GERMAN COUNCIL
of Economic Experts

THE GAINS MUST NOT BE SQUANDERED

Annual Report 2007/08

Chapter One
Chapter Two to Seven: Summaries

November 2007

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Preface

The German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) hereby presents the English translation of the complete first chapter and the summaries of the other six chapters of its Annual Report 2007/08. The first chapter gives a brief review of the latest developments, prospects and policy issues of the German economy discussed in the report.

The complete report is divided into seven chapters:

I. The gains must not be squandered

II. The global an German economic situation and outlook

III. Stability of the international financial system

IV. Social security: more positives than negatives

V. Fiscal policy on the right track so far

VI. Labour market: on the way to higher employment

VII. Should the acquisition of equity stakes by foreign investors be restricted?

The data used in the report of the Council were the latest available in end-October 2007.

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

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CHAPTER ONE

The gains must not be squandered

I. Muted economic outlook

II. There is a reform dividend

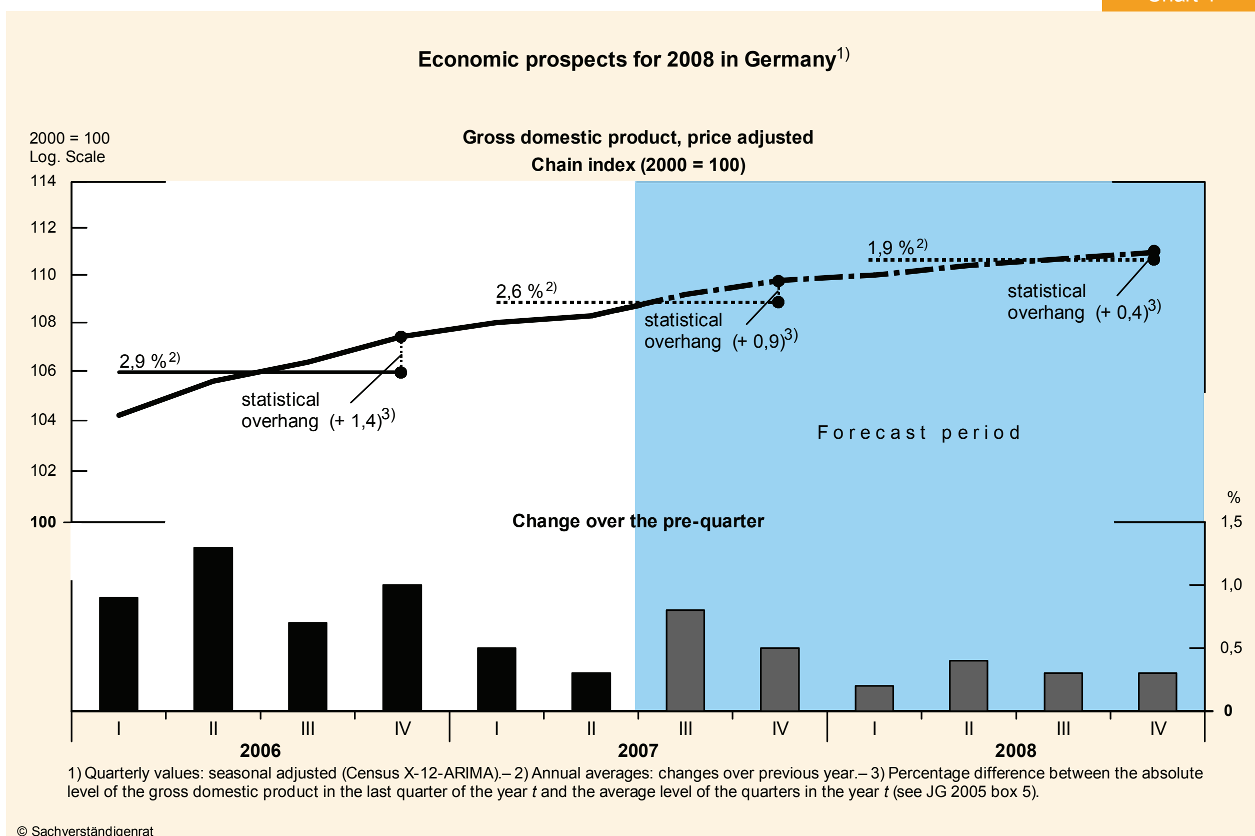
III. Economic policy during the upturn – positives and negatives

IV. Economic policy options: what should, and should not, be done

CHAPTER ONE
The gains must not be squandered

1. Following the surprisingly strong upturn in 2006, which was reflected in an increase in gross domestic product (GDP) of almost 3 per cent, the German economy remained in healthy shape in 2007. GDP grew by 2.6 per cent despite the dampening effects of the hike in value added tax (VAT) and the uncertainty engendered by the virulent crisis in the financial markets in the third quarter. As the global economic risks have increased, however, the pace of expansion is set to slow down. Consequently, German GDP is likely to grow by 1.9 per cent in 2008 (Chart 1).

Chart 1



The present good shape of the German economy is the result not only of the cyclical recovery that began at the start of 2005 but also of a series of far-reaching and wide-ranging adjustment processes initiated in response to the growing competitive pressures on the global product and factor markets. Policymakers contributed to Germany's **economic resurgence** by launching in part very extensive reforms in the fields of taxation, the labour market and the social security systems, as did German enterprises by streamlining their organisational structures and adjusting their balance sheets. This applies not least to wage negotiators who, by concluding moderate and flexible pay settlements, made an important contribution to the marked improvement in German firms' price competitiveness. At the end of 2007 Germany is a much more attractive investment location than it was during the last upturn in the business cycle.

2. A number of problems with which the politicians had to contend in previous legislative periods, and which were also addressed in past Annual Reports of the German Council of Economic Experts (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*), were,

by comparison, no longer as pressing or prominent in 2007. To a certain extent this is due to the fact that the policymakers, particularly in the years from 2001 to 2006, successfully tackled many challenges – such as ensuring the sustainability of the statutory pension insurance scheme (*Gesetzliche Rentenversicherung*) and creating supplementary funded private pension components or combating the causes of entrenched unemployment by means of the Hartz reforms of the labour market. To a rather greater extent it is due to the cyclical upturn in the past two years, which contributed much to the consolidation of central, regional and state government budgets as well as to the revival of the labour market and hence to the stabilisation of the social security schemes on the revenue side. But the economic upswing has also meant that problems which were prioritised in tougher times have become less pressing in the perception of both the general public and the policymakers, a case in point in the context of labour market policy being the persistently poor employment prospects of the low-skilled and the long-term unemployed. It is indisputable, however, that the positive macroeconomic development of the past two years has opened up a **wider radius of action** for policymakers. The key need now is not to waste the chance offered by the expanded opportunities for policy action but rather to seize it with a view to achieving a further sustained improvement in the prospects for growth. Just as it is gratifying that the policymakers' financial room for manoeuvre has expanded, so it is frustrating that a whole series of measures that were considered or adopted during the recent past revealed no clear economic policy strategy but instead smacked of tactical electioneering. A good policy course does not always have to consist of a quantum leap. Given the constraints imposed by the dictates of political compromise, a series of smaller steps can also constitute a good policy path, provided the steps are all in the same direction and are based on a planned itinerary.

3. Unfortunately, such a clear direction is not evident at present – in contrast to the situation during the previous legislative period. On the contrary, welcome and pioneering reforms that have been initiated are in danger of being checked or even reversed. Examples of such reforms which are in danger of being diluted include the raising of the retirement age to 67, the provisions of unemployment benefit II (*Arbeitslosengeld II*) or shortening the maximum period of entitlement to unemployment benefit (*Arbeitslosengeld*). At the same time remaining problems, which it should actually be easier to resolve during a cyclical upturn but which are suddenly perceived as less being less urgent under the radiating feel-good factor once the economy picks up, are slipping out of the focus of attention or sliding down the list of priorities. This is attested by the current state of the projects to rapidly reduce central government borrowing, overhaul the low-wage sector or reform the system of financing the statutory health insurance scheme (*Gesetzliche Krankenversicherung*) and the public long-term care insurance scheme (*Soziale Pflegeversicherung*). Many political decisions are necessarily based on value judgements concerning the appropriate distribution of national income, and not even the government's expert economic advisers can always dispel the uncertainties concerning the implications of various policy options. Thus politicians indisputably have a democratically legitimated prerogative to determine the nature and scope of the measures that are to be taken, quite apart from having to solve the often onerous task of mobilising the political majorities needed to implement them. However, the consequences of pursuing a policy which – as during the last upturn from 1999 to 2001 – failed to take action in key problem areas came home to roost during the ensuing phase of economic upturn in the form of a marked contraction of the economic policymakers' radius of action and an increasingly urgent need for reform. It

is therefore now, while the economic setting remains favourable, that the policymakers should take the key steps to reinforce the foundations for growth and employment so as to ensure that they retain sufficient room for manoeuvre when the economy experiences tougher times. This is why the German Council of Economic Experts has entitled the Annual Report 2007/08 "**The gains must not be squandered**".

I. Muted economic outlook

4. The hike in value added tax (VAT) by 3 percentage points, which was adopted at the end of 2005 and came into force on 1 January 2007, boosted GDP in 2006 owing to precipitated spending in the fields of consumption and housing construction. Conversely, this frontloading effect – together with the withdrawal of purchasing power brought about by the tax rise – noticeably dampened the rate of expansion of GDP this year and thus overstated the year-on-year change in macroeconomic momentum. Measured by the growth rate of actual output compared with that of potential output, the peak of the current upturn nonetheless occurred in mid-2006 (Chart 1). Since then GDP has been running above the German economy's long-run tension-free expansion path. This positive output gap increased by a smaller amount in the course of 2007 and will nearly close in the course of 2008, as the course of actual output will lie marginally below the potential growth rate of 1.7 per cent. In conjunction with the buoyant trajectory from the current year, this will result in **GDP growth of 1.9 per cent in 2008**. Given the good shape in which the German economy is currently in, this should not be seen as an indication that the upturn has run its course or even that a recession is around the corner. The reason for this is that the rise in aggregate output in the coming year will be driven mainly by stronger domestic demand, whereas the main causes of the slackening of the growth dynamics are external, namely the virulent financial market crisis which flared up in the third quarter of 2007 and whose full repercussions cannot yet be definitively gauged, the economic slowdown in the United States and the associated tendency for the US dollar to depreciate.

5. The **causes of the financial crisis** are complex (sections 130 ff.). By dint of an overly expansionary interest rate policy pursued by the Federal Reserve, a macroeconomic environment was created in the United States in the years 2003 to 2005 that not only triggered a real estate boom but also concurrently created powerful incentives for financial market players to "lever up" their rates of return through high borrowing. A greater depreciation of the US dollar, which would have dampened households' propensity to borrow by pushing up prices and interest rates, was prevented for a long time by large-scale foreign exchange market intervention by central banks from emerging market economies. Another problematic development was the carry trade, especially involving the Japanese yen. It offered financial market players with a high risk appetite a very cheap source of refinancing even after the key interest rates in the United States had returned to a neutral level. In addition, it led to a depreciation of the yen against the US dollar which further amplified the global current account imbalances. The scale and worldwide spillover of the crisis on the US real estate market would not have been possible, however, without newly developed **securitisation techniques**. These enabled banks in the United States to grant mortgage loans and then sell them to investors all over the world. Moreover, securitisation was accompanied by a marked lowering of credit standards, not least because it is now possible, through "product structuring", to magically transform loan portfolios consisting of subprime mortgages largely into highly rated financial in-

struments. A key role is being played in this by the rating agencies as they stamp the seal of quality, as it were, on such products. The biggest threat to the stability of the financial system, however, emanated from the massive maturity transformation by quasi-banks (special-purpose vehicles – SPVs). They served to turn long-term US mortgages into very short-term instruments. Unlike regulated banks, these SPVs did not hold a capital cushion as a safeguard against their exposures, and they neglected the risk that the financing instruments which they issue might one day be spurned by the potential purchasers. As these quasi-banks could operate only via the umbilical chord of credit lines from an established credit institution, the liquidity problems which they encountered in the third quarter of 2007 endangered the stability of the banking system. In many countries the central bank, in its role as the lender of last resort, was consequently obliged to provide lavish liquidity assistance. By contrast, hedge funds – contrary to widely held fears – posed no systemic danger to the financial system in 2007.

6. This financial market turmoil has dulled the global economic outlook, with the result that next year exports will grow more slowly than imports and foreign trade may be expected to provide only a modest stimulus for the German economy. The main impulses for overall economic activity in 2008 will therefore come increasingly from the domestic sector (Table 1).

The marked uplift on the labour market continued in 2007 and was reflected in a sharp increase in total employment (+1.7 per cent), including notably also in jobs subject to full social security contributions (+2.2 per cent), along with a steep decline in unemployment by around 700,000 persons. This strong dynamic will persist in 2008, and although the increase in employment and decrease in unemployment will become less pronounced in the course of the year, the buoyant state of the labour market is playing a major role in lifting disposable incomes in real terms and hence stimulating private consumption, which with an increase of 1.7 per cent will become the main driver of economic expansion. By contrast, investment in machinery and equipment and in construction will make a smaller contribution to GDP growth. In 2007 investment in machinery and equipment jumped by over 10 per cent. The twin reasons for this were the high level of capacity utilisation, which triggered investment in capacity extensions, and, to a lesser extent, advanced orders from firms to forestall the expiry of degressive depreciation in connection with the forthcoming reform of business taxation. The pace of growth of investment in machinery and equipment will slacken perceptibly in the aftermath of the capacity extensions and the counterswing to the advanced corporate investment effect. Construction investment will likewise decelerate owing to stagnating housing construction and lower industrial building activity in the wake of the weaker investment trend in machinery and equipment. The inflation rate in 2008 will average 2.0 per cent and will thus be on a par with the 2007 level. Allowing for the fact that the hike in VAT created a considerable baseline effect in 2007, which will drop out next year, the unchanged rate of inflation year on year actually implies an acceleration of the underlying rate of price increases. To date, however, there is no sign of inflationary pressure that would run counter to the objective of price stability.

The situation of **public finances** improved appreciably in 2007, thanks above all to the increase in VAT, so that a balanced budget was achieved at the level of general government. Only central government recorded a deficit. The increase in tax rates led in addition to a marked fall in the structural deficit. In 2008, by contrast, the situation of public finances will improve only slightly.

Even so, the general government fiscal balance will show a surplus of 0.2 per cent unless expenditure grows distinctly faster than planned. The financial situation of the social security funds should likewise remain good. Retirement pensions are likely to be raised by about 1 per cent in 2008.

Table 1

Key economic data for Germany

	Unit	2004	2005	2006	2007[1]	2008[1]
Gross domestic product	%[2]	*1.1*	*0.8*	*2.9*	*2.6*	*1.9*
Total domestic demand	%[2]	*– 0.2*	*0.3*	*1.9*	*1.5*	*1.9*
Investment in machinery & eq.	%[2]	*4.6*	*6.0*	*8.3*	*10.7*	*3.4*
Construction investment	%[2]	*– 3.8*	*– 3.1*	*4.3*	*2.6*	*1.7*
Other investment	%[2]	*2.1*	*4.8*	*6.7*	*4.6*	*4.5*
Consumption expenditure	%[2]	*– 0.2*	*0.1*	*0.9*	*0.4*	*1.7*
Private housholds[4]	%[2]	*0.2*	*– 0.1*	*1.0*	*– 0.1*	*1.7*
General government	%[2]	*– 1.5*	*0.5*	*0.9*	*2.0*	*1.7*
Exports of goods and services	%[2]	*10.0*	*7.1*	*12.5*	*8.2*	*6.0*
Imports of goods and services	%[2]	*7.2*	*6.7*	*11.2*	*6.5*	*6.5*
Employment (domestic)	million	38.88	38.85	39.09	39.77	40.08
Registered unemployed	million	4.38	4.86	4.49	3.78	3.46
Employees[5]	million	26.56	26.24	26.37	26.95	27.21
Unemployment rate[6]	%	*10.5*	*11.7*	*10.8*	*9.0*	*8.3*
Consumer prices[7]	%[3]	*1.6*	*2.0*	*1.7*	*2.1*	*2.0*
General government balance[8]	%	*– 3.8*	*– 3.4*	*– 1.6*	*0.0*	*0.2*

1) 2007: own estimate, 2008: forecast.– 2) Price-adjusted; changes over previous year.– 3) Change over previous year.– 4) Including private non-profit institutions.– 5) Employees subject to social insurance contributions.– 6) Share of registered unemployed in total civilian labour force (dependent civilian employed persons, self-employed, family workers). Source: years 2004 to 2006 Federal Labour Office (Bundesanstalt für Arbeit).– 7) Consumer price index (2000 = 100).– 8) Net lending of the central, state and local governments and the social security funds, as % of nominal gross domestic product; deficit ratio (–).

7. Hence the German economy can look back on two good years of macroeconomic performance featuring not only a perceptible rise in output but also a marked and long awaited improvement on the labour market and in the situation of public finances, including the statutory social security systems. Furthermore, the year-on-year decline in the expansion rate of GDP in 2008 and the projected narrowing of the positive output gap do not mean that the cyclical upturn which began at the start of 2005 will come to an end next year. GDP growth will no longer be fuelled by the global economy but, instead, primarily by domestic demand.

II. There is a reform dividend

8. In the past few years, and also still at the beginning of the current legislative period, the policymakers were obliged to act in what was a difficult macroeconomic environment. Potential growth was low, and the modest increase in GDP was very largely supported by foreign trade. The labour market was characterised by rising or at least persistently high unemployment and an erosion of jobs subject to full social security contributions. In turn, this depressed the revenue level of the statutory social security systems. Thus the statutory pension insurance scheme, despite a freezing of the pension level, and the statutory health insurance scheme were under constant pressure to raise their contribution rates, while the public long-term care insurance scheme, notwithstanding

an ongoing real erosion of benefits, had to grapple with the problem of underfunding, which was rapidly depleting the scheme's accumulated reserves. The scope for economic and social policy initiatives was substantially constrained in addition by high primary deficits in the government budgets and repeated infringements of both national and European rules limiting the permitted level of borrowing. This precarious situation generated unavoidable pressure to take remedial action which forced the political decision-makers to make what was in part a radical and far-reaching change of course; this comprised flat government spending since 2002 leading to a marked decline in the government expenditure ratio, the healthcare reform in 2003, the four Acts Promoting Modern Labour Market Services (*Gesetze für moderne Dienstleistungen am Arbeitsmarkt*), popularly known as Hartz I to IV, between 2002 and 2004 and the Pension Insurance Sustainability Act (*Rentenversicherungsnachhaltigkeitsgesetz*) in 2004.

9. A comparison of the macroeconomic situation in the years 2002 to 2005 with the current economic setting shows clearly that **a marked improvement has occurred in many problem areas**. The number of unemployed has fallen substantially, and the decline not only affected recipients of unemployment benefit, and hence the statutory unemployment insurance scheme (*Arbeitslosenversicherung*), but also embraced the unemployed recipients of unemployment benefit II, who had and have far poorer chances on the labour market. The rise in employment, which has been evident for quite a while now, accelerated and notably related to jobs subject to full social security contributions, which in 2007 grew by the robust rate of 2.2 per cent. This had a positive knock-on effect on the revenue situation of the statutory social security systems. In the statutory health insurance scheme the health insurance institutions (*Krankenkassen*) were largely able to eliminate their debts by the end of the year, and even the financial situation of the chronically indebted public long-term care insurance scheme eased somewhat, while the statutory unemployment insurance scheme, which also benefited from the recovery of the labour market, especially on the expenditure side, generated high surpluses despite a sharp cut in its contribution rates, which was only partly counterfinanced by the new tax-financed funded grant from central government. In the statutory pension insurance scheme the buoyant revenue trend made it possible to top up the sustainability reserve (*Nachhaltigkeitsrücklage*), and thanks to the strong cyclical revival in 2006 pensions were raised with effect from 1 July for the first time since 2003. If the legislation raising the standard retirement age to 67 is implemented as adopted by the lower house of parliament (*Deutscher Bundestag*) in April, this measure, together with the pension reform of 2004, will ensure that the previously existing sustainability gap in this foremost system of old-age provision will largely be plugged. A further advantage of raising the retirement age is that it will help to counteract the decline in the potential labour force related to the ageing of the population and in this way will strengthen growth and, compared with the *status quo ante* of a standard retirement age oft 65, will produce higher pension adjustments and hence a higher pension level, to the benefit of existing pensioners (sections 263 ff.).

The situation of public finances improved considerably, with the result that in 2007 general government recorded a balanced budget and a marked decrease in the structural deficit. Central government, which unlike state government, local government and the social security systems still ran up a deficit, nevertheless managed to reduce its new borrowing appreciably and to avoid once again invoking the exemption clause in Article 115 of the Basic Law (*Grundgesetz*) which permits

the defined borrowing limit to be overridden in exceptional situations and which, in its present form, has provoked much criticism. In addition, following the conclusion of the first stage of the reform of Germany's federal structure (*Föderalismusreform*), the willingness to establish a more effective system of curbing debt incurrence by central and state government is now apparent within the framework of the Federal Reform Commission II (*Föderalismuskommission II*). Last but not least, a reform of business taxation was set in train which – notwithstanding considerable shortcomings, especially regarding the objective of ensuring equal treatment for equity and debt capital – represents a fundamentally correct systemic changeover to a dual income tax (*Duale Einkommensteuer*) which will distinctly enhance the attractiveness of Germany's tax regime for businesses (sections 397 ff.).

10. It is not that remarkable that a strong economic recovery such as that which we have witnessed during the past two years should have led both to an easing of the labour market situation and to higher revenue for the statutory social security systems and other levels of general government. A more important consideration is that there are now also clear signs of a deep-rooted **structural recovery**. The sharp rise in full-time employment, the higher employment intensity of the present upturn, the above-average fall in unemployment and a marked improvement in the ratio of vacancies to job-seekers (sections 485 ff.) are indicators which, in the aggregate, point to more than just a cyclical and hence merely temporary revival of the labour market but rather to a sustained increase in the potential labour force and to a reduction in entrenched unemployment.

In the **statutory social security systems** the curbing of expenditure growth and hence of contribution rates that was initiated with the reforms of the past few years is beginning to bear fruit. The weakening of the expenditure dynamics is attributable to cuts on the benefits side of the statutory social security systems, such as the shortening of the maximum period of entitlement to unemployment benefit, a change in the nature and scope of active labour market policy, the new pension adjustment formula in the statutory pension insurance scheme and a reduction in the range of benefits provided under the statutory health insurance scheme. All these measures will have a lasting effect. The decline in the general government structural deficit will likewise continue to have an impact beyond the present cyclical upturn, although this was due less to a moderate pattern of expenditure than to the revenue-boosting effect of raising the standard rate of VAT. It should also be noted that the termination of the structural crisis in the construction industry and the balance sheet adjustments undertaken in the corporate sector have eliminated major obstacles which have hampered the expansion of GDP in the past few years (sections 98 ff.). Another key factor is the in part substantial wage restraint which has been practised for several years now and which has lastingly improved the international competitiveness of German enterprises. This is mirrored not only in the country's successful foreign trade performance or in reindustrialisation, a strengthening of the German economy's industrial base that took many people by surprise (AR 2004 sections 465 ff.), but also in a high and rising interest on the part of foreign investors in firms active in Germany.

11. Many of these developments are at least indirectly attributable to policy measures taken in the previous legislative period. The public discussion on the nature of the recent economic revival has therefore thrown up the concept of a **reform dividend** as the yield of the previously implemented structural reforms, which can be interpreted as an investment in the German economy's

growth prospects. Such a dividend – understood to mean higher potential growth, a lower employment threshold, a reduction of entrenched unemployment, soundly financed social security systems and structurally balanced public finances – is reflected not least in a greater radius of action in pursuing economic and social policy objectives. It is impossibly to precisely quantify such a yield of past reforms understood in this way as this would require a knowledge of a hypothetical development if such measures had not been taken. But the aforementioned improvements on the labour market, in the social security systems and in the situation of public finances as well as through the distinctly enhanced attractiveness of Germany to investors are findings which cannot be explained solely by cyclical factors but rather provide clear indications that there is indeed a reform dividend. For individuals this reform dividend consists in a rising employment level, secure jobs and improved income prospects, and for enterprises in a permanently improved operational infrastructure. In turn, this gives policymakers a regained measure of fiscal policy manoeuvre which will enable them – unlike what happened in the period 2002 to 2005 – to react anticyclically in a future economic downturn and not curtail the effects of the automatic stabilisers by raising taxes and social security contributions or cutting benefits.

12. This positive picture needs to be counterbalanced, however, by insistently drawing attention to the danger of incorrectly assessing the present constellation or adopting a nonchalant approach. First, it is important to remember that, despite the improvement in the economic situation, a number of unresolved problems are still outstanding and that, despite a rise in potential output since 2005 from 1.2 per cent to 1.7 per cent, Germany's growth prospects remain moderate. Second, the fact that fiscal policymakers now have a greater scope for discretionary action does not necessarily imply that should make immediate use of this by, for example, neutralising a revenue-led reduction in the structural deficit through an increase in government expenditure. Third, policymakers must resist the temptation of overestimating the magnitude of the sustained improvements and consequently of doling out the gains overgenerously, e.g. by using cyclical increases in tax revenue, i.e. those which are solely due to the temporary upturn in economic activity, in order to permanently lower tax rates. In the last two cases the situation in the next downturn would be worse than before and the reform dividend would have been squandered. Recent economic policy measures, both those that have been implemented and, even more so, various projects that are planned or under discussion, give rise to fears that the political decision-makers are taking insufficient account of all three aspects and that they are making similar errors to those made during the peak of the upturn in 1999 and 2000, when not only was no effort made to initiate structural reforms on the labour market and in the social security systems beyond the measures adopted by the last administration led by Helmut Kohl but economic policy disinvestments were made, as it were, in that correct reforms of the previous government were reversed as being antisocial and supposedly superfluous. Examples include the reversal of the measures to make dismissal protection legislation (*Kündigungsschutz*) more flexible or the scrapping of the demographic factor (*Demografischer Faktor*) in the statutory pension insurance scheme. And in the field of fiscal policy the windfall revenue gains which accrued amid the euphoria surrounding the new economy were misinterpreted as being structural and hence permanent, with the consequence that the revenue shortfalls resulting from the reform of the income tax or corporation tax regimes were not fully counterfinanced. This laid the basis for many of the problems which occurred in the subsequent downturn when the measures which had earlier been reversed or not undertaken then had to be implemented

after all – sometimes in a modified and quite often in a harsher form – but in a less benign macroeconomic setting. Cases in point include the renewed relaxation of the job protection regulations, the introduction of the sustainability factor (*Nachhaltigkeitsfaktor*) in the statutory pension insurance scheme or the comprehensive reform of active labour market policy and wage substitutes by means of the Hartz laws.

III. Economic policy during the upturn – positives and negatives

13. At the beginning of the current legislative period the policymakers moved to make the statutory pension insurance scheme resilient to demographic challenges with the courageous and correct "Pension at 67" (*Rente mit 67*) and also dismantled some of the self-blocking mechanisms in the federal decision-making structure; to this extent it carried on from where the previous government had left off. Subsequently, the long-term orientation of economic and fiscal policy to tackling the central problems of the German economy and improving the country's growth prospects, which was enshrined in the coalition agreement (*Koalitionsvertrag*), was increasingly abandoned in favour of pursuing an economic and social policy which, behind a facade of hectic political posturing, boils down to indulging in pork-barrel politics. Measures which a few years previously had been regarded as urgently necessary and which had also been adopted by the party congresses, vanished from the political agenda. Instead, options were discussed under the catchword "further development" (*Weiterentwicklung*) by which reform measures that had been implemented with great difficulty were effectively curtailed or reversed. As this finding applies in different degrees and guises to many fields of policy, the reform dividend stands in danger of being squandered. Furthermore, a tendency became apparent – as is attested by the public debate on sovereign wealth funds and financial investors – to seek to block undesired outcomes of the economic process directly through **state intervention** without taking due account of the systematic dependencies of the existing instruments and those which had been newly introduced for this purpose. All in all, therefore, the interim verdict on the recently envisaged or adopted measures from the first half of the current legislative period is that they add up to a **patchy performance**.

14. In the area of **labour market policy** the steps forward taken with the Agenda 2010 were called into question on several counts. The results of the evaluation of active labour market policy confirm the correctness of streamlining the available set of instruments over the past few years and should have prompted policymakers to concentrate these instruments further on those measures evaluated as being successful in order in this way to increase the effectiveness of active labour market policy. Instead, a range of new instruments were introduced that are likely to perceptibly impair the operability of the labour market policy arsenal (sections 514 ff.). It would also be regrettable if the political decision-makers were to heed the calls now being made to roll back the measures facilitating the use of subcontracted labour across the board, as this form of full-time employment subject to social security contributions creates an important oasis of flexibility, especially in the absence of attempts to de-rigidify existing job protection rules, and consequently recorded significant growth, particularly in the initial phase of the upturn.

Shortening the maximum period of entitlement to unemployment benefit to between 12 and 18 months was a key decision that was convincingly substantiated in terms of both labour market policy and pension policy. This is because of the two key components of unemployment benefit,

namely the amount of the benefit and the period of entitlement, it is – as empirical studies show – less the amount of the benefit than the duration of the entitlement that encourages recipients to remain unemployed for longer, especially when, as in the past, it interacts with measures promoting early retirement or similar arrangements for the unemployed. In disregard of the statutory unemployment insurance scheme's inherent nature as an insurance policy against the risk of becoming unemployed, the Social Democratic Party (*Sozialdemokratische Partei Deutschlands – SPD*), following the Christian Democratic Union (*Christlich Demokratische Union – CDU*), is now calling for the maximum period of entitlement to unemployment benefit for older employees to be significantly extended because "there is enough money in the kitty". While this may go down well with voters as a symbol of social justice, in essence this proposal would effectively expand the non-insurance-related benefits (*versicherungsfremde Leistungen*) in the statutory unemployment insurance scheme. The associated costs, amounting to around 0.2 contribution point, ought to be financed – if at all – out of general tax revenue (sections 323 ff.). Such a measure – however it is funded – would be clearly counterproductive to the aim which the governing parties have set themselves of increasing the employment rate of older employees, in particular. A logical corollary of this would be a need to couple the extension of the period of entitlement with the axing or cutting of the supplement currently granted on switching from unemployment benefit to unemployment benefit II, as this was intended to provide compensation for shortening the period of entitlement to unemployment benefit.

With the introduction of further industry-specific minimum wages, especially in the services sector, the growth of the industries affected will be stunted, including that of industries which could provide additional employment opportunities for unskilled workers, in particular (sections 575 ff.). Even more questionable are attempts to hollow out the kernel of the recent labour market reforms, namely the introduction of a basic allowance for job seekers (*Grundsicherung für Arbeitsuchende*). This was conceived as a benefit which integrally links the safeguarding of the social-cultural minimum subsistence level with the encouragement to take up work by means of a corresponding top-up earnings facility (*Hinzuverdienstmöglichkeit*) that is equivalent to a wage subsidy (*Kombilohn*). The introduction of a general **wage supplement for low-paid workers** (*Erwerbstätigenzuschuss*) that is currently under discussion – it has even been suggested that it should be co-financed from contributions to the Federal Employment Agency (*Bundesagentur für Arbeit*) – which, via a new form of transfer on top of wages, is intended to prevent the neediness (*Hilfebedürftigkeit*) of low paid employees as defined in the Second Book of the Social Security Code (*Sozialgesetzbuch II*) from arising in the first place, calls into question this character of the basic allowance for job seekers, and that at the price of substantial extra financial and administrative costs for setting up and running this new transfer system (sections 528 ff.). If the overhaul of the low-wage sector, which was announced as a central policy plank of the coalition agreement of November 2005, were to take the form of such measures, then retaining the unsatisfactory *status quo* would be a far better alternative.

15. In the **social security systems** the carving-out of non-insurance-related tasks from the statutory unemployment insurance scheme through the Hartz IV reform and, in particular, the raising of the standard retirement age in the statutory pension insurance scheme to 67 were clearly positive reform steps. However, these two measures, which to date form the twin peaks of the grand coali-

tion government's social policy reform landscape, are in danger of being eroded by the planned increased involvement of the Federal Employment Agency in the costs incurred for the recipients of unemployment benefit II and the definition of further groups qualifying for exemption from the standard retirement age, not to mention the implementation of the harebrained idea of "rewarding pension insurance periods reached at the age of 60 and more with special bonus points that increase the pension level" (SPD National Executive Committee, 16 October 2007). And if, as is envisaged, the contribution rate to the statutory unemployment insurance scheme were to be lowered significantly further below the adopted figure of 3.9 per cent, the objective of placing the financing of this sector of the social security systems on a sustainable footing would be put on the backburner. Given the uncertainty concerning the extent of the undisputed improvements on the labour market and hence of the permanent savings achieved, policymakers, if they were to make another substantial cut in the contribution rate, could soon find themselves in the embarrassing position of having to raise the rate again procyclically during the next downturn in the business cycle. This applies even more to a possible extension of the maximum period of entitlement to unemployment benefit that is to be financed out of contributions.

In the **statutory health insurance scheme** and the **public long-term care insurance scheme** the quite appropriate expenditure-side measures regarding both the health insurance institutions and the long-term care insurance scheme contrast with the ultimately failed attempts to reform the financing side. The German Council of Economic Experts drew attention in its last Annual Report to the manifold shortcomings of the healthcare fund (*Gesundheitsfonds*), which is a fudged compromise that comes nowhere near to tackling the central challenges of a financing reform, namely decoupling contributions from wages and overcoming the segmentation of the insurance market (AR 2006 sections 279 ff.). The adopted reform of the public long-term care insurance scheme likewise envisages on the financing side no more than a pusillanimous continuation of the *status quo*, with the result that the time window for initiating a fundamental reform of the method of funding this social security system, which could still have corrected the error made when it was introduced in 1995 of designing it as a wage-centred pay-as-you-go system, is now effectively closed (sections 309 ff.).

16. After the situation of **public finances** improved markedly following the rise in VAT, a series of measures were planned or adopted which will lead to permanent extra expenditure, especially for central government. This is problematic in that central government still has the greatest need for fiscal consolidation, the permanence of the sharp revenue growth during the past two years, over and above the hike in VAT, is uncertain and, should infant daycare facilities be extended, the division of responsibilities between central and state government, which has just been more clearly delineated with the first stage of the reform of the federal structure, would be blurred again. Further examples of budgetary projects that merit a critical appraisal are the envisaged raising of the flat-rate tax-free allowance for amateur coaches, the planned increased allocation of tax resources to promoting profit-sharing for employees in the form of the particularly problematic capital participation (*Kapitalbeteiligung*), diverse promotional instruments in the field of energy policy or job-based parental benefit (*Elterngeld*). Even if measures such as support for renewable energies or parental benefit are deemed *per se* to be meaningful and desirable, this does not of itself constitute a convincing rationale for increasing expenditure. This can be seen in the area of family policy

in which a mass of explicit and implicit promotional measures are opaquely intertwined and where the setting-up of a family allowance agency (*Familienkasse*), in which all financially relevant family policy measures are brought together in a transparent way, is long overdue. A family policy based on the precept of efficiently deploying what continue to be scarce tax resources should therefore have set out by first comparing the aspired aims with the impact of the existing set of instruments and then deciding, over and above rebalancing or realigning the existing toolkit, whether and on what scale additional spending is really needed. The same applies to energy policy, environment policy and, as discussed above, to active labour market policy.

17. In the aggregate, therefore, the political decision-makers give the impression of pursuing a short-sighted policy replete with tactical manoeuvres, while important problems are not yet being resolved but, at most, tackled half-heartedly or completely ignored. At the same time there is a growing risk that, in overestimating the likely duration of the current economic upturn, the policymakers are slowly but surely frittering away the expanded scope for discretionary fiscal policy action and are thereby unnecessarily exacerbating the consequences of subsequent economic downturns. For while measures such as a motley medley of industry-specific minimum wages, restrictions on subcontract labour or the extension of the period of entitlement to unemployment benefit will doubtless not jeopardise the current cyclical upturn, their obstructive effects will reveal themselves during the next downturn and thereby make it longer and deeper. And that another economic slowdown or even a recession will occur – not in 2008 but in the subsequent years – is, notwithstanding the uncertainty surrounding all forecasts, a regrettable certainty.

IV. Economic policy options: what should, and should not, be done

18. Unfortunately, it is unlikely that the government coalition parties, which are currently locked in an embrace of conflicting interests, will find the strength in the second half of the current legislative period to reopen the package of financing measures of the healthcare reform which, in introducing the healthcare fund, will not resolve any of the outstanding problems. It is equally unlikely that, with a view to lastingly improving the employment prospects of the long-term unemployed, in particular, the existing employment protection rules will be made less rigid. Not is it probable – even if this is a problem which a grand coalition would seem predestined to solve – that the deliberations of the Federal Reform Commission II will lead to a general restructuring of the federal financing relationships between central and state government. That these key and pressing reform projects, the necessity for which has repeatedly been underlined by the German Council of Economic Experts and others, will probably remain unresolved in the current period is all the more regrettable as the present favourable constellation of an economic upturn and such a big majority in both houses of parliament is unlikely to recur so soon. This makes it all the more important not to squander the gains that have been made so far and to try, in what is still a benign macroeconomic setting, to at least carry forward the reforms initiated during the past few years along the path previously mapped out. This does not mean pump-priming the economy. First and foremost it should be a question of strengthening the long-term growth forces, especially as this will also better equip the German economy to deal with future cyclical setbacks.

19. The crisis in the **international financial markets** poses a difficult challenge to economic policy makers. On the one hand, central banks and, in some cases, finance ministries, too, feel

compelled to support the banking system through extensive interventions, even if they are aware of the fact that in the process they are increasing the risk of moral hazard in the future. On the other hand, it is inherently next to impossible to devise a regulatory framework that provides a foolproof guarantee against misguided actions by banks and other market players in the future. And whatever approach to tackling this problem is taken, it is important not to call into question the chances of achieving an allocation of capital that is conducive to boosting growth and a broader diversification of risk which go hand in hand with securitisation and loan repackaging.

A substantial contribution to enhancing stability which would be institutionally relatively easy to implement could be attained if the central banks were to orient themselves more than hitherto to the objective of financial market stability, without neglecting their mandate to assure monetary stability. In view of the extensive integration of the financial markets, a nationally organised banking supervision system – in which prudential responsibility is, moreover, often split between several different institutions – no longer appears appropriate. For the European Union it will therefore be necessary, sooner or later, to aim for an integrated European banking supervisory authority. For Germany a significant step forward could be taken by concentrating responsibility for supervising banks on the Deutsche Bundesbank (sections 201 ff.). The coexistence of two regulators appears to make just as little sense as a far-reaching segregation of prudential and monetary policy responsibilities as practised, for example, in the United Kingdom.

The past few months have shown that a more market-based financial system is subject to considerable transparency deficits. Progress will be made in this respect with the introduction of the Basel II capital framework, which in Pillar 3 contains comprehensive disclosure requirements, especially for securitised products, and in Pillar 2 a general capital backing requirement for credit lines. Greater transparency could be achieved in addition through a better integration of the national central credit registers that exist in the euro area. Extending the range of participating countries would be a further conceivable option. Important information on hedge funds could be obtained through regular surveys of prime brokers, as have been conducted for some time by the Bank of England. In addition, all of these market players are making increased efforts to provide greater public transparency through codes of conduct and best practice. To facilitate a better evaluation of credit risks in the securitisation world, it would also appear helpful if investors and rating agencies alike were informed as to whether the especially risky equity tranche is still held by the originator of the loan. Furthermore, by setting up a separate rating scale for structured products, rating agencies could make it clear that these are relatively illiquid assets subject to special risks. Finally, thought could also be given to seeking to standardise these products more via trading on a stock exchange.

20. The activities of foreign investors, especially if they are state-owned as in the case of **sovereign wealth funds**, has aroused fears that they could launch a wholesale takeover bid for German firms. These fears grew more acute during the ensuing public debate, and calls were made to erect a protective barrier against undesired foreign private or public investors. Concrete suggestions for regulation were made by alluding to other countries which have imposed corresponding restrictions. A look at the international economic interlinkages, however, shows that Germany, as a major exporter of capital, should have a strong vested interest in open capital markets. It is not with-

out good reason that Germany has traditionally had an open capital flow regime. Moreover, the allusion to regulations in other countries ignores the fact that, at least within Europe, only a very marginal deviation is permissible from the basic principle of the free movement of capital. Most of the deviating regulations in the European Union have been ruled invalid by the European Court of Justice, which emphasises that the concept of public order and security must be interpreted narrowly so as not to open the floodgates to protectionist interests (sections 601 ff.).

An economic analysis of these fears that have been expressed in conjunction with foreign equity stakes and takeovers shows that they are in large part exaggerated or even unfounded and not infrequently arise purely on account of the investor's nationality (sections 616 ff). In many cases the reservations about foreign investors appear in addition to mask industry policy ambitions, although the track record of such endeavours in highly developed economies is rather sobering.

While the possibility that takeovers or the acquisition of equity stakes may indeed be contrary to the public interest cannot be ruled out entirely, this holds regardless of the nationality and domicile of the investor. The existing set of instruments, particularly competition rules, offers a sufficient basis for tackling this issue in most cases. Any legislative adjustments should focus first on these instruments in order to facilitate the application of anti-trust regulations to individual takeover attempts which, in the aggregate, reveal themselves to be part of an overall strategy of rolling integration as well as to mergers in which the resultant market clout will increase over time owing to the exhaustibility of resources such as natural gas or oil (sections 627 ff.). In addition, the state always has the possibility, by retaining a stake in key infrastructural enterprises such as railways, harbours or airports, to safeguard the undeniable public interest in such utilities.

The German Council of Economic Experts therefore sees no need to limit equity acquisitions by foreign enterprises beyond the extent already regulated in the Foreign Trade and Payments Act (*Aussenwirtschaftsgesetz*). If, however, the policymakers were to opt for tighter controls on equity acquisitions, the instruments introduced for this purpose would have to meet high demands concerning the prohibition criteria and the assessment procedure. For one thing, this is necessary so as to obviate the danger of subsequently falling foul of a ruling of the European Court of Justice. For another thing, this would create an instrument which could easily be misused by policymakers to veto unwanted takeovers or equity acquisitions. It is the German economy that would be the victim of any retaliatory measures.

The recently submitted draft law to limit investment (*Gesetz zur Investitionsbeschränkung*) does not meet these high demands. It envisages setting up, via an amendment to the Foreign Trade and Payments Act, an approval procedure for the takeover of or acquisition of a substantial stake in enterprises domiciled in Germany where this would impair public order or security. It does not lay down a corresponding list of criteria for defining such an eventuality. Not does it specify what kind of investors are deemed to be dangerous, so that, by implication, all foreign investors will be placed under general suspicion. Although a general registration requirement is not envisaged, the Federal Ministry of Economics and Technology (*Bundesministerium für Wirtschaft und Technologie*) can intervene in a planned takeover or acquisition of a major stake within three months and impose conditions for approval or prohibit it. If the federal ministry does not exercise its power of

veto within the set three-month period, the takeover or acquisition of an equity stake will take effect. If this draft law reaches the statute book, it would create an instrument open to extreme misuse which would far exceed the limit of what is economically justifiable or desirable.

21. In **labour market policy** the key need is to place on the agenda, during the current legislative period, the task of reviewing and refining the basic allowance for job seekers, but not, as envisaged hitherto, by introducing a wage supplement for low-paid workers that would degut the very essence of the basic allowance, but rather by accentuating the wage subsidy elements already contained within unemployment benefit II. Such a focused further development is appropriate to enable the key conceptual thrust of unemployment benefit II – namely, to couple the assurance of the socio-cultural minimum subsistence level for the unemployed with incentives to take up work on the primary labour market – to take root better in the current brightening employment climate than was possible at the time of its introduction at the end of the last downturn. The most important requirements are to eliminate the favouring of "minijobs" subject to no social security contributions and to peg payment of the full standard rate of unemployment benefit II more strongly to the proven readiness to take up work on the primary or, as an interim solution, secondary labour market, as the German Council of Economic Experts explained in detail in its corresponding expertise (Expertise 2006b).

22. The remaining need for reform in the **social security systems** is spread very unevenly over the various sectors. In the statutory unemployment insurance scheme and the statutory pension insurance scheme important necessary reforms have already been implemented. The key need here, besides individual adjustments, is therefore to secure the reform gains against the twin perils of revisionist attack and the proposed revolutionary overthrow in favour of a guaranteed basic income (*Grundeinkommen*). In the statutory health insurance scheme and the public long-term care insurance scheme, by contrast, there is a continuing need for major initiatives on the financing side.

23. In the **statutory health insurance scheme** the introduction of the healthcare fund, which was adopted last autumn and enacted this spring, threw away the chance of achieving a fundamental reform of the method of financing this scheme which would both overcome the inefficient segmentation of the insurance market and, by changing over from income-related to flat-rate contributions, also reduce the tax wedge that is so detrimental to employment. It would be best if the healthcare fund were not to see the light of day at all, or at least not in the form decreed, because of the considerable problems that are already foreseeable, especially the additional contribution which, in its present form, would distort competition. To facilitate a transition in the medium term to the concept of a citizen's flat-rate contribution model (*Bürgerpauschale*), which would be much more conducive to boosting growth and employment, the contributions ought to be collected by the fund rather than the health insurance institutions, the share of the health insurance institutions' spending financed by wage-related contributions should be reduced in favour of non-income-related additional contributions which would vary from one health service institution to another, and the social equalisation component (*sozialer Ausgleich*) required for this flat-rate supplementary contribution should be financed out of the fund's resources and not paid by the health insurance institutions (AR 2006 sections 294 ff.).

24. Owing to the interlinkage between the statutory health insurance scheme and the **public long-term care insurance scheme**, the decision to set up the healthcare fund likewise scuppered the prospects of initiating a pioneering and sustainable reform of the method of financing the public long-term care insurance scheme which, owing to the comparatively short period of its existence as a pay-as-you-go system, could have been progressively switched over to a fully funded system at acceptable costs. This would not only have eliminated the taxation character of the current income-related contributions but would also have very largely terminated the intergenerational redistribution to the detriment of future generations which is a salient feature of this branch of the social security systems. At the current juncture, the postponement of a fundamental financing reform in the statutory health insurance scheme means that the only option left for the public long-term care insurance scheme, too, is to at least lessen the intergenerational shift in burden-sharing between contribution payers and the typically elderly nursing care patients by expanding the principle of contribution rate splitting, which in principle already exists between employees and pensioners. To this end employees' contribution rates would have to be largely frozen so that the brunt of the pressure to increase contribution rates resulting from rising expenditure would be shouldered primarily by the pensioner generation which actually causes this cost increase. This additional contribution burden on future pensioners should and could be cushioned by acting in the short term to marginally raise the level of government promotion of private and company-based supplementary saving for old-age provision ("Riester private care plan" as a complement to the existing Riester private pension plan; sections 312 ff.).

25. The programme in the **statutory unemployment insurance scheme**, by contrast, is comparatively modest. The chief objective on the financing side is to prevent the contribution rate from falling below a sustainable level. The politicians cannot and must not fool themselves into believing that cyclical downturns, with the associated extra expenditure and revenue shortfalls, are a thing of the past. For this reason the contribution rate should not initially be lowered markedly below the agreed rate of 3.9 per cent. On the expenditure side it is necessary both to resist efforts to siphon off funds from the Federal Employment Agency's budget in order to finance new benefits that are, for the most part, non-insurance-related and to ensure that the remaining non-insurance-related benefits are eliminated or else are financed out of general tax revenue, in line with the logic of a market-based macro-policy philosophy. The planned abolition of the compensatory amount (*Aussteuerungsbetrag*) currently payable by the Federal Employment Agency to central government should be implemented, but not the envisaged extension of the maximum period of entitlement to unemployment benefit, the roping-in of the statutory unemployment insurance scheme to help pay the costs of the administration and reintegration measures in respect of the basic allowance for job seekers or even the co-financing of the proposed wage supplement for low-paid workers (sections 280 ff.).

26. In the **statutory pension insurance scheme** there is no direct need for action – from the point of view of ensuring its long-term sustainability – following the last comprehensive reforms, as long as these bold steps to place the scheme's financing on a stable footing are not called into question. The mid-year pension increase and the foreseeable likely development in the coming years show that the new pension adjustment formula including the sustainability factor has proved its worth and that there is no reason for discretionary intervention in the pension adjustment for-

mula depending on the cash flow situation (sections 259 ff.). The buoyant macroeconomic situation offers the opportunity to top up the sustainability reserve and hence in this social security sector, too, to hold the contribution rate steady over the course of the business cycle and – as things stand at the moment – to lower it significantly from 2011 onwards. By the same token the politicians should leave the – unjustly much maligned – decision to raise the standard retirement age well alone instead of further neutering the incipient new rule through further exemptions. This applies all the more in view of the aforementioned positive repercussions for the potential labour force. For the rest, the second and third pillars will contribute increasingly to safeguarding the standard of living. The growing take-up, in particular, of the government-subsidised Riester supplementary pension savings scheme and the company pension schemes (*Betriebliche Altersversorgung*) are encouraging signs of a change of consciousness on the part of the general public. The Council's assessment regarding the adopted unlimited extension of exemption from social contributions in the case of payroll components converted into private pension savings direct by the employer (*Entgeltumwandlung*), which has given this form of company pension saving a big boost, is nevertheless mixed, depending on the estimated scale of the alternative responses available to employees and employers (sections 269 ff.). The coalition parties would be well advised, in addition, to finally recognise that the planned inclusion of housing purchases as an eligible form of government-subsidised saving under the Riester scheme is a blind alley which does not fit in with the principle of downstream taxation of pension benefits and the partial changeover introduced in 2001 to a funded system of old-age provision. The most important unresolved question in the area of old-age provision is that of the self-employed, who at the moment are not insured in any of the mandatory pension insurance systems. Such an insurance coverage is called for in order to counter moral hazard behaviour and a flight of low earners, in particular, out of the social insurance obligation (sections 284 ff.).

27. A completely misguided idea, by contrast, is the endeavour to replace the social welfare state in its traditional form by a **guaranteed basic income scheme** (*Grundeinkommenssicherung*) by largely abolishing the participative equivalent (*teilhabeäquivalent*) statutory unemployment and pension insurance schemes and, in contrast to the present basic allowance concepts that are geared to neediness – the job seeker's basic allowance, the basic allowance for elderly persons (*Grundsicherung im Alter*) and social assistance (*Sozialhilfe*) – would entitle everyone to an unconditional claim to a government transfer in the amount of the sociocultural subsistence minimum level of existence. Simulations performed by the German Council of Economic Experts for the most sophisticated proposal put forward by Dieter Althaus, the prime minister of the federal state of Thuringia, the so-called Citizen's Solidarity Allowance (*Solidarisches Bürgergeld*), show that the original version suggested by Mr **Althaus**, entailing a financing gap of around 220 billion euro, is purely and simply **unfundable**. If the original Althaus concept is modified so that its funding is assured – and that is the minimum requirement of any economic policy proposal that purports to be taken seriously – the proposal immediately loses much of its attractiveness.

Althaus rightly sees his proposal as constituting a social policy revolution. However, given the many attendant uncertainties and risks, such revolutions should promise clearly positive effects. With respect to the employment implications, however, this is certainly not the case if the financing of the proposal were to be assured at the same time. It appears nonsensical to want to replace

the established social security system by such a model right after key parts of the present system, such as the statutory pension insurance scheme and the statutory unemployment insurance scheme, have just been made fit for the future. Here, too, it can be seen that carefully planned small reform steps that are actually taken are superior to a utopian quantum leap. The sole viable component of the Citizen's Solidarity Allowance is the transition to a citizen's flat-rate contribution model in the statutory health insurance scheme and the public long-term care insurance scheme. Yet such a reform can be implemented separately in individual branches of the insurance system without any need to introduce a guaranteed basic income scheme (sections 324 ff.), the implementation of which would be a highly hazardous economic policy venture.

28. In the field of **public finances** there are grounds for hoping that, in the context of the Federal Reform Commission II, a more effective method of limiting new borrowing at the level of central and state government might be achieved. Such a debt brake (*Schuldenbremse*) is not only called for so as to protect coming generations against being overburdened by having to service a high debt and simultaneously having to face a stunting of economic growth caused by the high debt level, it is also and not least required in view of the experience of the past few years of the paralysing effect that a structural imbalance in public finances has on government's ability to govern. In spring the German Council of Economic Experts, at the request of the Federal Government, elaborated a comprehensive proposal for an effective way of curbing the incurrence of government debt. It takes as its starting point the economically meaningful elements of Article 115 of the Basic Law, namely the pegging of long-term new borrowing to the increase in the stock of net government assets (the golden rule of fiscal policy) and the toleration of temporary deficits so as to smooth expenditure flows over the business cycle, but at the same time overcomes the shortcomings of the current rules which led in the past to their being circumvented and to the present high levels of indebtedness. To this end it narrows the current broad definition of investment, precisely defines both the scope of the cyclical deficit and the concept of a recession, records deviations from the defined level of permissible new borrowing on an offsetting account and prevents persistent overdrawing of this account by means of effective penalties. This combination of measures would ensure that the contraventions of both the spirit and intent of the rules limiting borrowing that were repeatedly observed in the past would not recur and that the **debt-to-GDP ratio** (but not the debt level of currently around 1.5 trillion euro) would be permanently **reduced** (Expertise 2007). The present grand coalition, with its large majority in both houses of parliament, offers a golden opportunity to set in train such a comprehensive reform.

Closely related to this is the need to continue the consolidation course on the expenditure side that has been pursued during the past few years. It must be emphatically pointed out that the rise in value added tax at the beginning of this year has exhausted the potential scope for reducing the structural budget deficit on the revenue side. It is therefore vital to underpin the revenue-based consolidation steps of the past two years with measures on the expenditure side, both in order, with a view to capping new borrowing, to eliminate that part of the structural deficit that is not matched by a corresponding rise in the stock of net government assets and to free up financial resources for other measures that are considered necessary, such as in the field of education policy, family policy, the alternative refinancing of non-insurance-related benefits that are deemed desirable, especially in the statutory health insurance scheme, or in environmental policy. On the other hand, it

makes little sense to focus budgetary policy on reducing the debt level, for in that case long-term, structural fiscal surpluses, despite positive net investment that would also benefit later generations, would be used to pay off debt, and this would imply a redistribution of income in favour of future generations for which, in the view of the German Council of Economic Experts, there is no need.

Policymakers should resist calls, which are currently being voiced in all political parties, to **reform spouses' income splitting for taxation purposes** (*Ehegattensplitting*) in favour of the popular family income splitting (*populäres Familiensplitting*) – i.e. increasing the splitting divisor by the number of children – not least for distribution policy reasons. There is much to be said in favour of leaving the current system of spouses' income splitting well alone and granting tax breaks to families as hitherto via the medium of child benefit (*Kindergeld*) and tax-free allowances for children.

29. Such a package of measures as outlined above will doubtless be too little for some and too much for others. However, the German Council of Economic Experts considers it both a challenging and a realistic programme. The programme is challenging not only because of those things that are still to be done but also – in view of the current thrust of economic policy – precisely because some popular – or populist – steps should be better left undone. That such a package of measures is both realistic and realisable can be seen by taking a look back at the reforms that were successfully implemented in the past few years. If the policymakers follow the path mapped out in the years from 2002 to the start of 2006, then they will not only lay the basis for retaining a comfortable margin of manoeuvre in policymaking also during future economic downturns but will also make a contribution of their own to ensuring that the German economy remains in healthy shape, is better able to withstand cyclical setbacks and can move onto a higher growth path.

CHAPTER TWO TO SEVEN

Summaries

Chapter II	The global and German economic situation and outlook
Chapter III	Stability of the international financial system
Chapter IV	Social security: more positives than negatives
Chapter V	Fiscal policy on the right track so far
Chapter VI	Labour market: on the way to higher employment
Chapter VII	Should the acquisition of equity stakes by foreign investors be restricted?

CHAPTER TWO: Summary

The global and German economic situation and outlook

The economic situation in 2007

- The global economy was in a very robust state in 2007 when, in the third quarter, it was hit by the financial crisis emanating from the real estate market in the United States. Moreover, the course of global economic development was less heterogeneous than in the preceding years, with the macroeconomic momentum in the United States and Japan slackening while the euro area and the emerging market economies of South-East Asia recorded another sharp rise in gross domestic product (GDP).

- In Germany GDP in 2007 grew by the robust rate of 2.6 per cent. The dampening effects of the hike in valued added tax were largely offset by the buoyant underlying dynamics of the cyclical upturn. Economic development was fuelled by a strong rise in investment in machinery and equipment and by a sustained high external demand. By contrast, private consumption stagnated in the wake of the restrictive fiscal policy.

The outlook for 2008

- Following a prolonged and very strong upturn, the world economy will grow at a slower pace next year. In the United States the course of development will again lie below the long-run potential growth rate. In the euro area and in Japan the pace of expansion will decelerate. The other economies in Asia, by contrast, will continue to drive global growth.

- In Germany GDP will expand at the rate of 1.9 per cent in the coming year. The lower growth rate compared with 2007 is attributable, in particular, to a smaller contribution from the external sector. Domestic demand – particularly private consumption – will become the mainstay of economic development.

- The recovery on the labour market will continue in 2008 in a weaker form. The level of employment will increase by 0.8 per cent to 40 million persons, with the number of jobs subject to full social security contributions rising by 1.0 per cent to 27.2 million. Unemployment will fall further to 3.46 million persons on an annual average.

- Public finances will generate a budget surplus in 2008 of 0.2 per cent of nominal GDP. Fiscal policy will abandon its restrictive course.

- The rate of increase in consumer prices in Germany next year will amount to 2.0 per cent; there is no sign of inflationary dangers.

CHAPTER THREE: Summary

Stability of the international financial system

The global financial markets encountered heavy turbulence in 2007. After a very clement climate had prevailed for a protracted period, a **massive crisis of confidence and liquidity** irrupted in the third quarter. The stability of the system could only be assured by interventions by the principal central banks on an exceptionally large scale. In the meantime the situation has clamed down somewhat, but the precise impact and implications for the international financial markets of the risks and strains emanating from the crisis on the US real estate market are still unclear.

The causes of the turmoil are complex. Owing to an **overly expansive interest rate policy course pursued by the US Federal Reserve Bank (Fed)**, a macroeconomic setting was created in the years 2003 to 2005 which not only triggered a real estate boom but concurrently created high incentives for financial market actors which, like hedge funds, "lever up" their rate of return through high borrowing. The large-scale foreign exchange market interventions by central banks from emerging market economies had a destabilising effect. They prevented a sharp devaluation of the US dollar which – via higher prices and interest rates – would have had a dampening effect on households' propensity to borrow. Another problematic development is the **carry trade**, especially involving the Japanese yen. It offered financial market players with a high risk appetite a very cheap source of refinancing even after the US central bank had returned its key interest rates to a neutral level. In addition, the carry trade led to a depreciation of the yen against the US dollar which further amplified the global current account imbalances.

The scale and worldwide spillover of the crisis on the US real estate market would not have been possible, however, without newly developed **securitisation** techniques. They promoted the originate-and-distribute business model which enabled banks in the United States to grant loans to households and then sell them to investors all over the world. Moreover, securitisation was accompanied by a marked lowering of credit standards, not least because it is now possible, through "**product structuring**", to magically transform subprime loan portfolios largely into investment-grade financial instruments. A key role is being played in this by the rating agencies as they stamp the seal of quality, as it were, on such products.

The biggest threat to the stability of the financial system, however, emanated from the massive maturity transformation by **quasi-banks** (conduits und structured investment vehicles – SIVs). They served to turn long-term US mortgages into very short-term instruments (asset-backed commercial paper – ABCP). Unlike regulated banks, these vehicles did not hold a capital cushion as a safeguard against their exposures, and they neglected the risk that the financing instruments which they issue might one day be spurned by the potential purchasers. As these quasi-banks could operate only via the umbilical chord of credit lines from an established credit institution, the liquidity problems which they encountered in the third quarter of 2007 endangered the stability of the overall banking system. In many countries the central bank, in its role as the **lender of last resort**, was consequently obliged to provide lavish liquidity assistance.

Contrary to widely held fears, **hedge funds** posed no systemic danger to the financial system in 2007, although some fairly large funds had to be closed.

As the crisis has not yet been overcome, it is too early to draw definitive lessons. One crucial requirement for the future that has clearly emerged, however, is that the processes connected with securitisation and internationalisation must be brought into a better equilibrium but without calling into question the benefits which they create. It is equally clear that there can be no question of simply returning to the *status quo ante* once the current problems have been resolved, as the support operations carried out by the central banks have substantially increased the risk of **moral hazard**. All in all, this confronts economic policymakers in every country with tough choices and challenges.

At the macroeconomic level it is becoming evident that the interest rate policy of the **central banks** now has a bigger impact on the financial system than was the case in the traditional world of bank-based financing. Besides pursuing the objective of price stability, monetary policymakers should therefore pay greater heed than hitherto to **financial market stability**. The experience of the United States shows that it is not sufficient to gear monetary policy solely to the current or expected inflation rate. The European Central Bank's two-pillar approach is a good starting point for such a dual strategy.

In the **institutional framework of banking supervision** a considerable discrepancy is evident between the close global integration of the markets and the purely national basis of regulation, which is compounded in many countries by the coexistence of several different prudential authorities. At the level of the European Union, therefore, it would be expedient sooner or later to establish a single prudential authority, which could be oriented to the decentralised structures of the European System of Central Banks. A fundamental issue that needs to be clarified in this context is whether **responsibility for banking supervision should be entrusted to the central bank** or vested in an independent financial market supervisory agency. It would make macroeconomic sense if monetary policymakers were also able to draw on information about the state of the financial system when charting the interest rate policy course. In the question of assigning competence for banking supervision, central banks have considerable comparative advantages owing to their proximity to the market. At the national level there is thus much to be said for the idea of bestowing sole responsibility for banking supervision in Germany on the Deutsche Bundesbank.

The central problem of the past few months has been a massive **transparency deficit**. A key step forward will be made with the introduction of the new regulatory framework **Basel II** which, in its Pillar 3, contains comprehensive and detailed disclosure requirements, especially for securitised products. Basel II also contains stricter rules for backing credit facilities with capital. An additional contribution towards enhancing transparency could be made through a better integration of the national central **credit registers** that exist in the euro area; extending the range of participating countries would be a further conceivable option. Information on **hedge funds** could be obtained through regular surveys of prime brokers, as are conducted by the Bank of England. In addition, these market players are making increased efforts to provide greater public transparency through codes of conduct and best practice. To facilitate a better evaluation of the risks connected with securitised loans, it would also appear helpful if, in particular, **rating agencies** were informed as to whether the especially risky equity tranche is still held by the originator of the loan. Furthermore, by setting up a separate rating scale for structured products, rating agencies could make it clear that these are relatively illiquid assets subject to higher revaluation risks.

CHAPTER FOUR: Summary

Social security: more positives than negatives

The financial situation of the **social security systems** improved appreciably as a result of the economic recovery and past reforms. With the exception of the public long-term care insurance scheme (*Soziale Pflegeversicherung*), all of the individual schemes posted revenue surpluses in 2007.

In the **statutory pension insurance scheme** (*Gesetzliche Rentenversicherung*) the strong cyclical upturn in 2006 made it possible to moderately increase the pension level in 2007 for the first time since 2003. A slightly higher pension adjustment is likely in 2008. The sustainability factor (*Nachhaltigkeitsfaktor*) enables pensioners to participate in the positive labour market trend without jeopardising the long-term contribution targets.

With the adoption of the "Pension at 67" (*Rente mit 67*), the last key measure to safeguard the long-term financing of the public pension system was implemented. This move, which raises the standard retirement age to 67, will dampen future increases in the contribution rate and simultaneously enlarge the potential labour force, thereby improving Germany's economic growth prospects in the face of an ageing population. The policymakers should vigorously resist all and any attempts to further dilute this reform measure, which is of great significance for pension and growth policies.

The indefinite prolongation of the exemption from social contributions in the case of payroll components converted into private pension savings direct by the employer (*Entgeltumwandlung*) will give a further boost to company-based pension schemes (*Betriebliche Altersvorsorge*), albeit at the price of disadvantaging older insurees and employees who do not make use of this option.

Following the consolidation of the statutory pension insurance scheme, the key need now is to counter the risks of old-age poverty arising from changed insurance biographies. This requires initiatives in the field of labour market and employment policy specifically targeted at combating long-term unemployment, in order to forestall or shorten the receipt of unemployment benefit II (*Arbeitslosengeld II*) as this is associated with perceptible pension losses. In addition, an insurance obligation should be laid down for all self-employed persons who are not already mandatorily insured in another system of old-age provision.

In the **statutory health insurance scheme** (*Gesetzliche Krankenversicherung*) the healthcare reform of March 2007 did not solve any of the problems relating to health service financing – namely the need to end the segmentation of the healthcare market caused by setting an income ceiling for compulsory contributions (*Versicherungspflichtgrenze*), which enables high earners to opt out of the public scheme, and the need to decouple healthcare costs from labour costs. The newborn healthcare fund (*Gesundheitsfunds*) is the hapless offspring of squabbling political parents. If the fund is set up as envisaged, it will lead to huge competitive distortions among the health service institutions (*Krankenkassen*).

The reform measures on the benefits side of the **public long-term care insurance scheme** (*Soziale Pflegeversicherung*) which the government adopted in October are to be welcomed. The financing side, however, has been left pretty much unchanged. This means that the time window for initiating a fundamental reform of the method of funding this social security system, which could still have corrected the error made when it was introduced in 1995 of designing it as a pay-as-you-go system, is now effectively closed. If the current financing principle is retained, there is still the option of contribution splitting, meaning asymmetric increases in the contribution rate to the detriment of pensioners, both in order to reduce the intergenerational redistribution effects of this system and to prevent rising long-term care nursing costs from pushing up labour costs. The additional contribution burden on future pensioners which this would entail would have to be off-set by extending the scope of government promotion of private and company-based supplementary saving for old-age provision ("Riester private care plan" – *Pflege-Riester*).

If policymakers wish to achieve a lastingly stable contribution rate to the **statutory unemployment insurance scheme** (*Arbeitslosenversicherung*) over the entire business cycle, there is very little scope for exceeding the agreed cut to 3.9 per cent. Under no circumstances should such redistribution measures be financed out of insurance contributions to the Federal Labour Agency (*Bundesagentur für Arbeit*); as a matter of principle, such measures can only be funded via the central government budget out of general tax revenue. Calls to extend the maximum period of entitlement to unemployment benefit (*Arbeitslosengeld*) – purely on the grounds that there is "enough money in the kitty" – are misguided and would represent a costly setback in labour market policy.

As a radical alternative to the piecemeal reforms that have been initiated during the past few years in the individual sectors of the social security system, calls have been made from various quarters to completely abolish the social security systems in their present form and to introduce instead an unconditional guaranteed basic income (*Grundeinkommen*). Simulations performed by the German Council of Economic Experts for the so-called **Citizen's Solidarity Allowance** (*Solidarisches Bürgergeld*) show that its introduction in the form put forward by its propounder Dieter Althaus, the prime minister of the federal state of Thuringia, would create a gigantic financing gap of nearly 230 billion euro in the government budgets. If the original Althaus concept is modified so that its funding is assured – and that is the minimum requirement of any policy concept that purports to be taken seriously – the proposal loses its superficial attractiveness.

CHAPTER FIVE: Summary

Fiscal policy on the right track so far

Public finances

- The **general government budget** was **balanced** again for the first time since 1989. The structural deficit likewise declined to 0.3 per cent in relation to nominal potential output. The reduction in the general government financing deficit was chiefly attributable to cyclical extra revenue from direct taxes and the raising of the value added tax and insurance tax rates by 3 percentage points.
- In its judgment of 9 July 2007 concerning the constitutional conformity of the Federal Budget Act (*Bundeshaushaltsgesetz*) of February 2004, the Federal Constitutional Court (*Bundesverfassungsgericht*) ruled that the current provisions of Article 115 of the Basic Law (*Grundgesetz*) do not suffice in order to ensure the effective curbing of government borrowing. The German Council of Economic Experts submitted a detailed concept for redefining the national borrowing limits (Expertise 2007) which could be swiftly implemented within the framework of the Federal Reform Commission II (*Föderalismusreform II*). Given the comfortable majorities commanded by the governing parties in both the lower house (*Deutscher Bundestag*) and the upper house of parliament (*Deutscher Bundesrat*) and in view of the improved budgetary situation of central, state and local government as well as the social security funds, this chance should not be wasted.
- Under the assumption that the business cycle follows a normal pattern and that policymakers firmly cap demands for additional spending, financial surpluses could be generated in the general government budgets in the next few years which could be used in a variety of different ways. Of the possible alternatives – increasing expenditure, reducing the debt level, lowering the burden of taxes and social security contributions – the German Council of Economic Experts favours the option of **lowering the tax burden**. From an efficiency perspective, the choice would seem to lie be between reducing the solidarity surcharge (*Solidaritätszuschlag*) on income tax and corporation tax, cutting the income tax rate or further easing the business tax burden.

Reform of business taxes

- A key element of the reform of business taxes is the **reduction in the tax burden** on corporations (*Kapitalgesellschaften*) from 1 January 2008 from currently around 40 per cent to around 30 per cent. This merits a **positive assessment** as it enhances Germany's attractiveness as an investment location.
- On 1 January 2009 a **flat-rate withholding tax on capital income** (*Abgeltungsteuer*) will be introduced at a rate of 25 per cent. The deficient coordination between business taxes and the flat-rate withholding tax constitutes the **Achilles heel of this reform**. It will further increase the existing distortions in respect of investment financing decisions. From 2009 the taking-up of debt capital will be the most favourable method of financing in terms of tax treatment. This is diametrically opposed to the legislators' intention to strengthen the equity base of German enterprises. If, for reasons not relating to taxation, investments are financed from retained profits or by taking up equity capital, this will push up the capital cost of real investment. This will tend to impair the investment activity of firms operating at the national level. The objective of

achieving the neutrality of the corporate legal form for investment purposes will likewise not be achieved by the forthcoming reform of business taxes. Nor is this finding invalidated by the envisaged preferential tax treatment of the retained earnings of non-corporations (*Personenunternehmen*) with subsequent downstream taxation.

- In order to limit the tax revenue shortfalls resulting from these measures to around 5 billion euro (based on the impact over a full year), the reform of business taxes envisages a comprehensive package of **counterfinancing measures**. Most of these measures deserve a **critical** appraisal. They will increase the complexity of the tax system and worsen the institutional framework for investment.
- On balance, the advantages outweigh the disadvantages, however, so that the business tax reform in 2008 represents an **improvement vis-à-vis the *status quo***.

Taxation of spouses and families under the spotlight

- The parties that make up the ruling grand coalition – the Christian Democratic Union (*Christlich Demokratische Union – CDU*) and the Social Democratic Party (*Sozialdemokratische Partei Deutschlands – SPD*) – are currently both considering initiating a **reform of spouses' income splitting for taxation purposes** (*Ehegattensplitting*), although with different reform aims and reform concepts. In its new draft programme aimed at strengthening marriage and the family, the CDU intends to develop the current system of splitting spouses' joint income, i.e. aggregating their combined income and then dividing it into two equal halves for tax assessment purposes, into a system of family income splitting (*Familien-Splitting*). By contrast, a working group of the SPD Bundestag group and the SPD National Executive Committee prefers a technical **real splitting** with a permissible tax transfer between the spouses of 15,000 euro or 20,000 euro.
- The replacement of the joint tax assessment of spouses by a **real splitting of spouses' incomes** – meaning the separate assessment of spouses' actual incomes coupled with a limited permissible tax transfer between the spouses of 15,000 euro or 20,000 euro – would yield maximum extra revenue of 5.11 billion euro. Under this form of taxing spouses' income the recipients of small taxable incomes would face a disproportionately higher tax burden than under the *status quo*. By shifting capital income and profit income between the spouses, high income earners could largely replicate the tax effects of spouses' income splitting, whereas couples with low incomes would still be subject to a high relative tax burden. The amount of additional tax revenue that could be generated under these assumptions would be negligible.
- If spouses' income splitting were to be transformed into a system of **family income splitting**, the computation results of both variants indicate an additional strain on public finances of between 3.10 billion euro and 5.95 billion euro. Family income splitting would chiefly benefit recipients of high taxable incomes. Whether family policy objectives could be attained in this way appears questionable. It seems more sensible to promote families as now via the combination of child benefit (*Kindergeld*) and tax-free allowances for children.
- All in all, therefore, there is much to be said in favour of **leaving** the current system of **spouses' income splitting well alone** and granting tax breaks to families as hitherto via the medium of child benefit and tax-free allowances for children.

CHAPTER SIX: Summary

Labour market: on the way to higher employment

Labour market development

- The clear revival on the labour market continued in 2007. The level of employment increased during the year by 1.7 per cent to an annual average of just under 40 million persons, while the number of people in jobs subject to full social security contributions rose by 2.2 per cent to almost 27 million.

- Registered unemployment fell in 2007 by 15.7 per cent to below 3.8 million persons on an annual average, which corresponds to a decline in the unemployment rate from 10.8 per cent in 2006 to 9.0 per cent. In eastern Germany the unemployment rate stands at 15.0 per cent and is roughly twice as high as in the western part of the country.

- Both the number of recipients of unemployment benefit II (*Arbeitslosengeld II*) and of income-support households (*Bedarfsgemeinschaften*) decreased markedly. On an annual average there were around 5.2 million recipients of unemployment benefit II grouped in just under 3.8 million income-support households.

- The situation on the vocational training market eased appreciably at the end of the 2006/2007 career guidance year.

Labour market reforms

- Both estimates of a non-cyclical unemployment rate and a comparison of several cyclical upturns point to the probability that the current development on the labour market has not been caused solely by a cyclical recovery but is also characterised by a higher flexibility and dynamics. This is additionally indicated by the declining number of long-term unemployed and jobless persons coming within the legal definition of the Second Book of the Social Security Code (*Sozialgesetzbuch II*).

- The final report now available on the evaluation of labour market policy measures undertaken by economic research institutes confirms the preliminary results according to which the promotion of vocational further training (*Berufliche Weiterbildung*), bridging grants (*Überbrückungsgeld*), business start-up grants (*Existenzgründungszuschuss*) and reintegration grants (*Eingliederungszuschüsse*) merit a positive assessment. However, the evaluation results for the bulk of expenditures on active labour market policy have not yet been made available.

- The planned extension of the additional children's allowance for poor parents (*Kinderzuschlag*) into a general wage supplement for low-paid workers (*Erwerbstätigenzuschuss*) is misguided. This project conflicts with the principle of the basic allowance for job seekers (*Grundsicherung für Arbeitsuchende*).

Shortage of suitably qualified workers

- A marked shortage of skilled workers, in particular, has emerged just recently in certain regions. This relates above all to engineers, technical professions and manufacturing trades.

- Short-run solutions to the problem of the shortage of suitably qualified workers include a corresponding fanning-out of the wage structure by skill level, stepping up further training efforts, mobilising skilled persons from among the unemployed and the inactive labour force as well as recruiting from abroad. In the medium to long term a clear improvement in the efficiency of the education system is a crucial requirement.

Wage formation

- In 2007, as in the two preceding years, the macroeconomic scope for distributing the national income was not exhausted to the full by the negotiated wage settlements. To that extent the wage negotiators on both sides of industry lived up to their employment policy responsibility.

- The wage conflict at the principal German railways company Deutsche Bahn AG has clearly revealed the tensions between labour contract singularity (*Tarifeinheit*), i.e. the sole validity of a single collective labour contract within an enterprise, and labour contract plurality (*Tarifpluralität*), i.e. the simultaneous validity of different collective labour contracts within an enterprise. Labour contract plurality finds its justification in Article 9 (3) of the Basic Law (*Grundgesetz*), although from an economic viewpoint it can lead to higher pay settlements compared with labour contract singularity as well as to problems of practicability.

- The proposal to introduce a minimum wage at the German post office enterprise Deutsche Post AG should be vigorously rejected.

- The plans put forward by the ruling coalition government parties for employee participation in the running or capital of their enterprise (*Mitarbeiterbeteiligung*) fail to convince. While a voluntary, plant-level employee participation scheme can be meaningful for an enterprise, this is no reason for making it a government responsibility, let alone for granting new subsidies for this purpose.

CHAPTER SEVEN: Summary

Should the acquisition of equity stakes by foreign investors be restricted?

The announcement made by the People's Republic of China that it was transferring part of its foreign currency reserves to a sovereign wealth fund unleashed an intense debate in Germany about protective measures against such state-owned public funds. This quickly proliferated into calls for general restrictions on the acquisition of equity stakes by foreign investors. The debate was nurtured by nebulous fears of endangerment as well as a general feeling of unease concerning new actors on the financial markets in particular and globalisation in general. What tended to be forgotten in the process was the fact that Germany itself has a strong vested interest in open capital markets. As a surplus country Germany exports capital and is reliant on the fact that its investors are welcome in other countries. German investors hold equity stakes in firms worldwide in the amount of 800 billion euro, compared with the 390 billion euro which foreigners have invested in Germany. On account of this high degree of capital integration Germany, for reasons of enlightened self-interest, has hitherto been an exemplary advocate of open capital markets.

Dangers are perceived as coming primarily from **foreign sovereign wealth funds**. Such institutions are set up as a rule in order to build up a capital stock with a view to countering problems ensuing from the exhaustion of finite resources or the ageing of the population. This indicates an investment strategy geared to maximising returns and diversifying risks. In the public perception, by contrast, sovereign wealth funds are suspected of primarily pursuing political and strategic investment aims. It should be pointed out in this context that sovereign wealth funds have been around for several decades, especially in the oil-exporting countries, without up to now posing any perceptible threat to German enterprises. On the contrary, they were greeted with open arms as long-term investors in German firms.

In order to consider possible reasons for a general **limitation of capital flows**, it is first necessary to define what specific public interest could possibly be impaired by the acquisition of equity stakes by foreign investors. The next logical move is to consider whether existing instruments perhaps suffice to safeguard the public interest. If a need for supplementary measures is identified, the next question to ask is whether these can take the form of interventions other than those which impede the free movement of capital. Another issue that needs clarifying is whether a new instrument is precisely trained on the target in mind and whether it might lead to undesired side-effects. Finally, it is necessary to bear in mind the European regulatory prohibitions on instruments that limit the free movement of capital.

Under **European law** the principle of free capital movement may be restricted only in precisely defined cases in order to safeguard public order and security. The European Court of Justice and the European Commission rightly interpret this concept narrowly. This is intended to prevent individual member countries from undermining the principle of free capital flows and taking protectionist measures under the pretext of protecting national security. The European Commission has accordingly objected to corresponding French regulations, while the European Court of Justice has nullified a series of deviating provisions in other member states.

The analysis shows that attempts to justify restricting the acquisition of equity stakes in German firms by foreign investors on economic grounds have to clear high hurdles. The economic rationale put forward for such interventions is nearly always unconvincing, either because it is not clear in what way a takeover would supposedly impair the public interest or because other, less invasive instruments are available, such as competition law.

The German Council of Economic Experts therefore sees no immediate necessity to limit equity acquisitions by foreign enterprises beyond the extent already provided for in the Foreign Trade and Payments Act (*Aussenwirtschaftsgesetz*). If the policymakers were nevertheless to opt for tighter controls on equity acquisitions, the instruments introduced for this purpose would have to satisfy stringent standards concerning the prohibition criteria and the assessment procedure. This is necessary not only so as to obviate the danger of subsequently falling foul of a ruling of the European Court of Justice, but also because otherwise a tool could be created which could easily be misused by policymakers to veto takeover bids that are publicly labelled as undesirable – to the detriment of the German economy. The proposals made to date, especially the draft amendment of the Foreign Trade and Payments Act, do not satisfy these stringent standards, however. They should therefore not be pursued further in the present form.

Appendix

I. Tables: Forecasts for 2008

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

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

Table A

Key data from the national accounts for Germany
For 2007 estimates, 2008 forecasts

Changes from previous year in %

	2005	2006	2007	2008
Use of domestic product				
Price-adjusted (at previous year's prices)				
Consumption expenditure, in all	+ 0.1	+ 0.9	+ 0.4	+ 1.7
Private consumer spending[1]	– 0.1	+ 1.0	– 0.1	+ 1.7
General government consumer spending	+ 0.5	+ 0.9	+ 2.0	+ 1.7
Gross fixed capital formation	+ 1.0	+ 6.1	+ 6.1	+ 2.6
Machinery and equipment	+ 6.0	+ 8.3	+ 10.7	+ 3.4
Constructions	– 3.1	+ 4.3	+ 2.6	+ 1.7
Other products	+ 4.8	+ 6.7	+ 4.6	+ 4.5
Stockbuilding[2)3)]	+ 0.0	– 0.1	+ 0.1	+ 0.0
Total domestic demand	+ 0.3	+ 1.9	+ 1.5	+ 1.9
Net exports[2]	+ 0.5	+ 1.1	+ 1.2	+ 0.2
Exports of goods and services	+ 7.1	+ 12.5	+ 8.2	+ 6.0
Imports of goods and services	+ 6.7	+ 11.2	+ 6.5	+ 6.5
Gross domestic product	**+ 0.8**	**+ 2.9**	**+ 2.6**	**+ 1.9**
Use of domestic product				
at current prices				
Consumption expenditure, in all	+ 1.4	+ 2.0	+ 2.0	+ 3.1
Private consumer spending[1]	+ 1.4	+ 2.3	+ 1.7	+ 3.3
General government consumer spending	+ 1.4	+ 1.0	+ 2.7	+ 2.7
Gross fixed capital formation	+ 0.9	+ 6.7	+ 9.0	+ 3.0
Machinery and equipment	+ 4.9	+ 7.1	+ 9.8	+ 2.2
Constructions	– 2.2	+ 6.8	+ 9.1	+ 3.7
Other products	+ 2.1	+ 3.7	+ 2.4	+ 1.7
Total domestic demand	+ 1.5	+ 3.0	+ 3.4	+ 3.2
Net exports	.	.	.	.
Exports of goods and services	+ 8.3	+ 14.0	+ 8.5	+ 6.8
Imports of goods and services	+ 9.2	+ 14.3	+ 6.5	+ 6.6
Gross domestic product	**+ 1.5**	**+ 3.5**	**+ 4.4**	**+ 3.5**
Deflator				
Consumption expenditure, in all	+ 1.4	+ 1.1	+ 1.6	+ 1.4
Private consumer spending[1]	+ 1.5	+ 1.4	+ 1.8	+ 1.6
General government consumer spending	+ 1.0	+ 0.2	+ 0.7	+ 1.0
Gross domestic product	+ 0.7	+ 0.6	+ 1.8	+ 1.5
Total domestic demand	+ 1.2	+ 1.1	+ 1.8	+ 1.3
Origin of national product				
Employment (domestic)	– 0.1	+ 0.6	+ 1.7	+ 0.8
Total number of man-hours worked	– 0.6	+ 0.5	+ 1.8	+ 1.5
Productivity (per hour)	+ 1.3	+ 2.4	+ 0.8	+ 0.4
Distribution of national income				
National income (factor costs)	+ 1.4	+ 3.6	+ 3.8	+ 3.9
Compensation of employees	– 0.6	+ 1.7	+ 3.4	+ 4.0
of which: net compensation of employees[4]	– 0.1	+ 0.4	+ 4.2	+ 4.2
Property and entrepreneurial income	+ 5.9	+ 7.2	+ 4.7	+ 3.7
Disposable income of private households[1]	+ 1.7	+ 1.9	+ 2.1	+ 3.1
Ratio of saving of private households[1)5)]	10.5	10.5	10.9	10.7
Memo:				
Unit labour costs[6] (Domestic concept)	– 1.0	– 1.1	+ 0.6	+ 2.0
Consumer prices (Consumer Price Index 2000 = 100)	+ 2.0	+ 1.7	+ 2.1	+ 2.0

1) Including private non-profit institutions.– 2) Contributions to changes in real GDP (percentage of real GDP in previous year).– 3) Including acquisition less disposition of valuables.– 4) Net wages and salaries.– 5) Saving as a percentage of disposable income plus pension funds reserves less private consumption expenditures.– 6) Compensation of employees per employees in relation of gross domestic product (price-adjusted) per persons engaged.

Table B

General Government revenues and expenditures for Germany[1)]
For 2007 estimates, 2008 forecasts

	2006	2007	2008	2007	2008
	Euro billion[2)]			Changes from previous year in %	
Revenue	1 017.2	1 067.0	1 092.0	+ *4.9*	+ *2.3*
of which:					
Taxes	530.5	579.4	591.8	+ *9.2*	+ *2.1*
Social security contributions	401.1	400.7	411.4	– *0.1*	+ *2.7*
Expenditure	1 054.5	1 066.8	1 086.6	+ *1.2*	+ *1.9*
of which:					
Intermediate consumption	97.8	102.1	106.3	+ *4.5*	+ *4.1*
Compensation of employees	167.7	170.3	175.5	+ *1.5*	+ *3.1*
Income from property (pay out)	64.9	67.0	68.1	+ *3.3*	+ *1.5*
Transfers (pay out)	662.0	661.1	669.7	– *0.1*	+ *1.3*
Gross capital formation	32.8	37.0	39.0	+*12.9*	+ *5.5*
Others	29.4	29.4	28.0	*X*	*X*
Net lending	– 37.3	0.2	5.5	*X*	*X*
Memo:					
Expenditure ratio[3)]	*45.4*	*44.0*	*43.3*	*X*	*X*
Tax ratio[3)]	*23.3*	*24.4*	*24.1*	*X*	*X*
"Abgaben" - ratio[3)]	*39.6*	*39.9*	*39.5*	*X*	*X*
Financial balances ratio[3)4)]	– *1.6*	*0.0*	*0.2*	*X*	*X*

1) General Government and Social Security Funds according to definitions of the National Accounts. General Government: Federal government, Länder, local authorities including ERP-Special Fund, Equalization of Burden Fund, *Vermögensentschädigungsfonds* and parts of "Federal Railway Trust", "German Unity Fund", "Redemption Fund for Inherited Liabilities".– 2) Deviations are due to rounding.– 3) Expenditures/taxes and inheritance tax, taxes to the EU/taxes and inheritance tax, taxes to the EU and social security contributions/financial balances as a percentage of nominal GDP.– 4) Deficit ratio (–).

Table C

Forecasts for the Labour Market for Germany[1)]

For 2007 estimates, 2008 forecasts

	2006	2007[2)]	2008[2)]
		Thousand persons	
Occupied population[3)]	43 233	43 304	43 323
Unemployed persons[4)]	4 227	3 596	3 304
Balance of migrant labour[5)]	82	62	60
Employment (domestic)	39 088	39 769	40 079
Registered unemployment[6)]	4 487	3 783	3 463
of which:			
Former territory of the Federal Republic	3 007	2 491	2 237
New Länder	1 480	1 292	1 226
Memo:			
Employees subject to social insurance[6)]	26 365	26 952	27 214
		Rates (%)	
Unemployment rate[6)7)]	*10.8*	*9.0*	*8.3*
ILO-Jobless rate[8)]	*9.8*	*8.3*	*7.6*

1) Annual averages.– 2) Own estimation; according to definitions of the National Accounts. Deviations are due to rounding.– 3) National concept.– 4) Definitions of the International Labour Organisation (ILO).– 5) Persons engaged (domestic concept) less persons engaged (national concept).– 6) Source for 2006: Federal Labour Agency (Bundesagentur für Arbeit, Nürnberg).– 7) Definitions of the Federal Labour Agency (Bundesagentur für Arbeit).– 8) Unemployed persons in percent of labour force; definitions of the unemployed based on the ILO concept.

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

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

The Bundestag has enacted the following Law:

Article 1

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

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

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

Article 2

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

Article 3

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

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

Article 4

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

Article 5

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

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

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

Article 6

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

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

Article 7

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

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

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

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

Article 8

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

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

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

Article 9

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

Article 10

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

Article 11

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

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

Article 12

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

Article 13

This Law becomes effective on the day following its announcement.