GERMAN COUNCIL
of Economic Experts

Securing the future through responsible economic policies

Annual Report 2009/10

Summary

Preface

The German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) hereby presents the English translation of the complete first chapter of its Annual Report 2009/10. 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 six chapters.

I. “Die Zukunft nicht aufs Spiel setzen” (Securing the future through responsible economic policies)
II. The economic situation and development in the world and in Germany
III. Macroeconomic challenges for the next decade
IV. Financial system on drips: before a difficult physical withdrawal
V. Fiscal policy and social security: priority must be to consolidate the budget
VI. Industrial policy: letting market processes be effective and facilitating innovations
VII. Labour market: looking ahead – starting an education initiative

The data used in the report of the Council were the latest available in end-October 2009.

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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FIRST CHAPTER

Securing the future through responsible economic policies

I. The current conjuncture: slight recovery but no upturn

II. Exit strategy: fiscal consolidation and overcoming the financial crisis

1. European monetary and fiscal policy facing difficult unwinding processes
2. The national perspective: priority must be to consolidate the budget
3. Reforms for a stable financial market architecture

III. Education and innovation: investments in the future

1. Reforming the education system: need for an education offensive
2. Innovation and industrial policies
3. Improving Germany's attractiveness as an investment location

Securing the future through responsible economic policies

1. The new German government that was elected in September 2009 faces big economic **challenges** in the next few years. Two tasks top the agenda:

- It must devise and execute an **exit strategy** to roll back the state's massive intervention during the crisis without compromising the ensuing stabilization.

- It must stimulate and initiate **investment in education and innovation** that will lift Germany onto a higher growth path.

If the government fails to accomplish these tasks, it will condemn Germany for years to come to lower economic growth, a spiralling public debt that mortgages the birthright of future generations and a banking system dependent on government handouts. In other words, Germany would be struck by the same debilitating disease that paralysed the Japanese economy during its "lost decade" in the nineties. The coalition agreement signed by the three governing parties CDU, CSU and FDP suggests that the new government has not yet grasped the magnitude of the challenge it faces, especially with regard to engineering the right exit strategy.

2. Devising a credible exit strategy and maintaining stable growth are two sides of the same coin. These twin objectives should be informed by the following insights:

- Unwinding the intervention strategy without endangering the fragile economic recovery will be a delicate **balancing act**. For this reason the exit should not start straightaway, i.e. in 2011 rather than in 2010. But it is important, too, that the government quickly and clearly signals its resolve to consolidate the budget.

- The exit strategy must embrace **fiscal policy**, **financial market stabilisation** and **monetary policy** as well as the interactions between these three arenas. It should include the goals of reducing government borrowing, progressively dismantling the support programmes in both the real and the financial sector and ending the unlimited provision of central bank liquidity.

- The exit strategy must be flanked by concrete measures to **increase investment** in human capital and in improving Germany's capacity to innovate. Such an economic policy would have the dual advantage of boosting growth and contributing to an orderly reduction of global economic imbalances.

3. The **main policy fields** involved will be fiscal policy, national and international financial market regulation, education and innovation policy as well as labour market and structural policy.

- The public sector must begin cutting its deficits as from 2011. As well as being a mandatory requirement of the new debt brake (*Schuldenbremse*) now enshrined in Germany's constitution (*Grundgesetz*), this is also a moral imperative to ensure just and fair intergenerational burden-sharing. **Budgetary consolidation** should start by curbing expenditure. If spending is not cut back sharply, taxes will inevitably have to be raised.

- The exit strategy for the **financial markets** should not be confined to reversing the explicit support measures granted to banks. It must be complemented by withdrawing the implicit public guarantees for private risks. This necessitates institutional regulations to avoid the moral hazard resulting from bail-outs of financial institutions, including far-reaching reforms both at the national and the international level. Specifically, these should include reinstating the market principle that insolvent banks are allowed to go under, sharply reducing incentives for excessive risk-taking by, for example, imposing higher capital requirements, and strengthening the role of the prudential supervisory authorities.

- Notwithstanding the tight budget constraints, the state should mobilise funds to invest in Germany's future by boosting education spending. This requires an **education offensive** that will both raise the nation's general level of educational achievement and improve learning opportunities for disadvantaged groups. This could be accompanied by an **innovation drive** to encourage the private sector to invest more in research and development. In order to fund these education and innovation campaigns, priorities in public finances must be clearly defined, which calls for especially stringent consolidation in other areas.

- Germany needs to be made more attractive for investors by eliminating anomalies in the overall taxation system, especially with regard to corporate taxes, making labour market rules more flexible and actively supporting the ongoing **structural change**.

4. The **coalition agreement** signed between the CDU, CSU and FDP on 26 October 2009 goes only part of the way towards meeting these challenges.

- The section on consolidating **public finances** fails to come up with convincing proposals. Instead of outlining a coherent fiscal consolidation strategy, it formulates vague intentions and avoids spelling out the specifics. This shortcoming is compounded by promising additional tax breaks totalling 24 billion euro, without revealing to the reader how these are to be financed.

- On the positive side, the coalition agreement's section on reforming **financial market regulation** addresses a number of important regulatory measures along the lines of the proposals made by the German Council of Economic Experts – GCEE (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*) itself. The litmus test will be, however, whether the government actually manages to put these measures on the statute book in the teeth of expected fierce resistance from powerful lobby groups. Furthermore, the coalition agreement glosses over the need to transfer prudential powers to the supranational level.

- It is good to see that **education and innovation** feature prominently in the coalition agreement. It announces that research and development are to be reinforced in various fields. In Germany central government has only limited jurisdiction in the education sector, however, so that on headline projects such as improving the teacher-child ratio in kindergartens and schools it can do little more than appeal to the state governments. Moreover, the coalition agreement is silent on key issues addressed by the GCEE in its Annual Report 2009/10, such as the introduction of a mandatory pre-school year.

– The coalition agreement's chapter on **improving Germany's attractiveness as an investment location** is a mix of good and bad points. On the positive side, the new government promises to act swiftly to remedy the shortcomings of the last reform of corporate taxation, e.g. by improving tax offset facilities for loss carryforwards and borrowing costs. On the negative side, it fails to address the pressing need to make collective bargaining rules more flexible. Other positives include the announcement that temporary employment contracts will be made easier and the rejection of a national minimum wage. Yet this is not matched by a corresponding rejection of the equally harmful idea of industry-specific minimum wages.

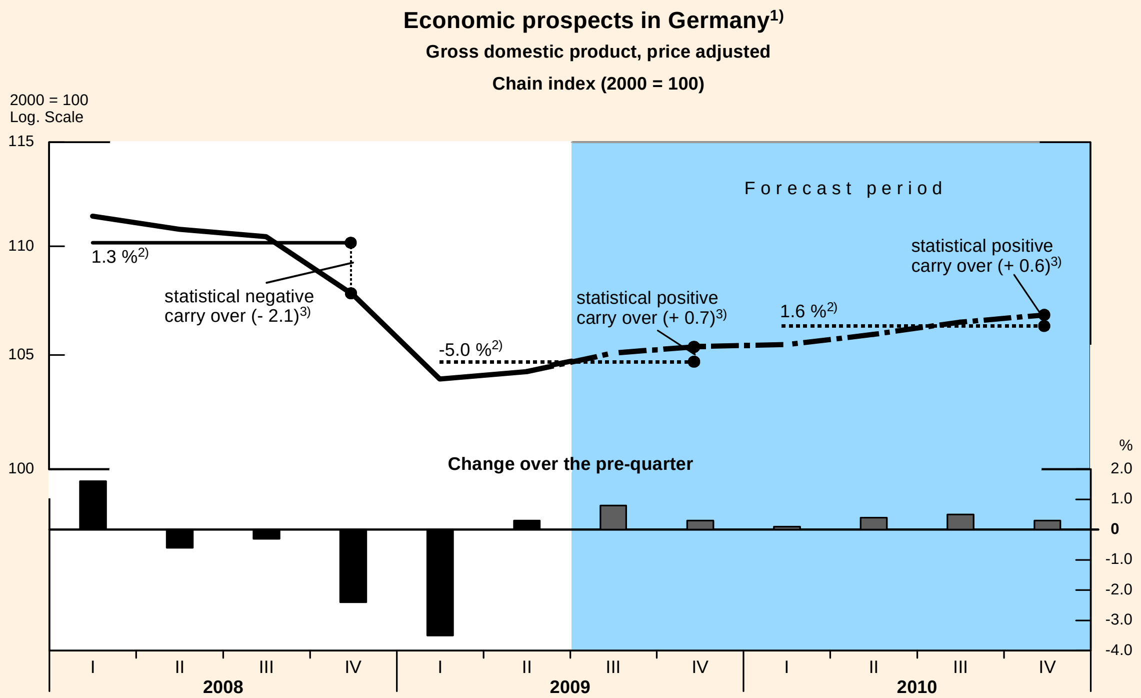
5. All in all, the coalition agreement falls short of the requirements on a range of major issues. It lacks a coherent exit strategy. It fails to specify concrete steps for reducing government borrowing, and, even worse, it holds out the prospect of lower taxes and higher spending. It does not even address, let alone tackle, the problem of squaring the conflicting goals of fiscal consolidation, tax cuts and investment in education and innovation. If the government really believes it can free up extra financial resources, it would be better advised to invest these in education and innovation rather than doling out free gifts in the form of "carer cash" for parents who do not send their children to kindergarten or a lower VAT rate for hoteliers.

An economic policy that lacks a coherent exit strategy and does not find the fiscal scope to invest in education and innovation runs the risk that it will **jeopardise the country's future by failing to pursue responsible economic policies**.

I. The current conjuncture: slight recovery but no upturn

6. Following the dramatic slump in output in late 2008 and early 2009, the German economy stabilised around the middle of this year (Chart 1). The contraction of gross domestic product (GDP) over four consecutive quarters came to an end in the second quarter of 2009. Both hard and soft economic indicators point to a modest pick-up in the second half of 2009 and in 2010. In 2009 GDP is likely to shrink by 5.0 per cent, while for 2010 the GCEE projects a slight recovery and an expansion of German output by 1.6 per cent.

Chart 1



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

Although the **downward slide has halted**, it will take years until the German economy will reach its pre-crisis level of production. The slightly positive signals for 2010 give no cause for a euphoric assessment of, for example, extra spending scope in the public budgets. The upturn is too weak and fragile for that.

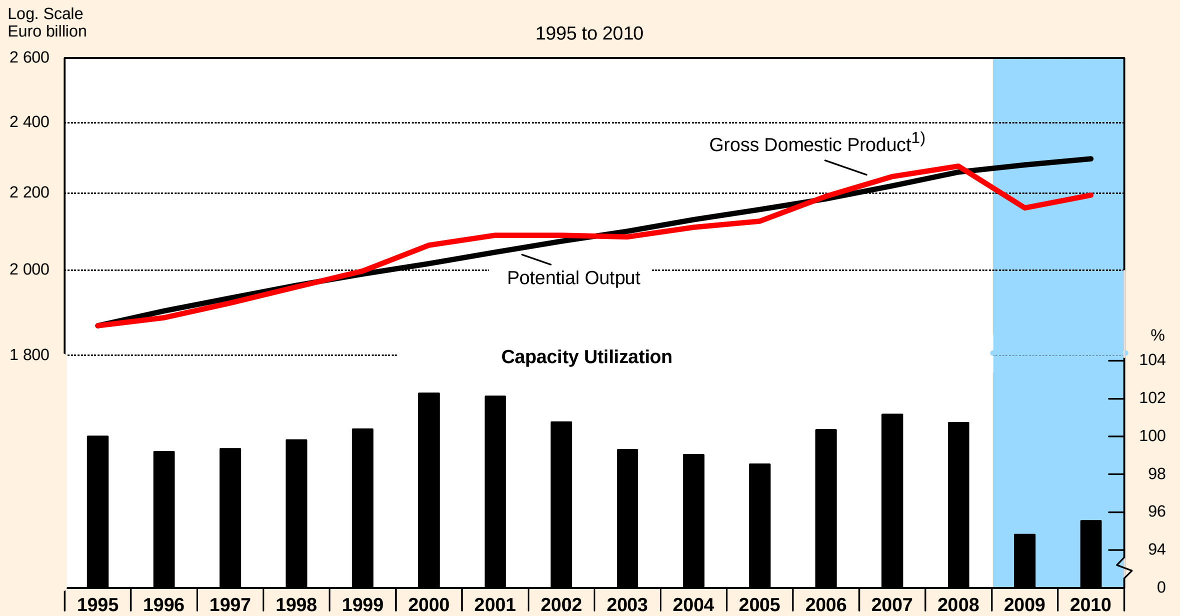
7. The development of aggregate **capacity utilisation** shows how steeply the German economy has been dragged down by the global economic recession. The degree to which the nation's production capacity is utilised is measured as the quotient of actual and potential GDP (Chart 2). It turned negative at the start of 2008 and in 2009 reached a historic low of under 95 per cent compared with previous decades.

Aggregate capacity utilisation is calculated on the basis of **potential output**, which is the estimated volume of goods and services that are produced when all capacities are running at their normal level of utilisation. This ratio, which is not directly measurable, is currently subject to great uncertainty. On balance, it may be said that the potential growth rate of the German economy amounts to 0.9 per cent in 2009 and will narrow to 0.7 per cent in 2010 (paragraph 437 ff. in the Annual Report).

The **medium to long-term growth rate** of potential output is subject to even greater uncertainty. Whether potential growth really does contract, as many economists fear, hinges crucially on the policy response to the deep recession. First, it is imperative to rigorously continue the task of restructuring the financial sector. Second, it is vital to prevent a sustained rise in government indebtedness, as this would act as a brake on growth. Third, the country's political leaders must at all costs resist the temptation to try to slow down the natural process of structural change for the sake of achieving a short-sighted quick fix, such as intervening to rescue enterprises in distress. On the other hand, if the crisis is understood and used as an opportunity to restructure, this could lead to a faster potential growth rate in the long run.

Chart 2

Potential Output, Gross Domestic Product and Capacity Utilisation



1) Price-adjusted, chain linked.

8. Given the exceptional underutilisation of production capacities, the **labour market** has held up remarkably well compared both with GDP and the predictions of many pundits. Firms have run down their employees' surpluses on working time accounts, shortened the standard working week and made use of government-subsidised short-time working arrangements. The official **unemployment** measure will consequently go up by only around 160,000 in the course of 2009. Given continuing underutilisation of their plant capacity, firms will be unable to keep their staff indefinitely on **short-time working** since, despite the government subsidies, this represents a cost factor for them. This inevitably means that there will be more lay-offs in 2010 than in 2009, pushing up official unemployment by an estimated 500,000. On the positive side, the pessimists who at the start of 2009 predicted that unemployment would reach the five million mark by the end of 2010 are well wide of the mark. In fact, the jobless total will barely amount to four million.

9. The way out of the crisis is dotted with numerous pitfalls. The **labour market** trend in 2010 is very hard to predict with any accuracy since the change in GDP and employment have surprisingly decoupled this year. In addition, a potential **credit supply squeeze** could endanger a self-sustaining economic recovery. Even though individual indicators so far merely point to a tightening of credit standards rather than to a "credit crunch", there is a significant risk that a recovery in the real sector could be hampered during the forecast period by developments in the financial sector, since the latter is struggling both with its unfinished business of cleaning up balance sheets and the need to bolster its capital buffers. This underscores the great importance of pressing ahead with the task of overhauling the financial sector.

10. Even if the economy recovers faster than expected, the lingering aftermath of the financial crisis will severely challenge policymakers for a number of years. Germany's economic performance has been thrown back to the level of around 2005, and it will take quite some time for it to regain its pre-crisis level. The German government and European Central Bank (ECB) responded to the massive problems that occurred in the real and financial sectors with a battery of fiscal and monetary measures, ranging from several stimulus packages to a dedicated rescue fund for ailing financial institutions. In the process the state incurred enormous, hitherto scarcely conceivable **financial burdens** and launched a series of institutional and financial intervention measures in the banking sector on an unprecedented scale.

Though they did not get it all right, the policymakers were basically correct to act the way they did. Without their intervention things would have been much worse. But going forward, the main priority in overcoming the crisis must now be to downsize the state's role again to its pre-crisis level. First and foremost, this means resolutely reversing the steep rise in public debt. In 2009 the **general government deficit** in Germany will rise to 3.0 per cent of nominal GDP and thus reach the ceiling laid down for this reference value in the European Stability and Growth Pact (SGP). In 2010, this ratio is set to **climb significantly**, despite the gradual economic upturn and not counting the cost of the measures announced by the new government. The combination of an additional fiscal stimulus of around 10 billion euro vis-à-vis 2009 plus the less favourable development of key macroeconomic aggregates will push the deficit ratio up to 5.1 per cent. The debt ratio will swell in the medium term to 80 per cent. This is likely to be mirrored by the euro-area debt ratio, which could well climb to 84 per cent in the coming year.

II. Exit strategy: fiscal consolidation and overcoming the financial crisis

11. The first major economic policy challenge facing the new government is to devise and implement an **exit strategy**. This means first and foremost reducing new public borrowing. Right now, however, the political leaders in Germany as in many other euro-area countries show little enthusiasm for battling the public debt. Moreover, it is doubtful whether the SGP will suffice on its own to instil the budgetary discipline required to achieve this task. It follows that the fiscal policy exit strategy must be embedded in an international economic policy context and coordinated with the central banks' reversal of their expansionary monetary policy.

Second, the task of mopping up the mess in the financial sector and of correcting regulatory deficits must be resolutely continued. This, too, requires an exit strategy which will be just as difficult as unwinding the expansionary monetary and fiscal policy measures undertaken to prop up the real economy. Yet the biggest challenge is not simply the daunting task of reversing the explicit support measures, which will stretch over many years. The toughest test will be to reverse the **implicit public guarantees for private risks**. There have been similar examples of the public sector picking up the private sector's tabs in industry, notably in the decision to rescue individual firms in the context of the **German Economic Support Fund** *(Deutschlandfonds)*. Here, too, the new German government needs to draw up and execute a plan to run down public subsidies.

1. European monetary and fiscal policy facing difficult unwinding processes

12. The European Central Bank (ECB) continues to pursue the twin-track strategy of keeping the still fragile financial system awash with liquidity and helping to pump-prime the Eurozone economy with rock-bottom interest rates. Even if it is too early for the ECB to reverse its accommodating policy stance and cut the liquidity supply to a normal level, it must take care to ensure that its massive provision of cheap funding to the banking system neither causes the financial system to overheat again nor jeopardises its monetary stability mandate. A reliable bellwether for this are inflation expectations which, however, have remained firmly anchored around the ECB's target value, despite its injection of superabundant liquidity into the financial system.

The ECB can reverse the interventionist monetary policy stance which it has pursued during the crisis fairly easily – unlike Europe's fiscal policymakers. The ECB has several policy options to absorb the **excess liquidity** which it provided in the wake of the financial crisis. As soon as the financial markets are strong enough, the ECB can begin to markedly shorten the maturity of its currently up to one-year refinancing operations and to return to a rationed credit supply strategy. This will enable it to close the at present very wide gap between the overnight EONIA rate (around 0.4 %) and the ECB's key policy rate (1.0 %). Alternatively, the ECB could mop up the excess liquidity in the banking system very quickly and on a large scale through its deposit facility.

Given the ECB's **sovereign political independence** vis-à-vis national governments and the European Commission, there can be no doubting its resolve to begin a monetary policy exit strategy as soon as necessary. Hence monetary stability in the euro area is not endangered by the ECB's present policy, despite the raft of unconventional measures it has rightly taken to deal with the exceptional situation.

13. The risks associated with the transition from the crisis intervention phase to normal macroeconomic conditions include the high **external indebtedness** of many **central and east European states**, which is largely denominated in foreign currency. This concerns not only economic welfare in these countries themselves but also the stability of euro-area banks that are heavily exposed to this region both through direct loans and majority shareholdings in local financial institutions. The Asian crisis underscored the dangers that can ensue from a downward spiral fed by a depreciating domestic currency and the problems this brings for private borrowers heavily indebted in foreign currency. The simplest way to hedge the risks of enforced devaluation would be to grant these countries immediate full membership of the European Monetary Union. But this would entail both legal and stability problems. A second-best option could be for the ECB to announce that it will intervene to defend these countries' currencies if they come under major speculative attack and extend the maturity of intervention credit under the Exchange Rate Mechanism II. As this would neutralise the disciplining effect of the foreign exchange markets, such unilateral support could only be offered if the countries concerned credibly promised to consolidate their public finances.

14. The tough test that lies ahead in the coming years could be made even harder by the possibility of **sudden changes in global exchange rate parities**. One potential source of instability are the swollen foreign reserves of many emerging market economies, which are mostly held in US dollars. A controlled transition to a more diversified reserve asset system could be achieved through a joint commitment by the central banks to sell off their US dollar holdings only gradually and over a protracted period. This could be modelled on the Washington Gold Agreement in which the central banks pledged to space out their gold sales over time. This should be flanked by a limited right to convert US dollar balances into special drawing rights (SDR) with the International Monetary Fund (IMF). The IMF has already created an institutional framework for this with the Note Purchase Program that it set up this year.

15. Compared with the ECB's monetary policy exit strategy, the **euro-area fiscal policy switch from high structural deficits** to a close-to-balance budget position as stipulated in the SGP is likely to prove a much harder task to accomplish. The rate for reducing the structural deficit ratio of 0.5 percentage point per year defined in the amended SGP would push the euro-area average structural deficit ratio down to merely 2.2 per cent by 2015. Some countries would still have deficits well above the 3.0 per cent ceiling (Ireland and Spain) or, as in the case of France, only just below that level.

16. Failure on the part of the euro-area countries to sustainably reduce their indebtedness from 2011 onwards would have dire consequences. **Galloping growth of public debt** would restrict their fiscal policy options, which will in any case be narrowed in the coming decades by demographic pressures. If this were to kindle inflation expectations, the ECB would have to jack up its policy rates in response. This would produce a “bad equilibrium” characterised by high interest rates, low growth and straitjacketed fiscal policy. In addition, Germany's adoption of a stringent, rule-based debt brake will pose a risk that the fiscal situations of the individual member states might increasingly diverge, which in turn would lead to higher risk premiums for countries pursuing a laxer budgetary course.

17. In view of the enormous fiscal challenges that will confront Europe in the decade ahead, it is questionable whether the existing SGP rules suffice to discipline the national governments. Judging by their fiscal track record over the past ten years, this may well be doubted. Greece, for example, was allowed to exceed the deficit ratio of 3 per cent throughout that period – with the exception of 2006, when it dipped slightly to 2.9 per cent – without once having to face official sanctions under the SGP. It would therefore make sense to reinforce the SGP by setting up a European **Fiscal Consolidation Pact** equipped with ambitious, transparent, stringent and persuasive provisions for executing the exit from the expansionary fiscal policy stance.

- Each country would have to chart a fixed course to a close-to-balance budgetary position. This would ensure a more ambitious consolidation strategy than under the SGP with its focus on the 3 per cent ceiling.

- The consolidation path would be transformed into a **structural expenditure rule**. This would make it easy to assess whether a government is sticking to its promised budgetary discipline. During the consolidation phase the member states would have to define all spending-related tax provisions *ex ante*. The European Commission could publish a report twice a year reviewing the fiscal compliance of all the member states, thus ensuring a high degree of transparency.

- This would certainly stiffen **financial market discipline**, which already in 2009 demanded high risk premiums for some member states. Contrary to the SGP rules, the European Commission might also be granted a right of proposal for initiating sanctions, which would increase the pressure on the Council.

- As the ultimate instrument of persuasion, those countries that do not comply with the Pact's provisions could be obliged to temporarily raise their taxes ("debt surcharge").

18. Given the various current political initiatives at the European level to dilute the SGP's provisions, proposals to stiffen the fiscal framework may not seem all that realistic at the present time. Yet the cardinal virtue of a credible consolidation path is that it would thwart the emergence of high inflation expectations and so enable the ECB to take account of possible negative demand effects due to a Europe-wide reduction of structural deficits when setting the interest rate level. The German government should lobby its European partners to adopt such an approach – assuming that it can put its own fiscal house in order first.

2. The national perspective: priority must be to consolidate the budget

19. The previous CDU-SPD Grand Coalition government that was in power up to September 2009 managed to stabilise the financial markets and aggregate demand with the aid of huge sums of money. It acted correctly on the whole. But the direct consequence of its action is a dramatically ballooning level of **public debt** which carries very great risks. On the one hand, it implies shifting the cost burden onto future generations, who will at least have to pay the interest on the accumulated debt. On the other hand, the increased government debt will depress economic growth in the longer run, in other words it will achieve the exact opposite of what is required in the comings years.

Given the combination of falling tax revenue and rising public expenditure, the general government fiscal deficits will expand sharply in the next few years and rise way above the ceiling of 3 per cent in relation to nominal GDP laid down in the EC Treaty. Similarly, the debt-to-GDP ratio will climb to over 80 per cent and thus far exceed the 60 per cent limit stipulated in the EC Treaty. While this increase in government debt was largely caused by the crisis and thus more or less unavoidable, it must not become a permanent fixture.

20. The **debt brake** has introduced a constitutional limit on government borrowing which will force public budgets to consolidate in the next few years and, in the case of central government, lays down a binding consolidation path. The amended Article 109 (3) of the Basic Law stipulates that the budgets of central and state government must be "generally balanced without resorting to debt incurrence". Pursuant to Article 115 (2) of the Basic Law, this "general balancing" of the budget limits central government's structural new borrowing, i.e. debt incurrence adjusted for cyclical fluctuations, from 2016 to no more than 0.35 per cent of nominal GDP. Even stricter debt rules apply to the state governments, for which structural new borrowing is totally prohibited as from 2020. The benchmarking to structural deficits is justified by the fact that they permanently raise the general government debt level and the resulting interest burden, whereas cyclical deficits more or less cancel out over the course of the business cycle and do not affect the debt level over the medium term.

For the years 2010 to 2013 the German Financial Planning Council (*Finanzplanungsrat*) projects a structural deficit ratio of central government of around 1.6 per cent. If this ratio is carried forward to the year 2016, the constitutional consolidation requirement comes to 1.25 per cent of GDP. Given an average nominal GDP growth rate of 3¼ per cent, as assumed in the German government's medium-term financial plan after the year 2010, the debt brake alone will impose a **consolidation requirement** on central government of approximately 37 billion euro.

21. Compliance with this new legislative *status quo* will compel the German government to **reduce its structural deficits**. It does not have to do so in a single step, however. Article 2 section 9 (2) of the Act Accompanying the Second Reform of Germany's Federal Structure (*Begleitgesetz zur zweiten Föderalismusreform*) requires central government to reduce its structural deficits "in equal steps". This means central government must begin budgetary consolidation in 2011. The consolidation obligation rightly will not start until after next year. On the contrary, a package of measures agreed by the previous Grand Coalition government (notably higher tax offsets for contributions to the statutory healthcare insurance scheme (*Gesetzliche Krankenversicherung*) and the public long-term care insurance scheme (*soziale Pflegeversicherung*) will trigger a fiscal impulse totalling roughly 10 billion euro in 2010. It is only starting in 2011 that a continuous consolidation requirement of around 6 billion euro must be achieved, though this will have to be supplemented each year up to 2016 on average by a further 6 billion euro. In 2016 compliance with the constitutional debt rule will then have been achieved.

22. Some people have given the impression that the **consolidation obligation** will be reached more or less automatically through tax cuts leading to higher **growth**. It is true that a permanently higher growth rate would ease the pressure on the public purse thanks to additional extra tax revenue. If the long-run nominal GDP growth rate were lifted from 3¼ per cent to 4 per cent – assuming an inflation rate of 1.8 per cent – this would amount to an unrealistically high potential growth rate of 2.2 per cent, which would lower central government's estimated debt brake-related consolidation need of 37 billion euro by one-third at most. In other words, while a higher growth path could ease the consolidation task, it cannot cause it to vanish into thin air. Conversely, permanent slightly lower growth would greatly complicate the consolidation task.

23. Central government budget consolidation cannot be achieved without either **painful deep cuts** in public spending or an increase in taxes or other levies. While cutting spending is always preferable to raising taxes, central government may not be able to achieve its consolidation target by spending cuts alone, so that tax increases may be unavoidable at the end of the new legislative period or the start of the next one.

Assessment of the coalition agreement

24. Though the coalition agreement mentions the need for budgetary consolidation, it does not specify how this is to be done. By announcing further tax cuts totalling 24 billion euro in a full year plus additional spending, it compounds its failure to list a single measure detailing how it will tackle the existing consolidation requirements. In view of the enormous consolidation requirements, such unfunded promises of tax cuts are incompatible with pursuing a sound fiscal policy. As all the measures contained in the coalition agreement have been explicitly declared subject to funding capacity, the government should have no trouble explaining that there is simply no money in the kitty for unfunded tax breaks. Whether the new German government accepts the fact or not, the truth is that the government budgets cannot be consolidated without either deep cuts in public spending or higher taxes or levies.

Measured against the key fiscal challenge in the coming period – the consolidation of public budgets – the **coalition agreement is vague** and, in every respect, **disappointing**.

3. Reforms for a stable financial market architecture

25. One year after the dramatic implosion, which for a time threatened to become a meltdown, the mood on the financial markets has brightened markedly. Tensions on the interbank markets have abated, share prices are rebounding and even the stock market valuations of many banks are on the way to regaining their level prior to the collapse of Lehman Brothers. The renewed large profits of banks which survived the crisis only thanks to government aid, along with the high salaries and bonuses of bank managers, have rekindled public anger but concurrently suggest that the financial markets crisis has been largely overcome.

This impression is illusory for a number of reasons. As before, the financial system is reliant on unlimited and virtually free liquidity provision by the central banks. As before, banks face substantial balance sheet dangers in the form of still not fully impaired toxic securities and potential write-downs and loan loss provisions as credit quality worsens under the impact of the strains on the real economy. As before, banks enjoy both explicit and implicit guarantees from the tax payer to bail out their creditors should the worst come to the worst, which is akin to giving them a blank cheque to bloat their balance sheets and incur extra risks. Moreover, the implicit guarantee via government support measures is gigantic. As The Bank of England's chairman Mervyn King, paraphrasing Winston Churchill's famous wartime quotation, said, "Never before have so few owed so much to so many" (speech held on 20 October 2009 in Edinburgh).

There is thus a pressing need for an **exit strategy**, which will prove equally as tricky as scaling back the expansionary monetary and fiscal policy measures to shore up the real economy. The biggest challenge is not so much unwinding the explicit support measures – though that will be hard enough and will take years – as in unravelling the implicit public guarantees for private risks.

26. The first priority must be to rapidly and durably **repair bank balance sheets and restructure** banks whose business model has proved to be non-viable. This has been a major shortcoming of Germany's crisis management to date. There is therefore a danger that Germany could repeat Japan's "lost decade" experience, with credit supply being squeezed further and further. Although the German government introduced a new instrument in July to facilitate the outsourcing of problematic assets and non-strategic business units, these measures are both voluntary and bound by unattractive conditions, so that their take-up rate is likely to be fairly low. Attempts to restructure banks with unsustainable business models have likewise made little progress for similar reasons.

Germany must resolutely push ahead with restructuring and recapitalising its banks if it is to avoid emulating the paralysing stagnation of Japan's "lost decade". This calls on the state to actively identify and restructure undercapitalised financial institutions. Banks that are going concerns but have an insufficient equity base must be pressurised into divesting non-performing portfolios and business lines and seeking fresh capital. If they are unable to raise own funds on the market, they should be given an injection of taxpayers' money by the government-owned dedicated rescue vehicle, the Financial Market Stabilisation Fund (*Sonderfonds Finanzmarktstabilisierung* – SoFFin). Banks that do not have a viable business model should be restructured and, if necessary, wound up. To speed up this "sink or swim" approach to dealing with ailing banks, they could be subjected to extensive stress testing, the underlying assumptions and results of which for individual institutions should be made public. Such transparency is crucial both for establishing clarity about the banks' ongoing viability and for validating prudential support.

27. The biggest hurdle facing the exit strategy, however, is to credibly curb the **implicit public guarantee of private risks**. A government threat to withdraw its underwriting promise and allow ailing banks to go bust with immediate effect simply would not be believed in the aftermath of the disastrous Lehman bankruptcy. What is more, the implicit state guarantee that already existed before the crisis has been vastly magnified by the rescue packages; even bigger banks have been formed as a result which, if they ran into distress, would give rise to even larger contagion effects, and even small banks of no systemic relevance such as Deutsche Industriebank AG (IKB) have been rescued. The market penalties for failure have, in effect, been abolished and replaced by a public insurance scheme. The consequence of this is that private sector players now have little or no incentive to handle risks with care. The supervisory authorities face an "empty threat" problem: any threat they may make to let a financial institution fail loses all credibility as soon as a systemic crisis breaks out. What must be done, therefore, is to realign the incentive structures in the public and private sectors in a way that largely shifts liability back onto the shoulders of the owners and creditors. This will require a series of interlocking reforms that reduces systemic risk, lays down a *modus operandi* for dealing with distressed financial institutions, lessens the incentives for excessive risk-taking in an upturn and reorganises the regulatory and supervisory structure. Such a reform package could be modelled on the following four **principles for reforming financial market regulation.**

28. First, the **treatment of systemic institutions**, markets and instruments has to be radically revised with a view to minimising contagion risks in the event of a crisis. This requires identifying systemic institutions, markets and instruments and subjecting them to particularly intense and stringent oversight. Safeguards must be introduced which neutralise the incentive for a bank to become systemically important and hence too big or too connected to fail in a crisis. This must be backed up by ensuring that, in a crisis, the financial sector has to bear the bulk of the costs itself. One way of achieving this would be to impose a capital surcharge on systemically relevant institutions.

The GCEE is of the opinion, however, that it would be better to adopt a more direct approach to regulating systemically relevant institutions. To this end a European **Stability Fund** could be set up into which institutions with an international focus would pay a levy in line with their systemic importance. Such a solution would have the added advantage that the private sector would have to bear part of the costs of systemic crises itself – the financial sector would make a contribution to insuring and hence ensuring its own stability. The fund would thus have two functions. It would lower the incentive for a bank to become systemically important and thereby reduce the intensity of future crises. And should a crisis of systemic dimensions break out, the financial institutions themselves would at least have frontloaded part of the rescue costs.

29. Second, an **effective intervention and restructuring regime** must be put in place to combat moral hazard ensuing from an over-lenient treatment of distressed institutions in a crisis. In order to make sure that shareholders, lenders, management boards and supervisory boards carry their fair share of liability, it is necessary to create intervention options which, whenever an institution runs into stress, force it to make timely adjustments and, if the bank breaches the regulatory rules, lead to its winding-up or workout, preferably on the lines of the good bank/bad bank model. To counter the "empty threat" problem, the intervention and restructuring regime would have to include thresholds triggering intervention by the prudential supervisors.

30. Third, the **system's resilience** must to be increased and its procyclicality decreased. This requires implementing tougher and better coordinated measures which kick in during an economic upswing, i.e. when risks are being incurred. In particular, changes are needed with respect to remuneration systems, capital rules and the regulation of liquidity risk. In addition, prudential supervision should take a more panoramic view, leaving no blind spots and encompassing within its field of vision the interaction between macroeconomic and monetary developments on the one hand and financial stability aspects on the other. Along with resolute responses by monetary policymakers to counter wayward developments on the financial markets, **contingent capital** (debt obligations that are automatically converted into equity capital in a crisis) could reduce the incentive to take on excessive risk in an upturn.

Many of the regulatory reforms adopted in the course of last year are steps in the right direction. But care must be taken to avoid producing a string of motley measures that do not add up to a coherent whole. Moreover, one major test is still ahead, namely the precise calibration of the new instruments. That is the point in time when all the lobby groups affected will cry foul and do their utmost to prevent any tightening of the screw.

31. Fourth, **prudential supervisory competencies must be reallocated** such that the power to intervene is concentrated where not only the competencies but also the incentives for resolute intervention lie. At the national level this means systematically transferring prudential competencies to the Deutsche Bundesbank and extending their scope to all systemically relevant financial institutions, banks as well as insurers. An additional option would be to set up a unified deposit insurance scheme under the umbrella of the Deutsche Bundesbank. These moves should be accompanied by devolving certain prudential competencies to the European level. The creation of a single European supervisor for systemic institutions should also be the guideline for the national reforms.

Assessment of the coalition agreement

32. The **coalition agreement** outlines a number of important measures that are in line with the proposals put forward by the GCEE. For example, the new German government advocates strengthening capital requirements as well as differentiating them according to the degree of risk and systemic relevance. Other good points in the coalition agreement include the intention to enable banks to bear a greater share of the losses that occur in a crisis themselves, to reduce the procyclical elements of both accounting standards and prudential capital requirements and to introduce suitable legal instruments for restructuring and winding up ailing financial institutions. Another welcome decision is to concentrate banking supervision in Germany at the Deutsche Bundesbank.

As many of the necessary reforms cannot be implemented within a national framework, it is reassuring to see that the new government pledges to play a pioneering role in developing and agreeing solutions at the European and international level. However, the coalition agreement fails to include a clear acknowledgement of the need to transfer some prudential powers to the supranational level. While the section on "Competition and the domestic market" (*Wettbewerb und Binnenmarkt*) includes an expression of support for the creation of a "unified EU-wide banking supervisory authority", this is contradicted elsewhere in the document by statements to the effect that national competencies are to remain undiminished and that the already agreed yet insufficient reforms of EU financial market oversight are to be implemented rapidly. The wish to retain **national responsibilities** must not be allowed to stand in the way of establishing an effective prudential supervisory system.

Though their general intentions are good and their basic thrust is right, Germany's new political leaders still have to face the acid test of implementation, for as soon as they start spelling out the details of their proposals they will have to overcome the blocking tactics of well organised vested interests. On the one hand, the financial sector will oppose regulations that will inevitably squeeze future earnings. On the other hand, national authorities will resist surrendering powers to the supranational level.

III. Education and innovation: investments in the future

33. The unwinding of the crisis-related support measures and the withdrawal of public guarantees for the financial system are a necessary but not sufficient condition for a sustained recovery from the crisis. Germany also needs to promote and undertake **structural investment in its own future** in order to halt the economy's slide to a lower growth path and boost the prospects of climbing to a higher growth path. By pursuing a policy actively geared to the goal of higher investment, Germany could simultaneously make a contribution of its own to reducing global imbalances in the form of high current account surpluses and deficits.

For this, **education policy** must be given the highest priority. The funding of education policy reforms requires the courage to redefine public spending priorities, in other words to retrench more in other areas. But the state must match interventionist zeal in reforming the public education system with cautious self-restraint when it comes to taking industry policy measures. It should thus attempt to build a forward-looking institutional framework for promoting **research and knowledge transfer** and avoid backward-looking measures that conserve outmoded structures or efforts to create "national champions".

1. Reforming the education system: need for an education offensive

34. Education policy is a promising means of moving to a higher growth, albeit one that has an impact more in the medium to long term. This involves eliminating **two existing shortcomings**. The first is that Germany's **level of educational achievement** is only middle-ranking by international standards. The second is the lack of **equal opportunities** in the German education system, since children and young adolescents from educationally challenged social backgrounds are at a disadvantage when it comes to gaining higher educational qualifications.

The GCEE therefore proposes launching an **education offensive** that would flesh out the education compact concluded between central government and the state government premiers in October 2008, which foresees raising general government expenditures on education and research to 10 per cent of GDP by 2015.

By signing this compact, the country's political leaders have made a collective education policy pledge. Praiseworthy **priorities** have been set for the central government budget. While these education policy plans are not incompatible with the need for fiscal consolidation, they do make that task harder to achieve. Hence the challenge is to identify **practical starting**

points for reforms in the education system that would be conducive to achieving the stated education policy aims, assuming expenditures are freed up for this purpose.

35. An education policy offensive should be guided by two principles. First, rather than attempting to improve each tier of the education system in isolation, the focus should be on ensuring that the available financial resources are optimally allocated across the entire education cycle. Recent studies in education economics show that the highest returns in respect of subsequent professional development result from investing in educational innovations as early as possible, starting at the pre-school and infant level.

The second principle concerns the importance of enhancing the efficiency of the institutional framework for achieving higher educational attainment. Cross-country studies demonstrate that a widely varying output quality can ensue from a given government educational input. This highlights the importance of institutional factors such as the autonomy of, and competition among, schools or a more flexible and efficient transfer from elementary school to grammar school. Even fairly inexpensive reforms of the institutional rules governing the education system could lift the level of educational achievement.

36. The two chief shortcomings of the German education system – below-par educational performance and lack of a level playing field for children from all social strata – can be mitigated first of all through better schooling for infants and young children and the introduction of a mandatory pre-school year, which would disproportionately benefit children from educationally disadvantaged homes. On top of this, all-day schools should be introduced nationwide, and the selection process which decides which children will be promoted from elementary school to grammar school should be made more flexible.

The overall level of educational performance can be additionally improved by getting schools themselves to try harder. **Competition among schools** to attract pupils – and hence public grants – along with **increased autonomy for schools**, for instance in planning their curriculum and recruiting teachers, could spur schools to better their performance.

In the **dual vocational training system** combining classroom theory and workplace practice, the present plethora of specialised vocational groups should be replaced by a smaller number of more broadly defined training professions to facilitate the necessary future adjustment to structural change. If need be, the state could consider temporarily offering extra tuition classes for trainees.

The necessary further training by employers and firms could be fostered by subsidising such on-the-job training measures. Sweden has achieved good results in this respect.

Finally, there are sound arguments for levying flat-rate student fees at German universities and for leaving the academic door open to trainees at dual vocational training colleges, including enabling them to switch to a university course.

In Germany the education system falls within the field of responsibility of the state governments (Article 70 et seq. of the Basic Law). Parliament needs to consider how far the reality of the federal structure of the education system matches the country's education policy needs.

Assessment of the coalition agreement

37. Education is rightly assigned prominent importance in the coalition agreement. This is all the more creditable as central government has only limited powers in the field of education. Many of the coalition agreement's passages on education policy are therefore in effect demands addressed to the state governments, e.g. in calling for higher teacher-children ratios in schools and kindergartens or harmonised education and performance standards throughout Germany. Yet the document is short on specifics, and falls far short of outlining a coherent overall strategy for lifelong learning.

Nonetheless, the coalition agreement contains a number of individual measures which point in the right direction. These include the idea of introducing language assessment tests for all infants at the age of four coupled with mandatory pre-school German language training where necessary. There is a general recognition of the need to expand the number of infant and elementary school teachers and to adequately train them. In addition, a start-up account for every newborn child containing an initial credit balance of 150 euro is to be set up out of public funds, with further government bonuses for future contributions. There are sensible plans to make the dual vocational training system more flexible and modular and to extend early work-related school lessons, especially for youngsters from immigrant families. In the field of tertiary education the coalition government, in tandem with the state governments, proposes to set up a national student grants programme and to strengthen the autonomy of universities.

Although the coalition agreement's chapter on education policy by no means meets the requirement of outlining a strategic vision, it does contain a number of useful individual measures.

2. Innovation and industrial policies

38. Looked at from an industrial economics perspective, recessions may be viewed as restructuring phases in which excess capacities are reduced and outdated business models are subjected to critical review, thereby laying the basis for the next upturn. The state's role in this scheme of things is to act as a strong and neutral **arbiter**, ensuring that market principles are upheld and providing a practical legal framework for restructuring the economy. However, the previous Grand Coalition government responded to the current economic crisis by **directly intervening** in the economic process, also outside the financial markets, on a huge scale. In particular, it temporarily changed the traditional basis of corporate financing by establishing a "German Economic Support Fund" (*Wirtschaftsfonds Deutschland* or *Deutschlandfonds*). But the government also provided direct support to entire industries as well as individual firms, partly by giving them preferential fiscal treatment and partly by granting them direct financial aid and guarantees.

In doing so, the state partly abandoned its role as an independent arbiter. The GCEE believes that the establishment of the **German Economic Support Fund** can nevertheless be justified by the difficulties of restoring the supply of credit to firms solely by propping up the financial market. The country's political leaders would have been better advised, however, to do more to bolster banks' capital base. Moreover, they did not use the Fund as an equal and equitable source of financial support for all comers. Instead they gave special support to the crisis-hit **automobile industry**. In the case of the carmaker Opel the state abandoned all pretence of neutrality by channelling massive resources into the attempted rescue of a single company. The competitive distortions and tax burdens that such selective rescue attempts entail cannot be justified.

39. Looking to the future, the proper role of **industrial policy** needs to be defined**.** The active crisis management which the government was obliged to perform for a time during the current crisis is certainly not a model that should be emulated going forward. An industrial policy which wrongly sought to steer the economy to a higher growth plane by supplanting the entrepreneur's role of making corporate decisions and assuming corporate risks would more likely end up stunting macroeconomic growth. Instead, policymakers should revert to their traditional, more modest role of pursuing an economic policy that is focused on defining an appropriate operational framework conducive to facilitating macroeconomic recovery and long-term growth, while leaving entrepreneurial activities and their microeconomic outcome – in the form of commercial success or failure – to the private sector. This supports the wisdom of pursuing a "horizontal" industrial policy focused on providing a solid **infrastructure** and ensuring properly functioning **competitive structures** at both national and international level.

Above all, the role of industrial policy should not be misconstrued as identifying particular companies as being strategically important and granting them direct support. The public sector certainly cannot justify such a role by claiming to be better than the private sector at **recognising** market opportunities. Furthermore, this approach inevitably entails substantial **costs** for the rest of the economy, so that such a "vertical" industrial policy would still be highly suspect even if government bureaucrats really did possess superior insights. The negative consequences of abandoning the principle of pursuing an arm's length horizontal industrial policy are graphically illustrated by the never-ending artificial conservation of the German hard coal industry and the promotion of renewable energies under the Renewable Energies Act (*Erneuerbare Energien Gesetz*). It would make better industrial policy sense to clearly reject calls to retain a permanent **subsidized mining industry** on a reduced scale (*Sockelbergbau*) in the forthcoming review of whether to stop supporting the coal industry, as permanently pouring taxpayer's money into coalmining would not be a meaningful instrument for safeguarding the national energy supply. Much the same applies to the **photovoltaic industry**, where the deliberate pushing of renewable energies under the Renewable Energies Act by guaranteeing to purchase their output for the national grid at overgenerous rates should be corrected. It is already becoming apparent that this government subsidisation will prove more of a hindrance than a help to the competitiveness of the German solar industry in the long term, even though it guarantees healthy profits to the industry at the expense of electricity consumers.

40. Instead of distorting competition by selectively supporting individual industries or technologies, the state should perform its proper role of leading the economy to a higher growth path by pursuing an appropriate **innovation policy**. This objective is gaining added importance with the growing technical sophistication of the production process, the shortening of innovation cycles and increasing global economic integration. On the one hand, governments themselves cannot create or control technological progress, but must wait and see what emerges from the melting pot of discovery and invention. On the other hand, they can effectively assist and actively stimulate the process of technological transformation. This requires doing more than safeguarding a competitive market environment, vital though that is. Above all, an innovation policy worthy of the name needs to strengthen the **infrastructure** for nurturing innovativeness by widely promoting the golden triangle of education, research and knowledge transfer, to set suitable **incentives** for releasing the creative forces of competition and to regard each promotional measure as a transparent and temporary **learning process**. While every concrete promotional measure inevitably contains a certain vertical industrial policy thrust, whenever the latter threatens to displace the original innovation policy intentions – as in the case of the state's tardiness to execute a timely exit from its start-up help for the photovoltaic industry – such a supposed government booster programme actually ends up being a drag on growth and welfare.

As the GCEE sees it, German innovation policy over the past years has broadly been **on the right track**. Spending on research and development has been stepped up, and the dedicated high-tech programme has added a new element to research promotion which might well help to reduce Germany's deficits in leading-edge technologies. Notwithstanding the budget constraints, the next step must be to **increase the financial basis** for promoting research and innovation. Other key aims should be to further **improve** promotional practice in the light of concrete experience, to retreat from sponsoring projects where this is warranted and to ensure a better overall **coordination** of the diverse promotional endeavours. The selective favouring of the photovoltaic industry by the Renewable Energies Act has clearly shown that the direct political promotion of individual technologies is a poor substitute for setting appropriate price signals – such as by imposing a general tax on carbon dioxide. It has demonstrated, too, the negative consequences of directly promoting individual technologies when the state misses the cue to terminate its support. Policymakers cannot be blamed *per se* for helping to initiate a particular technological innovation which ends up costing money without leading to the desired goal. They are to **blame**, however, if they fail to make a timely exit once a project has clearly flopped – or succeeded.

Assessment of the coalition agreement

41. The newly elected German government has essentially defined the **right path** towards boosting the nation's innovativeness. In keeping with the principles underlying an effective innovation policy which the GCEE has set out in its Annual Report 2009/2010, the coalition agreement recognises the need to strengthen Germany's innovative capabilities with a view to dynamising the country's long-term macroeconomic growth potential. It is perfectly reasonable, too, for the public sector not to leave the task of developing new technologies and opening up new markets entirely to the private sector but to play a role of its own by seeking to strengthen the **innovation infrastructure** through promoting education and research. Two corresponding proposals contained in the coalition agreement are particularly welcome, namely the announced adoption of an Act Guaranteeing the Freedom of Scientific Research (*Wissenschaftsfreiheitssgesetz*) granting greater autonomy to universities and scientific research institutions and the proposed introduction of **tax incentives** for companies that undertake research and development. The actual impact of these institutional changes will depend very much, however, on their precise framing. The government is also right to continue several key innovation projects launched during the past few years, such as the excellence initiative and the high-tech strategy. But here, too, it is the concrete implementation and especially the actual level of funding of the projects that will ultimately determine whether and to what extent the government's innovation policy manages to propel the economy forward to a higher growth path.

Viewed in the aggregate, however, the competition and industry policy plans outlined in the coalition agreement must be viewed with **some scepticism**. Thus while it is correct to see the crisis management measures through to the end of the economic crisis and so maintain the German Economic Support Fund until the end of 2010, it would be wrong to keep it afloat beyond then. One can only hope that the vague reference in the coalition agreement to developing an **exit strategy** from the extraordinary government measures taken to tackle the crisis quickly acquires concrete shape. Similarly, the planned changes to competition and insolvency legislation will have to be judged on their specific content, though at least their basic thrust – supplementing competition law by an effective instrument to downsize corporate giants and improving the chances of corporate restructuring under insolvency law – is headed in the right direction. By contrast, the announced ring-fencing of the pharmaceutical market from competition represents a big step backwards. It makes a mockery of the claimed aim to improve national economic welfare by ensuring free and fair competition.

3. Improving Germany's attractiveness as an investment location

42. Investment is one of the key drivers of higher economic growth. It comprises expenditure on both human and real capital. Germany has a great deal of ground to make up in this respect as its **investment ratio** has been lagging way behind that of other countries for quite some time now. To put this right, measures must be taken to boost domestic investment, which in turn means improving the **attractiveness of doing business in Germany**. In the field of economic policy this requires reforming **the corporate tax code** and **labour market regulations**, while **wage bargainers** need to prioritise the need to preserve existing jobs and create new ones.

43. The lessons of the financial and economic crisis include the need to strengthen the capital base of banks and firms alike. A **withholding tax on investment income** was introduced in 2009 following the reform of the corporate tax regime but is not fully compatible with the latter. This has led to the unequal tax treatment of equity-financed investment compared with debt-financed investment. The GCEE has repeatedly drawn attention to this anomaly (Annual Report 2008, paragraphs 378 ff.). As righting this wrong by bringing the corporate tax regime into line with the withholding tax on investment income would rip a sizeable whole in tax revenue, the new government must keep this tax distortion in mind but put it on the back-burner for the time being. By contrast, a few minor tweaks – such as easing the tax-offsetting facilities for borrowing costs and loss carryforwards – would suffice to remove obstacles to investment created by the last reform of corporate taxation. In the field of **income tax** the GCEE sees a need for policy action in the longer term but no pressing necessity for general cuts in income tax rates in the coming years. The fiscal stimulus packages and the raft of tax breaks contained in the Act Reducing Citizens' Tax Burden (*Bürgerentlastungsgesetz*) have already afforded massive and permanent tax relief to tax payers.

By loosening the institutional framework governing the labour market, parliament could pave the way to an **employment-oriented wage policy** and in this way improve Germany's attractiveness to investors. This notably entails changes in collective bargaining legislation and employment protection rules. Minimum wages, especially sector-specific ones, are counterproductive and must be rejected. **Wage negotiators** must continue to do their bit towards creating new competitive jobs as well as safeguarding existing jobs. They have made impressive progress in recent years towards making collective labour agreements more flexible, thereby confirming the GCEE's oft expressed view that wage settlements must take full account of each industry's peculiarities and that labour agreements must contain effective plant-level **opt-out clauses** for struggling firms. If and when the economy, as expected, picks up slightly, wage negotiators should tailor their settlements more to each industry's **relative profitability** and not seek to fully exhaust the income-sharing options so as to enhance the attractiveness of investing in Germany businesses. These, too, are points which the GCEE has been attempting to hammer home for some years (see, for example, Annual report 2008, paragraphs 557 ff.).

Assessment of the coalition agreement

44. The **corrections to the corporate tax reform** contained in the coalition agreement are a step in the right direction. The more generous tax-offsetting rules for borrowing costs and loss carryforwards are both to be welcomed. Another positive sign is the government's intention to set up a committee to review local government finances and reform local business tax, even though the past history of such "reform committees" gives little cause for optimism.

Less positive are the planned changes to **inheritance tax**, especially the mooted regionalisation of tax rates and tax-free amounts. It would be better to reform inheritance tax by granting equal treatment to all asset classes both in terms of valuation and tax rates. This could be counterbalanced by sharply lowering the tax rates in the tax brackets I to III.

45. The coalition agreement says too little about loosening the **institutional framework** governing the labour market. It largely dodges the issues of reforming collective bargaining legislation and job protection rights. It confirms the importance of wage bargaining autonomy and signals a greater role for the national mediation committee (*Tarifausschuss*). While the coalition agreement rejects the notion of a national minimum wage, it fails to expressly reject the equally dangerous idea of industry-wide minimum wage levels. But it will at least review the legislation on minimum working conditions by 2011 and implement judges' rulings on outlawing unfair wage levels. A very tentative easing of hiring and firing conditions is proposed in connection with extending short-term employment contracts.

All in all, the coalition agreement does not go far enough towards making the labour market more flexible – yet another instance of a missed opportunity.

Appendix

I. Tables: Forecasts for 2010

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 2009 estimates, 2010 forecasts

Changes from previous year in %

	2007	2008	2009	2010
Use of domestic product				
Price-adjusted (at previous year's prices)				
Consumption expenditure, in all	0.1	0.8	1.1	0.4
Private consumer spending[1]	– 0.3	0.4	0.8	– 0.1
General government consumer spending	1.7	2.1	2.2	1.8
Gross fixed capital formation	5.0	3.1	– 8.8	1.4
Machinery and equipment	11.0	3.3	– 20.9	1.5
Constructions	0.0	2.6	– 0.4	1.2
Other products	6.5	5.3	4.2	2.5
Stockbuilding[2)3)]	0.0	0.4	– 0.9	0.1
Total domestic demand	1.0	1.7	– 1.8	0.7
Net exports[2]	1.5	– 0.3	– 3.3	0.9
Exports of goods and services	7.5	2.9	– 14.7	6.3
Imports of goods and services	4.8	4.3	– 9.0	4.5
Gross domestic product	**2.5**	**1.3**	**– 5.0**	**1.6**
Use of domestic product				
at current prices				
Consumption expenditure, in all	1.6	2.8	1.4	1.1
Private consumer spending[1]	1.4	2.5	0.5	0.6
General government consumer spending	2.2	3.7	4.2	2.8
Gross fixed capital formation	7.7	4.2	– 9.3	0.6
Machinery and equipment	10.2	2.7	– 22.0	0.6
Constructions	6.3	5.8	0.5	1.0
Other products	3.4	1.6	– 3.9	– 3.4
Total domestic demand	2.9	3.7	– 1.9	1.3
Net exports	.	.	.	.
Exports of goods and services	8.0	3.5	– 17.0	6.5
Imports of goods and services	4.9	5.8	– 14.1	3.4
Gross domestic product	**4.4**	**2.8**	**– 4.0**	**2.7**
Deflator				
Consumption expenditure, in all	1.4	2.0	0.2	0.8
Private consumer spending[1]	1.8	2.1	– 0.3	0.7
General government consumer spending	0.5	1.6	2.0	1.0
Gross domestic product	1.9	1.5	1.0	1.1
Total domestic demand	1.9	1.9	– 0.1	0.6
Origin of national product				
Employment (domestic)	1.7	1.4	– 0.0	– 1.5
Total number of man-hours worked	1.8	1.3	– 3.0	– 0.0
Productivity (hourly basis)	0.7	– 0.0	– 2.0	1.6
Distribution of national income				
National income (factor costs)	3.5	2.5	– 5.0	2.4
Compensation of employees	2.8	3.7	– 0.2	0.3
of which: net compensation of employees[4]	3.0	3.2	– 0.4	2.2
Property and entrepreneurial income	4.8	0.2	– 14.0	7.0
Disposable income of private households[1]	1.6	2.7	0.4	0.8
Ratio of saving of private households[1)5)]	10.8	11.2	11.2	11.4
Memo:				
Unit labour costs[6] (Domestic concept)	0.2	2.2	4.9	– 1.2
Consumer prices (Consumer Price Index 2005 = 100)	2.3	2.6	0.3	1.2

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 2009 estimates, 2010 forecasts

	2008	2009	2010	2009	2010
	Euro billion[2)]			Changes from previous year in %	
Revenue	**1 091.8**	**1 066.3**	**1 044.6**	**– 2.3**	**– 2.0**
of which:					
Taxes	592.6	565.1	547.0	– 4.6	– 3.2
Social security contributions	408.1	411.5	410.0	+ 0.8	– 0.4
Expenditure	**1 090.8**	**1 138.4**	**1 169.5**	**+ 4.4**	**+ 2.7**
of which:					
Intermediate consumption	106.6	113.0	117.3	+ 6.0	+ 3.8
Compensation of employees	172.1	177.0	180.1	+ 2.8	+ 1.7
Income from property (pay out)	67.1	64.3	67.6	– 4.1	+ 5.1
Transfers (pay out)	675.7	713.3	730.0	+ 5.6	+ 2.4
Gross capital formation	37.4	40.1	47.8	+ 7.1	+ 19.1
Others	31.9	30.7	26.8	X	X
Net lending	**1.0**	**– 72.1**	**– 124.9**	**X**	**X**
Memo:					
Expenditure ratio[3)]	*43.7*	*47.5*	*47.6*	X	X
Tax ratio[3)]	*24.2*	*24.0*	*22.7*	X	X
"Abgaben" - ratio[3)]	*39.6*	*40.2*	*38.1*	X	X
Financial balances ratio[4)]	*0.0*	*– 3.0*	*– 5.1*	X	X
Debt ratio[5)]	*65.9*	*71.8*	*75.3*	X	X

1) General Government and Social Security Funds according to definitions of the National Accounts. General Government: Federal government, Länder, local authorities including ERP-Special Fund, Care of children development, *Vermögensentschädigungsfonds* and parts of "Federal Railway Trust", "German Unity Fund", "Redemption Fund for Inherited Liabilities".– 2) Deviations ar due to rounding.– 3) Expenditures/taxes and 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) In relation to the GDP in nominal prices.– 5) Debt (as defined under the Treaty of Maastricht)/Government expenditure in relation to the GDP in nominal prices.

Table C

Forecasts for the Labour Market for Germany[1)]

For 2009 estimates, 2010 forecasts

	2008	2009[2)]	2010[2)]
	Thousand persons		
Occupied population[3)]	43 361	43 445	43 391
Unemployed persons[4)]	3 141	3 250	3 785
Balance of migrant labour[5)]	59	77	45
Employment (domestic)	40 279	40 273	39 651
Registered unemployment[6)7)]	3 268	3 432	3 965
of which:			
Former territory of the Federal Republic	2 145	2 317	2 804
New Länder	1 123	1 115	1 161
Memo:			
Employees subject to social insurance[6)]	27 510	27 492	26 925
	Rates (%)		
Unemployment rate[6)8)]	*7.8*	*8.2*	*9.4*
ILO-Jobless rate[9)]	*7.2*	*7.5*	*8.7*

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 2008: Federal Labour Agency (Bundesagentur für Arbeit, Nürnberg).– 7) By the new adjustment of the labour market policy measures to 1.1.2009 the results are not comparable with previous years.– 8) Definitions of the Federal Labour Agency (Bundesagentur für Arbeit).– 9) 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.