# FIRST CHAPTER

# Assume responsibility for Europe



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# Assume responsibility for Europe

**1.** Europe's economic policymakers face momentous challenges. The sovereign debt crisis in the euro area, which was initially confined to Greece, widened and deepened into a crisis of confidence. Amid mounting mutual mistrust among banks, lending on the interbank market largely dried up and the situation on the financial market recalled the dark days of 2008 that followed the collapse of Lehman Brothers. The nervousness was heightened by a widespread lack of confidence in the politicians' ability to rigorously and vigorously tighten the fiscal reins. Leaders in many countries, facing the unalterable necessity of consolidating public finances, were additionally confronted with the dilemma that pursuing a restrictive budgetary course might magnify the economic slowdown. As a result, monetary union is now trapped in a **vicious circle of an interlocking sovereign debt crisis and a banking crisis**.

**2.** In this daunting setting the **German economy** has remained remarkably robust in 2011. Gross domestic product (GDP) will probably grow by 3.0 per cent this year but then slow perceptibly to 0.9 per cent in 2012. The labour market has performed especially strongly. The annual average number of officially unemployed persons in 2011 stands at 3.0 million, which is the lowest level in a decade. It is likely to fall further to 2.9 million in 2012.

These projections are, however, subject to sizeable risks that are hard to quantify. The German Council of Economic Experts – GCEE (*Sachverständigenrat*) has therefore decided this year to compute alternative scenarios for Germany's cyclical development in the coming period. If the sovereign debt crisis is not contained, this will have a considerable impact on the German economy's external sector. If the escalation of the crisis is confined to the euro area, output will grow in 2012 by just 0.4 per cent. If global distortions concurrently lead to a stagnation of world trade, Germany will experience a slight decrease in GDP in 2012.

## I. Overcome the crisis in the euro area

**3.** Germany has a **particular responsibility** in overcoming the euro crisis. After many calls had been made for the country to act as lead firefighter, German policymakers eventually assumed this role with the economic initiatives taken at the euro summit of 26 October 2011, where German pressure was instrumental in the adoption of extensive measures to combat the crisis. The necessary inclusion of such a European dimension was, by contrast, largely lacking in the German government's abrupt change of course in energy policy.

### Overcome the crisis in the euro area

**4.** Safeguarding the stability of monetary union is not only in the interests of Europe, it is also in **Germany's own best interests**. Clearly, whatever measures are taken to solve the euro crisis will entail great expense and considerable uncertainty. In the end, all possible rescue scenarios involve high costs and high risks. In Germany the sometimes heated public debate focused on the high financial risks that taxpayers were bound to incur, with some commentators conflating their commiserations at the euro's unfortunate demise with congratulations on the imminent resurrection of the D-Mark.

Yet Germany has been a principal beneficiary of monetary union up to now. While it is extremely difficult to give a reasoned answer to the hypothetical question of whether Germany would have fared better had it kept the D-Mark instead of adopting the euro, Germany's track record prior to the launch of monetary union, as well as that of other export-oriented countries, suggests that a currency with a stable external value has positive effects on the real economy. The numerous appreciations of the D-Mark in the past caused severe economic problems for exporters and destroyed many jobs on balance. The recent appreciation of the Swiss franc demonstrated the explosive dynamics of a currency surge fuelled by speculation. In order to curb substantial negative consequences for the Swiss economy, the central bank felt obliged to peg the Swiss franc *de facto* to the euro. Given the global interconnection of money and capital markets, the benefits of open product markets can only be had if, at the same time, it is ensured that the resulting instabilities pose no serious threat to the real sector. And this protection does not come for free.

The politicians have evidently failed to **convince public opinion** of this self-evident fact. What is more, they have often given the impression of being "pushed, pulled and paraded" by the financial markets instead of taking charge themselves (German president Christian Wulff, 24 August 2011).

**5.** It only dawned slowly on the euro-area governments that putting together increasingly gigantic rescue packages was not going to calm the escalating nervousness on the financial markets. However, the decisions taken by the **Euro summit** on 26 October 2011 offer a chance of restoring the financial markets' confidence in the stability of monetary union at least for the time being.

- A sovereign debt haircut of 50 per cent and a new aid programme worth 130 billion euro are designed to open up for Greece a realistic prospect of consolidation. A bail-in of the private sector is to be achieved by means of a "voluntary" exchange of Greek government bonds.

- Leveraging the effective credit line of the European Financial Stability Facility (EFSF) to over one trillion euro is intended to ease the funding problem of countries currently facing liquidity difficulties. The leverage is to be effected by the EFSF providing investors who buy new government bond issues of euro-area problem countries partial insurance against the risk of sovereign default. In addition, the EFSF, acting *in tandem* with other public and private lenders via special-purpose vehicles, will purchase bonds on the secondary market and in this case, too, partially underwrite the associated risks.

- The resilience of the banking system is to be strengthened by improving banks' capitalization through extraordinary buffers for risky government bonds and a higher core tier 1 capital ratio of 9 per cent. These capital requirements are to be met by 30 June 2012. Failing that, the banks are to be recapitalized by their domestic government. If the sovereign itself cannot provide the extra funding, the EFSF will have to provide credit to it.

**6.** Quite apart from the fact that important details of these decisions still have to be ironed out, it is by no means certain that this will suffice to allay the nervousness on the financial markets even in the short term, let alone in the long term. The crucial precondition for achieving that goal is the implementation of a credible policy aimed at consolidating public finances in the problem countries. The ball is now in their court.

If the current political uncertainty in Greece can be overcome, the decisions agreed in October 2011 should **buy time**, in a similar way to the situation in May 2010 when the European Central Bank (ECB) decided to start purchasing government bonds so as to help defuse the tensions on the financial markets. At that time the political leaders did not make sufficient use of the respite this afforded them in order to convincingly tackle the task of fiscal consolidation and, by reforming the financial market architecture, enhance the resilience of the financial system and break the vicious circle of an intertwined sovereign debt crisis and a banking crisis. They must not make that mistake a second time.

### Stabilizing public finances in the euro area

**7.** The task of stabilizing public finances in the euro area must follow a two-pronged approach. The immediate challenge is to avert the danger of a systemic crisis. This needs to be additionally flanked by putting in place a new institutional framework for monetary union that ensures fiscal discipline in the member states.

**8.** To **rapidly defuse tensions** on the markets, it is imperative that all countries concerned implement a convincing strategy to consolidate their public finances without delay. The two steps – the expanded rescue package and credible fiscal consolidation measures – together open up a realistic prospect of stabilizing the euro area. This should be the political leaders' first aim. It is still possible, however, that the nervousness on the financial markets may persist. Given such an unfavourable scenario, a strategy of **constant expansion of the EFSF would come up against limits**. The dual danger would arise of an uncontrolled collapse of monetary union or the original sin of unlimited purchases of securities by the ECB.

Such a scenario of persistent investor nervousness on the financial markets would be attributable to inadequate fiscal consolidation results on the part of the member countries. This does not necessarily imply that in the euro-area states in question the will to achieve fiscal discipline is lacking or insufficient. If this were the case, monetary union would indeed be a basket case and would be doomed to fall apart. It is simply that, in the context of an economic downturn, fiscal consolidation can be harder to achieve and may disappoint the financial markets even though the countries concerned are in fact ready and willing to tighten their fiscal belt.

**9.** At this point, at the latest, more radical steps would have to be considered. They must focus on initiating a strategy that credibly reduces government indebtedness. One option could be a **debt repayment pact** (*Schuldentilgungspakt*) as proposed by the GCEE. This model is aimed at convincingly bringing the level of government indebtedness back below the 60 per cent ceiling stipulated by the Maastricht Treaty via a common redemption fund (*Tilgungsfonds*) and binding national debt brakes. In return, the participating countries would have the opportunity to partly finance their debt through a fund backed by joint liability. A key feature of this model is that the fund runs itself down automatically over time by means of a fixed schedule of repayment obligations. This automatic debt run-down, together with restrictive terms and stipulations, would make such a debt redemption fund a very different animal from Eurobonds.

**10.** Under the debt repayment pact, debt amounts above the Maastricht reference value of 60 per cent of GDP would be transferred to a common redemption fund subject to joint liability. A consolidation path would concurrently be laid down for each country under which it would be obligated to autonomously redeem the transferred debt over a period of 20 to 25 years. This is roughly equivalent to the debt reduction rule contained in the Stability and Growth Pact (SGP), which stipulates that excess debt above the 60 per cent ceiling must be reduced at an annual rate of 1/20.

The debts that remain exclusively with the participating countries would be additionally limited by the introduction of national debt brakes. To stabilize the European financial markets, the debt repayment pact offers euro-area member countries the possibility of covering their current funding needs (for the redemption of outstanding bonds and new borrowing) via the **redemption fund** until the credit facility is fully utilized. As existing debts are thus not transferred to the fund all at once but instead successively over a **roll-in phase** of around five years, this would provide strong incentives for fiscal discipline. Thereafter a country's outstanding debt level would comprise

- debts for which it is individually liable amounting to 60 per cent of its GDP, and

- debts that, at the time of the transfer, exceed the reference value of 60 per cent of GDP and are transferred to the redemption fund. These debts are likewise redeemed by the individual country. The transferring country bears the primary liability and the redemption fund a secondary liability.

**11.** As a result, the redemption fund would accumulate a portfolio of bonds totaling around 2.3 trillion euro in the coming years. Italy would hold the biggest share in this portfolio with 41 per cent followed by Germany with 25 per cent. Other major obligors of the redemption fund would be France, Belgium and Spain. Key features of the concept are that there would be an upward cap on the amount of the debt in the redemption fund after the roll-in-phase and that, in addition, each country is obliged to redeem its own debt over a period of between 20 and 25 years. The joint liability during the repayment phase means that **safe bonds** would be created by means of which the European financial system could be stabilized until the national bond markets regain sufficient functionality. The transfers to the redemption fund would have to be structured in a way that ensures that the transferred debt is indeed paid down over a period of approximately 20 to 25 years. At the same time it must be ensured that

- the establishment of the redemption fund is and remains an exceptional episode of limited duration, and

- the debts for which the member countries are solely liable do not again exceed the ceiling of 60 per cent of GDP stipulated in the Maastricht Treaty.

12. The redemption fund as thus constructed is conceivable only if the joint liability is flanked by **strict fiscal discipline** that is based on various pillars.

**First**, the redemption fund requires the inclusion of a national debt brake in the constitutions of the participating countries as this is the only way to ensure the credibility of the long-term consolidation obligation. The debt brakes should be geared to the objectives of the reformed Stability and Growth Pact. In particular, it must be ensured that the structural budget deficit, following a transitional period, does not exceed the limit of 0.5 per cent of GDP. The binding nature of the national debt brakes should be reinforced by requiring that they be additionally monitored by an independent European agency such as the European Court of Auditors.

**Second**, a safeguard must be included that enables the joint liability for new debt to be halted if a country does not comply with its commitments stipulated by the consolidation and growth strategy. In this case the roll-in would be stopped immediately and the country in question would then be fully exposed once more to the mechanisms of the international financial markets.

**Third,** to guarantee its payments to the fund, each participating country must promise to levy a surcharge on a national tax (value added tax and/or income tax), the proceeds from which would not flow to the national budget but instead would be channeled directly into the redemption fund.

**Fourth,** in order to limit the liability risk and as an individual contribution, all participating countries would pledge part of their international reserves (foreign exchange or gold reserves) as security against their liabilities. A contribution amounting altogether to 20 per cent of the credit underwritten by the fund should be hedged in this way.

**Fifth**, to cover the eventuality that an individual participating country is called on to pay up under its joint liability, its risk would have to be limited by agreeing a burden-sharing scheme among the remaining solvent participating countries.

13. The debt repayment pact would be robust to a challenge before the **Federal Constitutional Court** (*Bundesverfassungsgericht*). According to a ruling by the court of 7 September 2011, the Deutsche Bundestag (lower house of parliament) may not transfer its budgetary responsibility to other agencies through unspecified budgetary authorizations. One of the court's stipulations is that the German parliament must be able to decide on expenditure-related assistance payments to Germany's European partners on a case-by-case basis. Another is that the potential burdens on the central government budget must be limited in terms of time, scope and amount. Whereas the amount of financial obligations that Germany would incur under the debt repayment pact can be reliably delimited, it is not so easy to guar-

antee the duration of the commitment. It follows that the setting-up of such a redemption fund can be seriously envisaged only if there is a contractual safeguard prohibiting the fund from becoming a permanent entity for bankrolling the euro countries. The German parliament would therefore need to erect a legal fence guarding against the danger of the redemption fund's self-perpetuation in line with Article 146 of the Basic Law (*Grundgesetz*) concerning sovereign decision-making.

14. Ensuring the future fiscal soundness of the euro area additionally requires further reforms to the **Stability and Growth Pact**. The recent legislative thrust in connection with the "six-pack" proposals will make it easier to identify misdirected developments early on and to penalize them more effectively. As such they represent an advance on the *status quo ante*. However, the new version of the Stability and Growth Pact still retains discretionary decision-making powers for the Economic and Financial Affairs Council (ECOFIN) at the key stages of the sanction mechanism under the excessive deficit procedure. The sequence of steps under the excessive deficit procedure should be completely determined by decisions of the European Commission, and these decisions should be overturnable only by a qualified majority of the Economic and Financial Affairs Council (ECOFIN). It is worth considering a set-up similar to that in competition law involving the transfer of the Council's decision-making competencies in full to a **commissioner in charge of economic and financial affairs**.

15. The overriding medium-term objective in the coming years must be to seek to strengthen fiscal discipline by devising a smarter rule-based arrangement, more independent decision-making within the Stability and Growth Pact and **preventive market discipline** via a stable long-term regulatory framework for public borrowers and private financial institutions.

**Stabilizing financial institutions in the euro area**

16. The crucial need in Europe not only to consolidate public finances but also to stabilize the private financial system was graphically highlighted in mid-2011 with the renewed breakout of a **crisis of confidence in the European banking system**. It was triggered largely by feedback effects of the sovereign debt crisis in the euro area and threatened to escalate rapidly.

The euro-area heads of state or government thus felt forced to announce steps to stabilize the banking system. The 70 large European banks that were subjected to a quick stress test by the European Banking Authority (EBA) are required to increase their core tier 1 capital ratios to 9 per cent of their risk-weighted assets and also to establish an extraordinary capital cushion for risks emanating from sovereign exposures. These two measures must be implemented by mid-2012, failing which the banks are to be **recapitalized** using public funds. If the sovereign itself is unable to recapitalize its banks, it will be able to apply for resources from the EFSF. The EBA's provisional calculations indicate a combined current capital shortfall of 106 billion euro. Greek banks account for the lion's share of this outstanding capital requirement with 30 billion euro, followed by Spanish banks with 26 billion euro and Italian institutions with some 15 billion euro. The respective capital gaps of German banks (around 5 billion euro) and

French banks (around 9 billion euro) are fairly small, in the German banks' case thanks in part to write-ups on their holdings of German government bonds.

**17.** The GCEE welcomes the "bank package" as it can make a contribution to strengthening confidence in the banks and enhancing the stability of the financial system. Even so, it is conceivable that the planned measures may lead to adverse effects. There is a danger, in particular, that marking government bond portfolios to market may create uncertainties in valuing balance sheets and foster **accelerated deleveraging**. If banks are unable to raise the necessary extra capital under their own steam, they may prefer reducing their risk-weighted assets to a partial nationalization. Although the banks are expected to meet the higher capital requirements by raising private capital or retaining dividends and bonus payments, it is not clear how prudential supervisors will enforce this demand. Whether this bank package represents the long-awaited big breakthrough will depend on the degree to which it helps to overcome the crisis of confidence and risk premiums on government bonds decline.

**18.** Sovereign debt crises are not a modern invention. The first documented payment default of a country dates from the 4th century B.C. Down the centuries and increasingly since the 1970s more and more sovereign debt crises have occurred, often in conjunction with a banking crisis and a currency crisis, giving rise to the expressions twin crisis and triple crisis. Nearly half of the financial crises over the past decades were triple crises, which caused extremely high macroeconomic costs. In view of these costs the International Monetary Fund (IMF) proposed a new international financial architecture with an insolvency regime for sovereign states.

Although reforms at international level have fallen well short of these proposals, the main planks of a robust **regulatory framework for the euro area** can nonetheless be derived from the debate on the international financial architecture. An effective regulatory framework needs to meet three requirements. First, it requires an insurance component for sovereign liquidity problems, with countries having to qualify in advance to acquire the insurance benefits by their good conduct. Second, the granting of more extensive support must be subject to stringent conditions. And third, a transparent, predictable and credible mechanism must be put in place for bailing in the private sector in the event of solvency problems.

**19.** The GCEE proposes a regulatory framework that meets these demands. Countries with a debt-to-GDP ratio of up to 60 per cent would have unlimited access to credit from the European Stability Mechanism (ESM) as long as they fulfill the precondition of a sound economic and fiscal policy. Countries with a debt ratio between 60 per cent and 90 per cent can receive credit only if they implement multi-year adjustment programmes. If a country's debt ratio exceeds 90 per cent of its GDP, it will be able to apply for ESM loans only after restructuring its debts owed to private creditors. Such a regulatory framework would lay the basis for an effective because **preventive market discipline** since the conditions under which the private sector would have to take a hit would be transparent, predictable and credible. Such a framework can only be introduced in the medium term, however, after the euro-area countries have reduced their debt ratios to 60 per cent.

**20.** Also, the reforms to date for dealing with **systemically important financial institutions** (SIFIs) will not achieve the goal of preventing banks from taking sovereign states hostage. The envisaged reforms would be based on two pillars. First, a comprehensive international prudential supervisory regime is to be set up that would monitor cross-border financial institutions effectively in normal times, including a cross-border insolvency procedure to facilitate an orderly reorganization and restructuring of systemically relevant institutions in an emergency. Second, such institutions should hold significantly higher buffers in the form of capital and liquidity so as to lower the likelihood of losses leading to a financial institution's insolvency.

**21.** The reform of the **insolvency regime for banks** falls well short of the mark. Although in some countries national restructuring regimes have been created, these will prove of little use unless they can be applied effectively to institutions operating across borders. The reform proposals at international and European level merely seek to improve the coordination of national measures and therefore do not fill the bill of establishing an effective and credible insolvency regime. The GCEE has repeatedly argued the case for setting up a European restructuring fund equipped with appropriate powers to reorganize and restructure systemically important financial institutions.

**22.** In the absence of external buffers and the discipline of an effective restructuring and insolvency regime, it is all the more important to stiffen the resilience of systemically important institutions so that they are able to absorb unexpected losses without outside help. Since, from a macroeconomic perspective, capital generates far greater benefits than costs, it makes sense to **further strengthen the capital buffers** in order to bolster the resilience of the banking and financial system as a whole. The introduction of a leverage ratio has the advantage that, in contrast to risk-weighted capital ratios, it is robust to incorrect risk valuations both in internal models and external models of the rating agencies. A leverage ratio captures all balance sheet positions with their full risk weight and thereby avoids, for example, the uncertainties of the valuation problem associated with government bonds.

One of the stumbling blocks to agreeing on the level of the leverage ratio is the lack of a uniform and internationally comparable definition. The **Basel definition** will set a standard that harmonizes different accounting systems, adjusts total assets and also takes off-balance-sheet positions into account. To create a solid basis for evaluating a leverage ratio it would therefore be highly advisable to bring forward the planned publication of a uniform and internationally comparable leverage ratio, which at the moment is scheduled for 2015. The GCEE believes it would be appropriate, on the basis of the Basel definition, to limit a financial institution's on-balance-sheet and off-balance-sheet activities to 20 times its core capital. This equates to a **leverage ratio based on Basel of 5 per cent** (and is probably equivalent to an unadjusted balance sheet leverage ratio of roughly twice that level). The Basel Committee's proposed leverage ratio of 3 per cent could be taken as a starting point and then raised progressively until 2019. Its introduction should be shadowed by ongoing evaluation studies that examine its financial and macroeconomic impact in relation to the macroeconomic utility of a robust financial system.

**Policy recommendation: think and act European**

23. Germany's economic policymakers will continue to face exacting challenges in 2012. Essentially this means no less than accepting and assuming responsibility for Europe. The stability of monetary union has to be safeguarded and outstanding key reforms of the financial market architecture need to be resolutely advanced. In Europe Germany must become the central generator of strategic visions and projects. Such a proactive role for Germany in shaping European economic policy must not stop at mastering the euro crisis and reforming the financial market architecture. An equally important arena is energy policy. Unfortunately, Germany's go-it-alone change of direction in 2011 showed no evidence of having a convincing strategy for embedding its national energy policy within a European context (sections xxx ff.).

## II. Germany in an uncertain setting

24. The salient feature of Germany's economic development so far has been a strong recovery process in the course of which the losses sustained in the recession of 2009 were recouped. In mid-2011 German GDP consequently regained its **pre-crisis level** (Chart 1). However, the second quarter of 2011 saw the hitherto very dynamic upturn start to falter, even if the second-quarter figures were distorted by extraordinary factors.

The currently available economic indicators up to September 2011 suggest that the upturn will slow down towards the end of 2011. This is due first and foremost to a cooling of global economic momentum, which up to now has buoyed Germany's business activity via export demand. In addition, the sovereign debt crisis in the euro area and the associated problems in the financial sector are **shackling economic development** in the euro area. Another factor is that a number of industrial countries are having to tackle the task of consolidating their public finances. On the other hand, there is a good chance that the emerging market economies will continue to expand, albeit at a less dynamic pace. After German economic output was again helped in 2011 by a contribution from the external sector, it will have to rely in 2012 solely on the components of domestic demand.

The GCEE forecasts a growth rate of GDP of 3.0 per cent for 2011 and of 0.9 per cent for 2012. This means that **the upturn in Germany is slowing down**. This represents a return to normal following the rapid boom. Consequently, GDP will settle again on a long-term path of moderate expansion in line with potential output. Inflation will ease slightly following the price rises in spring 2011. Consumer prices look set to rise by 2.3 per cent in 2011 and then by merely 1.9 per cent in 2012 (Table 1).

Table 1

**Key economic indicators for Germany[1)]**

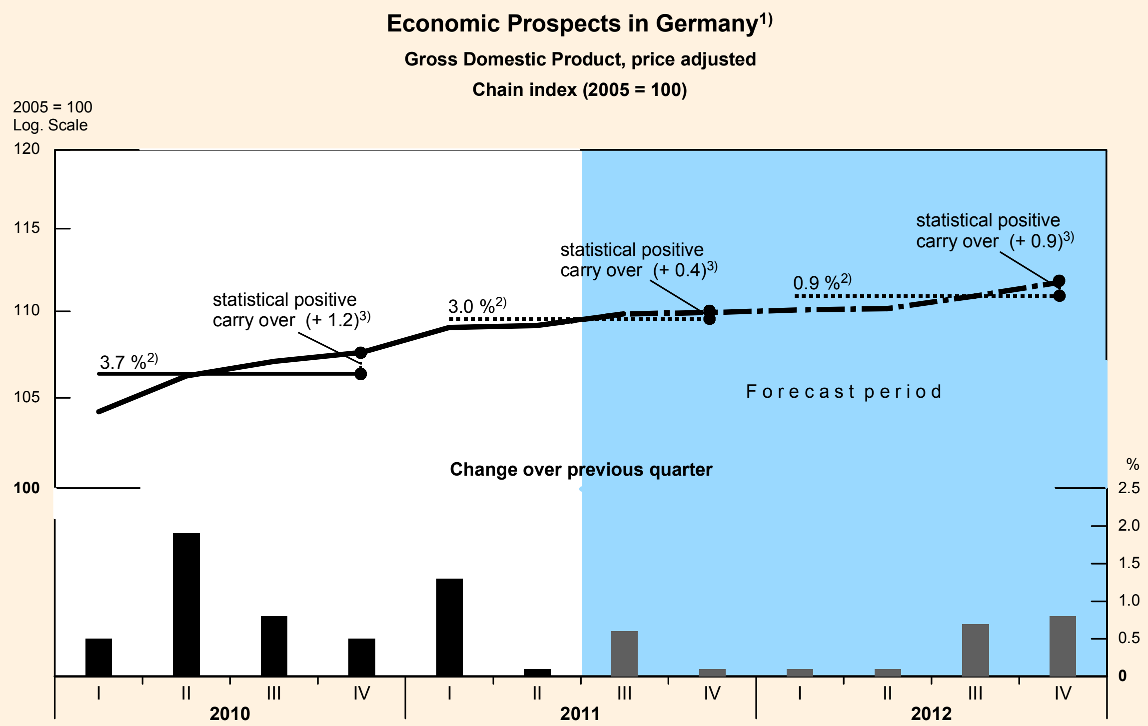
| | 2008 | 2009 | 2010 | 2011[2)] | 2012[2)] |
|---|---|---|---|---|---|
| Gross domestic product | 1.1 | – 5.1 | 3.7 | 3.0 | 0.9 |
| Private consumption[3)] | 0.6 | – 0.1 | 0.6 | 1.1 | 0.9 |
| Government consumption | 3.1 | 3.3 | 1.7 | 0.8 | 0.9 |
| Investment in machinery & equipment | 3.6 | – 22.8 | 10.5 | 8.8 | 3.1 |
| Buildings | – 0.7 | – 3.0 | 2.2 | 5.2 | 1.5 |
| Other investment | 7.0 | 0.6 | 4.7 | 3.8 | 2.8 |
| Total domestic demand[4)] | 1.3 | – 2.6 | 2.4 | 2.4 | 1.3 |
| Terms of Trade[5)] | 0.0 | – 2.6 | 1.5 | 0.7 | – 0.3 |
| Exports of goods and services | 2.7 | – 13.6 | 13.7 | 7.8 | 3.2 |
| Imports of goods and services | 3.3 | – 9.2 | 11.7 | 7.1 | 4.2 |
| Persons employed (domestic)[6)] | 40.35 | 40.36 | 40.55 | 41.09 | 41.23 |
| Registered unemployment, stocks[6)] | 3.26 | 3.42 | 3.24 | 2.97 | 2.89 |
| Persons employed, covered by social security[6)] | 27.51 | 27.49 | 27.76 | 28.41 | 28.69 |
| Unemployment rate[7)] | 7.8 | 8.1 | 7.7 | 7.1 | 6.9 |
| Consumer prices[8)] | 2.6 | 0.4 | 1.1 | 2.3 | 1.9 |
| General government balance[9)] | – 0.1 | – 3.2 | – 4.3 | – 1.1 | – 0.7 |

1) Unless otherwise indicated: price-adjusted (changes over previous year); Change over previous year in percent (%).– 2) 2011: own estimate, 2012: forecast.– 3) Including non-profit institutions serving households.– 4) Domestic use.– 5) In percentage points.– 6) Thousands persons.– 7) Unemployment rate referred to entire civil sector workforce (employees, self-employed including unpaid family workers). Source: years 2008 to 2010 Federal Labour Office (Bundesagentur für Arbeit).– 8) Consumer price index (2005 = 100), change over previous year in %.– 9) Net lending of the central, state and local governments and the social security system, as % of nominal gross domestic product.

**25.** At the current end the strength of the upturn and the evolution of GDP are subject to major risks. The deceleration of global economic expansion and the nervousness in the financial system pose a renewed danger to the German economy via the foreign trade channel. As the risks are very hard to quantify, the GCEE has calculated **alternative scenarios** for Germany's economic development in the next year.

The uncertainty surrounding the resolution of the sovereign debt crisis may have a major impact on world trade. There is a real danger that the already fraught funding conditions for sovereigns may tighten further. If the escalation of the crisis is confined to the euro area, the scenario projects a decrease in the volume of world trade from 4.9 per cent to 3.5 per cent. In that case German GDP would expand by only 0.4 per cent. If the many risks and uncertainties lead to a stagnation of world trade in 2012, the rate of change of German GDP would drop to -0.5 per cent and thus to a recession.

Chart 1

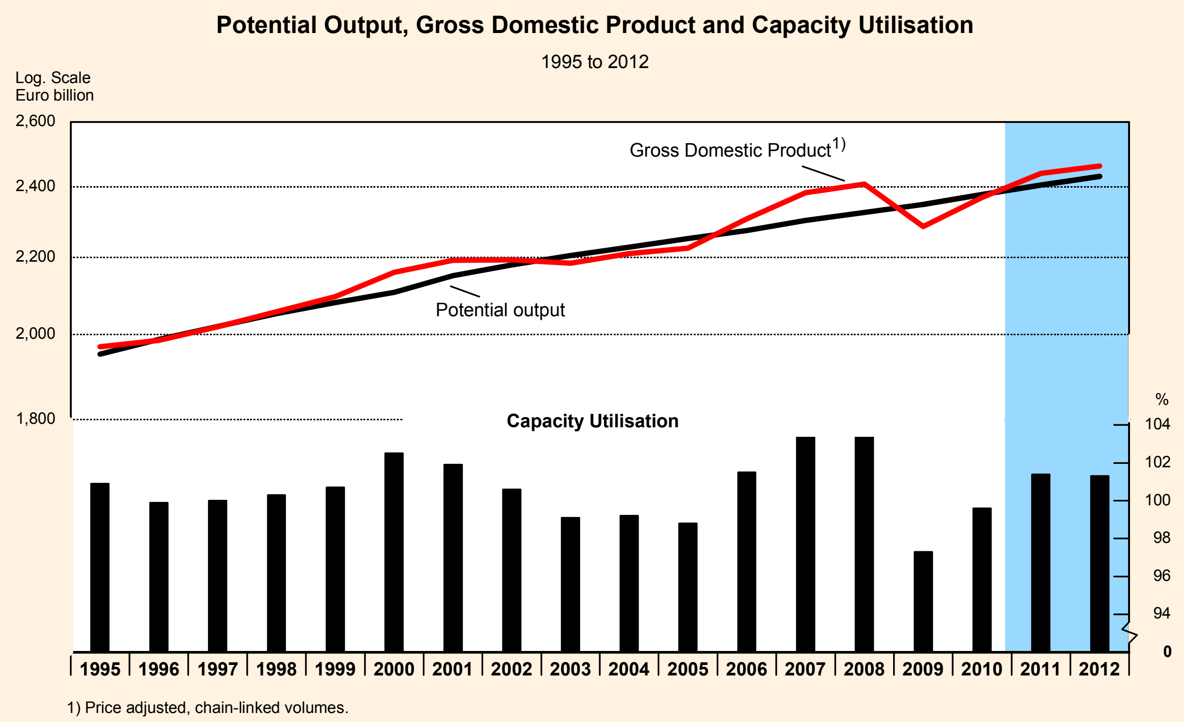



1) Quarterly values: seasonally adjusted (Census X-12-ARIMA).– 2) Annual averages: changes over previous year.– 3) Percentage difference between the absolute level of the gross domestic product in the last quarter of the year t and the average level of the quarters in the year t (see JG 2005 box 5).



**26.** At the moment, however, the German economy is in a phase of slight overutilization of production capacities; in other words, actual output is above **potential output**, which is defined as the economic output that could be generated by a normal level of utilization of all production capacities without additional inflationary pressure (Chart 2). Although aggregate labour productivity initially declined, unemployment barely fell during the recession. Even if the decline in labour productivity has still not been fully reversed, the hoarding of labour by employers was a key factor supporting the ensuing recovery. The GCEE puts potential growth at 1.2 per cent in both 2011 and 2012 (section on economic development). The relative overall output gap, i.e. the difference between actual and potential output in relation to potential output, in 2011 thus comes to around 1.4 per cent.

Chart 2






**27.** On the back of the strong economic upturn, working hours, employment and hourly productivity all increased in Germany in 2011. **Employment** increased by 537,000 persons compared with 2010 while official **unemployment** decreased by 266,000 persons. In 2012, in a weakening economic setting, the number of employed persons is likely to rise – mainly thanks to the statistical overhang effect – by 143,000 to 41.2 million, and the official jobless total to fall by 81,000 to just below 2.9 million.

**28.** The consolidation of **public finances** made good progress in 2011 and should make further strides in 2012. With the deficit ratio recording a decline from 1.1 per cent to 0.7 per cent, the target of a balanced budget seems a much closer prospect than seemed possible at the height of the crisis. As in the case of overall economic development, forecasts of the net fiscal surplus or deficit are subject to major uncertainty. Given a renewed slump in economic activity, tax revenue can be expected to shrink perceptibly. And the revenue side has been the mainstay of budgetary consolidation to date. Receipts from some taxes registered their highest growth rates in 2011 since German reunification. Yet even if the negative scenarios do not materialize, revenue dynamics may be expected to slacken in 2012. Although Germany's fiscal consolidation requirement has fallen overall, it is now becoming increasingly difficult to achieve. In 2011 the debt ratio receded somewhat following its surge in the previous year. It was still above 80 per cent, however. A further setback could occur in 2012 if additional euro-area states require assistance.

**29.** Notwithstanding all the external risks, it should not be forgotten that the German economy is well placed compared with other countries. The buoyant state of the labour market, the low budget deficit by international standards and the very favourable financing terms add up to a robust base for economic development going forward.

## III. Challenges in other policy areas

### 1. Energy policy: successful change only possible in European context

**30.** Following the nuclear catastrophe that occurred in Fukushima in Japan in March 2011 the German government submitted a raft of energy laws to the Bundestag at the end of June designed to completely change the direction of energy policy. As a result, the guiding principles of the government's energy policy took a radical turn after 14 months. Back in September 2010 the government had agreed on a comprehensive **energy plan**. This contained outlines of an overall strategy that would transform electricity generation in Germany such that renewable energies would become the principal source of generation by 2050. Key elements of the energy plan are a series of climate policy goals that chart existing emission and renewable energy targets up to 2050 plus changes to administrative legislation accelerating the expansion of the national grid.

**31.** Originally, however, a central component of the energy plan had been to prolong the operating leases of nuclear power plants as a holding technology until renewable energies were sufficiently developed to take over a leading role. This prolongation of the operating leases was passed by the Bundestag on 28 October 2010 as one of the first projects of the energy plan. Following the meltdown of the nuclear reactor in Fukushima, however, the German government performed a **nuclear policy volte-face** and announced a complete exit form nuclear energy by 2022. As a result, the current conservative-liberal government not only returned to the nuclear exit path embarked upon by a previous social democratic-green coalition, it also pledged in the subsequent extensive debates on the peaceful use of nuclear energy that it would not backtrack from its new line. Moreover, the climate policy targets in the energy plan were not revised despite the additional challenges that the exit from nuclear power generation entails.

**32.** This complete change of course in energy policy transforms the government's long-term climate policy targets from an abstract vision to a concrete social goal. In particular, a very different system of energy supply will be constructed in future. Whether this project can be brought to fruition will depend on the strategic choices as well as the operational successes and failures of the **coming years**. After all, the proclamation of the medium-term objective of a complete exit from nuclear technology and the definition of long-term aims for reorganizing the system of energy supply are by no means synonymous with their actual realization. In view of the inevitable conflicts of aims and interests, the probable technological and economic problems and the necessary huge innovation advances that will have to be made, the goal of engineering a complete exit from nuclear power generation within a decade will alone require superhuman efforts at all levels.

In particular, the costs incurred by the reorganization of the energy supply system need to be continually weighed against **competing alternative uses** of the national economic resources in order to safeguard the ongoing democratic legitimation of this project. Nonetheless, the launch of this sweeping change in energy policy also offers great opportunities. These notably include the possibility of demonstrating that a modern industrial society can abandon nuclear energy without massive welfare losses. A failure of this energy policy transformation, by contrast, would also deal a fatal blow to the aspired role-model in pioneering the exit from nuclear energy. Germany can thus simply not afford to allow its about-turn in energy policy to end in abject failure.

33. The reversal of the agreed prolongation of nuclear power plants' operating leases and the adoption of the raft of energy policy legislation affect all areas of energy supply. This applies especially to the electricity market, in which the closure of older nuclear power stations and the accelerated expansion of renewable energy sources will widen the geographical divide between electricity production and consumption and will thus necessitate a considerable expansion of the electricity supply grids. The costs of this grid expansion will be passed through to electricity prices and will therefore further push up the end user's costs for electricity, which are already inflated by all sorts of taxes and levies, intended not least to subsidize the build-up of renewable energy sources. Hence the successful **systemic integration** of renewable energies represents a key technological, political and financial challenge in implementing the new energy strategy.

34. Yet a debate on the further expansion of renewable energies that is focused exclusively on national energy policy fails by definition to take adequate account of the **international dimension** of a transformative energy strategy. At the end of the day the German government's policy resolutions amount to no more than the pledge it has already made at European level as its contribution to implementing the European Union's common climate policy targets for 2020, with which the European Union is seeking to assume a global pioneering role in climate protection. But as climate protection is a public good, the costs of its provision must be borne at the national level alone, whereas its benefits accrue to all nations. It follows that the European Union's pioneering role in respect of climate protection can only represent a transient situation and should not be pursued further unless it is guaranteed that other major polluters will, in turn, launch comprehensive initiatives to cut emissions.

35. Irrespective of these climate policy arguments, the competing choices for deploying the national economic resources dictate that every effort should be made to minimize the costs of achieving the European Union's climate targets. The **present strategy**, which conflates the sensible instrument of emissions trading with the extremely costly promotion of alternative energies – and which, to make matters worse, is fragmented into differing national promotion policies – clearly fails the test of economic efficiency.

Back in 2005 the European Emissions Trading System (EU-ETS) set a ceiling for greenhouse gas emissions of energy utilities and energy-gobbling industries. It regulates around half of all greenhouse gas emissions and is the European Union's foremost climate policy instrument. On top of this the member states of the European Union have set specific expansion goals for renewable energies with the Renewable Energy Directive. It is extremely doubtful, however, whether the additional promotion of renewables can make a contribution to climate protection given that the EU-ETS already defines a **binding ceiling** for the emission of greenhouse gases. Thus while emissions will be cut by generating electricity from renewable energy sources, emission rights in this area will be simultaneously freed up that can then be traded on the market and deployed in other areas covered by EU-ETS.

Another problem is that the member states of the European Union are pursuing the additional targets for raising the share of renewable energy sources primarily at the national level. Unlike the EU-ETS, which minimizes $CO_2$ avoidance costs by defining a uniform price across Europe, possible locational advantages are unused in the case of a purely nationally organized expansion of renewable energies. Furthermore, in promoting renewables the member countries often pursue additional technology and industrial policy objectives on top of the primary goal of expanding the share of alternative energy sources. For example, in its present form the German **Renewable Energies Act** (*Erneuerbare-Energien-Gesetz*), in particular, violates the principle of cost-efficiency. Owing to the legislative intent of giving preference to less economic technologies when promoting renewables, the $CO_2$ avoidance costs of the individual promotable technologies vary greatly. This causes the costs of promotion to explode. This is especially evident in the case of solar energy, which in relation to the volume of electricity it produces is by far the most heavily subsidized generating technology in Germany.

The main problem of the Renewable Energies Act is thus the costs associated with its (apparent) success. It has proved to be **very effective** in fostering extra capacity, but is at the same time **extremely inefficient**. In particular, the 20-year guaranteed minimum remuneration period at the prices valid at the time of constructing the renewables plant means that the renewables structure currently in place will continue to involve very high payment obligations for a lengthy period. Hence it would be impossible to lower the costs of the Renewable Energies Act in the foreseeable future even if the promotion of newly installed plant were to be ended immediately. This is because an immediate stop to the renewables expansion programme would merely reduce the volume of promotion over time only in so far as a plant that has been producing electricity for 20 years reaches the end of the promotion entitlement term. In this way additional costs had already been incurred by the year 2010 vis-à-vis expected future electricity prices amounting to a present value of over 80 billion euro.

**36.** Any further expansion of electricity generation from renewable energies in line with the European Union's expansion goals must be achieved at a much lower cost than under the current expansion scheme. Otherwise the transformation in energy policy could well forfeit public support. This aim can only be achieved by radically rethinking the current system of promoting renewable energies. What is needed is a new system that is more **market-oriented** and that increases the incentive to exploit economies of scale, particularly through an efficient dispersal of production sites in Europe. It will not suffice to pursue a transformative energy strategy as a go-it-alone national approach. What is required instead in future is to take greater account of the **European dimension** of the national expansion targets for renewables agreed at the level of the European Union.

**37.** This necessitates instruments that, unlike the Renewable Energies Act, distinguish between the cost-efficient construction of electricity generation capacity and dedicated promotion of innovation.

- For one thing, the expansion of the renewable energies should be steered not via a range of electricity storage payments but rather via a market-based steering of volume in the form of green electricity certificates. This would comply with the economic principle of a single price, which leads to an efficient selection between different options. In order, in addition, to be able to exploit specific locational advantages for renewable energies in Europe, this system should be **harmonized throughout Europe** in the medium term. One highly promising step that needs to be implemented without delay is the **harmonization of promotion rates** in Germany across all technologies.

- For another, as a matter of principle different economic goals should be pursued using different instruments. While the task of promoting the expansion of capacity for generating electricity on the basis of renewable energy sources currently supports low-cost technologies, the goal of finding new technological solutions can be left to an **autonomous technology policy**.

## 2. Public finances: consolidation has top priority

**38.** Thanks to the buoyant revenue situation, the start that has been made to consolidating public finances went better this year than the German government expected. **General government revenue** rose by 5.6 per cent, which was the highest year-on-year increase since 1994. The combined budget deficit of central, state and local government plus the social security funds amounted in 2011 to 1.1 per cent of GDP. Even so, central and state government are still running such high deficits that they need to step up their consolidation efforts if they are to meet their commitments under the debt brake (*Schuldenbremse*) – in the case of central government in 2016 and for the state governments by 2020. The **debt-to-GDP ratio** declined to 80.4 per cent but might well rise again if additional euro-area countries require assistance. All in all, the targets contained in the central government's draft Budget Act (*Bundeshaushaltsgesetz*) are not very ambitious. Given the general economic slowdown and the slacker revenue growth that it is likely to entail in 2012, we can expect at best small steps towards fiscal consolidation.

**39.** Central government still needs to spell out the details of how it intends to comply with the new debt-capping rule. For instance, a **loan is booked as a financial transaction** which initially has no impact on the deficit. Hence under the new debt accounting rules, defaulting or forgiven loans ought to be subtracted from the permissible maximum borrowing total. If not, this pushes up the volume of newly incurred debt which would not be limited by the debt rule. Central government could, for example, grant a loan to the Federal Labour Office (*Bundesagentur für Arbeit*) and later waive its repayment without this having any bearing on compliance with the debt brake. While this is unlikely given the Federal Labour Office's current financial situation, the Act implementing Article 115 of the Basic Law *(Artikel-115-*

*Gesetz*), which lays down the new debt incurrence rules, should be adjusted in order to prevent such potential evasion of the debt rule.

**40.** For their part, the state governments have been slow to enshrine the **debt rule in the state constitutions**. So far only Hesse, Schleswig-Holstein, Mecklenburg-Western Pomerania and Rhineland-Palatinate have managed to incorporate a debt rule into their statute book. In Lower Saxony a constitutional amendment has been drafted and is currently being debated. Baden-Württemberg, Bavaria, Bremen, Hamburg, Saxony, Saxony-Anhalt and Thuringia have debt rules that lack constitutional status. Berlin, Brandenburg, North Rhine-Westphalia and Saarland have no debt rule at all at present. To comply with the debt brake that has now been written into the Basic Law, Germany's national constitution, it is imperative that these states, too, introduce debt rules – and without trying to dilute them with creative accounting options.

**41.** At the moment it is unclear how the necessary **extension of the borrowing cap to local government** is to be achieved. In particular, it is uncertain whether the municipalities (*Kommunen*) are to be roped together with their respective state for the purpose of the debt rule. Under the Basic Law only central government (*Bund*) and the state governments (*Länder*) enjoy sovereign status, which means that local governments, despite the corporate autonomy bestowed on them by Article 28 (2) of the Basic Law, are merely sub-entities of the state government. Consequently, pursuant to Article 106 (9) of the Basic Law the revenue and expenditure of local government (including local government associations – *Gemeindeverbände*) are allocated to the revenue and expenditure of their respective state government. Although it would be meaningful to likewise attribute the municipalities' fiscal balance, i.e. the difference between their revenue and their expenditure, to the state level, this is not obligatory under existing legislation. This is because, given the municipalities' extensive legal autonomy, a strict segregation between state government and local governments exists, especially in terms of budget law. In economic terms, however, the municipalities should indeed be included as part of their state government for the purpose of the debt incurrence ceiling in order to prevent them from borrowing excessively and state governments from offloading their fiscal consolidation requirements onto their municipalities. This outstanding ambiguity needs to be speedily addressed and resolved by the legislature.

**42.** The state budgets face substantial **consolidation requirements** for the period 2011 to 2020 and also beyond. Growing civil servant pension burdens and shrinking dedicated supplementary grants from central government (*Sonderbedarfs-Bundesergänzungszuweisungen* will place extra strains on state budgets in future. The magnitude of the consolidation requirement varies greatly, however, from one state to another. Whereas Bavaria, Baden-Württemberg, Saxony and Hamburg need to undertake only small consolidation efforts or none at all, in order to comply with the debt rule, Berlin, Bremen, Saarland, Saxony-Anhalt and Thuringia will have to slash their current expenditure in the space of ten years up to 2020 by around one-fifth. But given rising and, in some cases, surging debt, the other states – above all North Rhine-Westphalia – likewise need to begin consolidating their budgets very soon.

**43.** On the tax policy front the political debate was dominated last year by the question of whether and to what extent the government might have leeway during the present parliament to reduce the taxes paid by the man and woman in the street. One of the options discussed was a reform of the income tax schedule. Calls to substantially streamline the tax system or to introduce a comprehensive reform of municipal finances by replacing local business tax (*Gewerbesteuer*) and the share of income tax revenue that currently accrues to local government with an entitlement to levy a local supplement on income tax and corporation tax went unheeded. Moreover, in March of this year the European Commission presented a draft directive for a **Common Consolidated Corporate Tax Base (CCCTB)**. A decision on the CCCTB is unlikely next year, not least on account of the likely revenue losses likely in Germany.

**44.** The discussion on reforming income tax has focused on so-called "bracket creep" (*Kalte Progression*) and the "middle bracket bulge" (*Mittelstandsbauch*). **Bracket Creep** refers to the additional tax burden on real incomes resulting from the fact that an inflation-offsetting rise in income automatically pushes the taxpayer up into a higher income tax bracket even if there has been no change in tax rates and tax thresholds. If no adjustment is made for bracket creep, the tax burden of all taxpayers rises continuously in the long term; increasing shares of GDP would be transferred to the state in the form of taxes. Bracket creep leads to unjustified extra taxation. Even appreciable rises in real wages often result in only small increases in real purchasing power. Despite the adjustments to tax brackets and changes in the tax base, the effects of bracket creep will cause an extra tax burden in Germany up to the year 2013 that the government should offset by lowering marginal and average tax rates. This would deplete tax receipts by around 3 billion euro per year. Moreover, a commitment to cancel the effects of bracket creep at regular intervals should be incorporated into income tax legislation. This would also take some of the heat out of the perpetual political squabble about reducing the income tax burden.

**45.** By contrast, the extra strains relating to the "**middle bracket bulge**" are not manifestly inequitable. The term "middle bracket bulge" refers to the steeper upward tax curve in the first tax progression zone according to the rising tax bracket thresholds defined under the current income tax regime. This leads to the perceived fear that middle-sized incomes carry an excessive tax burden. The income tax tariff scale is centrally devised in accordance with politically defined notions of fair and just burden-sharing that defy theoretical attempts to plot the "correct" continuum for the tax scale. Different options for adjusting the "middle bracket bulge" either lead to substantial tax revenue losses – the variants which the GCEE has computed lead to tax losses of between 12 and 25 billion euro – or they would require the entry tax rate above the tax-free allowance to be raised to almost 20 per cent to offset the lost revenue, in which case they would have an adverse impact on national income distribution. Given the high fiscal consolidation requirement, the GCEE therefore argues against adjusting the "middle bracket bulge".

**46.** A correction of bracket creep during the current legislative term should be counter-financed through **adjustments on the expenditure side** or the **elimination of tax benefits** so as not to jeopardize budgetary consolidation. Potential savings on tax benefits could include axing the flat-rate commuting allowance (*Pendlerpauschale*) and the tax exemption of supplements paid for working at nights, on Sundays or on public holidays, as well as restructuring the taxation of the non-pecuniary benefit (*geldwerter Vorteil*) of using company cars for private purposes. The government should also review the tax-deductibility of services commissioned by households (*haushaltsnahe Dienstleistungen*) and repair and maintenance work commissioned by households (*Handwerkerleistungen*) if the underlying aims, especially curbing undeclared work, are not achieved or are achieved only at unacceptably high costs.

## 3. Labour market: ongoing employment boom

**47.** In 2011, as in 2010, the German labour market was buoyed by an unexpected **upward thrust**, even though this weakened a little in the second half of the year. The official number of unemployed persons fell further in the course of 2011 vis-à-vis the previous year and dipped below the three million mark continuously since May 2011 and on an annual average throughout 2011, whereas last year this barrier was undershot only in October and November. In October 2011 the official jobless figure fell to just 2.74 million and thereby reached a new low not equalled since 1991. Conversely, the number of employed persons increased further in the course of 2011 and the annual average employment total for 2011 of close on 41.1 million persons marked the highest score since the reunification of Germany in 1990. The number of jobs fully subject to social contributions rose to an annual average of 28.4 million in 2011, which was higher than at any other time during the past 15 years.

**48.** During the crisis year 2009 the German labour market proved very robust thanks to the hoarding of labour accompanied by a reduction of average working time. But equally remarkable is the almost continuous rise in employment since the middle of the past decade and, in this connection, the fact that the situation in 2011 is actually better than before the crisis. The reason for this success is the interplay of three factors: the **favourable international economic setting**, a generally **employment-friendly wage policy** and the effect of the **labour market reforms** carried out from 2003 to 2005.

However, this impressive evolution of the labour market does not obviate the longstanding need to make the labour market more flexible. At the latest when the economy cools down, it is to be feared that the rigidities on the labour markets will act like a ratchet blocking the necessary adjustments. The still unacceptably high level of unemployment and the high level of underemployment demand institutional reforms as well as a wage policy that is not just employment-neutral but positively employment-friendly.

**49.** Contrary to what some observers have suggested, the upswing on the labour market has not occurred at the expense of the employees. In addition to the creation of numerous new and competitive jobs, the positive overall economic situation has also been reflected in a **marked increase in employee compensation**. On average in 2011 aggregate hourly gross wages and salaries per employee rose by 4.1 per cent year on year, while wages per employee went up at the somewhat slower rate of 3.2 per cent. The fact that the growth of gross wages and salaries per employee was smaller than the hourly increase is due to the employees' longer working time owing to the crisis-induced catch-up requirement. In real terms, i.e. after deducting the rise in consumer prices that amounted to 2.3 per cent in 2011, gross earnings likewise increased appreciably. The fact that the rise in real net earnings was not as great is thus not the fault of the private sector.

However, these average values conceal a growing industry-specific and skill-related **differentiation of the wage structure**. Thus the intensifying competition among firms for skilled workers and the associated upward pull on wages does not extend to low-skilled workers. This underscores the importance of vocational training for this section of the workforce. If that proves an unrealistic proposition, social policymakers must step into the breach.

**50.** Sceptical observers of the recent labour market development question the quality of the newly created jobs, including jobs fully subject to social contributions, owing to the increase in part-time working, the growth of temporary jobs and above all, the surge in hirings from agencies which, it is argued, frequently pay dumping wages. Another common allegation is that regular jobs have simply been substituted by temporary jobs for the most part. In actual fact, however, agency-hired male workers earned just about 10 per cent less than comparable full-time staff in 2009. In 2011 only 17 per cent of the growth in the number of jobs subject to social insurance contributions was attributable to the rise in **agency-hired workers**.

**51.** At the end of 2010 the Federal Labour Court (*Bundesarbeitsgericht*) **negated the legal capacity** of the Association of Christian Trade Unions (*Tarifgemeinschaft Christlicher Gewerkschaften*) **to conclude collective labour agreements** with temporary hiring and recruitment agencies. The consequence of this is that the collective agreements they have concluded with such agencies are null and void. This has sparked a debate as to whether the hired workers affected can lodge a backdated claim to higher pay, and the social security schemes a backdated claim for social contributions, to the hiring firm for the period prior to the ruling. The GCEE takes the view that those firms that signed collective bargaining deals with the Christian trade union should be granted **grandfathering cover**.

**52.** Analyses to date of the factors responsible for the largely stable labour market development during the last sharp recession, which often focus on the reduction in working time, tend to take no account of the impact of German firms' **relocation of parts of the value added chain** to other countries. In the 1990s and the 2000s a considerable portion of German companies shifted some of their production steps abroad. This meant that the downward adjustment of labour levels during the recession took place partly in the foreign subsidiaries, not least because the German institutional regulations on short-time working and their further extension made it cheaper for firms to keep hold of their workers in Germany. For the crisis year 2009, when German GDP plummeted by 5.1 per cent, empirical studies provide evidence that, during the global slump, the adjustment of employment levels at the foreign production locations was indeed significantly higher than in Germany.

## 4. Social security schemes: sound financial position, but reforms neglected

**53.** The strong macroeconomic momentum and the healthy labour market situation have made a major contribution in 2011 to the comparatively positive financial situation of the social security schemes. The financial position of the **statutory pension insurance scheme** (*Gesetzliche Rentenversicherung*) is so good that the government is likely to reduce the contribution rate to 19.6 per cent from 1 January 2012. Furthermore, the "Government Dialogue on Pensions" initiated by the Federal Ministry of Labour and Social Affairs (*Bundesministerium für Arbeit und Soziales*) has put age-related poverty at the centre of the political discourse.

**54.** The GCEE accepts that, in recent years, the combination of a deteriorating labour market situation, the resulting rise in freelancing, the widening of the pay structure at the lower end of the wage scale and the reforms of the pension system, which will push down pension levels, might result in future in an increase in the number of retired people having to apply for welfare payments or top-up payments and hence in an increase in age-related poverty. At the present time it is not possible, however, to precisely quantify the expected rise in **age-related poverty** owing to the unclear long-term employment and income trends and, more especially, the existence of additional retirement incomes and accumulated assets.

Consequently, now is not the time for curative measures aimed at expanding the range of the statutory pension insurance scheme's social benefits, even if they are tax-financed. Instead, policymakers should concentrate on preventive measures. The GCEE lists among these the **introduction of an insurance obligation for freelancers and one-person firms for whom there is currently no social insurance obligation**, an education policy that raises the level of skills and qualifications and thus lowers the risk of unemployment, a health policy that supports both firm-level and individual prevention initiatives with a view to lessening the risk of disability-related reduced earning capacity, and an expansion of private old-age provision. This could ensure as far as is humanly possible that each generation itself assumes the costs of avoiding age-related poverty rather than automatically passing these on to subsequent generations.

**55.** The raft of revenue and expenditure reforms implemented in the Statutory Health Scheme Funding Act (*Gesetzliches Krankenversicherungsfinanzierungsgesetz*) adopted in 2010, especially the raising of the contribution rate to 15.5 per cent and partial capping of spending growth, have contributed, alongside the positive labour market situation, to a gratifying financial position for the **statutory heath insurance scheme** (*Gesetzliche Krankenversicherung*) in 2011. These measures will probably have an influence only in the short run, however. What is more, few health insurance institutions appear prepared to levy additional contributions in 2012, and they might well refrain from doing so in 2013 as well. It thus remains to be seen whether future spending growth in the health service really will be funded by flat-rate top-up contributions with waivers for hardship cases.

Ideally these **additional contributions** should be used to convert the statutory heath insurance scheme's funding mechanism to a citizens' flat-rate contribution system with a tax-financed social equalization component (*Bürgerpauschale*), as favoured by the GCEE. Moreover, given the growing expenditure pressure generated by demographic factors and the ongoing medical and technical advances, it is important to exploit untapped efficiency reserves, to strengthen competition among health service providers and to achieve a better balance between in-patient and out-patient treatment.

**56.** In view of the current sound conjunctural setting and labour market situation, the **public long-term care insurance scheme** (*Soziale Pflegeversicherung*) should also post a positive result at the end of 2011. Nevertheless, expenditure is likely to outgrow revenue in the short to medium term, so that the public long-term care insurance scheme will record deficits in the future. These will be caused by the envisaged automatic increases in benefits and growth in the number of recipients plus the worsening ratio of contribution payers to benefits recipients due to demographic change. The GCEE suggests that the reform of the scheme's funding basis, which the government has announced but not yet implemented, should be geared to lightening the load on future generations by reducing the volume of intergenerational redistribution. As in the case of the statutory heath insurance scheme, this should ideally be achieved by introducing a citizens' flat-rate contribution system with a tax-financed social equalization component. Should this not prove possible, consideration should be given to other measures, such as higher contributions for co-insured spouses, the introduction of government-subsidized additional private long-term care insurance provision or the establishment of a mandatory funded second pillar.

**57.** The financial situation of the **statutory unemployment insurance scheme** (*Arbeitslosenversicherung*) has likewise been boosted by the buoyant economy and labour market. Although the statutory unemployment insurance scheme will show a deficit at the end of 2011, this will be smaller than expected. Even so, it is evident that the raising of the contribution rate by 0.2 percentage point to 3 per cent will not suffice to avoid running up a financial deficit in an economic upturn and to build up reserves for economic downturns.