KEY MESSAGES AND EXECUTIVE SUMMARY OF THE ANNUAL REPORT 2018/19

KEY MESSAGES

WORLD TRADE

- ↘ Strengthening the multilateral rule-based trading system and the WTO
- ↘ Responding as EU to protectionism through retaliatory measures under WTO rules
- ↘ Concluding new free trade agreements with the United States and other countries

INTERNATIONAL TAX COMPETITION

- ↘ Abolishment of the solidarity surcharge to curb the recent rise in statutory business taxes due to the local business tax
- ↘ Rejection of the proposals for taxation of digital companies and minimum taxation only as interim solution
- ↘ Possible introduction of a patent box as a tax competition instrument and an allowance for corporate equity to eliminate the distortion in the tax system

CLIMATE AND ENVIRONMENTAL PROTECTION

- ↘ Working towards a standard international carbon price as a steering instrument
- ↘ Strengthening the EU ETS and involvement of all end-users for effective sector coupling
- ↘ Localised solutions for problems with nitrogen oxide and particulate matter; e.g. congestion charge

BREXIT

- ↘ If possible, preventing Brexit and creating legal clarity for the possibility of a reversal
- ↘ Avoiding a disorderly Brexit, but preparing for its possible effects
- ↘ Negotiating an agreement for the United Kingdom that is as comprehensive as possible – without allowing cherry picking

EUROPEAN UNION

- ↘ Reinforcing the principle of subsidiarity in the EU and focusing on European added value
- ↘ Aligning financial resources to the so defined tasks of the EU, e.g., more for public security, infrastructure, and basic research
- ↘ Allocating payments from the structural and cohesion funds not indiscriminately, but rather based on the objectives of the funds, especially the objective of economic convergence

EURO-AREA

- ↘ Normalisation of monetary policy in the Euro-Area with symmetric reaction to macroeconomic developments, balance sheet reduction and communication of normalisation strategy
- ↘ Reduction of public debt ratios to create fiscal space, supported by reformed fiscal frameworks; avoidance of long-term transfers without giving up national sovereignty
- ↘ Further advancement of the Banking Union and Capital Markets Union, in particular termination of regulatory privileges for sovereign exposures and reduction of barriers to integration

SHORTAGE OF SKILLED WORKERS AND MIGRATION

- ↘ Better opportunities to increase working time of part-time workers and flexibility in work organization and working times, as well as full-day care
- ↘ Raise labour force participation through low labour market hurdles, flexible retirement and fiscal measures to increase female employment
- ↘ Increase of professionally qualified immigration, especially from non-EU countries, through a Skilled Workers Immigration Act

PENSION SYSTEM

- ↘ Avoiding the double restriction for the contribution rate and the net replacement rate beyond the year 2025
- ↘ Flexibilization of the statutory pension age and linking it to higher life expectancy to avoid one-sided burden on younger generations
- ↘ Avoiding policies, such as the mothers' pension II, that aggravate the already existing sustainability gap at the expense of future generations

RESIDENTIAL PROPERTY AND PRIVATE CAPITAL FORMATION

- ↘ Expansion of supply by a reduction of regulation such as rent control; lowering transaction costs by a reform of the property transfer tax, encountering social segregation
- ↘ Opening of occupational pensions for acquisition of owner-occupied residential property
- ↘ Creation of additional macroprudential instruments and consideration to apply macroprudential measures

HEALTH CARE

- ↘ Reduction of high capacities and small-scale hospital structures through competitive elements and structural adjustment in the hospital sector
- ↘ Financing health insurance funds through non-income-related additional contributions and development of the health insurance system into a citizen allowance with social compensation
- ↘ Conversion of hospital financing from a dual to a monistic system and expansion of cross-sectoral care

DIGITALISATION AND TECHNOLOGICAL PROGRESS

- ↘ Emphasizing the opportunities of technological change and, in particular, digitalisation, which in the past has created more new jobs on balance
- ↘ Empowering the population to adapt through the right conditions, better start-up funding and a modern education system
- ↘ Strengthening innovation openness and social esteem of entrepreneurship in order to exploit opportunities and advantages of technological change

DIGITALISATION – INFRASTRUCTURE AND PUBLIC ADMINISTRATION

- ↘ Increasing the connection speed in Germany without preference given to any specific technology, under increased competition and only with state-subsidies in individual cases
- ↘ Utilization of efficiency potentials in the digitalisation of public administration and the healthcare sector, for example through a central portal and the electronic patient file
- ↘ Increasing private ICT investments, for example through the promotion of complementary investments and a modern educational system

DIGITALIZATION – INDUSTRIAL POLICY AND REGULATION

- ↘ Renouncing government-intervened industrial policy in favor of individual companies and technologies, instead ensuring appropriate infrastructure and effective competition
- ↘ Avoiding discriminatory regulation of traditional and new businesses and business models
- ↘ Modernization of competition law, but no special taxes for digital companies

1. The German economy is maintaining **one of its longest upswings in the post-war period**. However, a less favourable foreign trade environment, temporary production issues and capacity bottlenecks are slowing the pace of expansion. The growth rate of gross domestic product (GDP) of 1.6 % for 2018 and 1.5 % for 2019 is thus gradually moving towards the currently estimated potential growth of around 1.5 %. Global economic growth is also likely to slow down. Euro area GDP growth rates are forecast at 2.0 % for 2018 and 1.7 % for 2019. An escalation of the trade conflict, a disorderly Brexit, or a resurgence of the euro area crisis harbour risks for economic development.

2. The German economy faces major challenges – in particular the uncertain future of the multilateral global economic order at international level, and demographic change at national level. Both challenges particularly affect Germany. Strengthening the European Union (EU) would be part of the answer to the international challenges. Embracing the structural change resulting from digitalisation would help to master the national challenges. This requires setting the **right course for economic policy**.

3. The Federal Government should tackle the **necessary reforms** boldly and seize the opportunities that present themselves. In order to secure prosperity in the long term, economic policymakers should improve Germany's economic framework and create leeway for addressing new challenges. They should refrain from an interventionist industrial policy.

Global multilateralism and European integration

4. Since President Trump took office, the United States has withdrawn from several multilateral organisations and agreements. Particularly in international trade and global climate protection, the international community suffers welfare losses from unilateral national actions to resolve matters. The United States' **protectionist measures** and the reactions of trading partners have increased average tariff rates. However, the situation thus far is not comparable to the type of trade war seen in the 1920s and 1930s.

   The EU should consider retaliatory measures under World Trade Organisation (WTO) rules to credibly punish rule infringements. In addition, the **WTO** should be reformed and thereby strengthened. The EU should take advantage of the opportunity to further increase welfare and conclude new free trade agreements, for example with the United States. Adopting its own protectionist measures, such as a general requirement for approval of foreign direct investments, are not in Germany's long-term interests.

5. The United States' withdrawal from the Paris Agreement constitutes a setback in efforts for a global solution to **climate protection**. This is particularly serious, as the aim should be to strive for global climate protection approaches encompassing all sectors, technologies and regions, such as a uniform international carbon price, instead of energy transitions at national level. The EU could take an initial step and establish a uniform comprehensive price. Unlike the reduction of carbon emissions, which is a global issue, the problem of **particulate**

matter and nitrogen oxide emissions in cities must be addressed at local level. City centre congestion charges that make polluters bear a portion of the costs and that vary based on local pollution levels and vehicle exhaust emissions would be better than driving bans.

6. Various OECD countries that previously had higher statutory corporate tax rates than Germany have lowered their **tax rates**. Complete elimination of the solidarity surcharge could offset the rise in business tax rates induced by the local business tax since the tax reform in 2008. Creating a patent box in Germany that is in line with OECD rules (nexus approach) could be considered as an element of tax competition. The proposals for taxing digital companies discussed at EU level should, however, be rejected. A minimum taxation can only provide an interim solution.

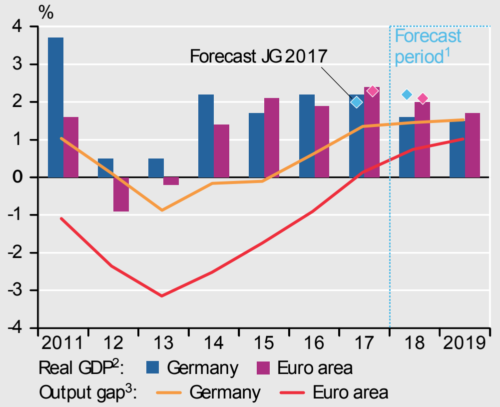
7. The global challenges underscore the value of the European Union as a political project that promotes peace among its member states and contributes to increasing prosperity. At present, the EU is increasingly challenged by eurosceptic parties, such as in Italy, and by **Brexit**. As Brexit is likely to be associated with negative consequences particularly for the United Kingdom, but also for the remaining EU member states, the best solution would still be for the United Kingdom and the negotiating partners to find a way to prevent Brexit. The risk of a disorderly Brexit makes systematic preparation necessary to avoid upheavals. If Brexit cannot be prevented, the objective should be to conclude a follow-up agreement that minimises the damage for both sides as much as possible but that does not allow any “cherry picking” for the United Kingdom.

8. Brexit will require reorganisation of the **EU's finances**. The EU's multiannual financial framework for 2021-2027 that will have to be renegotiated could be seen as an opportunity to focus it on European added value. This would require reinforcement of the principle of subsidiarity and concentration of financial resources on the EU’s tasks in line with this principle, i.e., greater allocation to public security, infrastructure and basic research. Instead of distributing money from the Structural and Cohesion Funds across the EU using a “watering can” principle, resources should be much more focused on the funds' stated goals.

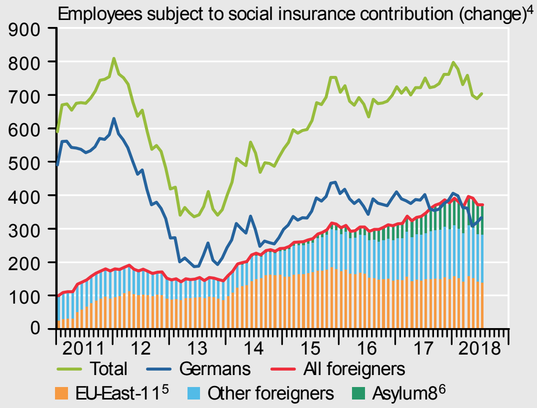
9. The European Central Bank (ECB) needs to manage the transition to a normal monetary policy successfully in order to permanently stabilise the euro area. The **ECB’s monetary policy**, however, remains highly expansionary despite a considerable increase in inflation. There is a risk that the turnaround in monetary policy will be too late. Moreover, the ECB should communicate an approach to reducing its balance sheet. Governments need to move towards sustainable financial policies in order to create future leeway.

Macroeconomic development

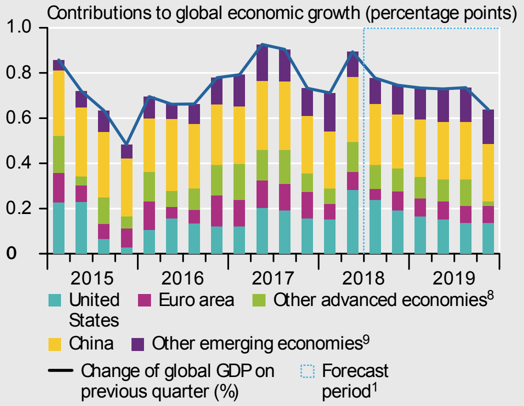
Overutilisation of capacity in Germany and euro area is increasing, growth is decreasing.



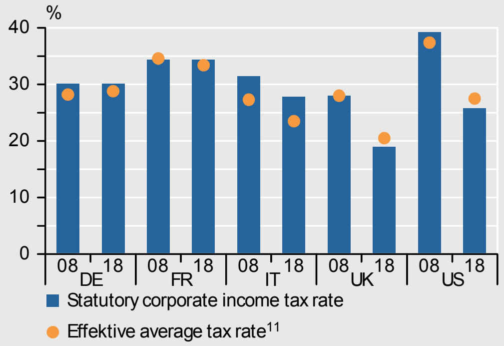
Immigrant workers are largely responsible for the rise in employment



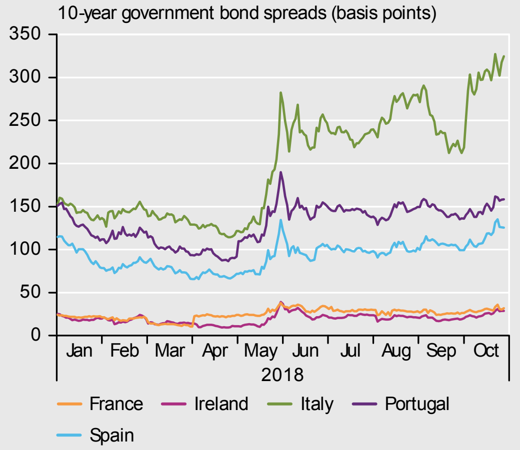
Trade conflict and Brexit pose risks to global upswing.[7]



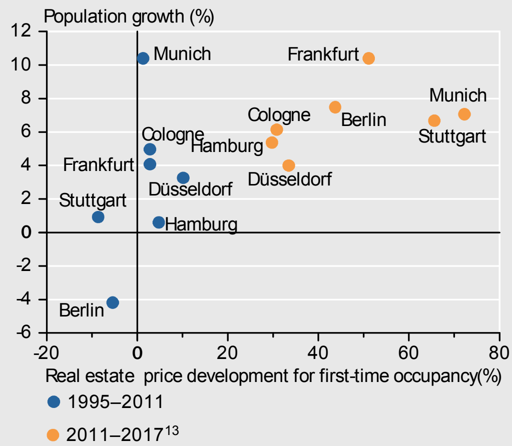
US tax reform has intensified international tax competition.[10]



The increase in risk premium on Italian government bonds is evidence of market discipline.[12]



Low interest rates and demographic factors increase pressure on real estate prices.



1 – GCEE forecast. 2 – Change on previous year. Diamond: see GCEE Annual Report 2017 for 2017 and 2018. 3 – Relative deviation of GDP from potential output. 4 – Absolute change measured in thousands of workers subject to social insurance contribution on month of the previous year. 5 – EU-East-11: Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Czech Republic. 6 – Asylum8: Afghanistan, Eritrea, Iraq, Iran, Nigeria, Pakistan, Somalia, Syria. 7 – Global GDP (weighted total of national economies listed). 8 – Rest of the European Union as well as Canada, Hong Kong, Japan, Norway, Republic of Korea, Switzerland, Singapore, Taiwan. 9 – Argentina, Chile, Columbia, Indonesia, Malaysia, Mexico, Philippines, Thailand, Turkey. 10 – DE-Germany, FR-France, IT-Italy, UK-United Kingdom, US-United States. 11 – Data for the United States as of 2018, data for other countries as of 2017. Based on announced and implemented changes in tax law, values for 2018 are expected to be unchanged. 12 – Yield spreads for 10-year government bonds of the respective country against German government bonds. 13 – Population growth for Berlin and Hamburg: 2011–2016.

Sources: bulwiengesa, European Commission, Eurostat, IMF, Federal Emplyment Agency, Federal Statistical Office, Thomson Reuters, ZEW, own calculations

10. In the euro area member states, a reduction of still **high debt levels** would be advisable in the current economic situation. Institutional reforms to strengthen and better enforce the EU's fiscal framework could support this objective. The considerable increase in spreads on Italian government bonds in light of Italy's budget plans is evidence of market discipline. When a member state is in danger of losing its market access, it can obtain loans from the European Stability Mechanism (ESM) in return for conditionality. Further developing the ESM, by enabling an orderly restructuring of government debt and implementing the fiscal backstop for the Single Resolution Fund (SRF), would make sense.

11. Proposals currently on the political agenda to reform the European monetary union are aimed at improving **risk sharing** between member states. In reality, the common monetary policy can only react to differing economic trends in the member states to a limited extent. National fiscal policy, and particularly the effect of automatic stabilisers, plays a central role in stabilising country-specific developments. This does not require a European fiscal capacity, which bears the risk of creating a transfer union through the back door. Substantial long-term transfers without a transfer of sovereignty should be avoided.

12. Credit and factor markets also play an important stabilising role. Removing the obstacles to financial integration in Europe by deepening the **European Banking Union** and the **Capital Markets Union** is a longer-term goal. By removing the regulatory privileges of sovereign exposures and introducing a fiscal backstop to the Single Resolution Fund (SRF) the sovereign-bank nexus should be further loosened. The removal of such regulatory privileges along with efforts to continue the reduction of risk is essential for creating a common deposit insurance scheme. Harmonising insolvency law, equal tax treatment of debt and equity, and expanding the competencies assigned to the European Securities and Markets Authority (ESMA) are key to fostering the development of an integrated capital market.

Demographic change and digitalisation

13. **Demographic change** will necessitate changes in almost all areas of economic policy at national level. The current "demographic pause" and economic upswing are setting the stage for reforms that strengthen growth and economic sustainability.

14. Employment has risen substantially. Meanwhile there are noticeable shortages of skilled workers. An initial approach to reducing the **skilled worker shortages** is implementing measures to better utilise the available labour force potential. One idea would be enabling part-time workers to more easily increase their working hours, for example, through a more flexible work organisation and further expansion of full-day childcare. The law regarding working hours (*Arbeitszeitgesetz*) should be modernised to give workers more flexibility in distributing their working hours across the work week, enabling them to achieve a better balance between work and private life.

15. A second approach provides for measures to **increase** the domestic **labour force potential**. This includes increasing labour market participation through lower labour market hurdles, flexible retirement models and measures to raise the proportion of women in the labour force. **Migration** is playing an increasingly important role in the labour market and now accounts for more than fifty percent of growth in employment subject to social security contributions. A permanent high level of skilled immigrant workers will likely be essential in order to secure prosperity in Germany. This could be increased by means of the planned immigration law for skilled workers.

16. **Germany's fiscal policy** is set to become more expansionary next year. The structural deficit, adjusted for cyclical and transitory effects, can be expected to amount to 0.8 % of nominal GDP this year, and drop to 0.1 % next year. Measures are also under discussion that would create more strain on social security systems already under demographic pressure.

    Fixing both contribution rates and replacement ratios in the **statutory pension scheme** until 2040, assuming an unchanged retirement age from 2030, would mean significantly increasing the necessary contributions from the federal budget. This would likely require tax increases. Instead, a gradual increase of the statutory retirement age, ideally by linking it to future life expectancy, is needed. Measures that neglect demographics and thus increase the sustainability gap to the detriment of future generations should be avoided.

17. **Residential property** prices have risen sharply in the past few years as growth in housing demand has outstripped the increase in supply, particularly in metropolitan areas. Exaggerated developments in residential property prices in major cities cannot be ruled out. Given the moderate development of loans and indebtedness, there are no acute risks to financial stability for the time being. Nonetheless, the activation of macroprudential tools should be considered to counter the risk of a collapse in real estate prices and the elevated interest rate risks.

    Regulations such as the rent ceiling only address the symptoms of the problem. In particular, measures to **expand housing supply** are advisable in order to tackle the socio-political challenges. These include reducing property and real estate transfer tax distortions and regulations. In addition, there is room for improvement in social housing, not least to prevent social segregation. Occupational pension schemes should be opened up to include acquiring owner-occupied real estate, to promote private accumulation of real estate assets.

18. The financial strain on the **healthcare system** can also be expected to increase noticeably in the future due to demographic change and medical and technological advances. There are some indications of overprovision and misprovision in various areas of the healthcare system. Introducing competitive elements and consolidation in the hospital sector could reduce high capacities and small-scale structures. Transition from a dual to a monistic system of hospital financing and the expansion of cross-sectoral care provision offer efficiency potential. Funding health insurers via additional non-income-based health insurance premiums and further development of the health insurance system into a scheme based on

a flat-rate per capita health insurance premium (*Bürgerpauschale*) including a mechanism for social compensation could boost health insurance market competition.

19. It is likely to be close to impossible to offset the labour volume decline resulting from demographic change. What is needed instead is greater productivity growth. High hopes are pinned on **digitalisation**. Technological change – and digitalisation, above all – offer ample opportunities, with more new jobs created than lost in the past. However, technological progress brings profound changes to the economy and society. The top priority should be on efforts to better enable people to utilise the opportunities inherent in the digital transformation, for example, through better framework conditions, strengthening of start-up financing, and a modern education system. There also needs to be greater social esteem for innovations and entrepreneurship.

20. **Investment in information and communication technologies** and the required infrastructure are an important factor for digitalisation to contribute to productivity growth. Connection speeds should be increased in a technology-neutral manner, relying on greater competition and only subsidised by the government in specific cases. In addition, exploiting the efficiency potential in digitalisation of administration and the healthcare system by means of a central online portal and electronic patient files is advisable.

21. Whenever structural change becomes visible and technological changes become apparent, the calls for **industrial policy interventions** become louder. In order to ensure long-term success, a country that wants to promote innovation should refrain from interventionist industrial policy that regards identifying strategically significant future markets and technologies as the state's responsibility. It should rely on decentralised expertise and the individual actions of a variety of players in an economy and should focus on ensuring a sound infrastructure and viable competition. Micromanagement interventions that benefit specific vested interests should be avoided, particularly in digitalisation. Anti-trust law should nonetheless be modernised, but a special tax on digital companies avoided.