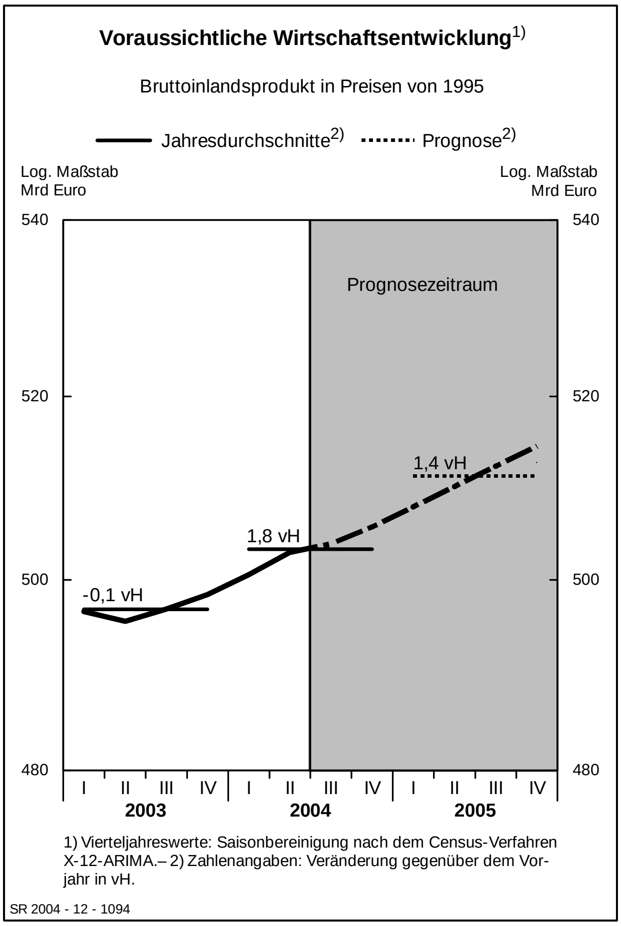
FIRST CHAPTER AND SUMMARY OF THE ANNUAL REPORT 2004/2005

EXTERNAL SUCCESSES – INTERNAL CHALLENGES

1. In 2004 the German economy pulled out of a three-year phase of stagnation. Gross domestic product (GDP) expanded by 1.8 per cent and the underutilisation of capacity – the so-called output gap – narrowed slightly. However, the welcome acceleration reflected by this overall growth rate – also in view of Germany's low trend growth – masks the fact the cyclical development this year was characterised by a pronounced duality: a very buoyant export momentum and a strong rise in the net external balance contrasted with a persistently sluggish domestic sector. Private consumption stagnated and business investment by companies likewise disappointed the already modest expectations. Unless and until a more balanced profile is attained between external and internal demand, the hopes of a continuation of the upswing remain fragile. This was starkly demonstrated by Germany's economic performance in the third quarter of the current year when, with export activity weakening distinctly and domestic demand still lacklustre, the conjunctural dynamics slackened perceptibly.

The strong rise in external demand in 2004 was fuelled by a buoyant global economy and a corresponding marked increase in world trade. The fact that even the sharp appreciation of the euro at the start of the year had no noticeable adverse effect on the export figures underscores once again that German firms' foreign sales are more dependent on real economic developments in the trading partner countries than on the influence of the exchange rate seen in isolation. Looking ahead to 2005, the pace of growth of the world economy will slow somewhat, not least in view of the oil price surge. And the renewed appreciation of the euro that was evident in the autumn is also likely to have a slightly dampening impact on Germany. The stimulus coming from the external sector will thus weaken a little; yet overall the international setting will continue to bolster Germany's economic activity next year. While domestic demand will both strengthen slightly and be spread more widely, it will not act as the engine of a broadly based recovery. Gross domestic product will grow by 1.4 per cent in 2005, i.e. a little les robustly than this year (Chart 1). In this situation the output gap will narrow only slightly. A straight comparison between the projected growth rate for 2005 and the growth rate in the current year suggests a slowing of macroeconomic momentum. This picture is distorted, however, as the absolute figures take no account of the different number of working days. Thus this year contains 1.3 more working days than next year. Taking that into account, the forecast year-on-year deceleration in the growth rate equates to a more or less unchanged pace of cyclical expansion in 2005.

Schaubild 1



The main risks to the forecast lie in the evolution of the euro exchange rate and in the movement of the oil price. While the associated downside risks for the economy have gained in importance in recent weeks, we consider at present that the most likely scenario in 2005 is an increase in GDP of 1.4 per cent.

2. The finding of a very robust export trend on average since 2001 coupled with stagnating internal demand has fuelled much discussion this year. Some interpret this as evidence of the irrelevance of Germany's much documented structural problems. For others, by contrast, the export figures principally mirror the cost improvements brought about by an ever-growing share of imported inputs, whether via conventional imports or via imports on the part of subsidiaries in the wake of a prior outsourcing of production; these observers thus see the export trend, as it were, as a mirror image of the shortcomings of Germany's domestic production base. These contrasting positions raise a whole number of difficult theoretical questions, starting with the definition and measurability of international competitiveness and the employment effects of international trade and relocations of production abroad to the question of the possible causes of the observable relative declining significance of German industry. This year's Annual Report examines some of these issues and seeks to make a contribution towards putting the associated debates on a more objective footing.

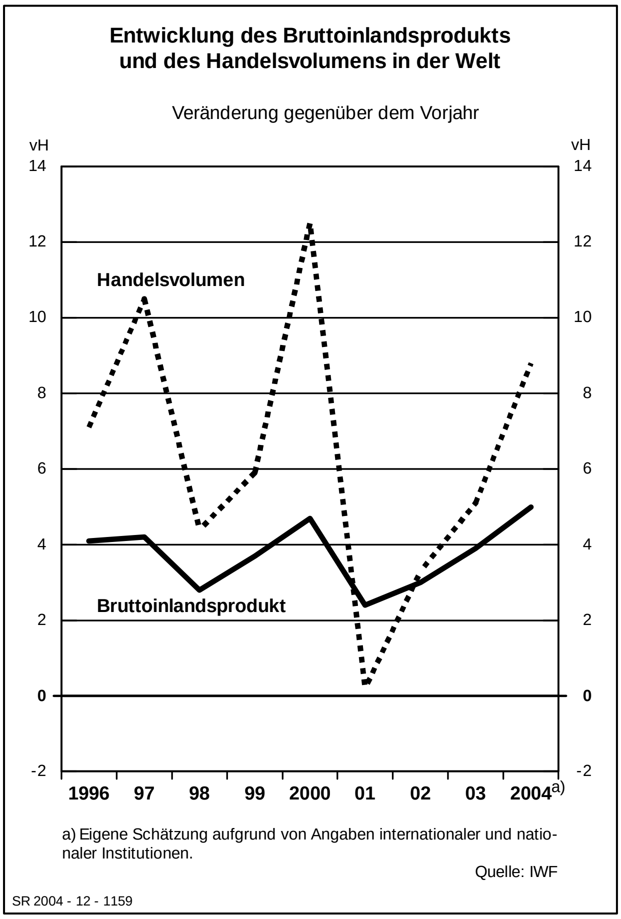
3. On balance it turns out that many of the fears expressed in this connection, which essentially boil down to the possible negative consequences for the German labour market, do not stand up to closer scrutiny. German companies have improved their competitive position on the international markets in the past few years. This is reflected in the observed export increases, which in addition have also had a positive impact on the domestic employment situation. Against this background, Germany's poor growth record which was registered over the same period has – besides a cyclical weakness – its principal cause in misdirected developments and shortcomings in the domestic economy. They find their most palpable expression in the country's low trend growth, which this year amounts to little more than 1 per cent. There are diverse reasons for this. In the past few years the German Council of Economic Experts (*Sachverständigenrat*) has focused in its Annual Reports on the associated problem areas and the possible starting approaches for a set of economic, fiscal and social policies geared to growth and employment. The 2004/2005 Annual Report continues this tradition. We pay special attention this year to possible reform options in connection with financing the statutory health insurance scheme (*Gesetzliche Krankenversicherung*) and the long-term care insurance scheme (*Soziale Pflegeversicherung*). In this context the German Council of Economic Experts presents some proposals for discussion. In the past few years considerable problems have also become apparent in the German education system. The list of shortcomings essentially relates to all levels of the German education system, from the elementary school level right up to the organisation of the tertiary segment, i.e. the college and university sector. Lastly, the question of the future design of the economic reconstruction programme in eastern Germany (*Aufbau Ost*) is simultaneously of key importance for the economic outlook for Germany as a whole.

4. The persistent weak momentum of the domestic economy, magnified not least by the problems of a few long established major German enterprises that hit the headlines in 2004, is reflected in a meanwhile widespread tendency in Germany to paint an overly dismal picture of the country's future economic outlook. Such a sombre view disregards two positive aspects. Firstly, the German economy has a basically competitive entrepreneurial base, which has enabled it to profitably exploit the advantages of the international division of labour even during the recent difficult economic years. Secondly, the very fact that the current growth weakness is attributable to domestic determinants also holds out the prospect of achieving a change for the better through internal efforts. It is not the frequently cited anonymous constraints of globalised markets that are shaping Germany's economic destiny, nor does a low trend rate of growth constitute an incurable malaise. With this in mind, the German Council of Economic Experts has entitled this year's Annual Report "External successes – internal challenges".

I. WORLD ECONOMY: BROADLY BASED UPSWING

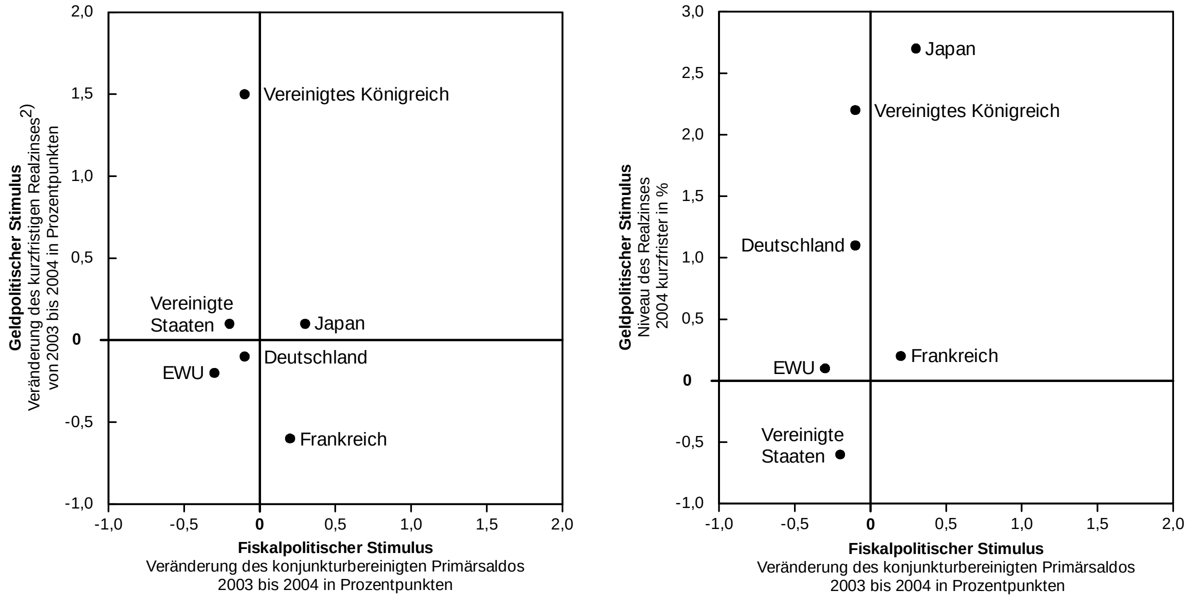
5. The **world economy** developed in 2004 more dynamically than it has done for almost 30 years. Global output grew by 5.0 per cent, while the volume of world trade expanded by almost 9 per cent – well above its multi-year average since 1970 of not quite 6 per cent – and this despite an increase in the price of oil by around 60 per cent up to October (Chart 2). All the main economic regions participated in the global economic upswing. Although a more restrictive monetary policy stance was introduced in some countries, the ongoing low real interest rate level and the abundant supply of global liquidity continued to support the growth of the world economy in the present year. No noticeable impulse was imparted in the major economic regions in 2004 by fiscal policy, measured by the change in the cyclically adjusted primary balances, nor was there any appreciable improvement in the situation of public finances in the wake of the robust macroeconomic development (Chart 3).

Schaubild 2



6. Irrespective of the fact that the global economic upturn in 2004 was more broadly based than in 2003, **marked regional disparities** were discernible in the respective economic dynamics (Table 1). The cyclical evolution in the United States proved very robust. With an annual

Schaubild 3



1) Ein negatives Vorzeichen des fiskalpolitischen Stimulus bedeutet eine Verringerung des konjunkturbereinigten Primärsaldos (Erhöhung eines bestehenden Primärdefizits beziehungsweise Verringerung eines bestehenden Überschusses).– 2) Kurzfrister Nominalzins abzüglich Deflator des Bruttoinlandsprodukts.

Quellen: CBO, OECD

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average growth rate of 4.4 per cent, the country's potential growth of around 3 per cent was significantly exceeded. Besides the United States, the South-East Asian economies, especially China, were the main drivers of the global upswing. The unbroken strong growth in China continued to galvanise the entire surrounding region including Japan. Buoyed by a sharp revival in domestic demand, the upturn had a more balanced profile than in 2003. The clear signs of overheating in the Chinese economy forced the authorities there to take administrative adjustment measures which, while they showed an initial impact in the course of the year, did not in the end halt the strong growth of gross domestic product. China's uninterrupted import dynamics pushed up both demand and prices on the international commodity markets, which was most evident on the oil market. In Latin America the initial doubts about the robustness of the incipient upswing were increasingly dispelled by the strengthening domestic demand in the course of 2004. In addition, the rising raw materials prices had a beneficial effect in the region on balance. In Europe the conjunctural recovery likewise firmed this year. The pace of macroeconomic development was slower than in the other regions, however, so that on a global scale Europe remained the cyclical slowcoach in 2004.

Tabelle 1

Gesamtwirtschaftliche Entwicklung in ausgewählten Ländergruppen und Ländern

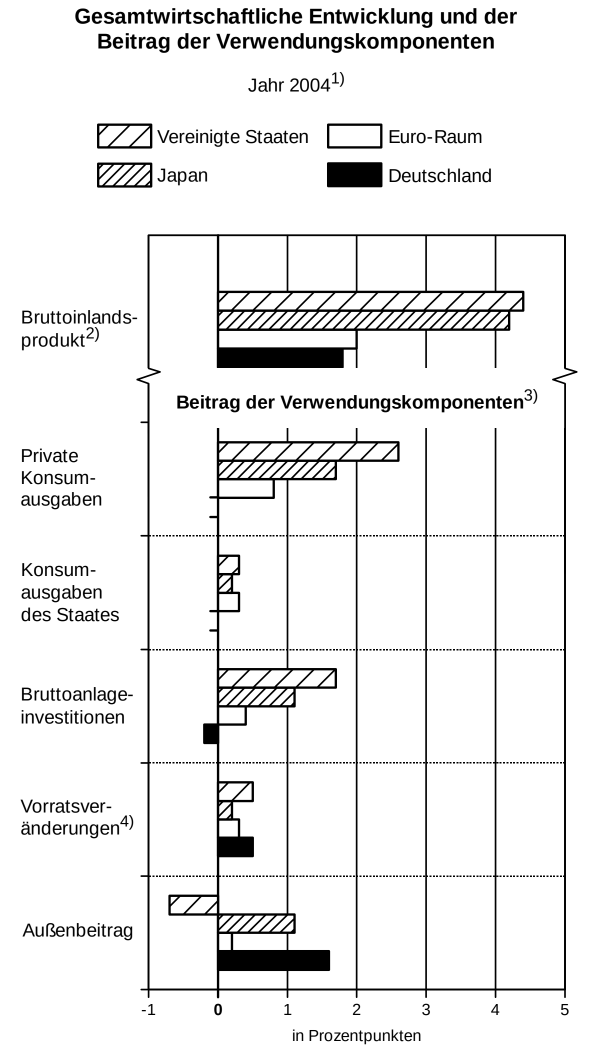
Ländergruppe/Land	Bruttoinlands-produkt (real)[1]		Anteil an der Ausfuhr[2] Deutschlands
	2004	2005	2003
	Veränderung gegenüber dem Vorjahr in vH[3]		vH
Europäische Union[4]	+ 2,4	+ 2,2	64,0
Neue EU-Mitgliedstaaten[5]	+ 5,0	+ 4,5	8,5
EU-15[4]	+ 2,3	+ 2,1	55,5
Euro-Raum[4]	+ 2,0	+ 2,0	43,3
darunter:			
Deutschland	+ 1,8	+ 1,4	X
Frankreich	+ 2,5	+ 2,2	10,6
Italien	+ 1,2	+ 1,7	7,4
Niederlande	+ 1,3	+ 1,8	6,2
Vereinigtes Königreich	+ 3,3	+ 2,8	8,4
Vereinigte Staaten	+ 4,4	+ 3,3	9,3
Japan	+ 4,2	+ 2,3	1,8
Lateinamerika[6]	+ 4,7	+ 3,6	1,7
Südostasiatische Schwellenländer[7]	+ 5,7	+ 4,7	3,4
China	+ 9,2	+ 8,0	2,8

1) Eigene Schätzung auf Basis von Angaben internationaler und nationaler Institutionen. - 2) Spezialhandel. Vorläufige Ergebnisse. - 3) Die Veränderungen gegenüber dem Vorjahr für die Ländergruppen sind gewichtet mit ihren Anteilen am nominalen Bruttoinlandsprodukt der Welt in jeweiligen Preisen und Kaufkraftparitäten im Jahr 2003. - 4) Die Veränderungen gegenüber dem Vorjahr sind gewichtet mit den Anteilen am realen Bruttoinlandsprodukt (in Euro) der Europäischen Union im Jahr 2003. - 5) Estland, Lettland, Litauen, Malta, Polen, Slowakei, Slowenien, Tschechische Republik, Ungarn, Zypern. - 6) Argentinien, Brasilien, Chile, Kolumbien, Mexiko, Peru, Venezuela. - 7) Hongkong (China), Malaysia, Singapur, Südkorea, Taiwan, Thailand.

7. The strong overall economic recovery in the **United States** led to a marked increase in the degree of aggregate capacity utilisation. For the first time since the beginning of the latest downturn in 2001 the level of non-farm payroll employment in the USA rose on an annual average, even though the increase fell short of the general expectations. The growth in employment, together with the tax refunds disbursed in the first half of the year, led to renewed robust consumption (Chart 4). The private saving ratio fell to a record low, which, given the barely rising net assets ratio and the high indebtedness of private households, represents a risk for the consumption profile during the coming period. Private gross fixed investment, especially in machinery and equipment and software, boomed in 2004 in anticipation of the expiry of the special depreciation facilities at the end of the year. The indicators of sentiment in the manufacturing and service sectors signal a continuing expansionary investment environment. The positive domestic economic setting was reflected in a further increase in imports. Exports

were unable to keep pace with this, with the result that the current account deficit widened further this year. In combination with the high government budget deficits – the cyclically adjusted deficit rose by around 0.4 percentage point in 2004 and the cyclically adjusted primary deficit was likewise not reduced – the imbalances in the US economy remain.

Schaubild 4



1) Eigene Schätzung aufgrund von Angaben internationaler und nationaler Institutionen.– 2) Veränderung gegenüber dem Jahr 2003 in vH.– 3) Zur Veränderung des Bruttoinlandsprodukts.– 4) Einschließlich Nettozugang an Wertsachen.

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Against this background the questions of the global economic implications of the twin deficits and the question of the financeability of the high capital inflows into the United States remained a subject of public debate. In the short run there are few indications of an abrupt reversal of the capital flows. The exchange rate-oriented commercial policy of numerous Asian countries, whose central banks financed more than 70 per cent of the US current account deficit in 2003, is unlikely to change fundamentally in 2005. In the longer run, however, an appreciation of these countries' currencies is inevitable and from a European perspective also desirable, for an effective depreciation of the US dollar realised in any other way implies an excessively large appreciation of the euro.

Expansionary impulses for the US domestic economy continued to come from monetary policy. Even though the interest rate turnaround initiated from mid-2004 lessened the monetary stimulus, the still low real short-term interest rate level essentially continues to signal an accommodating stance. The money market interest rates are far below a neutral short-term level which would be appropriate for the present state of the US economy. Nevertheless – and this is astonishing in view of the high macroeconomic growth rates that have continued for several quarters – no acute inflationary pressure is discernible. The increase in consumer prices has slowed down, and an easing of pressure is also coming from the evolution of the core inflation rate of private consumption spending.

8. The **Japanese economy** continued its recovery in 2004 on a broad front, with output growing by 4.2 per cent. Here, too, the upswing acquired a more balanced profile in the course of the year in respect of the individual expenditure aggregates. Whereas at the start of the year expansion was still export-driven, the domestic components picked up steam as the year wore on. Gross fixed investment increased even faster than in 2003 in the wake of further restructurings in the enterprise sector and higher profits. Private consumption expenditure likewise went up, despite another fall in real incomes, thanks to the first rise in employment in six years. Given this constellation of forces, the Japanese economy experienced in 2004 its first self-propelled upturn since the late 1980s – without any new fiscal impulses but with an ongoing expansionary monetary policy stance. Even so, Japan has still not succeeded in breaking free from its deflationary tendencies. It should be noted, though, that these are overstated by the GDP deflator and understated by the consumer price index. The country probably still has a negative output gap which, together with a slow adjustment of expectations, explains the dogged persistence of a falling price level. Moreover, lending is continuing to decline, although the big banks are pressing ahead with the task of weeding bad loans out of their portfolios. All in all, therefore, Japan looks set to overcome its phase of deflation in the not-too-distant future. But once that happens – at the very latest – economic policymakers will need to focus their attention more on the situation of public finances, with the debt-to-GDP ratio now having risen to 164 per cent and the cyclically adjusted budget deficit having declined only marginally to around 7 per cent.

9. The momentum of the **euro-area economy** strengthened distinctly in 2004. The pace of development was nonetheless markedly weaker than in other regions of the world and also than in the other European countries. The cyclical upturn was supported by a robust global economic demand, but domestic demand also made a key contribution in some countries. The euro area's aggregate gross domestic product expanded in 2004 by 2.0 per cent. The output gap consequently narrowed only slightly, particularly compared with the development in the United States and in Japan. With the recovery still taking time to firm, there was barely any

improvement on the labour markets this year. On a longer-term view, however, a lowering of the employment threshold has been observable in the euro area since the second half of the 1990s. This has contributed to the fact that employment has constantly increased even in the latest downturn up to 2003.

The economic recovery this year was not reflected in a corresponding improvement in the situation of public finances. With regard to its impact on business activity, the fiscal policy situation in the euro area was slightly expansionary this year: according to the European Commission's estimates, the cyclically adjusted deficit increased by 0.2 percentage point, while the adjusted primary surplus decreased a little by 0.3 percentage point. The European Central Bank continued to pursue an expansionary monetary policy course, leaving its key rates unchanged. Short-term real interest rates remained at a very low level. And a comparison of the actual interest rate level with a neutral interest rate derived from a Taylor rule confirms the finding of an expansionary monetary policy stance. Furthermore, the provision of liquidity in the euro area was abundant, although the rate of monetary expansion declined on an annual average. The European Central Bank's decision not to join in the cycle of interest rate rises initiated by numerous other central banks was made possible not least by the persistently low inflation expectations. These largely remain below 2 per cent, and even measured in terms of the actually realised inflation rate in 2004 of 2.1 per cent, only a marginal overshooting of the medium-term target for price level stability was recorded. This small deviation is principally due to administered price increases in some countries and the rise in the oil price. Estimates suggest an inflation-boosting effect of the oil price surge of the order of around 0.7 percentage point in the euro area for this year. Nevertheless, on balance, the impact of the oil price surge on inflation may be said to be limited so far. Further evidence of this is that the core inflation rates, variously defined, have been barely below the realised HICP inflation rate on an annual average.

10. Following the accession of ten new countries to the **European Union** in May 2004, their future entry into the euro area represents their last key step towards integration into the European economic and monetary union. At present none of these countries fulfils all the necessary criteria. Owing to the country-specific differences in the convergence towards the euro area achieved to date, an enlargement of the common monetary zone in several stages appears the most likely scenario. Another debate affecting the future of the European Union was triggered by the European Commission with the presentation of the European financial plan for the years 2007 to 2013. The scheduled increase in expenditure which it contained triggered a lively debate in particular between the net contributors and the net recipients in which the line of demarcation ran not only between countries but also between different tiers of government in individual member countries. Whereas the decision on the European Union's medium-term financial framework will not be taken until the end of 2005 at the earliest, the signing of the treaty on a European Constitution in 2004 was an institutional milestone. With respect to the functional viability of a European Union that in future will comprise 27 and more members, the

introduction of a "dual majority" for decision-making within the Council should be highlighted. This will have considerable consequences for the relative clout of individual countries on the Council.

II. GERMANY: EXPORT-DRIVEN UPTURN – NO EASING OF THE DOMESTIC ECONOMIC PROBLEMS

11. The cyclical revival that began to emerge in mid-2003 continued in 2004. This ended a three-year phase of stagnation. A similarly stubborn phase of low macroeconomic growth rates was last observed at the beginning of the 1980s. Even though, recording an annual average rate of growth of 1.8 per cent, the cyclical momentum was a little stronger than had been forecast one year earlier – and also exceeded the estimated potential growth rate of just over 1 per cent – the unbalanced pattern of this year's upswing failed to dispel the doubts about the robustness of the cyclical development (Table 2). The contributions to growth of the individual aggregate expenditure components were distributed too unevenly. A very buoyant export momentum has continued to contrast with a lacklustre domestic economy. Admittedly, this picture of an export-led recovery was not exactly untypical for the German economy in some past years, too. Yet such a sustained split between positive external influences and stagnating or even negative internal consumption, which has been in evidence for four years now, was not seen in the past. The sole exception was the year 2003, but this, too, only in view of a weak external impulse; in 2004 domestic demand again contributed nothing to the overall economic expansion.

– On the back of the dynamic global economic trend, the **exports** of goods and services increased by over 6 per cent in the first six months of this year compared with the second half of 2003. As imports grew far more slowly than exports, the contribution of the external sector to overall growth rose further from the previous year's already high level and was virtually the sole component in the recorded growth rates of GDP. In the second half of the year export activity slowed perceptibly and, in conjunction with a still robust momentum of imports, dampened the external impulse. Irrespective of the fact that the fundamentally positive export balance of the past years attests to German firms' improved price competitiveness on foreign markets, this demonstrates just how vulnerable the sustainability of the cyclical recovery must remain in the absence of significant support from the domestic economy.

Tabelle 2

Wirtschaftliche Eckdaten für Deutschland

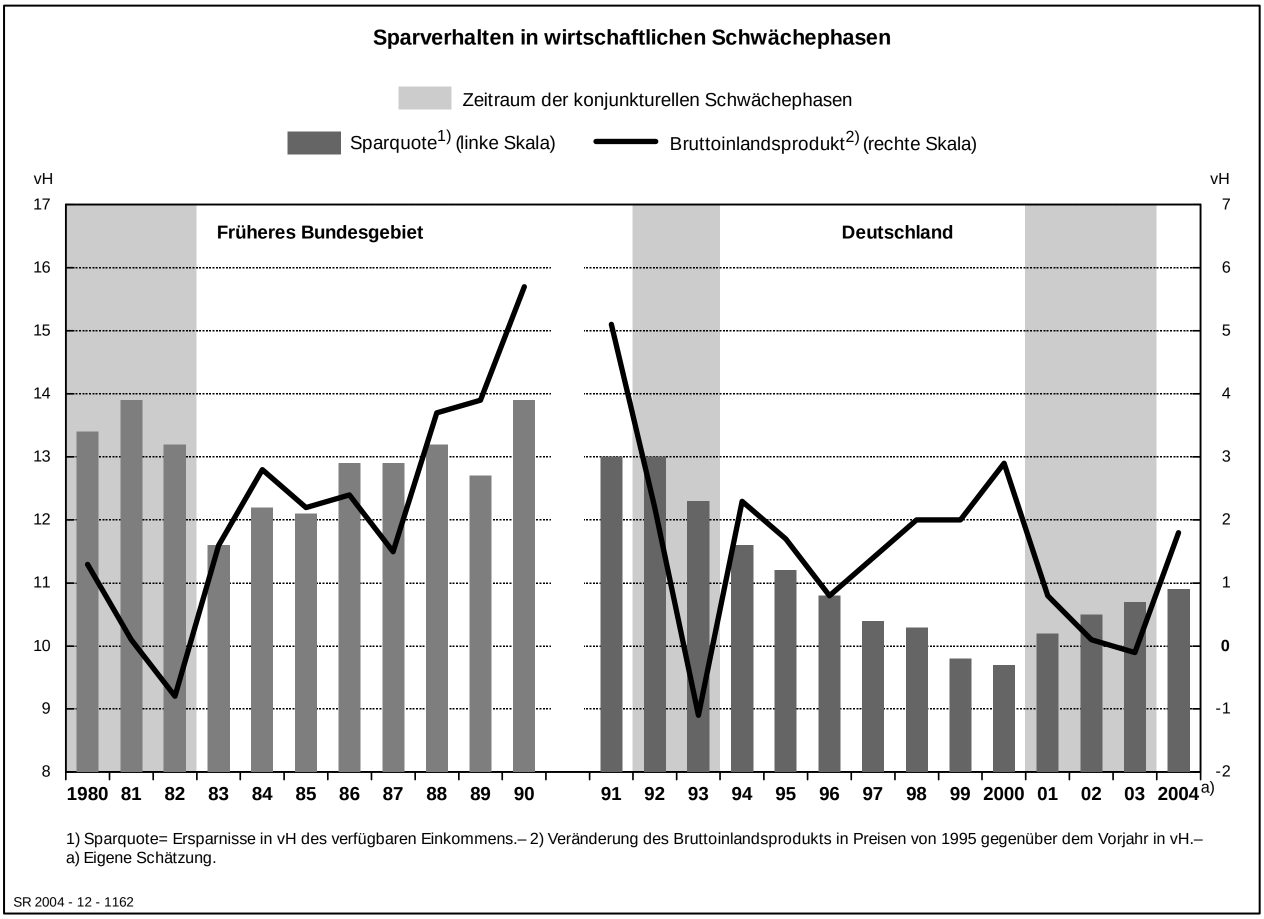
	Einheit	2001	2002	2003	2004[1]	2005[1]
Bruttoinlandsprodukt	vH[2]	*0,8*	*0,1*	*-0,1*	*1,8*	*1,4*
Inlandsnachfrage[3]	vH[2]	*-0,8*	*-1,9*	*0,5*	*0,2*	*0,8*
Ausrüstungsinvestitionen	vH[2]	*-4,9*	*-8,6*	*-1,4*	*-0,7*	*3,8*
Bauinvestitionen	vH[2]	*-4,8*	*-5,8*	*-3,2*	*-1,9*	*-1,6*
Sonstige Anlagen	vH[2]	*5,5*	*1,4*	*1,7*	*2,4*	*5,0*
Konsumausgaben	vH[2]	*1,6*	*-0,1*	*0,0*	*-0,1*	*0,5*
Private Haushalte[4]	vH[2]	*1,7*	*-0,7*	*0,0*	*-0,0*	*0,7*
Staat	vH[2]	*1,0*	*1,9*	*0,1*	*-0,1*	*-0,0*
Exporte von Waren und Dienstleistungen	vH[2]	*5,7*	*4,1*	*1,8*	*10,3*	*5,9*
Importe von Waren und Dienstleistungen	vH[2]	*1,0*	*-1,6*	*4,0*	*6,8*	*5,1*
Erwerbstätige (Inland)[5]	Tausend	174	-226	-382	58	163
Registrierte Arbeitslose[5]	Tausend	-37	208	316	1	-3
Arbeitslosenquote[6]	vH	*9,4*	*9,8*	*10,5*	*10,5*	*10,5*
Verbraucherpreise[7]	vH	*2,0*	*1,4*	*1,1*	*1,7*	*1,6*
Finanzierungssaldo des Staates[8]	vH	*-2,8*	*-3,7*	*-3,8*	*-3,9*	*-3,5*

1) Jahr 2004: eigene Schätzung, Jahr 2005: Prognose (Ziffern ■ff.). - 2) In Preisen von 1995; Veränderung gegenüber dem Vorjahr. - 3) Inländische Verwendung. - 4) Einschließlich der privaten Organisationen ohne Erwerbszweck. - 5) Veränderung gegenüber dem Vorjahr. - 6) Anteil der registrierten Arbeitslosen an allen zivilen Erwerbspersonen (abhängig zivile Erwerbspersonen, Selbständige, mithelfende Familienangehörige). Von 2001 bis 2003 Quelle: BA. - 7) Verbraucherpreisindex (2000 = 100); Veränderung gegenüber dem Vorjahr. - 8) Finanzierungssaldo der Gebietskörperschaften und Sozialversicherung in der Abgrenzung der Volkswirtschaftlichen Gesamtrechnungen in Relation zum nominalen Bruttoinlandsprodukt.

– **Private households' consumption**, the most important component of domestic expenditure, proved disappointing in 2004, too. The year-on-year contraction by 0.1 per cent means that German households' consumption has fallen for the third year in a row. This was caused primarily by the weak momentum on the labour market. Although there was a small rise in the level of employment, this was due chiefly to a rising number of low paid part-time workers and self-employed persons induced by labour market policy. The number of employees subject to social security contributions decreased further. As a result of this as well as the muted increase in both negotiated wages and actual earnings, gross wages and salaries went up by merely 0.4 per cent. This rise fell well short of the increase in disposable income of 1.8 per cent, which was boosted in particular by the tax relief measures introduced at the start of the year.

The weak growth of consumption in the past few years has raised the question as to whether this perhaps signals a change in consumer behaviour. The falling ratio of nominal consumption expenditure to disposable income points to a rather untypical pattern in view of the real economic development during the past four years, since in previous sluggish phases in the early 1980s and the years 1992/1993 no comparable reduction was observed – the mirror image of this development is the saving ratio, which this year went up marginally to 10.9 per cent (Chart 5).

Schaubild 5



Such a pattern of consumption, in the context of unchanged long-term income expectations, is hard to reconcile with the hypothesis of intertemporal consumption smoothing, because under this scenario a cyclically induced flat or falling level of income ought to be offset by a lower saving ratio in order to maintain the accustomed consumption pattern. The Council's own estimate of private consumption does not indicate, however, that a structural break has occurred in consumption behaviour. It follows from this that the restrained private consumption of the past few years primarily reflects the low income growth and rising unemployment. This is also supported by the evolution of the indicators of consumer confidence. In particular, the concerns about job security have magnified again this year. Besides the public debate about the labour market reforms, these were triggered by the economic problems of some renowned large German firms, which came under the spotlight of public attention during the autumn. It is also conceivable that private households have reduced their income expectations in view of the weak trend growth in recent years and that this has been reflected at least in part in an unusually strong consumption restraint.

– **Investment activity**, too, was again disappointing in 2004. Gross fixed investment fell for the fourth year in succession (by 1.1 per cent). Hopes that the investment restraint would come to an end, which had been nurtured by the mild revival in the second half of 2003, were abruptly dented at the beginning of this year. Both investment in machinery and equipment and construction investment declined markedly in the first six months of the year. From mid-2004, however, an upward trend was observed at least in the case of investment in machinery and equipment. This indicates that the ongoing process of balance sheet consolidation is no longer decisively hampering fixed capital formation, as a result of which the favourable overall investment environment of low interest rates and rising corporate profits is now gaining greater weight. In addition, the level of capacity utilisation in manufacturing industry began to recover from its low point in the middle of 2003 and is currently slightly above its multi-year average. However, the sharp drop in investment in machinery and equipment during the first half of the year pushed down the annualised average level by a further 0.7 per cent. The brightening of the investment horizon for machinery and equipment during the course of 2004 was not matched by a corresponding pick-up in construction investment. It contracted by 1.9 per cent, which was the ninth such decrease in ten years. There was a particularly sharp fall in investment in commercial construction, whereas investment in residential construction stagnated. Investment in public construction projects was likewise down on an annual average, although a distinct upturn occurred from the summer onwards – presumably caused not least by the better budgetary position of local government, which is the principal initiator of public construction projects.

12. The continuing divergent dynamics as between the external and internal components is increasingly raising the question of whether this development may be a reflection of a **new cyclical adjustment pattern** of the German economy. One possible and widely discussed cause of such a change could be the institutional framework of European monetary union. The relevant transmission processes have their supposed root causes in observable and in some cases persistent inflation differences, which for the countries of the common currency zone translate into real interest rate differentials and in addition trigger changes in the real effective exchange rates between these countries. Germany's lower comparative inflation rate in principle produces higher real interest rates but also a real depreciation against the other countries in the euro area. These countervailing adjustment mechanisms could offer an explanation for Germany's strong export growth, on the one hand, and its concurrent weak domestic economy compared with the other euro-area countries, on the other, during the downward phase of the business cycle from 2001 to 2003 and the current upturn. A comparison of the macroeconomic changes within

the euro area for the period from 2001 to 2004 shows that this hypothesis can claim a certain plausibility.

For the year 2004 the European Commission's forecasts from this autumn are used in order to ensure a consistent basis of cross-county comparison. These differ little from the estimates of the German Council of Economic Experts.

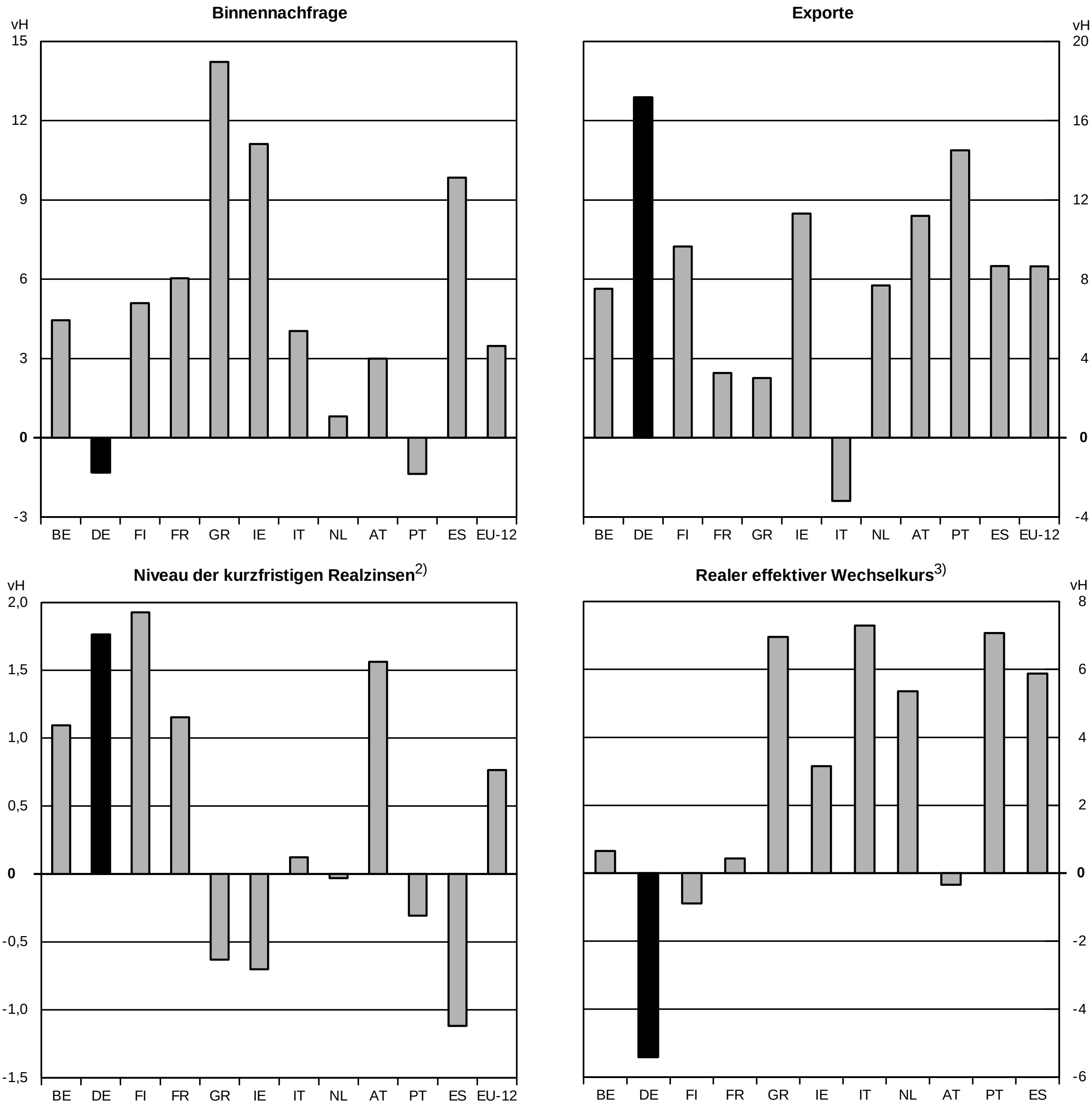
Looking first at the evolution of the output gaps, it can be seen that the cyclical downturn from 2001 onwards did not affect the German economy unduly harshly compared with the other euro-area countries. In 2004 the German output gap was at the same level as the euro-area average, whereas in the preceding years it had been marginally below it. The lower comparative growth rates of German GDP have their main cause in a steeper decline in trend growth by international standards. This is illustrated by the fact that even Germany's positive output gap in 2000 was below the average level in the euro area; hence the fact that Germany's GDP growth rates have been so weak since then is not because of a high starting level in relation to potential growth. Naturally, there have also been dampening effects in the past few years caused by demand shocks; this is borne out by the Council's own analysis of the decomposition of Germany's cyclical development into supply and demand-side influences. But owing to their global nature, these also affected the other countries in the euro area – for example, the recession in the United States or the adverse effects on confidence of terrorist bombings or geopolitical uncertainty. Compared with other countries, however, domestic demand in Germany has receded over the last four years; in no other euro-area country was this case. The relative weakness of Germany's domestic economy relates both to private consumption spending and gross fixed investment – i.e. both of the relevant expenditure components. Conversely, Germany's export dynamics in the period from 2001 to 2004 were the most robust of all the member countries of monetary union.

With respect to the two relevant endogenous **adjustment channels in a monetary union, the short-term real interest rate and the real exchange rate**, it emerges that, on average over the past four years, Germany had a short-term real interest rate that was 1 percentage point higher than the average for the euro area (Chart 6). Given identical short-term nominal interest rates, this reflects Germany's lower average inflation rate – measured in terms of the realised

Schaubild 6

Konjunkturelle Anpassungsmuster im Euro-Raum I[1)]

Jeweils Veränderung im Zeitraum der Jahre 2001 bis 2004
(mit Ausnahme der kurzfristigen Realzinsen)



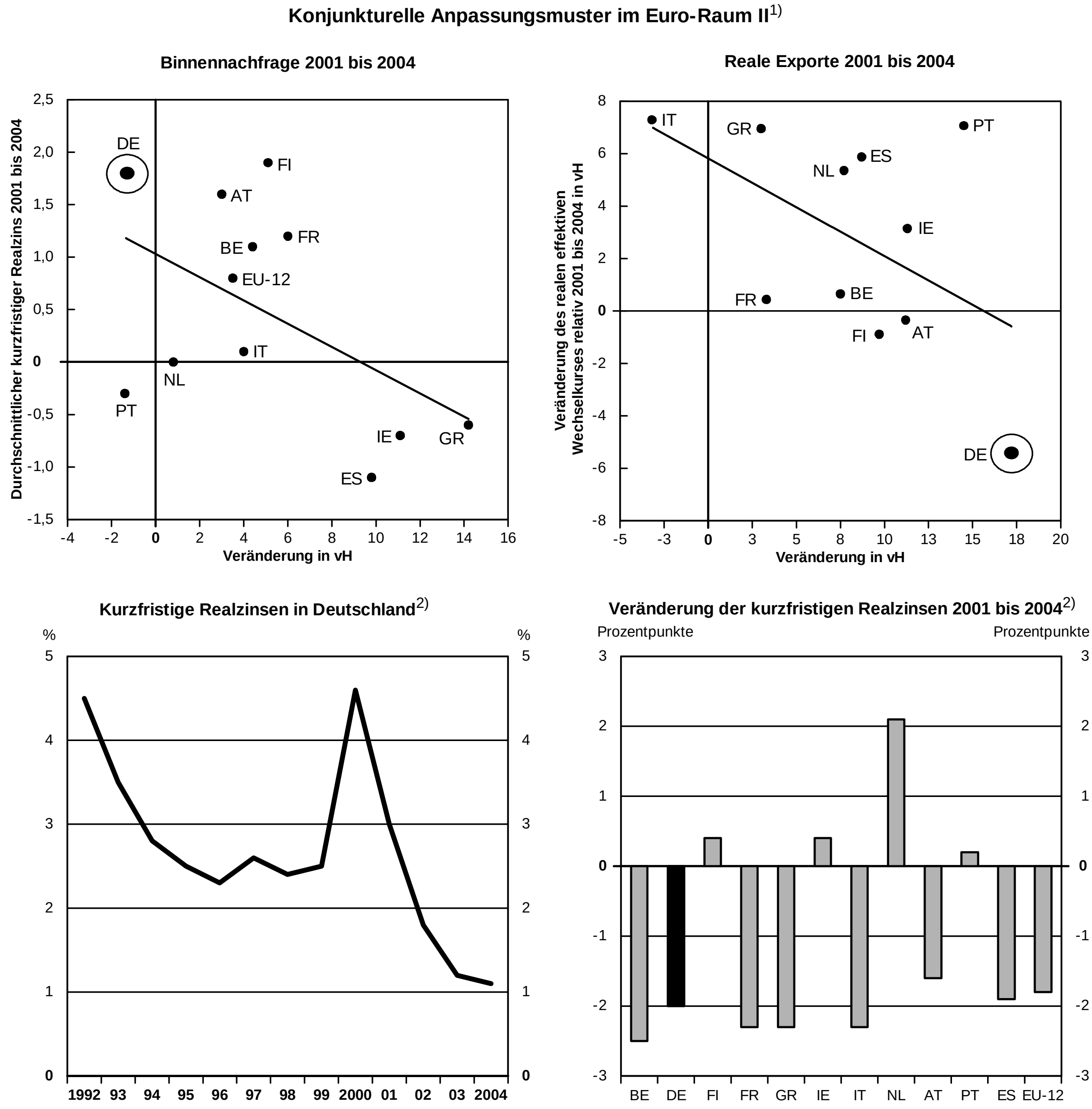
1) Für das Jahr 2004 Schätzung der EU-Kommission von Oktober 2004. Betrachtete Länder: Belgien (BE), Deutschland (DE), Finnland (FI), Frankreich (FR), Griechenland (GR), Irland (IE), Italien (IT), Niederlande (NL) , Österreich (AT), Portugal (PT) und Spanien (ES).– 2) Kurzfristige Nominalzinsen abzüglich Deflator des Bruttoinlandsprodukts.– 3) Relative Entwicklung zu den jeweils 14 anderen EU-Ländern (EU-15 ohne Luxemburg).

Quelle für Grundzahlen: EU

SR 2004 - 12 - 1164

changes in the respective GDP deflators of Germany and the other euro-area countries. However, this change in the relative national price level led to a marked cumulative real effective depreciation against the other countries amounting to over 5 per cent. A comparison of the respective change in the real effective exchange rate with the export growth of the individual countries in a cross-section analysis produces a significant negative correlation (Chart 7). A similar negative correlation in the euro area also shows up for the average short-term real interest

Schaubild 7



1) Für das Jahr 2004 Schätzung der EU-Kommission vom Oktober 2004. Betrachtete Länder: Belgien (BE), Deutschland (DE), Finnland (FI), Frankreich (FR), Griechenland (GR), Irland (IE), Italien (IT), Niederlande (NL) , Österreich (AT), Portugal (PT) und Spanien (ES).– 2) Kurzfristige Nominalzinsen abzüglich Deflator des Bruttoinlandsprodukts.

Quelle: für Grundzahlen: EU

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rate and the increase in domestic demand. The latter is largely driven, however, by the development in three countries: Ireland, Greece and Spain. Generally, for the short observation period the correlation between the real exchange rates and export growth seems to be more robust than for the relationship between domestic demand and the level of short-term real interest rates.

With all due caution, bearing in mind the short observation period and the simple correlation analysis, it would seem that the macroeconomic adjustment processes induced by inflation differentials do tend to offer a partial explanation for the differences in the various national cyclical paths within the European monetary union. Naturally, this solely concerns the different, i.e. the **relative, adjustment profiles** between the individual countries. But more important in this context with a view to Germany is that, if this is the case, the endogenous adjustment reactions via a real effective depreciation are definitely having a supporting effect. This tendency is augmented by the fact that an improvement in price competitiveness has a cumulative effect and hence increasingly counteracts the real interest rate effect of the same magnitude that occurs in a given period. It follows that only the hypothesis of a somewhat lagged adjustment may be inferred from this.

A study made by the European Central Bank arrives at a similar finding. This also highlights the possible bias arising from the fact that real interest rates are normally calculated via the realised inflation rate. In particular over short time horizons, however, the observed pattern of the evolving price level may deviate from the long-run inflation expectations. According to the European Central Bank, this can also be observed for the euro area. The standard deviation of the national inflation expectations of the individual states in the period 1999 to 2004 is regularly far smaller than that of the actual inflation rates in the individual countries.

The above considerations are of little help when it comes to the question of the **absolute stimulus** observed for Germany as a result of short-term real interest rate movements; as mentioned, they can only help us to understand relative cross-country adjustment patterns. Looking at the absolute numbers, short-term real interest rates in Germany are currently at a very low level, and the observed fall in this variable – which, along with the absolute level, can likewise be regarded as an indicator of the potential stimulus imparted by monetary policy in the national context – shows that the German economy has been able to profit from a marked decline since 2001. Moreover, this decline in the real short-term interest rate level was no smaller than that of the euro-area average.

13. The low level of investment during recent years has quite often been ascribed to an overly **restrictive bank lending policy**. And indeed surveys indicate a tightening of credit standards right up to the current margin. However, neither analyses carried out by the Deutsche Bundesbank nor the German Council of Economic Experts' own updated estimates at the macroeconomic level can corroborate the fears of a credit crunch – in the sense of a restrictive credit supply deliberately initiated by the banks for their own policy reasons. Rather, the negative credit volume curve can still largely be explained by supply-side determinants. However, marked differences are discernible between the different banking groups. Thus it has been evident for some time now that the large banks, in particular, have been more cautious in granting loans to

the enterprise sector. This would seem to be attributable chiefly to their profitability problems during the past few years.

The earnings situation of German **banks** has displayed a trend deterioration over the past ten years. It fell to a new low in 2003, with an average return on equity of 0.7 per cent. This poor profitability has particularly affected the German large banks and the group of state-owned Landesbanks, which have even recorded negative results. For 2004 a modest improvement in the earnings situation is expected against the background of reduced risk provisioning and a further reduction in general administrative spending. Despite the weak profitability, the **stability of the German banking system** appears, as before, to be assured. For example, German banks' core capital ratio remains at a satisfactory level. Furthermore, stress tests performed by the Deutsche Bundesbank in conjunction with the International Monetary Fund indicate that the German banking system's resilience to crises remains assured, despite the weak earnings performance.

This raises the question of whether the poor earnings performance of German banks represents a short-term phenomenon, which will correct itself once the economy picks up speed, or whether it is an entrenched feature of the German banking system – independent of the overall economic situation. In particular, German banks' lower level of returns vis-à-vis their international competitors – which is evident across all the banking groups – might be an indication that the weak profitability is not exclusively attributable to the problematic cyclical situation. In fact, it has often been suggested that a direct link exists between the structure of the German banking system and its low profitability. The International Monetary Fund, for instance, puts the German banks' weak profitability down to the German banking system's three-pillar system, from which – in part owing to the privileged position of the public-sector banks – competitive distortions and (operational) inefficiencies are said to result.

At present there is a dearth of sound empirical studies for the German banking system devoted to these issues. A purely descriptive analysis of the competitive situation and possible inefficiencies on the German banking market usually yields no clear-cut results. The large number of rescue mergers, competitive restrictions in the savings and cooperative bank sector resulting from their effective regional monopolies as well as barriers to market access represented by the savings banks' immunity to being purchased might be possible signs of inefficiencies and competitive distortions. But there is no clear-cut evidence for this. On the other hand, international experience offers proof of successful openings of a previously segmented banking structure. Seen in this perspective, the proposals to reform the public banking sector that are currently being made in many German states (*Länder*) are to be welcomed.

14. Despite the improved macroeconomic development, the **situation on the labour market** worsened further in 2004. Although the number of employed rose marginally year on year by 0.2 per cent, this was due mainly to the further sharp increase in the self-employed and a growing number of exclusively low paid part-time workers exempted from paying taxes and social security contributions (*geringfügig Beschäftigte*) supported by the active labour market policy. The number of employed persons paying regular social security contributions went down again, albeit at a slower rate. The implications of the strong growth in low paid part-time

workers remains ambiguous on account of an unsatisfactory dataset. The possible displacement of socially insured jobs represents a potential danger, especially in the enterprise sector – which is indicated by the steep fall in that employment segment. However, there is no assured statistical evidence for this hypothesis as yet. At any rate, the subsidised "mini-jobs" are making no contribution to the decline in registered unemployment, as is attested by the high number of registered unemployed in this labour market segment (around 600,000 persons). The latter group have no incentive to overcome their unemployed status merely for the sake of a mini-job.

Registered unemployment showed a further marked increase in 2004. Since, however, individuals undergoing aptitude tests and training measures (just under 100,000 persons) have no longer been included in the jobless figures as from this year, this development does not show up in a simple year-on-year comparison, which indicates a stagnation of the number of unemployed. Just how dire the actual situation is this year is shown by the fact that if these figures are adjusted for this effect, some months in 2004 registered the highest number of jobless individuals since German unification in 1990. It should also be noted, though, that the level of latent unemployment, which per se was raised by the changed statistical recording method, decreased further this year.

15. In the field of labour market policy the introduction of Unemployment Benefit II (*Arbeitslosengeld II*) in a slightly amended form – following a quite heated public debate – from 1 January 2005 constitutes one of the most significant reform steps on the labour market of the past decades. Unemployment Benefit II is a correct and major step forward which puts an end to the segregation into two tax-financed benefit systems – unemployment assistance (*Arbeitslosenhilfe*) and social assistance (*Sozialhilfe*) – for which there was never any theoretical justification. Moreover, the improved possibility for recipients to top up their benefit level through additional earned income strengthens their incentive to work. It is likely that the new Unemployment Benefit II will be paid in future to just under 2.9 million needy households encompassing almost 6 million members. More than half of these persons are capable of working and hence are available for job placement and other work encouragement measures. According to estimates of the German government and the Federal Employment Agency (*Bundesagentur für Arbeit*), approximately 400,000 to 500,000 current recipients of unemployment assistance will no longer qualify for it in future owing to stricter means testing. There have also been sharp public controversies on the issue of the new scheme's organisational structure. The solution that was finally arrived at after prolonged political squabbling, namely the splitting of administrative responsibilities into bilateral partnerships (*Arbeitsgemeinschaften*) between the Federal Employment Agency and local social welfare offices (*Sozialamt*), on the one hand, and an optional go-it-alone approach for individual municipalities, on the other, will at best serve as a kind of prolonged field study to determine the ultimately more efficient solution. Not least in order to give those concerned a prospect of finding work in the context of the currently difficult labour market situation, the German parliament has additionally decided to extend the range of

subsidised work opportunity programmes ((*Arbeitsgelegenheiten*) already available under the legislation applying to recipients of social assistance. The associated expansion of the secondary labour market began already at the end of 2004 and in principle represents a potentially useful instrument in the sense of the "promote and push" (*Fördern und Fordern*) approach, which is the guiding principle behind the reform. Even so, this instrument is not unproblematic owing to the extra remuneration payable on top of Unemployment Benefit II. In order to effectively combat the potential danger, which cannot be clearly gauged at present, that this might trigger a transfer of jobs from the primary to the secondary labour market, the institutions concerned will need to display great prudence when allocating such employment opportunities.

16. The worrying **trend in public finances** continued in 2004. The general government budget deficit amounted to 3.9 per cent in relation to Germany's nominal GDP and thus widened further compared with the 2003 figure, which means that the Maastricht criterion has been clearly exceeded for the third year in succession. The fact that the deficit did not decline this year despite the improved general economic setting is attributable to two principal reasons. Firstly, the export-driven cyclical recovery, which led to no across-the-board improvement on the labour market, has had a smaller impact on the revenue side of public budgets than might have been expected if the upswing had been more strongly rooted in the domestic economy. This applies especially to receipts from turnover tax. Secondly, however, the unsatisfactory course of development of the general government deficit this year also reflects the impact of legislative measures. In particular, income tax rates were lowered appreciably at the start of 2004 without the ensuing decrease in revenue being accompanied either by a reduction of public spending on a sufficient scale or – as was at first hoped – by additional tax receipts owing to a stronger revival of domestic demand.

Central government was confronted with particular budgetary problems in 2004 in consequence both of specific difficulties on the revenue side of the Federal budget – such as the steep drop in the profit transferred by the Deutsche Bundesbank – and of a deliberate shift of resources in favour of the other tiers of government. By contrast, state government, local government and the social security funds – the latter primarily thanks to savings in the health service sector – were able to improve their budgetary situation vis-à-vis 2003, in some cases by a distinct margin.

The cyclically adjusted deficit in 2004 amounted to a little less than 3½ per cent in relation to nominal GDP and thus, like the unadjusted budget deficit, more or less matched the prior-year figure. At first sight this might seem surprising in view of the bigger year-on-year expansion of GDP. However, for calculating the structural budget balance the German Council of Economic Experts does not use aggregate output gaps but rather disaggregated cyclically adjusted individual measures of government revenue and expenditure items. Calculated on this basis, it transpires that the cyclically induced additional public expenditure for the current year resulting from the persistently poor labour market situation and the further rise in unemployment comes to the substantial sum of around 2.5 billion euro. On the revenue side of the public budgets, cyclical factors led in 2004 to income losses totalling approximately 7.5 billion euro net, above all in the form of lower receipts from turnover tax, special excise taxes and wage tax, as well as lower social security contributions, in the wake of the weak domestic demand and a very muted growth of gross wages and salaries.

17. The adoption in 2004 of the **Act revising the income tax treatment of contributions to and income from retirement pensions – Retirement Income Act** (*Gesetz zur Neuordnung der einkommensteuerrechtlichen Behandlung von Altersvorsorgeaufwendungen und Altersbezügen – Alterseinkünftegesetz*) represents a far-reaching tax policy measure. The Act, which was necessitated by a decision of the Federal Constitutional Court (*Bundesverfassungsgericht*) from 2002 which ruled that the current differences between the taxation of ordinary state pensions and the pensions of public sector employees with the status of civil servants (*Beamte*) are incompatible with the principle of equal treatment (*Gleichheitsgebot*) enshrined in the German Federal Constitution (*Grundgesetz*), envisages a gradual transition to the downstream taxation of old-age provision. Staggered over a lengthy transitional period, contributions to the statutory pension insurance scheme (*Gesetzliche Rentenversicherung*), but also certain contributions to private pension schemes, will be exempted from income tax; instead, pension incomes will ultimately be fully subject to taxation. It is likely that this reform will greatly alter private households' saving and investment habits as the downstream taxation of income – which in principle is favourable for the tax payer – will only apply to a defined range of pension savings products and, for example, the current preferential tax treatment of endowment life insurance policies will be at least curtailed. But the Retirement Income Act will also affect the size of the tax burden faced by different groups of the working population over the course of their lives. In the case of civil servants, this is attributable to the fact that the tax-free allowance currently granted to civil servants on their pension savings will be progressively abolished; civil servants can thus be considered to be "losers" under the reform. The situation of employees who pay into the statutory pension insurance scheme presents a differentiated picture. Measured over the complete lifetime, the tax burden on young employees in particular will be reduced because they will benefit from the relief afforded to them by the Retirement Income Act at an early stage of their life but will be faced with the additional tax burden only in the distant future. For middle-aged single employees with a fairly large income, by contrast, the changeover to downstream pension taxation will mean a heavier tax burden.

18. All of the individual **social security schemes** (*Sozialversicherung*) experienced continuously low receipts in 2004 on account of the weak development of incomes subject to social security contributions.

In the case of the **statutory health insurance scheme** the Act modernising the statutory health insurance scheme (*GKV-Modernisierungsgesetz*) is beginning to make an impact. The introduction of a quarterly charge for visits to doctors' surgeries (*Praxisgebühr*) is having not just a financial effect but also a steering effect, which is reflected in a drop in the number of visits to doctors' surgeries. In turn, this fall in patients' visits is leading to fewer prescriptions and hence to lower expenditure on pharmaceuticals. The revenue side of the statutory health insurance scheme has been positively affected by the Federal transfer amounting to 1 billion euro and the extension of the contribution liability to company pensions. The relief afforded by the health service reform has been offset by the scheme's poor revenue performance, however, so that contribution rates have not yet been lowered, as was hoped, although this was also partly due to the fact that the health insurance institutions preferred first to reduce their debts and replenish their reserves rather than lower contribution rates. The Act modernising the statutory health insurance scheme had originally also envisaged removing the provision of dentures from the range of insured services and instead to finance this via a flat-rate payment contribution; however, this plan was subsequently dropped and in its place an additional contribution rate was introduced which actually has nothing to do with the provision of dentures. Together with the additional contribution rate for sickness benefit (*Krankengeld*), this will increase the burden of contributions for insurees from 1 July 2005 by 0.45 percentage point while concurrently alleviating the employers' burden. It is hoped that this will lead to positive employment effects. In view of the potential medium-term adjustment responses in future collective bargaining over pay and other labour conditions, however, this effect may not be expected *a priori* beyond the short term.

In the **statutory pension insurance scheme** the Pension Insurance Sustainability Act (*RV-Nachhaltigkeitsgesetz*) initiated another pension reform step with the intention of curbing the level of contributions over the long term by pegging pension adjustments more closely to revenue growth and additionally coupling them to the changing demographic trend by means of a so-called sustainability factor (*Nachhaltigkeitsfaktor*). Altogether these measures are designed to keep the contribution rate down to 22 per cent up to the year 2030. Measured by the implied yields, it can be seen that the reform will, in particular, make older and middle-aged cohorts worse off and younger cohorts born from 1976 onwards better off than under the status quo prior to the reform.

In the **statutory long-term care insurance scheme** urgently required reforms were not undertaken. In order to accommodate a ruling of the Federal Constitutional Court from 2001, which had demanded an easing of the contribution burden for parents, parliament passed the Act taking account of childcare (*Kinderberücksichtigungsgesetz*). It raises the contribution rate for childless couples and individuals by 0.25 percentage point. Basically, this equates to nothing more than an increase in wage tax for a defined social group with negative allocation effects.

The wage-linked contribution base of both the statutory health insurance scheme and the long-term care insurance scheme means that contributions act like a wage tax. Consequently, contribution increases are no different from a tax increase, which ultimately hampers growth and employment. **Projections of the contribution rates** for these two social security schemes indicate – depending on income growth and assumptions concerning expenditure growth – steep to very steep increases in the contribution rates in the coming decades. Such increases would have enormous negative consequences, which is why a reform of the method of financing these two social security schemes is imperative. The changing age structure of the population alone means that the contribution rate to the statutory health insurance scheme will have to be raised by around 3 percentage points, while the contribution rate to the long-term care insurance scheme will have to be more than doubled. As the age-specific expenditure profiles in the long-term care insurance scheme show an even steeper curve than those of the statutory health insurance scheme, i.e. expenditure is concentrated on older insurees, the sensitivity of the long-term care insurance scheme to a change in the age structure is greater than in the statutory health insurance scheme.

The likely course of development next year

The pace of cyclical recovery will be sustained in 2005. The macroeconomic momentum will continue to be supported by impulses from the external sector; in the course of the year domestic consumption will then gradually become more widely based. According to our forecast, German gross domestic product will grow next year by 1.4 per cent. The slight deceleration compared with 2004 is due not least to a smaller total of working days in 2005. Adjusted for these calendar effects, the development of GDP does not show such a marked slowing of overall business activity.

Unemployment will remain at a high level; for the first time since 2001 there will be a modest rise in the total number of employees.

Under the baseline forecast the general government budget deficit will amount to 3.5 per cent. In order to comply with the deficit ceiling laid down by the Stability and Growth Pact, savings of around 12 billion euro are required. Hence it appears probable that the deficit ceiling stipulated by the Stability and Growth Pact will again be exceeded in 2005.

The rate of increase in consumer prices will remain moderate and will equal 1.6 per cent in Germany in 2005.

The principal risk to the forecast comes from the development of oil prices and exchange rates. The higher oil prices carry the risk that the global economic setting could be dampened more strongly than we have assumed. Given the weak momentum of domestic demand, this poses a danger to the supporting influence via foreign trade and hence for the overall economic dynamics next year.

The likely course of development in 2005: Hopes of a cyclical upturn rest on a revival of domestic activity

19. The hopes for the year 2005 are that the cyclical recovery will no longer be based solely on the external impulses. The global economic momentum will slow down slightly in the coming year but will still remain robust. If the macroeconomic momentum in Germany is to be maintained in this setting, domestic economic activity must play a stronger role. Although the conjunctural

development in 2004 disappointed these hopes, the current underlying conditions create a propitious platform for enabling internal consumption to gradually break free from its torpid state. The scenario is subject, however, to significant risks from a possible further appreciation of the euro or another oil price surge.

The **global economy** will be a little less dynamic next year. Above all, the consequences of the latest oil price rise and the fact that the United States will probably come close to exhausting its potential growth in 2005 as the monetary and fiscal stimuli peter out point to a certain deceleration of the global upswing. Yet in view of the robust overall state of most national economies, the consequences will remain limited. Within such a constellation, the volume of world trade will expand once more in the coming year by the appreciable margin of 7.0 per cent. Given these global parameters, the **pace of economic development in the euro area** will continue, although it will not noticeably pick up speed. While export growth will probably slow down somewhat, this will be compensated by a revival of domestic demand.

Monetary policy in the euro area will retain its expansionary course, and it is similarly unlikely that fiscal policy will have an excessively retarding impact next year on balance given the forecast largely constant cyclically adjusted deficit.

20. Turning to the likely course of development in Germany, the essentially robust external setting will continue to have a stimulatory influence, even if this will not be quite as strong as in 2004. In the course of 2005 the national macroeconomic development will be underpinned by a gradual recovery of the domestic demand components. Positive signs are already discernible in the increase in investment in machinery and equipment at the beginning of the year. But in view of the merely moderate growth of disposable incomes and a still fragile revival on the labour market, private consumption expenditure will increase only marginally in 2005, too. Nevertheless, the stagnation of the propensity to consume will progressively come to an end next year.

With an **increase in gross domestic product of 1.4 per cent**, the pace of economic activity seen in 2004 will be maintained. This statement may appear surprising at first sight since this means a year-on-year fall in the GDP growth rate from 1.8 per cent to 1.4 per cent. However, these raw figures mask differences in the respective number of **working days** in the two years. Thus there will be 1.3 fewer working days in 2005 than in 2004. It is, admittedly, difficult to estimate the macroeconomic importance of more or fewer working days for a concrete cyclical situation in individual cases, and the customary calendar effects of the official statistics show only a median value for the past. Nonetheless it seems fairly safe to assume that the smaller number of working days in the coming year will also have a corresponding effect on output. If one takes account of this working-day effect, which is quite divorced from the actual underlying cyclical momentum, one arrives at the diagnosis of a more or less unbroken velocity of overall economic activity despite the smaller increase in GDP.

21. Against this background **export growth** will amount to 5.9 per cent in 2005 compared with over 10 per cent in the current year. Imports will expand slightly by just over 5 per cent, with the result that the smaller external contribution will also lead to a weaker impulse on the overall economy. Even so, the external sector will still contribute roughly half to the aggregate growth rate of 1.4 per cent.

Next year **fixed asset investment** will end its phase of continuous contraction that has been witnessed since 2001, although this will be due exclusively to an increase in investment in machinery and equipment and in other investment. The volume of construction investment will fall once more, and this downward slide has not yet bottomed out. The one optimistic sign on the construction front concerns the second inference, namely that construction investment will contract by a smaller margin next year.

Household demand will expand moderately in 2005 on the back of a limited rise in disposal incomes. Gross wages and salaries will grow a little more strongly than this year in the wake of the initial, albeit still very modest, increase in employment. Private households' incomes will be boosted in the coming year by another cut in income tax rates and the start of the changeover to downstream taxation of pension contributions (Retirement Income Act) in the total amount of around 7.5 billion euro. However, this will be accompanied by higher social security contributions.

Consumer prices will increase by 1.6 per cent next year, i.e. at much the same rate as this year, and so will not additionally depress real disposable incomes. The gradually expiring baseline effects of the increases in administered prices in 2004 will contrast with further rises in tobacco tax and the effects of the oil price surge.

22. The **forecast for the labour market** in 2005 is complicated by the introduction of Unemployment Benefit II. This measure has considerable implications for the number of registered unemployed, but their impact will vary in terms of the size, sign and timing and hence will influence both the level and the evolution of registered unemployment. The precise effect cannot be gauged reliably, however. In view of these complexities, the German Council of Economic Experts has decided this year to first forecast the development on the labour market without taking account of the measures introduced by the Hartz IV Act and is publishing them separately in an additional estimate.

The increase in employment will continue next year. For the first time since 2001 the number of employees is also likely to go up. Owing to the envisaged rise in job opportunities in the context of the introduction of Unemployment Benefit II the number of employed persons will probably grow on an annual average by around 150,000 persons. The level of unemployment according to the old definition will remain constant in 2005. In view of the rise this year, that implies a decrease in the number of unemployed over the course of the year. After taking account of the changed legislative framework, however, it is estimated that the jobless total will rise by roughly 150,000. In February the number of registered unemployed may even exceed the 5 million mark. The main factor pushing up the recorded level of unemployment is the fact that, as a result of the reform, recipients of social assistance who are capable of working and who hitherto were not registered as unemployed will be newly included in the jobless statistics as from January 2005. This will probably affect some 380,000 persons. In anticipation of the foreseeable public reaction to such a rise in unemployment, it is important to point out that this is a purely statistical effect which, moreover, contributes to clarity and transparency. The aspect most worthy of criticism in this context is the failure to include this group of persons in the official jobless figures in the past.

23. The **situation of public finances** will show no noticeable improvement in 2005. The general government budget deficit will reach 3.5 per cent, thereby breaching the deficit criterion laid down in the Stability and Growth Pact for the fourth year running. If the 3 per cent ceiling is to be complied with, additional savings totalling around 12 billion euro will have to be made next year. It should be noted in this connection that the Federal Government does not bear the sole responsibility for developments over the past years. All tiers of government as well as the social security funds have contributed to the desolate plight of public finances; Germany's decentralised federal structure allows the state governments to effectively obstruct the savings which central government is seeking to make in the form of a reduction of tax breaks while at the same time publicly clamouring that the Federal Government alone bears the blame and shame for the general government deficit.

The Federal Government is planning a number of special measures so as to keep the deficit within the Maastricht limit in 2005. These notably include the securitisation of the pension claims of Bundes-Pensions-Service für Post und Telekommunikation e.V., which could yield savings of 5.45 billion euro in the coming year in Federal transfers to that institution. Yet even if these planned transactions are actually executed, it will be difficult to bring the deficit back down below the 3 per cent ceiling, quite apart from the fact that in economic terms this measure amounts to an additional intergenerational increase in public debt. Based on a forecast deficit of 3.5 per cent in relation to nominal GDP and an aggregate growth rate of 1.4 per cent, the cyclically adjusted deficit will probably decrease slightly in 2005.

24. The main **risk for our forecast** lies in the scenario of a more pronounced deterioration in the global economic environment that is assumed by us. In an overall setting characterised by persistently sluggish consumption and a still fragile recovery of investment, much will depend,

especially in the first few months of 2005, on a continuation of the supportive impulses from global economic activity. The biggest danger to the world economy at the moment is posed by the movement of oil prices. The increase seen in 2004 will itself have a dampening impact on developments in 2005. Even so, bearing in mind that the empirical experience of the effects of past oil price shocks shows that such price increases did not seriously impair the real economy in the recent past and that, moreover, in real terms the current oil price rise is well below those of 1973/1974 and 1979/1980, the adverse impact should be limited. The German Council of Economic Experts' own empirical estimates suggest that an unexpected oil price rise of 10 per cent will slow the growth rate of German GDP by about 0.1 per cent on average over the next three years. Studies carried out by other institutions for the world economy find an effect of a similar order of magnitude. Our forecast assumes an annual average oil price of 42 US dollars in 2005. This price broadly corresponds to the average price of crude oil futures contracts concluded for 2005.

Another risk lies in a potential further marked appreciation of the euro's exchange rate. Our forecast is based on an exchange rate of the euro against the US dollar of 1.27. For Germany's real effective exchange rate a constant level is likewise assumed for the forecast period. Our own estimates indicate that an appreciation has a significantly negative effect on the course of macroeconomic development in Germany both bilaterally and in real effective terms.

III. EXTERNAL SUCCESSES – INTERNAL CHALLENGES

25. For several years now the sole signs of macroeconomic dynamism in Germany have come from foreign trade – to be more precise, from a largely robust export activity or a robust external balance except for the year 2003. The economic forecasts of the German Council of Economic Experts as well as of other institutions have been suffused during the past years with the hope that, on the one hand, the impulse from external activity would not cease and, on the other, that the increases in production and income generated by foreign demand would at last also pass through to the other domestically oriented sectors. However, the cyclical state of the German nation in 2004 continued to be marked by a stark contrast, and even if the domestic economy looks set to strengthen a little in 2005, the underlying constellation remains more or less unchanged: while German goods and services are in great demand abroad, domestic consumers and investors appear averse to purchasing them. This finding raises a diverse array of questions.

Whereas for some observers the booming export trend is an indication that the much cited structural problems are not deeply rooted – since the buoyant external activity shows that Germany is internationally competitive – others consider the domestic economic problems to be the mirror image of the positive export record. The country's successful export performance, according to this view, is simply an expression of the evolution towards an internal production base characterised by a constantly shrinking volume of value creation. To be more precise:

owing to the accelerated shifting abroad of the production of upstream value creation chains, the foreign demand for German products is, allegedly, now being satisfied by an ever-larger share of intermediate goods imported from abroad and an ever-smaller share of goods "made in Germany". According to this school of thought, in the extreme case this could result in the gradual loss of Germany's industrial base and consequently a large number of jobs. If these fears were to be largely substantiated, this would at least also partly explain why the global economic momentum is not being reflected in an upturn in domestic employment and investment in Germany. These different positions are connected with a number of complex theoretical issues, starting with the question of what is meant exactly by international competitiveness and how Germany rates in this respect, to the analysis of the motives behind and implications of the growing volume of international trade and of foreign direct investment by Germany companies for jobs and the domestic economic structure.

26. On balance it is to be noted that the **competitiveness** of German firms on the international markets has increased during the past years. This is reflected in the rising export figures but also has a positive effect on domestic employment – and that is particularly relevant for the country's internal development. Although the domestic share of value added in exports has decreased, this can also be interpreted as an expression of a growing international division of labour, which enhances the price competitiveness of German companies. Furthermore, the increased export volume, i.e. the quantitative effect, has more than offset the smaller domestic value creation per exported product unit, so that the creation of value via exports has increased faster than overall domestic value creation. In the manufacturing sector – the mainstay of Germany's exports – this has produced additional jobs on balance since the mid-1990s.

27. One development that is often regarded as a problem concerns the **employment effects of the relocation of production** abroad. Foreign direct investment (FDI) of German firms expanded in leaps and bounds in the 1990s. In particular, the regional share of the transition countries, especially in eastern Europe and in China, has grown perceptibly in the past years. Measured in terms of total FDI, however, the bulk of German foreign direct investment has been channelled into the industrialised countries. Horizontal direct investment serves as a rule to break into foreign markets and thus has different implications for domestic employment than the relocation of production, by means of which parts of the production process are shifted abroad for cost saving reasons (vertical direct investment). This being the case, the dynamic development of vertical direct investment, especially towards eastern Europe, implies in principle greater adjustment needs in certain segments of the German labour markets than is the case for horizontal investment. The resulting employment effects are not easy to calculate, however, as horizontal investment, too, may, as in the case of imported inputs – in vertical investment activities the relocation of production facilities and import activity actually frequently go hand in hand – may strengthen the competitiveness of German companies, which also has positive repercussions for domestic jobs.

Reliable empirical studies on the employment effects of German direct investment in eastern Europe are extremely scarce at the moment. The findings in the few available studies – including for other industrial countries – are not uniform; a common tendency which is emerging, though, is that the losses in domestic employment from the relocation of production abroad are quantitatively limited.

28. This also puts into perspective the fears, encapsulated by the dramatic term **deindustrialisation**, of a threatening loss of Germany's industrial base. A relative decline in the shares of the production sector with regard to value creation and employment has indeed been apparent for decades. But this is not a specifically German problem but rather an experience that is shared in a very similar form by all industrial countries. Germany's development in this respect is not particularly exceptional; if anything, the importance of industry is still greater in Germany than in virtually all other industrial nations. International trade and foreign direct investment play only a minor role in the causation of this sectoral structural change. The major explanatory factors, by contrast, are a differing sectoral productivity trend – this is generally higher in industry than in the services sector – and long-run shifts in the demand structure towards services.

29. All in all, therefore, this shows that the banner headlines proclaiming catastrophic effects of the growing internationalisation of trade and production on the German economy are grossly exaggerated. The process of globalisation is creating a clear need to adjust and demands greater flexibility, particularly on the labour market. But domestic enterprises have coped comparatively well with these challenges, as is borne out by developments over the past few years. The disappointing evolution of the labour market, by contrast, demonstrates the persistence of substantial deficits, although the main external channels of influence cannot be held responsible for Germany's employment problems.

30. This still leaves the question of whether Germany's internal economic problems are primarily attributable to a weak domestic demand or whether the principal causes are located rather in a decrease in the growth potential. One thing is quite clear: it is insufficient to identify demand problems as the root-cause of the weak development of the national expenditure aggregates. For it follows by definition that a weak growth of gross domestic product will also be reflected in a weak development of the demand components. While this question involves complex empirical identification problems, our own analyses – but also those of other institutions – yield a largely uniform picture: Germany's sluggish growth, which has been apparent since the mid-1990s in comparison with other countries, is not primarily cyclically induced but is due rather to a **low trend rate of growth** that has been evident for a number of years. Given the documented findings concerning the influence of external impulses, it is equally clear that the causes lie in domestic misalignments and failings. In other words, international competitiveness and weak

growth are not mutually incompatible. It is first and foremost the growth that is influenced by the underlying domestic structures and it is the domestic determinants for more employment that generate the increase in real income and thus in the standing of living. The visible successes of the German economy abroad but also the experience of other European countries during the past few years suggest that a home-grown improvement in the growth outlook is indeed possible. This does not mean that demand aspects play no role at all, just as no one seriously denies that Germany was also affected by negative cyclical shocks in recent years. But when it comes to creating the basis for higher long-term real income growth and safeguarding the foundations for a sustained improvement in the employment conditions, attention must be focused more on those areas which – each in its own way – can help to achieve these fairly long-term objectives. This is all the more important as major determinants of the short-term stabilisation of cyclical fluctuations, such as monetary policy, are more than adequately performing their function at the moment – while concurrently safeguarding the long-term objective of price level stability.

31. Economic policy has a key role to play in creating an environment that is conducive to growth and employment. The weak growth momentum seen during the past years has highlighted the problems for the development of income and employment resulting from low trend macroeconomic growth rates. These – along with the effects attributable to the cyclical sluggishness – have for some time now likewise shown up clearly in the financial problems of the government budgets and the social security systems. Economic policymakers have responded in the past few years with a series of reform measures. These were aimed chiefly at the statutory pension insurance scheme and the labour market. In the face of strong public opposition, especially in connection with the labour market reforms, and despite a steep slide in the opinion polls, the adopted decisions were implemented in a basically unchanged form. This deserves recognition. Precisely with a view to the measures adopted for the labour market it should, moreover, be emphasised that many of the central reform components – such as the shortening of the period of entitlement to unemployment benefit (*Arbeitslosengeld*) – will only enter into force or develop their full impact in the coming years.

32. In other policy fields, by contrast, there is still much to be done. For the key area of public finances and tax policy the German Council of Economic Experts outlined what, in its view, constitutes the key elements of a policy geared towards growth and employment in last year's Annual Report. In this year's Annual Report, therefore, only some of the previously addressed points are taken up again and explained against the background of the current public debate. The focal points of the policy fields examined in greater depth this year lie in the area of the statutory health insurance scheme and the long-term care insurance scheme, the structural problems of the German education system and the question of how the economic reconstruction programme for eastern Germany can be realigned towards greater growth through the agreements on the new Solidarity Pact II (*Solidarity Pact II*).

Statutory health insurance scheme

From an economic perspective a uniform health insurance market with a general minimum insurance obligation and flat-rate payments unrelated to the level of income is the superior solution.

The citizen's flat-rate model (*Bürgerpauschale*) has the following advantages:

– Healthcare costs are decoupled from labour costs.

– The erosion of the wage-related contribution base is overcome.

– The indispensable social equalisation component is more transparent and can be achieved more selectively by being shifted to the tax and transfer system

– The tax wedge, which is detrimental to employment, is reduced and in this way the marginal levy burden is also lowered for the majority of employees.

– The equivalence principle (*Äquivalenzprinzip*) is strengthened.

Consequently, this concept is far superior, especially in respect of the implications for growth and employment, to models of a citizens' insurance scheme (*Bürgerversicherung*) with contributions depending on income levels.

Long-term care insurance

For the long-term care insurance scheme, too, the German Council of Economic Experts proposes a changeover to flat-rate contribution payments unrelated to income levels.

Since in the long-term care insurance scheme – unlike in the statutory health insurance scheme – a transition from a pay-as-you-go system to full capital funding is in principle still possible, the German Council of Economic Experts puts forward a proposal for a transition to a cohort-specific capital-funded long-term care insurance scheme.

If the policymakers decide not to initiate the changeover to a funded system, the system of financing the long-term care insurance scheme, like the suggestion for a citizen's flat-rate model of funding the statutory health insurance scheme, should be changed over to a pay-as-you-go system of flat-rate contributions. In this case, too, a complementary capital funding component is possible with a view to smoothing the contribution level.

1. The statutory health insurance scheme and the long-term care insurance scheme: flat-rate premiums instead of income-related contributions

33. The wage and pension-oriented sliding scale of contributions on which the method of financing the statutory health insurance scheme and the statutory long-term care insurance scheme is based is no longer appropriate. The problems associated with funding these two social security schemes are reflected in their weak level of revenue over the past few years. Contributions are akin to a wage tax with negative effects for growth and employment. For employers higher health and nursing care costs mean higher (non-wage) labour costs, which can likewise have a negative impact on employment. Less employment leads to lower contribution receipts, which in turn pushes up contribution rates. This is a vicious circle which must be broken – not least in the light of the rises in contribution rates occasioned by the ageing of the population. This can be

accomplished by changing over from the present income-related funding system to **flat-rate contributions that are not pegged to income levels**.

34. The public debate about the correct design of the **system of financing the statutory health insurance scheme** is frequently handicapped by the fact that the central aspects of any reform – the definition of the group of insurees, the method of gauging the level of contributions and the method of capital funding – are tossed and shunted around in a rather unsystematic fashion. For the general public the high frequency with which new reform models are presented consequently comes across as a confusing plurality of different models without the underlying premises and economic implications becoming sufficiently clear.

Concerning the definition of the range of insurees, the German Council of Economic Experts considers that a health insurance system in which **all citizens are compulsorily insured** is superior, in terms of both allocation and distribution policy, to the current system with its segmented health insurance market. At present the market is divided, above all owing to the existence of a defined income threshold for compulsory membership of the public scheme (*Versicherungspflichtgrenze*) which segregates the public and private health insurance schemes, and there is an inefficient risk mix to the detriment of the statutory health insurance scheme. In addition, individuals with an income above the threshold for compulsory membership of the public scheme as well as civil servants and the self-employed may opt out of the statutory health insurance scheme with its system of redistribution, which is why, also under distribution policy considerations, the abolition of the threshold for compulsory membership of the public scheme and the creation of a uniform health insurance market appear necessary.

The German Council of Economic Experts has already pointed out in previous Annual Reports that a transition to a **system of contributions divorced from the level of income** is beneficial for growth and employment. Such a shift away from the wage and pension-oriented method of calculating contributions will decouple healthcare costs from labour costs, reduce the employment-hostile tax wedge and hence marginal tax and social security burdens, reinforce the principle of equivalence between contributions and benefits and overcome the problem of an eroding contribution base. By contrast, calls for the introduction of a citizens' insurance model, which would extend the contribution liability to additional types of income, would have the effect of an income tax and should be rejected.

Capital funding can also make sense in a health insurance system in order to smooth the contribution burdens over time. Several different variants of such a funded scheme are conceivable: capital funding within the health insurance system, where insurees of a given age cohort accumulate savings via the risk pool of the insurance cover or through the formation of a collective capital stock, and via capital formation outside the health insurance system as a form of old age provision at the individual level. The various possible designs differ in particular with respect to their intergenerational redistribution effects. Whereas the cohort-specific capital funding in the current private health insurance scheme and individual external capital funding ultimately merely produce a smoothing of the contribution burden and have no intergenerational redistribution effects, the formation of a collective capital stock will lead to redistribution effects from those generations which build up the capital stock to those generations which profit from the smoothing of contribution levels ultimately achieved by the capital formation.

35. On balance the German Council of Economic Experts comes to the conclusion that, from an economic point of view, a health insurance system financed via flat-rate contributions not connected to income levels in which a minimum insurance obligation for everyone exists is the best alternative. Capital funding can be useful in order to bring about a smoothing of contributions over time. However, a greater resilience to demographic challenges need not necessarily be connected with a changeover to a fully funded system. This fact, together with the associated changeover costs, lead us to the finding that in the field of the statutory health insurance scheme it is indeed possible to retain the present pay-as-you-go financing system but that it should be possible to supplement this with elements of capital funding. The German Council of Economic Experts presents the **citizens' flat-rate model** for discussion, a health insurance system in which the whole population would be compulsorily insured, which charges flat-rate contributions unconnected with the level of income and which is organised on a pay-as-you-go basis. The method of calculating the flat-rate contribution is that the individual health insurance institution (*Krankenkasse*) divides the costs caused by its insurees among all its members. Such a flat-rate premium would amount to 198 euro per month, with children being co-insured for no extra charge. The contribution share currently paid by the employer would be disbursed to the employee as additional gross pay.

The fact that under this system the defined income threshold for opting out of the public scheme would be abolished and that all citizens, i.e. including civil servants and the self-employed, would be compulsorily insured does not mean that the **private health insurance scheme** would be abolished. On the contrary, private and public health insurance institutions would compete with one another on a uniform – and now much larger – health insurance market to insure the around 80 million insurees. The private health insurance institutions would, admittedly, have to change in that in their full insurance business they would have to adjust the way in which they calculate contributions. Their supplementary insurance business would not be affected by the proposal of a citizens' flat-rate model.

The pay-as-you-go system for the citizens' flat-rate model can be supplemented by a capital funding component. One possibility would be for each individual person to accumulate capital in the context of saving for old-age provision which he or she later encashes in order to finance the increased contributions under the pay-as-you-go system. Depending on the age of the insuree, additional monthly saving shares of between 10 euro and 25 euro would be needed in order to achieve a smoothing of the contribution level. Supplementing the basic pay-as-you-go system by means of a collective capital stock is also conceivable in principle.

As the transition to a flat-rate system of contributions divorced from the level of income would entail additional burdens for some people on low incomes compared with the status quo, a **social compensation component** will have to be established. The German Council of Economic Experts proposes that transfers should be paid if the flat-rate contribution amounts to more than

13 per cent of the insuree's income. Given a flat-rate contribution of 198 euro, this would give rise to a transfer volume of 30 billion euro. In the event of a supplementary individual system of capital funding the transfer volume would amount to the somewhat higher total of 34.5 billion euro. The disbursement and taxation of the contribution share currently paid by the employer would yield additional revenue of around 17 billion euro, so that 13 billion euro (or in the second case 17.5 billion euro) would need to be financed by means of expenditure cuts or tax increases. If the policymakers decide that tax increases are the sole option, this could be effected either by raising the standard rate of value added tax or via a proportional income tax (amounting to a parallel shift in the income tax rate). The VAT financing option is the better alternative in terms of efficiency but is inferior to income tax financing in terms of the distribution effects.

36. For the **long-term care insurance scheme**, too, the German Council of Economic Experts places the abandonment of wage-oriented contributions and the creation of a uniform insurance market at the centre of its reform options. At the moment there is no competition at all in the long-term care insurance scheme; this situation would change fundamentally with the introduction of a premium not pegged to income levels and a uniform market, with the premiums being set individually by each insurance institution. Specifically, two possible methods of financing are conceivable under the reform model. Firstly, a changeover could be considered to a **funded model** in which each cohort finances its own long-term care costs (cohort model) and the contribution level is smoothed over time through cohort-specific savings, i.e. the accumulation of a cohort-specific capital stock. Any changeover from a pay-as-you-go system to a funded system incurs costs. Given the fact that the long-term care insurance scheme has been in existence for only a relatively short while, however, these changeover costs would be smaller than in the case of the statutory health insurance scheme. Even so, any changeover needs to take account of the problem of today's old generation and the current benefit recipients. In the concrete case a gradual phase-out of the present long-term care insurance scheme can be achieved by leaving people born up to 1950 in the pay-as-you-go system and switching those born from 1951 onwards to the new system. The changeover costs would be shared between these two groups: the older cohorts who remain in the current-type long-term care insurance scheme would pay a uniform flat-rate contribution to the pay-as-you-go scheme of 50 euro per month; this is justifiable given that it is precisely these generations who have profited considerably from the introduction of the pay-as-you-go scheme. As the revenue generated from this contribution would be insufficient, however, the gap between the revenue and expenditure of the expiring pay-as-you-go system would have to be bridged by the younger cohorts through an additional flat-rate payment over and above their own insurance contribution. If the contributions resulting from this financing scheme should prove to constitute an excessive burden for individual persons in relation to their current income, this would have to be corrected via a tax-financed compensation mechanism.

37. If, on the other hand, the policymakers decide they wish to stick to the pay-as-you-go system, it would make sense in this case, too, to change over to a **system of financing via flat-rate premiums** with a social compensation component to be paid out of general taxation. As in the statutory health insurance scheme, a system of flat-rate contributions organised on a pay-as-you-go basis would be introduced. At the present time the flat-rate contribution would come to around 25 euro per month. The transfer volume of the social compensation component that would be necessary in this case, too, would initially be smaller than under the cohort model. In the course of time, however, the flat-rate contributions and hence the transfer volume will tend to rise on account of demographics and the age-dependency of the long-term care insurance scheme. At the latest by the year 2050 the citizen's flat-rate would exceed the premium under the cohort model, for the transition to a funded system will have been concluded by then, so that the transition costs will have been financed. In the event that the pay-as-you-go system is retained, these costs will also be incurred but will then be shifted to the future as ultimately they represent simply the implied debt of the pay-as-you-go system. In other words, this implied debt also has to be serviced in the pay-as-you-go system, by the future contribution payers and via the higher transfers from the future tax payers.

Irrespective of which reform option is desired on the financing side, reforms are also called for on the benefits side. These concern a constant upward adjustment of the flat-rate benefit rates, a convergence of the benefit levels for out-patient and in-patient care and an improvement in the situation of people suffering from dementia.

Education system

Human capital is a key factor for future growth in Germany and the welfare of every individual. To ensure that it is available in sufficient quantity, a high-performing education system is indispensable. International comparisons as well as national findings show, however, that the German education system does not possess this efficiency on a sufficient scale.

Germany's education policymakers have already taken some key reform steps which, however, need to be continued and supplemented by further measures. The guiding principles of a comprehensive reform of the education system should be:

– The distribution of public resources among the individual branches of the education system must be oriented to the social returns, i.e. in those areas in which the individual today already achieves a high individual return on education the share of resources to be raised privately can be higher. Conversely, this means that the pre-school sector and the primary school sector need to be given more financial resources, whereas in the tertiary education sector it is appropriate to launch a student loan programme and to demand greater co-payments from students in the form of student fees.
– To ensure a high level of educational performance nationwide, central performance standards are required, and compliance with these standards should be demonstrated and also made transparent. At the same time, the educational institutions must be given greater autonomy to achieve these standards, such as in the choice of teaching materials and course contents as well as the selection and remuneration of the staff.
– To reduce the wide variation in educational performance by international standards and the great importance of the social background for educational success, the promotion of gifted students must be intensified and the support for disadvantaged children must begin as early as possible and be tailored to the individual child. This notably requires the further extension of a free and also obligatory range of education and care already at the pre-school stage.

2. The German education system: not a good report

38. Human capital is both an important factor for a national production base and a theoretically and empirically confirmed key determinant of growth. In addition, the individual level of education – as is suggested both by other empirical findings as well as our own estimations – has a substantial influence on the level of income that an individual can attain in the course of his life and per se reduces the risk of becoming unemployed. A central role for human capital as economically realisable knowledge is played by the **education system**. Studies from past years have identified shortcomings in this respect in the German education system and highlighted its relative performance and efficiency. Although Germany has a well educated population with a high level of completed secondary level II schooling by international standards, it is in danger of successively losing this lead. Even under macroeconomic considerations – which are far from being the sole yardstick by which the importance of individual education can and should be assessed – such recognisable deficits and shortcomings in the education system should set the alarm bells ringing, because it is very hard to rectify the misdirected developments which they mirror at the individual level and these may potentially perpetuate themselves throughout a person's entire working life. Conversely, this naturally also implies that initiated reforms only become fully effective over a long time horizon.

39. The **problems of the German education system** are especially virulent in the secondary education sectors I and II. German school pupils demonstrate a below-average level of performance in this respect by international comparisons amid a very wide dispersion. These two findings together imply that a substantial part of German pupils at this age possess only elementary cognitive abilities and knowledge. Moreover, individuals' social background plays a marked role in Germany for their educational success. Another problem is that German pupils are older than their counterparts in other countries at comparable levels of the education system.

Looking at the overall **structure of the education system**, one thing that stands out by international comparison is the uneven allocation of public resources to the individual branches of education. In Germany an above-average share of education in the elementary sector, i.e. in the pre-school segment, is financed by private resources. A relative poorer status in this respect can also be noticed at the primary school level and in the secondary school I sector. By contrast, only a small share of private resources is deployed in the tertiary education sector. The public funds invested in this sector in relation to GDP roughly correspond to the OECD average, with the result that a below-average overall level of funding may be established for the tertiary sector. The length of study is excessively long by international standards, and despite the fact that a course of study in Germany is normally free of charge, the enrolment and graduation ratios are comparatively low. The marked segmentation of the test results at school level according to the pupils' social background recurs in the tertiary sector as measured by university admissions: thus

18 per cent of working class children attend college, compared with 63 per cent of the children of civil servants.

40. Some fundamental **reform proposals** may be derived from these recognisable deficits. However, it should be emphasised that the question of the quality of the education system hinges significantly – and probably primarily – on the way in which cognitive abilities are transmitted, i.e. on curricular and pedagogical issues. Topics such as the structure of the German education system, the incentive effects built into it as well as the level and distribution of the resources allocated to it also have an intrinsically economic dimension, however. In the school segment this includes the transition to a greater orientation to results in the form of **central performance standards** coupled with a greater autonomy for schools in the field of spending on materials and staff. The policymakers have initiated a number of measures in this area in the past years. It is necessary to counter the entrenchment of educational deficits rooted in pupils' social background earlier and more resolutely. The associated promotional measures should begin already at the **pre-school stage**. To ensure that they reach all pupils, i.e. above all the worst affected problem cases, it would be meaningful to introduce obligatory attendance for all children during the final pre-school year, to be financed completely by the public purse. Such an early form of promotion, if systematically continued during the school years, would in addition improve the degree of access to college and university of children from socially disadvantaged families, since the associated empirical findings indicate that the small share of the student population that comes from these social groups is not due primarily to lower parental income but rather is determined at a much earlier stage by learning deficits that subsequently cannot be rectified.

41. In some fields these measures will likewise require supplementary funding. Yet education policy cannot be restricted to the provision of additional resources, for existing international comparisons of performance strongly indicate that there is a no clear link between **public spending on education** and the performance of a given education system. One problem of the German education system lies in the inefficient distribution of the allocated resources across the various sectors. Thus public resources should be invested first and foremost in areas where high supplementary social returns are to be expected. This principally concerns – and this shows up very clearly in empirical studies – the elementary and primary school sector, even if reforms in this area are only possible in the medium to long term owing to a high share of personnel costs. By contrast, a course of study in the tertiary sector, i.e. universities and colleges, also yields significant returns of a purely private nature via an improved earning power. In Germany, however, the private financing share is very high precisely in the elementary sector, whereas in the tertiary sector it is very low. That being so, greater private participation in the costs of a college or university education via **student fees** is not only justifiable but also appropriate. These should vary according to the particular university and faculty on account of the associated steering effects and the improvement of the financial base. It must be ensured in this context that the resources raised through student fees improve the net financial position of tertiary institutions

and are not simultaneously neutralised by a corresponding reduction of public resources. In order to enhance the equality of access to a college education, a system of student loans should be introduced which should incorporate the loan components of the current student grant (*BAföG*).

Economic policy for eastern Germany

- Even 14 years after the unification of Germany an economic policy specifically dedicated to the economic reconstruction of eastern Germany (*Aufbau Ost*) is still called for in order to compensate for the handicaps in the eastern part of the country resulting from the GDR era. Equal living conditions in the sense of almost equal economic performance per citizen or employed person cannot be attained, however. This applies to both eastern and western Germany.

- There is no obvious magic formula for *Aufbau Ost*. Many of the proposed quick-fix solutions do not stand up to closer inspection. Calls for a concentration of the promotional resources on regional growth poles are based on shaky empirical foundations; a reorientation of promotional and structural policy to clusters of enterprises can be no more than a supplemental element of a much wider promotional strategy; the discussion about special economic zones is fruitless; the debate about West-East transfers should be conducted at a non-emotional level.

- The present promotional policy has considerable shortcomings, however. The resources channelled to eastern Germany under the Solidarity Pact I (*Solidarity Pact I*), and which were largely intended to alleviate the special burdens connected with the division of Germany, were used for the specified purpose in 2002 and 2003 only in Saxony. In individual east German states the degree of misallocation of the Solidarity Pact resources is unacceptably high.

- The abolition of the earmarking of resources from the Investment Promotion Act (*Investitionsförderungsgesetz*) from 2002 was a mistake which should be corrected within the framework of the Solidarity Pact II (*Solidarity Pact II*). The Investment Grant Act (*Investitionszulagengesetz*) should expire definitively n 2006.

- The Solidarity Pact II should be reoriented. Its defined conditions of allocation are too restrictive; they cannot be achieved in the short term, nor are they meaningful in the long term. Besides equalising the east German states' below-average financial strength and infrastructural shortcomings, it should also be permissible to use the resources of the Solidarity Pact II for promoting business investment as well as for debt repayment. In this case it must be ensured, however, that the resources really are used exclusively for these purposes. But this can be safeguarded via corresponding stipulations concerning the Basket II (*Korb II*) resources.

- Up to the year 2030 the population in eastern Germany outside the conurbations will contract by up to 20 per cent. This has far-reaching implications for public finances which should be taken into account now when making expenditure and infrastructural decisions.

- Unemployment has become entrenched in eastern Germany to an alarming degree. And this situation will not change in the near term unless there is strong economic growth in Germany. Wage policymakers can support the labour market reforms that have been initiated through moderate pay settlements and a greater wage spread reflecting different skill levels. Wage subsidies should be rejected.

3. Economic policy for eastern Germany: no magic formula available

42. One of the main reasons for Germany's lower trend growth rate is German unification and the resulting economic burdens. The **process of economic recovery in eastern Germany** has faltered since the mid-1990s; the east German unemployment rate is twice as high as that in western Germany. Naturally, this identification of the economic situation in eastern Germany as

a brake on pan-German growth in no way belittles the glorious achievement represented by German reunification. It seems more than likely that within Europe only the German economy would have been able to mobilise the mammoth economic effort associated with this process. At the present time, therefore, the most that can be hoped for in view of the clearly difficult starting position is to lay the basis for a strengthening of the east German growth forces. There is no magic formula, and quick-fix solutions should be mistrusted anyway in view of the complexity of the problems.

43. The basic question of whether a specific growth and promotion policy is necessary for eastern Germany must be answered in the affirmative given the particular economic circumstances in that part of the country. This is underscored by a special regional analysis for the whole of Germany based on the macroeconomic variables gross value added per inhabitant and unemployment: even fourteen years after German unification the east German regions still appear as a homogeneous group in which no discernible intermixing with west German labour market regions has occurred. It is also in this light that the question of the **equality of living standards**, which has been the topic of fairly animated discussion this year, is to be seen. It is an economic truism that such equality cannot mean a mere levelling, unless at unacceptably high economic costs. Regional imbalances exist between North and South in the western part of the country, and such imbalances will persist even following a successful convergence process between East and West and within the east German federal states. At present, however, the east German states are still to be regarded as an entity characterised by common problems which justify separate consideration and specific policy approaches.

44. From 2005 the Solidarity Pact I will be superseded by the **Solidarity Pact II** which will remain in force until 2019. Over the entire period the east German states will be allocated Basket I and Basket II funds totalling 156 billion euro. Basket I, with a value of 105 billion euro, is primarily envisaged to cover the unification-related special burdens ensuing from the presumed infra-structural deficits. The Solidarity Pact resources for the coming 14 years, amounting to 15 billion euro per year, offer the east German states the possibility to promote a basis for a largely self-sustaining economy via carefully targeted investment. For this it is imperative, however, that the allocated resources are also utilised for the intended purpose, i.e. are used primarily for investment purposes. In the course of 2004 a debated raged on the associated meaningful strategy of the future promotional policy. Our own analyses show that a promotional policy concentrated on **regional growth poles** rests on empirically questionable foundations. In one of its past Annual Reports the German Council of Economic Experts identified such growth poles on the basis of potential factors that presumably positively influence growth. A look back reveals, however, that the growth centres identified therein expanded at below-average rates in the past years. While this does not mean that a regional focus in future promotional policy is erroneous per se, it does illustrate the difficulties of identifying such potential growth cores. This scepticism should also accompany the currently much discussed proposals concerning **cluster**

promotion. The attempt to identify clusters of enterprises – regionally differentiated and displaying a stronger sectoral orientation than in the growth pole concept – that are capable of achieving higher overall productivity growth, on account of spatial proximity or other connectivity via externalities, is likely to encounter considerable information problems in practice. A cluster concept should therefore be seen at most as supplementing a general promotional strategy.

45. Another controversial issue, besides the question of the regional concentration of promotional resources, is whether the Solidarity Pact resources earmarked under Basket I should be used in future, too, exclusively for infrastructural investment, or whether – as proposed by a group of experts advising the German Federal government – primarily business investment should be promoted. The German Council of Economic Experts' own analyses suggest the conclusion that the promotion of business investment within the framework of the joint activity between central and state government "Improving the regional economic structure" (*Verbesserung der regionalen Wirtschaftsstruktur*) has influenced the economic development on the east German labour markets more strongly than infrastructural promotion. It must be noted, however, that other methods of investment promotion could not be taken into consideration owing to a lack of data. It would thus be premature to infer from this the need to starkly limit infrastructural promotion and to concentrate the resources on the promotion of business investment. It is probably more a question of complementary promotional avenues. Consequently, it ought to be permissible to use the promotional resources for *Aufbau Ost* and also within the framework of Basket I both for plugging a remaining infrastructural gap and for promoting business investment as well as, where appropriate, for debt repayment. What investment is promoted on what scale can best be decided locally in the east German municipalities and states. One of the advantages of a federal state structure is precisely that municipal decision makers have better local information than central decision makers and that therefore decentralised political decisions are able to accommodate the preferences of citizens better.

The promotion of business investment via government investment grants should, however, be terminated once and or all as from 2006. This promotional variant is far more prone to abuse than a system of promotion granted on a case-by-case basis.

46. To ensure that the allocated promotional resources are also actually used for the intended purpose, namely redressing the specific locational weaknesses of the east German economy within the next 14 years, it is imperative that the resources are indeed used for investment and not consumption. The lessons learned from the solidarity transfers to date show a sobering picture in this respect: all the east German states except Saxony have used a large part of their Solidarity Pact resources for non-intended purposes. This indicates that the overall volume of the Solidarity Pact resources exceeds the real requirements. This can no longer be rectified, however, so that it is now especially crucial to safeguard a proper appropriation of the resources.

This could be done by curtailing the transfers wherever it is found that they are not being put to the intended use. Another conceivable option, however, could be to tie the Basket I resources to the funds for promoting business investment under Basket II. The details of the latter have not yet been finalised, so that it is still possible to ensure, via corresponding cofinancing arrangements, that a complete drawing-down of Basket II funds simultaneously means the complete exhaustion of the resources available for investment under Basket I.

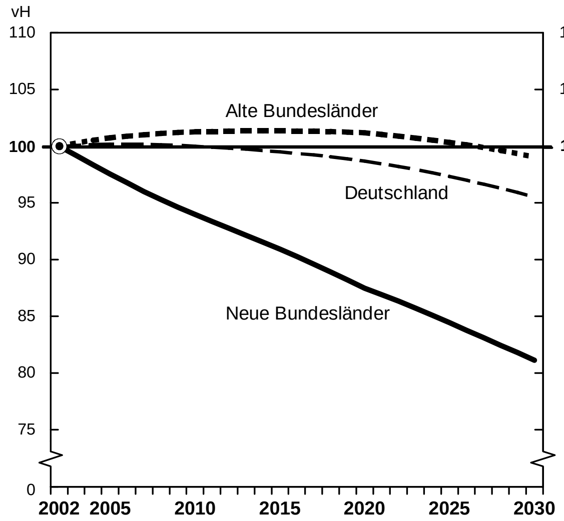
47. Against this background the German Council of Economic Experts supports a reorientation of the Solidarity Pact II. On the one hand, the present statutory restrictions on how the resources may be utilised should be relaxed. Besides topping up the east German states' below-average financial base and modernising their infrastructures, it should be permissible to use the Solidarity Pact II resources for promoting business investment and, where appropriate, for debt repayment. This would presumably accord with the east German states' own interests. In return, however, it should be ensured that the resources are indeed deployed exclusively for these defined objectives. The Basket II appropriations could be designed accordingly with this aim in mind.

48. One aspect which up to now has received insufficient public attention is the fact that the demographic changes in the east German states over the coming 25 years will be far greater than in the western part of the country (Chart 8). According to the regionalised tenth coordinated population forecast of the Federal Statistical Office (*Statistisches Bundesamt*) (average of variants 4 and 5), the east German states will lose 12.5 per cent of their inhabitants on average by the year 2020 and almost 20 per cent up to 2030. The population curve in western Germany looks pretty stable by comparison. Up to 2020 the number of inhabitants in the west of the country will rise by around 1 per cent compared with the population level in 2002 and thereafter shrink by 1 per cent up to 2030. This looming depopulation of eastern Germany is caused by East-West migration as well as the drop in the birth rate in the years following unification – as a result of which the cohorts entering the east German labour market in the next ten years will decrease by almost half and the number of people exiting it will rise significantly from the end of this decade.

Schaubild 8

Bevölkerungsentwicklung in Deutschland im Zeitraum 2002 bis 2030[1)]

I. Bevölkerungsstand im Jahr 2002 = 100 vH



II. Veränderung im Zeitraum 2002 bis 2020 und 2002 bis 2030 in vH

	2002 bis 2020	2002 bis 2030
Neue Bundesländer	-12,5	-18,9
Mecklenburg-Vorpommern	-10,9	-16,5
Brandenburg	- 9,5	-17,2
Sachsen-Anhalt	-16,3	-22,5
Sachsen	-13,4	-19,4
Thüringen	-11,4	-17,5
Berlin	- 0,6	- 3,7
Alte Bundesländer	+ 1,2	- 1,0

1) Ergebnisse für die einzelnen Länder auf der Basis der regionalisierten 10. koordinierten Bevölkerungsvorausberechnung (Durchschnitt der Varianten 4 und 5).– Gebietsstände alte und neue Bundesländer ohne Berlin.

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This demographic development will have considerable consequences for the already tense situation of public finances in the east German states. Our own rough calculations indicate a decline in real revenue in the order of 16 per cent up to 2020. Real revenue per inhabitant will fall by around 5 per cent. On the expenditure side, by contrast, the corresponding demographically induced saving effects will be less noticeable, so that public budgets will face further strains on balance. This prospect makes it all the more crucial that the Solidarity Pact resources be used to strengthen the economic base of eastern Germany if the East is to avoid the danger of being permanently dependent on the west German payer states and the Federal Government. Attention should already be paid today, however, to ensuring that the planned infrastructural investment takes due account of the foreseeable contraction of the population.

49. The situation on the east German labour market remains desperate, and no perceptible improvement is in sight. It is precisely here that the serious economic policy errors committed in the first half of the 1990s are coming home to roost most palpably. Unemployment has become entrenched within the space of just a few years, and the share of long-term unemployed is markedly higher in eastern Germany than in the western part of the country. Even if there is no magic formula promising a quick-fix solution, some starting points for a gradual improvement of the situation nonetheless exist. For example, wage policymakers should halt the drive towards a further convergence of east German wages and salaries to west German levels by means of disproportionately high increases in east German negotiated pay rates. This needs to be accompanied by a wider spread of pay rates reflecting different skill levels. By contrast, the models of wage subsidies throughout the east German states that have been discussed in some quarters merit a sceptical assessment. The available empirical studies on such models regularly find that across-the-board wage subsidies provide only a marginal boost to employment at a high cost. Furthermore, a large number of people, even if they manage to find work thanks to such wage subsidies, will be lastingly unable, on account of their low productivity, to support themselves and any dependants on the strength of their earned income alone. As this group of persons would thus require supplementary government transfers on top of the wage subsidies, the promotion of low-paid jobs is better assured by a means-tested guaranteed minimum income with incentive-compatible possibilities to top this up with some earned income, such as is offered in essence by Unemployment Benefit II and, in an even greater measure, by a model developed and favoured by the German Council of Economic Experts (Annual report 2002 section 447 ff.). This is because under such a solution non-subsidised market wages can still be paid in the low-wage segment, with the result that – in contrast to a system of subsidising wages based on target groups – it does not lead to a splitting of incomes and the associated crowding-out effects. The "me too" exploitation effect on the part of the other employees in this segment associated with a blanket subsidisation of low wages, including the problems of definition and evasion that result from specifying a certain threshold as a low wage, likewise do not occur in the case of a guaranteed minimum income, as transfer payments are subject to a means test – to which the other employees in the low wage segment, such as those merely earning extra pin money, would not subject themselves.

Public finances

- The situation of public finances remains a cause for concern. With the schemes envisaged by the Federal Government plus some additional measures it might be possible to avoid an excessive deficit in 2005.
- The income from borrowings of 43.7 billion euro for the year 2004 contained in a draft supplementary Federal budget exceeds the proposed expenditure on investment in the Federal budget by 19.1 billion euro. It is questionable whether this can be justified by invoking the exception clause of an alleged disturbance of the overall economic equilibrium pursuant to Article 115 of the German Constitution.
- The budget deficit ceiling of 3 per cent in relation to nominal gross domestic product laid down in the Maastricht Treaty will be exceeded in 2004 for the third year in succession, with

the deficit set to reach 3.9 per cent. If this deficit limit is breached yet again in 2005, the excessive deficit procedure pursuant to Article 104 EC Treaty should be further applied against Germany, and possible sanctions should then be accepted.

– Some of the modifications to the European Stability and Growth Pact proposed by the European Commission are sensible, but others are not. The European Stability and Growth Pact should be adhered to in order to avoid its being further damaged. The goal of more growth necessitates a lasting reduction of government indebtedness.

Tax reform

– The greatest need for action in connection with a fundamental tax reform concerns business taxation and, more specifically, the integration of income tax and corporate taxes. The sharpening international competition between different tax regimes requires a reduction of the effective burden of taxes on profits.

– Minimum rates of taxation and the linking of minimum taxes and resources received from the European Structural Fund are economically unsound.

– Minimum corporation tax rates are economically defensible, in particular, if the rules for determining profits are harmonised throughout the European Union. The imposition of minimum taxes at the national level by limiting loss-offsets should be rejected.

Reform of the federal structure

– Efforts aimed at reforming Germany's federal structure will remain half measures unless accompanied by a radical reform of the national financial constitution (*Finanzverfassung*). It is to be hoped that the Commission Reviewing the Federal State Structure (*Bundesstaatskommission*) will manage to agree on a fundamental reshaping of the financial constitution. It is to be feared that this will not be the case.

– On the expenditure side the joint activities of central and state government (*Gemeinschaftsaufgaben*) defined in Article 91a and 91b of the German Federal Constitution should be (largely) abolished. The legislation concerning monetary benefits pursuant to Article 104a (3) of the Constitution as well as the financial aid pursuant to Article 104a (4) of the Constitution could likewise be scrapped for the most part and the associated tasks transferred to the responsibility of the state governments. This must be accompanied by a transfer of resources to the state governments or the municipalities.

– On the revenue side the chief requirement is to give central government and state government greater autonomy in determining their revenue profile.

– In the longer term there is a need to radically restructure the interstate financial compensation arrangements (*Länderfinanzausgleich*).

– The European Stability and Growth Pact should be supplemented by a national stability pact containing effective penalty clauses.

4. Fiscal policy: continuing urgent need for action

50. The **situation of public finances** remained strained in 2004. Consequently, fiscal policymakers perpetually face a very tough task. They are caught between the devil of persistently sluggish domestic consumption and investment demand and the deep blue sea of consolidation constraints ensuing from the deficit limits imposed by Article 115 of the German Federal Constitution and the Stability and Growth Pact as well as a public finance position that is unsustainable in the long term (Annual Report 2003 sections 438 ff.). According to the forecast path of cyclical development in 2005, however, domestic demand will pick up a little. Given such a prospect, Article 115 of the German Federal Constitution should be complied with in 2005 – the Federal

Government's justification for overshooting the borrowing limits in the current year by invoking the exemption clause of a "disturbance of the overall economic equilibrium" is already a highly dubious claim in the cyclical setting of 2004. Compliance with Article 115 of the Constitution next year will only be possible by means of substantial privatisation proceeds. But this contradicts the real spirit of the constitutional rule because privatisation leads to the disposal of government assets, i.e. de facto to disinvestments, not matched by countervailing investments. The efforts to adhere to the Maastricht rules in 2005 rely to a great extent on the securitisation of pension claims. These are measures which generate revenue streams today by postponing the related expenditure burdens until tomorrow. This, too, is not conducive to achieving fiscal sustainability. Despite all the criticisms of these operations, it must be conceded, however, that the Federal Government has, for one thing, made appreciable consolidation progress on the expenditure side and, secondly, that the option of boosting revenue by reducing tax breaks has been regularly obstructed.

Judging from the present perspective, it will be difficult even with these measures to comply with the 3 per cent ceiling of the **Stability and Growth Pact** in 2005. Yet this is essential if the Pact, which suffered severe damage as a result of the Council of Ministers' decision of November 2003, is to be reanimated. The ruling of the European Court of Justice from this summer once again underscored the fact that each and every fiscal rule in monetary union will remain a dead letter unless and until the member countries are also prepared to honour those rules. It would be a bitter irony of history if, precisely on account of *Germany's* fiscal policy conduct, the Pact were to be emasculated beyond recognition. Translated into the here and now, this means that the European Commission should resume the excessive deficit procedure against Germany that has been suspended for the time being. If Germany should then fail yet again to meet the agreed consolidation targets, it would have to accept the further measures and penalties envisaged under the procedure. It need not come to this, however. Under the likely cyclical scenario assumed by us for 2005, it ought to be possible to cope with any additional savings that might become necessary. The German Council of Economic Experts outlined potential saving measures in last year's Annual Report. These should be resorted to if necessary, which also implies that the Bundesrat – the upper house of parliament – should not attempt to torpedo such measures in view of the European implications.

In the summer of 2004 the European Commission put forward some **proposals for a reform of the Stability Pact**. In the view of the German Council of Economic Experts, some of these would meaningfully complement the existing Pact, while others would probably have the opposite effect. Including a country's level of accumulated explicit and implicit debt is in principle a sensible modification of the rules, which at the moment are heavily biased towards the current budget deficit. Another welcome suggestion is the aim of establishing mechanisms to counter the pursuit of a procyclical policy during an upturn. In the past such procyclicality was a problem of fiscal policy in many member countries, as has been documented by numerous empirical studies (Annual Report 2003, sections 789 ff.). On the other hand, a critical verdict is warranted by proposals to take greater account than hitherto of country-specific circumstances when defining a medium-term budgetary target and in the context of the excessive deficit procedure. It should be remembered that, in its present form, the Pact already facilitates a careful consideration of a country's fiscal policy in the light of an array of indicators. Any further-going explicit consideration of national peculiarities would both open the door to manifold manipulation and reduce the transparency of the entire set of rules.

51. Another topic still on the fiscal policy agenda is the **reform of the tax system**. It is unlikely that there will be any major new initiatives in this area during the remainder of the current legislative period. In view of the sharpening competition between national tax regimes and the continuing low level of domestic investment, however, Germany urgently requires a growth and investment-friendly tax system. In this connection the German Council of Economic Experts has put forward the proposal of a dual income tax system for discussion. This is – as a number of estimations of different reform proposals this year have shown – a reform model which, while entailing relatively small revenue losses for the tax authorities, would produce an almost perfect marriage between business taxes and income tax and, as a result, would substantially improve the neutrality of the German tax system in respect of firms' and entrepreneurs' choice of financing method and legal form. On top of this, a lowering of the high effective corporate tax rates in Germany would enhance the country's attractiveness as an investment and production location. Germany has a very high business tax burden by international standards. Although the picture looks rather better once shareholder taxation is included, focusing solely on the enterprise level is more relevant for questions concerning investment and the location of production sites and hence is the more appropriate approach.

One issue which has been the subject of animated political debate this year in both Germany and the European Union is the question of tax policy measures aimed at limiting competition between different national tax regimes, which is currently intensifying in the wake of EU enlargement. Among the proposals that have been put forward are national minimum overall tax ratios – which is nonsensical because overall tax ratios reveal nothing about the investment incentives arising from the tax system – and **minimum tax rates**. The latter should likewise be rejected within the present framework of business taxation as every prescribed minimum tax rate could be thwarted via the options available for defining the calculation base. On the other hand, limiting international tax competition in the case of profits taxed according to the source principle is not fundamentally unjustified since in this case there is indeed a possibility that the international rivalry to attract investment leads to inefficiently low tax rates. Cross-country tax competition will sharpen appreciably in the future also if in the European Union – as is at least being considered as a possibility – there were to be a changeover over the medium term to taxing companies on a consolidated basis. But realistically, in this case, too, the adopted minimum tax rates will be well above the current German levels owing to the prevailing decision-making structures in the European Union in taxation matters. Which ever way one looks at it, therefore, there is no way of avoiding a reform of corporate taxation in Germany, leading to a reduction of firms' tax burden.

52. The experience of the past years has clearly demonstrated that the main institutional obstacle to reform in Germany is the country's present **federal structure**. Owing to the state governments' integral involvement in the legislative process by virtue of forming the upper house of parliament, every major reform project becomes the subject of an endless political tug-of-war which massively increases the uncertainty of those involved and burdens the already cumbersome policymaking process with additional political costs. Hence Germany's present decentralised federal structure needs to be reformed; however, any reform of the country's federal system will remain incomplete as long as it does not tackle the root cause of the intergovernment policymaking paralysis, namely the national financial constitution. It is thus to be hoped that the Commission Reviewing the Federal State Structure that is currently in session will manage to agree on a fundamental reshaping of the financial constitution. It is to be feared that this will not be the case.

The German Council of Economic Experts has in the past repeatedly outlined the **principles of an appropriate reform**. On the expenditure side the joint activities of central and state government defined in Article 91a and 91b of the German Federal Constitution should be (largely) abolished. The legislation concerning monetary benefits pursuant to Article 104a (3) of the Constitution as well as the financial aid pursuant to Article 104a (4) of the Constitution could likewise be scrapped for the most part and the associated tasks transferred to the responsibility of the state governments. This must be accompanied by a transfer of resources to the state governments or the municipalities, whereby mechanisms should be implemented where appropriate to ensure that the allocated resources are used as earmarked. On the revenue side the chief requirement is to give central government and state governments greater autonomy in determining their revenue profile. In the longer term there is a need to radically restructure the interstate financial compensation arrangements.

Wage policy and the labour market

- All in all, Unemployment Benefit II represents an appropriate step forward; it remains to be seen what its consequences will be in respect of boosting employment. The contribution of wage policymakers is crucial in this context.
- A voluntary extension of working times coupled with corresponding pay levels can open up possibilities of growth; an extension of working time without extra pay, enshrined in collective labour agreements, can help to maintain jobs and, to a certain extent, to create new jobs. The key need is to render working times more flexible.
- The dual system of vocational training is in need of reform, above all the training costs for enterprises must be lowered. The training levy originally planned by the German government would have been counterproductive.

– Wage policymakers should continue their employment-friendly course and introduce a wider spread into the wage structure based on the level of skill. A minimum wage is an inappropriate and even harmful instrument. It is particularly unnecessary if there is an employment-friendly guaranteed minimum income. There is a continuing need for a more flexible institutional framework on the labour market.

5. Wage policy: dynamic and competitive labour markets as engines of growth

53. Besides the implementation of the Hartz IV reform, two things are principally shaping the employment policy debate: the question of a general extension of working time and the discussion on the possible enactment of minimum wage legislation.

One of the potential measures for boosting employment discussed in 2004 was the **extension of working hours**. This discussion was triggered not least by the additional number of working days contained in the calendar year 2004 and the associated positive conjunctural effect on the rate of growth of gross domestic product. A distinction needs to be made here, however, between two dimensions of the working time issue, namely an extension of working time with and without corresponding extra compensation. In the current situation the latter has been at the focus of attention. As this lowers hourly earnings and hence firms' labour costs, it has been touted as an instrument for safeguarding jobs. Yet even this is uncertain, at least in the short term, as the initial effect would presumably be merely that working time performed exclusively as overtime would be transformed into normal working time paid at the standard rates, whereas in the short run it is also possible that the number of employed could actually fall in view of the empirically relevant elasticities of the aggregate labour demand. And even if in the long term additional adjustment processes should generate an increase in employment, there is a need to caution against euphoric statements concerning the expected effects. A sizeable share of the higher demand for labour resulting from a general extension of working hours without extra compensation will be met by the longer hours worked by the existing employees. Seen in this light, an across-the board extension of working time is inferior to other instruments as a means of reducing unemployment in Germany. Such a measure makes sense when the objective is to safeguard existing jobs in crisis situations. The trend that was observed in this respect in the current year gives grounds for optimism, for both at plant level and in collective bargaining between the social partners an increased degree of insight, understanding and flexibility was evident in this respect.

54. A general extension of working hours might be meaningful, however, under growth policy aspects. Thus it can be observed that in comparison with the neighbouring countries in the euro area, but also vis-à-vis the United States, one explanatory factor for Germany's low growth rates in the 1990s is a **decline in the number of total hours worked**. It is true that since the early 1990s Germany – measured by productivity per hour – has recorded rises similar to the average of the euro area or the United States. But precisely in comparison with the robust growth

registered by the USA, the number of hours worked per employed person has fallen in Germany by 0.6 per cent on an annual average since 1991, whereas in the United States it has remained constant. Admittedly, other factors have also influenced the differences in the evolution of the total number of hours worked, such as a distinctly faster rate of expansion of the population in the USA, and a good part of the decline in the total number of hours worked in Germany – as a comparison of the periods 1991 to 1997 and 1997 to 2003 shows – is undoubtedly attributable to the decrease in the labour force participation ratio, which presumably ensued from German unification. Nevertheless, the finding remains that an extended working time per employed person would indeed have growth-boosting effects. Yet the key question is then not whether this longer working time should be accompanied by extra compensation or not, but rather what causes can be identified for the decline in the annual number of hours worked. The increase in the number of part-time workers has doubtless played a certain role. In addition, however, the grey economy is undoubtedly of some relevance in Germany's case, as the few studies that exist on the subject indicate. A key contributory factor to the latter in Germany is the high level of taxes and social security contributions, which emphatically underscores yet again the urgent need for a reform of the statutory health insurance scheme and the statutory long-term care insurance scheme, featuring a switch from the current wage-related financing method to a system of contributions unrelated to income.

55. A major contribution to improving the labour market situation can and should also be made by an employment-friendly wage policy with moderate pay increases that do not fully exhaust the available scope for income distribution. In 2004 the wage negotiators played a significant part in this respect. This wage policy course should be maintained in the coming years. In addition, negotiated earnings should be differentiated according to skill levels, regional circumstances and sectoral differences. An equally important role is played by the general conditions that are defined by the institutional framework on the labour market. What is needed here is to ensure greater flexibility. However, the introduction of a **statutory minimum wage** would be counterproductive. The German Council of Economic Experts explicitly rejects this on account of its negative implications for employment. Germany possesses a well developed system of guaranteed minimum incomes which has, moreover, been given an additional incentive to take up paid employment through the amalgamation of unemployment assistance and social assistance to form Unemployment Benefit II, with an enhanced possibility to top up the benefit level with earned income. A minimum wage is therefore not just inappropriate, it is also unnecessary.

56. Another issue that was in the forefront of public attention again in 2004 was the tense situation on the **apprenticeship market**. Any approach aimed at clearing the apprenticeship market or at least aligning demand and supply more closely with one another has to start by considering the expected training returns and costs. The first thing to list in this context is education policy: both general schools and vocational schools should make the maximum contribution towards ensuring

that enterprises have a large stock of well qualified applicants to choose from and that the practical skills acquired in the enterprise are underpinned by a sound theoretical foundation, so that the trainee's value to the enterprise is enhanced; splitting the training course into modules improves the job prospects of poor learners. The positive effects, even in the short term, of **freezing or lowering trainee remuneration** are confirmed by empirical evidence: this increases the willingness to train and to offer apprenticeships on the part of enterprises that already offer training courses.

57. One member of the German Council of Economic Experts, Peter Bofinger, does not share the view that it is conducive to employment if negotiated wage rates are kept below the real scope for income distribution. A central cause, he says, of the divergent strands of macroeconomic development in Germany is that employees have participated only partly in the productivity growth generated on the supply side. This is why both consumers and general government, which benefits from wage growth via social contributions and wage tax, have both lacked the necessary purchasing power to exploit the available growth potential. The risks of a policy of wage moderation are illustrated by the example of the Japanese economy. Nominal wages have risen even more slowly there in the past few years than in Germany, yet this has not led to a more favourable employment trend.

In the setting of European monetary union a policy of wage restraint has implications for the real exchange rate and the real interest rate. Whereas the consequences for the real exchange rate and hence competitiveness are positive, the repercussions for the interest rare are negative. These are based on the fact that only 30 per cent of a fall in the German inflation rate caused by wage restraint is reflected in the euro area's Harmonised Index of Consumer Prices. An interest rate cut by the European Central Bank that might possibly ensue from this is likely to be much smaller than the fall in the German inflation rate, with the result that the real interest rate for German firms rises. This effect is likely to outweigh the benefits, at least in the short term, arising from an improvement in competitiveness. For wage policy in Germany as well as in the other member countries of the euro area the following rule-of-thumb therefore suggests itself: the rise in nominal wages should be oriented to the increase in a country's productivity and simultaneously contain a component offsetting inflation which corresponds to the European Central Bank's defined target value for monetary stability. This would prevent the national wage policies from exerting any disruptive macroeconomic effects on the home country or the other member countries of the euro area. This would concurrently reinforce the effectiveness of the monetary policy course pursued by European Central Bank.

Such a wage policy would have no detrimental effects on the German economy's international competitiveness. The country's good price competitiveness would be maintained given a wage policy oriented to productivity advances. A necessary precondition for this, however, is that the euro does not appreciate further against the US dollar. Numerous Asian central banks have decided in the past few years to safeguard the competitiveness of their economies by preventing their currency from appreciating vis-à-vis the US dollar, or at least limiting the extent of such an appreciation, through interventions on the foreign exchange markets. The European Central Bank would therefore be ill advised if it were to pursue a strategy of "benign neglect" in the event of a continuing appreciation of the euro.

58. In the field of fiscal policy, too, this member of the German Council of Economic Experts considers it necessary to attach greater importance to demand effects than the majority do. The Stability and Growth Pact has led in the past few years to a passive orientation of fiscal policy in the euro area, which has contributed substantially to its weak growth. A rigid adherence to the 3 per cent ceiling would even have led to a procyclical course. It would therefore be wrong to penalise German fiscal policy for not following a more restrictive line in recent years. In contrast to the majority of the Council's members, Professor Bofinger considers the proposals made by the European Commission to make the rules more flexible to be appropriate. At the same time, macroeconomic coordination in the euro area should be intensified in future to ensure a harmonised fiscal policy course. In view of the sluggish domestic economic development in Germany, German fiscal policymakers should refrain from further sharpening the already restrictive course plotted for 2005.

With regard to the tax burden on German firms, this Council member sees no clear evidence for the necessity of reducing the effective tax burden on profits. All methods of calculating the actual tax burden are based more or less on arbitrary assumptions. The finding of a very high burden compared with other countries is put forward by the Council majority using calculations based on a model approach developed by Devereux and Griffith. Using the "European Tax Analyzer" developed by the Centre of European Economic Research (*Zentrum für Europäische Wirtschaftsforschung*) in Mannheim, the combined burden at the enterprise and shareholder level turns out to be merely average, and an even smaller burden may be assumed for non-corporations. Calculations made by the European Commission comparing the implied taxation of the factor capital across Europe actually find that German firms have a below-average tax burden.

Such is the minority view of this member of the Council.