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Raising the Potential
of the Domestically Oriented
Sector in Germany

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RAISING THE POTENTIAL OF THE DOMESTICALLY ORIENTED SECTOR IN GERMANY

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By André Eid and Andrés Fuentes Hufilter

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ABSTRACT/RÉSUMÉ**Raising the Potential of the Domestically Oriented Sector in Germany**

Germany's manufacturing sector, which plays an important role for exports, has been performing well over the past decade in terms of labour productivity growth and international competitiveness. However, the services sector has had much slower growth rates. Competition often appears to be hindered by protection of incumbents. Reforming and deregulating the domestically oriented sectors, including network industries, crafts and professional services would release hidden growth potential and prove beneficial to the economy as a whole. It could also help strengthen domestic demand and reduce dependence on exports.

This Working Paper relates to the *2014 Economic Survey of Germany* (www.oecd.org/eco/surveys/economic-survey-germany.htm).

JEL classification: L50, L80, L84, L88, L98

Keywords: Germany, regulation, services, competition policy, renewable energy.

Relever le potentiel des secteurs orientés sur le marché intérieur en Allemagne

Au cours de la dernière décennie, le secteur manufacturier allemand, qui joue un rôle important dans les exportations, a enregistré de bons résultats, en termes de hausse de la productivité de la main-d'œuvre comme de compétitivité internationale. Le secteur des services en revanche affiche des taux de croissance bien plus modestes. Il semble que la concurrence y ait souvent été entravée du fait de la protection des entreprises en place. Réformer et déréglementer les secteurs orientés sur le marché intérieur, notamment les industries de réseau, l'artisanat et les services professionnels, permettrait de libérer le potentiel de croissance caché et serait bénéfique pour l'économie dans son ensemble, et contribuerait en outre à renforcer la demande intérieure et à réduire la dépendance par rapport aux exportations.

Ce document de travail se rapporte à l'Étude économique de l'OCDE de l'Allemagne, 2014 (www.oecd.org/fr/eco/etudes/etude-economique-allemande.htm).

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Mots clés : Allemagne, régulation, services, politique de concurrence, énergies renouvelables.

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RAISING THE POTENTIAL OF THE DOMESTICALLY ORIENTED SECTOR IN GERMANY

By André Eid and Andrés Fuentes Hutfilter¹

This paper covers regulatory policies in a variety of markets, mainly in the services sector. Some of these issues have been addressed in several OECD *Economic Surveys of Germany* (OECD, 2014, 2008, 2006). In this paper, they will be discussed with the objective of providing detailed proposals for regulatory reform.

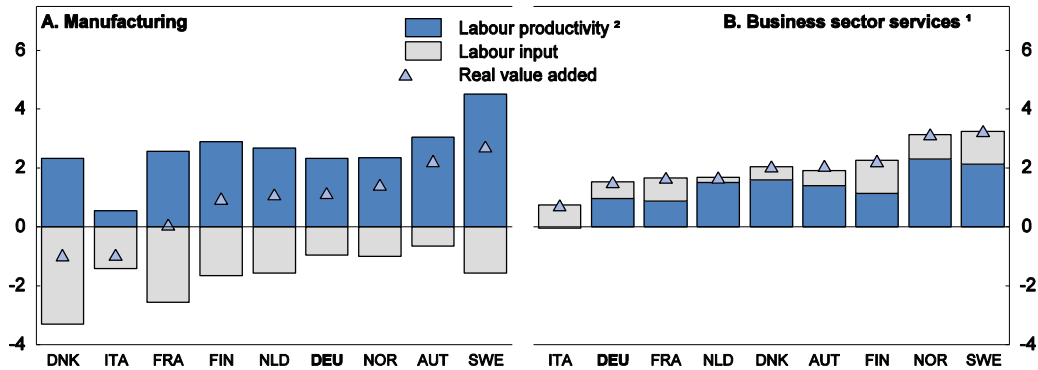
As in all high-income countries, services contribute most to economy-wide value added. However, at 69%, the services share in Germany was the smallest among the 10 largest economies in the euro area in 2012, mirroring the relatively large contribution of manufacturing activities. The services share increased from 62% to about 70% in the last decade of the 20th century and has been relatively stable since. Labour productivity, measured in total hours worked, has developed favourably in manufacturing, rising at an annual growth rate of 2.6% between 2000 and 2011. At the same time, measured labour productivity growth in the service sector has been slightly below 1%. In comparison to other OECD countries, telecommunication services as well as professional, scientific and technical services have performed especially poorly. Measured labour productivity for the latter actually decreased, at an annual growth rate of -2.0%.

Seen from a different angle, both manufacturing and the business services expanded their real value added between 2000 and 2011 by about one fifth. However, in manufacturing the workforce fell by 7.3% (or 570 000 jobs), while in business services it rose by 12% (or 1.9 million jobs). The resulting differences in labour productivity growth between both sectors (Figure 1) also have implications for job quality, skill patterns and education requirements, if one assumes that workers are paid according to their marginal product.

1. André Eid is Economist at the German Federal Ministry for Economic Affairs and Energy and was seconded to the Economics Department of the OECD while preparing this paper. Andrés Fuentes Hutfilter is Senior Economist in the Department of Economics of the OECD. This paper was originally produced for the *2014 OECD Economic Survey of Germany* (OECD, 2014), published in May 2014. The authors would like to thank officials of the German Federal Ministry for Economic Affairs and Energy as well as Robert Ford, Andreas Wörgötter, Andreas Kappeler, Rudolph van der Berg, John Davies, Stephen Perkins, Sean Ennis, Cristiana Vitale, Stephan Wernicke and Sabine Zigelski for their useful comments.

Figure 1. Real value-added and productivity growth in manufacturing and services

Average annual growth rates, 2000-11 or latest year available



1. Business sector services comprise the following ISIC Revision 4 categories: Wholesale and retail trade, repair of motor vehicles and motorcycles; Transportation and storage; Accommodation and food service activities; Information and communication; Financial and insurance activities; Professional, scientific and technical activities; Administrative and support service activities. They exclude real estate activities.
2. Labour productivity is calculated as real value added divided by total hours worked.

Source: OECD STAN database.

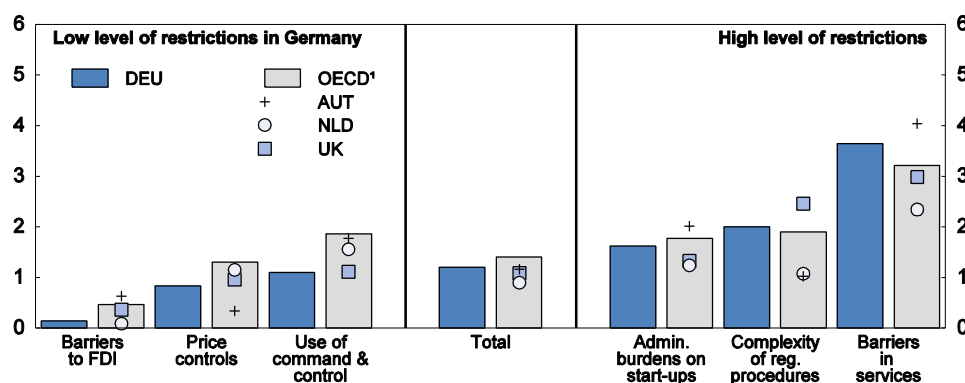
Product market regulation has become more conducive to competition but barriers remain in some services

Germany has considerably improved its product market regulation (PMR) over the past 15 years and ranked among the top 5 out of 33 reporting countries in 2013 according to the overall score of the OECD's PMR indicator. In international comparison, Germany has relatively low barriers to trade and investment and resorts little to price controls and command and control regulation (Figure 2). Since 2008 the German authorities have expanded the availability of single contact points, and lowered the administrative burdens for corporations, for instance by introducing a "light" version of a limited liability corporation.

Nevertheless, Germany's regulatory protection of incumbents in service sectors not open to international competition remains elevated. Lacking or incomplete ownership separation holds back competition in most network industries. Professional services continue to be quite strongly regulated in international comparison and the complexity of regulatory procedures is one of the highest among OECD countries.

Figure 2. Product market regulation

Scale 0 (least restriction) to 6 (most restrictions), 2013



1. Unweighted average of 29 countries except Luxembourg, Mexico, Poland, Turkey and the United States.

Source: OECD (2014), Production Market Regulation database.

How to make services more innovative and productive

Opening new markets by removing entry barriers and unnecessary regulatory restrictions, as well as allowing more competition in existing markets, is a prerequisite to promote innovation, job creation and investment in the service sector. A strong and productive service sector could be an economically stabilizing factor in two dimensions. Most importantly, internally it would establish a reliable second pillar to the German growth model, where economic activity is based strongly on manufacturing and exports. In addition, empirical evidence shows that competitive service regulation also has positive effects on employment and productivity of downstream industries that use services as inputs (Bourlès et al., 2011). With regard to the second dimension, the benefits of a strengthened domestic economy would also be felt externally and could contribute to a more balanced economic growth path *vis-à-vis* trading partners by strengthening domestic demand growth in Germany.

Incumbents could be exposed to more competition from market entrants in network industries

Telecommunication

Machine-to-machine (M2M) communication, also called the “internet of things”, is expected to be the market’s main growth driver of the future. Machines and devices will increasingly communicate autonomously via mobile networks. M2M communication is rapidly gaining significance in the automotive and in the energy sector (e.g. smart metering) or in applications related to smart-city technologies (traffic light regulation, toll systems). Initiatives to ensure competitive market conditions in this sector would have large benefits to consumers and unleash significant potential for innovation, economic and social development.

Research conducted by the OECD indicates that an enormous potential lies in breaking up exclusive rights of issuing SIM cards (OECD, 2012). Germany is one of only few EU countries where issuing SIM cards remains limited to mobile spectrum holders and to manufactures for testing purposes (CEPT, 2013). This is mostly a regulatory issue as it is technically feasible to permit third parties like mobile virtual network operators (MVNO) and non-telecom operators to do the same. For example, manufacturers of cars wishing to install SIM cards for mandatory safety services or manufacturers of smart meters are locked into their initial choices of a mobile network operator once their products have been distributed to

consumers. Prohibitively high costs to change these SIM cards effectively rule out competition afterwards. The possibility of rerouting the built-in SIM cards could generate savings that amount to EUR 1-2 billion in the automobile sector alone and considerably widen applications of IT services in moving vehicles.

Similarly, a German MVNO, such as a large retailer, can only resell SIM cards of a mobile operator. Wanting to switch the operator would mean resending thousands of new SIM cards to end-consumers. By contrast, a large Dutch or French retailer can simply reprogramme all its SIM cards to a new network operator once the contract ends and for the end-consumer nothing changes. As M2M communication is spreading, the impact of liberalization would be beneficial to businesses and consumers in various fields throughout the economy. Enabling businesses in all sectors to seamlessly switch network providers, to purchase mobile roaming at lower cost and to increase reliability would generate large cost savings and lower the barrier for introducing new products and services (OECD, 2012).

Privatisation of the remaining 32% of shares of the incumbent operator, Deutsche Telekom, would strengthen market perceptions of the neutrality of government with respect to the incumbent and its competitors.

Railways

Continuing vertical integration through a holding company generates incentives for the incumbent, Deutsche Bahn (DB), to give its own transport service providers preferential access to infrastructure over competitors, as 98% of all train services depend on infrastructure provided by Deutsche Bahn (FNA, 2012). According to the Federal Network Agency (FNA, *Bundesnetzagentur*) market shares of competitors have more or less stagnated since 2009. The incumbent still provides three quarters of all freight transport, 87% of short-distance and over 99% of long-distance passenger transport services. This is unlikely to be sufficient to drive costs, service quality and tariffs to efficient levels. Competition in short-distance transport is slightly more common, as local public transport services are usually assigned through tenders.

Several cases of discrimination against competitors have been reported. For example, anti-competitive elements of the track fee system of DB have repeatedly been declared illegal by the courts, or have been banned by the Federal Network Agency. Following a recent investigation of the EU Commission, DB Energie, the sole supplier of traction power in the market, committed to introduce a new price system this year and to partially separate its traction network from traction supply. Discrimination against competitors can also occur through denying access to information and operating systems. It is only since 2011, and again through the intervention of the regulator, that all competitors have enjoyed proportionate access to operations control centres, the main decision making units for railway track utilisation. Providers of passenger transport services, in particular, still do not have equal access to an integrated ticketing system. There are some indications that the current ticketing system of the incumbent's affiliate, DB Vertrieb may obstruct competition via high user fees for third parties or via the non-transparent revenue distribution system used to assign competitors their shares from joint ticket revenues. In January 2014, the German competition authority (*Bundeskartellamt*) initiated proceedings against DB in this matter.

Ownership separation between infrastructure and transport operators, which is advocated by the German Monopoly Commission (2013a) and in the EU Fourth Railway Package (2013a), is a promising route towards more competition. This could be achieved by privatising the transport services of the vertically integrated incumbent, while maintaining public ownership of the infrastructure. The public network operator could also keep all services characterised by natural monopoly, including infrastructure and traffic management and an integrated ticketing system. However, the coalition agreement of the governing political parties from November 2013 voices the intention to maintain the integrated structure of Deutsche Bahn.

If the holding structure of DB were to be maintained, the limited powers of the regulator must be strengthened to avoid discrimination against competitors. As the draft Railway Regulation Law (ERegG-E) failed to be adopted in July 2013, the regulator FNA can still only engage in market surveillance upon a substantial suspicion of malpractice and not for simply collecting market information, for which participation is voluntary. It has no regulatory competencies to investigate market abuse for traction power and ticketing (Monopoly Commission, 2013a). Within the *ex ante* price-regulation procedure, the FNA must screen proposed pricing schemes for potential violations within the insufficient time span of only four weeks. Later amendments can only be imposed *ex post*. Currently, requests to access company records must be individually justified and mandated.

The authorities should aim to reinforce the regulator by assigning it more investigative and interventional competences. As in other regulated network sectors, market participants should face a clear set of binding rules to regularly furnish specific documents and information. It is desirable to change the price regulation system, introducing real *ex ante* regulation, where pricing schemes have to be fully approved in advance. This would reduce scope for the incumbent to discriminate against market entrants.

Access of market entrants to rolling stock should also be facilitated. Economies of scale in the production of rolling stock and high investment costs can deter market entry of newcomers. The fact that licensing periods for public concessions (not more than 15 years) are much shorter than life expectancies of rolling stock generates a substantial remaining-value risk. Evidence suggests that the German incumbent prefers scrapping its discarded rolling stock over selling it to competitors (EU, 2013b). This is profitable if the incumbent's anticipated decline in monopoly rent is larger than the remaining value of the used rolling stock. Therefore, regulatory authorities should consider requiring the incumbent to auction used rolling stock before scrapping it.

Postal services

Market entry and competition in postal services could be increased by creating equal conditions in value added taxation for all service providers. Nation-wide provision of universal postal services is exempt from VAT. This effectively shields the incumbent from potential competitors, who would have to ask for higher prices during market entry. Equal taxation of equal services could best be achieved by abolishing the privilege of VAT exemption for postal services, although such a change would contravene current EU legislation. A second-best solution would be to drop the requirement of "nation-wide provision" from the national VAT law, thereby granting the same privilege also to local and regional competitors (Monopoly Commission, 2011).

The public authorities should sell all remaining shares of Deutsche Post (21% of total shares, held by KfW bank) in order to minimise the potential of conflicting interests.

Renewable energy

The new governing parties have committed in their coalition agreement to reducing greenhouse gas (GHG) emission by 80-95% below the 1990 level until 2050. Price mechanisms, as the CO₂ emission certificate trading scheme, are insufficient to reach these long-term targets due to market failures associated with external effects from innovation spillovers and emission reduction in general. Markets also lack CO₂ prices for the long-term horizon due to uncertainty and high discount rates among businesses. Therefore, a support scheme for renewable energy sources (RES) can be appropriate. The dependence on RES has been reinforced by the decision to phase out nuclear energy generation by 2022.

A major challenge is to make the German support scheme more cost-effective. Subsidies for feed-in tariffs (FIT) will reach 0.8% of GDP in 2014 and are projected to rise further under the current setting. The

new governing parties have announced their intention of comprehensive reform of the RES Act (*Erneuerbare Energien Gesetz*, EEG). This reform should include both a clear vision of how to integrate renewable energies into the market in the long run and the corresponding milestones and measures to be implemented in the short and medium-term horizon.

The coalition agreement envisages a number of steps. The direct marketing model for RES, which is currently optional, will become mandatory for all new plants. This model sets incentives for RES producers to incorporate market prices into their feed-in decision. New RES plants must be controllable by network operators to enhance grid stability. And crucially, auctions are planned to determine subsidy levels from 2018 onwards.

Both auction and quota models are alternatives to the status quo, and would help to reveal market prices and allocate resources more efficiently. However, a technology-neutral quota model (Monopoly Commission, 2013b) has drawbacks such as long-term inflexibility and large windfall profits for the suppliers of comparatively cheap technologies (Bofinger, 2013), raising the cost of the subsidies. It would also constitute a drastic change to the current system involving substantial transition and adjustment costs (Löschel et al., 2013).

It therefore seems more pragmatic to open the existing system to market mechanisms. To encourage network stability and minimize the cost of network expansion, subsidies should be designed to reflect local costs of limited network capacities. Gradually, the feed-in tariffs could be transformed into an auction system, where investors bid on a fixed premium, which is paid over a plant's life span (Kopp et al., 2013). A competitive setting such as an auction system is important to incorporate market developments and price signals into decisions on investment and energy production.

Professional services regulation remains restrictive

The PMR sub-indicator for barriers in services, in which professional services such as lawyers, notaries, tax consultants, architects and engineers make up 50% of the weight, ranks Germany 19 out of 33 OECD countries in terms of regulatory restrictions, related both to strict conduct regulations and to elevated market entry barriers. This relatively high level of regulation for professional services may have contributed to poor productivity performance in this sector. The economic impact of deregulation could be significant as professional services account for around 10% of GDP (IFB, 2012) with an uncounted potential for additional services, which are currently subject to a variety of regulations.

In some professional and other services, regulation in different forms has been accumulating over time to meet different objectives, like consumer protection or other societal preferences. An example is the mandatory membership in chambers, which was motivated by the advantages of self-regulation to carry out regulatory tasks in a cost-effective way as well as their specific role in vocational training. It affects more than 3.6 million enterprises in chambers of commerce, 484 000 liberal professionals (IFB, 2012) and about one million enterprises in chambers of crafts (DIHK, 2012; StBA, 2013). The professional and crafts chambers each represent specific sectors and activities. Self-regulation in these chambers may result in the risk that entry barriers are established. Therefore, compulsory membership and self-regulation in these chambers should be examined with respect to the establishment of unintended entry barriers. It should be assessed whether the objectives can also be achieved in a more proportionate and equally effective way.

The crafts sector plays an important role for the vocational and educational training (VET) system. The ratio of trainees in the total work force is twice as high as in other sectors. About 95% of apprentices in the crafts are trained in the 41 professions, where self-employment is restricted to holders of tertiary level vocational diplomas (*zulassungspflichtiges Handwerk*). These crafts accounted for 480 000 enterprises in 2010, employing 10% of the total work force and generating a turnover of

EUR 435 billion (StBA, 2013). Alternatively, businesses can be managed by holders of a certificate of apprenticeship who have a minimum work experience of six years, four of which in a managing position. These restrictions are generally justified by appealing to consumer protection and the hazardous nature of these activities. In all other crafts entrepreneurs are exempt from professional qualification requirements. The safety criterion is vague and should be reviewed for some crafts such as hairdressers, painters and plasterers. Linking the employment status to education requirements is unique to crafts and professional services and does not exist for other business activities (IT, trade). The requirement of a master craftsman's diploma (*Meisterbrief*) in certain crafts such as hairdressers and painters also aims at sustaining the particularly large number of apprenticeships these crafts contribute to the VET system. It should be examined whether entry conditions could be further liberalized without jeopardizing the VET system.

Price regulation

Price competition is restricted in some professional services due to the existence of partially binding prices set by government or, as in the case of lawyers and notaries, legislated by parliament. The chambers play an important role in determining price regulation as interest groups in practice. They are likely to support their members' interests. These interests include higher prices. Arguments used in favour of price regulation include non-discriminatory access of consumers to public goods and consumer protection through high service quality. The argument of non-discriminatory access may hold in the case of lawyers, where low-value legal cases are cross-subsidized by high-value claims, which is used to determine reimbursements from the defeated party as well as legal aid. Nonetheless binding prices were abolished for extrajudicial services of lawyers. However, the argument seems less obvious in the case of architects and building engineers, where prices are also set by government.

The argument of consumer protection is usually employed to maintain price regulation for architects and engineers. It is based on the assumption that an appropriate compensation of providers translates into a higher service quality (BAK, 2013). Since Germany is the only member country in the European Union with price regulation for architects and engineers, there must be other and probably more market-oriented solutions to ensure service quality. Already existing legislation, for instance education and certification requirements for professionals, construction law or consumer protection law, are much better suited to address service quality. The authorities should, therefore, abolish price regulation for architects and engineers. Notaries in Germany act as public authorities. Therefore, prices of notaries' services are also regulated. The Netherlands abolished price regulation for notaries in 1999. Subsequently, fees for property conveyancing dropped by 30-40% and were only partially offset by increasing fees in previously cross-subsidized services (Schmid and Pinkel, 2007). The German government should give consideration to liberalizing prices of notary services too.

For services related to representation in court, lawyers could be given greater flexibility in pricing. For example, they could be given room to deviate from the principle of effort-based charges for specific tasks. This could include extending lawyers' possibilities to charge all-inclusive or "flat" fees and lowering the restrictions on outcome-based remuneration.

Exclusivity of rights

Lawyers with three years of work experience and with top scores in a specific examination can eventually become notaries through appointment by the administration. Exclusive rights of notaries include authentication of documents, services related to the conveyance of property, and entries or changes in official company registries.

For some of these exclusive rights it would be possible to open the market to a broader range of providers without harming service quality or endangering consumer protection. Lower fees for consumers

can thereby only be achieved, if such services were no longer subject to minimum price settings in the respective price regulation. Notary services like drafting the articles of association could be referred to regular lawyers or even to certified jurists with only the first state exam (*Diplomjurist*). Using the example of real estate transactions, preparatory and auxiliary services like pre-examination of the cadastre, draft of contract and changes of ownership in the cadastre after signing the contract could also be opened to related professions. Indeed, the United Kingdom introduced licensed conveyancers in 1985, who are subject to lower qualification requirements than notaries but exercise all activities related to the conveyance of property. As could have been expected from contestable market theory, they put pressure on tariffs just prior to their introduction (Domberger and Sherr, 1987) and to a lesser extent also afterwards (Stephen et al., 1994). Furthermore, the exclusive rights of notaries for all matters related to the commercial registry (*Handelsregister*) could easily be abolished. This would be especially beneficial to start-ups and would significantly lower their costs of market entry.

According to the World Bank's recent Doing Business Report (2013) Germany ranks only 111th out of 189 economies for the ease of starting a business despite the recent introduction of one-stop shops for new entrepreneurs. In comparison to the OECD average German start-ups face longer delays, more procedures and higher costs, the latter two being directly related to notary services. Instead, the registration process could be carried out by the companies themselves since they are also deemed capable of filing their own business registration (*Gewerbeanmeldung*) and tax reports. In addition, the authorities should consider opening legal counselling and representation in court to other professionals, for instance certified jurists with a certain amount of work experience.

Other restrictions

All remaining restrictions on advertisement in the Federal Lawyers Act and in the Rules of Professional Practice could be abolished. All advertising is in any case regulated in general competition law. Shareholder requirements for limited liability companies of lawyers, tax consultants, architects and engineers, demanding that the majority of shares and voting rights rest with the respective professions, represent an entry barrier. Consideration should be given to dropping them.

Box 1. Recommendations for raising the potential of the domestic sector

Network sectors

Telecommunication

- Liberalize the issuance of SIM cards.
- Sell the remaining government shares of Deutsche Telekom.

Railways

- Consider separating ownership of infrastructure from train operation. A public infrastructure manager could be responsible for all services subject to monopoly conditions, including traffic management and an integrated ticketing system.
- Facilitate access of market entrants to rolling stock.
- Strengthen the role of the regulator by improving its investigative and interventional competences. Move to full *ex ante* regulation of access conditions.

Postal services

- Ensure equal treatment in value added taxation for all service providers.
- Sell the remaining government shares of Deutsche Post.

Renewable energy

- Make feed-in tariffs more cost-effective by linking them to market developments. Consider reforms to advance the current support scheme into a competitive auction system.

Professional and handicraft services

- Scrutinize compulsory membership and chamber self-regulation in the professional and crafts chambers for entry barriers and lower entry requirements where possible.
- Examine if entry conditions to crafts could be further liberalized without jeopardizing the vocational education and training system.
- Abandon price regulation in some professional services. Abolish the price regulation for architects and engineers and consider liberalizing price regulation for notaries. Give lawyers more options to deviate from the principle of effort-based remuneration, e.g. allow all-inclusive fees for certain tasks and extend outcome-based payments.
- Reduce exclusive rights. For example, allow companies to register in the commercial registry without notary services and open the provision of auxiliary services in property conveyancing to other related professions. Reduce exclusive rights of lawyers in providing legal advice and representation in court.
- Review restrictions on business conduct. Abolish all remaining restrictions on advertisement for lawyers. Give consideration to abolishing restrictions on shareholders for limited liability companies of lawyers, tax consultants, architects and engineers.

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