# German Council of Economic Experts

# CONSOLIDATE PUBLIC FINANCES – REFORM THE TAX SYSTEM

## Annual Report 2003/04

***First chapter**[*)]*

*) The first chapter is a summary of the Annual Report 2003/04.
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## Preface

The German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) hereby presents the English translation of the first chapter of its Annual Report 2003/04. It contains a brief summary of the latest developments, prospects and policy issues of the German economy discussed in the report.

The complete report is divided into five chapters:



The data used in the report of the Council were the latest available in mid-November 2003.

The German Council of Economic Experts consists of five independent economists. They are appointed by the President of the Federal Republic of Germany, after nomination by the Government. Appointments are for five years, with the possibility of renewal (see 1963 Law on the Appointment of the Council in appendix). For further information about the Council contact the address below or our Internet homepage.

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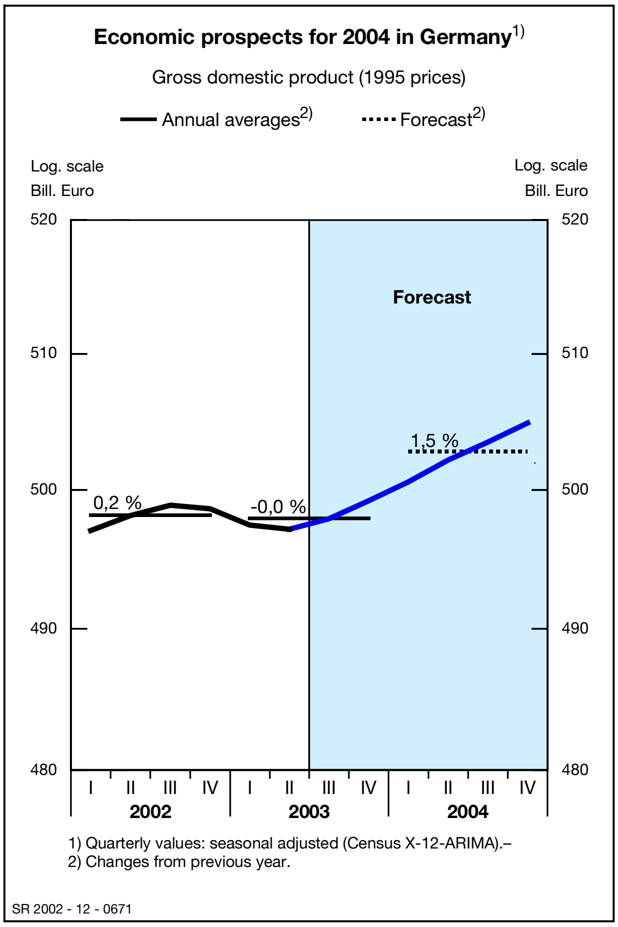
# FIRST CHAPTER OF THE ANNUAL REPORT 2003/04

## SUMMARY: CONSOLIDATE PUBLIC FINANCES – REFORM THE TAX SYSTEM

1. In Germany the economic slowdown persisted for the third year running. Gross domestic product (GDP) stagnated (Chart 1). Last year's hopes of a gradually strengthening recovery were negated in the spring of 2003 by the deteriorating global economic environment and the consequences of the euro's appreciation. This was reflected in decelerating GDP growth rates and a marked worsening of the situation on the labour market. From the middle of the year onwards export business picked up noticeably in the wake of a reviving world economy and was a key factor in the slight positive expansion of output during this period. Domestic demand remained very weak; the buoyancy of the external sector failed to spark a corresponding upturn in internal consumption in 2003. While the outlook for 2004 indicates some prospect of a brightening conjunctural horizon, the projected increase of 1.5 per cent in aggregate production signals a muted recovery which will not yet contribute to closing the output gap.

Chart 1



The forecast for the macroeconomic growth rate is based on the legislative status quo obtaining at the time the forecast was made. It thus took account of those tax policy measures already adopted in 2003 and intended to take effect in 2004 as well as those measures which – though not yet adopted – do not require the assent of the Bundesrat (upper house of parliament). In an alternative scenario it was assumed that the measures requiring the Bundesrat's assent, ie notably the plan to bring forward the tax reform and the fiscal consolidation measures contained in the Act Accompanying the Budget (*Haushaltsbegleitgesetz*), will indeed be implemented next year and that these will have the corresponding positive and negative effects on public budgets estimated by the German government. Based on these assumptions, GDP will grow in 2004 by 1.7 per cent. The small differential compared with the growth rate projected in the baseline forecast is due to the fact that the net relief for households and enterprises under the alternative scenario resulting from bringing forward the tax reform – equivalent to €15.6 billion – will be reduced to less than €4 billion owing to the diverse fiscal saving measures.

2. A key determinant of the intensity of the cyclical revival is the **growth of the potential output** as this indicates the pace at which an economy can expand over the medium term without any tensions. The smaller potential growth is, the sooner an upturn will reach the existing capacity limits and hence the sooner a state of macroeconomic stagnation will be reached in the event of negative cyclical impulses. The growth potential is thus a crucial factor both for business cycle analysis and for economic policy. An empirical analysis of the potential output using various estimation methods shows that the potential growth in Germany has slowed perceptibly in recent years and is currently around 1.5 per cent (sections 734 ff.). The underutilisation of aggregate capacity in 2002 amounted to approximately 1.0 per cent. These figures likewise suggest that the economic recovery is likely to be fairly muted. However, potential growth is not a fixed constant but rather can be influenced by economic policy measures (Annual Report 2002, sections 205 ff.).

3. The German Council of Economic Experts (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*) has repeatedly diagnosed the underlying reasons for the weak growth momentum and indicated possible ways to overcome them. During the past few months the German government has initiated numerous reforms. This applies especially to the labour market, but a number of long-term adjustments were also adopted in the statutory pension insurance scheme (*Gesetzliche Rentenversicherung*) in view of the serious financing problems. In the statutory health insurance scheme (*Gesetzliche Krankenversicherung*), too, a first step was taken towards a comprehensive

reform of the healthcare system. At present it is not quite clear in what form many of the reform measures will finally emerge from the complex legislative process; it is therefore not possible at the moment to make a definitive evaluation of the German "reform thrust". However, considering the measures already adopted and the basic tenor of the proposals currently going through the parliamentary procedure, the overall assessment is positive. German policy makers, who only a year ago showed no signs of following any clear course, have set in train a package of measures during the past few months, especially in relation to the labour market, which constitutes more than just a step in the right direction. This does not make it immune to points of criticism. Thus individual elements of the agreed labour market reforms, for example in the field of employment protection, were tackled too tamely; insufficient attention was paid to fundamental incentive effects in elaborating some quite significant details of the individual labour market and social policy measures, such as the amalgamation of unemployment assistance (*Arbeitslosenhilfe*) and social assistance (*Sozialhilfe*). In addition, the policy makers failed to seize the opportunity this year to radically restructure the statutory health insurance system on both the financing and benefits side. Nonetheless, the character of the public political discourse has undergone a remarkable and perceptible change: thus at the request of the government coalition parties, on the one hand, and the opposition parties, on the other, separate expert commissions drew up blueprints for further-going reforms of the social welfare systems which, despite all their differences, have fundamental points in common. In view of the fact that the German Council of Economic Experts made detailed proposals for reforms of the social security systems in its Annual Report last year and that the government commission took up many of those suggestions, no further proposals are made in this year's Annual Report; instead, the results of the Rürup-Commission are presented and commented upon. With regard to the labour market, the German Council of Economic Experts puts up proposals for discussion in its current report which elaborate on and supplement the comments it made in its report last year.

4. The consequences of the continuing sluggish overall economic setting manifested themselves particularly vividly in 2003 in the state of public finances. The ratio of the budget deficit to nominal GDP reached 4.1 per cent, thus once again exceeding the deficit ceiling prescribed by the Stability and Growth Pact, and in the coming year, too, Germany is highly unlikely to meet the 3 per cent criterion laid down by Brussels. It is true that a sizeable part of the steep increase in indebtedness is due to the weak macroeconomic dynamics. Yet the fact that in 2003 actual borrowing by central government alone was more than double the amount earmarked in the Federal budget – even though there was hardly any decrease in year-on-year GDP growth – also indicates that public finances are in need of a reorientation. Above all, it is imperative to create a

reliable planning basis for the income expectations and allocations of enterprises and households. Given that the general government deficits are fast assuming unmanageable proportions, this requires, firstly, the definition and implementation of a coherent long-term strategy aimed at reducing government borrowing. In 2003 policy makers initiated some important medium-term consolidation measures, especially in the statutory pension insurance scheme and in the statutory health insurance scheme. At the moment there is much uncertainty, however, about the extent to which the diverse tax policy measures will actually be implemented. Moreover, the proposed array of saving measures lack a clear and cogent overall framework. The German Council of Economic Experts therefore devotes particular attention to the question of budgetary consolidation. At present tax policy has many serious shortcomings. In particular, there is no discernible philosophy guiding and shaping tax legislation. But without such a philosophy the plurality of tax policy measures lack an overriding framework, and individual measures are often perceived as contradictory, ad hoc interventions. This tax policy chaos magnifies the uncertainty – over and above that which is inherent in economic life anyway – surrounding future income trends and profit expectations and is a stifling impediment to any robust cyclical upturn. The criterion of fiscal reliability also requires policy makers to bear in mind the medium and long-term consequences of financial and social policies. In particular, the looming demographic changes in the coming decades will undermine the sustainability of public finances unless a significant policy realignment occurs.

For all these reasons the discussion of the available scope for economic initiatives in the field of fiscal policy are the focal point of this year's Annual Report, which is entitled "Consolidate public finances – reform the tax system".

## I. World economy: upswing amid persisting uncertainty

5. Geopolitical uncertainty ahead of the war in Iraq plus the spread of the respiratory disease SARS dampened the momentum of the **world economy** at the beginning of 2003. Following the rapid end of the military conflict and aided by a recovery on the international financial markets, global confidence brightened from the spring. From mid-2003 the positive signals gauged from business sentiment were also reflected increasingly in the production data. Especially in the United States and Japan the extent of the recovery surpassed the general expectations (Table 1). In Europe, by contrast, the cyclical development was subdued; nevertheless, in this region, too, a slight improvement occurred in the second half of the year. The global economic upswing was supported by a stimulating orientation of monetary and fiscal policy in the world's major

economic regions, albeit with marked differences in the intensity of the discretionary impulses (Chart 2, page 6).

6. Low inflation rates, the already abundant supply of liquidity together with the expectation that the central banks in the industrial countries would not tighten interest rate policy for some time to come led in the first half of the year to a sharp decline in long-term interest rate levels on the international financial markets. The yields on long-term government bonds in many countries fell to their lowest level in over 40 years. From the middle of the year growing optimism that the global economic downturn had bottomed out as well as greater investor sensitivity to the growing budget deficits then caused long-term nominal interest rates to rise appreciably. Compared with their multi-year averages, however, they were still at a low level at end-2003.

Table 1

**Economic development in selected countries and groups of countries**

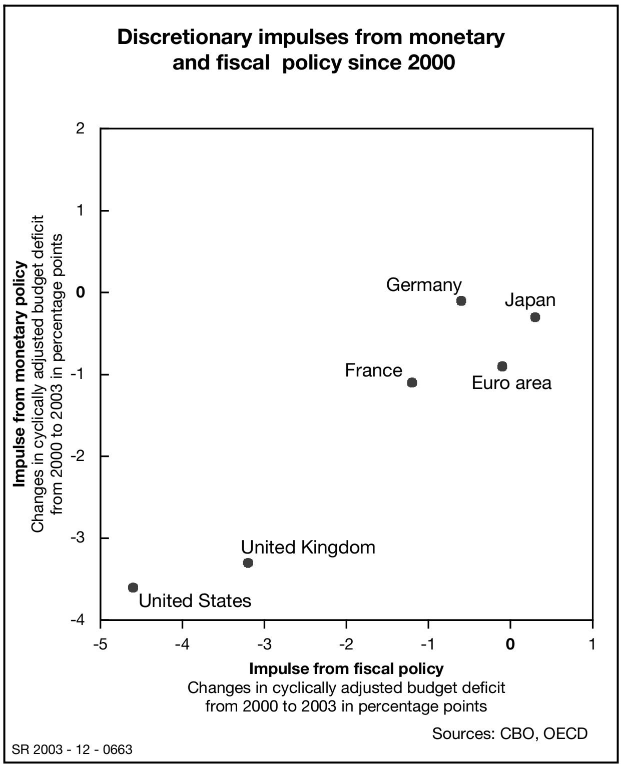
| Countries / groups of countries[1] | Gross domestic product, real[2] | | Share of German exports |
|---|---|---|---|
| | 2003 | 2004 | 2002 |
| | percentage changes from previous year | | % |
| European Union | + 0,7 | + 1,9 | 54,7 |
| Euro area | + 0,4 | + 1,8 | 42,6 |
| of which: | | | |
| Germany | - 0,0 | + 1,5 | X |
| France | + 0,2 | + 1,7 | 10,8 |
| Italy | + 0,4 | + 1,5 | 7,3 |
| Netherlands | - 0,7 | + 0,9 | 6,1 |
| United Kingdom | + 2,0 | + 2,9 | 8,4 |
| United States | + 2,9 | + 4,0 | 10,3 |
| Japan | + 2,7 | + 1,8 | 1,9 |
| Central and East European countries[3] | + 3,3 | + 3,8 | 8,8 |
| Latin American countries[4] | + 1,0 | + 3,7 | 2,0 |
| East Asian newly industrialising countries[5] | + 3,0 | + 4,6 | 3,5 |

1) Changes from previous year are weighted together with shares in world nominal GDP in 2002. - 2) Own estimate based on data provided by national and internatio-nal institutions. - 3) Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia. - 4) Argentina, Brazil, Chile, Colombia, Mexico Peru, Venezuela. - 5) Hongkong (China), South Korea, Malaysia, Singapore, Taiwan Thailand.

7. Not least owing to the weak development in the euro area, worldwide output expanded at an annualised average of 3.5 per cent, which was barely higher than in 2002. Global capacity utilisation in 2003 was actually marginally lower than it had been during the downturn in the early 1990s. The volume of world trade expanded by 3.7 per cent, which was only a little more than global GDP (Chart 3).

8. Business activity in the **United States** remained subdued at the start of 2003. Following a lacklustre first quarter, a strong upturn then occurred, thanks mainly to the abatement of geopolitical uncertainty.

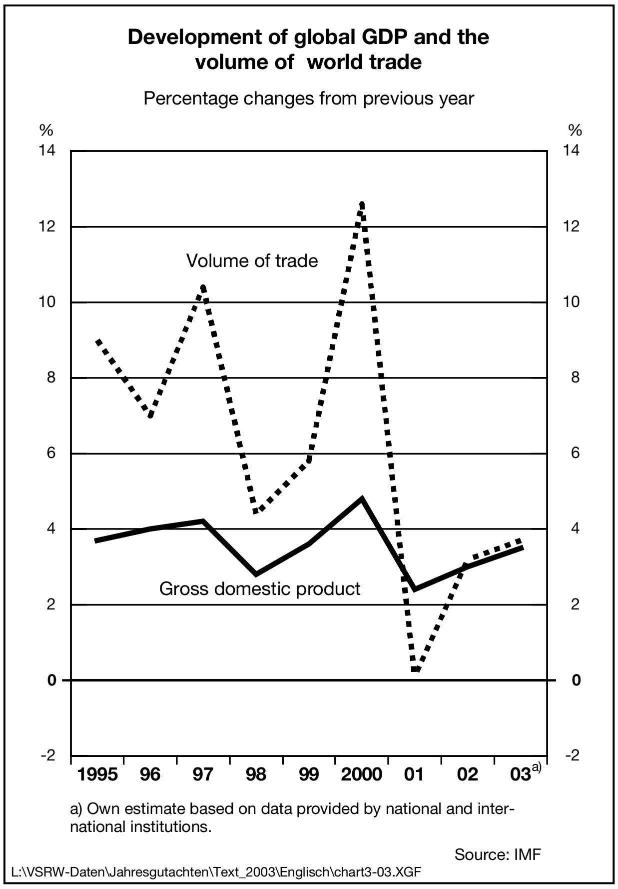
Chart 2




In the third quarter GDP, according to preliminary estimates, grew at a pace last seen in 1984. The upswing was strongly supported by the marked expansionary orientation of both monetary and fiscal policy. The overall economic development was fuelled by government and household consumption spending (Chart 4, page 8). Private consumption was bolstered by the Federal Reserve Bank's further cut in interest rates and by additional tax relief measures. The federal funds rate for overnight money was cut in June to just 1%, its lowest level for 45 years. In the course of the year the yields on long-term government bonds likewise reached lows last observed in 1958. The low level of interest rates gave an additional boost to consumption as it enabled consumers to refinance outstanding mortgages at lower rates and to use the resources thus released for consumption spending. But when long-term interest rates began to increase from mid-2003, the impact of this factor on the development of private consumption diminished.

In the enterprise sector the consolidation of balance sheets progressed further. The indebtedness of non-financial corporations in relation to nominal GDP, which had increased by more than 10 percentage points between the beginning of 1998 and the end of 2001, has since stabilised. The balance sheet restructuring undertaken by US firms had perceptibly dampened their propensity to invest during the past few years.

Chart 3

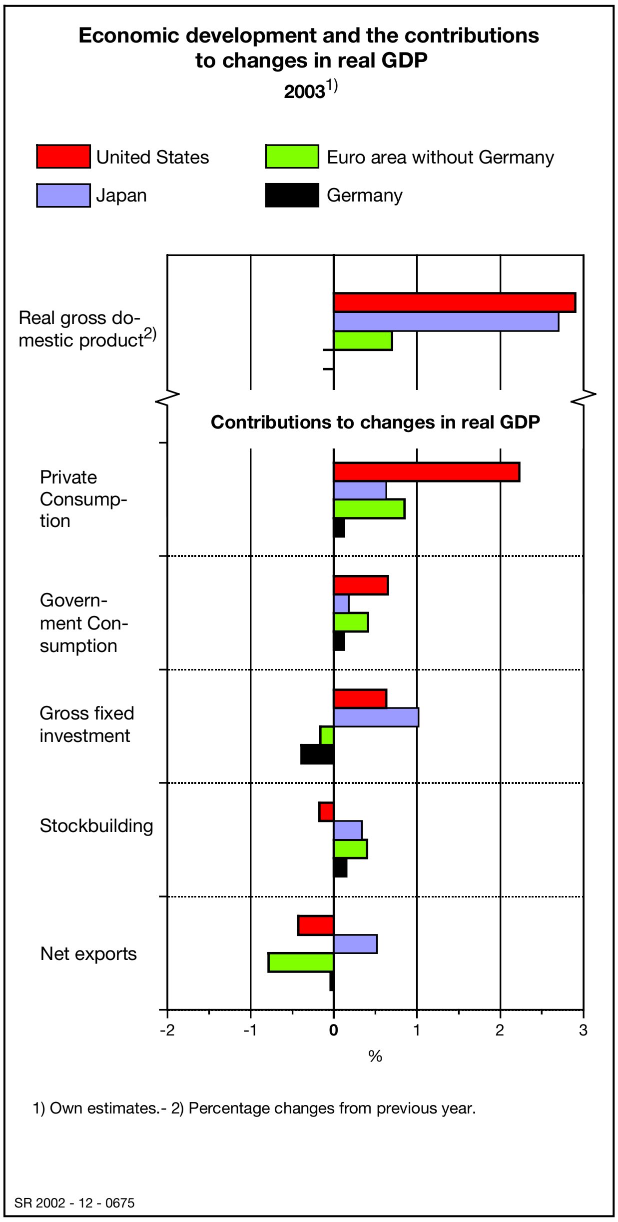



From the second quarter of 2003, however, a growing upward trend was recorded in gross fixed investment, with the result that the upswing became more widely based.

Even so, the muted development at the start of the year meant that the overall increase in GDP in 2003, at 2.9 per cent, again fell short (albeit only slightly) of the growth potential.

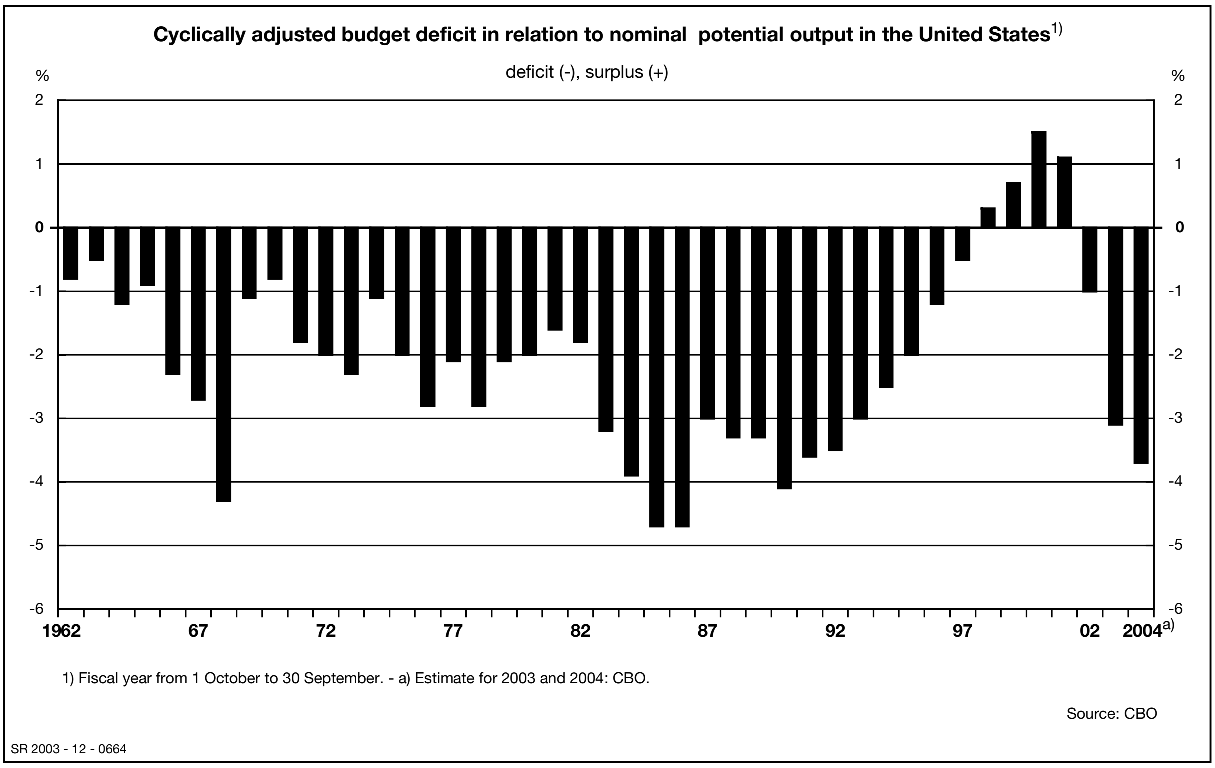
9. Given the accelerating upswing, attention focused more on the medium-term orientation of US economic policy. In particular, fiscal policy once again pushed up the government deficit considerably in 2003. The rise in the deficit was largely attributable to additional tax relief measures as well as higher defence spending. As a result, the cyclically adjusted budget deficit increased in the 2003 fiscal year to 3.1 per cent in relation to the nominal potential output. In 2004 the cyclically adjusted budget deficit will probably increase further by about 0.6 percentage point. Measured in these terms, the deterioration in the US budgetary position since 2000 has completely wiped out the consolidation successes achieved during the 1990s (Chart 5).

Chart 4



It will be difficult to maintain cyclically adjusted budget deficits of this magnitude in the coming years, not least because in the United States, as elsewhere, public finances will face additional strains in the foreseeable future stemming from demographic developments. The gradual withdrawal of the fiscal stimuli and a return to a sustainable budget policy course is a topic of considerable importance for the world economy, also in view of the further widening current account deficit. It is likely that an abrupt adjustment of the United States' current account would be accompanied by a further massive depreciation of the US dollar. This constitutes a sizeable risk for macroeconomic developments in Europe and hence also in Germany.

Chart 5




10. The course of economic development in **Japan** progressed better than expected; GDP grew at a rate of 2.7 per cent. It was driven chiefly by private investment. In the second half of the year additional positive impulses came from export business. The fact that the upturn in activity was not caused by any additional government stimulus package provides grounds for cautious optimism that the world's second largest economy could gradually overcome its long-lasting phase of stagnation. Even so, quite considerable risks remain to jeopardise a sustained recovery. The country is still in the throes of deflation; unemployment remains at what is by Japanese standards a very high level and the problems in the financial sector persist. The quasi-nationalisation of a major

Japanese bank in 2003 was a clear signal that the problems in the banking sector are far from having been overcome. The monetary transmission process continues to malfunction: an ongoing massive expansion of the central bank's money supply is not being reflected in the broad monetary aggregates and in credit growth.

11. The newly industrialising countries of **South East Asia** experienced a slightly lower level of business activity in 2003. The impact of the respiratory disease SARS but also domestic economic problems in a number of countries in the region led to a distinct slowdown, especially in the first half of the year. In the course of the year, however, the macroeconomic climate brightened increasingly in the wake of the global upturn and the rising demand, particularly for products related to information and communication technologies on the part of the industrial nations. Despite the existing impediments to growth, the countries in the Asia-Pacific region once again proved to be the most dynamically growing area of the world economy. Above all China, which has achieved growth rates of over 7 per cent during the past few years, proved largely robust to negative external influences. Structural problems are currently becoming increasingly apparent, however, especially in the banking sector. Their elimination is a crucial precondition for a gradual shift to a flexible exchange rate regime.

12. The momentum of business activity in the **euro area** slowed to a standstill in the first half of 2003. Gross fixed investment decreased once again and dashed the previous year's hope of an end to the prevailing investment restraint. But the strongest negative impulse came from the external sector. In the first two quarters exports fell by an annualised rate of over 4 per cent against the second half of 2002 owing to shifts in exchange rate parities. Business momentum was propelled solely by private and government consumption expenditure. The global economic recovery which began in the middle of the year spread to the euro area only with a time-lag and in a weaker form. It triggered a marked revival in export business, while private consumption spending continued to play a supporting role. Yet investment remained low. Output increased by 0.4 per cent on an annualised average. Compared with the trend in preceding downturns, the labour market has proved to be surprisingly robust during the present downswing. Although the level of employment has stagnated more or less since the end of 2002, a steeper fall in the number of employed might have been expected given the fact that output has been similarly flat. The same applies inversely to the unemployment rate. In both cases the labour market reforms that have been carried out in a number of countries over the past few years have doubtless had a positive effect.

    The degree of conjunctural congruence among the EMU member-states has increased discernibly since 1999. The contemporary correlation between the national levels of capacity utilisation among the major economies of the common currency zone has increased, and a general tendency is apparent towards a greater cyclical convergence. This development can presumably be explained to some extent by the fact that the downswing during the past two years was caused by a number of global shocks which had a symmetric impact. Notwithstanding this, the more pronounced alignment of the business cycles is welcome news for the euro area's single monetary policy, since the less heterogeneous the cycles in the individual member-countries are, the more appropriate the common official interest rate defined by the central bank is for them.

Economic policy makers in the euro area relied far less than their counterparts in the United States on providing discretionary anti-cyclical stimuli. The cyclically adjusted deficit in relation to nominal GDP has increased since 2000 by 0.4 percentage point to 2.3 per cent; the unadjusted deficit (excluding proceeds from the sale of UMTS licences) has deteriorated by 2.0 percentage points owing to the effect of the automatic stabilisers. In the course of 2003 the European Central Bank lowered its official interest rate in two stages by 75 basis points to 2%. The central interest rates in the euro-area countries thus reached their lowest level since the end of the Second World War. The easing of interest rate policy came in response to the lacklustre state of the real economy. Moreover, inflation expectations did not signal any threat to medium-term price-level stability. Viewed in the context of the persistently sluggish level of business activity, the monetary policy stance therefore remained expansionary. If the European monetary policy pursued since the start of monetary union is gauged by means of the popular Taylor rule, the frequently levelled criticism that the European Central Bank takes its interest rate policy decisions in complete disregard of the implications for real economic activity turn out to be unfounded also in respect of the past years.

On 1 May 2004 the European Union will be enlarged by ten more countries. The foundations for this were laid with the conclusion of the accession negotiations and the signing and ratification of the accession treaty in 2003. As all the acceding countries have a distinctly lower level of prosperity than the existing member-countries, the European Union's structural and regional policies will be confronted with new challenges. Per capita income in the eight central and east European acceding countries currently amounts to less than 50 per cent of the EU average. Although these countries are already launched on a process of real economic convergence, unless the pace of convergence accelerates, several more decades will elapse before the income gap between the European Union and the acceding countries aggregate is narrowed by even half. Concerning the prospect of a subsequent participation by those countries in European monetary union, the level of the general government budget deficits, especially in the larger acceding countries, constitutes the biggest hurdle from the present-day perspective with regard to their future ability to meet the Maastricht criteria.

## II. Germany: external revival alongside a weak internal demand

13. The hopes of a cyclical revival were again disappointed in 2003 (Table 2). GDP stagnated for the third year running. The fact that no positive growth occurred in GDP was due to a continuing very weak domestic demand and the extremely dampening external influences in the first half of the year. Following three years of stagnation, the scepticism among households and enterprises regarding a radical improvement in the income prospects and profit expectations was so deeply entrenched that even the powerful impetus imparted by the reviving world economy in the second half of the year, which was reflected in a marked rise in exports, failed to boost internal activity. But amid a robust global economic setting and in the absence of additional negative exchange rate influences, the components of domestic demand likewise gradually picked up towards the end of the year.

– The decelerating dynamism of the world economy at the beginning of the year and the impact of the euro's appreciation led to a decline in **exports** in the first six months. The export of goods and services contracted during this time at an annualised rate of over 2.5 per cent compared with the second half of 2002. But as the international environment improved from the spring onwards, exports picked up perceptibly from the third quarter. This confirms the fact that for German exports the income effect is more important than the exchange rate effect. The weak domestic demand led to a decline in imports, with the result that in the second half of the year the external sector made the strongest contribution to the increase in GDP.

– **Investment** in 2003 once again acted as a brake on economic activity, with gross fixed investment falling by 1.9 per cent. The fall in capital formation, which began in the second half of 2000, has not yet come to a halt. **Investment in machinery and equipment** receded by a further 0.3 per cent. This contrasted somewhat with the positive signs emanating from the business sentiment indicators from mid-year. Yet the latter had signalled a recovery already in 2002 which was not mirrored in the output data. In the current year the improved level of export activity presumably had a positive impact on the outlook for enterprises, although this was not reflected in the investment figures. This is corroborated by the fact that the increase in the level of new orders received in the second half of the year was driven almost exclusively by a higher external demand. Given the continuing below-average capacity utilisation, this was satisfied without any additional investment in capacity extensions. **Construction**

**investment** shrank by 3.6 per cent and was the main factor in the negative trend in fixed capital formation. This means that, with the exception of 1999, construction investment has decreased in every year since 1995. The decline in investment slowed down, however, in the course of the year. But this cannot be interpreted as a clear signal for an end to the adjustment process in the construction industry, because this development was principally attributable to housing construction, which was buoyed by two non-recurrent effects: the public discussion concerning the imminent discontinuation of the government grant to home buyers and extra work in connection with overcoming the flood damage in eastern Germany.

Table 2

**Key economic data for Germany**

| | Unit | 2000 | 2001 | 2002 | 2003[1)] | 2004[1)] |
|---|---|---|---|---|---|---|
| Gross domestic product | %[2)] | *2,9* | *0,8* | *0,2* | *0,0* | *1,5* |
| Total domestic demand[4)] | %[2)] | *1,8* | *-0,8* | *-1,6* | *0,0* | *0,9* |
| Investment in machinery and equipment | %[2)] | *10,1* | *-4,9* | *-9,1* | *-0,3* | *3,0* |
| Constructions investment | %[2)] | *-2,6* | *-4,8* | *-5,8* | *-3,6* | *0,2* |
| Other products | %[2)] | *9,0* | *5,6* | *1,6* | *1,9* | *4,5* |
| Consumption expenditure | %[2)] | *1,7* | *1,3* | *-0,3* | *0,3* | *0,6* |
| Private households[5)] | %[2)] | *2,0* | *1,4* | *-1,0* | *0,2* | *0,8* |
| General Government | %[2)] | *1,0* | *1,0* | *1,7* | *0,6* | *0,1* |
| Exports of goods and services | %[2)] | *13,7* | *5,6* | *3,4* | *1,1* | *4,8* |
| Imports of goods and services | %[2)] | *10,5* | *0,9* | *-1,7* | *1,4* | *3,4* |
| Employment (domestic) | thousand[3)] | 677 | 163 | -240 | -545 | -122 |
| Registered unemployment | thousand[3)] | -210 | -37 | 208 | 323 | 16 |
| Unemployment rate[6)] | % | *9,6* | *9,4* | *9,8* | *10,5* | *10,6* |
| Consumer prices[7)] | % | *1,4* | *2,0* | *1,4* | *1,1* | *1,2* |
| Financial balances ratio[8)] | % | *-1,2*[a)] | *-2,8* | *-3,5* | *-4,1* | *-3,4* |

1) Own estimate. - 2) In 1995 prices; percentage changes from previous year. - 3) Changes from previous year. - 4) Consumption expenditures and gross capital formation. - 5) Including private non-profit institutions. - 6) Definitions of the Federal Labour Office (Bundesanstalt für Arbeit). - 7) All items (2000 = 100). Percentage changes from previous year. - 8) Financial balance of general government as a percentage of nominal GDP. - a) Excluding one-off proceeds from the auction of the UMTS Licences.

– **Household consumption** picked up only marginally. After this component of demand had declined last year for the first time since German reunification, this year's growth rate of 0.2 per cent again fell short of the expectations. The disappointing trend on the labour market – the total number of hours worked decreased by 1.1 per cent – and the wide wage drift of minus 1.2 percentage points led to a slightly falling volume of gross wages and salaries. In addition, the increase in social security contributions resulting from the widening of the contribution base as well as a raising of contribution rates depressed net wages and salaries, which fell by as much as 1 percentage point vis-à-vis 2002. The fact that households' disposable incomes nevertheless increased on balance in 2003 by 1.4 per cent was chiefly attributable to received social benefits and transfers. Against this background and in view of the uncertainty about the future evolution of incomes generated by the ongoing discussions about tax and social policy measures, consumer confidence also remained weak.

14. The **situation of public finances** again deteriorated considerably in 2003. With a general government budget deficit of 4.1 per cent in relation to nominal GDP, the deficit ceiling laid down in the Stability and Growth Pact was clearly exceeded for the second time in succession. The deficits were run up by all tiers of government – especially by central and state government – but also by the social security funds. The rise in the overall deficit in 2003 was driven principally by the central government budget, due above all to increased expenditure necessitated by the higher unemployment. Already in October the German government submitted a supplementary budget (*Nachtragshaushalt*) which envisaged a rise in net borrowing from €18.9 billion to €43.4 billion. The Federal government's higher new borrowing requirement far exceeded its investment spending totalling €26.7 billion. In order not to infringe Article 115 (1) of the Constitution (*Grundgesetz*), the German government therefore once again had to invoke the escape clause by declaring that the overall economic equilibrium had been disturbed. Besides the cyclically induced deterioration in the budgetary position, reflecting the effects of the automatic stabilisers, the government's action radius was also severely restricted by structural factors. The structural budget deficit in 2003 was 3 ½ per cent in relation to nominal GDP.

The overshooting of the 3 per cent limit prescribed by the Stability and Growth Pact already in 2002 led to the initiation of the excessive deficit procedure by the European Commission and the ECOFIN Council. In the course of the year, however, it became increasingly evident that the 3 per cent ceiling will most probably be breached in the coming year as well. In response to this it became apparent, against the background of the parallel procedure initiated against France, that the European Commission would allow Germany to exceed the deficit ratio in the coming year, too, if it achieves consolidation progress amounting to 1 percentage point of the cyclically adjusted deficit ratio.

In view of the spiralling deficits, the German government initiated a package of tax and social policy measures in 2003 which will substantially ease the financial pressure on general government in the coming years. For 2005 savings of over €20 billion are earmarked which are to rise to more than €26 billion by 2007. For 2004, though, the planned advancement of the third stage of the tax reform implies a lessening of the consolidation impulse, especially for the central and state government budgets (Table 3). However, the impact on public finances not only of the advancement of the tax reform but also of many of the proposed tax savings is uncertain as they still have to be approved by the Bundesrat. Furthermore, the relief effect of some measures, such as the anticipated revenue from the announced tax amnesty, which is estimated at €5 billion, must be rated as highly optimistic.

Table 3

**Financial implications of the German government's reform measures[1)]**

million Euro

| | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| Central government | - 2 834 | + 7 347 | + 7 733 | + 8 607 |
| State government | - 4 126 | + 2 699 | + 3 235 | + 3 529 |
| Local government | + 1 443 | + 4 020 | + 4 194 | + 4 980 |
| Social security funds | + 6 260 | + 5 350 | + 6 250 | + 6 750 |
| Total | + 2 643 | +21 916 | +23 912 | +26 366 |

1) Act Accompanying the Budget 2004, reform of local business tax, encouragement of tax honesty, Basket II, Tax Amendment Act 2003, Retirement Income Act, Second and Third Act amending Social Security Code VI and other laws, Fourth Act Promoting Modern Labour Market Services, Act Modernising the Statutory Health Insurance Scheme, Act amending the Tobacco Tax Act and other excise tax laws; for details see table 40, page 186. - 2) Charges (-).

15. In the wake of the weak macroeconomic development the **situation on the labour market** worsened further in 2003. The level of employment again fell perceptibly by 1.4 per cent to 38.13 million employed persons. Registered unemployment increased to 4.38 million persons on an annualised average. This corresponds to an unemployment rate of 10.5 per cent compared with 9.8 per cent in 2002. Especially in the first half of the year the course of development on the labour market was very weak: in the course of the year the seasonally adjusted jobless total stabilised. However, this was attributable not to an improvement in the overall cyclical climate but to a stricter application of labour market policy. This entailed the labour offices (*Arbeitsämter*) stepping up their testing of unemployed persons' actual willingness to work and more stringently monitoring registration obligations. In consequence of this there was a rise in the number of deregistrations of previously registered unemployed persons who were now

assessed as not being available for and willing to work. In addition, active labour market policy was geared more to promoting regular employment, while "job creation measures" and vocational training schemes were reduced appreciably. This is a step in the right direction in view of the previously available empirical evidence concerning the effectiveness of these labour market policy instruments.

The year 2003 was marked by **diverse reform measures** on the labour market. In September the Act Reforming the Labour Market (*Gesetz zu Reformen am Arbeitsmarkt*) amended the existing statutory arrangements concerning job protection and the duration of entitlement to unemployment benefit (*Arbeitslosengeld*). In shortening the entitlement period for receiving unemployment benefit to a general maximum of 12 months (18 months for persons aged 55 or more) the German parliament took an important step towards reducing unemployment. There is also much empirical evidence to suggest that the duration for which unemployment benefits are paid has a negative impact on the level and length of unemployment. As the new rule will apply only after a two-year transitional period, the positive effects of this measure for the labour market (as well as the fiscal savings) will only be felt from 2006. When it came to amending the existing employment protection regulations, however, parliament largely abandoned its reformist zeal. This concerns both the definition of the threshold from which employment protection applies and the question of compensation in the event of compulsory redundancies. Welcome developments, by contrast, are the clarification of the social criteria governing the prescribed socially responsible selection (*Sozialauswahl*) of employees to be made redundant, the facilitating of exemptions to the rule of socially responsible selection and the limitations placed on the scope of judicial scrutiny in the context of achieving a reconciliation of interests at the plant concerned. Even so, the legal uncertainty for employees and employers alike in the event of a dismissal procedure, which was seen by many observers hitherto as constituting the most serious obstacle under the old provisions, will not be lessened significantly by the reform. In this year's Annual Report the German Council of Economic Experts therefore supplements its previous comments concerning a reform of employment protection legislation and relates this more closely to a far-reaching proposal for reforming the unemployment insurance scheme (*Arbeitslosenversicherung*), as the two institutional regulatory frameworks should not be considered in isolation from one another.

16. The planned amalgamation of unemployment assistance and social assistance announced in the Fourth Act Promoting Modern Labour Market Services (*Viertes Gesetz für moderne Dienstleistungen am Arbeitsmarkt*) puts and end to the parallel existence of two types of tax-financed support for unemployed persons and as such is to

be welcomed unreservedly. If long-term unemployment is to be reduced, however, it is necessary to strengthen the incentives to take up regular employment more than is envisaged in the current plans. The model drawn up by the German Council of Economic Experts to amalgamate unemployment assistance and social assistance in a single benefit payment for recipients of social assistance who are able to work and needy recipients of unemployment assistance contains – over and above the new arrangement also planned by the government – a more generous allowance to earn additional labour income under the new Unemployment Benefit II (*Arbeitslosengeld* II) than hitherto, which is also more generous than that in the planned new arrangement (Annual Report 2002 sections 447 ff.). Moreover, in the Council's model the taking-up of a job in the primary labour market is made more attractive by lowering the regular rate for recipients of Unemployment Benefit II. Insufficient account is taken of this incentive problem in the planned reform of the low-wage sector as it does not contain a more generous facility to supplement benefits with earned income coupled with the lowering of the standard rate of benefits. It is therefore to be feared that the planned reform will fail to attain its objective of boosting the employment rate of unskilled persons. In this context the envisaged two-year supplement for previous recipients of unemployment assistance is also counterproductive. The same applies to the stipulation that when unemployed persons take up a job, they must be paid the standard union rate or the minimum wage set for the locality in question. But despite all criticisms of this dilution of the work availability requirements (*Zumutbarkeitsregelung*), it should be noted that in future any type of activity will be deemed reasonable for recipients of Unemployment Benefit II, irrespective of their qualifications and previous profession.

The new rules applying since April with respect to "mini-jobs" and "midi-jobs" will likewise fail to perceptibly improve the employment prospects of the unskilled. On the one hand, they introduce a little more flexibility into the low-pay sector of the labour market, although the additional employment potential cannot be precisely quantified at present owing to a lack of clear statistical data. On the other hand, many of the extra jobs generated are likely to go to persons outside the problematic categories on the labour market. By contrast, for recipients of Unemployment Benefit II the taking-up of a mini or midi job remains unattractive owing to the restricted ability to supplement benefit payments with earned income.

17. On the vocational training market a clear overhang of applicants is apparent for the vocational training year 2002/2003, and for a time a shortfall of up to 70,000 apprenticeships was feared. As expected, this development reanimated the discussion about introducing a training levy (*Ausbildungsplatzabgabe*) as an instrument with which

to induce firms to ensure a sufficient supply of apprenticeships. Even though at the end of a vocational guidance year the gap between the number of unplaced applicants and the still vacant training places narrowed a little, there was still a statistical excess of around 20,000 applicants. It is too early to say whether this gap can be closed by the end of the year, since the figures for both unplaced applicants and unfilled training places will need to be adjusted for young persons who do not take up apprenticeships offered or who begin but subsequently abandon them. Regardless of this, the German Council of Economic Experts reiterates its view that the concept of a training levy, as is currently also being urged by sections of the government coalition, is inappropriate and will prove counterproductive (Annual Report 1997, section 367). Such a levy raises diverse problems in respect of its concrete features, for example regarding the appropriate assessment base or the treatment of firms not entitled to offer apprenticeships, and it is to be feared that, besides an expensive bureaucratisation of training, it would lead, on the one hand, to substantial "free rider" effects and, on the other, to the payment of the levy in lieu of providing training places. More apprenticeships and a strengthening of vocational training will not be achieved in this way.

**The outlook for the coming year**

- The momentum of business activity in Germany remains subdued. It will pick up only slowly in 2004 in the wake of the global upturn. GDP will grow by 1.5 per cent if the tax reform is not brought forward and by 1.7 per cent if the tax reform is brought forward and is largely funded by counterfinancing measures.
- The stability of the price level will not be endangered in 2004.
- The unemployment rate will stay above 10 per cent.

**The outlook for 2004: hopes for an upturn reliant on the world economy**

18. The hopes for 2004 are based on the scenario that the global economic upturn will continue and the buoyancy in the external sector will spread in the coming year to the domestic economy. The underlying conditions are favourable. On balance aggregate output in most industrial nations will grow distinctly more strongly in 2004 than in 2003.

The outlook for the German domestic economy is less clear. The European Central Bank is pursuing an expansionary course. Real interest rate levels are very low and at the moment there is much to indicate that the present level of central rates will be held until will into next year. Fiscal policy is under pressure to consolidate. A package of measures was adopted in 2003, especially in the social security systems, which envisages substantial net relief for 2004. By contrast, the implementation of the tax policy projects is subject to great uncertainty. This relates primarily to the advancement of the tax reform and its counterfinancing as well as to the reform of local business tax (*Gewerbesteuer*). The savings decided to date will *per se* have a contractionary effect. This will be offset by the lowering of the contribution rate to the statutory health insurance scheme which that will facilitate. In addition, the structural reforms that have been initiated should lead to a positive expectations effect for firms: the reform log-jam in Germany is beginning to dissolve. A rapid or strong impact is not to be expected from the reforms in the short run, however; their influence on domestic business activity in 2004 will therefore tend to take the form of boosting public confidence in the politicians' ability to act rather than in concrete employment and output effects. But together with the stimuli from the external sector, this should suffice to bring about a moderate recovery of domestic demand.

19. The German Council of Economic Experts normally makes its forecast for macroeconomic developments in the coming year on the basis of the legislative status quo. This means that, in the case of new laws or amendments, the Council exclusively takes account of those measures which, at the time the forecast is made, have already become law or which do no require the assent of the Bundesrat. This approach is normally fairly straightforward. Yet the forecast for 2004 is surrounded by considerable uncertainty in view of the many finance bills that are scheduled to enter into force in 2004 but the implementation of which is currently unsure given the Bundesrat's involvement in the further legislative process. This concerns the plan to bring forward the tax reform as well as the tax policy saving measures (Act Accompanying the Budget, reform of local business tax, Act to Promote Tax Honesty (*Gesetz zur Förderung der Steuerehrlichkeit*), Basket II (*Korb* II), The Tax Amendment Act 2003 (*Steueränderungsgesetz* 2003) and the Hartz IV Act (*Hartz IV-Gesetz*)). The implications of these measures are therefore disregarded in the Council's baseline forecast. Under these assumptions GDP is set to increase in 2004 by 1.5 per cent. In an alternative forecast it is assumed that the legislation in question becomes law in the form passed by the Bundestag (lower house). Based on this assumption, the growth rate of GDP is likely to be 1.7 per cent.

20. The two forecast scenarios share a number of identical assumptions. For example, both forecasts assume that the price of (Brent) oil in the coming year will average US$27 per

barrel. Following a modest expansion of 3.7 per cent this year, the volume of world trade is forecast to grow by 7.4 per cent on average in 2004. The real effective exchange rate of the euro remains unchanged from the level it reached in November 2003. The inflation risks remain low and so do not cause the European Central Bank to change the current level of its official interest rates.

21. In the wake of the continuing global economic recovery the growth of exports next year is set to amount to 4.8 per cent. Imports will also expand, though not as much as exports owing to the moderate nature of the domestic revival. The contribution of external trade to the increase in aggregate domestic output should come to around 0.7 percentage point.

Gross fixed capital formation will expand next year at the modest rate of 1.6 per cent. Investment in machinery and equipment will pick up progressively in the course of the year in the wake of the robust momentum of export business. Even so, the projected growth by 3 per cent does not signal a general uplift in investment dynamics. The dominant investment motives will remain replacement and rationalisation measures. Construction investment will likewise remain muted. The one exception will be housing construction, which should be boosted by the exceptional effects resulting from the public discussion about a pending discontinuation of the government subsidy to home buyers. With an annual average growth rate of 0.2 per cent, construction investment will nonetheless see the downward slide halted for the first time since 1999.

Private consumption expenditure will make a small contribution to animating business activity next year. Following an increase of 0.2 per cent this year, an expansion of 0.8 per cent is expected next year. In 2004 disposable incomes will merely grow by a similar margin as in the current year. Consumer prices will rise by 1.2 per cent in the coming year, ie at virtually the same pace as this year.

22. The decline in employment which has persisted for three years will initially continue in 2004, although as the year wears on, the level of employment will rise a little; but on an annual average the number of employed persons in Germany will still fall by 0.3 per cent to 38.00 million (Table C, page 57). The number of registered unemployed will increase only marginally compared with 2003 to reach 4.40 million. This is inconsistent with the experience that the number of jobless individuals lags behind the trend in employment, so that in 2004 a steeper increase should normally be expected. That this is not so is due to the fact that, as in 2003, the cyclical development will be masked by policy changes in the management of the unemployed which are leading *inter alia* to higher deregistrations of non-recipients of unemployment payments from the official unemployment statistics, thereby dampening the expected rise in unemployment ensuing from the employment trend.

23. While the government fiscal deficit will be cut slightly from €86.6 billion this year to around €74.8 billion in the coming year, it will remain at a very high level. Hence the target of keeping the deficit ratio under 3.0 per cent will be missed for the third year running. In our baseline forecast the deficit in relation to nominal GDP will amount to 3.4 per cent, while in the alternative risk scenario it will climb to 3.6 per cent. If, however, the third stage of the tax reform is brought forward but the other planned consolidation measures are not taken, the general government deficit in relation to GDP will match the current year's level of 4.1 per cent.

## III. Consolidate public finances – reform the tax system

24. In 2003 the German economy was again unable to break free from the prevailing stagnation. The modest revival that occurred in business activity was due mainly to external influences. Unemployment rose further. Of the four main macroeconomic goals – stability of the price level, a balanced external position, high employment and an appropriate and steady rate of economic growth – which the German Council of Economic Experts is obliged to consider under the terms of its statutory mandate, the two last-mentioned goals were missed this year for the umpteenth time. This disappointing balance is basically no different from that recorded in last year's Annual Report. Last year the German Council of Economic Experts noted the absence of a coherent strategy for generating more growth and employment in view of the largely aimless nature of economic policy. Since then – and this is the fundamental difference compared with the situation one year ago – economic policy makers have set a number of projects in motion. This basic assessment must not hide the fact that, in view of the uncertainty concerning the implementation of many measures, it contains a considerable portion of advance plaudits and that some aspects warrant criticism. Nevertheless, these moves are headed in the right direction, so that the evaluation of the government's economic policy is more positive than a year ago.

25. This assessment must be differentiated, however. It essentially applies to the measures introduced on the labour market and in the social security systems. It does not apply to fiscal policy in general or to tax policy in particular. Admittedly, the problems currently facing general government are due in part to cyclical causes, and they undoubtedly owe something to the merely half-hearted reforms undertaken in the past in the social security systems. If the situation is then compounded by this or that additional difficulty, government deficits on the scale recorded last year and this year are a virtually unavoidable consequence. But fiscal policy makers merit criticism not so much on account of the cyclically induced deterioration of the government deficits as because of

the fact that they undertook too little in their own domain last year to improve the prospects for more growth and employment. The consolidation of public finances with the objective of lowering government indebtedness, an objective which the German Council of Economic Experts expressly supports and with which fiscal policy makers built up a stock of public confidence in the past few years, was increasingly subjected to the proviso of a favourable cyclical setting. As the macroeconomic momentum slackened, the provisions of the Stability and Growth Pact were seen more and more as a growth-inhibiting straitjacket which could be circumvented through a more flexible interpretation of the rules. Central government net borrowing once again exceeded public investment expenditure, and the distortions at the interface between income tax and business taxation were not eliminated. Tax policy legislation in general has lost all sense of purpose and direction, while the income tax regime in particular is fast losing any appearance of coherence or logic. Instead, the concept of a discretionary anti-cyclical role for fiscal policy has gained increasing prominence.

26. The German Council of Economic Experts judges economic policy according to its ability to formulate and implement a consistent strategy for more growth and employment. In view of the future demographic changes, this also requires economic policy makers to consider the consequences of current policy over a long-term horizon. This applies especially to fiscal policy and social policy. Against the backdrop of the initiated reform measures and the existing reform deficits, one of the focal points of this year's Annual Report is the role which fiscal policy must assume in connection with such a policy concept. In view of the persisting failure to achieve the labour market goals, the German Council of Economic Experts also puts forward proposals for discussion that are designed to supplement the reform measures that have been set in train so far.

### 1. Safeguard stable public finances

(sections 390 ff.)

27. During the past few years the German government has made the necessity of consolidating public finances an integral part of its fiscal policy. In the "Guiding Principles of Fiscal Policy" (*Finanzpolitische Leitplanken*) in 2000 the fundamental objectives of fiscal policy were defined as to "reduce debt for sustainable public finances" and to "promote growth and employment by a sustainable and equitable system of taxes and fiscal charges". This occurred in the realisation that "Today's debts are tomorrow's taxes and social security contributions". In the past year, however, the stringent consolidation requirement on which this philosophy is based was weakened by adopting a more anti-cyclical fiscal policy. The government plans to bring forward the third stage of the tax reform. The reason adduced for this is the need to bolster the

necessary structural reforms and the initiated consolidation course with an anti-cyclical stimulus, given the weak macroeconomic development. A package of tax and social policy measures was put together which will indeed produce a marked consolidation effect in the coming years, provided the measures are implemented on the scale envisaged. However, this is open to some doubt at the moment, particularly in the case of the tax savings, in respect both of the measures' implementation and their financing. This also applies to the tax relief itself. This means that the trend in public finances is subject to considerable uncertainty in the coming year. If the tax reform is brought forward and the corresponding counterfinancing measures are introduced by the Bundesrat, the general government deficit in 2004 is likely to amount to 3.6 per cent in relation to nominal GDP.

28. The hope that bringing forward the tax reform will give a positive impetus to economic activity is accompanied by the growing likelihood that the deficit ceiling laid down in the Stability and Growth Pact will be breached yet again next year. Given the empirical evidence concerning the small short-run macroeconomic impact of a discretionary, credit-financed tax cut, this is a high price to pay, because there is a danger that fiscal policy, caught in the dilemma of following long-term consolidation requirements and a short-term stimulus objective, will be perceived as pursuing two irreconcilable goals. The loss of credibility that this would entail would be particularly great if the tax relief measures were adopted but the tax consolidation measures were to fall by the wayside in the negotiations between the German government and the parliamentary opposition in the course of the mediation procedure. For reasons of political economy, this is a not improbable outcome. The fate of the Act to Reduce Tax Concessions (*Steuervergünstigungsabbaugesetz*) affords a graphic illustration of how fiscal consolidation measures can be diluted beyond recognition in the context of the "cooperative federalism" that prevails in Germany. In view of the pressing need for consolidation, this would be the worst possible solution.

*Renaissance of discretionary fiscal policy*

29. The idea that the arsenal of fiscal policy instruments can and should be used to effectively counter the current cyclical slowdown has gained importance in recent years in Germany as elsewhere. The most prominent example is to be found in the United States, where fiscal policy has been deployed increasingly in a discretionary manner with a view to stabilising macroeconomic momentum. With the planned advancement of the third stage of the tax reform the German government now likewise intends to engineer tax relief of around €15.6 billion for the coming year that is to be partly credit-financed. Some €7 billion of this total affects the central government budget of which

€5 billion is to be financed through higher borrowing. It is not yet clear how state and local government will finance their share. The majority of the existing empirical studies on the consequences of a credit-financed tax cut come to the conclusion that such a measure triggers positive conjunctural effects in the short run. But the corresponding multipliers are normally small. Thus a lowering of the tax burden in relation to nominal GDP by 1 percentage point boosts the growth of aggregate output in the short run by around 0.2 to 0.5 percentage point. This small positive macroeconomic stimulus from tax relief measures has to be weighed against the possible loss of credibility in the medium-term consolidation path associated with a higher deficit. Given this alternative, along with a structural deficit in 2003 of 3½ per cent in relation to nominal GDP, the German Council of Economic Experts would have advised against advancing the tax reform. Since, however, the Bundestag has meanwhile voted to bring forward the third stage of the tax reform, this step should also be implemented. The constant vacillation of tax policy must be terminated once and for all, for such zigzagging likewise damages the public's confidence in the politicians' ability to govern. The Council wishes to caution, however, against a possible future renaissance of discretionary fiscal policy. The small stimulus effects are counterbalanced by the large risks of effectively pursuing a pro-cyclical policy which stem from the fact that the policy measures come too late, on account of the time-lag in the diagnosis and decision-making process, and thus have a pro-cyclical impact instead of the intended anti-cyclical effect. This does not imply that fiscal policy makers should make no attempt whatsoever to steady the level of business activity; but as a general rule they should perform this task by allowing the automatic stabilisers to take effect and should not dissipate their energies in a political tug-of-war over measures to kick-start the economy. The remaining unresolved problems in the field of fiscal policy are too important for that.

**Stability and Growth Pact**

- The Stability and Growth Pact is a meaningful and necessary set of rules. It is designed to ensure the sustainability of the national fiscal policies in the euro area and to prevent potential conflicts between the single monetary policy and the national fiscal policies.

- The European Commission is currently not living up to its role as the guardian of the Pact. It should apply the Pact consistently and respond more rigorously to infringements of the Pact.

- The ECOFIN Council currently bears even greater responsibility than the European Commission for undermining the Pact. It has postponed the decision concerning further steps in the excessive deficit procedure initiated against France, with the outcome left open. If there is a repeated failure to punish infringements of the Pact's provisions by imposing sanctions, the Pact is effectively dead.

– In consequence of its repeated and continuing infringements of the Pact's budgetary rules, Germany must initiate resolute consolidation measures immediately. Otherwise it will have to accept possible sanctions – beginning with the surrender of a non-interest-bearing cash deposit.

*Stability and Growth Pact: flexibility stretched to breaking point*

30. In 2003 Germany ran up a budget deficit of 4.1 per cent in relation to nominal GDP and thus exceeded the deficit limit of 3 per cent laid down in the Stability and Growth Pact for the second year in succession. And next year, too, it will fail to bring down the deficit ratio to below this ceiling. Moreover, with a structural deficit of over 3 per cent, the German government is still far from achieving the medium-term objective of a balanced budget. It was thus a logical consequence that an excessive deficit procedure was initiated against Germany at the start of the year. A similar procedure has also been initiated against France. The initiation more or less simultaneously of an excessive deficit procedure against the two largest countries in European monetary union constituted the Pact's first acid test. The ECOFIN Council's decision at its meeting at the start of November to postpone a ruling on the European Commission's recommendations to France pursuant to Article 104 (9) of the EC Treaty has for the moment plunged the Pact into an existential crisis. The European Commission's recommendation to tolerate France's overshooting of the 3 per cent ceiling up to 2005 in return for a promise to reduce the cyclically adjusted deficit ratio by 1 percentage point was a move which stretched the flexibility of the Stability and Growth Pact to breaking point. The fact that the ECOFIN Council has been unable so far to muster the requisite majority in support even of this lax requirement risks destroying the Pact completely.

31. The Stability and Growth Pact is a meaningful set of rules. It is designed to prevent possible conflicts between the single European monetary policy and the still national fiscal policies in the euro-area member-states and, in addition, to safeguard the sustainability of public finances and in this way strengthen the long-term prospects for growth. That sound public finances exert a positive influence on the long-run level of output is also corroborated for the member-countries of European monetary union by empirical findings (sections 789 ff.). According to the rationale underlying the Pact, the aforementioned aims require a balanced budgetary position and hence, for countries in which the cyclically adjusted budget is in deficit, corresponding consolidation efforts. Quite a number of countries have managed to reduce their deficits and cumulative debt

levels markedly in recent years. Starting from a status quo of a balanced budget, it is then possible for fiscal policy to achieve a stabilisation of the economy, also given normal cyclical fluctuations, by allowing the automatic stabilisers to operate, without coming into conflict with the 3 per cent deficit criterion. Thus if the deficit limit is breached during a not excessively dramatic downswing of the business cycle – as in the case of Germany and France – this can only be explained by a failure to consolidate in the recent past.

32. In this case there is indeed a conflict of aims between short-run anti-cyclical requirements and the deficit criteria prescribed by the Pact. But the logic of the Pact allows the countries concerned two basic options: if policy makers pursue the aim of bringing government deficits below the 3 per cent ceiling, this implies a pro-cyclical policy; if policy makers wish to avoid this, they must – according to the applicable rules – accept an excessive deficit procedure together with its possible consequences. A country which finds itself in such a difficult situation is thus not absolutely compelled to pursue a policy that reinforces the cyclical fluctuations, but in this case it must live with the consequences of its decision. By not allowing this conflict of aims to emerge openly and allowing instead the repeated breaching of the deficit limit without imposing sanctions runs the risk that the Stability and Growth Pact may degenerate into a regulatory dead letter. This is why the decisions of the European Commission and of the Council of Ministers in the current excessive deficit procedure in respect of France must be viewed so critically.

33. A strict interpretation of the Pact would require the imposition of sanctions by the end of 2004 at the latest unless the deficits were lowered beneath the 3 per cent limit in the coming year. In the case of Germany and France this is an unrealistic scenario. Consequently, the rules ought to be applied as envisaged. The envisaged sanctions normally start with an unremunerated cash deposit. In the cases under consideration here this would probably not have to be deposited before the end of 2004 and would entail comparatively small financial burdens in 2005 and 2006, as only any interest payments for financing the cash deposit would be incurred as costs. Only after that would, in the event of a continuing infringement, the cash deposit be converted into a fine.

34. The German Council of Economic Experts is opposed to a radical reform of the Stability and Growth Pact. None of the alternatives proposed by politicians or economists offers such clear-cut advantages that they counterbalance the risk of an extensive remodelling of the Pact in the present situation. This does not preclude the possibility of gradual reforms, but these could largely be implemented within the present scope of the Pact.

These include strengthening the European Commission's role in respect of early warnings and in the course of the excessive deficit procedure.

**Sustainability of public finances**

- To assess the sustainability of public finances it is necessary to take account not only of the explicit general government debt but also of the implicit government debt, which results notably from the statutory pension insurance scheme, the statutory health insurance scheme and the non-contributory retirement pension entitlements of public sector employees with the status of civil servants (*Beamte*).
- The sustainability gap shows an irrefutable need for action in fiscal and social policy. According to our calculations, the gap is now several times as high as the explicit general government debt ratio of 60.8 per cent measured in the base year 2002.
- The level of the implicit general government debt ratio can be reduced by approximately half if the statutory retirement age is raised in the long term from 65 to 67 years and the pension adjustment formula is supplemented by a sustainability factor (*Nachhaltigkeitsfaktor*).

*Safeguard the sustainability of public finances*
(sections 438 ff.)

35. One of the central aims of the Stability and Growth Pact is to safeguard the sustainability of fiscal policy. The EMU member-countries are obliged pursuant to Article 121 (1) of the EC Treaty to achieve "the sustainability of the government financial position". The assessment of sustainable public finances is gauged by the level of general government fiscal balances and debt levels. Yet these indicators provide only limited information as to whether a given fiscal policy is sustainable. They merely express, in the case of the deficit ratio, the present or, in the case of the debt ratio, the past orientation of fiscal policy. Hence the two indicators fail to reflect the fact that, besides the securitised explicit government debt, a second form of government debt exists, namely the implicit liabilities. The latter arise as the difference between the future unsecuritised payment commitments based on current policy and the future revenue stream that must cover these obligations. Such unsecuritised future payment obligations are rooted above all in the benefit commitments of the social security funds, but also in government pension commitments to civil servants which must be honoured in the future. If future revenue – discounted to the present value – does not suffice to meet future payment commitments, an implicit debt exists.

36. This makes it clear that the question of a sustainable fiscal policy cannot be answered by solely considering the current government deficits or the disclosed debt level. It is also necessary to take a long-term view of the consequences that are implied by projecting current policy into the future. In this year's Annual Report the German Council of Economic Experts for the first time presents an analysis of the sustainability of fiscal policy based on the concept of generational accounting. The results confirm that there is a considerable future consolidation requirement in respect of public finances. The share of implicit debt in relation to nominal GDP in 2002 is several times higher than the explicit debt ratio of 60.8 per cent. The overall sustainability gap, defined as the sum of the two debt level ratios, totals around 330 per cent in the baseline scenario. Closing this sustainability gap so as to ensure sustainable public finances would require, assuming unchanged revenue levels, cutting all present and future government expenditure by some 12 per cent. In relation to 2002 this would imply reducing the government expenditure ratio from 48.5 per cent to 42.6 per cent or reducing current government expenditure by more than €120 billion. Given the various problems of definition, classification and forecasting associated with such a long-run analysis, the concrete numerical values for the computed sustainability gaps need to be interpreted with some caution. Notwithstanding this qualification, it is clear that the actual consolidation requirement facing German fiscal policy in the coming decades is several times higher than that suggested by the current deficits and the officially reported debt ratio.

37. An analysis of the origins of the sustainability gap shows that it is caused primarily by a combination of two things: the demographic trend in the coming decades and the pay-as-you-go social security systems. Policy makers can do little to change the course of demographic development, so any attempt to narrow the sustainability gap must be directed towards the social security systems. For example, a pension reform as proposed by the Commission for Achieving Sustainability in the Financing of the Social Security Systems (*Kommission "Nachhaltigkeit in der Finanzierung der Sozialen Sicherungssysteme"*), popularly known as the Rürup-Commission after the name of its chairman, would reduce the implicit debt ratio by almost half by raising the statutory retirement age and introducing a sustainability factor (*Nachhaltigkeitsfaktor*) to take account of the demographic changes. Seen in the light of this longer-term context, there is no alternative for a consolidation strategy that aims to face up to the future challenges other than to introduce bold reforms in the statutory pension insurance scheme and the statutory health insurance scheme.

**Social security**

- The healthcare reform of 2003 (Act to Modernise the Statutory Health Insurance Scheme) introduced some important, though far too timid, steps towards strengthening competition.
- The health premium model (*Pauschalprämienmodell*) proposed by the German Council of Economic Experts for reforming the method of financing the statutory health insurance scheme is superior to the alternative option of an all citizens' insurance scheme (*Bürgerversicherung*) in terms both of allocation and above all employment policy.
- The raising of the statutory retirement age and the introduction of a sustainability factor into the pension adjustment formula are suitable for stabilising the statutory pension insurance scheme in the long term.

*Social security: reform efforts and reform discussions*
*(sections 289 ff.)*

38. Corresponding reform proposals for the individual social security schemes have been put forward by the Commissions appointed by the German government and the opposition parties CDU/CSU. Despite all their differences in individual points, the two reform programmes both recognise the need, in view of the demographic development and the wage-related financing of the social security schemes, to restructure the statutory social security systems and their current pay-as-you-go funding basis. The German government has taken some initial legislative steps in the fields of the statutory health insurance scheme and the statutory pension insurance scheme towards implementing the proposals of the Rürup Commission. As the German Council of Economic Experts gave detailed consideration in its Annual Report of last year to the reform options in the field of the social security systems, the measures of the German government as well as the proposals made by the Rürup Commission in these policy areas are assessed in this year's Annual Report in the light of the concepts of the German Council of Economic Experts.

39. In the statutory health insurance scheme the adoption of the Act to Modernise the Statutory Health Insurance Scheme (*GKV-Modernisierungsgesetz*) ushered in the start of a more comprehensive healthcare reform. The Act, which was passed in consensus with the CDU/CSU opposition, envisages important measures on the expenditure side and towards strengthening competition. Greater recourse to supplementary payments by patients and the introduction of charges for visits to doctors' surgeries are to reinforce

the revenue of the statutory health insurance institutions (*Gesetzliche Krankenkassen*) in the coming year by €3.2 billion. From 2005 onwards the dropping of the provision of dentures from the standard services offered by the statutory health insurance scheme is to yield savings of around €3.5 billion. From 2006 sickness benefit (*Krankengeld*) is to be financed solely by the insured persons, at least partly through a supplementary contribution. This last-mentioned solution is conceptually unconvincing since it is not directly related to sickness benefit but instead merely creates a one-off shift in the currently equal financing shares of employees and employers. As this does not change the overall burden of taxes and social security contributions on employers and employees, no significant employment effects may be expected from this measure. Another aspect which merits criticism is the decision to move towards financing via transfers from the Federal budget. This is supposed to cover non-insurance-related benefits (*versicherungsfremde Leistungen*); yet the transfer has not been explicitly coupled to this category of expenditure but instead is to be paid into the system as a general grant and financed through a multi-stage increase in tobacco tax. The self-perpetuating momentum which such transfers can generate once they have been called into being, and the associated limitations which they may impose on the scope of fiscal policy action, can be seen in the example of the statutory pension insurance scheme (section 268). Some first tentative competitive elements were adopted in connection with the distribution of pharmaceuticals. On balance, however, the reform insufficiently reinforced competition at the level of the service providers, not least owing to the influence of interventions in the consensus-finding process motivated by the desire to protect the vested interests of certain lobbies. The German government hopes that these reform measures will enable the contribution rate to be cut to 13.6 per cent in the coming year. This expectation appears overly optimistic.

40. A decision on a fundamental reform of the method of financing the statutory health insurance scheme was not taken in 2003. In this connection the Rürup-Commission presented parliament with two alternative models for financing healthcare services: a health premium model incorporating a distributive component, and a method of financing via an all citizens' insurance scheme, ie an income-based health insurance scheme encompassing a wider group of compulsorily insured persons and types of income subject to insurance payments as well as the raising of the income ceiling subject to contributions. In its last Annual Report the German Council of Economic Experts already expressed its clear preference for a financing model based on premiums, giving two main reasons. Firstly, a premium-based model decouples the future growth of healthcare costs from the contributions, which are currently tied to labour income; this appreciably enhances the incentive to work for the bulk of income recipients. Secondly, it increases the equivalence between contributions paid into and benefits

drawn out of the statutory health insurance scheme. Moreover, the premium model, too, contains – and this is an aspect which politicians and the media alike tend to largely overlook – a social equalisation component for recipients of low incomes, which would be financed via the disbursement to the employee and the subsequent taxation of what was previously the employer's contribution to the statutory health insurance scheme.

The alternative model of a citizens' insurance scheme is manifestly inferior to the health premium model in respect of its likely employment effects. The inclusion of additional categories of income in the assessment base will achieve only a limited decoupling of contributions from wages. And it comes at the cost of additional distortions that ensue from raising the income ceiling subject to contributions and including additional types of income in the assessment base. Negative employment effects are actually likely on balance. The popularity of the citizens' insurance model can be explained primarily by its income redistribution effects, which are perceived as being more equitable than the financing model based on premiums. It should be borne in mind, however, that distribution aspects yield little net gain if the volume of resources available for redistribution is decreased rather than increased by the supposedly more equitable measures.

41. In 2003 the **statutory pension insurance scheme** again faced the threat of a rise in the contribution rate brought about notably due to the erosion of revenue; and just as in the preceding years, this was countered by ad hoc measures. While this may be welcome from the point of view of safeguarding jobs, it further dented public confidence in the dependability of the statutory pension insurance scheme. Among the adopted measures were the non-adjustment of pensions in 2004, a further lowering of the minimum required fluctuation reserves (*Schwankungsreserve*) and the unilateral financing by pensioners themselves of the contribution to the social long-term care insurance scheme (*Pflegeversicherung*) in the coming year. This last measures boils down in effect to an effective cut in net pensions of 0.85 per cent

In the context of the continuing sluggish macroeconomic setting and given the prospect of rising demographic pressures vis-à-vis the assumptions which underlay the pension reform of 2001, additional medium-term pension legislation measures became necessary. In this connection the German government intends to abolish the crediting of years spent in college towards the pension accrual period, to raise the actual average age at which retirement pensions are claimed by eliminating incentives to take early retirement and to modify the pension adjustment formula in a way that takes due account of both a lower birth-rate and a rising life expectancy. These measures are right. In particular, the proposal made by the Rürup Commission to add a sustainability factor to the pension formula as an expression of revenue-oriented expenditure policy is an appropriate innovation in view of the demographic trend. Yet the lifting of the actual average age on retirement, however welcome the dampening of the incentives to retire prematurely may be, needs to be supplemented by the raising of the statutory retirement age. Like the Rürup-Commission, the German Council of Economic Experts has proposed a progressive increase in the statutory retirement age, beginning from 2011, as a suitable policy. The measures recommended by the Rürup-Commission would keep the rise in the contribution rate below 22 per cent up to 2030. Moving towards such a more strongly revenue-oriented expenditure policy – which certainly makes sense – will, however, lead to lower implied yields for the middle and younger age-cohorts and to a marked lowering of the gross pension level. The upside for the younger cohorts is that they will gain financial leeway to make supplementary private pension arrangements by which the benefit reductions under the unfunded public pension scheme can be mitigated or even overcompensated – depending on the precise yield and saving period. In the light of the demographic strains weighing on the sustainability of the pay-as-you-go pension system and hence on public finances in general, the German Council of Economic Experts advocates that the corresponding proposals of the Rürup-Commission be implemented as speedily as possible.

42. The **social long-term care insurance scheme (Soziale Pflegeversicherung)** is likewise in need of reform given the deficitary development during the past few years. Yet in this case the German government has not even taken up the proposal made by the Rürup-Commission, which essentially aims to maintain the present system and to keep the contribution level constant by raising the financial burden on pensioners and promoting the accumulation of an individual capital stock. It would have been better in any case – and would still be feasible – to organise long-term care by switching to a funded private nursing insurance scheme (*Private Pflegeversicherung*). The development over the past few years, during which the reserves initially built up following the establishment of the social long-term care insurance scheme in 1995 rapidly dwindled, clearly shows that it was a mistake to fund the long-term care insurance scheme on a pay-as-you-go basis – a fact which the German Council of Economic Experts emphatically pointed out at the time (Special Report 1994, reproduced as an annex to the Annual Report 1995).

**Budgetary consolidation**

- Budgetary consolidation should serve to attain long-term objectives.
- Past experience shows that consolidation achieved through spending cuts has a more lasting impact than consolidation achieved through revenue increases. Successful budgetary consolidation does not require a favourable cyclical setting.
- Reducing or abolishing tax concessions in order to finance tax cuts has positive macroeconomic effects. But reducing tax concessions is also appropriate for fiscal consolidation purposes.
- A selective, criteria-based reduction of financial aid and tax concessions is superior to an across-the-board approach.
- The volume of the reductions in expenditure and abolition of tax concessions proposed here will total over €25 billion per year once the measures take full effect. This does not include tax concessions granted to companies; their reduction needs to be integrated into a reform of business taxation.
- Spouses' income splitting – ie the practice of defining spouses' individual tax assessment base as half their joint income (*Ehegattensplitting*) – is not a tax concession. The tax-offsettable standard mileage allowance for commuters (*Entfernungspauschale*) is not generally a tax concession; it is therefore defensible to reduce it.

*Consolidation of public finances: strategies and options*
*(sections 455 ff.)*

43. Over and above the decisions and projects concerning the statutory social security systems, for which a substantial net relief effect is anticipated in the coming years, the German government has also set in train a comprehensive package of tax measures. If implemented in their entirety – including the Fourth Act Promoting Modern Labour Market Services – this will yield estimated extra revenue for central, state and local government from 2005 of the magnitude of more than €17 billion per year. In 2004, based on the assumption of the advancement of the third stage of the tax reform including the planned savings, a revenue shortfall of approximately €4 billion will be recorded, however. Given the ballooning deficits and the identified sustainability gap, a medium-term consolidation requirement in excess of that is both obvious and irrefutable. The hope that this fiscal pressure can be circumvented solely through higher economic growth is unrealistic. To that extent the measures of the German government

are correct and necessary, even though they constitute just a first step. This being the case, it would be disastrous if the fate of the Act to Reduce Tax Concessions were to be repeated. However, the insight that public finances are in urgent need of restructuring is gaining increasing acceptance across party-political divisions. In the past few months the parties have been virtually vying to outbid one another in identifying potential saving measures. What is still lacking, in the opinion of the German Council of Economic Experts, is an economically founded analysis of the starting points and fields of activity of a promising consolidation strategy. In other words, it is easy to compile a list of savings totalling billions of euros; but without convincing arguments it is far harder to marshal a political majority for their implementation.

44. Consolidation means an improvement in the cyclically adjusted government primary balances, ie the balance of government expenditure and revenue excluding cyclical effects and excluding government interest payments. This implies that consolidation efforts can be made on the expenditure side and/or on the revenue side of the general government budget. The lessons learned from past consolidation phases in the EMU countries demonstrate, however, that a permanent improvement in public finances is more likely to be attained if consolidation focuses on the expenditure side. Moreover, it has been shown that rigorous saving measures can also be initiated in a difficult macroeconomic setting without the cyclical deteriorations feared from the short-run consolidation measures necessarily occurring. In fact, in many cases the opposite effect is noted. Hence there is no justification for making the need to consolidate dependent on a favourable cyclical situation. For this reason the German Council of Economic Experts advocates adopting a consistent and long-term consolidation strategy. This should be pursued independently of the cyclical fluctuations by generating cyclically adjusted primary surpluses, with the task of smoothing economic fluctuations being left to the automatic stabilisers.

45. In the political discussion about consolidation, the scrapping of tax concessions unaccompanied by a corresponding lowering of tax rates is often labelled a tax increase which should be rejected. This argument is unconvincing for a number or reasons. For one thing, the distinction between tax concessions and government expenditure is often not as clear-cut as it appears in the public debate. Many tax concessions, such as the grant to home buyers which – according to the accounting conventions used in the German government's financial statistics – is booked as lessening tax revenue, are equivalent to expenditures in economic terms. Even more important, however, is the fact that the elimination of tax subsidies curbs the distorting effects and hence the additional tax burdens by widening the tax assessment base. This is directly evident if tax rates are cut simultaneously with the widening of the tax assessment base. But in principle it also

applies if, instead of cutting the tax rates, the government reduces its deficits and hence the future government tax burden. The scrapping of tax concessions must not therefore be declared a taboo area in any credible consolidation strategy.

46. The reduction of subsidies, ie financial aid and tax concessions, should be selective and criteria-driven. The "scatter-gun" method, ie an across-the-board cut by a uniform percentage, must therefore be rejected. Not every kind of financial aid or tax concession is unjustified, and a uniform cut does not differentiate between cases which have strongly distorting effects and cases where this is far less so or for which there may even be sound economic grounds. The criterion by which the German Council of Economic Experts assesses the justification of the subsidies in question is that of efficiency: subsidies must be reduced selectively, first and most strongly wherever they cause the largest negative welfare effects. Government interventions are normally described as having a distorting effect, which reduces efficiency and hence impairs employment and growth, if a government intervention, eg a tax measure, distorts an individual's decision over and above the primary income deduction: in short, whenever excess burdens occur.

47. Against this background this Annual Report identifies and economically analyses a number of expenditures and subsidies, many of which have for quite some time featured prominently in the public discussion about the relevant consolidation choices. This includes the field of active labour market policy as a major expenditure item. Important financial aid items and tax concessions are also examined. The aggregate volume of the measures considered totals around €60 billion. The total volume of those items examined which should be abolished completely comes to around €25 billion. In addition, a number of subsidies are identified which, if they cannot be completely abolished, could well be sharply reduced. Some of these have already been included in the Act Accompanying the Budget. A quite substantial number of these, however, have not been tackled resolutely enough to date. This scope for further consolidation must be utilised in the coming years. In the field of active labour market policy, for example, the process which has been embarked upon of cutting unpromising measures should be vigorously continued. This principally relates to "job-creation measures" and parts of the arsenal of training schemes. Among the major financial aid items that should be scrapped altogether are the grants for the sale of German coal and the promotion of housing construction (including the grant to home buyers). In the context of subsidies granted as tax concessions, there are no grounds warranting the tax-free supplements for working on Sundays, public holidays or at night. The same applies, for example, to the tax-free saving allowance (*Sparerfreibetrag*), the special expenditure allowance (*Sonderausgabenabzug*) for contributions paid under life insurance contracts, the tax exemption for life insurance income, the tax-free allowance for coaches and the special

expenditure allowance for donations to churches, political parties and for non-profit purposes. By contrast, the hotly debated standard mileage allowance for commuters cannot be classified *per se* as a tax concession. Although a case can be made for reducing this facility, its complete abolition cannot be substantiated for reasons of efficiency. Spouses' income splitting is likewise consistent with the overall logic of the tax system and hence should not be abolished. This list of potential savings on tax subsidies does not embrace tax concessions to enterprises since these should be incorporated into a reform of business taxation.

A study of the distribution of market income and income tax liability which the German Council of Economic Experts carried out this year for the first time revealed, in respect of income from rents and leases, that around half of the recipients who were subject to tax and had a positive income of more than €250,000 recorded negative income from rents and leases. Another notable fact is that the negative income from this income category rose with increasing positive income, and in the income brackets above a total positive income of €500,000 amounted on average to between €130,000 and €510,000 (sections 822 ff.). This suggests that the losses were motivated purely by tax considerations based on generous depreciation rules.

**Reform of federalism**

- The political decision-making processes in Germany are slow, opaque and unpredictable. The primary cause of this political failing is the federal nature of the decision-making structures.
- The present system of cooperative federalism must be replaced by a competitive federalism; federalism without competition is no real federalism at all.
- A functioning federalism must include a limited degree of tax-raising autonomy for state government.
- The mixed financing arrangements between central and state government should be curtailed.
- The framework legislation (*Rahmengesetzgebung*) issued by central government and the competing legislation should be restricted.

*Reform of federalism: break down the barriers to decision-making*
*(sections 510 ff.)*

48. It will only be possible to implement a sustainable, economically founded consolidation strategy in Germany if the current institutional barriers to political decision-making can

be broken down. Such barriers, as the past few months have once again demonstrated, are only partly attributable to the fact that it is difficult for the political decision-makers to marshal majorities in their own ranks for a course that entails some deep incisions. A more significant factor for the painfully slow decision-making processes is the federal structure of the German political system. For a long time now the political decision-making processes in Germany have been slow, opaque and unpredictable. This fosters a feeling of insecurity among the citizens and produces a permanent uncertainty concerning the increases and decreases in their burdens even in the immediate future. Thus up to mid-November 2003 a decision had still not been taken as to whether the third stage of the tax reform will be brought forward and what counterfinancing measures will be adopted. The actual form which federalism takes in Germany constitutes a big – perhaps the biggest – obstacle to the implementation of fundamental reforms, notwithstanding the fact that in some cases the Bundesrat can act as a meaningful corrective to individual legislative projects. It is not a question, however, of the specific content of individual decisions but rather of the decision-making mechanism. A reform of Germany's "cooperative federalism" is imperative if economic and fiscal policies are to acquire greater reliability.

49. There is now a shared awareness among the politicians of the need to reform the present federal structure. On 16 October 2003 the Bundestag set up a joint commission of the Bundestag and the Bundesrat with the aim of modernising the country's federal structure. The establishment of this commission is certainly to be welcomed. It is to be hoped that it will manage to make courageous recommendations for reform which are then swiftly implemented by the political bodies. It is to be feared, however, that this hope will be disappointed. The remit of the newly established commission excludes some central issues. These notably include a revision of the overall system of financing the expenditure of the various tiers of government, with an unravelling of the joint tax-raising arrangements between central and state government and an associated (limited) tax autonomy for the state government bodies (*Bundesländer*). At the moment any modification of the tax rates and assessment bases of the joint taxes (*Gemeinschaftssteuern*) – which make up around two-thirds of total tax revenue in Germany – is only possible with the assent of both the Bundestag and the Bundesrat. The in-built barriers to decision-making which this system generates must be dismantled, otherwise any reform of the federal structures will be incomplete.

50. There is no question of wanting to abolish Germany's federal structure. But there is a pressing need for a release from the political "gridlock" that has arisen in the course of the decades as a result of the interlocking structures of central, state and local government on the revenue side and in the legislative process via the Bundesrat (which

is composed of representatives of state government). A radical restructuring of the country's federal structure must be geared to achieving more competition between the individual tiers of government. This can only be done by granting a greater degree of autonomy in the fulfilment of tasks and, above all, in revenue-raising. Serious shortcomings exist in this respect at present. State government has virtually no possibility to influence tax revenue; joint financing and joint tasks lead to misplaced incentives and the blurring of responsibilities; one tier of government can decide on tasks and expenditure which another tier has to accept. In all these areas there is an urgent need for action. The German Council of Economic Experts has repeatedly drawn attention to this (Annual Report 2000 sections 169 ff.). The basic elements of a reformed federal system should comprise greater tax autonomy for state government – whether via a system of segregated tax-raising powers (*Trennsystem*) or (and this is probably the more realistic variant) via a supplemental levy facility (*Zuschlagsystem*) added onto a uniform, lowered Federal tax rate or onto the resulting tax revenue – along with the extensive elimination of the numerous instances of joint financing, except for those cases in which pronounced cross-government externalities may be presumed, such as in the field of basic research.

**Tax policy**

– In terms of the effective tax burden on enterprises, Germany remains a high-tax country.

– Owing to its volatility, German tax policy has lost a great deal of credibility; the tax regime has moved further away from the ideal of a structured, rational system.

– To enhance Germany's attractiveness as an investment location and to reduce the distortions in investment and financing decisions and in the choice of legal status for enterprises, two different approaches are conceivable: either the integration of corporation tax into income tax (tax reform option I) or a dual income tax regime (tax reform option II).

– Local trade tax/local business tax (*Gewerbesteuer/Gemeindewirtschafts-steuer*) should be transformed into a municipal supplement added either to income tax and corporate tax (option I) or to a tax on labour income and capital income (option II).

– The German Council of Economic Experts considers the dual income tax model the more advantageous tax reform option; the proportional tax rate to be applied to capital income should be set at around 30 per cent, while labour income should be subjected to a tax regime ranging from a bottom rate of 15 per cent to a top rate of around 35 per cent.

## 2. Taxation policy: from chaos to a structured system

(sections 518 ff.)

51. Besides reducing debt, one of the two "Guiding Principles of Fiscal Policy" formulated by the German government in 2000 was to "promote growth and employment by a sustainable and equitable system of taxes and fiscal charges". The German taxation - system as it exists in 2003 is far removed from those aims. A study of the fiscal attractiveness of investment decisions in comparison with major European partner countries, based on the effective marginal and average tax rates, shows that Germany has lost ground over the past two years as an investment location. For businesses Germany remains a high-tax country. This applies equally to domestic and cross-border investment.

However, it is not only the country's attractiveness as an investment location that has suffered. German income tax legislation is fast losing any semblance of being a structured, rational system. Income tax is turning more and more into an unsystematic schedular tax without any indication of the emergence of some new overriding set of taxation principles. The problem is compounded by the fact that German tax policy has also lost credibility on account of its volatility. Tax policy has become a ball tossed back and forth in the ping pong of conflicting interests within the German government, between central, state and local government and between government and opposition. This is a disastrous development, both regarding the planning certainty of consumers and investors and for Germany's general image.

*Violation of the synthetic income tax principle under current law, and reform options*

52. The point of reference of the current system of income taxation is the classical synthetic income tax. In the ideal case all income, regardless of its source or origin, is taxed in the country of residence. No distinction is made between the different types of income either in the tax assessment base or in the tax rate. The present-day tax system violates this principle in a number of ways. There can be no question of the uniform taxation of different types of income.

- This principle is violated systematically by the different method of determining income – profit income (*Gewinneinkünfte*), on the one hand, and net income (*Überschusseinkünfte*), on the other. This leads to differences in the taxation of capital gains: they are essentially exempt from taxation in the case of net income but subject to tax in the case of profit income. Similar systematic differences are evident in the treatment of capital income. It is privileged vis-à-vis other types of income via the tax-free saving allowance. Similarly, the introduction of the income tax relief facility (*Halbeinkünfteverfahren*), under which half of dividend income is taxable, has created differences in the taxation of distributed profits and income in the same amount derived from other sources. Income from certain endowment life insurance policies is exempt from tax.

- The parallel income tax and corporate tax regimes give rise to distorting effects in connection with firms' financing decisions and choice of legal status.

- Furthermore, in a synthetic income tax system, profits and losses should be given equal tax treatment. Yet German tax law contains a number of restrictions on offsetting losses within a particular income category and also between different income categories.

- A basic principle of income taxation is the net principle (*Nettoprinzip*). It ensures in particular the tax-deductibility of business or professional expenses (*Erwerbsausgaben*). Violations of this principle are to be found in current income tax law, for example, in the treatment of the cost of acquiring equity investments in joint-stock companies both on the part of natural persons and of corporations. In particular, the question of the tax-deductibility of the investment costs in the case of cross-border acquisitions leads in addition to considerable problems of safeguarding the national tax revenue.

53. These examples, which by no means concern peripheral areas of German income tax law, clearly demonstrate that German income tax has moved a long way from the ideal of a synthetic income tax. The conclusion to be drawn from this is obvious: Germany needs a radical reform of income tax and business taxation. In this connection the German Council of Economic Experts presents two reform options in its Annual Report. Under tax reform option I corporate tax is integrated into income tax. Under tax reform option II – a dual income tax system – capital income and labour income are taxed differently. On the basis of an explicit set of criteria and after considering the respective advantages and disadvantages of the two options, the German Council of Economic Experts comes out in favour of changing over to a dual income tax regime.

Tax reform option I adheres to the ideal of a synthetic income tax. The dual income tax regime, by contrast, would introduce a modification of this principle. It should be noted, however, that even under tax reform option I it is not possible to realise the ideal form of a synthetic income tax in accordance with the principle of income-source neutrality. For that to happen, it would be necessary to change over to a full imputation system (*Vollanrechnungsverfahren*) of income earned abroad, which is not a viable option in view of the currently applicable double taxation agreements, which normally stipulate the tax-exemption of such income. In addition, in respect of corporate tax EC legislation would require the full recognition of foreign corporate tax payments. This might seriously jeopardise domestic tax revenue, for under a full imputation system the tax paid abroad on profits generated abroad would have to be recognised by the German fiscal authorities. In view of these problems a full imputation system, although conceptually convincing, is not a realistic option for every reform proposal.

*Tax reform option I: integration of corporation tax into income tax*

54. Under tax reform option I, corporate tax would be integrated into income tax in such a way that the top rate of income tax would correspond to the corporate tax rate. To ensure that the tax burden on corporations remains internationally competitive, a low top rate of income tax must be attained. A level of 30 per cent up to a maximum of 35 per cent represents a realistic upper bound. The convergence of the top rates of income tax and corporate tax would require, as a logical corollary, the exemption of domestically generated dividend income and capital gains from the sale of shares in corporations. Otherwise dividends would be taxed more highly at the level of shareholders. The converging of the top tax rates would not, however, manage to achieve neutrality in the choice of firms' legal status and financing as long as the progressive income tax system is retained.

55. Whereas under this reform option, capital gains from selling equity shares in corporations must be tax-free, capital gains from the sale of shares in non-corporations and the capital gains from real estate held as personal assets would be fully liable to income tax. This, too, means that neutrality between different legal forms of business organisation cannot be achieved. On account of the EU legal provisions outlawing discriminatory practices, exempting dividend income generated in Germany from tax implies that dividends that are transferred to non-residents must likewise not be taxed. By the same token, dividend income and capital gains received from abroad would also have to be exempted from German tax. The origination principle (*Quellenprinzip*), according to which incomes are taxed at the locality where they originate, would thus be very largely achieved. Hence this would still be far removed from taxing income according to the residence principle. Moreover, taxing incomes largely according to the origination principle runs the considerable risk of triggering an international tax-cutting race, which might lead to the need to further lower the top rate of income tax for competitive reasons, with the all the associated consequences for national tax revenue.

56. Even if under tax reform option I full neutrality in the choice of the enterprise's legal status cannot be achieved and the distortions in the financing decisions cannot be completely eliminated either, the two problems are nonetheless considerably mitigated compared with the status quo. The coupling of the corporate tax rate to the top rate of income tax leads to the consequence, however, that – if a competitive tax burden level is to be achieved – the top rate of income tax will have to be lowered substantially. This can only be done, while safeguarding the level of tax revenue, if simultaneously the tax assessment base for contributions is drastically broadened. The attractiveness and

prospects of success of this reform option thus hinge crucially on whether the volume of tax concessions can be rigorously pruned back.

*Tax reform option II: dual income tax regime*

57. Tax reform option II modifies the principle of a synthetic income tax. It would be replaced by a "dual income tax regime", a systematically structured tax which differentiates between two types of income – a broadly defined capital income, and labour income – and taxes these differently. Capital income, consisting of the profits of non-corporations (ie sole proprietorships and partnerships), corporate profits, interest income from rents and leases as well as private capital gains, would be taxed at a low proportional rate. As under tax reform option I, the total tax burden should not exceed 30 per cent. By contrast, labour income would be taxed progressively; it primarily comprises wages, including imputed entrepreneurial income, civil servant pensions, statutory retirement pensions and government transfers. In order to limit tax arbitrage, however, the top rate of tax should not lie significantly above the capital income tax rate; even so, this option gives tax policy a wider action radius than does reform option I. The separate levying of corporate taxes from corporations would be retained, although corporate tax and capital income tax are fully reconciled with one another. This will be ensured by two different means. Firstly, the corporate tax rate matches the proportional rate of capital income tax. Secondly, the double taxation of dividends and of capital gains from the sale of shareholdings in corporations is completely avoided. Hence this system does indeed constitute a dual income tax regime: the taxation of labour income goes hand in hand with the taxation of capital income, with corporate tax being completely integrated.

58. The principal argument in favour of switching to a dual income tax regime is that is would yield efficiency gains. A dual income tax system strengthens the neutrality of the tax regime with respect to decisions concerning investment, financing and legal status, and it enhances the country's locational attractiveness in the context of growing international capital mobility. This leads to an improvement of the growth conditions and the chances of employees to earn higher incomes. Furthermore, the systematic quality of tax law will be improved compared with the status quo through a consistent and uniform taxation of capital income. Specifically, a dual income tax regime has the following advantages vis-à-vis the present system:

- Neutrality of business taxation. The convergence of the tax rates for corporate profits and private capital income to the corporate tax rate, the complete integration of corporate tax into capital income tax and across-the-board proportional tax rates for all capital income fundamentally ensure the financing neutrality of the taxation system. All methods of financing are taxed at the same level, irrespective of the personal circumstances of the capital providers. Thus the tax regime does not differentiate either between the different legal forms.

- Locational attractiveness to potential investors. The arguments in favour of having differentiated tax rates for labour income and capital income relate mainly to considerations of efficiency. Capital income is far more internationally mobile than labour income. The decoupling of the tax rate for capital income from the taxation of labour income thus creates a flexible instrument that enables the country to participate successfully in international tax competition, without the overall total tax revenue directly suffering.

- A more systematised tax structure. A comprehensive taxation of capital income at a proportional rate limits possibilities for tax arbitrage between the different incomes concerned and substantially reduces definitional problems in the allocation of revenue and expenditure.

59. Under a dual income tax regime, as under tax reform option I, dividends earned in Germany are tax-exempt. While full imputation is also a possibility, this is not advisable given the potential effects on revenue. Capital gains from the sale of equity shares in corporations would likewise be exempted from the tax for the sake of practicability. The same applies to foreign dividends and corresponding capital gains. Thus under a dual income tax regime, too, the taxation of cross-border income follows the origination principle. In contrast to tax reform option I, however, it is possible under a dual income tax regime – owing to the split tax rates – to lower the tax rate on capital income, with a view to enhancing the country's locational attractiveness, without this requiring a parallel reduction in the income tax rates – at least within certain limits.

60. One of the principal problems of a dual income tax is the classification of entrepreneurial profit and labour income in the form of entrepreneurial income. The fact that capital income is normally taxed at a lower rate than labour income creates incentives at non-corporations to formally disclose labour income as profit, so as to reduce the overall tax burden. A perfect solution will not be possible in this case. In attempting to solve the associated classification problems it is possible, however, to draw on the experience of the Scandinavian countries, which in the first half of the 1990s changed over to a dual income tax regime. In those countries profit income is usually calculated via an assumed rate of return on the capital deployed; the labour income, which is subject to the progressive income tax system, is then computed as a residual between the disclosed balance sheet profit and the computed profit income. The

incentives for arbitrage between the two types of income diminish with the size of the differential between the top rate of income tax and that applying to capital income. This suggests keeping the rates relatively close to one another. But this concurrently reduces the scope for income redistribution under a dual income tax regime.

*Reform of local business tax: a mixture of farce and tragedy*

61. In order to strengthen the neutrality of the tax regime in respect of the choice of legal form and financing, local trade tax (*Gewerbesteuer*) in its present form should be abolished. By contrast, a municipal supplemental levy to be added to income tax and corporation tax, which the German Council of Economic Experts advocates, can be integrated without any problem into a reformed income tax and corporation tax regime. The ballyhoo surrounding the possible reform of local trade tax and the proposal to change its name to "local business tax" (*Gemeindewirtschaftssteuer*) not only shows just how paralysing a discussion on tax reform can be, it also demonstrates how, through the massive interventions of trade associations or other lobby groups, what was originally still a tolerable reform model may mutate into a solution that is even worse than the status quo.

The law passed by the Bundestag on 17 October of this year, besides increasing the basic federal rate (*Steuermesszahl*) from the originally planned 3 per cent to 3.2 per cent, also continues to include half of firms' debt interest and other non-income-related elements in the scope of the local business tax. The German government's original bill of 8 September, by contrast, had envisaged excluding virtually all non-profit-related components.

Compared to the status quo, the regulations on local business tax adopted so far by the Bundestag (section 531) will bring about a further deterioration in the underlying tax framework. In the context of national business activity the effective marginal and average tax burdens of corporations will increase by up to 1 percentage point. It would have been wiser, as envisaged in the government's original bill, to completely drop the inclusion of half of the interest paid on long-term debt since this would have enhanced Germany's attractiveness as a business location in tax terms. For corporations the effective marginal tax burdens, given the inclusion of the investors and average modes of investment financing, would have been around 2 percentage points lower than the under the regulations now adopted.

**Wage policy and labour market**

- The wage negotiators on both sides of industry should adopt an employment-friendly approach and should not fully exhaust productivity when negotiating collective pay agreements.

- There should be a wider spread in the wage structure relative to the degree of training and qualifications, especially in respect of low-skilled jobs.

- The legislation governing collective labour agreements should be made more flexible.

- Current employment protection legislation should be modified and extended. This includes limiting the scope of the required substantiation for dismissals by the employer and introducing further flexibility in the form of options to waive the statutory employment protection rights.

- For recipients of Unemployment Benefit I the incentives to take up work sooner should be strengthened by raising the payment level during the first phase of unemployment but then lowering it with the increasing duration of unemployment.

- The employers' contributions to the statutory unemployment insurance scheme should be made partly firm-specific by linking them to the net costs incurred by the statutory unemployment insurance scheme as a result of employees made redundant by the firm in question.

- The German Council of Economic Experts renews its call for a fundamental reform of social assistance/Unemployment Benefit II in order that more employment is created in the low-wage sector. Parliament should not introduce a statutory minimum wage in the context of determining what work unemployed persons can reasonably be expected to take up.

## 3. Wage policy and labour market: act responsibly to use chances for more employment

(sections 633 ff.)

62. The situation on the labour market, which was already dire, worsened further in 2003. This year, however, the German government responded to the continuing grim reality with a series of bold reform initiatives. Important draft laws have been set in train; some have already been adopted while others are still awaiting parliamentary implementation. The last category notably includes the plan to amalgamate unemployment assistance and social assistance. The opposition parties intend to use their majority in the Bundesrat to push through measures that go further than those of the German government on the

question of incentives for those recipients of Unemployment Benefit II who are able to work to take up regular paid employment. The German Council of Economic Experts believes that these intentions are headed in the right direction in principle but nonetheless pose certain problems of their own. But the worst possible solution for the employment prospects of the persons concerned would be if the government and opposition parties were to veto one another's proposals in the legislative process with the result that no compromise solution is reached. All in all, however, things are beginning to move on the labour market. These chances to attain higher employment must be seized in the coming years. Wage bargainers on both sides of industry have a special responsibility in this context.

*The responsibility of wage negotiators and parliament*

63. What is needed above all is a medium-term moderate wage policy. This should take due account of plant-specific circumstances and skill levels and, for as long as a situation of underemployment prevails, should not fully exhaust the available scope for income distribution. Collective pay agreements derive their legitimacy not least from the fact that they take on board such macroeconomic considerations. In this year's Annual Report the German Council of Economic Experts takes a close look at this wage policy concept and critically examines a number of possible objections. These particularly concern the issue of the macroeconomic effects of a strategy of wage restraint as well as the question of correctly measuring the available scope for income distribution. Statistical variables that are widely considered key indicators of the orientation of wage policy, especially unit labour costs, have various conceptual shortcomings which make them sub-optimal indicators of a restrained wage policy. The decisive factor is labour productivity, in particular the marginal productivity adjusted for changes in employment. If the scope for income distribution determined by this measure is exceeded, job-shedding will occur. If the available scope for income distribution is fully utilised, the outcome is merely that job-shedding is avoided. Only if the level of income distribution is kept somewhat below that of adjusted productivity growth are jobs created on balance. A wage policy committed to this maxim should, in order to ensure that enterprises have planning certainty, be geared to the longer term and be oriented to microeconomic (ie sector-specific or plant-specific) ratios. An *ex post* assessment of collective wage policy must rely, however, on evaluating the corresponding macroeconomic ratios owing to substantial data problems. They show that in 2003 wage policy makers again failed to live up to their responsibility to create more employment. The wage negotiators on both sides of industry fully exhausted the expected scope for income distribution; it was only by curtailing voluntary supplementary benefits

(*übertarifliche Leistungen*), ie via a negative wage drift, that enterprises were able to prevent the actual scope for income distribution from being fully utilised.

The German Council of Economic Experts sees no grounds for the widely expressed fear that demand might be dented by such a collective wage policy, especially if it is conceived as a reliable and credible strategy geared to the medium term. After all, increases in collective pay levels that are tailored to fostering employment represent an improvement in the supply-side conditions – a cheapening of the factor labour, enhanced international competitiveness and, as a result of higher profits, potentially also growing investment – which in turn facilitates job creation. This does not mean that the demand side of the economy is unimportant – let alone irrelevant. It means, rather, that the macroeconomic chain of causality, which leads from wage moderation to greater employment, cannot be adequately determined via purely expenditure-oriented analysis. In a nutshell, employment is generated primarily through the conditions on the labour market.

64. The consequences of collective wage policy cannot be laid exclusively at the door of wage bargainers. Conditions conducive to promoting an employment-friendly wage policy must also be embedded in the legislation governing collective labour agreements (*Tarifvertragsrecht*). The German Council of Economic Experts has consistently pointed this out for several years, although so far there have been no significant moves towards a more flexible solution. The relevant demands include, for instance, a re-interpretation of the favourability principle (*Günstigkeitsprinzip*), the revocation of the override effect (*Sperrwirkung*) of section 77 (3) of the Industrial Constitution Act (*Betriebsverfassungsgesetz*) for employees not bound by collective labour agreements, the shortening of the period for which collective labour agreements remain binding on enterprises which have opted out of the national employers' federation (*Arbeitgeberverband*) or the abolition of open-ended general pledges (*Allgemeinverbindlicherklärungen*). Lastly, consideration should be given to seeing to what extent an effective escape clause can be inserted into the Central Collective Labour Agreements Act (*Tarifvertragsgesetz*) to enable mutual arrangements to be concluded locally at enterprises that are otherwise bound by national, regional or sectoral labour agreements (*tarifgebundene Unternehmen*).

There are dissenting views within the German Council of Economic Experts on the positions stated in the last two sections, the case for which is argued in greater detail in this year’s report (sections 659 ff. and 675).

*Employment protection: greater legal certainty and equality of opportunity*

65. The modifications made to existing employment protection legislation by the German government with the Act Reforming the Labour Market (*Gesetz zu Reformen am Arbeitsmarkt*) are to be welcomed to the extent that they now restrict the criteria for the prescribed socially responsible selection (*Sozialauswahl*) of employees to be made redundant and limit the scope of judicial scrutiny in the context of achieving a reconciliation of interests (*Interessenausgleich*) between the employer and the works' council (*Betriebsrat*). This has created an important basis for enabling the problems connected with the previous provisions of the employment protection regulations to be reduced to some extent. Another further requirement, however, is to limit the scope of the required substantiation for dismissals by the employer so as to further lessen the persisting legal uncertainty in the dismissal process, the extensive recourse to labour courts and the associated high costs for the enterprises. The amendment to the law provides for the possibility of agreeing on a severance payment at the time of dismissal within the framework of signing a mutual termination contract (*Auflösungsvertrag*). Thought should be given to supplementing this by also envisaging *ex ante* arrangements after the end of the employee's probationary period (*Probezeit*). Two options are possible in this connection. One the one hand, employees could voluntarily agree to waive their employment protection rights in the event of a subsequent compulsory redundancy in return for a commitment by the employer to make a severance payment in lieu if this eventuality should occur. On the other hand, employees could be granted the right, in agreement with the employer, to fully surrender all employment protection rights in return for negotiating a higher wage. The level of the severance payment or wage mark-up should be regulated individually between the employee and the employer so as to take due account of firm-specific circumstances. The implementation of these options would give employees and employers alike a large measure of flexibility, so that the preferences of both sides would be considered.

*Reform proposals for unemployment insurance and subsistence provision*

66. This year the German government initiated reforms in the fields of wage substitutes and subsistence provision, although in some cases the legislative process has not yet been completed. The salient features of these reforms include the shortening of the maximum duration of the period of entitlement to receipt of unemployment benefit, which in future will be known as Unemployment Benefit I (*Arbeitslosengeld I*), to 12 months (to 18 months in the case of employees aged over 55) and as well as the amalgamation of unemployment assistance (*Arbeitslosenhilfe*) and social assistance (*Sozialhilfe*) to form Unemployment Benefit II (*Arbeitslosengeld II*). While some of the provisions run

counter to the goal of reinforcing the incentives to work for unemployed persons able to work – in particular, the two-year supplement to Unemployment Benefit II for former recipients of Unemployment Benefit I and the introduction of a minimum wage in the context of defining reasonable criteria for taking up paid employment (*Zumutbarkeits-regeln*) – these are nonetheless bold and appropriate reforms. In this connection the German government has thus taken on board some important proposals which the German Council of Economic Experts made in last year's Annual Report.

67. In order to reinforce the incentives for recipients of Unemployment Benefit I to swiftly begin the search for new employment, over and above shortening the entitlement period, the German Council of Economic Experts has developed its proposals further and now presents an extended reform proposal for discussion: during the initial phase of unemployment the level of Unemployment Benefit I should be raised above the current level, but it should then be lowered with the increasing duration of unemployment. The precise curve of the wage substitute rate should be drawn in such a way that the reform is cost-neutral for the statutory unemployment insurance fund (*Arbeits-losenversicherung*). The payment of a higher rate for unemployed persons with children requiring support is exogenous to the statutory unemployment insurance scheme and is not warranted either by a desire to assist families with children or single parents, since the amount of the assistance rises not in accordance with the number of children but instead with the previous labour income. The higher rate should therefore be scrapped and – if parliament deems it necessary – replaced by a tax-financed supplement to child benefit (*Kindergeld*).

68. The present statutory unemployment insurance scheme also creates incentive distortions on the part of enterprises resulting from an insufficient internalisation of the costs caused by lay-offs; besides the loss of plant-specific human capital and of the social environment, these are above all the expenditure incurred by the statutory unemployment insurance scheme. The uniform contribution rate of employers leads to a cross-subsidisation among enterprises with different dismissal behaviour and to macroeconomically inefficient dismissal decisions. Instead of seeking to compensate for this through a rigid, uniform set of employment protection regulations, parliament should deploy the steering effect of levies oriented to the "perpetrator pays" principle also on the labour market. The German Council of Economic Experts therefore recommends partly differentiating employers' contributions to the statutory unemployment insurance scheme on an enterprise-specific basis: the employers' contributions should be geared to the net costs of compulsory redundancies which the statutory unemployment insurance scheme actually incurs. Moreover, such a system, which in other countries is also known as "experience rating", would partly assume the

task of employment protection by making the substantial macroeconomic costs of lay-offs selectively more expensive at the microeconomic level. As a *quid pro quo*, employment protection regulations could be relaxed in the context of compulsory redundancies and could be confined to protecting workers against discrimination and offsetting the disadvantages directly associated with lay-offs.

**Monetary policy**

- Monetary policy makers have ensured a high degree of price-level stability and anchored inflation expectations at a low level. The European Central Bank should continue this resolute policy. The ample supply of liquidity and the historically low interest rates provide a good basis for a revival of business activity.

- In the wake of a strategic review the target considered consistent with price-level stability was defined more precisely and the conceptual role of broad monetary aggregates was properly clarified. The increasingly integrated "big picture" of all risks to price stability makes sense, although the full integration of the strategy's two pillars would have been more rational.

- The methods used to collate all the information relevant for decision-making could be made more transparent and understandable. The European Central Bank should further strengthen the role of its inflation and economic forecasts both in its decision-making and in its communication.

## 4. Monetary policy: review of the monetary strategy

(sections 719 ff.)

69. After more than four years of experience of the single monetary policy, the European Central Bank reviewed its monetary policy strategy at the beginning of 2003 and made a number of sensible adjustments. One result of the strategic review was a more precise definition of price-level stability. The European Central Bank now conceives this as a year-on-year increase in the Harmonised Index of Consumer Prices over the medium term of "below but close to 2 per cent". The new definition is intended to offer greater protection than in the past against not only inflationary dangers but also deflationary risks, take account of possible statistical measurement errors in consumer price developments and adequately reflect the heterogeneity of the inflation rates in the euro area. This merits a positive assessment; however, a more precise numerical definition of the inflation target and the monetary policy decision-making horizon would have been conducive to enhancing transparency. A second outcome of the strategy review was the restructuring and re-weighting of the strategy's two pillars. The conceptually correct clarification of the role of broad monetary aggregates is to be welcomed, as is the less

prominent role now assigned to the money stock. However, it would have been more rational to have merged the two separate pillars of the monetary policy strategy. Furthermore, the European Central Bank should also elaborate a clearer conception of what information it elicits from the various indicators of economic and monetary analysis, how it combines these two sources of information and checks them against one another, and how it derives from all that an overall picture of the economic situation in the euro area which is both free of contradiction and relevant to its decision-making. The German Council of Economic Experts is of the opinion that this could be achieved most easily by incorporating quantitative inflation projections more into the monetary strategy. This should not be interpreted as a call for a purely model-based, mechanistic form of monetary policy that should be exclusively oriented to formal models. The projections could also include model-exogenous information which appears relevant for evaluating inflation risks in the current decision-making situation. But a stronger focusing on forecasts would improve the transparency of the decision-making process. In addition, assigning a greater role to forecasts, also in the ECB's communication policy, would make it easier for the European Central Bank to steer market expectations ahead of meetings of the ECB Governing Council at which interest rate changes are on the agenda, without necessarily having to unambiguously signal an imminent interest rate move.

# Appendix

## I. Tables: Forecasts for 2004

Table A: Key data from national accounts for Germany
Table B: General Government revenues and expenditures
Table C: Forecasts for the Labour Market

## II. Law on the Appointment of a Council of Experts on Economic Development

Table A

**Key data from the national**
For 2003 partly estimates,

Absolute

| | Unit[1] | 2002 | 2003 | 2004 | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|
| | | | | | 1 hf | 2 hf | 1 hf | 2 hf |
| **Use of domestic product** | | | | | | | | |
| ***at current prices*** | | | | | | | | |
| Consumption expenditure | Euro billion | 1 640,92 | 1 661,3 | 1 688,5 | 810,47 | 850,8 | 820,2 | 868,3 |
| Private households[2] | Euro billion | 1 236,49 | 1 251,0 | 1 280,1 | 614,69 | 636,3 | 625,0 | 655,1 |
| General government | Euro billion | 404,43 | 410,3 | 408,5 | 195,78 | 214,5 | 195,2 | 213,2 |
| Gross fixed capital formation | Euro billion | 391,96 | 382,0 | 388,7 | 181,74 | 200,3 | 183,8 | 204,9 |
| Machinery and equipment | Euro billion | 151,85 | 149,7 | 154,7 | 71,18 | 78,5 | 71,8 | 82,9 |
| Constructions | Euro billion | 215,52 | 207,5 | 208,1 | 98,56 | 109,0 | 99,6 | 108,6 |
| Other products | Euro billion | 24,59 | 24,8 | 25,9 | 12,00 | 12,8 | 12,4 | 13,4 |
| Change in stocks[3] | Euro billion | - 13,1 | - 9,3 | - 14,0 | + 11,53 | - 20,9 | + 3,8 | - 17,7 |
| Total domestic demand | Euro billion | 2 019,73 | 2 033,9 | 2 063,3 | 1 003,74 | 1 030,2 | 1 007,8 | 1 055,5 |
| Net exports | Euro billion | + 90,7 | + 98,4 | + 115,3 | + 39,16 | + 59,2 | + 56,5 | + 58,9 |
| Exports of goods and services | Euro billion | 757,64 | 765,6 | 809,4 | 373,53 | 392,1 | 392,1 | 417,3 |
| Imports of goods and services | Euro billion | 666,97 | 667,3 | 694,0 | 334,37 | 332,9 | 335,6 | 358,4 |
| **Gross domestic product** | **Euro billion** | **2 110,40** | **2 132,3** | **2 178,6** | **1 042,90** | **1 089,4** | **1 064,3** | **1 114,3** |
| ***at 1995 prices*** | | | | | | | | |
| Consumption expenditure | Euro billion | 1 513,64 | 1 518,4 | 1 527,4 | 748,18 | 770,2 | 749,5 | 777,9 |
| Private households[2] | Euro billion | 1 125,29 | 1 127,6 | 1 136,1 | 555,29 | 572,3 | 556,0 | 580,1 |
| General government | Euro billion | 388,35 | 390,8 | 391,3 | 192,89 | 197,9 | 193,5 | 197,8 |
| Gross fixed capital formation | Euro billion | 396,94 | 389,2 | 395,5 | 185,46 | 203,8 | 187,5 | 208,1 |
| Machinery and equipment | Euro billion | 152,48 | 152,0 | 156,6 | 72,66 | 79,3 | 73,1 | 83,5 |
| Constructions | Euro billion | 217,07 | 209,3 | 209,8 | 99,24 | 110,1 | 100,3 | 109,5 |
| Other products | Euro billion | 27,39 | 27,9 | 29,2 | 13,56 | 14,4 | 14,1 | 15,1 |
| Change in stocks[3] | Euro billion | - 22,0 | - 19,0 | - 17,3 | + 3,5 | - 22,5 | - 0,3 | - 16,9 |
| Total domestic demand | Euro billion | 1 888,57 | 1 888,6 | 1 905,7 | 937,14 | 951,5 | 936,7 | 969,0 |
| Net exports | Euro billion | + 101,13 | + 100,4 | + 113,8 | + 41,46 | + 59,0 | + 56,0 | + 57,8 |
| Exports of goods and services | Euro billion | 722,63 | 730,7 | 765,5 | 357,35 | 373,4 | 372,4 | 393,2 |
| Imports of goods and services | Euro billion | 621,50 | 630,3 | 651,7 | 315,89 | 314,4 | 316,3 | 335,4 |
| **Gross domestic product** | **Euro billion** | **1 989,70** | **1 989,0** | **2 019,5** | **978,60** | **1 010,4** | **992,7** | **1 026,8** |
| Gross national income | Euro billion | 1 989,49 | 1 984,5 | 2 015,2 | 969,44 | 1 015,1 | 984,3 | 1 031,0 |
| **Deflator** | | | | | | | | |
| Consumption expenditure | 1995 = 100 | 108,4 | 109,4 | 110,6 | 108,3 | 110,5 | 109,4 | 111,6 |
| of which: private households[2] | 1995 = 100 | 109,9 | 110,9 | 112,7 | 110,7 | 111,2 | 112,4 | 112,9 |
| Gross domestic products | 1995 = 100 | 106,1 | 107,2 | 107,9 | 106,6 | 107,8 | 107,2 | 108,5 |
| Total domestic demand | 1995 = 100 | 106,9 | 107,7 | 108,3 | 107,1 | 108,3 | 107,6 | 108,9 |
| **Origin of national product** | | | | | | | | |
| Employment (domestic) | thousand | 38 671 | 38 126 | 38 004 | 37 933 | 38 320 | 37 689 | 38 320 |
| Working hours[4] | hours | . | . | . | . | . | . | . |
| Total number of man-hours worked | hours bill. | 55,79 | 55,0 | 55,1 | 27,02 | 28,0 | 27,0 | 28,1 |
| Productivity (per hour) | Euro per hour | 35,66 | 36,1 | 36,7 | 36,22 | 36,1 | 36,8 | 36,5 |
| **Distribution of national income** | | | | | | | | |
| National income (factor costs) | Euro billion | 1 571,51 | 1 579,7 | 1 610,0 | 760,68 | 819,0 | 775,2 | 834,8 |
| Compensation of employees | Euro billion | 1 130,46 | 1 133,4 | 1 149,7 | 536,21 | 597,2 | 542,0 | 607,7 |
| of which: net compensation of employees[5] | Euro billion | 593,48 | 587,6 | 601,9 | 274,63 | 312,9 | 280,0 | 321,9 |
| Property and entrepreneurial income | Euro billion | 441,05 | 446,3 | 460,3 | 224,47 | 221,8 | 233,2 | 227,1 |
| Disposable income of private households[2] | Euro billion | 1 365,28 | 1 384,6 | 1 407,9 | 691,84 | 692,8 | 702,5 | 705,4 |
| of which: saving of private households[2)6)] | Euro billion | 146,34 | 154,5 | 151,8 | 86,72 | 67,8 | 88,5 | 63,3 |
| **Memo:** | | | | | | | | |
| Unit labour costs[7] | 1995 = 100 | 103,1 | 103,7 | 103,9 | 99,7 | 107,6 | 99,7 | 107,9 |
| Consumer prices[8] | 1995 = 100 | 103,4 | 104,5 | 105,7 | 104,3 | 104,6 | 105,4 | 106,0 |

1) Deviations are due to rounding. - 2) Including private non-profit institutions. - 3) Including acquisition less disposition of valuables. -
4) Including working day variations. - 5) Net wages and salaries.

Table A

**accounts for Germany**
for 2004 forecasts

Changes from corresponding period of the previous year in %

| 2002 | 2003 | 2004 | 2003 | | 2004 | | |
|---|---|---|---|---|---|---|---|
| | | | 1 hf | 2 hf | 1 hf | 2 hf | |
| | | | | | | | **Use of domestic product** |
| | | | | | | | ***at current prices*** |
| + 0,9 | + 1,2 | + 1,6 | + 1,5 | + 1,0 | + 1,2 | + 2,1 | Consumption expenditure |
| + 0,3 | + 1,2 | + 2,3 | + 1,6 | + 0,7 | + 1,7 | + 3,0 | Private households[2)] |
| + 2,6 | + 1,5 | - 0,5 | + 1,3 | + 1,6 | - 0,3 | - 0,6 | General government |
| - 6,8 | - 2,5 | + 1,8 | - 4,1 | - 1,1 | + 1,1 | + 2,3 | Gross fixed capital formation |
| - 9,3 | - 1,4 | + 3,4 | - 2,6 | - 0,4 | + 0,9 | + 5,7 | Machinery and equipment |
| - 5,9 | - 3,7 | + 0,3 | - 5,7 | - 1,9 | + 1,0 | - 0,4 | Constructions |
| + 1,0 | + 0,9 | + 4,2 | + 0,2 | + 1,6 | + 3,7 | + 4,7 | Other products |
| . | . | . | . | . | . | . | Change in stocks[3)] |
| - 0,6 | + 0,7 | + 1,4 | + 1,2 | + 0,2 | + 0,4 | + 2,5 | Total domestic demand |
| . | . | . | . | . | . | . | Net exports |
| + 3,6 | + 1,1 | + 5,7 | + 1,3 | + 0,8 | + 5,0 | + 6,4 | Exports of goods and services |
| - 3,4 | + 0,0 | + 4,0 | + 2,5 | - 2,3 | + 0,4 | + 7,7 | Imports of goods and services |
| **+ 1,8** | **+ 1,0** | **+ 2,2** | **+ 0,8** | **+ 1,3** | **+ 2,0** | **+ 2,3** | **Gross domestic product** |
| | | | | | | | ***at 1995 prices*** |
| - 0,3 | + 0,3 | + 0,6 | + 0,7 | - 0,0 | + 0,2 | + 1,0 | Consumption expenditure |
| - 1,0 | + 0,2 | + 0,8 | + 0,7 | - 0,3 | + 0,1 | + 1,4 | Private households[2)] |
| + 1,7 | + 0,6 | + 0,1 | + 0,7 | + 0,6 | + 0,3 | - 0,1 | General government |
| - 6,7 | - 1,9 | + 1,6 | - 3,1 | - 0,9 | + 1,1 | + 2,1 | Gross fixed capital formation |
| - 9,1 | - 0,3 | + 3,0 | - 0,3 | - 0,3 | + 0,6 | + 5,3 | Machinery and equipment |
| - 5,8 | - 3,6 | + 0,2 | - 5,6 | - 1,7 | + 1,1 | - 0,6 | Constructions |
| + 1,6 | + 1,9 | + 4,5 | + 1,6 | + 2,3 | + 3,8 | + 5,1 | Other products |
| . | . | . | . | . | . | . | Change in stocks[3)] |
| - 1,6 | + 0,0 | + 0,9 | + 0,7 | - 0,7 | - 0,0 | + 1,8 | Total domestic demand |
| . | . | . | . | . | . | . | Net exports |
| + 3,4 | + 1,1 | + 4,8 | + 1,6 | + 0,7 | + 4,2 | + 5,3 | Exports of goods and services |
| - 1,7 | + 1,4 | + 3,4 | + 4,4 | - 1,4 | + 0,1 | + 6,7 | Imports of goods and services |
| **+ 0,2** | **- 0,0** | **+ 1,5** | **- 0,1** | **+ 0,1** | **+ 1,4** | **+ 1,6** | **Gross domestic product** |
| + 0,5 | - 0,3 | + 1,5 | - 0,5 | + 0,0 | + 1,5 | + 1,6 | Gross national income |
| | | | | | | | **Deflator** |
| + 1,2 | + 0,9 | + 1,0 | + 0,9 | + 1,0 | + 1,0 | + 1,1 | Consumption expenditure |
| + 1,3 | + 1,0 | + 1,6 | + 0,9 | + 1,0 | + 1,5 | + 1,6 | of which: private households[2)] |
| + 1,6 | + 1,1 | + 0,6 | + 0,9 | + 1,2 | + 0,6 | + 0,7 | Gross domestic products |
| + 1,0 | + 0,7 | + 0,5 | + 0,5 | + 0,9 | + 0,5 | + 0,6 | Total domestic demand |
| | | | | | | | **Origin of national product** |
| - 0,6 | - 1,4 | - 0,3 | - 1,6 | - 1,2 | - 0,6 | - 0,0 | Employment (domestic) |
| - 0,5 | + 0,0 | + 0,4 | + 0,1 | - 0,0 | + 0,5 | + 0,4 | Working hours[4)] |
| - 1,1 | - 1,4 | + 0,1 | - 1,5 | - 1,2 | - 0,2 | + 0,4 | Total number of man-hours worked |
| + 1,3 | + 1,4 | + 1,4 | + 1,4 | + 1,3 | + 1,6 | + 1,2 | Productivity (per hour) |
| | | | | | | | **Distribution of national income** |
| + 1,9 | + 0,5 | + 1,9 | - 0,4 | + 1,4 | + 1,9 | + 1,9 | National income (factor costs) |
| + 0,8 | + 0,3 | + 1,4 | + 0,2 | + 0,3 | + 1,1 | + 1,8 | Compensation of employees |
| + 0,2 | - 1,0 | + 2,4 | - 1,0 | - 1,0 | + 1,9 | + 2,9 | of which: net compensation of employees[5)] |
| + 4,8 | + 1,2 | + 3,2 | - 1,8 | + 4,4 | + 3,9 | + 2,4 | Property and entrepreneurial income |
| + 0,5 | + 1,4 | + 1,7 | + 1,9 | + 0,9 | + 1,5 | + 1,8 | Disposable income of private households[2)] |
| 10,6 | 11,0 | 10,6 | 12,4 | 9,6 | 12,4 | 8,8 | Ratio of saving of private households[2)9)] |
| | | | | | | | **Memo:** |
| + 0,7 | + 0,6 | + 0,2 | + 0,6 | + 0,6 | + 0,0 | + 0,3 | Unit labour costs[7)] |
| + 1,4 | + 1,1 | + 1,2 | + 1,0 | + 1,1 | + 1,1 | + 1,3 | Consumer prices[8)] |

6) Disposable income including adjustment for the change in net equity of households in pension funds reserves less private consumption expenditures. - 7) Compensation of employees per employees in relation of gross domestic product at 1995 prices per persons engaged. - 8) Consumer Price Index (2000 = 100). All items. - 9) Savings as percentage of disposable income.

Table B

**General Government revenues and expenditures[1)]**
For 2003 estimates, 2004 forecasts

| | 2002 | 2003 | 2004 | 2003 | 2004 |
|---|---|---|---|---|---|
| | Euro billion[2)] | | | Changes from previous year in % | |
| Revenue | 949,5 | 961,6 | 981,5 | *+ 1,3* | *+ 2,1* |
| of which: | | | | | |
| Taxes | 477,6 | 482,9 | 500,1 | *+ 1,1* | *+ 3,6* |
| Social security contributions | 389,0 | 396,3 | 398,8 | *+ 1,9* | *+ 0,6* |
| Expenditure | 1 023,9 | 1 048,3 | 1 056,3 | *+ 2,4* | *+ 0,8* |
| of which: | | | | | |
| Intermediate consumption | 84,5 | 84,6 | 85,5 | *+ 0,2* | *+ 1,0* |
| Compensation of employees | 167,7 | 169,2 | 169,4 | *+ 0,9* | *+ 0,1* |
| Income from property (pay out) | 65,2 | 66,2 | 68,0 | *+ 1,5* | *+ 2,6* |
| Transfers (pay out) | 638,9 | 658,6 | 665,0 | *+ 3,1* | *+ 1,0* |
| Gross capital formation | 34,3 | 32,3 | 31,9 | *- 5,8* | *- 1,5* |
| Others | 33,3 | 37,2 | 36,6 | *X* | *X* |
| Net lending | - 74,3 | - 86,6 | - 74,8 | *X* | *X* |
| Memo: | | | | | |
| Expenditure ratio[3)] | *48,5* | *49,2* | *48,5* | *X* | *X* |
| "Abgaben" - ratio[3)] | *40,6* | *40,8* | *40,7* | *X* | *X* |
| Financial balances ratio[3)] | *- 3,5* | *- 4,1* | *- 3,4* | *X* | *X* |

1) General Government and Social Security Funds according to definitions of the National Accounts. General Government: Federal government, Länder, local authorities including ERP-Special Fund, Equalization of Burden Fund, Vermögensentschädigungsfonds and parts of "Federal Railway Trust", "German Unity Fund", "Redemption Fund for Inherited Liabilities". - 2) Deviations are due to rounding. - 3) Expenditures/taxes and inheritance tax, taxes to the EU and social security contributions/financial balances as a percentage of nominal GDP.

Table C

**Forecasts for the Labour Market[1)]**

| | 2002 | 2003 | 2004 |
|---|---|---|---|
| | | Thousand persons | |
| Occupied population[2)] | 42 006 | 41 741 | 41 632 |
| Unemployed persons[3)] | 3 396 | 3 675 | 3 688 |
| Balance of migrant labour[4)] | 61 | 60 | 60 |
| Employment (domestic) | 38 671 | 38 126 | 38 004 |
| Registered unemployment[5)] | 4 060 | 4 383 | 4 399 |
| of which: | | | |
| West Germany | 2 498 | 2 755 | 2 765 |
| East Germany | 1 563 | 1 628 | 1 634 |
| Hidden unemployment[6)] | 1 749 | 1 612 | 1 511 |
| of which: | | | |
| West Germany | 1 061 | 1 040 | 1 007 |
| East Germany | 687 | 571 | 504 |
| | | Rates (%) | |
| Unemployment rate[5)7)] | *9.8* | *10.5* | *10.6* |
| Rate of registered and hidden unemployment[8)] | *13.4* | *13.9* | *13.8* |
| EU-standardized unemployment rate[9)] | *8.6* | *9.3* | *9.4* |

1) Annual averages. Own estimate for 2003 and 2004; according to definitions of the National Accounts. Deviations are due to rounding. - 2) National concept. - 3) Definitions of the International Labour Organisation (ILO). - 4) Persons engaged (domestic concept) less persons engaged (national concept). - 5) Source for 2002: Federal Labour Office (Bundesanstalt für Arbeit), Nürnberg. - 6) Public employment programs, early retirement programs, full-time participants in further education programs and retraining courses subsidised by the Federal Labour Office, participants in German language courses, subsidised shorttime workers (number of persons calculated as equivalent to unemployment). - 7) Definitions of the Federal Labour Office (Bundesanstalt für Arbeit). - 8) Registered and hidden unemployment in per cent of labour force (national concept). - 9) Definitions of the EU based on the ILO concept.