GERMAN COUNCIL
of Economic Experts

SEIZE THE CHANCE –
BOLDLY ADVANCE THE REFORMS

Annual Report 2005/06

Summary

(First Chapter)

The complete report is published in German under the title:
„Die Chance nutzen – Reformen mutig voranbringen“
and may be obtained (order number: 7700000-06700-1; ISBN 3-8246-0767-0) from booksellers or directly from SFG - Servicecenter Fachverlage GmbH, Part of the Elsevier Group, Holzwiesenstraße 2, D – 72127 Kusterdingen; (Phone: +49/7071/935350, Fax: +49/7071/935335, Internet: http://www.s-f-g.com, e-mail: destatis@s-f-g.com)

Preface

The German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) hereby presents the English translation of the first chapter of its Annual Report 2005/06. It contains a brief summary of the latest developments, prospects and policy issues of the German economy discussed in the report.

The complete report is divided into seven chapters:

The data used in the report of the Council were the latest available in mid-November 2005.

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

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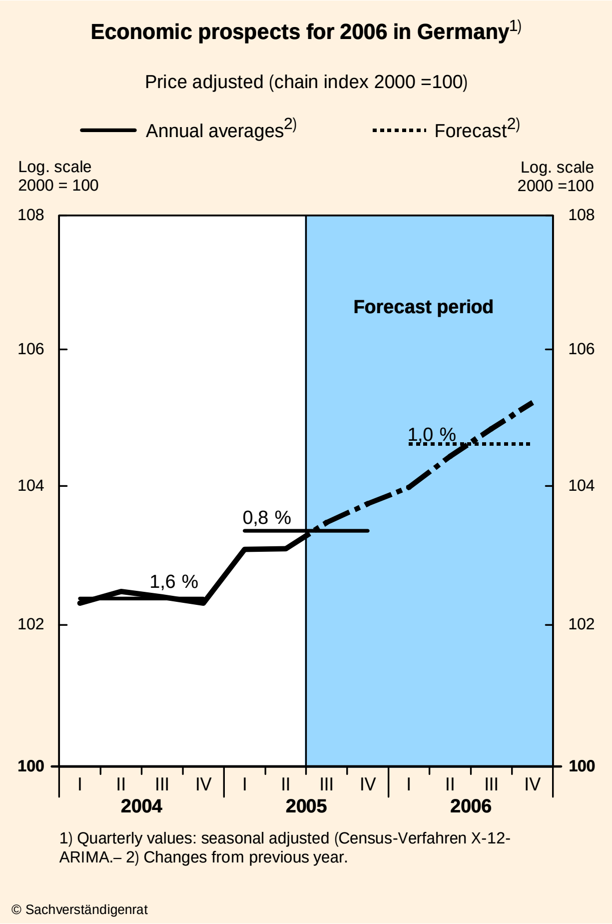
First Chapter

Seize the chance – boldly advance the reforms

I. Complex problems – differentiated answers

1. The German economy is still not in good shape. With 4.89 million officially registered jobless persons, unemployment is at a crushingly high level. Economic growth is weak, also compared with most other EU member states. Given a growth rate of potential output of little more than 1 per cent and a forecast growth rate of gross domestic product (GDP) of 1.0 %, no change is to be expected in 2006 either (Chart 1). The social security schemes are suffering from an ongoing revenue shortage, not least as a result of the persisting decrease in the number of employees subject to full social security contributions. The budgets of central government and of many state governments are in a desolate situation, and strenuous efforts will be needed to comply with the criteria laid down in the European Stability and Growth Pact and to keep below the borrowing ceilings stipulated in the national constitution (Basic Law) and in the state constitutions. In eastern Germany there is still no sign of a self-sustaining economic upturn and the cost of financing the huge transfer payments continues to place an enormous strain on the German economy as a whole.

Chart 1



1) Quarterly values: seasonal adjusted (Census-Verfahren X-12-ARIMA.– 2) Changes from previous year.

Faced with these problems, the German government has initiated a whole series of important and far-reaching reforms during the past few years despite resistance and opposition from many quarters. With a raft of legislation designed to reform the labour market (*Hartz-Gesetze*), modernise the statutory health insurance scheme (*GKV-Modernisierungsgesetz*), place the funding of the statutory pension insurance scheme on a sustainable footing (*RV-Nachhaltigkeitsgesetz*), switch from upstream to downstream taxation of retirement pensions (*Alterseinkünftegesetz*) and also with the phased introduction of numerous changes to the income tax regime, considerable progress has been made towards reform. Many German firms are proving to be competitive on the world markets both in terms of prices and technology. Growing international integration does not pose a threat to the economy but is, rather, a support for it. The bewailing of Germany's supposed inability to reform or warnings of the alleged dire consequences of globalisation for the German economy are exaggerated.

2. Yet the impulses provided by Germany's continuing success in export business have failed so far to stimulate the domestic economy, and the aforementioned difficulties on the labour market, in the social security systems and in public finances persist. This shows clearly that it is not enough to simply hope that the economy will recover by itself.

On the contrary, in the light of the experience of the past years and decades, four key problem areas may be identified which the politicians need to tackle in the new legislative period if a marked improvement in the economic situation is to be achieved.

- Even prior to the reunification of Germany a stepwise increase in and growing entrenchment of unemployment became apparent in western Germany which was accompanied by rising long-term unemployment and a particularly unfavourable labour market situation, especially for low-skilled persons. These labour marketproblems were exacerbated by German reunification and the subsequent massive layoffs in eastern Germany. The largely statistically induced rise in registered unemployment following the introduction of unemployment benefit II (*Arbeitslosengeld II*) to temporarily over 5 million persons at the beginning of 2005 starkly revealed the true extent of underemployment. One indicator of the poor situation on the labour market is a pronounced decline in employment subject to full social security contributions. This is one of the main reasons for the fraught financial situation of the social security funds for many years now, while the high social security contributions are a heavy handicap for employees and enterprises alike.

- Public finances are in an extremely precarious state. This holds equally for the long-term outlook and for the current deficit. The sustainability gap of the general government budgets amounts to several times the current explicit government debt of more than 1.5 trillion euro or 67.7 % of nominal GDP. The projected general government deficit in 2006 will amount – if the policymakers fail to take short-term countermeasures – to 74 billion euro or 3.3 % of nominal GDP.

- The growth rate of potential output of the German economy, which comprises the combined effects of institutional conditions such as the tax and social security regime and labour market regulations but also ongoing special factors and the aftermath of German reunification, has fallen continuously over the past few years to little more than 1 per cent. This is preventing a lasting and profound recovery and makes the German economy prone to slide into stagnation whenever it encounters even small shocks.

- One of the problems overriding these challenges is the labyrinthine federal decision-making process. The precise structure of Germany's "cooperation-oriented" federal framework constitutes a high hurdle in the way of rapid political decision-making. The tortuous path of even successful and welcome reforms such as the Hartz laws reforming the labour market shows that the decision-making processes are frequently painfully slow, opaque and unpredictable. All too often they end in fudged compromises.

3. These difficulties condition and compound one another. For example, the persistently high and entrenched unemployment is not only a waste of labour and human capital which impairs growth prospects but also entails massive fiscal losses. A weak economic momentum driven mainly by exports is reflected in low tax revenue, and when the budget is balanced not by cutting subsidies but instead by reducing public investment, this also hampers the growth potential. Moreover, with underemployment rooted in low mobility, skill mismatches, high reservation wages and excessive statutory or negotiated minimum wages, even a higher rate of economic growth will not bring about an appreciable reduction in unemployment. The precarious labour market situation is causing widespread insecurity among employees, consequently depressing private consumption – which is the principal component of aggregate demand; the buoyant export dynamics cannot ignite domestic business activity. While the urgent need to consolidate public finances points to the necessity of achieving speedy compliance with the European Stability and Growth Pact, a key missing link is the absence of a binding national stability pact which would apportion the consolidation burdens between the individual tiers of government. Instead, the federal principle and a dense web of intergovernmental financial transfers are paralysing the initiative of the state governments to improve their budget positions. All these difficulties are compounded by the lingering economic consequences of German reunification which, magnified by policymaking errors in the immediate post-unification years, are reflected in extremely high and entrenched unemployment and the need to finance persistently high transfers.

There are no easy answers to such complex, interrelated problems, and the widespread yearning for simple and quick fixes that would cause employment levels to shoot up and catapult the economy onto a higher growth path will remain pipe dreams. What is actually required is a carefully coordinated and coherent package of measures in various policy fields.

4. These are the challenges that have to be confronted by the new government that takes up office following the general elections on 18 September, regardless of its political complexion. At the time of going to press, the most likely outcome is a grand coalition between the CDU/CSU and the SPD. Many observers fear that such a constellation will be characterised by political paralysis and the search for the lowest common denominator. That this need not necessarily be the case is attested by the experience of the previous grand coalition from 1966 to 1969, which pushed through important reform projects such as the restructuring of the fiscal framework with the concept of joint tasks and joint taxes, the Economic Stability and Growth Act (*Stabilitäts- und Wachstumsgesetz*) or the introduction of stipends and student grants under the Education and Training Promotion Act (*Berufsausbildungs- und Förderungsgesetz – BAföG*). Even if, nearly forty years on, many of the decisions taken then merit a critical assessment, a grand coalition can nonetheless form a sound platform for bold and comprehensive policy measures and for a continuation of the reform course that has been set in train. For this reason the German Council of Economic Experts (*Sachverständigenrat*) has entitled its 2005/06 Annual Report:

Seize the chance – boldly advance the reforms

5. The Council has elaborated a package of measures which focus on reforming the regulation of the labour market and the taxation and social security regime in a manner conducive to promoting employment and growth. The instruments in the individual policy areas dovetail and complement one another and take due account of the likely consequences for aggregate demand as well as supply-side conditions. This package of measures comprises the following (Table 1, pages 8 f.):

- proposals to reform Germany's **federal structure** which disentangle the nexus of prerogatives, financial ties and tasks of central government and the state governments with a view to moving towards a more dynamic federal framework and dismantling institutional obstacles to decision-making;

- measures for the **labour market** concerning wage substitutes, active labour market policy, wage formation and job protection legislation which could loosen the entrenchment of unemployment in general and improve the employment prospects of the long-term unemployed and the low skilled in particular;

- proposals for new forms of funding the **social security systems** which lighten the contribution burden by carving out non-insurance-related benefits and consequently reduce the tax wedge that is so detrimental to employment;

- a proposal to reform business taxation by means of a **dual income tax** which eliminates the present severe distortions that are hampering investment, enhances Germany's attractiveness as a business location and hence counters an erosion of the tax base;

- suggestions for modernising the **financial markets** designed to raise their growth-promoting efficiency;

- and, last but not least, concrete steps for short, medium and long-term **budgetary consolidation**, especially on the expenditure side and in the field of tax breaks, in order to satisfy the requirements of the Stability and Growth Pact and concurrently to limit the foreseeable increase in the fiscal burdens in the coming years and decades.

6. If there is one problem which a grand coalition appears ideally suited to solving it is the restructuring of the **interrelationships between central government and state government**. The necessity to do so is undeniable and was demonstrated by the establishment of the "Commission reviewing federal structures" (*Bundesstaatskommission*) jointly set up by the two houses of parliament (Bundestag and Bundesrat) in October 2003, which was mandated to come up with suggestions for modernising the existing federal structure in Germany. In retrospect the efforts of this committee, which ended in failure in December 2004, should be evaluated fairly critically. Key questions, especially in the field of greater tax autonomy for state government, were taboo from the outset. The complex of dual financing ventures, with the exception of the joint task of extending and constructing colleges and universities (which was fiercely disputed right up to the

end), was not part of the negotiations. The further development of the institutionalised system of intergovernmental financial transfers, which is fundamentally flawed by false incentives, was likewise not on the agenda, nor were the respective responsibilities of the individual levels of government in meeting the criteria of the European Stability and Growth Pact rendered any less ambiguous.

A fresh start is imperative, but it should not be confined to a rehash of the "Commission reviewing federal structures" as this would give rise to the danger that the new negotiations might be restricted to the points on which a consensus has already been agreed. A major opportunity would then go begging once again. The key requirements are, firstly, to disentangle the twisted knot of revenue and expenditure links between central and state government and, secondly, to create an interstate financial equalisation system which contains stronger incentives to promote buoyant regional economies.

7. While the "Hartz laws" introduced correct and also far-reaching measures to revive the **labour market** in the field of wage substitutes and active labour market policy, they will need time to take effect. However, one of the defining features of labour market policy in recent years has also been to make the labour market more flexible at the fringes, i.e. by creating or revamping non-standard forms of employment such as limited-contract work, loan labour or low paid part-time employment largely exempt from tax and social security contributions ("mini-jobs"). However, this has led to the creation of a kind of two-class labour market. It would be better – and this is the intention behind the Council's proposals – to spread the identified adjustment requirement more equally among all employed persons and to make the labour market more flexible across the board. The proposed adjustments concerning wage-setting, collective bargaining laws or employment protection legislation can help to more effectively counter attempts to evade paying social security contributions by formally switching from employed to self-employed status or by substituting non-standard employment contracts for standard working arrangements with a consequent erosion of the social security scheme's contribution base. An associated stimulation of both the demand for and supply of labour would, by increasing the total number of hours worked, boost overall wages and salaries and hence meet a key condition for reviving private consumption.

8. Social security contributions are relevant components of the tax wedge between product wages, in short labour costs, and consumption wages, that is employee's disposable income. A **reform of the method of financing the social security schemes**, which – in the interests of lower labour costs and an associated rising demand for labour as well as higher disposable labour income – is oriented to reducing the tax wedge that is so detrimental to employment and growth, increases both aggregate demand in the short term and potential output in the long term. The volume of extraneous, i.e. non-insurance-related benefits financed out of social security contributions, which are directly linked to wages and hence labour costs, currently amounts to over 65 billion euro. A gradual changeover to financing these components out of general tax revenue is both consistent with the theoretical principles underpinning Germany's social market economy (*Ordnungspolitik*) and suited to counteracting the erosion of employment subject to full social security contributions. The degree of equivalence between the level of contributions and the corresponding entitlement to benefits determines what particular new method of financing would be appropriate in each case. For the statutory health insurance scheme (*Gesetzliche Krankenver-*

sicherung) and the public long-term care insurance scheme (*Soziale Pflegeversicherung*) the Council advocates flat-rate contributions and a changeover to the far more appropriate tax-financing of the social equalisation component. The right approach for the statutory pension insurance scheme (*Gesetzliche Rentenversicherung*) and the unemployment insurance scheme (*Arbeitslosenversicherung*) is to gradually raise the tax-financed central government grants. Non-insurance-related benefits are general societal tasks and should therefore be funded out of general tax receipts. If, in the course of changing the method of funding such social security expenditure, taxes are increased and social security contribution rates are concurrently reduced, the aggregate burden of taxes and social security contributions remains the same but is distributed differently – thereby lessening the load on the factor labour.

9. International comparisons show that Germany is at the top of the European league table in terms of both nominal and effective tax rates on the profits of corporations. A **reform of business taxation** enhancing Germany's attractiveness as a business location would strengthen aggregate demand via rising investment and thus also the demand for labour. This would simultaneously expand potential output, for which investment constitutes an important link to cyclical developments via real capital formation. Low tax rates on corporate earnings – this is attested by international examples – can also expand a country's profit tax substrate and thus expand the radius of fiscal policy action. This is why reforming business taxation is a pressing priority, and to this end the Council presents in this year's report a further elaborated version of the dual income tax. Via a lower rate of taxation of capital incomes of 25 % this concept enhances Germany's attractiveness to potential investors and concurrently establishes the neutrality of taxation in respect of corporate financing options, which is important for reasons of macroeconomic efficiency. In this connection the policymakers should refrain from the scheduled implementation of the tax policy measures agreed at the "job summit" on 17 March 2005 regarding a lowering of the corporation tax rate and a reform of the inheritance tax.

10. Besides the tax system, the corporate financing setting and hence the **financial markets** play a key role in ensuring an efficient allocation of the factor capital. A well developed, competitive financial sector contributes to economic momentum by improving firm's financing conditions, creating opportunities for risk diversification and mobilising capital for new, productive purposes. At present the German financial system is in a phase of restructuring. The key task facing the policymakers is not to obstruct this process – which expresses itself, for example, in the appearance of new instruments and actors or in a consolidation process within the banking sector – but rather to support it with constructive regulatory measures.

11. The need for **budgetary consolidation** is not primarily a question of complying with European or constitutional provisions. Weightier reasons are the negative effects of existing large sustainability gaps in the general government budgets. A sustainability gap – and this is a robust finding in public finance research – impairs an economy's long-term growth prospects and leads to extra burdens for future generations.

A credible fiscal consolidation policy geared to the long term which also takes due account of cyclical factors counteracts this and stabilises the expectations of investors and consumers alike. To enable Germany to comply with the provisions of the European Stability and Growth Pact already in 2006, the Council puts forward a consolidation programme that can be implemented in the short term with a volume of more than 6 billion euro. This consolidation target can be achieved simply by reducing tax breaks and without raising the standard rate of value added tax (VAT).

12. The programme for more employment and growth described in detail below is not an immediate programme but rather will require the full legislative period of four years to be implemented. On the other hand, the sooner the individual elements of the programme are implemented, the sooner it will begin to bear fruit.

A whole series of measures, namely those which – like the proposals regarding the labour market, the financial markets and the reform of Germany's federal structure – will not require the expenditure of any tax resources, can and should be initiated in the short term. Other measures will require the mobilisation of financial resources. This principally relates to the reform of business taxation and a change in the method of financing non-insurance-related benefits. Both measures are of paramount importance in the medium and long term and should be initiated as soon as possible. Given the required lead time, these projects should be realised in 2007 or in 2008 at the very latest. Priority should be given to implementing the reform of business taxation in a single step, whereas a regime change in the financing of the social security systems is also conceivable as a phased process.

Attempting to finance the substantial total resources needed to consolidate public finances, lower the taxation burden on firms and to change the method of financing the social security schemes solely by cutting expenditure and doing away with tax privileges would be both unrealistic and also economically misguided since maintaining certain subsidies may actually be appropriate in terms of macroeconomic efficiency (sections 468 ff.). In connection with introducing a dual income tax or a change in the method of financing the social security systems with a view to boosting employment and growth, it is thus both necessary and defensible to raise the standard rate of VAT, especially as both projects essentially entail a rebalancing of existing tax and levy burdens whereby the overall burden will be distributed differently – in a manner more conducive to employment and growth – but in the sum-total will not increase.

However, the Council strictly cautions against raising the standard rate of VAT in 2006 for the purpose of budgetary consolidation. It is possible to consolidate public budgets by reducing financial assistance and tax subsidies, which include exemptions from turnover tax and the taxation of certain services at a reduced rate. If the politicians cannot muster the necessary vigour to do this – despite the dire straits in which public finances find themselves – they will definitely lack the vim required to counterfinance a reform of business taxes or a change in the method of financing the social security systems. Choosing the supposedly easy option of raising the standard rate of VAT for the purpose of budgetary consolidation would thus permanently block the implementation of these urgently needed reforms. Compared with a credible consolidation on the expenditure side, such a tax increase would merit a more critical assessment also in view of the weak macroeconomic dynamics.

13. One member of the Council, Peter Bofinger, cannot subscribe to a number of points in the programme presented here. A detailed discussion of this is contained in Chapter 3, sections 322 ff.

Table 1

A programme for the coming legislative period

Reform of the federal structure

- Abolish the joint tasks pursuant to article 91a and 91b of the Basic Law – transfer the financing of these tasks completely to state government
- Cancel the financial benefits legislation pursuant to article 104a (3) of the Basic Law and of the financial assistance pursuant to article 104a (4) of the Basic Law
- Grant greater autonomy to central and state government in revenue-raising
- Restructure the system of interstate financial equalisation, replacing the orientation to tax-raising potential by the orientation to economic potential
- Establish an effective National Stability Pact with sanctions as an adjunct to the European Stability and Growth Pact

Proposals for labour market policy

<u>Unemployment benefit</u>

- Consider degressive payments
- Scrap higher wage substitute rate of 67 % for unemployed persons with children and replace it by tax-financed child benefit
- Limit period of entitlement to 12 months, irrespective of how long recipients have paid contributions and how old they are

<u>Unemployment benefit II</u>

- Abolish supplements payable during the transition phase from the old unemployment benefit
- Limit maximum duration of earned income top-up and reduce free allowance and lump-sum paid to employer
- Review incentive effect for taking up work

<u>Labour market policy</u>

- Systematically continue reducing active labour market policy after evaluation
- Amalgamate transitional benefit and start-up grant for unemployed persons who become self-employed
- Abolish subsidised "mini-jobs" as a sideline to a main job
- Rescind obligation to set up Personnel Service Agencies (PSA), lower level of starting pay
- Refrain from widespread additional wage subsidies

<u>Employment protection</u>

- Make employment protection rules more flexible, two variants:
  - Option model: individual waiver of employment protection in return for later redundancy payment or higher wages
  - Generally abolish employment protection in the event of redundancy in return for *ex ante* introduction of binding compensation arrangements

<u>Wage formation</u>

- Redefine employee favourability principle to include job security
- Ensure effective liberalisation clauses in collective labour agreements
- Limit continuing validity of collective labour agreements after firms leave industry federation to six months
- Examine possibility of exempting plant-level agreements with firms not covered by collective labour agreements from section 77 (3) of the Industrial Constitution Act
- Refrain from national or industry-specific minimum wages
- No declarations of general applicability

Tax policy

- Enhance Germany's attractiveness as an investment location and ensure corporate financing neutrality by introducing a dual income tax of 25 % on all capital income, with the following concrete provisions
  - Taxation of corporations and their shareholders: retained profits at 25 %, including solidarity surcharge and municipal tax. Dividends and capital gains from selling stakes in corporations: tax-free if based on normal profits; additional tax of 25 % if stemming from excess profits. Normal profits are determined by the normal rate of return of 6 % on balance sheet equity; excess profits are earnings higher than this.

  - Taxation of interest on borrowed funds: 25 %
  - Withholding tax of 25 % on earnings from borrowed funds, dividends and capital gains (if excess profits)
  - Taxation of non-corporations: 25 % on normal profits, otherwise apply personal income tax rate; (extend income scale by proportional zone with 25 %)
- Refrain from planned reform of inheritance tax

Budgetary consolidation

Short-term measures

Mobilise 6 billion euro so as to achieve a general government deficit ratio of 3 % in 2006
Abolish or reduce, *inter alia*, grant to home buyers, tax exemption for supplements paid for working on Sundays, public holidays or nights, saver's tax-free allowance, favourable tax treatment of media-related mutual funds, tax-free allowance for amateur coaches, reduced turnover tax rate for selected services, commuter's allowance
No increase in standard turnover tax rate for budget consolidation purposes

Medium-term measures
- Combat turnover tax fraud more vigorously; seek to achieve switch to reverse charge model

Long-term measures
- Implement Civil Service Pensions Sustainability Act: apply benefit cuts introduced in recent public pension reform equally to civil servant's pensions

Social policy

Statutory pension insurance scheme
- Supplement pension adjustment formula by a clawback factor
- Raise statutory retirement age progressively to 67 from 2011
- Gradually switch to tax financing of non-insurance-related benefits currently paid out of contributions and not yet covered by central government transfers

Health insurance scheme
- Switch to a citizen's flat-rate contribution model independent of income and a uniform insurance market, if necessary with supplementary funded component to smooth contribution level, finance social equalisation via taxes
- Strengthen competition among service providers

Long-term care insurance scheme
- Introduce system change to funded cohort model with flat-rate, cohort-specific contributions independent of income; finance social equalisation via taxes
- alternatively: change over to citizen's flat-rate contribution model independent of income, if necessary with supplementary funded component to smooth contribution level, finance social equalisation via taxes
- dynamise flat-rate benefits, improve benefits for dementia sufferers, reduce misdirected incentives in favour of in-patient care

Unemployment insurance scheme
- Evaluate and if necessary reduce measures to promote labour market
- Initiate gradual switch from current method of financing non-insurance-related benefits out of contributions by scrapping compensatory payment to government

Financial markets

SME financing
- Limit promotional measures to development of private equity markets

Financial centre – financial investors
- Refrain from further-going regulation of hedge funds and private equity companies at national level, no additional limitation of voting rights etc.
- Support international approaches to enhancing transparency of hedge funds

II. The course of economic development in 2005 and 2006

1. The situation in 2005

14. The **world economy** proved robust in 2005, although global GDP's expansion rate of 4.3 % did not match the dynamic pace attained in 2004 (5.1 %). Positive impulses came from the ongoing expansionary stance of monetary policy in the world's major regions (United States, euro area, Japan) and the associated favourable financing conditions. Against this background sharp rises in asset prices were evident in several countries, including the USA. This increased household wealth and thereby additionally strengthened the propensity to consume and domestic business activity. The main negative influence on macroeconomic momentum was the oil price, which rose to record nominal levels and led to a marked absorption of purchasing power in the importing countries. Yet the consequences were very muted for a number of reasons: the price rise was largely demand-induced, the oil intensity of production has decreased compared with past oil crises, the pace at which oil revenues from the oil-producing countries are recycled into the oil-consuming countries has accelerated, and there have been no second-round effects in the form of inflationary wage increases which would have obliged monetary policymakers to take countermeasures.

15. The salient feature of the world economy at present remains the heterogeneous pattern of development, as global expansion is being primarily propelled by the very robust dynamics in China and the United States, whereas the momentum of economic activity in Europe has been weaker. The robust growth of business activity in the USA is continuing despite a gradual tightening of monetary policy aimed at smothering the inflationary risks which have become apparent in what remains a favourable underlying cyclical environment. US GDP rose in 2005 by 3.6 % (Table 2) on the back of a sharp expansion of both private consumption and private gross fixed capital formation. Japan's GDP recovered from its lacklustre performance in the second half of 2004 to expand by 2.2 % in 2005, fuelled by a revival of consumption and a stronger investment propensity. The remarkable expansion of the Chinese economy continued, with output growing by 9.2 % in 2005; overheating appears unlikely in the context of a receding inflation rate. The path of economic development in the euro area was very muted in 2005, with GDP recording a year-on-year expansion of just 1.3 %. Among the reasons for this were the very high oil price, a weak consumption propensity among households due to the rather small growth of disposable income, and a lacklustre investment propensity, which was due not least to dulled corporate sentiment, particularly in the first half of the year. The situation of public finances in the euro-area countries remained tense. With Germany, France, Italy, Portugal and Greece, almost half of the states breached the deficit ceiling of 3 % of nominal GDP laid down in the Stability and Growth Pact. The amended fiscal framework of the pact was concurrently weakened considerably by additional scope for interpretation and repetition loops. The credibility and disciplining effect of the reformed pact will therefore hinge crucially on the direction which the excessive deficit procedure against Germany takes.

Table 2

Macroeconomic development in selected countries and groups of countries

Percentage changes from previous year[1)]

Countries / groups of countries	Gross domestic product[2)]	
	2004	2005
European Union[3)]	+ 1.6	+ 2.0
New EU member states[4)]	+ 4.2	+ 4.5
EU 15[3)]	+ 1.4	+ 1.9
Euro area[3)]	+ 1.3	+ 1.7
of which:		
Germany	+ 0.8	+ 1.0
France	+ 1.3	+ 1.8
Italy	+ 0.4	+ 1.1
Netherlands	+ 0.6	+ 2.0
United Kingdom	+ 1.7	+ 2.4
United States	+ 3.6	+ 3.0
Japan	+ 2.2	+ 2.0
Latin America[5)]	+ 4.0	+ 3.8
Southeast Asian emerging market economies[6)]	+ 4.1	+ 4.4
China	+ 9.2	+ 8.7

1) Changes from previous year for the groups of countries are weighted with their share in the world's nominal gross domestic product at current prices and purchasing power parities in 2004. - 2) Own estimate based on data provided by national and international institutions. - 3) Changes from previous year are weighted with the shares in the European Union's real gross domestic product (in euro) in 2004. - 4) Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia. - 5) Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela. - 6) Hongkong (China), Malaysia, Singapore, South Korea, Taiwan, Thailand.

16. The monetary policy course pursued by the European Central Bank remained expansionary, with key interest rates unchanged and market interest rates in the euro area remaining at an historically very low rate across the entire maturity range. Monetary expansion consequently accelerated distinctly in the course of 2005 following the slowdown in 2004, and in conjunction with a flattening yield curve the demand for loans increased throughout the private sector. In contrast to the monetary indicators, measured inflation expectations do not yet point to increased medium-term price risks. Despite sustained high oil prices, inflation in the euro area remained largely stable – on an average of the first nine months of 2005 the Harmonised Index for Consumer Prices Index (HICP) rose by 2.1 % vis-à-vis the first three quarters of 2004. This marginal overshooting of the European Central Bank's target figure was attributable to the fact that the steep increase in the energy sub-index, which at the time of going to press had risen by around 12 % year on year, was partly offset by a weaker price trend for processed food and services and statistical drop-out effects relating to increases in administered prices in 2004. Despite the rather limited indications of a burgeoning build-up of inflationary pressures in the euro area, both the abundant liquidity supply and the ongoing high oil prices call for heightened vigilance by the central bank.

17. A central topic of economic debate in Europe was the actual or alleged **crisis of the European Union**. Besides the reform of the Stability and Growth Pact, the macroeconomic consequences of monetary union, the failure to ratify the treaty for a European constitution, the future financial parameters for the European Union's budget and the commencement of accession negotiations with Turkey were the subject of animated discussion. In retrospect it can be seen that the problems associated with and urgency of these topics were often presented in an exaggerated form. For example, while the single monetary policy doubtless imposes a greater adjustment requirement on the member states of the monetary union with respect to asymmetric shocks and asynchronous business cycles, monetary union has also yielded clear benefits which, despite a partly adverse global economic setting, have given the member countries an historically unparalleled measure of price level stability, an intensification of trade and a currency with a stable external value. The persistent inflation differentials on which much public discussion has focused and the associated real interest rate differentials indeed pose a particular challenge to the single monetary policy, which must always be geared solely to the development of the currency area as a whole. At the same time, it should not be forgotten that countries such as Germany, although confronted with a higher real interest rate owing to the central rate-setting than would have perhaps been the case if monetary policy had remained autonomous, are concurrently enjoying improved price competitiveness. As this effect accumulates over time, the dampening impact of higher real interest rates is being increasingly compensated, especially as even in Germany historically low real interests are being recorded.

The European integration process has suffered a severe setback with the rejection in France and the Netherlands of the treaty for a European constitution, particularly as the flawed decision-making and voting procedures based on the Nice Treaty will continue to apply until further notice. In economic terms, however, this development is less dramatic, since even the present rules provide a stable framework for the single monetary policy and for national fiscal policies. The fears that arose following the failure of the negotiations on the financial framework for the period 2007 to 2013 need to be similarly qualified. The delay may even offer the chance to reform the contribution rebate granted to the United Kingdom or the level and composition of agricultural expenditure. Following the start of accession negotiations with Turkey, that country will need to qualify for membership in the Union in the coming years. This process will require at least ten years, and an unlimited freedom of labour movement is not to be expected before 2022. Given the perspective of accession, the convergence process is likely to advance further. This would reduce the still considerable income gap vis-à-vis the present member countries during the transition phase and hence limit the burdens for the European Union ensuing from a potential accession.

18. In **Germany** a self-sustaining and broadly based economic recovery failed to materialise in 2005 as well. On an annual average GDP expanded by a mere 0.8 %, compared with a rise of 1.6 % in 2004. A particular strain was placed on macroeconomic developments by the huge oil price hike, especially as there was no countervailing dampening effect from an appreciating euro. The increase in GDP in 2005 was fuelled chiefly by the sharp growth of exports, whereas domestic demand remained sluggish. Private consumption declined amid a persistently precarious labour market situation, and even the investment trend for machinery and equipment showed no marked resurgence. Construction investment, which has been a drag on economic developments for some years now, shrank further. While the surge in oil prices pushed up the level of inflation in the second half of the year, the Harmonised Index of Consumer Prices increased only slightly over twelve months from 1.8 % to 2.0 %.

19. The decline in **potential output growth**, which has been evident since the mid-1990s irrespective of the measurement method applied, has opened up a growth gap vis-à-vis the other countries in the euro area. This is an impediment to an economy's long-term outlook and means that aggregate output risks sliding into stagnation even given comparatively small adverse impulses. The estimates for 2005 indicate more or less unchanged potential growth vis-à-vis 2004 of between 1.0 % and 1.2 %. These figures translate into a relative output gap, defined as the relative difference between actual GDP and potential output, of between -0.6 % and -0.8 %.

20. The anaemic consumption climate evident since 2002 continued in 2005, in which **private consumption** receded by 0.3 %. The main reasons for the marked purchasing restraint were the persistently weak employment and income trends – household's disposable income increased by merely 1.3 % – the associated dampened consumer sentiment and reduced purchasing power owing to higher energy prices. Gross wages and salaries, which are a major determinant of disposable income, contracted by 0.3 % in nominal terms owing to the continuing strained labour market situation characterised by a growing share of low paid part-time jobs, the small growth of negotiated wages and a continuing curtailment of voluntarily agreed wage components. Although the entry into force of the third and final stage of the income tax reform 2000 and the start of the changeover to the downstream taxation of pensions adopted in the Retirement Income Act (*Alterseinkünftegesetz*) brought some relief to households, this was thwarted by higher social security contributions. Firstly, on 1 January 2005 the contribution rate to the long-term care insurance scheme was raised by 0.25 percentage point for childless persons. Secondly, while the general contribution rate paid jointly by employers and employees was reduced by 0.9 percentage point in the middle of the year, an additional contribution of 0.9 % of income subject to social security contributions to be paid solely by members of the statutory health insurance scheme was concurrently introduced.

21. While the restrained investment trend observable since 2001 eased at the end of 2003, no real revival has been apparent since then. Despite temporary sharp export growth, the **investment upturn** has remained moderate so far in the context of an unsteady cyclical development and ongoing muted domestic sales prospects. As the international sales outlook remained favourable in view of the robust global economic trend, large export-oriented companies, in particular, are likely to have expanded their investment demand more strongly than small firms that are more reliant on the domestic market. Given disparate profitability in the enterprise sector, investment in machinery and equipment increased only moderately (4.2 %), especially as the lacklustre consumption climate and the oil price surge additionally inhibited investment. Rationalisation was the key objective throughout the business sector, with capital expenditure confined to replacement investments. The ongoing consolidation efforts of enterprises, which have probably used part of their profits in order to redeem their outstanding debts rather than to make new investments, also tended to depress investment expenditure.

Whereas **construction investment** had been temporarily boosted at the end of 2004 by anticipatory effects connected with a mooted reduction of the government grant for home buyers as well as by some large-scale industrial and commercial construction projects, it dropped markedly again at the beginning of 2005, although this was largely weather-induced. These production losses were largely cancelled out in the course of the year. The downward trend in construction investment which has persisted for a decade now (with the exception of 1999) nonetheless continued. The bottom of the trough, and hence a turnaround in the fortunes of the building industry, was still not reached. All in all, construction investment contracted by 4.6 %.

22. The weak domestic demand contrasted once again with a renewed sharp expansion of **exports** of goods and services. Export growth, which in 2004 had contributed substantially to the increase in overall output, amounted in 2005 to 5.5 %, although the pace of expansion fell well short of the prior-year figure owing to the somewhat slower growth of the global economy compared with 2004. **Imports** of goods and services likewise rose noticeably, with the result that the increase in the nominal import ratio continued. The principal factor behind this, with domestic demand growing only moderately, was the increased import of intermediate goods, which in turn was connected with the rise in export business. A decelerating factor, by contrast, was the increase in import prices which, on the one hand, was driven mainly by the continuous rise in energy prices and, on the other, was not offset (as had been the case in 2004) by countervailing exchange rate movements. After dipping at the start of 2005, imports picked up more and more as the year wore on and recorded an average annual rise of 4.1 %.

23. The situation on the German **labour market** remained precarious in 2005. Employment increased marginally by 0.1 %, but this was mainly attributable to the greater number of persons in low paid part-time jobs, government promotion of self-employment and subsidised earned income opportunities for benefit recipients. The ongoing fall in "normal" employment subject to full social security contributions by almost 400,000 persons is a cause for concern, however. The trend in registered unemployment was inflated by the introduction of unemployment benefit II (*Arbeitslosengeld II*). It rose by around 510,000 persons compared with 2004 to 4.89 million registered unemployed. Much of this rise was caused by the first-time statistical recording of social assistance recipients able to work, who were previously not included in the official jobless figure, which shows above all that the full scale of underemployment had not been fully captured previously by the official statistics. The number of unregistered unemployed persons, by contrast, decreased further as the scope of active labour market policy measures was cut back.

24. The worrying development of **public finances** continued in 2005. With a general government budget deficit of 3.5 % of nominal GDP, the reference value laid down in the European Stability and Growth Pact was clearly exceeded for the fourth year in succession. If, as Eurostat has announced, the sale of government claims on the successor institutions to Deutsche Post is not recognised as reducing the deficit, the deficit would be ¼ percentage point higher still. Both government income and revenue increased only moderately in 2005. The weak government revenue trend was unchanged vis-à-vis 2004, as were the reasons for this trend. Besides a further lowering of income tax rates, the main factors were the stagnation of the assessment base for major taxes and for social security contributions along with a pattern of macroeconomic activity that continued to be fuelled principally by external impulses and thus yielded comparatively little tax revenue. The government expenditure ratio declined slightly against 2004, primarily because of the further fall in the compensation of employees and government gross capital formation but also as a result of savings on subsidies and transfers. Hence the budgetary difficulties cannot be attributed to a pronounced increase in government expenditure. Given the weak revenue trend, however, the economising efforts of fiscal policy did not suffice to achieve a substantial alleviation of the structural budgetary problems. The most that can be said is that a further increase in the general government current deficit was avoided.

25. The financial position of all of the **social security schemes** continued to be dogged by a weak revenue trend. The statutory pension insurance scheme experienced liquidity difficulties. For the first time it had to take up a loan from central government in order to finance its benefits. In order to prevent the contribution rate from rising to 20.2 % in 2006, the deadline for paying contributions was brought forward from the middle of the following month to the end of the current month. This will yield one-off extra revenue for the statutory pension insurance scheme of around 9.6 billion euro, and the contribution rate for 2006 could be kept constant at 19.5 %. The other social security schemes, too, will profit from the advancement of contribution payments: the unemployment insurance scheme by 3.1 billion euro, the long-term care insurance scheme by 0.6 billion euro and the statutory health insurance scheme by 6.7 billion euro.

The expenditure of the statutory health insurance scheme rose again sharply in 2005 following a fall in 2004 caused by the Act Modernising the Statutory Health Insurance Scheme (*GKV-Modernisierungsgesetz*). The main cost driver was spending on pharmaceuticals, which jumped by almost 20 % in the first half of the year. The statutory health insurance scheme nonetheless managed to post a surplus, although essentially this was only possible because central government raised its transfer by 1.5 billion euro. With this surplus the accumulated net debts of the statutory health insurance scheme have presumably been largely eradicated. The sharp expenditure growth and the continuing sluggish development of revenue from contributions do not indicate that a significant lowering of contribution rates can be achieved. It appears, rather, that the Act Modernising the Statutory Health Insurance Scheme has produced only a brief breathing space and that further contribution rate increases will be necessary in the near future.

2. The outlook for 2006

26. The dampening effects of the rise in energy prices will have a reinforced impact on **global economic development** in 2006. The likely price increases that are looming will trigger monetary policy reactions in the form of moderate interest rate rises. As long, however, as there are no second-round effects via inflation-driving wage increases, the thrust of monetary policy will remain expansionary and will thus continue to support global economic activity. The growing integration of the emerging and transition economies will lend additional impetus to world trade and the growth of productivity. Although the GDP growth rates in the United States and in China will be a little smaller in 2006, global output will slow only marginally on balance. The course of economic development in Europe will accelerate a little on the back of rising investment (Table 3). Given an annual average increase in the euro-area Harmonised Index of Consumer Prices of 2.1 %, the monetary policy course of the European Central Bank will not act as a brake.

Risks of a more pronounced slowdown of the world economy, and hence for the course of development in Germany, continue to arise, apart from the oil price trend, from a correction of the US current account deficit and a price slump in the real estate markets, which in a number of countries have expanded very dynamically in the past few years. An increase in long-term interest rates could trigger a price decline in those markets with corresponding adverse effects on private consumption.

27. In **Germany** GDP will rise by 1.0 % in 2006 according to our calculations. Owing to a statistical overhang of 0.4 percentage point, the path of cyclical development in the coming year will thus at best match the rate recorded in 2005. The mainstay of business activity remains foreign trade. Exports of goods and services will expand sharply again by 6.3 %, and in connection with a marked increase in imports, too, the external sector's contribution to macroeconomic growth will amount to 0.8 percentage point. By contrast, no broad-based recovery of domestic demand is to be

Tabelle 3

Key economic data for Germany

	Unit	2002	2003	2004	2005[1]	2006[1]
Gross domestic product	%[2]	*0.1*	*-0.2*	*1.6*	*0.8*	*1.0*
Total domestic demand	%[2]	*-1.9*	*0.6*	*0.6*	*0.0*	*0.3*
Investment in machinery & eq.	%[2]	*-7.5*	*-0.2*	*2.6*	*4.2*	*4.3*
Construction investment	%[2]	*-5.8*	*-1.6*	*-2.3*	*-4.6*	*-1.5*
Other investment	%[2]	*1.3*	*3.3*	*1.8*	*2.4*	*4.0*
Consumption expenditure	%[2]	*-0.1*	*0.1*	*0.0*	*-0.4*	*-0.1*
Private housholds[4]	%[2]	*-0.5*	*0.1*	*0.6*	*-0.3*	*-0.2*
General government	%[2]	*1.4*	*0.1*	*-1.6*	*-0.6*	*0.1*
Exports of goods and services	%[2]	*4.2*	*2.4*	*9.3*	*5.5*	*6.3*
Imports of goods and services	%[2]	*-1.4*	*5.1*	*7.0*	*4.1*	*5.0*
Employment (domestic)	million	39.10	38.72	38.87	38.92	39.09
Registered unemployed	million	4.06	4.38	4.38	4.89	4.80
Employees[5]	million	27.63	27.01	26.56	26.17	26.01
Unemployment rate[6]	%	*9.8*	*10.5*	*10.5*	*11.8*	*11.6*
Consumer prices[7]	%[3]	*1.4*	*1.1*	*1.6*	*2.0*	*2.0*
General government balance[8]	%	*-3.7*	*-4.0*	*-3.7*	*-3.5*	*-3.3*

1) 2005: own estimate, 2006: forecast. - 2) Price-adjusted; changes against previous year. - 3) Change against previous year. - 4) Including private non-profit institutions. - 5) Employees subject to social insurance contributions. - 6) Share of registered unemployed in total civilian labour force (dependent civilan employed persons, self-employed, family workers). From 2002 to 2004, source: Federal Labour Office (Bundesagentur für Arbeit). - 7) Consumer price index (2000 = 100). - 8) Fiscal balance of central government, state government, local government and the social security funds, as defined in the national accounts, in relation to nominal gross domestic product.

expected during the coming period. The outlook on the labour market will brighten only slowly, and the gradual improvement will not be strong enough to stimulate private consumption in 2006. The dampening effects of high energy prices and the associated price rises will withdraw considerable purchasing power from households, especially as this will not be cushioned as in the past years by income tax cuts. Real incomes will thus fall again in 2006 and private consumption will decline by 0.2 %. A more favourable picture is presented by investment in machinery and equipment. Besides the basically robust outlook for export business, this is due mainly to the improved financing structure of enterprises, and hence a continuing moderate expansion of investment in machinery and equipment of 4.3 % is anticipated. In the case of construction investment the multi-year adjustment process has not yet been concluded. However, the first signs of stabilisation are beginning to show in commercial and industrial construction, so that the contraction in 2006 will amount to only 1.5 %.

28. The **increase in employment** will pick up a little in 2006 to around 0.4 %. The number of self-employed will grow much more slowly owing to the expiry of the government subsidisation of unemployed persons starting their own one-person businesses, the resultant reduced promotion of self-employment and the increase in the failure rate of such subsidised business start-ups. The decrease in standard employment subject to full social security contributions will slow further in 2006 to 0.6 % or around 160,000 persons, so that around 26.01 million employees subject to social security contributions may be expected on an annual average. In the second year following the introduction of unemployment benefit II the number of jobless individuals will total approximately 4.80 million on an annual average and will thus be some 90,000 persons fewer than in 2005. Despite a further rise in subsidised work opportunities for benefit recipients, unregistered unemployment will fall further in 2006 to around 1.16 million persons.

29. The situation of public finances is likely to improve slightly in 2006, above all because no new revenue losses will result from a lowering of income tax rates. The current deficit of central, state and local government and the social security funds will decrease but will again exceed the criterion laid down in the Stability and Growth Pact with a figure of 3.3 % of nominal GDP. In order to bring the deficit ratio back down to 3.0 % in 2006, savings in the general government budget of around 6 billion euro would be needed based on the present situation. In the medium term particular initiatives are required with respect to the central government budget. The German government puts the size of the structural financing gap between expenditure (excluding investment) and current receipts for the years from 2007 at around 25 billion euro. In order to safeguard the constitutionality of the central government budgets on a lasting basis a consolidation of central government finances by a similar magnitude is imperative.

III. A proposed economic policy programme

1. New approach to reforming the federal structure

30. The present form of "cooperative federalism" constitutes a high hurdle to rapid political decision-making and, given opposing majorities in the lower house (Bundestag) and upper house (Bundesrat), leads not only to delays but also to some questionable compromises – for example, the conciliation procedures surrounding the Third and Fourth Acts Promoting Modern Labour Market Services (*Drittes und Viertes Gesetz für Moderne Dienstleistungen am Arbeitsmarkt*) and the Municipal Options Act (*Kommunales Optionsgesetz*). For this reason the urgently required revitalisation of the reform of the federal structure should focus above all on increasing the decision-making autonomy of the individual levels of government.

The German Council of Economic Experts made extensive proposals in this respect in last year's Annual Report (AR 2004 sections 787 ff.) aimed at modifying the current cooperative federal structure towards a **proactive federal structure**. The amendments to the Basic Law proposed by the Commission reviewing federal structures which ended in failure in December 2004 concerning

- article 84 of the Basic Law, which regulates the approval of the Bundesrat whenever central government wishes to influence procedural rules,
- article 72 of the Basic Law, which concerns the competing legislative initiatives, and
- article 23 of the Basic Law, which regulates the involvement of the state governments (Bundesländer) in matters relating to the European Union,

would have been a meaningful start to a reform of the federal structure, if agreement had been reached, but no more than that.

31. The objective must be a far more radical **disentanglement of the political decision-making process** in Germany. This will require returning responsibility for the joint tasks established by the reform of the financial framework of 1969 (article 91a and 91b of the Basic Law) to state government. Additional intergovernmental relationships which urgently need reviewing are in particular the Federal Order Administration (*Bundesauftragsverwaltung*) (article 104a (2) of the Basic Law) and the legislation governing financial benefits regulated in article 104a (3) of the Basic Law. A disentanglement of expenditure needs to be accompanied by greater revenue-raising autonomy for the individual levels of government. As it is unlikely that the federal revenue-sharing principle can be departed from in the case of the major taxes – and this should be refrained from also in view of the diversification advantages of a tax federation – it would seem appropriate to make the current intergovernmental financial framework more transparent and more flexible on the revenue side. One way of doing this, given a uniform nationwide assessment base for income tax and corporation tax, would be to grant state government the right adjust the "central government rate" by a premium or discount within a predefined corridor. In addition, the orientation of the current financial equalisation between the individual state governments could be changed from tax-raising power per inhabitant to GDP per inhabitant. This would ensure a simple and incentive-friendly financing system (AR 2004 sections 799 ff.).

32. In addition to a reform of the federal structure as outlined above, a **national stability pact** should be implemented as soon as possible as a complement to the European Stability and Growth Pact. The latter's procedural rules require member states, which are represented by the central governments, to ensure that the prescribed debt ceilings are adhered to. Such a responsibility of central government for general government indebtedness stands in contrast to the budgetary autonomy of the state governments guaranteed by the Basic Law. This autonomy can lead to incentives to incur debt which arise from the federative principle (*bündisches Prinzip*) as more precisely defined by the Federal Constitutional Court (*Bundesverfassungsgericht*). This principle obliges central government and the state governments – under certain conditions – to render assistance to state governments that encounter "extreme budgetary difficulties". This may give rise, especially for state governments with a high deficit or a high debt ratio, to incentives to increase indebtedness further and to rely on solidarity from the federal community.

Hitherto the state governments have refused to systematically implement the European Stability and Growth Pact as an intergovernmental federal stability pact with sanctions and have also refused to commit themselves to transparent stability reporting. Such a set of national fiscal rules, which was agreed in March 2002 as a "national stability pact", does not exhaust itself in the relatively generally defined rules of the new section 51a of the new Budget Principles Act (*Haushaltsgrundsätzegesetz*). For this reason it is necessary to elaborate a national stability pact stiffened by penalties (AR 2004 sections 803 ff.).

2. Labour market: continue the reform course

33. Two sets of problems characterise the precarious situation on the labour market: the particularly high unemployment among low skilled employees and the entrenchment of unemployment, which expresses itself above all in a high share of long-term unemployed. Any reform programme for more employment must tackle these problems and be gauged by its success in solving them.

34. A reduction of unemployment among **low skilled persons** requires both a higher demand for labour and a readiness on the part of the unemployed to accept such jobs at market-oriented wage rates. With respect to the demand for labour, firms treat the low skilled in the same way as all other employees, i.e. the labour costs have to be covered by the employee's corresponding productivity. In relation to the low-wage sector the key need therefore is to sufficiently differentiate the pay structure in line with skill levels. The onus of responsibility is primarily on the wage bargainers but also on the lawmakers, who should define an institutional framework for wage bargaining which facilitates a wider pay structure that matches skills, for example by extending the definition of the "favourability principle" (*Günstigkeitsprinzip*) which protects the interests of employees whenever collective labour agreements are departed from. The introduction of negotiated or statutory minimum wages would run counter to these intentions, however. Besides competitive wages, a functioning market for low skilled labour requires a demand for unskilled work. The size of the shadow economy, especially in the services sector, clearly indicates a considerable market potential. Regarding the readiness of the unemployed to accept jobs offered in the low-pay sector, the key requirement is to combine the minimum subsistence level provided by the social welfare system – unemployment benefit II – both with sufficiently attractive incentives to work and with effective sanctions.

A policy aimed at reducing **long-term unemployment**, the second key task, must start by boosting the dynamics of the labour market in such a way that the individual duration of unemployment decreases so that a *de facto* displacement of the unemployed from the labour market is avoided. In this context the economic policymakers can influence the efficiency of both job placement activities and job protection legislation. While this provides strong protection for employees in work, it makes it harder for unemployed persons to gain employment. Instead of easing employment protection rules across the board, the policymakers have liberalised the labour market at the margins by promoting non-standard forms of subsidised employment such as "mini-jobs". Although this was a response to the pressure to adjust, a better solution than creating such a two-class labour market would have been to spread the adjustment burdens more evenly among all employees by making the entire labour market more flexible. Wage policy, too, must make a contribution to improve the employmet opportunities of the long-term unemployed, e.g. by means of individually or collectively negotiated starting-level pay rates.

35. No one should have any illusions as to just how difficult it will be to even significantly reduce these problems, let alone to resolve them. The experience of other countries that have successfully fought unemployment teaches us that it is a long haul until the positive effects of reform measures begin to make themselves felt on the labour market. Much patience and a steady hand on the economic policy tiller are necessary, neither of which is likely to be easy given popular expectations of quick results. To this extent the criticisms of the most recent reforms on the German labour market – disregarding justified criticisms of points of detail – are wide of the mark.

It is also important to emphasise that it is not sufficient to tinker with a few policy knobs in the hope that this will engineer a radical improvement on the employment front. Instead the policy-makers must pursue a coherent **overall concept** and put together a package of measures which exploits the positive interactions of the individual measures of which each *per se* may not appear so impressive. All policy fields must contribute to such an overall package: government economic policy by setting an employment-friendly framework and wage bargainers by pursuing an employment-friendly course in which the scope for income distribution is not fully exhausted and the pay structure is widened further in line with different skill levels. In both policy fields it has been demonstrated in the past years that the actors are both willing and able to accept the challenges on the labour market – government economic policy, for example, in the form of the Hartz labour market reforms and the wage bargainers by pursuing a moderate wage policy conducive to employment. These economic policy actors should resolutely continue the course on which they have embarked. Wage policy plays an important role in preserving and creating competitive jobs. The lawmakers can ensure, by making the institutional framework more flexible and setting the right incentives to take up paid work, that these jobs are indeed taken up, not least by the low skilled and the long-term unemployed.

36. In its Annual Report the Council presents a package of strategies for discussion which encompass a total of **five central fields of action**. The first field of action concerns **earnings-replacement benefits**, i.e. old unemployment benefit and unemployment benefit II. In the system of wage substitutes the Hartz laws have set in train far-reaching and appropriate changes. This does not rule out subsequent corrections. Concerning the level of unemployment benefit, the Council's proposals relate, on the one hand, to a degressive benefit structure and, on the other hand, to the family component. In order to strengthen the incentives to take up work, the replacement rate could be progressively reduced with the increasing duration of unemployment, in such a way that the benefits could be set higher at the start of unemployment in order to mitigate the hardship connected with the loss of labour income. Thereafter the replacement rate falls successively and, from a given period of receipt, falls below its current level. The entitlement to unemployment benefit should not be extended beyond 12 months. The arrangements for older employees aged over 58, which are akin to an option of early retirement, should not be prolonged, and the supplements payable during the transition to unemployment benefit II should be abolished. The

Council further insistently cautions against heeding suggestions to peg the length of entitlement to unemployment benefit to the period of time over which the recipient has been paying contributions to the unemployment insurance scheme. Moreover, unemployment benefit levels should no longer be differentiated according to whether recipients have to provide for children. The inclusion of such a family component is an important but general societal objective which should thus be financed by the community of tax payers as a whole.

The policy thrust with regard to unemployment benefit II cannot be to call into question the guaranteed minimum standard of living but rather to seek to combine the defined subsistence level – especially unemployment benefit II – with sufficiently attractive incentive mechanisms for top-up earnings as well as supplementary sanctions against dilatory job-seeking in such a way that taking up work at a low level of pay commensurate with their productivity is rewarding for low skilled persons. Despite several reductions in the withdrawal rates for additional earned income – most recently on 1 October 2005 – the marginal tax burden remains high and, in effect, it has become more attractive to take up subsidised low paid part-time work, which is not without problems from the perspective of employment policy. If it should turn out that the current allowances for topping up unemployment benefit with some earned income still provide too little incentive for taking up low paid work, parliament should consider adjusting unemployment benefit II accordingly. Corresponding proposals have been made *inter alia* by the German Council for Economic Experts. The Council's proposals essentially comprise three elements. The facility to top up unemployment benefit II through earned income would be extended and the regular standard rate for recipients of income support payments who are able to work should be concurrently lowered. If the persons in question fail to find a job despite recognisable efforts, they would offer their labour services to municipal employment agencies in order in this way to at least regain the minimum benefit level prior to the lowering of income support payments. The existing facility to top up benefit with earned income ("one euro jobs") accords with the concept proposed here, although more attention must be paid than hitherto to ensuring that unemployment benefit II plus the top-up facility do not add up to an amount that would make taking up a job on the primary labour market appear unrewarding. In addition, at the least the level of the flat-rate amounts paid to the employer should be reviewed.

37. The second field of action relates to **active labour market policy**. It is already apparent that the Federal Employment Agency (*Bundesagentur für Arbeit*) is on the right track in appreciably curtailing spending on job creation measures; it should systematically continue this, based on a well founded evaluation. Another proposal which the Council puts forward for discussion is to amalgamate the two existing subsidies paid to unemployed persons who set up their own business – *Überbrückungsgeld* and *Existenzgründungszuschuss*, which is to expire at the end of 2005 – into one single limited-term promotional measure. The setting up of personnel service agencies should no longer be mandatory but should rather lie at the discretion of the responsible relevant labour agencies. Subsidised low paid part-time work ("mini-jobs") in the enterprise sector should be carefully assessed in view of possible crowding-out effects. Mini-jobs should be allowed in future only if exercised as the person's sole job; where they are exercised as a supplementary activity they should no longer be promoted. The experience to date gathered from "combi-wages" (*Kombilöhne*), i.e. wage subsidies, give cause for scepticism; in view of the current situation the

Council does not recommend introducing them across the board over and above the wage supplements that are already available. The introduction of statutory minimum wages is counterproductive, particularly in view of the need to strengthen the low-wage sector, and so the idea should definitely de dropped.

38. **Collective bargaining legislation** constitutes the third field of action. The lawmakers should create a more employment-friendly framework in the sense that national or sectoral labour agreements, which should be maintained, are made more flexible. This includes clarifying the scope of meaning of the favourability principle so that the criteria for assessing whether employment contract provisions which deviate from the standard labour agreement are more "favourable" for an employee may also include not just pay and working hours but also job security aspects. Furthermore, possibilities should be examined of loosening firm's compulsory ties to collective labour contracts. Declarations of sector-wide or industry-wide validity (*Allgemeinverbindlicherklärung*) should no longer be made. In particular, declarations of sector-wide or industry-wide validity should not be misused for the purpose of introducing an (industry-specific) minimum wage as this would pave the way to protectionism. Effective liberalisation clauses for collective labour agreements should enable plant-level agreements to be concluded that deviate from the national or sectoral arrangements. If the social partners fail to meet this requirement, consideration should be given to amending the Act on Collectively Negotiated Labour Agreements (*Tarifvertragsgesetz*) accordingly – as announced in the last government's "Agenda 2010". In addition, it should be examined to what extent plant-level agreements concluded with firms that are not bound by the industry-wide labour agreement may be exempted from the provisions of section 77 (3) of the Industrial Constitution Act (*Betriebsverfassungsgesetz*).

In the aggregate these proposals aimed at rendering collective bargaining legislation more flexible would strengthen the capability of jobless persons to compete for job opportunities with employed persons. These proposals are not meant as a cure-all for solving the labour market problems, but their contribution as part of an overall approach should not be underestimated.

39. **Employment protection rules** constitute the fourth field of action: although they have already been partly loosened as from the start of 2004, further comprehensive liberalisation is needed. To this end the Council puts forwards several options. One option could be for a newly recruited employee, at the end of his/her probationary period (*Probezeit*), to voluntarily waive his or her employment protection rights in the event of a later compulsory redundancy in return for an *ex ante* claim to a redundancy payment. A second option envisages that the employee, on being offered a permanent employment contract at the end of the probationary period, agrees with the employer to waive all and any employment protection rights in return for receiving a higher level of remuneration. If no agreement is reached between the employer and employee under these two options, a statutory rule would then come into play under which the onus of proof currently on the employer if the employee contests dismissal at a labour court would be reduced compared with the *status quo*. But this would still fail to eradicate one current legal uncertainty. A third option could thus be considered which is not only easier to implement but would also streamline present labour laws and simultaneously make them simpler: the protection against compulsory redundancy would be generally deleted from the Dismissal Protection Act (*Kündigungsschutzgesetz*); instead, redun-

dancy compensation would be payable at a level depending on the employee's length of service and subject to certain minimum standards which could be undershot only if specifically permitted in the collective agreement or in the context of a social plan. Hence compulsory redundancies would be made generally permissible and would be open to legal appeal only where common decency is offended by infringing a prohibition of discrimination or similar provision. The new dismissal rules would apply to all enterprises regardless of the number of employees but under a grandfathering clause would apply only to new employment contracts concluded after the new legislation comes into force.

40. The fifth field of action concerns not parliament but rather the **social partners**. Their contribution to creating new jobs is imperative and consists of two elements. First, with regard to the level of pay, collectively negotiated wage rates should not fully exhaust the available scope for income distribution. This is made up of the growth in labour productivity – more precisely the marginal productivity of labour – adjusted for employment fluctuations and expected inflation, albeit excluding price effects ensuing from increases in indirect taxes or in the prices of raw materials such as crude oil. Second, the pay structure needs to be broadened further in line with skill levels, especially in the low-pay sector. The reforms undertaken in the context of unemployment benefit II will have been in vain if no jobs arise in the low skilled sector owing to overly high wage costs. A sufficiently flexible pay structure in line with skill levels needs to bring wage costs into line with productivity.

3. Social security: different financing method for non-insurance-related benefits

41. A key reason for the contraction of employment subject to social security contributions and hence for the erosion of the assessment base of the social security schemes is the wide **tax wedge** between product wages, i.e. labour costs, and consumption wages, i.e. disposable labour income. This wedge is determined primarily by the wage-related contributions financed jointly by employers and employees. A wide tax wedge inhibits the demand for labour from enterprises and also leads to evasive reactions by employees that are detrimental to employment policy (e.g. illicit working).

The wide tax wedge and the high contribution rates have multiple causes. For example, the weak revenue trend seen in recent years has tended to trigger contribution rate rises or to prevent contribution rate cuts – e.g. in the statutory health insurance scheme. Another reason for high contribution rates can be the granting of excessively generous or unnecessary insurance benefits. Reform measures must then be aimed at reducing benefits with a view to lowering contribution rates. A further factor behind the high contribution rates is undoubtedly German reunification and the associated extension of the social security systems to eastern Germany, which is blighted by high transitional unemployment. However, these contribution rates may also be high because they include a **tax component** extraneous to customary insurance contracts. As a general principle contributions to social security systems ought to reflect the price of the insured benefits. In other words, there should be an equivalent linkage between contributions and benefits. The more this equivalence is distorted, the more social security contributions resemble a tax. Contributions are then no longer directly linked to an equivalent benefit, which encourages the usual tax evasion reactions. As the level of contributions and hence also the level of the tax depends on labour income subject to social security contributions, these evasive responses lead to a contraction of employment subject to social security contributions. Measures therefore need to be taken to reduce the tax-like character of contributions. Different approaches are required, however, for the individual social security schemes since the tax-like nature of contributions may be rooted in an inappropriate definition of the assessment base or may result from the fact that the contributions are being put to inappropriate use, i.e. in order to finance non-insurance-related benefits which really out to be paid for out of general tax revenue. In the statutory health insurance scheme and the public long-term care insurance scheme the tax-like nature of contributions is due to the fact that contributions are related to income whereas benefits are unrelated to income, thus leading to a non-insurance-related redistribution of income. In the unemployment insurance scheme and the statutory pension insurance scheme, by contrast, both contributions and benefits are related to income, so that in these two cases the tax-like nature of contributions results from the fact that they are being used to finance non-insurance-related benefits.

42. All benefits and redistributed income streams are non-insurance-related if they do not serve to compensate between low and high risks and do not accord with the insurance objective. In the health insurance scheme there is such a balancing between low and high health risks, in the long-term care insurance scheme between low and high nursing risks, in the unemployment insurance scheme between persons with a low and high unemployment risk, and in the pension insurance scheme between individuals with low and high life expectancy. This equalisation mechanism is an expression of the solidarity principle that typifies social security schemes. The interpersonal redistribution of income is not germane to this solidarity principle underlying social security schemes but is rather – just like measures which promote children and families – a task to be performed by society as a whole and is thus extraneous to the social insurance systems. Based on this definition, extraneous non-insurance-related parts totalling around 130 billion euro can be identified in the aforementioned social security schemes, whereas just over 60 billion euro is covered by transfers from central government (*Bundeszuschüsse*). This adds up to a misfinancing element in the four social security systems under consideration totalling over 65 billion euro.

43. In the statutory health insurance scheme the extent of the non-insurance-related income redistribution component amounts to over 40 billion euro and in the long-term care insurance scheme to over 5 billion euro. The associated non-insurance-related tax-like nature of contributions arising from the way in which the assessment base for contributions is measured can be eliminated by changing the method of calculating the contributions, i.e. by switching to income-unrelated **flat-rate contributions**. In the unemployment insurance scheme and the statutory pension insurance scheme, on the other hand, the income-related definition of the contribution assessment base is appropriate as in these cases the associated benefits are likewise similarly income-related, so that the equivalence principle (*Äquivalenzprinzip*) largely applies. The right approach in these two cases, therefore, is to finance the non-insurance-related benefits – to the extent that they are deemed to be necessary – via taxes by means of a central government transfer to the two social security schemes funded out of general taxation revenue.

44. If a tax is raised in order to pay for this transfer, it will not increase the aggregate burden of taxes and social security contributions since this explicit tax increase would be offset, via the lowering of contribution rates, by a matching decrease in the implicit tax contained in the contributions. Yet precisely because the aggregate tax and levy burden does not fall if the tax-like contributions which distort the supply of and demand for labour are reduced but the similarly distorting taxes are concurrently increased, it stands to reason that the net effect, also regarding the implications for employment, is unlikely to be very large. No appreciable employment effects may be expected from a mere change in the method of financing non-insurance-related benefits and from a greater tax-based financing of the social security schemes – as was suggested in the recent past, for example, by the CDU/CSU in the form of a cut in the rate of contributions to the unemployment insurance scheme by 2 percentage points, to be counterfinanced by raising VAT likewise by 2 percentage points. But as the assessment base for the collection of VAT is broader than the assessment base for social security contributions – i.e. an increase in VAT would burden not only labour income resulting from employment subject to social security contributions but also all labour income, transfers and profits out of which consumption is financed – the tax burden would be more evenly distributed and thus the tax burden on labour income subject to social security contributions would be lightened.

Positive employment effects are to be expected not only in the case of a turnover tax-financed reduction of contributions but for all counterfinancing variants (e.g. an increase in income tax or a decrease in government consumption). While such alternative financing methods do not offer a quick escape route from the present employment mire, a reduction of the implicit tax component in the social security contributions and hence lower contribution rates and a higher level of explicit taxation would enhance the attractiveness of employment subject to social security contributions and counteract the erosion of this "standard" form of employment. The available simulation studies indicate that the best allocative and distributive results are to be expected if the counterfinancing measures consist of a combination of value added tax and income tax.

45. The policymakers are thus called upon to take measures that will lower contribution rates and reduce the tax-like nature of contributions. In doing so, they need to address both the benefits side and the financing side of the individual social security schemes. The German Council of Economic Experts proposes concrete reform measures for the individual social security schemes on both the financing and benefits side.

Citizen's flat-rate contribution model in the statutory health insurance scheme

46. On the **financing side** of the health insurance scheme a changeover to a citizen's flat-rate contribution system (*Bürgerpauschale*) as proposed by the Council can eliminate the current tax-like nature of social security contributions almost entirely. The citizen's flat-rate contribution system is characterised by income-unrelated contributions corresponding to average health insurance expenditure per member (AR 2004 sections 485 ff.). This would strengthen the equivalence principle, and the non-insurance-related redistribution of income, which arises in the current system from the fact that contributions are income-related, would be largely eliminated. The concept put forward by the Council also envisages that the insurance obligation would be extended to the entire resident population. The abolition of the income threshold dividing the public and private health insurance schemes would overcome the inefficient segmentation of the health insurance market, which is characterised by risk segregation tendencies. In such a uniform market all suppliers of health insurance services, i.e. both public and private health insurance institutions – which would also offer the citizen's flat-rate contribution system and would have to abandon their current calculation of premiums in the full-value insurance business model – would enter into a fair and efficient competition. In the public debate on reforming the financing side of the health insurance system this important aspect has been neglected hitherto.

47. The citizen's flat-rate contribution model represents a convincing reform concept for financing the health insurance system. Healthcare costs are decoupled from labour costs. Increases in contributions do not automatically lead, as in the current system or in a citizen's insurance scheme (*Bürgerversicherung*), to higher non-wage labour costs and to a widening of the tax wedge that would be detrimental to employment. The tax wedge itself is reduced by the flat-rate contributions – even after creating a social equalisation mechanism. As the contributions have to be paid out of the insured person's entire income and are defined independently of the income level, a weak revenue trend such as is currently observable owing to the sluggish growth of total wages would no longer occur. There would no longer be any need to increase contributions in order to boost sagging revenue. Since the contribution corresponds to the average health expenditure per health institution member, transparency would be enhanced and the price function of contributions strengthened. The mere (and highly intransparent) income redistribution inherent in the present system would be eliminated from the system but not abolished; instead, it would be largely shifted to the tax system – through the creation of a means-tested transfer system – where it can be performed more transparently and selectively.

48. Irrespective of a reform of measuring the contribution assessment base, the **reforms on the expenditure side** initiated by the Act Modernising the Statutory Health Insurance System (*GKV-Modernisierungsgesetz*) must be pursued further. If high contribution rates are attributable to inefficiencies in service provision and insufficient competition in the system, these will hardly be eliminated by reforming the method of financing. The key determinants of the cost efficiency or cost profligacy of a healthcare system are, rather, the incentive structures governing insuree's demand behaviour and, in particular, the intensity of competition between the service providers on the one hand and the health service institutions on the other. Irrespective of what reforms are implemented on the financing side, further measures should be taken to eliminate inefficiencies and strengthen competition, for example, by widening the scope for the selective conclusion of contracts between the health insurance institutions and individual service providers and promoting integrated healthcare systems. Hospitals need to grant greater access to outpatient treatment. The ban on owners delegating the management of pharmacies and on the multiple ownership of pharmacies (which has meanwhile already been relaxed) should be scrapped. In addition, the morbidity-based risk-sharing structure and the electronic health card should be introduced swiftly and mergers between different kinds of health institutions should be permitted.

Long-term care insurance scheme: urgent need for reform

49. The public long-term care insurance scheme is the social security scheme with the most pressing need for reform both on the benefits and on the financing side. In this case, too, the financing system needs to be changed. With the **citizen's flat-rate contribution system** in the long-term care insurance scheme and the cohort model put forward in the Annual Report 2004/05 (sections 545 ff.), the German Council of Economic Experts presents two concepts for public discussion by means of which the non-insurance-related redistribution elements in the long-term care insurance scheme, and hence the tax-like character of the contributions to the scheme, could be significantly lowered and thus the tax wedge reduced. In both models the present income-related basis of contributions would be abandoned and the segregation between the public long-term care insurance scheme and private long-term care insurance institutions would be overcome. The concept of the citizen's flat-rate contribution system in the long-term care insurance scheme retains the current cross-cohort pay-as-you-go system. This flat rate would amount to around 25 euros per month. The government transfers needed to fund the social equalisation function, which would be funded out of general taxation, would amount to between 1 and 2 billion euros. Since the demographic problems of the long-term care insurance scheme are particularly large, it is expedient to set up a supplementary funded component at the individual level.

50. The **cohort model** favoured by the German Council of Economic Experts aims at changing over to a cohort-specific funded system. This is because the long-term care insurance scheme, as the most demographics-dependent system, is ideally suited to be financed according to the dedicated funding principle. This model is based on age cohort-specific premiums which arise when the expected expenditure on long-term care benefits of each cohort are distributed across the members of the cohort. To ensure that premiums do not rise disproportionately with advancing age, a capital stock is set up for the cohort for the purpose of smoothing out the premiums. The premium consists of a pay-as-you-go amount for the cohort and a savings amount, whereby the savings amount is initially positive and, when the cohort ages, becomes negative. The changeover to dedicated funding occurs gradually; for younger members a funded system is set up and at the same time for older persons the pay-as-you-go financing system is maintained, although with a different system of financing. This long-term care insurance system financed on a pay-as-you-go basis will contract as a result of the falling number of insured persons over time. The changeover from a pay-as-you-go system to a funded system will incur the typical, unavoidable changeover costs: on the one hand, the expiring system has to be continuously financed, and on the other capital has to be accumulated. To begin with, therefore, the contributions to the long-term care insurance scheme will increase for virtually all insured persons and government will have to pay between 5 and 8 billion euro net to cover hardship cases. However, after 40 to 45 years the pay-as-you-go system will expire – i.e. at that point in time when the demographic problems will be at their largest – and the contribution burden will be smaller than in the present system or also compared with a citizen's flat-rate contribution model. Policymakers thus need to think long-term but act short-term, since, given an ageing society, the cost of changing over to a funded system will increase the longer one waits.

51. Both concepts make it possible to counter the weak revenue trend and the resulting financial difficulties of the public long-term care insurance scheme. This makes it easier to implement the reform measures needed on the **benefits side**, such as the dynamisation of flat-rate benefits or making greater allowance for the needs of dementia sufferers.

Statutory pension insurance scheme: complete the reforms that have been initiated

52. On the **benefits side** the Act to Ensure the Sustainability of the Statutory Pension Insurance Scheme (*RV-Nachhaltigkeitsgesetz*) passed in 2004 constitutes the last link to date in a chain of reforms aimed at curbing the rise in contribution rates which place a burden on employment through a bundle of measures aimed at curtailing expenditure, i.e. benefits. Based on the assumptions underlying the 2004 pension reform, pensions payable under the statutory pension insurance scheme will be reduced by just over one-sixth up to 2030 compared with the legislative *status quo*. The net pension level before taxes of currently just over 52 % is to be reduced to 46 % up to 2020 and if necessary to a minimum level of 43 % by 2030. With the adopted reforms it will now be possible to limit the contribution rate to 22 % in 2030, despite the fact that German reunification has placed an additional burden on the statutory pension insurance scheme. The significance of the implemented reforms becomes clear if it is considered that right up to the mid-1980s contribution rates of up to 40 % were being forecast alone for West Germany for the year 2030.

53. In order to limit the contribution rate to a maximum of 22 %, further reform steps are necessary on the benefits side, although this should not include attempts to lower the pension level further to below the target threshold of 46 % and 43 % as that would call the legitimacy of the statutory pension insurance scheme into question. One step which should be taken, however, is to progressively raise the **statutory retirement age** from 2011 by one month per year to reach 67 years in 2034. This would alleviate the financing of the statutory pension insurance scheme by 0.6 contribution point up to 2030. If necessary the increase in the retirement age could be accelerated. The decision on raising the statutory retirement age, which would not affect the present generation of older employees, should be taken as soon as possible so that employers and employees alike can adjust to these changes (AR 2001 section 260; AR 2003 section 338).

54. In order to achieve the targeted contribution rates it is also crucially necessary to supplement the pension adjustment formula by a **clawback factor**. This must ensure that reductions in pension payments and hence in the payment level warranted by a contraction of wages and salaries, which are currently prevented by a non-reduction clause, are systematically implemented retroactively during subsequent phases of higher wage growth in the form of smaller pension increases. The aim of such a clawback rule is to ensure that the lowering of the pension level envisaged in the Act to Ensure the Sustainability of the Statutory Pension Insurance Scheme is actually attained.

55. The pension insurance contribution continues to contain a tax element due to the fact that the statutory pension insurance scheme finances certain non-insurance-related benefits which by rights ought to be paid for out of general tax revenue but which at the moment are not covered by the central government transfers. The key requirement on the **financing side** is to eliminate these tax elements. However, this cannot be achieved by changing the method of assessment for contributions to the statutory pension insurance scheme, as it is based on the principle of (participatory) equivalence and the pension entitlements and pension payments are oriented to the level of income subject to social security contributions. The implicit tax element in these insurance contributions – caused by funding non-insurance-related benefits out of contributions – can therefore only be lowered through a higher transfer from central government. The volume of non-insurance-related benefits not financed by central government transfers currently amounts to at least 6 billion euro.

The corresponding necessary increase in central government transfers is not only defensible but actually appropriate under the principles of a social market economy and would correspond to a cut in the contribution rate of around 0.7 percentage point.

Unemployment insurance scheme: first evaluate, then change the financing method

56. A dual strategy should likewise be pursued in the unemployment insurance scheme: both on the **benefits side** and on the financing side possibilities should be sought to lower contribution rates. The volume of non-insurance-related benefits financed from contributions in the unemployment insurance scheme totals some 19 billion euro. A changeover to financing these benefits by means of a higher central government transfer would enable the contribution rate to be lowered by over 2 percentage points. Precisely in the unemployment insurance scheme, however, the features and necessity of the identified non-insurance-related benefits should first be examined critically before changing the method of financing with a view to lowering contribution rates.

57. Only after examining all the possibilities of lowering contribution rates by pruning and refocusing insurance-related and extraneous benefits that are deemed to be superfluous should a start be made on the **financing side** on changing the funding method to achieve contribution cuts. Indeed, it makes sense to change the method of financing non-insurance-related benefits initially in the unemployment insurance scheme as there the largest cut in contributions can be achieved for a given financing volume. This is because cutting the contribution rate by 1 percentage point requires 7.3 billion euro in the unemployment insurance scheme, 8.7 billion euro in the statutory pension insurance scheme and 10.0 billion euro in the statutory health insurance scheme. A first step towards a new method of financing the unemployment insurance scheme could be to abolish the compensatory amount (*Aussteuerungsbetrag*) payable by the Federal Employment Agency (*Bundesagentur für Arbeit*) to the central government, which currently accounts for around 0.7 contribution point.

4. Tax policy: do the right things, avoid doing the wrong things

58. The most important tax policy task in the legislative period that has recently commenced consists in a reform of business taxation. An international comparison shows that Germany continues to levy the highest nominal and effective tax rates on the profits of corporations in Europe. By contrast, the standard rate of turnover tax lies at the lower end of the range permitted by EC legislation, the bottom rate of income tax in the lower third and the top rate in the middle of the league table of EU member states.

59. The primary aim of a reform of corporate taxation is to improve Germany's attractiveness as a business location; in addition, a far-reaching degree of decision-making neutrality – especially financing neutrality – within the taxation regime must be ensured. An implementation of the decisions of the job summit of 17 March 2005 – a lowering of the corporation tax rate from 25 % to 19 % and a flat-rate offsetting of local business tax (*Gewerbesteuer*) against income tax in the amount of 2.0 instead of 1.8 times the applicable local business tax base – would have been at most a necessary but insufficient first step. Therefore, these decisions should not be implemented straightaway since their implementation could well jeopardise the chances of the required "grand reform" outlined above being initiated during the current parliamentary term.

60. If the principle of **synthetic income tax** – i.e. the identical tax treatment of different types of income tax – is to be retained, a **flat tax**, which combines a low uniform marginal tax rate (say 25 %) on all taxable income with the integration of corporation tax into income tax, is an attractive reform option. The undisputed advantages of this concept, which was publicly discussed during the German general election campaign, are accompanied, however, by problematic distribution effects and unacceptable tax losses. For these reasons such a tax is unlikely to be implemented in the foreseeable future. Yet as prompt action is needed in the field of business taxation, it will be necessary to abandon the idea of synthetic income tax and change over to **schedular taxation**. This means that the income to be taxed is subject to different taxation schedules depending on the origins of the income in question. Such a scheduling is always a pragmatic compromise which, however, is unavoidable given the present realities.

In its Annual Report 2003/04 (AR 2003 sections 567 ff.) the German Council of Economic Experts proposed a **dual income tax**, which is oriented to achieving the two objectives of attractiveness for business investment and decision-making neutrality. In this year's report the Council puts forward a modified concept. It is postulated on the condition that deviations from current tax legislation are kept to a bare minimum as, in particular, the dualism of corporation tax for corporations and income tax for non-corporations (i.e. partnerships and sole proprietorships) is to be retained. Another condition is that non-corporations do not fare worse under the dual income tax than under the current income tax rules. After all, the revenue shortfalls associated with the tax reform should be limited.

61. The aims of reforming the business taxation regime cannot be achieved if the current **local business tax** is preserved. Local business tax should be abolished. It could be replaced by the concept of municipal finances put forward by the Stiftung Marktwirtschaft. However, the dual income tax proposed by the German Council of Economic Experts is also feasible in the context of retaining local business tax, although the intended objectives, especially the aim of financing neutrality, could then not be fully attained.

The concept put forward by the German Council of Economic Experts would tax all types of income classified as capital income at a uniform rate of 25 %. The rate of corporation tax would likewise amount to 25 %. The capital income and profits of corporations are thus taxed at the same rate of 25 %. The solidarity surcharge (*Solidaritätszuschlag*) on income tax of 5.5 % is included in this tax rate as is the burden that would ensue from a municipal tax.

Concretely, the following would apply to the taxation of **corporations** and their **shareholders**. Retained profits would be subject to a nominal tax rate of 25 %. For the taxation of distributed profits a distinction is made between "normal profits" and "excess profits". Normal profits are based on the "normal rate of return" on capital employed, which should be oriented to the risk-free rate of interest, with an add-on for the limited loss-offsetting facilities. In line with the imputed interest rate used in tax accounting, this standard rate of return may be set at 6 %. Profits in excess of this would be deemed excess profits. These are based on entrepreneurial labour that is not otherwise remunerated or on economic rents. Dividends classified as normal profits are tax-free for the shareholder; the tax burden thus remains at the initial rate of 25 %. Distributed excess profits, by contrast, incur additional taxation of 25 %. Hence the total tax burden comes to 43.75 % [0.25 + 0.25 (1 – 0.25) = 0.4375]. This roughly corresponds to the current top rate of income tax which, including the solidarity surcharge, amounts to 44.31 % [0.4431 = 0.42 (1 + 0.055)]. The close correspondence between the top rate of income tax and the tax burden on distributed excess profits limits the incentives to transfer the shareholder's labour income to the company by agreeing low manager remuneration. Capital gains are generally liable to taxation and are treated like distributed profits. The current tax exemption of profits from the disposal of equity stakes in corporations which amount to less than 1 % and are not to be classified as speculative gains would be abolished.

Interest on borrowed capital is likewise taxed at 25 %. The taxation of excess distributed profits and capital gains at a rate of 25 % as well as the interest on borrowed capital can take the form of a flat-rate withholding tax, if necessary coupled with a tax assessment option.

With respect to the taxation of **non-corporations**, the Council's model adheres to the principle of transparent taxation. However, non-corporations, too, deploy capital for which the return should be subject to the low tax rate. To this end the normal profit should be factored out of a sole proprietor's or partner's overall income and taxed within the income tax schedule at the flat capital income tax rate of 25 %. This can be achieved by simply adding a proportional component to the current income tax schedule. This would therefore ensure the neutrality of legal form with respect to the taxation of normal profits.

62. The model of a **general enterprise tax** (***Allgemeine Unternehmenssteuer***) presented by the tax code commission of Stiftung Marktwirtschaft on 22 September 2005 is likewise a schedular tax and hence also a dual income tax. A conceptual distinction is drawn between the taxation of enterprises and the taxation of entrepreneurs, whereas the German Council of Economic Expert's model envisages a different taxation of appropriately defined capital income and of other income.

From an economic viewpoint the dual income tax is superior to the concept put forward by Stiftung Marktwirtschaft in a number of points.

- The dual income tax concept put forward by the German Council of Economic Experts entails far fewer interventions into current tax legislation than does the model of Stiftung Marktwirtschaft, which introduces a new type of tax category with the general enterprise tax.

- In the case of corporations the Stiftung Marktwirtschaft model comes to a uniform preferential tax treatment of the entire corporate profit, whereas the Council's model leads "only" to the selective favourable tax treatment of profits equal to the rate of return on equity capital.

- The dual income tax would create extensive financing neutrality and would thus tend to counter creative tax accounting. Apart from the favourable tax treatment of profits equal to the rate of return on equity capital, this approach refrains from the neutrality of the legal form; for non-corporations the tried and trusted existing institutional conditions would be maintained. The model proposed by Stiftung Marktwirtschaft creates a further-going neutrality of the legal form but to this end must completely re-regulate the taxation of non-corporations. Moreover, financing neutrality is not ensured; all the resulting distortions as well as the difficulties of classification and collection of the present method of taxation will thus be tolerated further.

- A withholding tax on interest payments, dividends and capital gains (share price profits) is more compatible with the model proposed by the German Council of Economic Experts than with that of Stiftung Marktwirtschaft.

- Local business tax should be abolished; this should not be a stumbling block to a reform of business taxation, however. Local business tax could be retained more easily under the Council's model than under that of Stiftung Marktwirtschaft.

63. In January 2006 the German Council of Economic Experts, together with tax experts from the Max Planck Institute for Intellectual Property, Competition and Tax Law (Max-Planck-Institut für Geistiges Eigentum, Wettbewerbs- und Steuerrecht), Munich, and the Centre for European Economic Research (Zentrum für Europäische Wirtschaftsforschung, ZEW), Mannheim, will present a **study on dual income tax** commissioned by the government ministers Wolfgang Clement and Hans Eichel. It will contain detailed calculations on the cost of capital relevant for investment purposes and extensively formulated proposals for amendments to income tax law.

Inheritance tax

64. At the job summit held in March 2005 the German government and the main opposition parties CDU/CSU also agreed on a re-regulation of the taxation of inheritances and donations in connection with transferring entrepreneurial assets. To this end the German government and the CDU/CSU faction in the Bundestag each presented a "Bill to Safeguard Entrepreneurial Successions" (*Entwurf eines Gesetzes zur Sicherung der Unternehmensnachfolge*). Owing to the advanced general elections in Germany these bills did not reach the statute book. It is likely that the grand coalition which is taking shape in Germany will initiate a reform of inheritance tax during the current legislative period.

The German Council of Economic Experts considers that the proposed reform of inheritance tax will not lead to the desired goal. It will do little or nothing to help safeguard and maintain jobs; nor is reforming inheritance tax a pressing task with a view to enhancing Germany's attractiveness to business investors; granting further preferential tax treatment to business assets vis-à-vis other types of investment is not justified; contrary to the intention of the draft legislation, small and medium-sized enterprises (SMEs) would in many cases be worse off than under current inheritance tax rules; the envisaged distinction between productive and non-productive assets makes little economic sense and will encourage creative accounting; the envisaged ceiling for preferential tax treatment of business assets is arbitrary and does not relate in any way to SMEs; the planned different treatment for inheritance tax purposes of corporations depending on the size of the shareholding is likewise arbitrary and hardly compatible with the precept of equality before the law laid down in article 3 (1) of the Basic Law; the reform stands in glaring contrast to the goal of simplifying the taxation system. The desolate situation of public finances leaves no leeway for unnecessary tax cuts.

The reform of inheritance tax should be put on ice and incorporated into the more urgently required task of restructuring the taxation of capital income. This would also make it possible to take account of the pending ruling of the Federal Court of Justice (*Bundesverfassungsgericht*) on a possible infringement by the Inheritance and Donation Tax Act (*Erbschafts- und Schenkungssteuergesetz*) of the equality clause of article 3 (1) of the Basic Law.

5. Strengthen the efficiency of the financial and credit markets

65. Efficient capital and credit markets are important **drivers of growth**: they mobilise risk capital, improve firm's financing terms, ensure the dissemination of new technologies and in this way contribute to economic momentum; to that extent they are a precondition for and not just a consequence of economic growth. For this reason the promotion and modernisation of the financial markets is a central economic policy objective both at a national and European level. Moreover, the financial markets are undergoing a very dynamic development which is characterised by global integration, growing competition as well as new instruments and actors and which is acutely heightening competition among different national financial centres.

66. The German financial system is currently undergoing a radical and irreversible transformation towards a **stronger market orientation**. This shows up in the increasing use of capital market-based financing instruments, the growth of the market for equity capital, the rising importance of institutional investors and the growing significance of corporate governance. These developments are also relevant for firms that have no direct access to the capital market. In the past few years banks have begun to shift their default risk more and more to the capital market via credit derivatives or credit securitisations, so that on these grounds, too, it is to be expected that credit terms will be influenced increasingly by market conditions.

In the aggregate, this development offers chances to boost the efficiency of the German financial system. Admittedly, bank-based or, to be more precise, relationship-based systems have the advantage that, owing to the intrinsic long-term relationships between lenders and borrowers, they overcome information and control problems and in this way are cushioned against firm-specific shocks. But the concentration of information on financial intermediaries lessens the liquidity of the financial markets, the information content of market prices and competition between lenders. In addition, market-based systems are better able to finance new firms and technologies, whereas bank-based system's ability to adjust is often limited by firm's interlocking ties with one another or with political decision-makers.

67. The tenor of public debate in 2005 showed that the challenges accompanying the transformation process are also perceived as a threat. On the one hand, there is a popular mistrust of the growing importance of financial investors and the pressure which they exert on the companies they buy into. On the other hand, SMEs constantly complain that their access to funding has deteriorated markedly in recent years in the wake of bank's changed business policy and the waning importance of relationship banking.

68. A noticeable feature of the public debate on **financial investors and hedge funds** is that many of the arguments clearly miss the target and that different risks are continually conflated. First of all, it should be noted that hedge funds and private equity companies contribute to the efficiency of the financial markets. They support the price formation process, broaden investor's diversification options, take over higher risks from other market players and, in the case of private equity companies, they can provide new financing options for firms. Three different types of attendant risks can be differentiated: risks for investors in hedge funds, risks for enterprises in which hedge funds and private equity companies invest, and risks for the international financial system (credit risk and liquidity risk). This year public attention focused on the risks for enterprises, which were portrayed as the helpless prey of vulture-like financial investors interested solely in making a short-term killing who suck the lifeblood out of their hapless victims and then move on. This naïve notion has no grounding in economic reality for it implies that investors systematically destroy the value of the enterprise yet are concurrently able to sell their stake at a profit. By the same token, the criticism of the influence which financial investors exert on the investment company's management is largely misdirected – the investor takes a more active role in the investment company primarily if it serves to increase the value of his shareholding. Another widespread perception is that financial investors boost profits at the expense of jobs. A clash of aims between achieving a high return and securing a high level of employment may indeed exist in the short run; in the long run, however, only profitable companies can maintain a high level of employment or even increase it. On balance, the activities of both hedge funds and private equity companies bear no appreciable risks for companies and investors. At the national level there is no significant need for action either in respect of reinforcing investor protection or in protecting companies. Proposals such as limiting the voting rights of investors with a short-term investment horizon, short selling and stock lending should be rejected.

69. Greater attention, by contrast, should be paid to the potential **risk to international financial stability** that is associated with hedge funds. This arises from the fact that, owing to their huge and predominantly leveraged transaction volumes, a default of hedge funds such as the collapse of LTCM in 1998 might lead to the contagion of other market players on a considerable scale. Internationally coordinated regulatory measures aimed at enhancing the transparency of hedge fund's open positions, and thus at improving the risk assessment of the counterparties involved, could help to mitigate this risk. The calls for a greater exchange of information among market participants on a voluntary basis appear both sensible and practicable. Go-it-alone national approaches to the regulation of hedge funds should be rejected, however. At best these would be ineffectual, but they also risk damaging a national financial centre's attractiveness to international investors if such financial market actors vote with their feet and take their business elsewhere.

70. For **small and medium-sized enterprises** the altered financial setting and the associated change in bank's business policy, especially with respect to bank lending – traditionally the prime avenue for SME funding – has indeed led to a deterioration in financing conditions. In the wake of increased collateral demands on corporate borrowers, the sector's traditionally low level of capitalisation has increasingly become the Achilles heel of many SME's. This applies especially to smaller firms. Policymakers can make only a limited contribution to solving this problem, however. Besides improving the institutional framework conditions with a view to promoting growth and hence boosting SME's profit retention capacity, a targeted promotion policy in conformity with market conditions should focus above all on improving their access to equity capital. Another concern is that the expected ongoing process of bank consolidation might further exacerbate the financing problems of medium-sized enterprises. This apprehension can be allayed, however, to the extent that neither international experience nor initial empirical results for Germany indicate that the terms of financing of smaller firms necessarily worsen in proportion to the growing size of the lending banks. Rather the results for Germany show that credit institutions apply similar quantitative criteria in their credit standards irrespective of their size and group affiliation.

71. Great importance should continue to be attached to the objective of promoting Germany as a financial centre. In view of the accelerating evolution and growing international integration of these markets, policymakers need to closely monitor market development so that they can respond appropriately and flexibly to changing events and seize new opportunities that present themselves. The introduction of Real Estate Investment Trusts (REITs), a form of collective investment in real estate assets that is superior to the traditional mutual real estate funds in Germany, would be a fine example if it proves possible to find a satisfactory solution to the as yet unresolved problems associated with tax law.

6. Budget consolidation: plan long-term, act short-term

72. The primary task of budget consolidation is to safeguard the sustainability of public finances, that is to close an existing sustainability gap since this impairs an economy's long-term growth prospects and burdens future generations. This gap can be measured by projecting future general government revenue and expenditure trends based on the current fiscal legislation in a given base year, taking account of pending fiscal and social policy measures. Fiscal policy may be deemed to be sustainable if the present value of the future primary balances of government budgets matches the current level of indebtedness. The primary budgetary balance is the difference between current revenue less expenditure excluding interest expenditure on servicing the public debt. At present public finances are not sustainable. There is a **sustainability gap**, which – owing to the implicit government debt arising from the need to pay for the future non-contributory pensions of public sector employees with civil servant status (*Beamte*) and the pay-as-you-go social security systems – is substantially larger than the explicit general government debt. The future primary balances, based on the legislative *status quo* plus the fiscal and social policy measures already adopted but not yet implemented, fall far short of the amount needed to cover the liabilities arising from the general government debt. Closing the sustainability gap, if spread evenly year for year, requires an annual consolidation volume of at least 1.2 % of nominal GDP. Alone in 2006 this would amount to over 25 billion euro. This is an estimate that is based on optimistic assumptions.

A positive sustainability gap indicates an incontrovertible need for action by fiscal and social policymakers. The policymakers therefore do not have the luxury of deciding whether they will choose to close a sustainability gap by consolidating public finances. They have no choice – they are forced to take action under the intertemporal budget constraint, i.e. the need to balance general government budgets over time. They can choose, however, by what means – cutting expenditure or increasing revenue – they will close the sustainability gap and how they will distribute the consolidation measures over time.

73. How the necessary consolidation measures are spread over time depends on value judgements as to what is fair in both intergenerational and interpersonal terms, which ultimately is a political decision. The further the task of consolidating public finances is postponed into the future, the larger the future adjustment requirement will be. Measures to reduce the sustainability gap should also take account of the cyclical situation. In economic downturns it is advisable to ease the pace of fiscal consolidation. Another factor, finally, which needs to be taken into account is the statutory and contractual borrowing limits stipulated in article 115 of the Basic Law as well as in the European Stability and Growth Pact.

The task of reducing and closing the sustainability gap can be achieved in principle by cutting spending, increasing taxes and social security contributions or by a combination of the two. Growth and employment considerations point to the wisdom of reducing government expenditure. In addition, the reduction of tax concessions should play a key role in the fiscal consolidation process. The German Council of Economic Experts urgently cautions against raising the standard rate of turnover tax for the purpose of budgetary consolidation. This measure should be considered solely in conjunction with a sweeping reform of business taxation or a systemic change and the introduction of a new method of financing the social security systems.

74. In the last legislative period the government did indeed take some steps towards reducing the sustainability gap. Noteworthy examples are the Act to Ensure the Sustainability of the Statutory Pension Insurance Scheme (AR 2004 sections 314 ff.), the Act Modernising the Statutory Health Insurance Scheme (AR 2004 sections 330 ff.) as well as a limited reduction of tax concessions (AR 2004 box 17). Further-going proposals made by the last government to reduce tax breaks and subsidies were regularly blocked by the opposition majority in the upper house of parliament (Bundesrat). Correct and important though these measures were, they do not suffice to attain the long-term aim of budgetary consolidation – closing the sustainability gap – and to comply with borrowing limits stipulated by the European Stability and Growth Pact.

75. The German Council of Economic Experts has repeatedly drawn attention to **long-term** measures aimed at closing the sustainability gap. These primarily comprise

- raising the standard retirement age in the statutory pension insurance scheme from currently 65 years to 67 years through annual increments of one month from 2011 until 2035 (AR 2001 section 260; AR 2002 section 371; AR 2003 section 453);

- changing over from the pay-as-you-go method to a funded cohort model in the long-term care insurance scheme (AR 2004 sections 546 ff.).

This year's Annual Report additionally points to the necessity to apply the benefit restrictions adopted for statutory pensions equally to the non-contributory pensions of public sector employees with civil servant status, as was envisaged in the **Civil Servant Pension Sustainability Act** (*Ver-*

*sorgungsnachhaltigkeitsgesetz***)**. That law envisaged lowering the maximum civil servant pension level over the next 25 years from currently 73.8 % of a recipient's salary to 66½ % and simultaneously setting up a dedicated pension fund for civil servants. The draft law was withdrawn by the last government just before the parliamentary general elections after the Bundesrat had signalled its intention of rejecting it. The new government should re-submit the Civil Servant Pension Sustainability Act to parliament as soon as possible. This is not only required with a view to ensuring equal treatment for ordinary pensioners and retired civil servants, the law would also represent an important step on the way to ensuring sustainable public finances.

76. A **medium-term** contribution to consolidating public finances could be made by resolutely **combating turnover tax evasion**. The receipts lost each year in Germany as a result of turnover tax fraud are estimated at between 15 billion euro and 20 billion euro. This amount of tax evasion results from various forms of turnover tax fraud such as input, chain or carousel fraud; further tax losses ensue from corporate insolvencies or from tax evasion due to illicit working and untaxed final consumption.

The systemic fraud and tax losses associated with input tax deduction in the rendering of intercompany services can be prevented most effectively by technical changes in the method of taxing turnover. In this connection two models for combating turnover tax fraud have been developed and tested by means of business games: a partial modification of the turnover tax system by shifting the tax liability to the service beneficiary (reverse-charge model), and the introduction of an extensive cross-check system coupled with a changeover to the taxation of payments received both on the service input and output side (generalised taxation of actual receipts with cross-checking).

The reverse-charge model is preferable to the generalised taxation of actual receipts with cross-checking. It would substantially curtail both the existing openings for fraud in the case of input tax deduction and tax losses due to corporate insolvencies and so would lead to a significant increase in actual turnover tax receipts. Additional turnover tax revenue amounting to more than 4 billion euro is to be expected already in the first year of a regime switch.

The reverse-charge model cannot be introduced by a single country in isolation. It requires either an amendment to the Sixth EC Directive or at least an exemption authorisation by the Ecofin Council acting upon a proposal from the European Commission. The German government should do all in its power to bring about a regime change in the system of turnover taxation as soon as possible. Combating turnover tax fraud is an imperative requirement not only *per se* but also owing to the contribution it would make towards fiscal consolidation.

77. Besides the long-term and medium-term measures to overcome the sustainability gap, **short-term** consolidation measures are also required. The German Council of Economic Experts forecasts that Germany will record a deficit ratio of 3.3 % in 2006. Savings of around 6 billion euro would suffice to comply with the Stability and Growth Pact already next year. This savings target ought to be achievable. The current macroeconomic situation, at any rate, is no impediment to such a fairly modest consolidation programme. GDP will grow by 1.0 % in 2006 and thus in line with potential growth. Although the output gap remains slightly negative, so that radical consolidation measures would tend to have a procyclical impact, a consolidation volume of around 6 billion euro can hardly be termed radical. On the contrary, the German government could regain some of the lost confidence among consumers and investors if it were to send a clear and credible signal of moving in the direction of fiscal consolidation.

78. The politicians should demonstrate their will to consolidate already in 2006 and show that they also take the reformed Stability and Growth Pact seriously. The amount of 6 billion euro that this would necessitate could be raised in the 2006 tax year simply by cutting turnover tax and income tax breaks according to critieria tests and abolishing the grant to home buyers for new cases (Table 4). This would require, however, speedy **cabinet decisions** and the amendment of the relevant laws to enable the additional revenue to be generated in 2006. In the case of some cuts, e.g. the tax exemption for pay increments for working on Sundays, public holidays and at night or the saver's tax-free allowance (*Sparerfreibetrag*), the changes should be implemented in stages so that the groups of persons affected have time to adjust. The details of cutting income tax allowances were extensively catalogued in the Annual Report 2003/04. This year's report additionally lists measures to include losses in connection with tax deferral models (media or film-based mutual investment funds) through a new section 15b of the Income Tax Act (*Einkommensteuergesetz*).

As an alternative or supplement to abolishing turnover tax and income tax breaks, consideration could be given to cutting financial assistance at central, state and local government level. As the east German states, with the exception of the Free State of Saxony, last year once again made large-scale misappropriate use of the aid granted to them under the Solidarity Pact, another conceivable measure would be to curtail the Basket II resources, as the Council suggested last year (AR 2004 section 646 ff.). There is no shortage of starting points also for short-term budgetary consolidation.

79. Based on the argument of easier political enforceability, calls are frequently made to cut all subsidies, that is all financial aid and tax breaks, across the board by the same percentage according to the **"scatter gun" method**. From an economic point of view such an approach is more than unsatisfactory. Not all subsidies are intrinsically "bad" and therefore to be rejected. Where, for example, subsidies achieve an internalisation of positive external effects – such as in the promotion of basic research – they tend to boost welfare and should therefore be retained. The correct approach from an economic point of view would therefore be a selective, i.e. carefully targeted and criteria-based review of all subsidies.

Table 4

Examples of short-term consolidation measures: additional revenue in 2006

in million euro

Measure	Legal reference	Add. revenue in 2006
Turnover tax		
Taxation at full rate of 16 % from 1.1.2006:		
(1) Horticultural products	sec. 12 (2) Nos. 1 &2 TTaxAct; schedule 2 Nos. 6 to 9	315
(2) Print media	sec. 12 (2) Nos. 1 &2 TTaxAct; schedule 2 No. 49	2.000
(3) Animal husbandry	sec. 12 (2) No. 3 TTaxAct	.
(4) Dental technician services	sec. 12 (2) No. 6 TTaxAct	320
(5) Local public transport	sec. 12 (2) No. 10b TTaxAct	650
Abolition of tax exemption; taxation at full rate of 16 % from 1.1.2006:		
(6) Cross-border air passenger transport	sec. 26 (3) TTaxAct	100
Grant to home buyers		
(7) Abolition for new cases from 1.1.2006	Home Buyers' Grant Act	223
Mineral oil tax		
(8) Abolition of lower rate for agricultural diesel from 1.1.2006	sec. 25b MinOilAct	135
Income tax		
(9) Inclusion of losses arising from tax deferral models	new sec. 15b IncTaxAct	2.500
(10) Abolition of tax exemption for amateur coaches	sec. 3 No. 26 IncTaxAct	600
(11) Reduction of bonuses for working Sundays, public holidays and nights (add. revenue given full abolition: 1.8 bn. euro)	sec. 3b IncTaxAct	400
(12) Deductibility of entertainment expenses limited to 50 %	sec. 4 (5) No. 2 IncTaxAct	25
(13) Taxation of tonnage	sec. 5a IncTaxAct	8
(14) Reduction of commuter's allowance to 0.25 euro and of flat-rate employee allowance to 750 euro	sec. 9 (1) No. 4 IncTaxAct; sec. 9a No. 1 IncTaxAct	820
(15) Reduction of saver's allowance to 1.000 euro	§ 20 Abs. 4 EStG	360
Total additional revenue		**8.456**

Source: Council estimates based on German Finance Ministry estimates

However, the discretion associated with such an approach also leaves scope for misguided decisions made on a subjective or tactical basis with a view, say, to currying favour with particular groups of voters. A case in point was the implicit agreement not to discuss the present tax exemption of pay increments for working on Sundays, on public holidays and at night during the negotiations leading up to the formation of a grand coalition. Seen from this angle, the scatter gun approach does have its attractions. Although it may lead to economic distortions in individual areas, it at least holds out the prospect that a comprehensive reduction of tax breaks and thus a consolidation of public budgets will indeed be achieved. If, therefore, a criteria-oriented approach to fiscal consolidation fails, the scatter gun method should be resorted to as a second-best option. The state premiers Roland Koch and Peer Steinbrück have put forward a corresponding proposal. As the co-authors of the study "Cutting subsidies by consensus" (*Subventionsabbau im Konsens*) they are now ideally placed in the context of the emerging grand coalition – the former as prime minister of the state of Hessen and the latter as Germany's finance minister, to put their own proposals into practice.

Appendix

I. Tables: Forecasts for 2006

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

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

Table A

Key data from the national accounts for Germany[1)]

For 2005 estimates, 2006 forecasts

	2004	2003	2004	2005	2006
	Euro billion	Changes from previous year in %			
Use of domestic product					
Price-adjusted[2)]					
Consumption expenditure, in all		+ 0,1	+ 0,0	- 0,4	- 0,1
Private consumer spending[3)]		+ 0,1	+ 0,6	- 0,3	- 0,2
General government consumer spending		+ 0,1	- 1,6	- 0,6	+ 0,1
Gross fixed capital formation		- 0,8	- 0,2	- 0,8	+ 1,2
Machinery and equipment		- 0,2	+ 2,6	+ 4,2	+ 4,3
Constructions		- 1,6	- 2,3	- 4,6	- 1,5
Other products		+ 3,3	+ 1,8	+ 2,4	+ 4,0
Stockbuilding[4)5)]		+ 0,5	+ 0,5	+ 0,5	+ 0,1
Total domestic demand		+ 0,6	+ 0,6	+ 0,0	+ 0,3
Net exports[4)]		- 0,7	+ 1,1	+ 0,7	+ 0,8
Exports of goods and services		+ 2,4	+ 9,3	+ 5,5	+ 6,3
Imports of goods and services		+ 5,1	+ 7,0	+ 4,1	+ 5,0
Gross domestic product		**- 0,2**	**+ 1,6**	**+ 0,8**	**+ 1,0**
Use of domestic product					
at current prices					
Consumption expenditure, in all	1 725,29	+ 1,4	+ 1,3	+ 0,9	+ 1,2
Private consumer spending[3)]	1 312,53	+ 1,7	+ 1,9	+ 1,1	+ 1,4
General government consumer spending	412,76	+ 0,8	- 0,6	+ 0,2	+ 0,7
Gross fixed capital formation	384,94	- 2,2	+ 0,1	- 0,6	+ 1,1
Machinery and equipment	149,37	- 3,2	+ 1,7	+ 3,4	+ 3,8
Constructions	210,70	- 1,6	- 1,1	- 3,7	- 1,3
Other products	24,87	- 0,2	+ 1,6	+ 1,9	+ 3,7
Stockbuilding[5)]	- 4,04	.	.	.	.
Total domestic demand	2 106,19	+ 1,4	+ 1,5	+ 1,1	+ 1,5
Net exports	+ 109,46	.	.	.	.
Exports of goods and services	842,84	+ 0,9	+ 9,1	+ 6,1	+ 7,2
Imports of goods and services	733,38	+ 2,5	+ 7,0	+ 6,3	+ 7,2
Gross domestic product	**2 215,65**	**+ 0,9**	**+ 2,4**	**+ 1,3**	**+ 1,8**
Deflator					
Consumption expenditure, in all		+ 1,3	+ 1,3	+ 1,3	+ 1,4
Private consumer spending[3)]		+ 1,5	+ 1,4	+ 1,5	+ 1,6
General government consumer spending		+ 0,7	+ 0,9	+ 0,8	+ 0,6
Gross domestic product		+ 1,0	+ 0,8	+ 0,5	+ 0,7
Total domestic demand		+ 0,8	+ 0,9	+ 1,0	+ 1,2
Origin of national product					
Employment (domestic)		- 1,0	+ 0,4	+ 0,1	+ 0,4
Total number of man-hours worked		- 1,4	+ 0,8	- 0,6	- 0,2
Productivity (per hour)		+ 1,2	+ 0,9	+ 1,4	+ 1,3
Distribution of national income					
National income (factor costs)	1 658,32	+ 1,2	+ 3,6	+ 1,6	+ 1,8
Compensation of employees	1 134,49	+ 0,2	+ 0,3	- 0,5	+ 0,5
of which: net compensation of employees[6)]	600,28	- 0,7	+ 2,2	- 0,1	+ 0,5
Property and entrepreneurial income	523,83	+ 3,6	+11,7	+ 6,0	+ 4,5
Disposable income of private households[3)]	1 447,39	+ 2,1	+ 2,1	+ 1,3	+ 1,2
Saving of private households[3)7)] (Ratio of saving of priv. households)	153,84	10,3	10,5	10,7	10,6
Memo:					
Unit labour costs[8)] (Domestic concept)		+ 0,7	- 0,9	- 0,8	- 0,4
Consumer prices (Consumer Price Index 2000 = 100)		+ 1,1	+ 1,6	+ 2,0	+ 2,0

1) Deviations are due to rounding. - 2) Changes against previous year. - 3) Including private non-profit institutions. - 4) Contributions to changes in real GDP (percentage of real GDP in previous year). - 5) Including acquisition less disposition of valuables. - 6) Net wages and salaries. - 7) Disposable income in cluding adjustment for the change in net equity of households in pension funds reserves less private consumption expenditures. - 8) Compensation of employees per employees in relation of gross domestic product (price-adjusted) per persons engaged.

Table B

General Government revenues and expenditures for Germany[1)]

For 2005 estimates, 2006 forecasts

	2004	2005	2006	2005	2006
	Euro billion[2)]			Changes from previous year in %	
Revenue	956,8	961,4	970,5	+ *0,5*	+ *0,9*
of which:					
Taxes	481,2	483,6	493,3	+ *0,5*	+ *2,0*
Social security contributions	395,3	394,8	396,0	- *0,1*	+ *0,3*
Expenditure	1 038,0	1 040,6	1 044,9	+ *0,2*	+ *0,4*
of which:					
Intermediate consumption	89,5	90,3	90,6	+ *0,9*	+ *0,4*
Compensation of employees	168,7	167,8	166,6	- *0,5*	- *0,7*
Income from property (pay out)	62,9	63,8	65,5	+ *1,5*	+ *2,6*
Transfers (pay out)	653,8	655,6	662,6	+ *0,3*	+ *1,1*
Gross capital formation	30,8	30,1	30,2	- *2,0*	+ *0,1*
Others	32,5	33,0	29,5	*X*	*X*
Net lending	- 81,2	- 79,2	- 74,4	*X*	*X*
Memo:					
Expenditure ratio[3)]	*46,9*	*46,4*	*45,8*	*X*	*X*
"Abgaben" - ratio[3)]	*39,0*	*38,6*	*38,5*	*X*	*X*
Financial balances ratio[3)]	*- 3,7*	*- 3,5*	*- 3,3*	*X*	*X*

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

Table C

Forecasts for the Labour Market for Germany[1)]

	2004	2005	2006
		Thousand persons	
Occupied population[2)]	42 713	42 798	42 812
Unemployed persons[3)]	3 931	3 992	3 851
Balance of migrant labour[4)]	86	111	130
Employment (domestic)	38 868	38 917	39 091
Registered unemployment[5)]	4 382	4 890	4 803
of which:			
Former territory of the Federal Republic	2 783	3 269	3 257
New Länder	1 599	1 621	1 546
Hidden unemployment[6)]	1 405	1 236	1 156
of which:			
Former territory of the Federal Republic	912	800	706
New Länder	493	436	450
Memo:			
Subject to social insurance contribution employees[5)]	26 561	26 166	26 008
		Rates (%)	
Unemployment rate[5)7)]	*10,5*	*11,8*	*11,6*
Rate of registered and hidden unemployment[8)]	*13,2*	*14,0*	*13,7*
ILO-Jobless rate[9)]	*9,2*	*9,3*	*9,0*

1) Annual averages. Own estimate for 2005 and 2006; according to definitions of the National Accounts. Deviations are due to rounding. - 2) National concept. - 3) Definitions of the International Labour Organisation (ILO). - 4) Persons engaged (domestic concept) less persons engaged (national concept). - 5) Source for 2004: Federal Labour Agency (Bundesagentur für Arbeit, Nürnberg). - 6) Public employment programs, early retirement programs, full-time participants in further education programs and retraining courses subsidised by the Federal Labour Office, participants in German language courses, subsidised shorttime workers (number of persons calculated as equivalent to unemployment). - 7) Definitions of the Federal Labour Agency (Bundesagentur für Arbeit). - 8) Registered and hidden unemployment in per cent of labour force (national concept). - 9) Unemployed person in percent of labour force; definitions of the unemployed based on the ILO concept.

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

Dated August 14, 1963 (Federal Law Gazette I, page 685)

The Bundestag has enacted the following Law:

Article 1

(1) For the purpose of periodically assessing economic developments in the German Federal Republic, and to assist all authorities responsible for economic policy as well as the general public in forming a sound opinion, a Council of independent Experts is herewith being established.

(2) The Council of Experts consists of five members, who must possess a specialised knowledge of economic science and be experienced in matters of economic policy.

(3) The members of the Council of Experts must not be members of the Government or any legislative body of the Federal Republic or of the Laender, or of the public service of the Federal Republic, of a Land or of some other corporate body under public law, except as a university teacher or an assistant at an institute of economic and social science. Furthermore, they must neither be representatives of any trade organisation, association of employers or trade union, nor may they be bound to them by any permanent contract of employment or agency agreement. Moreover, they must not have held any position of that kind during the year preceding their appointment to the Council of Experts.

Article 2

In its Annual Report the Council of Experts will describe the current economic situation and its foreseeable development. The Council will investigate the possibilities of simultaneously assuring, within the framework of the free market economy, stability of the price level, a high rate of employment and equilibrium in foreign trade and payments, together with steady and adequate economic growth. The investigation will also include the formation and distribution of income and property. The Council of Experts will point out, in particular, the sources of actual and likely tensions between overall demand and supply which endanger the objectives referred to in the second sentence of this paragraph. The investigation is to be based on various assumptions, the different effects of which are to be described and analysed. The Council of Experts will point out undesirable developments and the possibility of avoiding or suppressing such developments, without, however, recommending any specific measures of economic and social policy.

Article 3

(1) The Council of Experts is only bound by the mandate set forth in this law; it is independent in the performance of its work.

(2) If, in the preparation of the report, a minority differs on specific questions, it has the right to express its disagreement in the Report.

Article 4

Before drafting its reports, the Council of Experts may give persons it considers qualified, in particular representatives of economic and social organisations, an opportunity to express their views on essential questions arising within the scope of its commission.

Article 5

(1) If the Council of Experts considers it necessary for the execution of its commission, it may hear the competent Federal Ministers and the President of the German Bundesbank.

(2) At their request, the competent Federal Ministers and the President of the Bundesbank will be heard.

(3) The authorities of the Federal Government and the Laender will furnish the Council of Experts with administrative support.

Article 6

(1) The Council of Experts prepares a report every year (Annual Report) and presents it to the Federal Government by November 15th. The Annual Report is submitted promptly by the Federal Government to the legislative bodies and is published by the Council at the same time. Within eight weeks the Federal Government presents its comments on the report to the legislative bodies. In this statement, the Federal Government presents the conclusions to which it has come with regard to economy policy.

(2) The Council of Experts has to elaborate additional reports whenever there are developments in individual fields which are likely to endanger the objectives referred to in the second sentence of Article 2. The Federal Government may commission the Council of Experts to submit additional reports. The Council of Experts presents the reports in accordance with sentences 1 and 2 to the Federal Government and publishes them; with regard to the date of publication the Council comes to an understanding with the Federal Minister for Economic Affairs.

Article 7

(1) The members of the Council of Experts are nominated by the Federal Government, and appointed by the President of the Federal Republic. On March 1 of every year -the first time after the end of the third year subsequent to the submission of the first report according to Article 6, Paragraph (1), first sentence- one member will withdraw from the Council. The order of withdrawal will be settled by lot at the first session of the Council of Experts.

(2) After nomination by the Federal Government, the President of the Federal Republic will appoint a new member for a period of five years. Re-appointments are allowed. The Federal Government will hear the members of the Council of Experts before nominating a new member.

(3) The members have the right to retire by giving notice to the President of the Federal Republic.

(4) If a member retires before the end of his term, a new member will be appointed for the remaining time. Paragraph (2) will apply accordingly.

Article 8

(1) Resolutions of the Council of Experts must be approved by at least three members.

(2) From among its members, the Council of Experts elects a chairman for a period of three years.

(3) The Council of Experts will establish rules of procedure.

Article 9

The Federal Statistical Office assumes the function of an office of the Council of Experts. Its work will consist in procuring and gathering source material, attending to the technical preparation of the Council of Experts` sessions, printing and publishing the Council's reports, and performing such other administrative work as may be required.

Article 10

The members of the Council of Experts and the staff of its office are bound to secrecy concerning the Council's conferences and the data of these conferences labelled as confidential by the Council of Experts. The duty of secrecy applies also to information received by the Council of Experts and labelled as confidential.

Article 11

(1) The members of the Council of Experts will receive lump sum remuneration as well as reimbursement of travelling expenses. The amounts to be paid will be determined jointly by the Federal Minister for Economic Affairs and the Federal Minister of the Interior.

(2) The remuneration and expenses of the Council of Experts will be borne by the Federal Government.

Article 12

According to Article 13, Paragraph (1), of the Third Law for the Transference of Burdens and Covering Resources to the Federal Republic, of January 4, 1952 (Federal Law Gazette I, page 1), this Law applies to the Land Berlin as well.

Article 13

This Law becomes effective on the day following its announcement.