GERMAN COUNCIL
of Economic Experts

CONFLICTING INTERESTS – MISSED OPPORTUNITIES

Annual Report 2006/07

First chapter

CONFLICTING INTERESTS – MISSED OPPORTUNITIES

Annual Report 2006/07

Summary

(First Chapter)

November 2006

The complete report is published in German under the title:

„Widerstreitende Interessen – Ungenutzte Chancen"

and may be obtained (order number: 7700000-07700-1; ISBN 978-3-8246-0795-2) 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 2006/07. 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:

I. Summary: Conflicting interests – missed opportunities

II. The course of economic development in 2006 and 2007

III. Global imbalance: adjustment underway

IV. Monetary policy: on track

V. Social security: light and shade

VI. Fiscal policy: a mixed picture

VII. Labour market: further action required despite change for the better

The data used in the report of the Council were the latest available in end-October 2006.

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.

At the time when the 2006 report was submitted the members of the Council were

Peter Bofinger **Wolfgang Franz** **Bert Rürup** (Chairman)

Beatrice Weder di Mauro **Wolfgang Wiegard**

Address: Sachverständigenrat zur Begutachtung der
gesamtwirtschaftlichen Entwicklung
Statistisches Bundesamt
D-65180 Wiesbaden
Germany

Phone: +49 / 611/ 75 2390 / 3640 - Office
+49 / 611/ 75 2762 - Secretary general: Stephan Kohns
Fax: +49 / 611/ 75 2538
E-mail: srw@destatis.de
Internet: http://www.sachverstaendigenrat.org

FIRST CHAPTER

Conflicting interests – missed opportunities

Conflicting interests – missed opportunities

1. Around one year ago the new grand coalition government entered office with a resolute air and an **ambitious agenda**. Rarely has a government been able to commence work on such a wave of popular support and expectation, additionally buoyed by an unexpectedly fast brightening of the economic horizon. The promptly taken decision to raise the statutory retirement age and the rapid conclusion of the first stage of the reform of Germany's federal structure nurtured hopes of speedy advances in the key economic policy fields identified in the coalition agreement (*Koalitionsvertrag*), namely the healthcare system, business taxation and the labour market. To date, however, these hopes have been largely disappointed. Despite the robust macroeconomic momentum, the initiatives launched in these important policy areas have got bogged down in the mire of conflicting interests.

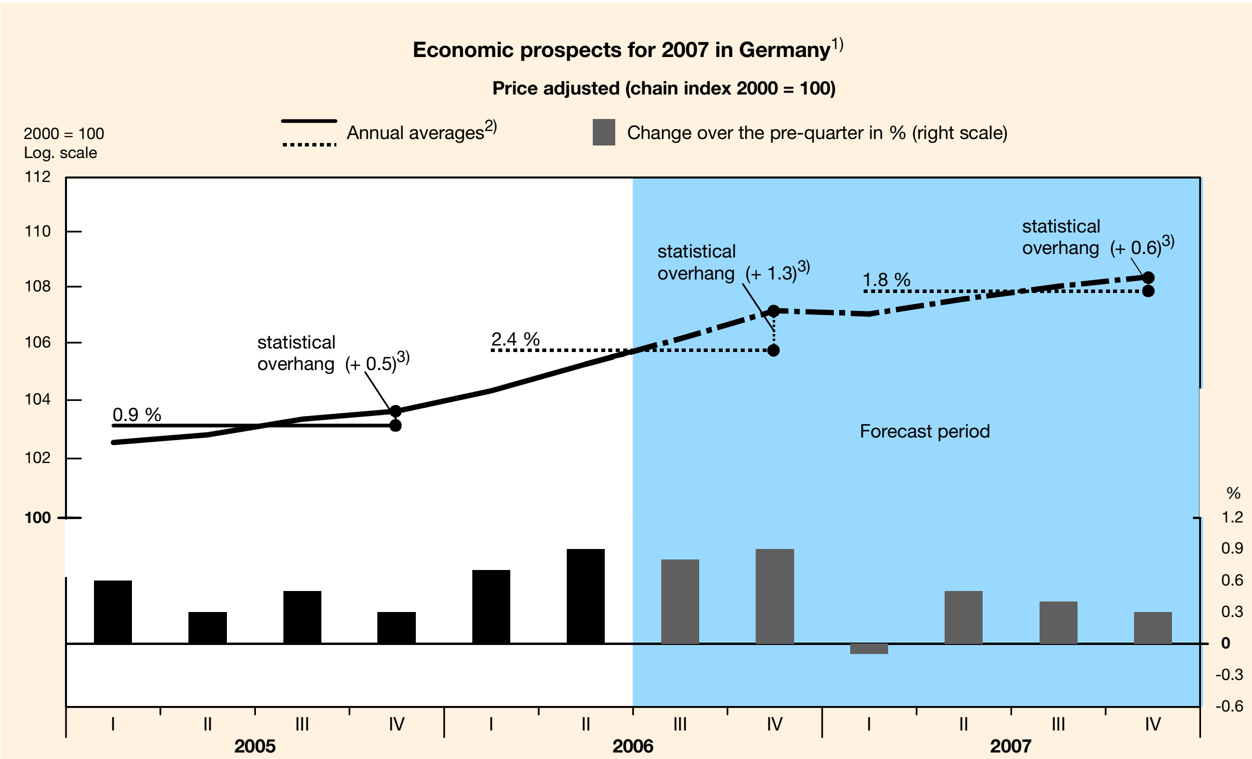
2. A case in point is the adopted reform of the **method of funding the healthcare system**. The central elements of an effective reform should have been the creation of a single healthcare market for the statutory health insurance scheme (*Gesetzliche Krankenversicherung*) and the private health insurance scheme (*Private Krankenversicherung*) as well as the decoupling of health insurance contributions from labour income. The respective original reform concepts of the coalition partners, the "citizen assurance" (*Bürgerversicherung*) on the one hand and the "healthcare premium" (*Gesundheitsprämie*) on the other, each contain one of these elements as an integral component – in the case of the citizen assurance, favoured by the Social Democratic Party (SPD), the single healthcare market and in the case of the healthcare premium, advocated by the Christian Democratic Union (CDU) and the Christian Social Union (CSU), an extensive decoupling of health insurance contributions from labour income – whereas the other element was vehemently rejected in each case. Yet the compromise that was finally arrived at in the course of tortuous negotiations, namely the establishment of a healthcare fund (*Gesundheitsfonds*), far from combining the best of both worlds, which one would have hoped for, contains none of the requisite features of an appropriate reform. Moreover, the healthcare fund was so dismally designed that it has been stripped bare of its remaining advantages. If the agreed concept is implemented as planned, therefore, the outcome will actually be a worsening vis-à-vis the *status quo*.

Given this disheartening development, it seems almost churlish to point out that the urgently needed reform of the statutory long-term care insurance scheme (*Soziale Pflegeversicherung*) has not yet even been begun. Conversely, the progress made in the field of pension reform deserves praise. The government's track record in the fields of tax policy and labour market policy – insofar as inchoate policy measures can be inferred from the current state of the discussion – is equally as patchy as in the field of social security. Regarding the reform of business taxation and the low-wage sector there is some hope, however, that the German government will be able to break free of the current stranglehold of party political vested interests and to find both cogent and effective answers.

3. The rather disappointing implementation balance to date of the reforms adumbrated in the coalition agreement is particularly regrettable in that the year 2006 not only offered politically **propitious conditions** for far-reaching and path-breaking measures in the principal economic policy areas but also that the underlying economic climate developed more favourably than it had done for many years.

Although the growth rate of gross domestic product (GDP) will decline from 2.4 per cent in 2006 to 1.8 per cent in 2007 (Chart 1), this deceleration is largely attributable to the raising of value added tax (VAT) by 3 percentage points as of 1 January 2007 and should not be seen as an indication that the economic upturn has already passed its peak. The underlying momentum of the upswing in 2006 will be affected less and the improvement on the labour market will continue. Hence the general economic parameters will remain favourable in 2007 and so cannot be used as an excuse for further dilly-dallying and shilly-shallying. If the required policy measures are not launched in the coming year, they will not get off the ground at all during the current legislative period, which will harm both the economy and the country.

Chart 1



1) Quaterly values: seasonal adjusted (Census X-12-ARIMA).– 2) Changes over previous year.– 3) Percentage difference between the absolute level of the gross domestic product in the last quarter of the year *t* and the average level of the quarters in the year *t* (see JG 2005 box 5).

I. The course of economic development in 2006 and 2007

4. In 2006 the cyclical recovery, which hitherto had been fuelled largely by external demand, at last significantly stimulated the domestic economy, too. The main causes of the unexpectedly strong **growth of gross domestic product** by 2.4 per cent, apart from the persistently buoyant export trend, were private investment and, although exaggerated by exceptional factors, private consumption (Table 1). It was particularly gratifying to see the cyclical revival spread to the labour market, where it was reflected not just in a decrease in unemployment by 330,000 persons to 4.53 million registered unemployed but also notably in a rise of regular employment subject to full social security contributions by 0.3 per cent to 26.3 million persons, after this figure had declined in 2005 by 1.2 per cent or nearly 325,000 persons.

Table 1

Key economic data for Germany

	Unit	2003	2004	2005	2006[1]	2007[1]
Gross domestic product	%[2]	*-0.2*	*1.2*	*0.9*	*2.4*	*1.8*
Total domestic demand	%[2]	*0.6*	*0.0*	*0.5*	*1.8*	*1.0*
Investment in machinery & eq.	%[2]	*-0.1*	*4.2*	*6.1*	*6.9*	*6.0*
Construction investment	%[2]	*-1.6*	*-3.8*	*-3.6*	*2.5*	*1.7*
Other investment	%[2]	*2.5*	*1.2*	*4.7*	*4.1*	*3.5*
Consumption expenditure	%[2]	*0.0*	*-0.3*	*0.2*	*0.9*	*0.3*
Private housholds[4]	%[2]	*-0.1*	*0.1*	*0.1*	*0.9*	*0.3*
General government	%[2]	*0.4*	*-1.3*	*0.6*	*0.9*	*0.5*
Exports of goods and services	%[2]	*2.4*	*9.6*	*6.9*	*10.2*	*6.6*
Imports of goods and services	%[2]	*5.4*	*6.9*	*6.5*	*9.9*	*5.3*
Employment (domestic)	million	38.72	38.88	38.82	39.05	39.30
Registered unemployed	million	4.38	4.38	4.86	4.53	4.27
Employees[5]	million	27.01	26.56	26.24	26.33	26.62
Unemployment rate[6]	%	*10.5*	*10.5*	*11.7*	*10.9*	*10.2*
Consumer prices[7]	%[3]	*1.1*	*1.6*	*2.0*	*1.7*	*2.3*
General government balance[8]	%	*-4.0*	*-3.7*	*-3.2*	*-2.2*	*-1.5*

1) 2006: own estimate, 2007: 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 2003 to 2005, 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.

5. Driven by the dynamic momentum of the global economy, which in the current year also reached the euro area, **foreign trade** again made a significant contribution to the pleasingly high rate of growth of gross domestic product in 2006. With imports and exports both expanding strongly, the net share of foreign trade in GDP amounted to 0.6 percentage point compared with 0.4 percentage point in 2005. This strong external growth, which has persisted for several years now, has meanwhile led to a perceptibly higher level of capacity utilisation, especially on the part of export-oriented enterprises, and obliged firms to expand their production plant in 2006.

6. **Investment in machinery and equipment** consequently grew at the faster rate of 6.9 per cent. A noticeable feature is that the revival of investment spread increasingly to domestically oriented firms. This was presumably aided not only by impulses from abroad and temporarily improved depreciation facilities but also by the balance sheet restructuring measures undertaken by firms in the preceding years. This enabled many enterprises to finance investment out of their own cash flow or, thanks to better credit ratings, via comparatively inexpensive loans.

7. A remarkable turnaround occurred in **construction investment**. It increased by 2.5 per cent and for the first time since 1999 made a positive contribution to growth. While the increase by

4.4 per cent in commercial construction no doubt reflects not least the expansion of capacity and thus the positive development of investment in machinery and equipment, the rise of 2.3 per cent in housing construction was largely due to exceptional factors. It was boosted by the abolition of government subsidies for home owners in new cases from 1 January 2006, which led to a rise in building permits and in the further course of the year to the realisation of construction projects, by promotional programmes for constructional energy-saving measures, by anticipatory effects triggered by the looming increase in turnover tax and, to a lesser extent, by the extended tax-deductibility of home improvement measures and other services rendered for households.

8. Exceptional factors likewise played an important role in the increase in **private consumption** by 0.9 per cent. A noteworthy influence in this respect, especially in the second half of the year, was the advancement of purchasing plans ahead of the announced raising of turnover tax by 3 percentage points on 1 January 2007. In addition, the revival on the labour market and the associated decline in the risk of unemployment are likely to have had a positive impact on consumption. As the growth of negotiated wages and salaries remained flat, disposable incomes likewise increased comparatively moderately, with the result that the increase in private consumption expenditure was partly financed by a fall in the national saving ratio.

9. The economic recovery eased the pressure on **public finances**. Tax revenue increased surprisingly robustly, with receipts from profit-related taxes, in particular, surging steeply. As government expenditure remained on a moderate path, growing more slowly than nominal gross domestic product, the general government deficit ratio declined from 3.2 per cent in 2005 to 2.2 per cent in 2006.

The revenue side of the **social security systems** likewise improved, but this was chiefly attributable to exceptional effects such as the increase in the central government grant to the statutory health insurance scheme and the advancement of the monthly deadline for paying contributions. In the case of the statutory unemployment insurance scheme (*Arbeitslosenversicherung*) expenditure was also curtailed sharply, so that, together with a newly introduced central government grant in this social security system, it will be possible to cut the contribution rate in the coming year from 6.5 per cent to 4.5 per cent or even less.

10. The development of **consumer prices**, which increased in 2006 by 1.7 per cent, was largely determined by the increase in oil prices – especially in the third quarter of 2005 and the first quarter of the current year. Overall, however, domestic price pressures remain subdued. Despite a growing pass-through of energy prices to downstream levels, there are at present no indications of second-round effects, as the wage trend remained exceptionally moderate in 2006. The monetary policy stance remained slightly expansionary, but shifted increasingly towards a neutral course.

11. Germany's economic performance in 2006 was thus remarkably positive. Gross domestic product grew faster than at any time since 2000 without generating any noticeable inflationary pressure, and the cyclical recovery at last spread to the domestic sector and the labour market. The macroeconomic momentum clearly exceeded the projections made in autumn 2005 and up to the start of the current year. The considerable gap between forecast and actual growth is attributable to several factors which caused the extent of the cyclical recovery to be underestimated.

- The expected slowing of global economic expansion did not occur; instead, the dynamic development seen in the year 2005 continued.

- The progressively rising oil price trend over a number of years, which in 2005 and at the start of 2006 experienced a further upward thrust, depressed overall economic activity less than in previous periods of high oil prices. This was caused by two factors. Firstly, the price rise was less sudden compared with previous price shocks and also largely demand-driven, with the result that the rising cost of energy was partly offset by a high foreign demand for goods and services. Secondly, quite apart from the aforementioned factor, the German economy seems to respond less elastically to changing oil prices today than in the past.

- The statistics concerning GDP growth and key aggregates for the year 2005 were revised in mid-2006, in some cases substantially. The revised figures indicate a more dynamic development for 2005 as a whole, which inevitably also led to faulty projections for 2006 as well.

- In addition, it may be assumed that the reforms which have been set in train during the past few years, for example concerning tax legislation or the labour market, took full effect for the first time during the current upturn.

- Another factor was the fiscal initiatives taken after the change of government (economic stimulus programme and VAT rise) which the forecasts made in autumn 2005 obviously could not take into account.

12. Although clearly restrictive impulses may be expected to emanate from fiscal policy in 2007 as a result of the increase in the standard rate of turnover tax and insurance tax each by 3 percentage points and the further curbing of tax breaks, the **outlook for 2007** indicates that the underlying dynamics of economic activity are unlikely to falter in the year ahead. Rather, the conditions are in place for an ongoing – albeit somewhat more muted – upturn, as the German economy will move into the new year with a well filled order book and a remarkably buoyant momentum. The commercial situation of companies went on improving into the fourth quarter of 2006. Firms' business expectations in the autumn of 2006, notwithstanding the decline during recent months, is still clearly above the average of the past few years, and survey results indicate that not only will the volume of both exports and investment expand perceptibly but also that, in addition, the growth of employment will continue next year.

Nevertheless, the trend in domestic demand will slacken during the forecast period owing to the restrictive fiscal policy setting. Private consumption and housing construction will both see demand weaken in 2007 as some planned expenditures were brought forward to 2006 so as to forestall the VAT rise, which, taken by itself, will slow the growth of gross domestic product by just under 0.2 percentage point. A far greater impediment will be presented by the erosion of purchasing power caused by the increase in turnover tax which *per se* will depress the development of private consumption expenditure by around 1 percentage point. In the aggregate, therefore, private consumption will offer little support to economic momentum in the coming year with a likely rise of 0.3 per cent. By contrast, investment in machinery and equipment will again expand substantially by 6.0 per cent. Besides the bright outlook for export business, this will be propelled by the favourable profit situation during the past few years. In the wake of a robust increase in investment in machinery and equipment, industrial and commercial construction investment will likewise go up in the year ahead, even if at a slower rate. The dynamic global environment will once again contribute positively to economic development in Germany. Although exports will grow less strongly than they have this year owing to the slight cooling of the global economy, import growth will decelerate more owing to a slackening of domestic demand. Consequently, foreign trade will make a net contribution to growth of 0.8 per cent. **Gross domestic product** will expand by 1.8 per cent altogether in 2007.

Boosted by the continuing economic recovery, the level of employment will carry on increasing in the coming year, not least in the "regular" employment segment comprising jobs subject to full social security contributions, and will thus help to cushion the foreseeable burdens on real disposable income. The number of persons registered as unemployed will fall further to 4.27 million. The contribution rates to the statutory health insurance scheme and the statutory pension insurance scheme (*Gesetzliche Rentenversicherung*) will rise, in part because of lower grants from the central government budget, whereas the general government deficit ratio will be cut appreciably to 1.5 per cent, not least on account of the increase in indirect taxes.

13. The world economic setting in general and the cyclical trend in Europe in particular remain crucial conditions for a continuation of the recovery in Germany. The slightly slower growth of global output assumed in the forecast from 3.9 per cent to 3.4 per cent next year is based on the realistic assumption that there will not be an abrupt correction of the current account imbalances which have accumulated in the last few years. The assumption for the euro area is that the monetary policy setting will shift to a broadly neutral course in keeping with the European Central Bank's strategy, so that the monetary framework will pose no obstacle to a continuing robust upturn.

14. For some years now the world economy has been witnessing **sharply growing current account balances** of individual countries and economic zones. The United States is the most prominent deficit country with a current account minus of almost 890 billion US dollars in 2006. Particularly large surpluses have been run up by a number of Asian states, especially Japan and China, in the oil-producing countries and in Germany. These developments have been accompanied by a huge increase in global foreign exchange reserves, although the growth is concentrated on a small number of countries situated mostly in Asia. Given the German economy's heavy reliance on foreign trade, this raises the question of whether this constellation, which is frequently and aptly referred to as a "**global imbalance**", might lead to a strong depreciation of the US dollar, a massive world economic slump or to a combination of both, which would then impact adversely on enterprises and jobs in Germany.

15. The analysis reveals that a large part of these imbalances has been caused by economic policy decisions in the United States. After the cyclical downturn in 2001 had been overcome, US monetary and fiscal policy was clearly too expansionary. While the deficit, via its demand effects, pushed the current account into the red, the very low key interest rates set by the Federal Reserve triggered a real estate boom and an unusually high level of new borrowing by households.

These developments would soon have come up against their natural limits had it not been for the willingness of the **Asian central banks** to finance the deficits, which were associated with a strong US domestic economy and a growing oil bill. Contrary to the popular assertion, the inflows of capital into the United States are not so much a reflection of the strong competitiveness of US firms as the desire of the Asian countries to prevent their national currencies from appreciating vis-à-vis the US dollar in order to protect their domestic export industry. As a result, the expansionary US economic policy was transmitted to the world economy, which is part of the explanation for the exceptionally robust global dynamics by historical standards in the years 2004 to 2006. In turn, this drove up oil prices and led to sharply rising current account surpluses in the oil-producing countries. On the other hand, the real economic recycling of the additional oil revenues by the oil-exporting countries will accelerate further in the coming years and thus help to reduce the imbalances.

Even though the net external indebtedness of the United States is not yet a cause of major concern, it is inconceivable that the US economy could sustain a current account deficit of over 6 per cent of nominal GDP indefinitely. This would require US households to maintain their exceptionally high propensity to incur debt in the future. This is unlikely, however, given the tightening of US monetary policy to what may be regarded as a neutral level and the waning of the real estate boom.

Whereas the US Federal Reserve Bank has already made its contribution to balanced economic growth in the United States, US fiscal policy needs to further consolidate public finances. In view of the current cyclical risks, the process of fiscal consolidation should not be achieved abruptly but rather over an extended period of time.

An **appreciation of the currencies in Asia**, especially of the Chinese Yuan, would substantially facilitate a smooth reduction of the global imbalances and for this reason has repeatedly been called for by international bodies. Given the vested national interests of the countries concerned, however, they have no direct incentive to pursue a more flexible exchange rate policy. The experience of the 1970s shows that stronger regional cooperation in the field of exchange rate policy can lay an important foundation for moving away from a one-sided orientation to the US dollar.

16. Although a reduction of the imbalances is ultimately unavoidable, it should be pointed out, with regard to the implications of the global setting for the German economy, that it is uncertain whether this reduction will begin already in 2007. In addition, there is a consensus that the most likely baseline scenarios for a reduction of the imbalances imply **comparatively small risks** for the course of economic development in Germany. Even so, economic policymakers should also be prepared to face risk scenarios characterised by a massive appreciation of the euro against the US dollar or by a sharp recession in the United States. On the one hand, this would call for action by the European Central Bank, which in the past, too, has shown itself ready to intervene in the foreign exchange market in order to stabilise "disorderly conditions". On the other hand, German fiscal policymakers have the advantage that the national deficit ratio is again comfortably below the 3 per cent ceiling laid down by the Maastricht Treaty, so that they would be in a position, in the event of a pronounced cooling of the global economy and the associated danger that the German economy might slide into recession, of allowing the automatic stabilisers to take effect and, if need be, also to take discretionary measures to stabilise the economy.

17. By virtue of setting monetary policy for the euro area, the **European Central Bank (ECB)** has an important influence on the macroeconomic conditions of Germany. In 2006 the ECB maintained its stability-oriented monetary policy in an environment characterised by uncertainty. The goal of price level stability – defined by the European Central Bank as a rate of price increases of below but close to 2 per cent – was again marginally overshot. The average inflation rate was 2.2 per cent, however, this was caused mainly by the sharp rise in oil prices which continued until the middle of the year. The European Central Bank tightened monetary policy in the course of 2006, but on balance it remained slightly expansionary. This is borne out both by the persistently low real interest rate level, the high rates of monetary and credit growth as well as by the Monetary Conditions Index figures and estimations of a Taylor rule.

The **two-pillar strategy** of the European Central Bank has frequently been criticised and there were calls for a change of strategy to inflation targeting. Any discussion on the merits of a strategy change should start with the observation that the ECB has been highly successful in anchoring inflation expectations at or around the defined level of price stability. Communication within the two pillar strategy has been difficult during phases when the signals from the two pillars were divergent. Despite this the ECB has managed to build up a high level of credibility. Consequently, the proponents of switching from the two-pillar strategy towards inflation targeting now have a harder case to make. Any change of strategy would have to be associated with clear advantages and must under no circumstances jeopardise credibility.

In view of the European Central Bank's successful stability track record to date and the large area of common ground shared by the two-pillar strategy and the strategy of inflation targeting, the German Council of Economic Experts (*Sachverständigenrat*) does not recommend an explicit change of strategy. Instead the strategy should be modified in such a way as to maintain it's advantages and reduce it's disadvantages in communication.

Recent empirical studies confirm the ability of monetary indicators to predict future price developments and strengthen the case for maintaining the monetary pillar. Furthermore, the monetary analysis can provide information on risks to the stability of the financial markets, which means that, over and above the objective of price level stability, it provides an important additional dimension to the monetary policy decision-making process.

However, the European Central Bank should also harness the advantages of inflation targeting by further focusing its external communication on inflation forecasts. Transparency concerning the role of the monetary analysis could be increased by publishing monetary inflation forecasts on a regular basis. The main communication problem arises when the monetary analysis is interpreted too narrowly by reducing it to a simple comparison of money growth and the reference value for M3 growth. This could be resolved by abolishing the reference value and eventually, replacing it with a monetary inflation forecast. Demands to increase the transparency of the decision-making process by publishing the minutes of ECB Governing Council meetings should be rejected.

In many countries, including within the euro area, **real estate prices** have risen markedly during the past few years. Even if the development in the euro area as a whole does not signal any direct threat from asset price bubbles, the risk that such bubbles may form does exist in some countries. Asset price bubbles pose major challenges to central banks as they are not easy to identify and, should they burst, could entail serious negative consequences for the real economy. In principle, the European Central Bank's strategy offers a flexible and appropriate analytical framework for identifying and responding to longer-term risks. In order to safeguard the overall stability of the financial system, however, prudential measures offer a suitable starting point.

II. Patchwork approach rather than a cogent concept

18. The coalition negotiations in the autumn of 2005 were characterised by the desire of the government parties to abandon the entrenched confrontational positions which they had occupied during the election campaign in a quest for common ground; and the indisputably **far-reaching reform agenda** in the areas of healthcare, business taxation and, though less ambitious, the labour market which was formulated in the coalition agreement of 11 November 2005 was aimed for the most part in the right direction. The ability to make swift decisions on such hotly disputed issues as raising the statutory retirement age to 67, introducing job-based parental benefit (*Elterngeld*) or the first stage of reforming Germany's federal structure initially justified the public faith that was placed in the new German government and nurtured hopes that this grand coalition would tackle the outstanding economic policy tasks with the same vigour and rigour as the previous grand coalition during the years 1966 to 1969 had set out to tackle the problems at that time.

19. In the second half of 2006 it became increasingly apparent that the German government is pursuing a zigzag course, caused by conflicting party political interests, in the three major areas of economic policy reform and is progressing very fitfully without pursuing any recognisable strategy. The reform of the method of funding the statutory health insurance scheme was a misguided decision; other decisions were put off, and even the outlines of the announced reforms remained vague. No consensual and convincing concepts in the field of business taxation or for a reform of the low-wage sector have been placed on the table so far. For some time now it has been evident that the policymakers' actions haven been dictated primarily by the search for (party) politically opportune compromises and hence solutions based on the lowest common denominator. If the progress actually made in the key economic policy reform fields is measured against that which could and should have been achieved, it emerges that in the grand coalition's first year of office the opportunity presented by the change of government to make rapid advances in major areas of economic policy has not been seized with both hands.

1. Social security: light and shade

20. Welcome steps in the field of the social security systems, which notably include raising the statutory retirement age, lowering the contribution rate to the unemployment insurance scheme and also the expenditure-side reforms in the statutory health insurance scheme, are counterbalanced by the misdirected and ultimately counterproductive reform of the financing-side of the statutory health insurance scheme. The urgently needed reform of the long-term care insurance scheme has not even been placed on the agenda to date. Further action, or rather fine-tuning, is required in connection with calculating pension adjustments as well as in the areas of surviving dependants' benefits (*Hinterbliebenenversorgung*) and the retirement pension arrangements of the self-employed.

21. The key aims of the **healthcare reform** of 2006 ought to have been

- to swiftly decouple healthcare spending from wage costs with a view to improving employment and hence growth prospects;

- to take concrete steps towards overcoming the segmentation of the health insurance market according to income and profession which is distorting competition in the healthcare market and promoting a two-class system of medical care;

- to intensify competition among healthcare service providers so as to boost efficiency and hence generate cost savings;

- to promote "genuine" competition between the individual health insurance schemes by creating an entrepreneurial framework in which they would have to vie with one another on the basis of their service profile and performance for the favour of healthy and sick insurees by means of innovative insurance solutions and efficient healthcare management.

22. Some **expenditure-side** measures that are to be **welcomed** include the reform of the method of remunerating self-employed medical practitioners, the reorientation of hospitals towards greater outpatient treatment or the expanded contractual freedom granted to the health insurance institutions (*Krankenkassen*); these are steps towards greater transparency and keener competition in the healthcare system. The same applies to permitting mergers between different kinds of healthcare institutions and the introduction of commercial accounting for health service institutions.

The agreements designed to reform the **private health insurance scheme** are, by contrast, less convincing. The inefficient segmentation of the healthcare market through the defined earnings threshold (*Versicherungspflichtgrenze*), below which membership of the public health insurance scheme is mandatory, will remain in place, and only a half-hearted attempt was made to resolve the problem of the portability of private insurees' provisions for higher healthcare costs with advancing age (*Alterungsrückstellungen*), which is crucial to intensifying competition within the private health insurance scheme. The introduction of a minimum service rate (*Basistarif*) in the private health insurance scheme covering the same range of healthcare services offered by the statutory health insurance scheme and open to anyone, regardless of their individual health risks, is to be welcomed in principle; however, in itself this still does not achieve genuine competition both within the private health insurance scheme and between the private and public health insurance schemes and also fails to overcome the segmentation of the health insurance market according to income and profession.

23. The **reform of the method of funding the statutory health insurance scheme** must be labelled a failure. Introducing a reform which purports to lower wage-related contributions by instead substantially raising contribution rates is an admission of political bankruptcy, particularly as this rise was largely necessitated by the fact that the central government grant newly introduced in 2004 to finance non-insurance-related benefits (*versicherungsfremde Leistungen*) – a move which was fully in line with the principle of a market-based macro-policy framework (*Ordnungs-politik*) – has been cut back and will be replaced from 2008 onwards by a new central government grant to finance non-insurance-related benefits. As a result of this stop-go policy course, €6.6 billion of tax resources will be siphoned off from the statutory health insurance scheme up to the end of the current legislative period compared with the legislative *status quo* prevailing in 2005. Thus the increased contribution rates are in effect a special wage tax levied on members of the statutory health insurance scheme for budget balancing purposes. The political decision-makers would be well advised to reverse the agreed curtailment of this central government grant.

The linchpin of the plan to reform the financing side, the **healthcare fund**, in which the contributions to the individual health service institutions are to be collected and then, together with tax resources in the form of flat-rate cost allowances, distributed to the individual health service institutions, is superfluous in its present form. Even worse, if implemented as agreed by the coalition partners in October it will have a highly distorting effect on competition and will actually constitute a retrograde step. This concept must therefore be rejected in its present form. As the starting date has been postponed to 1 January 2009, there is, however, an – albeit fragile – hope that some of the key aspects of the fund model might be sufficiently modified to produce a financing alternative that represents an improvement on the *status quo*. This could even create an opportunity in the medium term to change over to the concept of a ”citizen allowance”, which is superior from an employment and growth perspective (Annual Report 2004 sections 510 ff.). This would require, however, that

- the contributions are not collected, as originally envisaged, by the individual health service institutions but instead are transferred direct to the fund,

- the share of health institution spending financed from wage-related contributions is reduced and that correspondingly rising additional contributions are levied in the form of non-income-related *per capita* amounts which would be different for each health service institution but would not affect the structure of insured persons,

- both the social equalisation component (*sozialer Ausgleich*) required according to the level of the *per capita* amounts and the health insurance cover for children are financed out of tax resources to be transferred to the fund.

24. The **statutory long-term care insurance scheme** is the social security system which is most urgently in need of reform both on the benefits side and on the financing side. It is concurrently the scheme that has been the most woefully neglected by the political decision-makers.

Requirements on the benefits side include not only better provision for dementia sufferers but also the dynamisation of the flat-rate nursing allowances and, to ensure that nursing care at home is no longer placed at a disadvantage, a convergence of the flat-rate benefit rates for inpatient and outpatient nursing care.

As right as it was to set up a statutory long-term care insurance scheme in Germany, it was equally wrong to design such an insurance scheme established in the year 1995 – i.e. at a time when the policymakers were already fully aware of all the implications of the ageing of the population for the pay-as-you-go social security systems – for the bulk of the population as a pay-as-you-go system financed by wage-related contributions. In no other social security system are the implications of the foreseeable demographics so dire – and hence the introduction of fully funded elements so patently crucial – as in the long-term care insurance scheme. In view of the glaring reform deficit in this area, the German Council of Economic Experts urges the policymakers to heed its previously made proposals to change the method of financing this social security system, especially as changing over to a funded system becomes dearer and thus harder the longer one waits, bearing in mind the ageing of our society. With the **citizen allowance model** in the statutory long-term care insurance scheme and the **cohort model** the German Council of Economic Experts put forward two concepts for discussion in its Annual Report 2004/05 (sections 545 ff.). In both models the pegging of contributions to income is done away with, the segregation between the statutory long-term care insurance scheme and private long-term care insurance schemes is abolished and, most extensively in the cohort model, the challenges of demographically determined rising contribution rates are met by introducing dedicated funding.

25. The decision to progressively raise the statutory retirement age from currently 65 years to 67 between 2012 and 2029, with the result that the cohort born in 1964 will be the first to which the new rule will apply in full, is therefore expressly to be welcomed. The measure will strengthen the ongoing ability to finance this social security system and significantly reduce the sustainability gap in the general government budget. The original savings effect up to the year 2030 has been quantified by the German Pension Insurance Authority (*Deutsche Rentenversicherung*) at between 0.6 and 0.7 contribution point. If the change in the implied rate of return generated by the statutory pension insurance scheme is taken as a measure of the intergenerational redistribution effects of this measure, persons aged over 60 will benefit slightly, whereas particularly those born around the year 1965 will see the return on their contributions diminish by 0.2 to 0.3 percentage point.

Necessary though the **raising of the statutory retirement age** is, the associated option of claiming a full pension already at the age of 65 if the insuree has accumulated 45 contribution years is misdirected. This rule infringes the principle of participative equivalence (*Teilhabe-äquivalenz*) on which the statutory pension insurance scheme is based, according to which identical contributions – meaning the same number of pension remuneration points (*Entgelt-*

punkte) – establish identical pension claims. Moreover, the savings effect of raising the retirement age to 67 will consequently be reduced up to 2030 by around 0.2 percentage point.

26. After adopting the Act to Ensure the Sustainability of the Statutory Pension Insurance Scheme (*RV-Nachhaltigkeitsgesetz*), raising the statutory retirement age and introducing a clawback factor meanwhile termed a "modified protection clause" (*modifizierte Schutzklausel*), the policymakers have largely exhausted the possibilities available on the expenditure side to stabilise the statutory pension insurance scheme in the long term against the consequences of an ageing population. Further cuts over and above the benefit reductions agreed in 2004, i.e. lowering the pension level to below the currently valid pre-tax minimum insurance level (*Mindestsicherungs-niveau*) of 43 per cent, would undermine the system's legitimation. While there is still room for improvement in the statutory pension insurance scheme, the bulk of the necessary work on this reform project has now been accomplished.

Improvements which should be tackled in the period ahead, and which are necessitated above all by considerations of logical consistency and macro-policy correctness, are

- to change the benchmark used for calculating pension adjustments from the growth rate of gross wages and salaries to the growth rate of income subject to social security contributions,

- to reform the surviving dependants' pension system, and

- to respond to the transformation of the structure of employment and to the growing number of self-employed persons needing protection.

27. The benchmark currently used for calculating the annual **adjustment of the pension level** is the growth in gross wages and salaries per employee in the past year vis-à-vis the preceding year. Yet this gross measure of employee compensation also includes the earnings of public sector employees with civil servant status (*Beamte*), who do not pay pension contributions, that portion of labour income which exceeds the ceiling for paying contributions (*Beitragsbemessungsgrenze*) and income components converted into private pension savings by the employer (*Entgeltumwand-lung*). In addition, the growing number of people in workfare placements (*Arbeitsgelegenheiten*) earning a small wage in addition to receiving benefits, popularly known as "one-euro jobbers", is likewise affecting this benchmark figure: for example, 100,000 additional one-euro jobs reduce average gross wages and salaries by around 0.3 percentage point. In the aggregate, therefore, the measure of employee compensation to which pension adjustments are currently geared is an increasingly distorted indicator of the evolution of the actual contribution assessment base in the statutory pension insurance scheme. For this reason the German Council of Economic Experts, embracing the recommendation made by the Sustainability Commission (*Nachhaltigkeitskommis-sion*) in 2003, proposes that in future pension adjustments should no longer be oriented to gross wages and salaries per employee but instead should be geared to the *per capita* income of insured persons subject to contributions. This would ensure that the pension adjustment is geared to the income variable that is relevant for the contribution assessment base and hence for financing the system.

28. In 1997 the Federal Constitutional Court (*Bundesverfassungsgericht*) ruled that **surviving dependants' pensions** do not accrue from contribution-related entitlements. The pension payments made to surviving dependants that exceed the alternative payments applying pension splitting must therefore be classified as non-insurance-related benefits. Furthermore, both the Federal Constitutional Court's ruling and the practice of taking additional income into account when calculating the pension entitlement confirm that widows' and widowers' pensions are by nature a welfare benefit (*Fürsorgeleistung*) and do not have a maintenance function (*Unterhalts-funktion*) based on the level of the deceased spouse's statutory retirement pension. An appropriate reform option to reduce the insurance-unrelated income redistribution effect and thus the implicit tax contained in the contributions to the statutory pension insurance scheme would be to progressively restructure the surviving dependants' pension system. Due account could be taken of the welfare nature of surviving dependants' pensions by initially freezing and if necessary reducing the basic allowance for additional income that is not offset against the pension entitlement. It is also appropriate to offset not just 40 per cent but 100 per cent of any additional income when computing the pension. Another measure that should be taken is to raise the minimum age for receiving a full widow's pension (*grosse Witwenrente*) from 45 (in future 47) to 55 years. It goes without saying that all of these measures – following a protracted transition period – would solely apply to new cases.

29. In virtually every country the system of old age provision comprises several different tiers: a state-organised mandatory pension element partly financed out of general taxation revenue, an additional company pension component and supplementary private pension arrangements. In many countries the first tier consists of a universalistic system, i.e. one that is independent of the different types of occupation of the insured citizens. In Germany, by contrast, the first tier is structured according to the type of occupation, with the self-employed not obligatorily insured in any of these systems unless they belong to the liberal professions *(freie Berufe*) which have their own occupational pension schemes (*berufsständische Versorgungswerke*).

The statutory pension insurance scheme was conceived as a system of old-age provision for blue and white-collar workers. In the past years the nature of employment has undergone a major change, however. A fundamental shift has occurred away from conventional employee status subject to full social security contributions towards self-employment and subsidised low paid part-time jobs (*geringfügige Beschäftigung*). In particular, the number of so-called **newly self-employed** (*neue Selbständige*) is growing, that is self-employed persons without any employees (solo self-employed) whose income and wealth situation is in many cases worse than that of employees. There is a great risk that this group of persons will be inadequately insured in old age, with the consequence that their uncovered protection needs will give rise to future claims on the state for a minimum allowance as protection against poverty in old age. The protection of individuals against poverty in old age and the protection of the state against social welfare claims in old age are two sides of the same coin. For those self-employed persons who are not insured in an occupational pension scheme the German Council of Economic Experts therefore recommends introducing a **mandatory insurance obligation** to cover the risk of age-related poverty. This leads on to the question of whether, over and above such an insurance obligation, these self-employed persons should be incorporated into the statutory pension insurance scheme and, ultimately, whether the latter should be transformed into a scheme embracing all employed persons (*Erwerbstätigenversicherung*). This question cannot be answered analytically as it is by nature a political issue.

Basically, it boils down to a **moral choice**. From the point of view of ensuring equal treatment with those employees who are currently compulsorily insured, there is much to be said for including this group of the self-employed in the statutory pension insurance scheme; the price to be paid for such equal treatment, however, would be to extend the membership of a pay-as-you-go system that is characterised by a large element of implicit taxation and to involve a further group of persons in these costs. By contrast, the mere insurance obligation through membership of a funded system of old-age provision would exempt those self-employed persons who to date have not been insured from the implicit taxation that is typical of the statutory pension insurance scheme, but also exclude them from income redistribution elements such as the pension-boosting acknowledgement of periods of child-rearing or rehabilitation benefits. Expanding the group of persons insured in the statutory pension insurance scheme would lead, for a lengthy period, to lower contribution rates for "old" members but for the "new" members would entail a smaller return on their contributions compared with a funded system of old-age provision. Depending on what relative importance is attached to these desiderata, the choice will fall on either the "minimal" option of introducing a general insurance obligation or the "maximal" option of incorporation into the statutory pension insurance scheme.

2. Fiscal policy: a mixed picture

30. Gratifyingly, the financial situation of general government has improved distinctly. The deficit ceiling of 3 per cent laid down in the European Stability and Growth Pact will be undershot clearly in 2006, with a deficit of 2.2 per cent, and in 2007 will be even more comfortably complied with, falling to 1.5 per cent. Even so, the budgetary situation of central government remains precarious, and despite the rise in value added tax on 1 January 2007 further retrenchment efforts are called for. This is graphically illustrated by the major difficulties central government is experiencing in complying with the statutory ceiling for new borrowing stipulated in Article 115 of the Basic Law (*Grundgesetz*). At the same time, key reform projects, such as in the field of healthcare policy or business taxation, require funding from tax resources. The policymakers are constrained by the conflicting requirements of lowering the tax burden on profits, especially of corporations, reducing the distortions inherent in current tax legislation between different forms of financing and the different legal status of enterprises, and obeying the political diktat to limit the overall volume of tax relief to 5 billion euros. It is therefore hardly surprising that the reform efforts which have been generated so far by this attempt to square the circle have not only been rather unconvincing but have also in part proved counterproductive.

31. In the central government budget for 2006 planned new net borrowing exceeds budgeted gross investment by around 15 billion euros. This cannot be justified by the exemption clause contained in Article 115 of the Basic Law. It is thus the considered opinion of the German Council of Economic Experts that the **central government budget for 2006 breaches the Basic Law**. The reason given in the preamble to the 2006 Budget Act (*Haushaltsgesetz 2006*), presented in the spring of 2006, for invoking the exemption clause of Article 115 of the Basic Law is that in 2006 a serious and ongoing disturbance of the overall economic equilibrium was threatening which was directly endangering the objectives of a high level of employment and adequate economic growth, especially as the course of economic development was being fuelled mainly by the external sector, given the "fragile state of the domestic economy". The interpretation of this cyclical constellation as constituting a disturbance of the overall economic equilibrium is illogical and unconvincing. Furthermore, this line of argument smacks of political expediency. The excuse proffered by the central government to justify breaching the ceiling laid down in Article 115 of the Basic Law could be used by any government at any time as a pretext for overshooting the limit; this would completely nullify the intended binding effect of the constitutional borrowing limit enshrined in the German constitution. Given the present political lie of the land, however, there is not a sufficient number of members of the German lower house of parliament (*Deutscher Bundestag*) who could bring an action before the Federal Constitutional Court.

32. The experience of the year 2006 graphically illustrates the fact that Article 115 of the Basic Law, which is supposed to constitute a barrier to excessive government borrowing in phases of economic normality, has proved to be a paper tiger. The weak binding nature of this constitutional rule results, firstly, from the extensive discretionary leeway associated with interpreting the exemption clause, since a level of new borrowing that exceeds the volume of investment is permitted if this is necessary to avoid a disturbance of the overall economic equilibrium, and, secondly, from the ineffectual sanctions given the very long periods of time which the Federal Constitutional Court requires to deal with cases brought before it. The binding effect of the rule is additionally undermined, however, by the fact that it is currently possible to utilise credit authorisations not drawn down in prior years in the current year and – not least – by the fact that the way in which the concept of investment is interpreted runs counter to the economically well founded intention of Article 115 of the Basic Law. Consequently, a minimum requirement for the debt-financing of government expenditure ought to be that this increases the state's stock of assets so that subsequent generations, who have to bear the burden of servicing the debt, at least acquire as a *quid pro quo* a larger accumulation of assets together with the resultant higher income stream. Seen from this angle, however, taking gross investment as the defined cap for new borrowing is inappropriate as it fails to take into account the depreciation of the government's capital stock. By the same token, privatisation proceeds should be deducted from the amount of investment that is to be debt-financed as the disposal of equity interests diminishes the stock of state assets.

Such a narrower definition of investment could stiffen the binding effect of the investment-related borrowing ceiling laid down in the constitution and is far superior to the calls which are occasionally made to prohibit the debt-financing of public expenditure – either during a normal cyclical situation or across the business cycle. Using this **narrower definition of investment**, central government's planned borrowing for 2007 would exceed its investment expenditure by around 18 billion euros. This reveals the true extent of central government's structural budget gap and highlights the substantial fiscal consolidation requirement that will remain even after allowing for the extra income from the forthcoming increase in turnover tax and insurance tax. It is equally obvious that such a redefinition of investment, imperative though it may be, can only be introduced in stages and with extensive transitional periods so as not to overburden public finances.

33. The necessity to consolidate public finances does not ensue primarily from the need to formally comply with Article 115 of the Basic Law and to meet the debt criteria laid down by the Maastricht Treaty. The real imperative to consolidate results from the consideration underlying these rules that a high level of indebtedness impairs long-term growth prospects and places a burden on future generations.

The task of fiscal policy is to establish general framework conditions, by juggling government revenue and expenditure, that are equally conducive to promoting employment and growth and to ensuring an equitable distribution of income. And as both the policymakers' future radius of action and society's development prospects are constrained by state debt incurred in the past and present, it is imperative to continue the consolidation efforts which – as the decline in the government expenditure ratio in the last few years shows – began well before the central government budget for 2007. For even after taking account of the extra revenue from the increase in insurance tax and the earmarking of the revenue from 2 of the 3 percentage points by which VAT is being raised for consolidation purposes, it is far from guaranteed that the national debt ceiling defined by Article 115 of the Basic Law and the corresponding provisions in the respective state constitutions will be complied with lastingly, let alone that the long-term sustainability of public finances will be ensured. As the scope for fiscal consolidation on the revenue side through raising tax rates will be exhausted for the foreseeable future with the tax increases due to enter into force on 1 January 2007, any necessary further restructuring of public finances can only be achieved by cutting expenditure and closing tax loopholes.

34. The widely recommended "scatter gun" method, i.e. reducing all subsidies across the board by the same percentage, has no substantiated economic rationale, and the German Council of Economic Experts has therefore consistently rejected it. Instead, the Council latterly put forward proposals for **economically meaningful savings** on government expenditure and tax breaks (Annual Report 2003 sections 455 ff.; Annual Report 2005 sections 460 ff.). The German government implemented quite a few of these proposals at the start of the current legislative period, such as abolishing the subsidy paid to home buyers (*Eigenheimzulage*), a move which for a long time was blocked by the upper house of parliament (*Bundesrat*), reducing the saver's tax allowance (*Sparerfreibetrag*) and the commuter's tax allowance (*Entfernungspauschale*) as well as curbing tax deferral models (*Steuerstundungsmodelle*) which enable losses on shares in closed-end mutual funds to be offset against tax. This merits recognition. The associated budget relief will accumulate only in the course of time, however, and will be partly neutralised by the fact that the stimulus package known as the "impulse programme" (*Impulsprogramm*) has created new, costly tax breaks and tax loopholes.

The search for further scope for fiscal consolidation could usefully begin with those measures proposed in past Annual Reports which have not yet been initiated or have been implemented only in part. With regard to further curbing **tax breaks**, this could include, for example, the current tax exemption for supplements paid for working on Sundays, public holidays or nights, the tax-free allowance for amateur coaches and abolishing the reduced turnover tax rate for selected services (Annual Report 2005 sections 460 ff.). In the area of **financial assistance** the government's 20th Subsidy Report (*Subventionsbericht*) for 2006 still lists a volume of around 6 billion euros, while other studies, admittedly employing a much broader definition, arrive at a figure of more than 25 billion euros for the year 2005 (Boss and Rosenschon, 2006). Notable potential sources of savings also include coal production subsidies and a wide array of tax privileges in the field of agriculture, as these payments cannot be justified on the grounds of efficiency. According to the current Subsidy Report, the financial assistance measures included in the state budgets in 2005 totalled around 10 billion euros or – in the very broad definition that includes grants to hospitals or research institutes and including the local government level – around 60 billion euros (Rosenschon, 2005).

35. The potential for a consolidation strategy for public finances focusing on government expenditure and selective tax breaks is far from being fully exhausted. Even so, such a strategy based on efficiency arguments encounters barriers in two respects. Firstly, the relief associated with cutting or cancelling individual tax privileges makes itself felt only very slowly in some cases, and quite often legal ties exist which prevent any immediate abolition, for example in connection with the promotion of coalmining. Furthermore, households and enterprises alike need to be given a certain amount of time to adjust to announced cuts – in the case of the current tax exemption for supplements paid for working on Sundays, public holidays or nights, for example, by way of higher collectively negotiated supplements.

Secondly – and this is the more significant factor – the volume of expenditure categories and tax breaks whose abolition can be justified on purely economic grounds has become too small to be able to satisfy the existing consolidation requirement. This being so, the political decision-makers will have no other option in future than also to review those government spending categories and tax privileges that are motivated by considerations of income redistribution and whose abolition would entail substantial distributive consequences – also to the detriment of traditionally supportive electoral groups.

Such cuts cannot be justified on economic grounds alone but, rather, require a political decision based on value judgements. This should not be misconstrued, however, as implying that further expenditure-side consolidation measures are automatically precluded by a redistribution policy veto and that, therefore, either a high level of new borrowing must be tolerated or the consolidation requirement has to be met through higher taxes. Such thinking disregards the fact that higher government indebtedness or the raising of tax rates likewise entail distributive effects, which would certainly have to be compared with the redistribution policy *status quo*, not to mention the allocative distortions associated with raising tax rates.

In other words, it is not sufficient to argue that curbing government subsidies, transfers or also personnel expenditure is "unfair" because of the associated distributive implications. The proponents of this argument must also prove why the redistribution policy *status quo* resulting, for example, from transfer payments or tax privileges is supposedly "fairer" *a priori* than, say, the distributive effects associated with raising taxes or incurring debt. In view of the undeniable need to consolidate public finances, the political decision-makers will not be able to dodge these issues.

36. The coalition agreement rightly identifies the objectives of a **reform of business taxation** as improving Germany's attractiveness as a businesses location and ensuring extensive neutrality in respect of financing options and the choice of corporate legal status. These objectives were to be implemented along the lines of the "outline proposals" (*Eckpunkte*) agreed by the federal cabinet. Judging by the progress so far, however, this has not happened; moreover, the meandering public debate to date does not indicate any clear conceptual line of thinking. This is all the more regrettable as no previous German government was able to draw on such detailed proposals for an effective reform of business taxation as the present incumbent. Thus after being commissioned to do so by the federal ministers of finance and of economics and labour, the German Council of Economic Experts, together with 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 (*Europäische Wirtschaftsforschung (ZEW*), Mannheim, presented a proposal for a "Reform of income and business taxation by means of the **dual income tax**" (*Reform der Einkommens- and Unternehmensbesteuerung durch die Duale Einkommensteuer*), which goes a very long way to meeting the objectives of a reform of business taxation specified by the coalition parties. The German government has taken up neither the concept of a dual income tax proposed by the German Council of Economic Experts nor the tax concepts put forward by other economists and experts; and the supposed tax revenue losses which the federal finance ministry alleges would accrue if these proposals were implemented are unsubstantiated.

37. Instead, the political decision-makers chose to follow a different route with the outline proposals which the federal cabinet adopted on 12 July 2006. These envisage that the nominal total tax burden on corporations (*Körperschaften*) is to be reduced from currently around 39 per cent to less than 30 per cent. Local business tax (*Gewerbesteuer*) is to be retained; the **assessment bases** for calculating corporation tax and local business tax **are to be harmonised**. At the same time, measures are to be considered to counter the erosion of firms' taxable resulting from tax-deductible debt-financing and to stabilise the level of local government finance. Non-corporations (*Personenunternehmen*) are to be granted relief by means of an investment reserve (*Investitions-rücklage*) or a general granting of preferential treatment for retained profits. A final withholding tax (*Abgeltungssteuer*) of 25 per cent or at most 30 per cent is to be imposed on private capital income. The total volume of tax relief afforded to businesses by this reform is not to exceed 5 billion euros.

38. A reduction of the rate of taxation levied on the profits of corporations to below 30 per cent rates a positive assessment. Even though the effective overall tax burden on corporations would still remain above the average level of effective taxation on corporations in the EU-15 states and 5 percentage points above that of the EU-25 states, this would represent an important step towards improving Germany's attractiveness for business investment. By contrast, the other components of the outline proposals agreed by the federal cabinet concerning business taxation largely merit a negative assessment:

- The **envisaged final withholding tax** on private capital income is to be levied not only on debt-related interest but also on the whole amount of dividends and private capital gains. Given the tax-deductibility of financing costs from business taxes, the final withholding tax would not only infringe the aim of financing neutrality proclaimed in the coalition agreement but in addition, by increasing the cost of capital for self-financed investments, would lead to a worsening of investment conditions.

- The envisaged **harmonisation of the assessment bases** of corporation tax and local business tax would be a welcome move if the assessment base of local business tax were to be brought into line with that of corporation tax by abolishing the provisions of sections 8 and 9 of the Local Business Tax Act (*Gewerbesteuergesetz*), which expand or curtail the defined profit base. However, the German finance ministry chose a diametrically opposed solution by widening the assessment base of corporation tax to include financing costs and aligning it with that of local business tax. The aim behind this is to counter the erosion of firms' taxable result due to financial engineering; this would concurrently limit the tax revenue losses associated with lowering the tax rate. A general limitation of the deductibility of financing costs as business expenses would entail such enormous drawbacks, however, that the German Council of Economic Experts emphatically cautions against it. This is because such a move would both run counter to the goal of improving Germany's attractiveness as a business location and worsen the terms of domestic investment; furthermore, it would conflict with the European interest and royalty payments directive, and it would also violate the net principle (*Nettoprinzip*) which is one of the fundamental axioms of German income tax law. Although various "interest deduction ceiling" (*Zinsschranke*) models have been discussed as an alternative to the full or partial inclusion of, above all, interest expenditure on borrowed funds in the taxable result, the same misgivings apply – albeit in a milder form – as in the former case. In the upshot the proposals under discussion to include the cost of finance in firms' taxable result go way beyond the intended aim of combating the current scope for creative tax accounting. Specifically tailored measures are conceivable and appropriate to this end; for example, a variant of an interest deduction ceiling rule could be considered as a replacement for the current unwieldy provisions of section 8a of the Corporation Tax Act (*Körperschaftssteuergesetz*) concerning debt-financing by shareholders. Further-going regulations aimed at limiting the tax-deductibility of financing costs should be rejected.

39. Any perceptible enhancement of **Germany's attractiveness as a business location requires** a **significant lowering of the effective tax burden** on corporations. As a rule of thumb, it may be said that every 1 percentage point change in the level of corporation tax leads to a change in tax revenue of just over 1 billion euros. Additional revenue losses ensue if the tax relief granted to corporations is extended to non-corporations. A fundamental reform of business taxation which both boosts Germany's attractiveness to business investors and ensures neutrality vis-à-vis financing options thus cannot be achieved at zero cost. With the total volume of relief to be afforded to businesses capped at a maximum of 5 billion euros, the objectives of a reform of business taxation proclaimed in the coalition agreement cannot be attained. Unless the current plans are modified, the effective tax burden on corporations could barely be lowered *per se* by 5 percentage points. While this would still represent a step forward vis-à-vis the *status quo*, it would constitute a step back compared with the tax policy decisions adopted at the "job summit" (*Job-Gipfel*) in the spring of 2005, which means that the project of fundamentally reforming income and business taxes might as well have dispensed with the services of a grand coalition government.

Current development

40. The adoption of the Act amending the Basic Law (*Gesetz zur Änderung des Grundgesetzes*) and of the Act accompanying the reform of Germany's federal structure (*Föderalismusreform-Begleitgesetz*) in July this year was a first and important step towards unravelling the federal decision-making structures. However, a key requirement largely ignored by this first stage of the process of reforming Germany's federal structure (federal reform I) was the need to reorganise Germany's intergovernmental financial arrangements (*Finanzverfassung*), which the German Council of Economic Experts, among others, has been demanding for years. The grand coalition has, however, agreed on a plan to restructure the financial relationships between central government (*Bund*) and state government (*Länder*). The annex to the governing parties' parliamentary motion (*Entschliessungsantrag*) proposing the draft Act amending the Basic Law identifies the following key points of such a **federal reform II**:

- measures to avert and deal with budgetary crises,
- stronger autonomy of central, state and local government, and
- increased cooperation and possibilities to facilitate voluntary mergers between federal states.

Yet following the **ruling of the Federal Constitutional Court** of 19 October 2006 concerning the action for a declaratory judgement (*Normenkontrollantrag*) filed by the state of Berlin to confirm the existence of extreme budgetary hardship (*extreme Haushaltsnotlage*), the second stage of the reform of Germany's federal structure (federal reform II) cannot be put off any longer. The state of Berlin had argued that, as from 2002 at the latest, it was entitled to special supplementary grants from central government (*Sonderbedarfs-Bundesergänzungszuweisungen*) for the purpose of budgetary restructuring as since that time it has been suffering extreme budgetary hardship from which it is unable to liberate itself through its own devices. The Federal Constitutional Court rejected Berlin's action and ruled that the city-state was not experiencing extreme budgetary hardship. The court merely acknowledged a "tense" budgetary situation but one which, with all probability, Berlin would be able to overcome through its own efforts.

With this ruling the Federal Constitutional Court sharply tightened the prerequisites for granting supplementary central government grants for rehabilitation purposes compared with its judgement from the year 1992 on the issue of budgetary hardship. It ruled that granting such assistance requires not only relative budgetary hardship vis-à-vis the other federal states but also absolute budgetary hardship in the sense that an existential threat to a state, i.e. a **federal state emergency** (*bundesstaatlicher Notstand*), must have occurred which cannot be overcome without outside assistance. The court emphasised the great importance of self-reliance and political autonomy of the federal states, implying that they must themselves face up to the consequences of their budget policy decisions.

A notable feature, and one which has important implications for fiscal policy, is that the Federal Constitutional Court did not instruct parliament to take any specific measures. It merely admonished the policymakers, with reference to the agreed federal reform II, that the federative principle (*Bundesstaatsprinzip*) necessitates strategies for preventing and overcoming **budgetary crises**. The court thus tossed the ball back into the parliamentary court, although it left it up to the players to decide whether and, if so, how they want to change the rules of the game. This self-restraint exercised by the Federal Constitutional Court is to be welcomed in principle; however, it raises expectations and hence the pressure on the political decision-makers to develop solutions for avoiding or overcoming a "federal state emergency".

41. The **implications of this ruling** for the state of Berlin are **unclear**. It must be said that in the last few years Berlin has undertaken significant consolidation efforts which, according to its current budgets plans, should lead to primary budget surpluses in 2007 and thereafter. This fiscal policy course should be maintained, although the ruling gives the city-state very little incentive to do so. The suggestions made by the Federal Constitutional Court as to how Berlin could improve its revenue position turn out on closer inspection to be only partly substantive, because generating further privatisation proceeds from the disposal of the municipal housing stock, as suggested by the Federal Constitutional Court, would not really relieve the state budget. For one thing, it is likely that selling off such a large number of dwellings would trigger a steep price slump. For another, the proceeds obtained in the present from the disposal of these assets have to be offset against lower rental income in the future. Measured at market values, the privatisation proceeds and the present value of the net income resulting from these assets cancel one another out, so that in this case precisely nothing would be gained for the long-term sustainability of the state's finances. Raising tax revenue would yield only limited gains. There are only small incentives for the state of Berlin to increase local revenue from income tax or corporation tax through more rigorous scrutiny by the tax authorities. On account of the interstate revenue-sharing scheme (*Länderfinanzausgleich*) each extra 1 million euros of revenue would yield just 133,300 euros of income tax and 81,100 euros of corporation tax for Berlin's budget. This highlights the disincentives embedded in the current interstate revenue-sharing scheme. Extra revenue could indeed be generated by increasing the municipal leverage rate (*Hebesatz*) for property ownership tax (*Grundsteuer*) and the rate of property acquisition tax (*Grunderwerbsteuer*) as these taxes are factored into the state revenue-sharing scheme only in a standardised form and evasive reactions are rather unlikely. Another possible option would be to raise the municipal leverage rate for local business tax, which is currently below the national average (for municipalities with more than 50,000 inhabitants), although in this case evasive relocations to neighbouring areas cannot be ruled out. This underscores the fact that a certain degree of tax autonomy for the state governments must form an integral part of any strategy aimed at overcoming budgetary crises.

42. In relation to the concrete case of Berlin, the court's ruling is only of limited practical value. Concerning the prevention and tackling of future budgetary crises within the federal state structure, the ruling gives the legislature a large degree of discretion. This creates an opportunity for a meaningful restructuring of federal financial relationships in the second stage of reforming Germany's federal structure.

The most promising approaches to avoiding future budgetary crises are

- allowing the possibility of instituting insolvency proceedings against central, state and local government entities and/or

- introducing a constitutional "debt brake" (*Schuldenbremse*) on state governments' ability to incur debt.

The creditworthiness of the state of Berlin has been impaired neither by its continuous overshooting ever since 1993 of the ceiling for new borrowing laid down by Article 87 paragraph 2 of Berlin's constitution – which is framed very similarly to Article 115 of the Basic Law – nor by the Federal Constitutional Court's ruling of 19 October 2006. The rating agency Fitch contains to assign Berlin, along with all other German state governments and the central government, its highest "AAA" rating. Moody’s, too, has not altered its "Aa3" rating for Berlin since the Federal Constitutional Court's ruling. The financial markets evidently **rule out** the possibility of **insolvency** even in the case of highly indebted state governments. This is presumably connected with the fact that, under current law, central, state and local government cannot become insolvent. Thus section 12 (1) of the German Insolvency Code (*Insolvenzordnung*) states that insolvency proceedings may not be instituted against the assets of central government or any of the state governments.

Consequently, it is worth considering whether **central, state and local government** should also be made subject to **insolvency proceedings**. Notwithstanding substantial difficulties associated with determining and dealing with a case of an insolvency event, defining senior and subordinate claims and many other technical problems, the introduction of such federal state insolvency proceedings could generate substantial incentive effects for the states to limit their new borrowing. If, following the introduction of such insolvency proceedings, lenders would have to reckon with the possibility of the non-repayment of their claims, they would demand correspond risk premia and, in extreme cases, desist completely from subscribing to debt instruments issued by a particular state.

Such rules for sovereign debtors have been under discussion for quite some time now in connection with international debt crises (Annual Report 2002 sections 584 ff.). Furthermore, chapter 9 of the US insolvency code contains provisions for the insolvency of municipalities which could serve as a model.

A better solution would be to introduce an effective constitutional "**debt brake**" for state government, as has been in operation for some years now in Switzerland. At present most German state constitutions contain provisions stipulating a borrowing ceiling which, either in word or in spirit, match Article 115 of the Basic Law. These constitutional rules have not proved particularly effective, however. Two expedients which could help to tighten up these provisions are, firstly, a narrower definition of the investment that is to be debt-financed and, second, a binding rule on avoiding cyclical budgetary deficits over the course of the business cycle. A more precise definition of investment and any exemption clauses would make such borrowing rules for central and state government easier to substantiate and also more meaningful than the deficit limits defined in the EC Treaty.

43. A more stringent limitation of state government's ability to borrow would be economically incompatible with the stipulation in Article 109 (1) of the Basic Law that central and state government are to be autonomous and independent of each other in their budget management, unless state government were concurrently granted a certain degree of tax autonomy in return. Otherwise state governments would have no leeway to shape expenditure in line with the preferences of their citizens because their spending would invariably have to dovetail with their more or less exogenously defined revenue. In the context of federal reform II, therefore, especial importance should be attached to ensuring some tax autonomy for state government (Annual Report 2003 sections 513 ff.). This goes hand in hand with the need for a reform of the interstate revenue-sharing scheme which would reduce the negative incentive effects of the present system without immediately neutralising the advantages of greater tax autonomy for state government (Annual Report 2004 sections 799 ff.).

3. Labour market: further action required despite change for the better

44. The situation on the labour market has, fortunately, begun to brighten in the wake of the general economic revival. Unemployment is falling and all the components of employment, i.e. notably jobs subject to full social security contributions, are developing positively. However, the prime evil of the German labour market, namely the high and persistent level of unemployment, cannot and will not be remedied even by a prolonged macroeconomic recovery. A resolution of this problem, which is not only an economic but also a social issue, must begin – as the current public discourse concerning the emergence of a social "underclass" (*Unterschicht*) demonstrates – by tackling the poor labour market prospects of the low skilled and the high level of long-term unemployment. But the sorely needed initiative to make the institutional framework conditions governing the labour market more flexible was excluded from the coalition agreement. What the parties did include in the agreement, apart from an amateurish attempt to introduce elements of flexibility into job protection legislation, was the outline of an effective model for a "combi-wage" (*Kombilohn*) or wage subsidy, above all with a view to improving the employment prospects of the low skilled and long-term unemployed. This ongoing debate is being shadowed, on the one hand, by popular but job-killing calls for a minimum wage and, on the other, by dubious and outmoded wage subsidy models. Since, however, the working group commissioned with this task by the coalition and the ministry of labour and social affairs (*Bundesministerium für Arbeit and Soziales*) has so far been working on a reform of the low wage sector quietly and invisibly without attracting the glaring spotlight or blaring fanfare of media attention, it is still possible to hope that some progress towards reform may be made in this field that is indeed worthy of a grand coalition. By contrast, suggestions to extend the period of entitlement for drawing unemployment benefit (*Arbeitslosengeld*) are misguided as this would pave the way to a further rise in long-term unemployment.

45. There is plenty of evidence that in countries in which the statutory dismissal threshold is low, long-term unemployment tends to be significantly smaller than in countries with a high level of job protection. By contrast, the general employment situation and hence average unemployment rates are frequently unrelated to the prevailing employment protection rules. This is because a low level of job protection increases the fluctuation on the labour market and accordingly reduces the average duration of unemployment; a higher risk of dismissal for employees is the price to pay for better recruitment prospects for the unemployed.

Ultimately, even high legal hurdles to dismissal do not protect any employee against being laid off, yet they imply severance costs for the employer in the form of an unknown amount of *ex ante* compensation payments. These unknown and thus incalculable severance costs are a latent surcharge on top of money wages and thus cause employers to reluctantly set on new staff. Any effective attempt to combat long-term unemployment must include a thrust to make Germany's rigid employment protection rules more flexible in the interests of the 1.8 million long-term unemployed.

The intention proclaimed by the governing parties in the coalition agreement to "further develop the Employment Protection Act (*Kündigungsschutzgesetz*) with a view to generating more employment and lastingly safeguarding the protective function of anti-dismissal regulations for existing employment contracts" is therefore equally as contradictory as the arrangement arrived at in the course of the negotiations to retain the existing employment protection rules unchanged but to add the option of extending the initial waiting period until such protection applies to up to 24 months. As the various extraordinary dismissal rights (*Sonderkündigungsrechte*) were not be correspondingly adjusted, this would have led to a new state of limbo under labour law between a genuine probationary period (*Probezeit*) and an unlimited employment contract, which would have yielded little or no progress vis-à-vis the *status quo*, especially as the possibilities to limit employment contracts were to be curbed in return.

46. If the recruitment chances of jobless persons are to be improved and the emergence of long-term unemployment, including the associated stigmatisation and devaluation of profession-specific human capital, is to be avoided, a **reorientation** of the labour law provisions concerning **compulsory redundancies** (*betriebsbedingte Kündigungen*) is imperative. For this reason the German Council of Economic Experts is putting forward for discussion a proposal to generally delete the clause protecting workers against compulsory redundancy from the Job Protection Act and instead to introduce a claim to compensation whose level would depend on the employee's length of service and for which binding minimum standards would apply. The existing special provisions applying to members of workers' or staff councils (*Betriebsräte*) would not be affected. Sackings for personal or behaviour-related reasons would likewise remain unaffected; the current job protection rules would generally apply in these cases, although they should be reformed regarding the current onus of proof on the employer.

A compulsory redundancy could then be challenged in court only to the extent that it breached existing rules prohibiting discrimination or constituted a purely arbitrary act; in both cases the employee would have to produce plausible evidence of such an infringement by the employer. Employees would enjoy protection in the form of a period of notice graduated according to his or her length of service but in any case not exceeding six months. A grandfathering clause would ensure that the new regulation, which would be applicable to all firms regardless of how many employees they have, would apply only to new employment contracts concluded after the law has entered into force.

Such a reform of the provisions governing job protection would not necessarily reduce the costs of dismissal for the individual company, but it would render them calculable and also make labour law regulations simpler and more comprehensible, particularly for small and medium-sized enterprises. At the same time, employees would still enjoy a measure of protection against dismissal, and in the event of being laid off would receive some compensation for the associated hardship.

47. The key problem groups among the unemployed are the **low skilled and the long-term unemployed**. Germany has the unenviable distinction of heading the international league table in this respect; hence it is on these groups that labour market and employment policy should focus. While the majority of the long-term unemployed can formally be classified as skilled workers, prolonged joblessness frequently leads to a devaluation or loss of important skills and know-how, with the result that potential employers tend to treat people who have been without work for a lengthy period as low skilled, irrespective of their formal skills and qualifications. For this reason the entry wage obtainable on the primary labour market is likely to be equally low for both low-skilled persons and many of the long-term unemployed, which means that their best bet is to find a job in the low-wage sector.

The **low-wage sector** in Germany, in which some 6 million people or around one-fifth of all employees work, is by means underdeveloped by international standards. But it is not a domain of the low skilled, with the consequence that they have to compete for the jobs with skilled workers and, owing to their lower productivity, consequently have a worse chance of finding a job in this sector, which actually they ought to be predestined to occupy. A further downward spread is thus called for in the wage structure as this would both boost the demand for labour in the low-wage sector and ease the problem of crowding-out between skilled and low skilled workers.

48. The coalition agreement contained an intention to reform the low-wage sector. It further announced that the introduction of a wage subsidy model was to be considered, precisely with a view to improving the poor employment chances of these problem groups. Consequently, the minister of economics and technology asked the German Council of Economic Experts in the spring of 2006 to produce a study on this issue as a decision-making aid for the government. The Council met this request with its policy document **"Reform unemployment benefit II: a tailored wage subsidy model"** (*Arbeitslosengeld II reformieren: Ein zielgerichtetes Kombilohnmodell*).

As three-quarters of the jobless persons identified as belonging to these problem groups come within the jurisdiction of the second book of the Social Security Code (*Sozialgesetzbuch II*), and as unemployment benefit II (*Arbeitslosengeld II*) in its present form already contains wage subsidy elements – as is evidenced by the fact that around 900,000 persons currently receive unemployment benefit II as a top-up to their labour income – the German Council of Economic Experts regards a reform of unemployment benefit II as being a suitable and effective way to improve the employment prospects of this target group. The proposed reform is intended to enhance the attractiveness of taking up work – regular employment needs to be more rewarding than hitherto – and simultaneously to generate incentives to create new jobs by lowering wage costs.

49. The recommended restructuring consists of three modules.

A proposal consisting of three modules

Module 1: Introduction of an offset threshold (*Geringfügigkeitsschwelle*) for unemployment benefit II, i.e. earned income up to 200 euros is fully offset against unemployment benefit II, whereas benefit recipients can keep a substantial portion of earned income of between 200 euros and 800 euros. In addition, a flat-rate monthly amount of 40 euros is paid to cover any work-related expenses on earned labour income above 200 euros.

Module 2: Lowering of the standard benefit rate for recipients capable of working by 30 per cent, in return: improved earnings facility on the primary labour market for incomes between 200 euros and 800 euros: of each euro of earned income, 50 cents can be kept by the benefit recipient instead of 20 cents at present. If the benefit recipient takes on full-time employment in a workfare placement that is guaranteed for every person willing to work, the standard benefit rate is topped up to the previous level.

Module 3: Lowering of the ceiling for "minijobs" subject to no social security contributions from 400 euros to 200 euros; the sliding scale for "midijobs", in which reduced social security contributions are already payable today, is to be extended to cover the corridor from 200 euros to 800 euros in combination with a further reduced level of social security contributions.

The objective of modules 1 and 3 is to ensure that especially subsidised low paid part-time jobs known as **minijobs** are **replaced** by regular jobs subject to social security contributions in order to achieve a greater and more sustained integration of jobless persons into the primary labour market. To this end, earned income of up to 200 euros is offset in full against unemployment benefit II and thus rendered unattractive, whereas benefit recipients can keep a larger portion than hitherto of higher labour incomes that are subject to social security contributions. Secondly, the ceiling for minijobs is lowered from 400 euros to 200 euros and the burden of social security contributions on incomes of between 200 euros and 400 euros is eased considerably. These elements of the proposal have proved fairly uncontroversial in the public debate.

Module 2, the **central element** of the proposal, comprises a reduction of 30 per cent in the benefit rate for recipients able to work. This reduction has been wrongly perceived as lowering the guaranteed social minimum subsistence level. That is not so. It is a primary responsibility of every developed country to prevent existential poverty in all phases of its citizens' lives. Needy persons are entitled to solidarity from the social community. In the case of persons who are fit and able to work, on the other hand, society can and should demand a **reciprocal duty** in the form of independent efforts to reduce their neediness, specifically by accepting a job – even a poorly paid one – on the primary labour market or a workfare placement on the secondary labour market. Precisely this is also the underlying concept of the basic allowance for jobseekers (*Grundsicherung für Arbeitsuchende*, sections 1 and 2 of the second book of the Social Security Code). Persons in need have the same entitlement to the solidarity of society and the safeguarding of the social minimum subsistence level as hitherto but, in return, they should be expected to make efforts themselves to overcome or at least mitigate their neediness.

As not all jobseekers will find a regular job straightaway, a sufficient number of workfare placements must be made available. And benefit recipients who do not find a job on the primary labour market and so would like to take up a workfare placement must be paid the full level of benefit if no workfare placement can be offered to them. In the initial phase, up to 700,000 such workfare placements would need to be made available on the secondary labour market. In contrast to the *status quo* of the "one-euro" jobs, the **workfare placements**, in the context of the proposal made by the German Council of Economic Experts, would not lead to higher earnings but only to the topping-up of state benefit to the previous level of unemployment benefit II.

50. Although representatives of all the political parties lost no time in sharply criticising this proposed lowering of the standard benefit rate, it is crucial for the efficacy of the overall proposal. This is because not only the theoretical analysis but also the international and national practice of wage subsidies and wage subsidy elements in the social security system indicate that, while employees do respond to financial incentives in the form of wage supplements or generous rules for topping-up benefits with earned income, by far the largest **labour market effects** stem from changes in the level of **transfer payments** to the unemployed. Wage subsidy approaches which take the basic benefit level as given and are geared solely to improving the earned income top-up facility will therefore achieve, at most, limited positive employment effects despite incurring considerable costs.

Irrespective of the practical benefits of modules 1 and 3, quantitatively significant employment effects are only to be expected if the standard benefit rate is lowered. As far as quantifying these effects is concerned, the simulations which we have carried out imply that *in toto* the proposal would generate an extra 350,000 jobs on the primary labour market. This figure may appear small, but it is at least based on valid computations as opposed to pious hopes or pie-in-the-sky promises. Moreover, this reform will entail, at most, small additional burdens for public finances in the short run and will lead to significant relief in the medium to long run.

51. The crucial prerequisite for the employment effects of the model devised by the German Council of Economic Experts is that extra jobs will be created through the lowering of labour costs. Experience to date suggests that this will happen principally in the provision of unsophisticated services in the low wage sector. The calculations concerning the employment effects are based on the assumption that the higher labour supply will push down wages in these areas, which in turn will stimulate **labour demand**. At this point critics frequently object that the Council's proposal does not answer the question of how and where exactly these jobs are to be created. They call instead for the supposedly superior alternative of a tax-financed reduction in social security contributions. This line of arguments seems rather spurious, however, as it implicitly accepts the previously contested premise that lower wage costs stimulate new jobs.

52. Given the important role which the downward spread of the wage structure plays in improving the employment prospects of the long-term unemployed and the low skilled, any labour market policy measures which hamper or obstruct this process are hugely counterproductive – not just in connection with the German Council of Economic Experts' proposal for wage subsidies but also, in particular, in the context of the Hartz IV labour market provisions in their present form. This applies especially to the idea of introducing statutory or even industry-specific minimum wages that is currently being floated. As an instrument for ensuring a minimum labour income that would assure basic subsistence under the suggestive but misleading slogan "Fair pay for good work", a minimum wage is demonstrably inferior to a comprehensive, needs-related basic allowance in the form of unemployment benefit II.

Regarding the employment effects of a **minimum wage**, it should be noted that, according to the findings of international studies, minimum wages do not lead *per se* to job losses. In the case of the two best researched and thus regularly cited examples – the United States and the United Kingdom – it must be remembered, however, that, on account of their highly flexible and strongly liberalised labour markets, both of these countries differ very starkly from Germany. The one-to-one transposition of their isolated experience with minimum wages to the German labour market is thus quite misleading, as the equally well attested (but less frequently cited) negative employment effects connected with minimum wages in France shows.

The argument put forward in favour of minimum wages that the level of wages depends less on employee productivity than on employers' monopoly of demand may be valid in individual instances. In such a case a minimum wage – although it would have to be much lower than the levels currently under discussion – would not entail job losses. In the view of the German Council of Economic Experts, however, such a minimum wage, which would probably lie in the range of just over four 4 euros per hour, would not be an instrument for preventing exploitation but, rather, the thin end of the wedge towards a higher minimum wage level that would be detrimental to employment.

Another argument put forward in defence of minimum wages in connection with the introduction of a wage subsidy is the danger that workers or the state might be exploited by employers. In the absence of an established wage subsidy model, this fear is speculative and under the present circumstances cannot be used as a justification for introducing a minimum wage. Should this fear turn out to be well founded after the German Council of Economic Experts' proposals have been implemented, there would be sufficient time to reconsider the minimum wage instrument.

III. Summary appraisal

53. In the aggregate, therefore, the economic policy track record in 2006 – in what was a surprisingly buoyant macroeconomic setting – presents a mixed picture, also measured against the ambitious agenda set out in the government coalition agreement. Irrespective of the clear need to remedy the substantial shortcomings of the healthcare reform, however, it is highly improbable that the political decision-makers will unpick a policy package which they so laboriously put together, and it seems very likely that the opportunity of making a bold breakthrough in the overdue restructuring of business taxation has likewise been squandered.

Consequently, any hope of making greater advances must focus on three areas: an effective package of measures – which hopefully would break the narrow bounds of the coalition agreement – designed to improve the precarious employment situation of the low skilled and long-term unemployed, an overdue reform of the statutory long-term care insurance scheme, and the continued reform of Germany's federal structure. Blueprints for effectual reforms in these areas have been put forward – not least by the German Council of Economic Experts. Should the political decision-makers manage to unblock the impasse of their own making caused by the conflict of interests, the continuing bright macroeconomic outlook in 2007 represents a favourable foundation for re-embarking upon the path of economic policy reform and for resuming the forward march initiated by the promising steps taken at the start of the current legislative period.

Appendix

I. Tables: Forecasts for 2007

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 2006 estimates, 2007 forecasts

	2005	2004	2005	2006	2007
	Euro billion	Changes from previous year in %			
Use of domestic product					
Price-adjusted					
Consumption expenditure, in all	X	- 0,3	+ 0,2	+ 0,9	+ 0,3
Private consumer spending[2)]	X	+ 0,1	+ 0,1	+ 0,9	+ 0,3
General government consumer spending	X	- 1,3	+ 0,6	+ 0,9	+ 0,5
Gross fixed capital formation	X	- 0,4	+ 0,8	+ 4,4	+ 3,6
Machinery and equipment	X	+ 4,2	+ 6,1	+ 6,9	+ 6,0
Constructions	X	- 3,8	- 3,6	+ 2,5	+ 1,7
Other products	X	+ 1,2	+ 4,7	+ 4,1	+ 3,5
Stockbuilding[3)4)]	X	+ 0,3	+ 0,2	+ 0,3	+ 0,1
Total domestic demand	X	+ 0,0	+ 0,5	+ 1,8	+ 1,0
Net exports[3)]	X	+ 1,2	+ 0,4	+ 0,6	+ 0,8
Exports of goods and services	X	+ 9,6	+ 6,9	+ 10,2	+ 6,6
Imports of goods and services	X	+ 6,9	+ 6,5	+ 9,9	+ 5,3
Gross domestic product	X	**+ 1,2**	**+ 0,9**	**+ 2,4**	**+ 1,8**
Use of domestic product					
at current prices					
Consumption expenditure, in all	1 740,70	+ 1,1	+ 1,3	+ 2,2	+ 2,4
Private consumer spending[2)]	1 321,06	+ 1,7	+ 1,4	+ 2,4	+ 2,6
General government consumer spending	419,64	- 0,5	+ 1,1	+ 1,6	+ 1,6
Gross fixed capital formation	386,90	- 0,1	+ 0,7	+ 4,8	+ 3,9
Machinery and equipment	159,40	+ 3,1	+ 5,0	+ 6,0	+ 5,2
Constructions	202,31	- 2,5	- 2,7	+ 4,1	+ 3,0
Other products	25,19	+ 1,5	+ 2,1	+ 2,9	+ 2,4
Stockbuilding[4)]	- 2,61	.	.	.	.
Total domestic demand	2 124,99	+ 1,0	+ 1,4	+ 2,9	+ 2,6
Net exports	+ 116,01	.	.	.	.
Exports of goods and services	912,27	+ 9,5	+ 8,1	+ 12,9	+ 7,6
Imports of goods and services	796,26	+ 7,0	+ 8,6	+ 13,7	+ 6,5
Gross domestic product	**2 241,00**	**+ 2,1**	**+ 1,5**	**+ 3,2**	**+ 3,3**
Deflator					
Consumption expenditure, in all	X	+ 1,4	+ 1,1	+ 1,3	+ 2,0
Private consumer spending[2)]	X	+ 1,6	+ 1,3	+ 1,5	+ 2,4
General government consumer spending	X	+ 0,8	+ 0,5	+ 0,8	+ 1,1
Gross domestic product	X	+ 0,9	+ 0,6	+ 0,8	+ 1,5
Total domestic demand	X	+ 1,0	+ 0,9	+ 1,1	+ 1,6
Origin of national product					
Employment (domestic)	X	+ 0,4	- 0,1	+ 0,6	+ 0,7
Total number of hours worked	X	+ 0,6	- 0,4	+ 0,3	+ 0,4
Productivity (per hour)	X	+ 0,7	+ 1,3	+ 2,0	+ 1,4
Distribution of national income					
National income (factor costs)	1 675,13	+ 3,4	+ 1,5	+ 3,2	+ 2,9
Compensation of employees	1 129,26	+ 0,5	- 0,7	+ 1,0	+ 1,3
of which: net compensation of employees[5)]	601,43	+ 2,5	- 0,3	+ 0,4	+ 2,4
Property and entrepreneurial income	545,87	+ 10,4	+ 6,2	+ 7,7	+ 6,1
Disposable income of private households[2)]	1 459,76	+ 1,7	+ 1,7	+ 2,1	+ 2,5
Saving of private households[2)6)] (Ratio of saving of priv. households)	156,85	10,4	10,6	10,4	10,4
Memo:					
Unit labour costs[7)] (Domestic concept)	X	- 0,4	- 1,1	- 1,4	- 0,5
Consumer prices (Consumer Price Index 2000 = 100)	X	+ 1,6	+ 2,0	+ 1,7	+ 2,3

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

Table B

General Government revenues and expenditures for Germany[1)]
For 2006 estimates, 2007 forecasts

	2005	2006	2007	2006	2007
	Euro billion[2)]			Changes from previous year in %	
Revenue	975,9	1 005,0	1 030,5	+ *3,0*	+ *2,5*
of which:					
Taxes	493,0	520,4	547,9	+ *5,5*	+ *5,3*
Social security contributions	397,0	399,5	395,2	+ *0,6*	- *1,1*
Expenditure	1 048,5	1 056,7	1 065,5	+ *0,8*	+ *0,8*
of which:					
Intermediate consumption	96,1	100,5	104,3	+ *4,6*	+ *3,8*
Compensation of employees	167,5	166,3	166,0	- *0,7*	- *0,2*
Income from property (pay out)	62,0	62,8	64,8	+ *1,3*	+ *3,1*
Transfers (pay out)	659,8	666,2	671,0	+ *1,0*	+ *0,7*
Gross capital formation	30,2	30,8	32,0	+ *1,9*	+ *3,9*
Others	32,9	30,1	27,5	*X*	*X*
Net lending	- 72,6	- 51,7	- 35,0	*X*	*X*
Memo:					
Expenditure ratio[3)]	*46,8*	*45,7*	*44,6*	*X*	*X*
Tax ratio[3)]	*22,5*	*23,0*	*23,5*	*X*	*X*
"Abgaben" - ratio[3)]	*39,1*	*39,3*	*39,0*	*X*	*X*
Financial balances ratio[3)]	*- 3,2*	*- 2,2*	*- 1,5*	*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/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)]

	2005	2006	2007
	Thousand persons		
Occupied population[2)]	42 619	42 290	42 288
Unemployed persons[3)]	3 893	3 312	3 056
Balance of migrant labour[4)]	97	67	67
Employment (domestic)	38 823	39 045	39 299
Registered unemployment[5)]	4 861	4 532	4 266
of which:			
Former territory of the Federal Republic	3 247	3 040	2 847
New Länder	1 614	1 492	1 419
Memo:			
Employees subject to social insurance[5)]	26 236	26 326	26 623
	Rates (%)		
Unemployment rate[5)6)]	*11,7*	*10,9*	*10,2*
ILO-Jobless rate[7)]	*9,1*	*7,8*	*7,2*

1) Annual averages. Own estimation for 2006 and 2007; 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 2005: Federal Labour Agency (Bundesagentur für Arbeit, Nürnberg). - 6) Definitions of the Federal Labour Agency (Bundesagentur für Arbeit). - 7) Unemployed persons 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.