to be removed, relaxed, or modified, if its economic costs outstrip its expected or actual benefits.

- A specialized regulation that restrains or impedes competition is to be replaced by a regulation that is less inimical to market forces, if the latter also achieves the regulatory goal.

- A specialized regulation is not to be used in pursuit of regional and social policy objectives, for which there are generally more appropriate tools.

- A new specialized regulation is to be applied only temporarily. Older specialized regulations are to be subject to periodical review by the competition authorities (the Federal Cartel Office or the Monopolies Commission, for example).

- After deregulation, antitrust legislation is to be applied vigorously in the previously regulated sector in order to prevent the misuse of incumbent advantages to create artificial barriers against new entrants.

Guided by these principles, we have put forward a set of proposals for regulatory reform in two sectors having a long tradition of detailed state intervention in Germany: the private insurance sector and the transport sector. The Appendix provides an overview of the more salient recommendations. To translate them into action would require that the government fundamentally broaden the program of deregulation that it has so far applied to these two sectors. It should be noted that, depending on the particular case, regulatory reform does not just mean one-way deregulation, but can also mean some new regulation, provided that this new regulation addresses a market-failure problem in a cost-effective way. A case in point is the proposal of having standardized insurance contracts to cope with information asymmetries and opportunism. Another example is the creation of insurance guarantee funds to protect policyholders from insurers' failures, though not totally in order to maintain some incentive for policyholders to make the best choice among the companies offering a particular insurance. In the transport sector, a new regulation might be warranted to ensure that the negative external effects of traffic—pollution—are adequately internalized; technically, it is quite possible to do this.

There is considerable scope for approaching further sectors, of course. Economically rewarding targets for regulatory reform could be agriculture, coal mining, electric utilities, telecommunications, rental housing, craft trades, and the liberal professions—especially notaries, lawyers, tax consultants, certified public accountants, and appointed technical supervisors. For most sectors, we will submit proposals for deregulation shortly. The main problems stem from price controls, entry barriers, or both, applied by the regulatory bodies with varying avidity, whereas evidence about the existence of a market failure is confined to a few exceptional cases.

Despite the positive changes effected in recent years, the labor market is another area where existing regulations could be overhauled. There is still a complex system of collective wage setting, labor-market laws, and jurisdiction by the labor courts, which causes considerable rigidities in labor markets (Soltwedel 1988). Real wages and nonwage costs, as well as the level and structure of a firm's work force, cannot respond promptly to changing patterns of demand and technological advances. A few instances illustrate the basic problem: First, the dismissal of labor is so expensive, especially in the case of collective dismissal for economic reasons, that many firms are reluctant to hire new people, even when the business outlook is good. Second, the extensive dismissal protection discourages a takeover of a troubled firm by a healthy company, although this would save at least a part of the afflicted jobs. Third, dismissal protection reduces the incentive for employees to change occupations between firms and regions. Fourth, it is impossible for workers in declining industries to bid down wages with a view toward either keeping a job they would otherwise lose or getting one back if they are already unemployed. Fifth, unemployed young and low-skilled or wrong-skilled workers are prevented from pricing themselves into the market by voluntarily accepting standards below those set in collective agreements. Sixth, structurally weak regions within the German economy find it difficult to attract new investment because wage levels are frequently almost as high as in the more prosperous regions (interregional wage differentials do not adequately reflect interregional productivity differentials). And seventh, the transparency of job opportunities is lower than need be, as private professional services in this field are generally not allowed and the state employment agencies are not efficient enough—firms are more and more reluctant to request the free-of-charge assistance of these offices.

On the whole, it can be safely stated that a myriad of labor market regulations, which are applied in pursuit of well-intended social objectives, leads ultimately to unsocial results: The regulations benefit those who have a secure job and create considerable entry costs for those who are unemployed; deregulation could help to overcome such insider-outsider problems. Moreover, by increasing labor-market flexibility in a united Germany, deregulation would encourage West German companies to invest in the East, stimulate the start-up of new business there, and thereby facilitate the much-needed restructuring of employment and the creation of new, productive jobs in that part of the country. Since labor-market issues are sensitive issues in Germany and many people, including entrepreneurs, think that the functioning of labor markets must not be compared with that of goods and services, constructive reform proposals will have to draw judiciously the line between onerous regulations and positive regulations. Otherwise, public discussion is likely to focus on what labor unionists and social-democratic politicians choose to denounce as *social dismantling*, thereby forestalling any regulatory reform efforts in this area.

It is not yet clear whether, when, and in what economic activities determined deregulation will be effected in Germany.[9] On the one hand, the relaxation and ultimate elimination of harmful specialized regulations appear to be politically more difficult than tightening them or implementing new ones because

- powerful groups with vested interests, namely, the beneficiaries of specialized regulations, exert politically effective resistance to deregulation
- politicians and bureaucrats tend to overrate the economic rationale and the public interest for specialized regulations and underrate the social costs of regulations
- consumers and taxpayers are usually not fully aware of the losses they incur from wealth redistribution through regulation and normally underestimate the gains they could reap from deregulation

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9. The positive economic theory of regulation is not yet sufficiently developed and tested to allow predictions about changes in the regulatory framework. See Peltzman (1989).

On the other hand, despite the bias of the political process in favor of well-organized interest groups—a phenomenon common to many representative democracies—there are forces that may work for a repeal of specialized regulation. It is quite conceivable

- that structural change and technological advances will lower regulation-induced rents in specific sectors, which could erode support for continued regulation
- that potentially conflicting interests among producers will elicit counterpressures from other well-organized interest groups, who are already complaining about the costs of regulations, in favor of deregulation
- that the EC will push for changes where specialized regulations do not comply with basic EC provisions mandating the right of establishment in another member state and permitting cross-border trade in services
- that the Uruguay Round of multilateral trade negotiations of the General Agreement on Tariffs and Trade will succeed in extending the principle of nondiscrimination to trade in services, which would call for a removal of domestic regulations currently restraining this trade

At this stage, one can only hope that the pro-deregulation forces succeed. To be sure, the way toward regulatory reform is full of stones, the tyranny of the status quo (a concept once advocated by Becker and Gutowski) is great, but Germany has no other choice. The stakes in the challenging years ahead are too high. If the government designs a comprehensive program for deregulation, based on sound economic criteria, it may be able to overcome much of the resistance piecemeal actions usually meet. The broader the approach, the greater the probability that distributional concerns lose political weight—losers from one front of the deregulation battle may become winners on another.

Conclusion

The experience with government intervention at the microeconomic level has shown that many specialized regulations are unable to cope with the problems they were designed to solve. Activities so riddled with market failures that they require regulation are rare, and other motivations for specialized regulations seldom stand the test of cost-effectiveness. Conversely, the lessons that can be drawn from deregulation movements worldwide point to the great potential for economic gains, while costs are kept in check. Deregulation is not a panacea for structural problems, but the chances for overcoming them brighten if the sphere of competition is expanded as much as possible, preferably through an across-the-board approach rather than piecemeal actions.

Should Germany ultimately engage in a far-reaching deregulation, its position in an evermore competitive world economy would be strengthened. But not only Germany would benefit: A German economy that prospers would extend its dynamism to other countries—to its neighbors in Western and Eastern Europe, as well as to the rest of the Organization for Economic Cooperation and Development area and the developing world. For all of them, remarkable opportunities for expanding trade and private foreign investment and for sharing in technological advances would emerge.

APPENDIX

Proposals of the Deregulation Commission for the Insurance and Transport sectors

Sector	Deregulation proposals
Insurance	Liberalization of all insurance premiums except those of private health insurance.
	Permission of free competition regarding general insurance policy conditions. However, every insurance company has to offer a standard contract requiring prior approval by the Federal Insurance Supervisory Authority.
	Elimination of the obligation of car insurers to provide liability insurance at a given premium.
	Elimination of monopoly rights currently enjoyed by public insurance companies.
	Repeal of antitrust immunity, except for private health insurance companies and compulsory insurances.
	Opening the domestic market to cross-border trade in insurance services.
	Establishment of two insurance guarantee funds, one for life insurance and the other for non–life insurance except private health insurance. The funds are to protect individual policyholders in the general risk segment from loss in the event of their insurers' becoming insolvent. The coverage of claims of the insured persons has to be limited in scope, except in liability (third-party) insurances where claims have to be settled in full. The costs of the guarantee funds are to be financed by all insurers

From the report of the Deregulation Commission, March 1990, chapters 2 and 3.

Appendix (continued)

Sector	Deregulation proposals
	after a company's default occurs. The existing strict oversight mechanism is to be maintained to allow the federal authority to step in before a particular company becomes insolvent.
Railways	The Deutsche Bundesbahn is to be split into two companies: the railroad system operator and the carrier. Both companies are to be given greater management autonomy from the Federal Ministry of Transportation.
	New carriers, including those from other EC member states, must have access.
	All carriers are to be charged for the use of the railroad system at the long-term marginal cost of providing the network service; if a deficit arises at that price or if demand of railroad use exceeds capacity, surcharges are to be levied.
	The railroad system operator, a natural monopolist, is to be subject to price regulation. Carrier fares are to be liberalized.
	Removal of universal-service obligations (gemeinwirtschaftliche Pflichten) of the Deutsche Bundesbahn as carrier, and repeal of its antitrust immunity.
	Rail carriers are to bear the environmental costs of their activities.
Trucking	Elimination of truck licensing on domestic routes. Freight transportation by manufacturing companies on their own trucks is to be liberalized.
	Freedom of market entry is to be conditional only on the entrant being "able, solvent, and reliable."
	All price regulations are to be lifted.
	Haulers are to bear the environmental costs of their activities.
Bus transport	Liberalization of regular long-distance passenger services for a trial period and along selected dense intercity routes.
	On short-distance routes, regular bus transportation is to be franchised for a limited period (say, eight years), the contract being awarded to the company that bids the highest for the license fee or requests the lowest subsidy.

Sector	Deregulation proposals
	The bus companies are to bear the environmental costs of their activities.
Taxi transport	Removal of local taxi licensing.
	Relaxation of capital requirements.
	Binding taxi fares are to be nothing more than maximum prices. It should be possible to charge lower fares.
	Taxi owners are to bear the environmental costs of their activities.
Inland navigation	Opening of the freight market to non-German competitors where it is still prohibited—in the canal network and on the Danube and the Elbe rivers.
	Removal of binding freight fares.
	Repeal of antitrust immunity in the inland shipping industry.
	Ship owners are to bear the environmental costs of their activities.
Ocean shipping	Liberalization of foreign companies' access to coastal shipping in Germany.
	Germany should withdraw from the United Nations Code of Conduct for Shipping Liner Conferences of 1974.
	Shipowners are to bear the environmental costs of their activities.
Airlines	Liberalization of entry into domestic routes—also for carriers of other EC countries.
	Carriers are to be permitted to set fares without approval by the Federal Ministry of Transportation.
	Repeal of antitrust immunity in domestic aviation.
	Introduction of a system of bidding for scarce airport slots. "Grandfather clauses" for the right to take off and land at a German airport are to be phased out.
	Privatization of air traffic control. The coordination between the forty-two European control towers is to be improved.
	Airlines are to bear the environmental costs of their activities.

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