ECONOMIC POLICY: TIME FOR REFORMS

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I. LACKING AMBITIONS TO REFORM

1. Last year, the economic **expansion** in Germany and the euro area continued. A key pillar of this upswing is the unusually expansionary monetary policy of the European Central Bank (ECB). Yet, the recovery from the crisis in the euro area is still **not self-sustaining**. In fact, considerable **structural problems** persist in Europe. The member states of the European Monetary Union (EMU) do not undertake the necessary reform efforts. Fiscal consolidation has more or less ground to a halt in the euro area.

2. In some member states, the **extremely expansionary monetary policy** conceals the problems of weak potential growth and insufficient debt sustainability, which were among the root causes of the crisis. This monetary policy reduces the incentive to carry out further reforms and the willingness to consolidate fiscal budgets. At the same time, the monetary stance is notably more expansionary than the macroeconomic situation warrants. ↘ ITEMS 407 FF., 417 A prolonged period of low interest rates creates new problems. For example, monetary policy is increasingly threatening the stability of the European banking system. ↘ ITEMS 418 FF. Moreover, phasing out the very loose monetary policy will be more difficult the longer it continues.

3. If governments and central banks kick the can down the road, this harbours risks for the process of European integration. The crisis has already stirred up clear scepticism of the European Union (EU) among its citizens. The result of the "**Brexit**" referendum in the UK and the rising **popularity of eurosceptic political parties** signal the advancing retreat from Europe by voters. ↘ ITEMS 290 FF. This hinders a policy that prioritises fiscal consolidation and structural reforms even more. And this in turn weakens confidence in the long-term economic strength of the EU and so nourishes a sense of uncertainty about the economic outlook.

   During the euro area crisis, the Federal Government pursued an overall appropriate policy and thereby significantly contributed to strengthening its architecture (GCEE Special Report 2015 items 65 ff.). But it has neglected to press member states more strongly to strengthen the stability of the common economic and currency area through their **own efforts**. At the same time, the Federal Government does not lead by example through economic policies focused on strengthening potential growth.

4. The reform track record of the current government is disappointing. From the point of view of the German Council of Economic Experts (GCEE), the economically successful period – which was partly a result of past reforms – was **not used sufficiently** to prepare the German economy for future challenges. In view of decreasing innovation and disruptive technological changes, the Federal Government should have aimed much more at strengthening market forces and promoting structural change through suitable reforms.

5. These aims should feature high on the agenda of the next Federal Government as the long-term economic challenges have not become any smaller. **Demo-**

graphic change in Germany is having an increasingly dampening effect on innovation and is threatening the stability of the social security systems. The transformation in China ↘ ITEMS 919 FF. and the digitisation represent **changes** Germany needs to adjust to as an open, technologically oriented economy. Given these challenges, it remains necessary to reduce the public debt ratio and thus create **fiscal space**.

In addition, **European integration** cannot be succeed if it fails to visibly boost growth in the member states. The largest economy, Germany, should **set an example** here. Only if Germany sustainably and convincingly exploits growth potential is it credible that economic prosperity can be achieved across the EU without a transfer union.

6. In addition, we are on the cusp of considerable **global changes**, from which Europe and in particular Germany cannot isolate itself. Climate change is a global phenomenon that can only be countered through a reduction of global greenhouse gas emissions. A national energy transition alone is not enough. ↘ ITEMS 904 FF. Another example is the refugee influx in the past year. It has shown how conflicts or poverty in other parts of the world can have a direct impact on Europe and Germany. ↘ ITEMS 682 FF.

All conceivable solutions to these challenges at global level will require **substantial financial contributions** from developed economies. Solutions that are economically efficient are more promising to tackle these challenges. Furthermore, for Germany to contribute to meeting these challenges, the German economy needs to remain strong.

7. Germany currently enjoys the **tailwind** of “Agenda 2010” labour market reforms which allowed more market forces. ↘ ITEMS 710 FF. Together with a period of wage restraint and a functioning system of needs-based income supplementation, the reforms contributed to stable disposable incomes and supported private consumption. In addition, Germany currently enjoys a demographic respite as the majority of the baby-boom generation are still working; a larger decrease in the labour force is not to be expected until the next few years. ↘ ITEMS 592 FF.

8. In Germany, as in other EU member states, **an increased sense of uncertainty** prevails, as repeated financial market turbulence suggests. In Germany, the sense of uncertainty is additionally fuelled by the refugee influx, a perceived threat to internal security and the impression of increasing inequality. ↘ ITEMS 788 FF. Against this backdrop, the government did not show more action to secure future viability. On the opposite, the current government pursued measures which benefit individual voter groups (such as the mothers' pension and pensions from the age of 63 for long-term contributors) or which weaken market forces and may have negative side effects (such as the minimum wage).

9. This policy failed to alleviate uncertainty and dispel the dissatisfaction among those who see themselves as the losers of globalisation and digitisation. In the GCEE’s view, the right answers to the challenges of structural change remain to increase **productivity** and **adaptability** (GCEE Annual Report 2015 items 590 ff.). Only improved competitiveness can lay the groundwork for more in-

↘ BOX 1

Key elements of reforms for Europe and Germany

The GCEE has outlined **structural reforms** intended to enable Germany and Europe to meet the challenges of the future:

Reforms for Europe

– **More systemic competition among member states of the EU.** In order to bring Europe closer to its citizens again, institutional reform should reinforce the principle of subsidiarity. More integration is desirable in areas such as climate policy, asylum policy and internal security. Fiscal policy and labour market and social policy should remain national responsibilities. Delayed integration of EU migrants into the social systems is appropriate.

– **Promotion of free trade**. It is in Europe's interests to create a reliable regulatory framework for the international division of labour in the global economy. Therefore, the trade agreements like CETA with Canada and TTIP with the USA should be concluded. Likewise, a free trade and investment agreement with China should be pursued.

– **New direction for climate policy**. The EU Emissions Trading System (EU-ETS) should be expanded to all sectors to make climate protection as efficient as possible. National support schemes such as the Renewable Energy Act (*Erneuerbare-Energien-Gesetz* – EEG) should be abolished or at least made technology and sector neutral. Instead, support should be increased to research and development.

– **Stability in the euro area**. Greater credibility of the bank resolution framework and separation of joint banking supervision from the ECB could strengthen the banking union. The Federal Government should support an increase in the leverage ratio, particularly for systemically important institutions. The European Stability Mechanism (ESM) should be strengthened by rules for orderly sovereign debt restructuring in the event of a crisis.

Reforms for Germany

– **Priority for growth-friendly consolidation**. Stimulating additional public spending is not appropriate given the favourable economic situation. Temporary fiscal leeway should not be used for new structural expenditures. Public investment projects must pass a cost benefit analysis. Additional investment should be funded by reducing other, consumptive spending.

– **Efficiency-oriented tax policy.** Tax incentives must be strengthened in order to make investment and value creation in Germany more attractive. A corporate and income tax should be reformed towards a dual income tax which introduces an allowance for corporate equity. Further fiscal space can be used for a complete correction of bracket creep. A complete reform of the fiscal equalisation scheme governing the financial relationships between the Federal Government and the states is needed to reduce excessive inter-state redistribution and strengthen tax autonomy.

– **Sustainable social security systems**. In order to ensure the long-term sustainability of the statutory pension scheme, it is inevitable that the retirement age be coupled to longer life expectancy. Moreover, occupational and private pension provision should be made more attractive. A flat-rate per capita health insurance premium (*Bürgerpauschale*) including a mechanism for social compensation should be introduced

– **Flexible labour market and improved equality of opportunity**. In order to counter entrenched long-term unemployment, there should be no further restrictions to flexibility in the labour market, particularly in the low-wage sector. The constant expansion of labour market regulation is a step in the wrong direction. Equality of opportunity should be more of a priority, in education in particular, for example through improvements to early childhood education.

– **Deregulation of the service sector**. Free market access to the service markets, particularly to professional services and crafts (*Handwerk*), may strengthen competition as a discovery process and driver of prosperity. The rent ceiling should be abolished.

vestment, higher employment and stronger wage growth. This report summarises the GCEE's positions on current economic policy debates and outlines **reforms for the coming years**. ↘ BOX 1

II. CONTINUED UPSWING WITH RISKS

10. For the past few years, the **world economy** has been growing moderately. However, in a long-term comparison, current growth is not significantly below average. The current period should therefore be seen as normalisation compared to the unusually high growth rates and exaggerations prior to the financial crisis. Two key features of the current development are **weak growth in labour productivity** and decreased growth in global trade. ↘ ITEMS 120 F.

11. **Monetary policy** is an important driving force behind the current economic performance. ↘ ITEMS 122 F. Policy rates in advanced countries remain unusually low. In addition, extensive quantitative easing took place particularly in Japan and the euro area. In the UK, the Bank of England reacted to the Brexit vote with new expansionary measures. In the US, the rate hikes have been delayed.

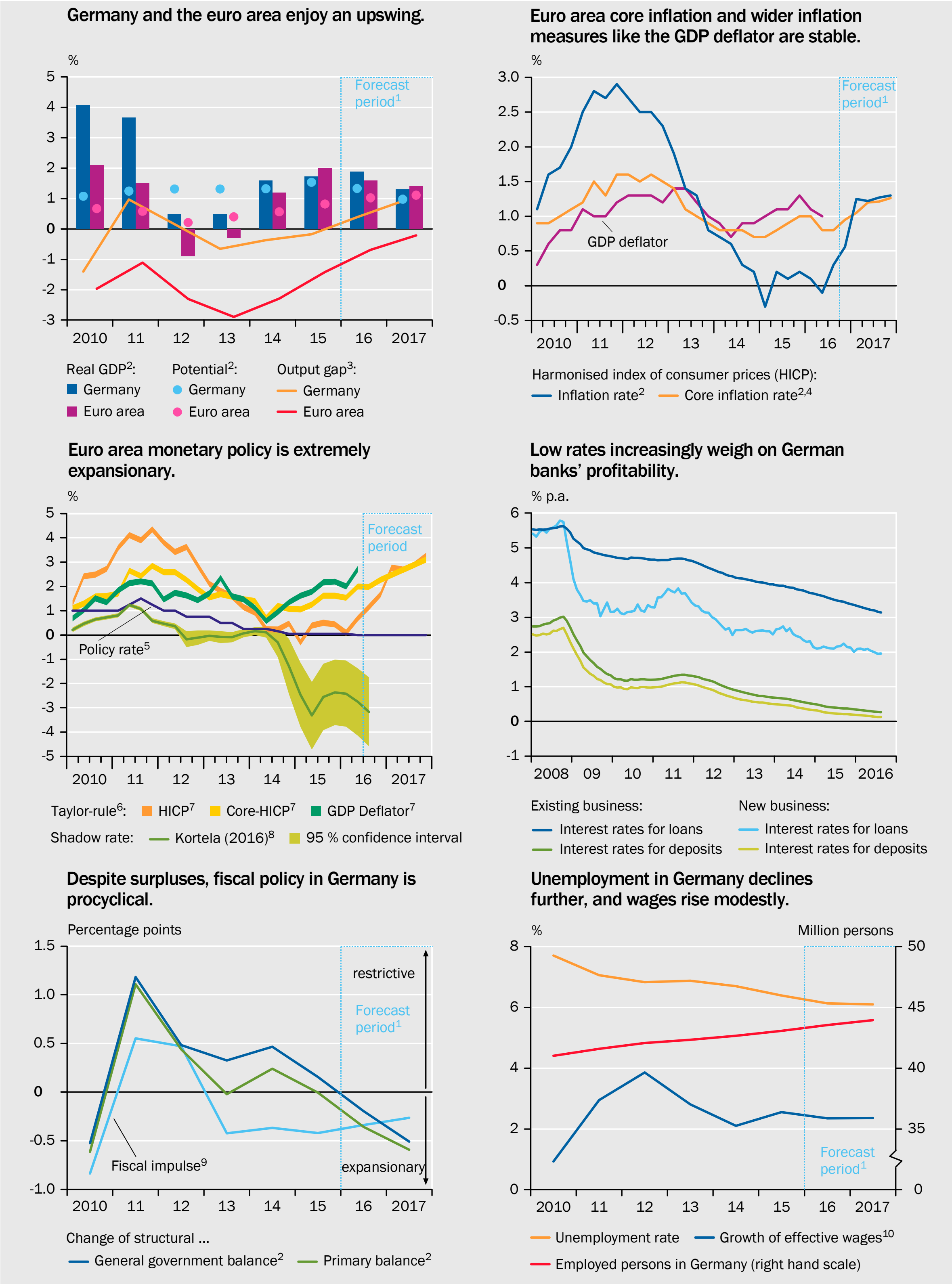
12. The extent of monetary stimulus raises **doubts as to the sustainability of growth** of the world economy. It also indicates a misallocation of tasks; permanently higher growth rates cannot be generated through expansionary monetary policy. The role of monetary policy is to stabilise prices and economic activity. Its expansionary effects on economic output are only temporary. Moreover, the current environment, in which all major central banks are pursuing ultra-loose monetary policy, sets **wrong incentives to maintain the expansionary monetary policy for too long.** The first central bank to exit this policy risks, among other, a stark exchange rate appreciation. This situation can be compared to a prisoner's dilemma, with a coordinated exit the best solution. However, each central bank separately has the incentive to remain expansionary.

13. Economic recovery continues in the **euro area**. ↘ CHART 1 GDP growth is above potential growth and the output gap is decreasing. Furthermore, unemployment has fallen in many member states. However, it is a problem that fiscal consolidation has ceased in some euro area countries despite high public debt levels, and little focus is placed on market-oriented reforms. ↘ ITEMS 172 FF., 189 F. This means that member states do not use the breathing space afforded by monetary policy to reduce debt. Structural adjustments are progressing only slowly in many member states. ↘ ITEMS 177 FF. Furthermore, non-performing loans weigh on balance sheets of some banks, which are suffering anyway in the low interest rate environment. ↘ ITEMS 506 FF., 514 FF.

14. The GCEE expects euro area **GDP growth** of 1.6 % and 1.4 % respectively for 2016 and 2017. ↘ ITEM 193 The enduring oil price decline until the beginning of 2016 contributed to low **inflation** as measured by the Harmonised Index of Consumer Prices (HICP). This effect is expected to come to an end in 2017.

↘ CHART 1

Overall economic development and challenges



1 – Forecast of the German Council of Economic Experts. 2 – Annual change. 3 – Relative deviation of GDP from its potential. 4 – Overall index without food and energy. 5 – Interest rate for main refinancing operations. 6 – Equation: $i = 2 + \pi + 0{,}5(\pi - \pi^*) + 0{,}5(y)$. i is the estimated money market interest rate, which depends on the real interest rate in the long-run equilibrium (estimated to be 2 %), the difference of the current inflation rate, π, the target of the central bank, π^*, and the output gap, y. 7 – Based on data of the ECB real time database and AMECO: For inflation the value of the current quarter is used and for the output gap the value of the previous quarter. 8 – Updated estimations of Kortela (2016). 9 – Corresponds to the sum of discretionary measures relative to nominal GDP. List of discretionary measures based on the annual autumn report of the Joint Economic Forecast. 10 – Gross wages and salaries (national concept) per hour worked.

Sources: Deutsche Bundesbank, European Commission, Eurostat, ECB, IMF, Federal Statistical Office, own calculations

Overall, the GCEE forecasts inflation of 0.2 % and 1.3 % respectively, and core inflation of 0.9 % and 1.2 % respectively for 2016 and 2017. ↘ ITEM 193

15. The global economic outlook is exposed to **risks**. ↘ ITEMS 126 FF. In addition to ongoing geopolitical risks, risks include a crisis-scale increase in political uncertainty in Europe, an unexpectedly stronger economic slowdown in China and possible turbulence on international financial markets. Exit negotiations with the UK following the **Brexit vote** are an addition challenge for the EU, which is already facing increasing centrifugal forces. The situation in Italy and smaller crisis-hit member states such as Greece and Portugal is also a concern.

16. The upturn in **Germany** continues. ↘ CHART 1 The GCEE expects real GDP in Germany to grow by 1.9 % in 2016 and 1.3 % in 2017, with the decline for next year largely attributable to a negative calendar effect. ↘ ITEM 225 GDP is set to exceed potential output as estimated by the GCEE. Several indicators such as capacity utilisation in the manufacturing sector and the very healthy labour market point to a slight overutilisation of production capacity. ↘ ITEM 194

17. The upswing was fuelled, among other things, by **final consumption expenditure** of private households and the state, and by housing construction. **Corporate investment**, on the other hand, expanded modestly. ↘ ITEMS 247 FF. The **labour market** remains in good shape. The number of people in employment will rise to over 44 million in 2017. **Fiscal policy** adds stimulus, despite the high budget surplus. ↘ ITEM 228 ↘ CHART 1 In a long-term comparison, exports are likely to expand only moderately given modest growth of the global economy.

18. Germany’s economic upturn is also attributable to the ECB's expansionary monetary policy. Its unconventional monetary policy measures have helped considerably to improve external competitveness of the German export industry. This is evident from the high **price competitiveness**, particularly compared to countries from outside the euro area. The low value of the euro contributes in major ways to export growth in 2016 and 2017. This in turn stimulates corporate investment. However, there is a risk that the German export industry will rely on this temporary boost of their price competitiveness and omit to prepare for a future normalisation.

III. REFORMS FOR EUROPE

19. The signatory countries to the Treaty of Rome, which laid the foundation stone for today's EU almost 60 years ago, agreed to “ensure the economic and social progress of their States by common action to eliminate the barriers which divide Europe” (Treaty establishing the European Economic Community). This included abolishing obstacles to the free movement of persons (Article 3, Treaty on European Union). And yet it is precisely migration – particularly within the EU –

which is the focus of **anti-European sentiment** taking increasing hold in some EU countries.

20. European integration has been a key factor in the **peace and prosperity** enjoyed in recent decades. The EU's common internal market was a major building block in this process. The EU's stable institutional framework has also enabled it to include more and more members in the single market, and thereby promote growth. In particular, the eastern enlargement after the fall of the iron curtain helped a stable transformation in the accessing countries. Coming March, the European Commission is planning to reveal its **vision for the future of the EU** in a white paper. The European project should be successfully continued.

21. However, it is meanwhile proving difficult to make the **economic benefits of the single market** clear to voters. The welfare gains of the free movement of persons, for example, have been confirmed in many studies. ↘ ITEMS 341 FF. Nonetheless, the “Leave” campaign in the UK's Brexit referendum succeeded in winning over voters with what were, in some cases, false claims, particularly regarding migration. **Better provision of information** based on scientific evidence can only offer limited help during this era of moderate growth. It is more important, that the EU – through the implementation of growth-friendly reforms – succeeds in achieving widely recognisable gains of prosperity.

1. European Union: Unity in diversity

22. On 23 June 2016, 52 % of voters voted in a referendum for the United Kingdom to **leave the EU**. However, the British government has thus far only announced its intention to begin the formal procedure in early 2017. The UK's exit from the EU would be **a great loss**, not only economically, but also politically. The EU would be losing a market-friendly voice, and the balance of power within the union would shift. ↘ ITEMS 315 FF. The best possible outcome of the impending negotiations would therefore be that “Brexit” could be averted.

23. However, even taking into account the long held and widespread scepticism in the UK about the EU, the outcome of this referendum should not be dismissed as an isolated case. Eurosceptic political parties are gaining ground in many member states. The impending exit negotiations should therefore bear in mind the **possibility of copycats**, and not allow any “cherry picking”, in order to prevent the risk of growing political instability in the EU.

24. Given the increasing centrifugal forces within the EU, it is by no means clear whether further development towards **more or less European integration** is the right answer to regain support for the integration process. The GCEE believes that the principle of subsidiarity needs to be reinforced within the EU. This would mean granting more national responsibility in some areas and more shared responsibility in others.

Reinforcing subsidiarity for more systemic competition

25. The **principle of subsidiarity**, as laid down in Article 5 of the Treaty on European Union, should be the guiding principle for key policy decisions. According to the principle, the EU only intervenes in policy areas in which it does not have exclusive competence when the policy objectives cannot be sufficiently achieved at member state level while they can be better achieved at EU level. However, it appears that the European Commission is increasing its area of responsibility, which neither the European Court of Justice nor other mechanisms have been able to counter effectively. ↘ ITEM 338

26. The GCEE favors reinforcing the principle of subsidiarity, and by so doing, enabling more **systemic competition** among member states in areas of national responsibility. The aim laid out in the European treaties of "creating an ever closer union among the peoples of Europe" should not be interpreted as granting the EU more competence in case of doubt. **Appropriate structures** could safeguard the principle of subsidiarity effectively in enacting and executing European law. A long-discussed proposal to this end is to establish a **subsidiarity court.** ↘ ITEM 340

Reallocating national and EU responsibilities

27. The central aim of the EU remains to secure a functioning internal market, which is key to effective competition. This is why the EU has **comprehensive internal market competence**. However, it should not derive from that any general powers to harmonise and unify entire areas of legislation which may impede competition between member states or regions.

28. Restrictions to the **four fundamental freedoms** – the free movement of goods, services, capital and persons – are extremely problematic. A permanent restriction on migration of EU citizens within the EU would not be compatible with a functioning internal market. Free movement of persons is essential for a common European labour market as it enables the efficient use of resources. Labour migration also forms an important balancing mechanism for euro area member states in the event of asymmetric economic shocks. Restricted labour migration would either demand more price and wage flexibility from member states, or require them to agree on large scale bilateral transfers. ↘ ITEM 341 FF.

The principle of free movement of persons is, however, compatible with **delayed integration into social security systems**, i.e. a gradual transition of EU migrants' claims to social security from the country of origin to the country of residence. The principle of free movement of persons concerns the migration in labour markets, not in social systems. This "tiered solidarity" could be governed in such a way that EU migrants do not have access to social benefits until they have spent a certain amount of time in the country of residence. They would remain entitled to benefits in their country of origin until they became fully integrated in their host country (SVR Migration, 2013).

29. There are still deficits in the realisation of the internal market as regards **movement of services** in particular. In Germany and other member states, these include barriers to market entry that hinder competition, such as compulsory membership of professional chambers or the necessity of obtaining a master craftsman diploma (*Meisterbrief*) in order to engage in that professional activity (GCEE Annual Report 2015 item 628). Binding fee schedules for many professional service providers in Germany also limit competition from other EU countries.

30. The EU's **foreign trade policy** is clearly a shared responsibility. Exports and the international division of labour linked with open global markets are of great importance to Germany as a business location. This means that significant positive welfare effects can be expected from free trade at least in the long run (GCEE Annual Report 2015 items 72ff.). Protectionist trends should be staved off, and the free trade agreements currently under discussion should be pursued as part of a growth-enhancing regulatory framework in a global economy. This applies in particular to the Comprehensive Economic and Trade Agreement (CETA) with Canada and the Transatlantic Trade and Investment Partnership (TTIP) with the USA. Negotiations with China should also be furthered for an investment agreement and initiated for a free trade agreement. ↘ ITEM 994

Removing non-tariff barriers to trade, for example via TTIP, will likely result in **stronger foreign trade** and fewer welfare-reducing distortions. In case of differing approaches to product norms, TTIP does not rule out bans when it comes to justified, serious concerns regarding consumer protection. Appropriate labelling can help in less serious cases. It would be amiss to conclude that US standards and rules in general are weaker than German ones and thus undermine German consumer protection. In fact, an agreement would enable exemplary standards and rules to be set that will likely have spillover effects to other trading partners.

31. As regards **internal security**, a common approach is advisable for areas in which inefficient parallel structures could be avoided. However, it is difficult to measure the costs and benefits in this policy area. In contrast to the European Commission's proposed global strategy for an EU security agency, the focus should be on reinforcing existing structures such as Frontex and Europol. Given the terrorist threat, the presumably higher long-term layouts for internal security can and must be met within the common fiscal rules of the Stability and Growth Pact and must not serve as an excuse for exceptions to the rules.

32. **Asylum and migration policy** is another policy area that requires shared action to achieve its objectives. Last year's high refugee migration showed that national-level decisions can have serious consequences for other member states, which is why common action is advisable. The free movement of persons within the EU and movement without border controls within the Schengen Area mean that effective protection of external borders is also a matter of shared responsibility. This requires the right balance to be struck between the jointly organised prevention of unwanted migration and joint aid for development in the migrants' countries of origin.

A global approach to climate policy

33. Given the global effect of greenhouse gases, a **global approach** to climate policy is needed. ↘ ITEM 904 FF. An efficient climate policy would ideally be based on a global emission certificate trading system that covers all countries and sectors. A global emissions tax may be an alternative, but is subject to major problems in terms of practical implementation. Particularly in light of the Paris Agreement on climate change and Germany's G20 chair in 2017, Germany should proactively shape a discussion aimed at global solutions. Until an effective global alliance can be formed against climate change, an at least EU-wide approach is preferable to isolated national efforts.

34. National approaches to climate policy which eschew the **advantages of the international division of labour** and attempt to reduce greenhouse gas emissions through restrictions, ecotaxes and subvention mechanisms at national level are neither efficient nor prudent in terms of climate policy. This is clear from the German energy transition, which so far has delivered sobering results. Firstly, it has not yet reached the emission reduction targets it set, and secondly, technology- and sector-specific subsidies under the Renewable Energies Act (*Erneuerbare-Energien-Gesetz* – EEG) has made reducing greenhouse gas emissions unnecessarily expensive. ↘ ITEM 906

35. It would therefore be far better to systematically expand **EU-wide emissions trading** to all sectors. A decision for a joint implementation mechanism would not pre-empt the distribution of burdens resulting from European emission reduction obligations. National economies whose voters want a stronger commitment to climate protection than the voters of other member states could accept a lower initial allocation of emission certificates.

A one-off intervention to reduce the number of excess emission certificates or the introduction of a price corridor for certificate auctions could stabilise the price signal from emissions trading, thereby reducing uncertainty for investors (GCEE Annual Report 2015 item 701).

36. The **tenders** introduced under the EEG 2017 are a step in the right direction, even though only some of them will be technology-neutral. However, a comprehensive certificate trading system would render national subsidy schemes and many areas of subsidies for new capacity of renewable energies unnecessary. Instead, support could be provided for investment in infrastructure and climate-related research and development.

Fiscal policy at national and EU level

37. It is vital that **responsibilities for fiscal policy remain at national level** in order to ensure functional competition between member states in attracting companies and investments. This is explicitly laid out in the EU Treaties. Agreements on fiscal policy at European level can only be made with the unanimous approval of the member states. The European Commission submits proposals and otherwise assumes a coordination function. In the case of indirect

taxes, for example, there is a harmonisation of sales taxation with minimum tax rates. On the subject of direct taxes, the member states agreed on rules for fair tax competition (Code of Conduct) without prohibiting it (GCEE Annual Report 2014 items 654ff.). The member states also make resolutions on the procedure for excessive deficits in the Economic and Financial Affairs Council (Ecofin), ultimately retaining national budgetary autonomy.

If the member states are not politically willing to accept a comprehensive transfer of national sovereignty over economic and fiscal policy, there is no basis for a fiscal capacity at European level. As this would violate the principle of **unity of liability and control**, the GCEE currently rejects a shift of revenues and spending to European level (GCEE Special Report 2015 item 110).

38. The **EU budget** should be **restructured**. The focus on agricultural, structural and cohesion policy is outdated. While the comprehensive system of farming subsidies causes immense economic inefficiencies, the effectiveness of the structural and cohesion policy has become questionable. A stronger link between the allocations from the structural funds and the European Commission's country-specific recommendations is desirable. ↘ ITEM 355 More importantly, there are new challenges requiring appropriate funding, although this does not necessitate a dedicated EU tax. Rather, the EU budget allocation should be made more flexible than it has been to date based on seven-year budget periods.

2. Euro area: policies for greater stability

39. Nineteen member states joined forces within the EU to create a monetary union. As this eliminated national monetary policy and exchange rates as an adjustment mechanism between the EMU member states, it is important to ensure that the necessary **adjustments take place via other mechanisms**. The sluggish recovery in the euro area in the aftermath of the crisis suggests that these stabilising mechanisms are too weak. This suggests that, in addition to the consolidation of public finances, further structural reforms are needed to make wage and price formation more flexible and improve labour mobility. ↘ ITEM 428

Good reasons for a less expansionary monetary policy

40. The ECB has drastically stepped up its quantitative easing this year, making its **monetary policy** even more **expansionary** than in the past. Although equilibrium interest rate estimates point towards a lower interest rate level, the fact that these estimates are subject to extreme uncertainty means that they should currently not be used to justify the monetary policy course. While the HICP has barely increased over the last few years due to the drop in energy prices, which are rather insensitive to monetary policy, other measures are pointing to inflation rates that are clearly positive, with no signs of any increased deflation risks. ↘ ITEM 405 FF.

As a result, the GCEE proposes that the ECB take greater account of **less volatile price indices**, such as the GDP deflator or core inflation, when making its monetary policy decisions. This would allow it to be more relaxed in its assessment of the low growth in consumer prices, which is closely linked to developments in international commodities prices. All in all, the GCEE reaffirms its opinion that it would be better to **slow down the bond purchase programme and end it early**. In addition, the ECB should not automatically reinvest proceeds from maturing bonds in its portfolio. ↘ ITEM 417

41. Given the development in inflation and economic growth in the euro area and the risks of sustained low interest rates, the GCEE does not consider the low interest rate level to be appropriate either for the euro area or for the German economy. In Germany, the economy is moving increasingly towards **capacity overutilisation**. ↘ ITEM 194 This increases the risk that the expansionary monetary policy will cause destabilising developments, such as unwarranted increases in asset prices, excessive interest risk on banks' balance sheets, and a weakening of bank and insurance company business models. Together with the decline in oil prices, the weak euro is fuelling Germany's high current account surplus.

Prices on the **German housing market**, which have been increasing steadily, have surpassed a critical threshold (BIZ, 2016). ↘ ITEM 424 Since the credit-to-GDP gap has remained within bounds, the situation cannot be described as a dangerous credit expansion. In order to allow countermeasures to be taken swiftly if necessary, the recommendation made by the Financial Stability Committee (AFS (2015)) more than a year ago should be implemented as soon as possible. This would involve closing data gaps and introducing macroprudential tools for the housing market, such as maximum loan-to-value and debt-to-income ratios (GCEE Annual Report 2015 item 417). The AFS (2015) also recommends that measures be taken to close data gaps on commercial real estate as there are signs that this segment is starting to become overvalued in parts of the euro area. ↘ ITEM 425

42. The mounting risks to financial stability are likely to make it increasingly difficult to exit the loose monetary policy. One possibility, for example, is that a decision will be made in the future not to tighten monetary policy for the sake of financial stability, although that would be the appropriate course of action from a monetary policy perspective (**financial dominance**). Moreover, the low interest rates are likely to have taken the pressure off governments to forge ahead with fiscal consolidation and reforms. Consequently, risks from high public debt could create a situation in which the central bank opts not to implement a necessary rate hike (**fiscal dominance**). In both cases, the ECB becomes a prisoner of its own policy. ↘ ITEM 421

43. The absence of national monetary policy and exchange rates as a mechanism for adjustments between the EMU member states requires greater **economic integration** in certain areas to cushion asynchronous economic cycles and prevent crises from imbalances. The principle of unity of liability and control, however, must be adhered to. In recent years, the GCEE has developed an according concept "**Maastricht 2.0**" (GCEE Annual Report 2012 items 174ff.) and refined it in a special report (GCEE Special Report 2015). Many of the elements of this concept have already been implemented, but more still needs to be done.

Needed action in the financial sector

44. Repeated turbulence in the European financial sector shows that the sector is still not sufficiently resilient to shocks. Although European banks have increased their regulatory capital ratios considerably since the crisis, the GCEE considers in particular many major banks still **insufficiently capitalised**, as measured by their leverage ratios. ↘ ITEMS 478 FF. In part, this is due to generous dividend payouts by many banks which could instead have strengthened their capital base.

The GCEE considers the envisaged leverage ratio of 3 % to be too low, and is therefore repeating its calls for a **leverage ratio of at least 5 %**. In analogy to the risk-weighted capital ratio, a **macroprudential** approach to the leverage ratio could also be considered, as is already the case in the United Kingdom. In particular, systemically relevant banks should be subject to higher unweighted capital ratios. This could allow the leverage ratio to serve as an effective backstop, alongside the risk-weighted capital ratios, in the event of increased systemic risks. ↘ ITEMS 488 FF.

45. **Low profitability** is making it more difficult for euro area banks to accumulate capital. ↘ ITEMS 500 FF. However, the **causes** of low profitability appear to be of a **structural** nature as profitability was already low before the crisis. In Germany, for example, cost efficiency has been low in international comparison for a long time. In addition, two other factors are putting pressure on earnings. Firstly, the **sustained period of low interest rates** is undermining bank business models (GCEE Annual Report 2015 items 381ff.). The burden of the low interest rate environment is likely to weigh much more heavily on banks' balance sheets in the future. Secondly, high levels of **non-performing loans** are harming confidence in the banking system in the former crisis countries. A swift clean-up of bank balance sheets is urgently needed. It is the task of policymakers, as well as supervisory authorities, to improve the overall conditions for the workout of non-performing loans. ↘ ITEMS 514 FF.

46. Policymakers should **not yield to pressure from banks** to dial back new regulation or to not tighten it any further, if this is contrary to enhancing systemic financial stability. At the same time, they should **simplify regulation** instead of making it increasingly complex. Moves to strengthen the unweighted capital ratios, for example, should take precedence over the further refinement of the capital regulation approach based on internal models. ↘ ITEMS 485 FF.

47. The GCEE rejects the idea of a **financial transaction tax**. This could have a detrimental impact on liquidity and pricing on the financial markets, meaning that it could also make raising equity more difficult (GCEE Annual Report 2013 item 388). In addition, it would increase the fragmentation of the European capital market. Moreover, it could be bypassed by shifting capital flows. In light of the above, a financial transaction tax would have very little impact in terms of stabilising the financial system.

Missing elements of the banking union

48. The establishment of a **banking union** marks a key step towards a more stable European architecture. The **Single Supervisory Mechanism** (SSM), which came into force in 2014, facilitates the coherent supervision of significant banks at European level and makes it more difficult for banks to shift risks to the central bank balance sheet (GCEE Annual Report 2014 item 297 f.).

49. The **European bank resolution rules** under the Single Resolution Mechanism (SRM) came into force at the beginning of 2016. They are intended to strengthen market discipline and lower expectations of the rescue of banks by the state. In fact, there are indications of increasing market discipline. Given the repeated turbulence on the financial markets and the resulting debate on the possible rescue of individual banks, however, **doubts remain as to the credibility of the resolution regime**. This begs the question whether it was a prudent to focus the new regulation that much on bail-inable debt instead of further increasing capital. ↘ ITEMS 524 FF.

50. While the new resolution regime weakens the contagion channel from banks to governments, the channel from governments to banks – driven by domestic sovereign exposure of the banking sector – still exists. Therefore, the GCEE repeats its call for **removing the privileges afforded to sovereign exposures** in banking regulation (GCEE Annual Report 2015 items 52ff.).

In Germany, this would affect not only a large number of major banks, but also **savings banks**. These have substantial holdings of domestic debt issued by municipalities and federal states, as calculations based on bank-by-bank data from Deutsche Bundesbank show. The analysis highlights the close links between German banks and subordinated government levels. To enhance financial stability, these concentration risks should be reduced. ↘ ITEMS 539 FF.

51. In the European debate, the idea of removing regulatory privileges for sovereign exposures meets political resistance. At the same time, the proposal for **European Safe Bonds (ESBies)** has garnered support (Brunnermeier et al., 2011). However, this proposal should only be considered if it also includes the removal of regulatory privileges for sovereign exposures and if implied liability risks can be limited. ↘ BOX 17

52. For further loosening of the ties between governments and banks, the European Commission suggests a **common European deposit guarantee scheme** (European Deposit Insurance Scheme, EDIS). From the perspective of the GCEE, **preconditions** are **currently not met**. First of all, legacy problems in the banking system need to be resolved, functioning European supervision and resolution need to be ensured and regulatory privileges for sovereign exposures need to be phased out. In addition, further **harmonisation**, for instance with regard to insolvency and foreclosure laws, could be advisable. ↘ ITEMS 546 FF.

53. The European Commission held a consultation in 2016 on the review of the **macroprudential framework** (European Commission, 2015a). The GCEE

has identified a need for action in several areas to make macroprudential regulation and supervision more effective.

- Firstly, the current organisational structure should be reviewed, in particular the considerable extent to which the **ESRB is dependent on the ECB** (Gurlit and Schnabel, 2015). It is questionable whether the ESRB would take decisive action in response to financial stability risks caused by monetary policy. In addition, the decision-making body is too big (GCEE Annual Report 2014 item 376).
- Secondly, the macroprudential toolkit runs the risk of **excessive fine-tuning** (GCEE Annual Report 2014 item 393). Preference should be given to robust tools, which is why macroprudential regulation should pay more attention to the leverage ratio.
- Thirdly, the ECB has far-reaching macroprudential supervisory powers under the SSM. For example, it has the power to tighten national macroprudential measures (GCEE Annual Report 2014 item 376). This is designed to prevent inaction bias at national level. There is, however, also the risk of an **inaction bias at European level** if the application of macroprudential measures conflicts with monetary policy objectives.

54. In the medium term, the GCEE continues to call for a **common integrated micro- and macroprudential supervision outside of the central bank**, ideally at EU level (GCEE Annual Report 2014 item 381). However, this would only be possible by amending European treaties.

Solid public finances, effective crisis mechanism

55. The **European fiscal rules** should finally be adhered to. Over the past year, a large number of countries have once again broken the rules or missed their agreed consolidation targets. ↘ ITEM 172 FF., 427 Motivated by political considerations, the European Commission yet again opted not urge for sanctions on the member states that broke the rules. This decision has further eroded the credibility of this euro area framework.

56. Consequently, it remains important to strengthen the **crisis mechanism**, as another flare-up of the euro area crisis cannot be ruled out. As the weak compliance suggests that debt ratios are unlikely to decline, there is a pressing need for the regulation of government debt restructuring. This would allow the ESM to provide effective crisis assistance even in cases involving high debt levels and would ensure that private bond investors contribute to crisis resolution. The GCEE has developed a detailed proposal in this regard. ↘ BOX 2

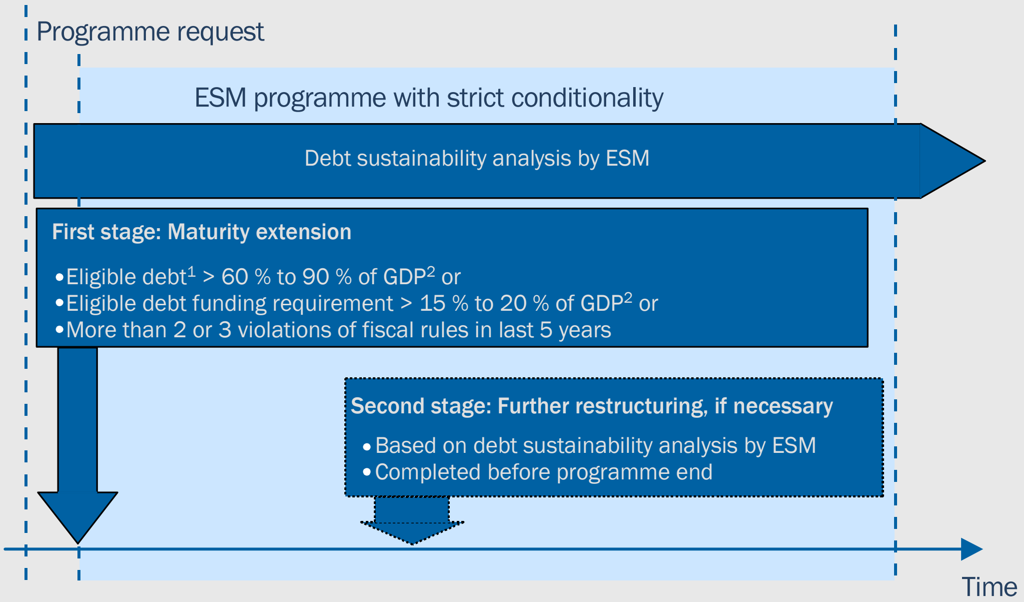
↘ BOX 2

A mechanism for regulating the restructuring of government debt in the euro area

The ESM was set up to grant emergency loans to member states in the event of another sovereign debt crisis. **High debt levels**, however, are inhibiting the effectiveness of the ESM. Higher debt service implies larger funding needs. Given that the ESM's resources are limited, this erodes the ESM's impact and undermines confidence in its ability to provide sufficient emergency loans. There is also a risk that a crisis country will be unable to service its high level of debt in the future, creating a default risk for the ESM. The ESM, however, can only provide transitional funding. Lending to a member state with a debt burden that is not clearly sustainable undermines the no-bailout clause set out in Article 125 of the Treaty on the Functioning of the European Union (TFEU).

These problems could be alleviated by **rules for orderly restructuring** in the event of a crisis. The GCEE has developed a detailed proposal, which builds on a **two-stage process** starting with the request by a crisis country for ESM assistance (Andritzky et al., 2016). ↘ CHART 2

↘ CHART 2
Scheme for restructuring public debt during ESM programmes



1 – Newly issued debt including Creditor Participation Clauses. 2 – Range of possible threshold levels.
Source: Andritzky et al. (2016a)

The first stage involves the ESM making a decision on whether the payout of rescue loans is to be tied to an agreement with the creditors to extend the **maturity** of their loans. This would reduce the funding need and ensure that all creditors contribute to crisis resolution. The GCEE proposes the first stage be triggered by a debt level of between 60 % and 90 % of gross domestic product (GDP) or by funding needs equating to somewhere in the region of between 15 % and 20 % of GDP. Moreover, a maturity extension should be demanded if the government of the crisis country has broken the fiscal rules at least two or three times in the past five years.

The second stage, at a later date, involves a decision being made during the ESM programme on whether a **debt haircut** is required. This step is taken later because it is easier to assess the need for, or the extent of, a debt reduction at such time.

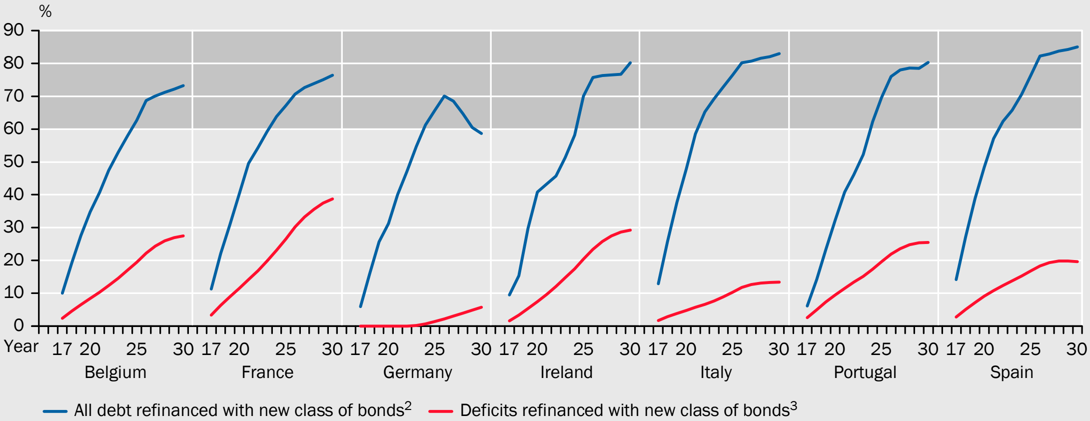
The first and second-stage restructuring can be implemented by a majority vote of holders of bonds and other financial claims. This requires the **incorporation of clauses** allowing loan agreements to be amended by way of an aggregate majority vote. Corresponding standard clauses for government bonds have been developed, such as by the International Capital Market Association, and are applied internationally. Bonds featuring these clauses are an improvement over the clauses used in the euro area since 2012, under which a separate vote is held for each bond series.

This means that the introduction of the mechanism requires, first and foremost, an **agreement by the member states** to issue new bonds that feature the creditor participation clauses (CPCs) proposed here. Only these bonds would be subject to restructuring under the new rules, whereas legacy debt would have to be addressed on a case-by-case basis, as in the past. The introduction of this sort of debt restructuring rule also comes hand in hand with the removal of the privileges of sovereign exposures in bank regulation (Andritzky et al., 2016).

The issue of new bonds to finance budget deficits or maturing debt would result in a gradual increase in the volume of outstanding bonds featuring CPCs. ↘ CHART 3 If all the financing needs of the member states were financed by such bonds, then in Italy, for example, these bonds would reach the threshold of 60 % of GDP by 2021. The speed at which the mechanism is introduced could be varied in order to give the member states more time to reduce **legacy debt**. The gradual issuance of these new bonds would send a credible signal that such a mechanism is being introduced.

↘ CHART 3

Penetration of debt stock with bonds including Creditor Participate Clauses (CPCs) issued from 2017[1]



1 – Assumes bonds are issued with new clauses starting in 2017 based on maturity profile of bonds as of end-2014, with (i) maturity of newly issued bonds similar to 2014 and (ii) nominal debt following European Commission (2015b) and extrapolated after 2017. 2 – Assumes that share of other debt relative to GDP remains constant. 3 – Deficits until 2026 based on European Commission (2015b), and convergence towards 0.5 % of GDP at an annual rate of 0.5 percentage points afterwards. Bonds with CPCs falling due are rolled into similar bonds.

Source: Eidam (2016)

57. Overall, the GCEE warns against **hasty integration moves**. These include, for instance, a European unemployment insurance or a common fiscal capacity. ↘ BOX 11 Uniting liability and control at the same level is an indispensable requirement for integration steps like these. For as long as member countries are unwilling to transfer national sovereignty over economic and financial policy to European levels, all reform proposals must withstand critical evaluation of the incentives they set for national economic and fiscal policy.

IV. REFORMS FOR GERMANY

58. The **current legislative period** was not sufficiently utilised to implement further reforms in order to strengthen Germany's position as an important business location. The economic success, which can largely be traced back to reforms and decisions made in the past, could have allowed measures to be implemented to

promote growth. Instead, the measures taken included the introduction of a national minimum wage and its subsequent increase, the implementation of a pension package that backtracked on earlier reforms, and regulatory intervention in markets, including the rent ceiling and the draft Equal Pay Act. While these moves may satisfy redistribution interests, they erode the basis for future welfare gains to the detriment of future generations.

Over the next few years, economic policy should focus more on enhancing the German economy's **competitive standing and future viability** (GCEE Annual Report 2015 items 68 ff.). It would be advisable to place greater trust in market processes in order to enable social participation not by way of redistribution further down the line, but by allowing individual economic success in the first place (GCEE Annual Report 2014 items 8 ff.).

1. Focus on equal opportunities

59. Despite the positive economic situation, the public debate suggests an increasing sense of uncertainty regarding the extent to which the economic prosperity can be safeguarded and its future outlook. It is, however, by no means clear how to ensure equal opportunities and inclusive growth in an increasingly globalised and digitised world. The GCEE believes that **providing a growth-friendly framework** and striking a **balance between growth and redistribution** that maintains a strong focus on growth-enhancing incentives is the best way of allowing the German economy to adapt to the demands of the future.

Participation in prosperity should be enabled primarily by giving individuals the chance to take part in the economic process. This is why efforts should **focus on employment growth.** This applies, in particular, if taking a holistic view of prosperity and progress, which is what the Federal Government pursues through its national dialogue on quality of life in Germany "*Gut leben in Deutschland*" (GCEE Annual Report 2015 item 576).

Conclusions from the inequality debate

60. The debate on the development of income and wealth inequality has found its way into the global agenda. It is also a subject of keen debate in Germany, even though **inequality in Germany** has remained largely unchanged over the past decade. ↘ ITEM 812 The positive situation on the labour market has contributed to preventing a larger dispersion of incomes. At the same time the German tax and transfer system redistributes income to a considerable degree.

61. A **flexible labour market** with **highly skilled** employees and the right incentives to be productive is the best way of ensuring employment and economic participation in the long term. The reforms introduced as part of the Agenda 2010 initiative are a good example of this. In conjunction with general wage restraint, these reforms helped to drive down unemployment and, in the process, prevent any further increase in income inequality. This means that moves to increase income redistribution always have to be weighed against the chance of weakening

the incentive to earn high market incomes by gaining qualifications and showing initiative and commitment. ↘ ITEM 842

62. However, wealth inequality in Germany is high, and income and wealth positions are entrenched. The entrenched income distribution reflects the stable, high proportion of households that now belong to the middle class. Also, there are various reasons for the **low private net wealth accumulation**. For example, the extensive tax and social security system reduces the incentives and options to accumulate private assets, particularly for lower-income households.

Given the extent to which it distorts investment activity, reviving the idea of a **wealth tax** is not advisable. As a capital tax, a wealth tax would hit small and medium-sized enterprises in particular. It would also create an incentive for companies to shift their locations abroad. Furthermore, a wealth tax has considerable collection and payment costs (Spengel et al., 2013; GCEE Annual Report 2013 items 594 ff.; Brülhart et al., 2016).

63. A targeted education policy could help to overcome entrenched income and wealth positions in the long term. The focus should be on improving **equal opportunities**, which result in improved educational opportunities and outcomes. This could include measures to make the education system more permeable, as well as a mandatory, free pre-school year. A functioning and flexible labour market provides the basis that allows employees to find the best way of putting their skills to productive use. ↘ ITEM 786

Increasing the absorption capacity of the labour market

64. The labour market has **continued its positive development**. In August 2016, there were 43.6 million people in work in Germany, more than ever before. But structural unemployment and the task of integrating recognised asylum seekers into the labour market, in particular, present major challenges. ↘ ITEM 738 FF. The long-term unemployed often present multiple obstacles to job placement, including a long period of unemployment, advanced age or health problems. The only promising labour market policy measures for this jobless category are ones that are closely tailored to individuals' situations.

65. The low-wage sector is crucial when it comes to tackling these challenges. The labour market reforms of the mid-2000s helped to bring more low-productivity workers onto the labour market. This has increased the proportion of people **employed in the low-wage sector**. Whereas in the past, a large number of young people worked in the low-wage sector, an increasing number of older people are now employed in low-wage jobs. This change reduces the potential for reaching higher-paid jobs, because this sort of mobility is more pronounced among younger workers. ↘ ITEM 757

66. Due to the expected increase in the labour force in the low-productivity sector, for example due to the entry of recognised asylum seekers into the labour market, measures must be taken to allow the low-wage sector to absorb more people. Active labour market policies, such as wage subsidies, often only work in the

short term and prove expensive due to freeriding. By contrast, **improved support for jobseekers** could help to better match labour market supply and demand. **Skill acquisition and training** can increase jobseekers' productivity in the long term, thus boosting their chances of employment.

Additional measures that create barriers for new entrants and build protective walls around existing employees should be rejected. When it comes to protecting workers against excessive adjustment demands, the **existing mechanisms on the labour market,** such as protection from dismissal and the binding effect of collective wage agreements, are likely to be extensive enough.

67. Moves to facilitate access to protected **service sectors**, for example by abolishing the requirement for individuals to hold master craftsman diplomas (*Meisterbrief*) in non-hazardous occupations, could promote self-employment. Mandatory membership of professional chambers and official fee schedules should be carefully assessed (OECD, 2016). It has long been known that certain service sectors, such as long-distance freight and passenger transport and the mobile telephony segment, need to be liberalised. This has been repeatedly pointed out by international organisations and the Monopolies Commission (GCEE Annual Report 2015 items 623ff.).

68. In some respects, the **minimum wage** restricts the absorption capacity of the low wage sector, because it prevents jobs being created for the less productive. This effect is lower in the current environment of an economic upswing with record employment levels and rising salaries than it would be if the economy were on a downturn. The increase in the minimum wage from €8.50 to €8.84 resolved for 2017 may be moderate, but by including more recent and higher wage settlements, the Minimum Wage Commission deviated from the previously agreed wage index with its very first decision. This may cause uncertainty for employers with regard to the future level of the minimum wage and could stand in the way of job creation.

69. On the whole, the German labour market is highly regulated by international standards. This means that every new regulatory measure has to involve a strict assessment of the additional costs and benefits. The **Equal Pay Act** recently agreed upon by the coalition does not pass this test. This legislation is to require companies with more than 200 employees to provide information on the average wages paid to staff of the opposite sex carrying out comparable tasks to any employee who requests this information. The GCEE deems the **additional administrative expense** to be disproportionate to the aim of ensuring equal pay for equal work, particularly given it is uncertain whether this aim can be achieved through the envisioned regulation.

Overall conditions to foster innovation

70. A climate of constant structural change is best created when market competition is fully functioning. Allowing individual companies to obtain a dominant position may result in these dominant positions being abused and economic inefficiency. **Competition**, in contrast, is the driving force behind entrepreneurial

innovation. Therefore, regulatory intervention seeks to limit the market power of individual companies and to prevent cartel arrangements. Hence, providing good infrastructure and ensuring a functioning competitive framework as part of "horizontal" innovation and industry policies is the right way to go.

71. The state should, however, steer away from pursuing **"vertical" innovation and industry policies** in which the state decides which markets and technologies of the future are of strategic significance and then provides targeted support to companies in these areas. Exceptions can be made if the external effects of research work are considerable, such as with basic research. **Targeted subsidies** should be subject to an open competition, should be granted for a limited period and should be subject to stringent performance reviews.

72. As digitisation progresses, innovation cycles will likely become even shorter. The way in which work is organised is expected to become increasingly flexible and additional new forms of employment are likely to emerge. Instead of attempting to negotiate all of the terms and conditions surrounding the **digitisation of the world of work** beforehand, this unavoidable structural change should be shaped in a constructive ways. This should see lost jobs being replaced by new ones, and would mean that digitisation would not necessarily translate into either substantial job losses or a substantially higher level of structural unemployment (Wolter et al., 2015; Eichhorst, 2015).

73. Improved qualifications open up greater labour market opportunities, especially given the challenges posed by digitisation and globalisation. More moves to promote training at the lower end of the skills scale are welcome. It could be achieved, for instance, by making **training courses more modular**. Lifelong learning has to be a matter of course. For employees, self-structured further training programmes in combination with allowances for leaves of absence should be expanded.

Requirements for the integration of recognised asylum seekers

74. Following the substantial and partly uncontrolled influx of refugees last year, the number of **new asylum seekers** arriving in Germany has dropped considerably. Nevertheless, migration from regions mired in poverty and conflict remains a key topic for policymakers, as the political resonance of the large refugee migration last year demonstrates. As a result, greater attention should be paid to **tackling the reasons for refugees leaving their countries**. Together with clear European migration rules and effective protection of external borders, this can form a consistent approach to migratory pressure. ↘ ITEM 683

75. In Germany, the task in hand now is to integrate recognised asylum seekers into the labour market and society at large. The additional **direct expenses** incurred by the public sector to cover the cost of living and integration measures for the refugees will have a negligible impact on the sustainability of public finances. ↘ ITEM 701 There are, however, other macroeconomic costs that are difficult to quantify and must not be overlooked.

76. The most decisive factor in determining the long-term impact of refugee migration is labour market integration. **Skills acquisition and good education** are the basis for leveraging the potential offered by the recognised asylum seekers and thereby opening up opportunities for them on the labour market. Consequently, the Federal Government should give **high priority** to measures aimed at increasing their employability. These measures should be closely intermeshed with the existing programmes offered by businesses, social partners and citizens' initiatives.

77. The **availability and quality of language and integration courses**, coupled with the incentives for integration and language learning set by the German Integration Act (*Integrationsgesetz*), provide a key foundation. Nevertheless, further occupational training is required in many areas of the labour market to allow refugees to access them. Given the difficulties of providing proof of existing qualifications, more should be done to modify eligibility requirements to include **suitable entry tests**. Incentives for training could be set by expanding **training programmes that lead to partial vocational qualifications**. Particular focus should be placed on **early childhood and school education**, as these promise particularly good integration prospects. The age limits for attending school could also be raised and compulsory vocational schooling could be extended to the age of 21 in all federal states. ↘ ITEM 709

78. Integration into the labour market will be facilitated by the **greater legal certainty surrounding residency status** provided for by the Integration Act. The combination of "incentives and demands" sends the right signal. The aim should be to achieve the **long-term integration** of recognised asylum seekers into the labour market. In this context, one needs to weigh up whether it makes more sense to allow asylum seekers to start work quickly or to let them pursue more in-depth labour market programmes that will initially reduce their earnings potential.

79. Regarding **labour market policy measures**, migrants should not receive any privileges over other labour market participants, but should not suffer worse conditions either. Promotional measures such as working opportunities under the German Social Code, so-called one-euro jobs, or wage subsidies could prove better suited to recognised asylum seekers than to other unemployed. The "priority check", which ensures no suitable EU applicant can be hired and which entails a considerable administrative burden, should be abolished once and for all. Entry barriers to the labour market should be kept low. Flexible employment contracts, such as temporary employment and contractual work (*Werkvertrag*), offer opportunities to enter the labour market. ↘ ITEM 719

80. Another aspect of refugee migration relates to the **availability of affordable housing.** Particularly in major cities, housing in the lower price segment is in short supply. ↘ BOX 3 The GCEE believes this should not be attributed to market failure. Therefore, market forces should not be weakened. The rent ceiling (*Mietpreisbremse*) could translate into lower supply on the rental market and hinder construction investment, in particular in the affordable housing segment.

Compensating for the low propensity to invest by introducing **special depreciation allowances** or increasing the **construction of social housing** would be the wrong course of action. Social housing has proven to be inefficient in the past and has quite rightly been restricted. Instead, the right approach would be to strengthen market forces, use long-term strategic planning of zoning to make sufficient land available for construction, and reduce administrative hurdles.

↘ BOX 3

How can the rising demand for affordable housing be met in densely populated areas?

The **shortage of housing** in densely populated areas and rising prices and rents have been fuelling a debate on suitable policy measures. Housing construction has been lagging behind the estimated demand for some time, with a trend towards excess supply in rural areas coming hand-in-hand with a lack of housing in cities.

This has pushed **real estate prices and rents** in cities up, while the rate of increase is moderate for Germany as a whole. In many places, the relative increase in the price of premium property has been more pronounced than in the lower price segments. In international comparison, housing costs in Germany are moderate in relation to incomes. ↘ CHART 4 The high proportion of rented properties, often with below-market rents for long-term tenants, has kept housing cost down, although rent-controlled contracts are increasingly coming to an end.

The **influx into cities**, a trend ongoing since the mid 2000s, is one of the reasons for the pressure on the housing markets in densely populated areas. While the population living in rural areas fell by 1.7 % in the period between 2008 and 2013, urban populations rose by 1.1 % (BBSR, 2015). This trend is being exacerbated by population growth, due in particular to higher migration, and by the continuing decline in household sizes. ↘ ITEM 803

With planning permission approvals on the rise, housing construction is expected to result in a gradual increase in supply. High land, planning and construction costs, as well as extensive requirements and demanding standards, concerning energy efficiency for example, are pushing up the **costs associated with new buildings.**

Supply shortages are particularly pressing for affordable housing (BMUB, 2015). As a result, the Federal Government, following the coalition agreement of 2013, introduced a rent ceiling (*Mietpreisbremse*) in June 2015. This sort of interference with market pricing can lead to uncertainty, reducing the incentives for making rented properties available. An initial empirical analysis provides evidence of slightly higher rent increases and slightly lower property price increases since the introduction of the rent ceiling in certain regions (Kholodilin, 2016).

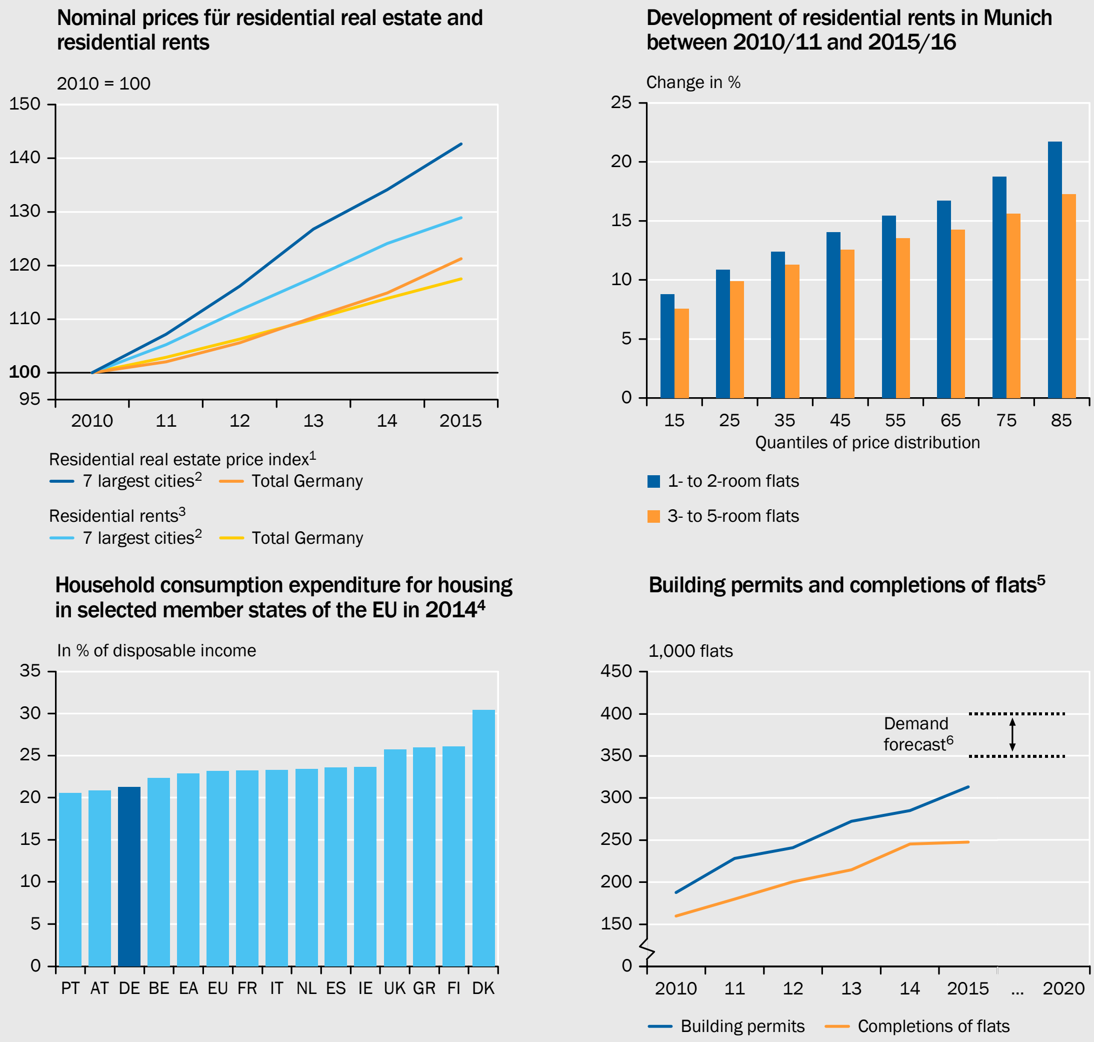
In November 2015, the Federal Government published a catalogue of measures as part of its “**Alliance for Affordable Housing and Building**”(*Bündnis für bezahlbares Wohnen und Bauen*). The initiative's proposals include more moves to promote affordable housing, improvements in releasing land for construction and measures to reduce construction costs.

The increase in **social housing subsidies** for the period from 2016 to 2019 to more than €1 billion signalled the revival of public-sector housing subsidies. These subsidies had been reduced in the past because they had proven to be relatively inefficient, often due tenants no longer meeting the eligibility criteria. This is why the GCEE favours providing assistance to households by providing according housing benefits, rather than funding properties via social housing construction (GCEE Annual Report 2013 item 879).

Calls are often made for housing construction to be state-subsidised in the form of **special deprecia-**

tion allowances. A corresponding draft act, however, failed only recently. In general, special depreciation allowances for residential properties are the wrong way of creating more affordable housing. Firstly, even if they are limited to relatively low prices per square metre, they can hardly be described as targeted because the thresholds have to be set in an arbitrary manner. Construction prices, however, vary from region to region. Secondly, special depreciation allowances run the risk of free rider effects. There is virtually no evidence of special depreciation allowances resulting in higher construction activity. Indiscriminate subsidies such as the “home buyer grant” (*Eigenheimzulage*), which has since been abandoned, are not the right approach either.

↘ CHART 4
Housing market indicators



1 – Weighted by stocks. Calculations by Deutsche Bundesbank based on information of bulwiengesa AG. 2 – Berlin, Hamburg, Munich, Cologne, Frankfurt (Main), Stuttgart, Düsseldorf. 3 – Offered rents for first time renting and re-lets. 4 – PT-Portugal, AT-Austria, DE-Germany, BE-Belgium, EA-euro area, EU-European Union, FR-France, IT-Italy, NL-Netherlands, ES-Spain, IE-Ireland, UK-United Kingdom, GR-Greece, FI-Finland, DK-Denmark. 5 – In residential and non-residential buildings. 6 – Annual requirement from 2015 to 2020; Assumption of BMUB.

Sources: BBSR, BMUB, Deutsche Bundesbank, Eurostat, Federal Statistical Office, Mense (2016)

A lack of available land for construction is often seen as the root cause of sluggish new housing supply. **Opening up the legal framework** could help to remove some of the obstacles to internal and external development of cities. Accelerating **planning permission procedures** and providing discretionary scope in respect of **regulatory requirements**, such as for energy efficiency, could facilitate construction activity and lower construction costs.

2. Solid fiscal policy and demographically sound social security systems

81. The strong economy currently generates **high tax and contribution revenues**. This is due, for one thing, to the high level of employment, which is having a positive impact on revenue from wage tax and social security contributions. The higher levels of consumption linked to higher employment are also translating into a substantial increase in VAT revenues. For another thing, revenue from taxes on profits is currently increasing significantly.

The statutory pension system is starting to benefit from a **demographic respite**, i.e. a period during which the ratio of non-working age to working age population is increasing only moderately. As the number of new pensioners has been relatively low in recent years, spending on pension payments has increased only moderately while revenues rose notably. Moreover, interest expenditures are currently falling every year thanks to the low interest rate level. This will create **fiscal leeway** in the years to come in spite of the additional expense associated for refugees and higher public spending in the current legislative period.

No actionism in public spending

82. Stimulating additional public spending is not appropriate in view of the current upturn. Rather, the future challenges and Germany's function as an anchor of stability within the euro area justify further debt reduction. If growth starts to slow down, automatic stabilisers should be allowed to work. Given uncertainty about its effectiveness, the government should abstain from a **discretionary approach to fiscal policy**, also given delays in the implementation process (Elstner et al., 2016).

83. There is evidence supporting the need for higher public investment, even though it is sometimes difficult what to classify as investment (GCEE Annual Report 2013 Box 19) and even though not all investive outlays per se make sense. Investment needs varies considerably between the federal states and the individual municipalities. The current Federal Government has launched an investment programme to the tune of €10 billion that includes commitments to municipalities. Capital expenditure on equipment by the German Armed Forces has also been increased. In the GCEE's view, additional public investment should be financed through budget reallocations, i.e. by cutting consumptive spending, so that **total spending is not increased any further**.

84. Furthermore, structures should be put in place to implement investments efficiently. This could be facilitated by the **reorganisation of the federal financial relationships**, which was agreed between the Federal Government and the federal states on 14 October 2016. ↘ ITEM 86 The agreement provides for the creation of a **state infrastructure company for federal motorways and major roads** which will assume responsibility for the creation, construction, maintenance and operation of these roads based on the lifecycle approach. This sort of infrastructure company offers an advantage in terms of reducing the ex-

isting inefficiency in the delegated execution of federal laws (*Bundesauftragsverwaltung*) across federal state borders, planning permission practice and implementation. It also offers opportunities for private investment. The structure could not least allow federal roads and, in particular, motorways to be financed using pay-as-you-drive road tolls.

Financing via road tolls should not, however, result in a further burden on car users by levying them in addition to road tax (*Kfz-Steuer*). If the infrastructure company is to be allowed to borrow funds in its own right, then a clear line should be drawn to indicate that the company is not part of the state sector, i.e. by not providing government guarantees (Expert Commission, 2016).

85. The GCEE takes a critical view of the idea of **public-private partnerships (PPPs)** playing more of a role in public investment. Firstly, they offer cost advantages mostly for large projects, while municipal investment projects are better financed in conventional ways. Second, it is important to weigh these cost advantages against the difficulty of putting a contractual mechanism in place to verify the quality of the infrastructure (Wissenschaftlicher Beirat beim BMF, 2016).

There is also a risk that **public liabilities** arising from **PPPs** will not be fully reflected in public debt statistics (GCEE Annual Report 2010 item 352, Wissenschaftlicher Beirat, 2016). Municipalities, for example, could exploit this using the non-recourse forfeiting of instalments. In this sort of model, the private partner transfers its receivables to a credit institution and the public partner declares that it is prepared to satisfy the receivables irrespective of the private partner’s performance of the services owed. This sort of agreement corresponds to a credit agreement but does not show up as such in public debt. Therefore, it would at least be advisable to adopt the more stringent accounting rules, which are used for European fiscal rules, also for determining compliance with the German debt brake.

Reforms for growth-enhancing tax policy

86. The **agreement on the financial relationships between the Federal Government and the federal states** misses an opportunity to make the fiscal equalisation system more efficient. Yet again the reforms have failed to grant the federal states tax autonomy. ↘ BOX 4 Instead, the federal states are putting themselves increasingly into the hands of the Federal Government with further supplementary federal grants, the transfer of key transport policy powers to the Federal Government, extended co-financing powers for the Federal Government in the area of municipal education infrastructure for financially strapped municipalities, new control rights for the Federal Government regarding the co-financing of federal state tasks and strengthened fiscal administration rights for the Federal Government.

Verticalisation is progressing. Previous progress made with Federalism Reform I in the area of mixed financing is being rolled back. If this process continues over the next few years, the **principle of federalism will be undermined**.

↘ BOX 4

The agreement on the reform of the financial relationships between the Federal Government and the federal states

The **current fiscal equalisation system** is a four-step system (GCEE Annual Report 2014 items 592ff.):

- The **first step** involves allocating income from joint taxes (wage and income tax, corporation tax, VAT) and from the taxes to which they are exclusively entitled (inheritance tax, real estate transfer tax and other taxes) to the Federal Government, federal states and municipalities.
- The **second step** involves distributing the tax revenue to which the federal states are entitled based on the first step to each federal state. Income tax revenue is distributed based on the principle of residence, whereas corporation tax is allocated based on where the companies have their permanent establishment. Three-quarters of the VAT revenue that the federal states are entitled to is distributed based on the size of the federal state's population, while one-quarter is allocated as part of the VAT redistribution process based on fiscal equalisation criteria. This favours the eastern German federal states in particular.
- The **third step**, which involves fiscal equalisation between the federal states in the narrower sense of the term, results in those federal states with above-average fiscal capacity making payments to those with below-average fiscal capacity.
- The **fourth step** includes general supplementary federal grants (*Bundesergänzungszuweisungen*, BEZ) that further improve the fiscal capacity of those federal states that still have below-average fiscal capacity after the fiscal equalisation process covered in step three. Supplementary federal grants for special needs are also granted to cover additional politically identified needs.

This system is **subject to considerable criticism**, because the lack of tax autonomy means that states tends to indulge in excessive spending and, at least until the debt brake becomes effective, to accumulate excessive debt. Moreover, the system results in high marginal transfer rates, particularly for the recipient states (GCEE Annual Report 2014 items 601ff.; Büttner and Görbert, 2016; Kronberger Kreis, 2016). For every additional euro that a recipient state receives as a result of companies setting up business there or due to the migration of tax revenue, the state can only retain around 20 cents. This applies, in particular, to revenue from wage and income tax. So it comes as no surprise that fiscal equalisation is **detrimental to growth** (Baskaran et al., 2016).

In December 2015, the state premiers presented a **consensus model for a reform of the fiscal equalisation system**, which was agreed virtually unamended with the Federal Government in October 2016. The model provides for a radical retreat from the current system. The horizontal fiscal equalisation between the federal states in the narrower sense of the term and VAT redistribution are to be abolished. Instead, equalisation between the federal states will be achieved in full via the allocation of VAT revenue, albeit at lower marginal transfer rates. To ensure that no federal state is put at a financial disadvantage as a result, the federal states will be awarded an additional fixed amount of €2.6 billion, taken from the VAT revenue, and additional VAT points worth €1.4 billion that will increase in tandem with VAT revenue.

In addition, the general **supplementary federal grants** will be increased and new supplementary federal grants put in place to equalise the fiscal capacity of the municipalities and to promote research in less successful federal states. Brandenburg will receive additional special supplementary federal grants to cover political administration costs. Saarland and the Hanseatic City of Bremen will continue to receive consolidation aid in the amount of €800 million. At least three federal states or the Federal Government have the right to request reorganisation of the system after 2030.

This reform has not only resulted in the state premiers asserting their interests to the detriment of the Federal Government. The new system also exacerbates the inefficiencies inherent in the current system, although the marginal transfer rates for wage and income tax, for example, are more favourable due to the reduction of the rate that applies to the VAT equalisation mechanism (Büttner and Görbert, 2016; Kronberger Kreis, 2016). Although one stage of the fiscal equalisation system will be dispensed with in the future, the reform will fail to increase transparency. Under the current system for fiscal equalisation between the federal states in the narrower sense of the term, allocations to federal states with weaker financial resources have to be resolved as part of the ordinary budget procedure. The parliaments of the financially strapped federal states can see the payments made by the other federal states and the fiscal equalisation payments that they lost because they generated higher revenue of their own. Under the new system, there will no longer be any donor and recipient states from a federal state parliament perspective. **Revenue will be distributed** in advance **in a much less transparent way.**

The expansion of the supplementary federal grants will also add to the inefficiency. Under this system, compensation will still be provided to cover the costs of political administration and, moreover, will be topped up for yet another federal state. This rewards federal states with higher administrative expenses in relative terms, which are given no incentive to reduce these expenses. Supplementary federal grants to promote research in less successful federal states go against the principles of the Federal Government's research promotion measures, which focus on research quality. This new instrument **rewards federal states with a poor research record.** The incentives in this area, which are so important to Germany's economic development, could hardly be any worse.

The incentive effect of the planned **supplementary federal grants based on municipal tax revenue** is particularly problematic. The grants will result in the **excessive transfer of municipal tax revenue** if the latter shows a marginal increase. This translates into substantial marginal transfer rates for the five non-city federal states in eastern Germany, along with Saarland (Büttner and Görbert, 2016; Kronberger Kreis, 2016). This **changes the fiscal capacity ranking**, meaning that unfavourable incentive effects are not the only issue. In this respect, it is likely the proposed reforms could actually be unconstitutional (Federal Constitutional Court decision (BVerfGE) 1, 117, 131f.). Essentially, it is clear that the **supplementary federal grants** supersede, and largely replace, the system for fiscal equalisation between the federal states in the narrower sense of the term. The proposed reform could also prove to be unconstitutional in this respect (BVerfGE 72, 330, 402).

No progress whatsoever has been made towards greater **revenue autonomy for the federal states**. The majority of the federal states vehemently resist the idea of even the slightest degree of tax autonomy over wage and income tax in a narrow corridor of tax rates. This creates the illusion among citizens in the federal states that other federal states and the Federal Government are responsible for funding their spending wishes. The fact that this could ultimately result in higher general tax rates is not taken into account. Consequently, state policymakers can only score political points via the spending side of their state budget, the result being that federal state spending is excessively high.

87. The existing fiscal space could be used for reforms to bolster the German economy's competitiveness and enhance efficiency, including through corporate and income tax reforms. An **allowance for corporate equity** should be introduced to achieve funding neutrality in corporate taxation. This would mark a further step towards a dual income tax system that was - quite rightly - mapped out with the introduction of the final withholding tax (*Abgeltungsteuer*). Given the low interest rate environment, such a reform would currently be associated

only with a slight revenue decline. The allowance cannot be described as a form of negative wealth tax because the concept does not provide for any tax reimbursements in the event of losses (GCEE Annual Report 2015 items 728ff.).

88. Further fiscal space should be used to fully compensate the **bracket creep**. On the one hand, taxpayers received relief of around €3.3 billion via the increase in the personal allowance and the tax allowance for children for 2015 and 2016, together with the increase in the other bracket thresholds in 2016. The additional burden from bracket creep since 2010, on the other hand, amounts to €5.1 billion (GCEE Annual Report 2015 items 843ff.)

89. The fiscal space is not sufficient to allow for a fundamental reform of the income tax system. Abolishing **"middle-class bulge"** by flattening the steeper rate progression in the first progression zone would be associated with revenue losses of up to €30 billion a year depending on the structure of the new tax rates (GCEE Annual Report 2011 items 361ff.). One option, which would actually only provide relief to middle-income groups, would mean that the top rate of tax would have to apply much sooner. Furthermore, the refund of excess taxes collected due to bracket creep means that the increasing rate compression is alleviated and similar income groups are granted relief. As a result, the GCEE does not see additional need for action in this respect.

90. As regards **inheritance tax**, the GCEE proposes the combination of a broad tax base and low tax rates with generous deferral rules (GCEE Annual Report 2015 items 808ff.). In contrast, the proposal that has currently been agreed makes inheritance tax law more complicated, inviting tax optimisation.

91. In June of this year, the state finance ministers approved an initiative launched by the Bundesrat (German Upper House) regarding **property tax reform**. A reform is overdue given the outdated way in which the assessment base is calculated (Academic Advisory Council to the German Federal Ministry of Finance, 2010; GCEE Annual Report 2013 item 613; GCEE Annual Report 2015 item 807). The proposal presented by the Bundesrat provides for a more straightforward valuation procedure as of 2022, based on the standard land value for undeveloped land and on the type of building and year of construction for developed properties. This will make it easier to revalue properties at regular intervals. Overall, the reform is to be revenue-neutral by giving federal states the power to set their own assessment factors (*Steuermesszahlen*).

The reform will inevitably result in distribution effects among property owners given property values are likely to have changed since the last valuation which so far was not been taken into account. The extent to which municipalities will be affected by different valuations varies. Since they set the assessment rates (*Hebesätze*) for property tax, the actual burden for property owners will depend on how the municipalities react to the changes in the assessment base. Property tax is a **relatively efficient tax in economic terms** because avoidance is difficult. The reform proposals are a step in the right direction, even though they do not go as far as the proposals made by academia (Academic Advisory Council to the German Federal Ministry of Finance, 2010).

More market in healthcare

92. **Healthcare spending** has a considerable impact on the sustainability of public finances. ↘ ITEM 594, ↘ CHART 79 Looking ahead, healthcare spending is set to increase due to demographic change and the increased costs caused by medical and technological progress. This makes it all the more important to prevent a scenario in which inefficiencies in the healthcare system drive costs up even further. As a result, the GCEE has set out proposals in the past for ways of reducing these inefficiencies within the healthcare system.

These include strengthening freedom of contract by expanding the use of selective agreements (GCEE Annual Report 2012 items 629ff.), a transition to a monistic system of hospital financing (GCEE Annual Report 2012 item 635), the reintroduction and targeted further development of the medical consultation fee (GCEE Annual Report 2012 item 594), the lifting of the ban on third-party and multiple ownership of pharmacies (GCEE Annual Report 2010 item 425) and the expansion of cost-benefit analyses for medicinal products to include alternative medicine (FAZ, 2016). The latest judgment passed by the ECJ, which found that the setting of fixed prices for prescription drugs in Germany contravenes EU law, could pave the way for more competition among pharmacies.

93. The GCEE also maintains that a non-income-based financing model for the statutory health insurance system is the best form of financing, such as a **flat-rate per capita health insurance premium (*Bürgerpauschale*)** including a mechanism for social compensation (GCEE Annual Report 2012 Box 23).

Three strong pillars for the pension system

94. **Demographic change** will inevitably put considerable pressure on the **statutory pension scheme** (GRV) in the foreseeable future. Although the reforms implemented to date have stabilised the statutory pension system for the medium term, the rising aged dependency ratio means that, if no further adjustments are made, the contribution rate will have to be increased considerably to over 22 %, and the gross replacement rate, in other words the relative pension level before taxes for a median earner, will have to be reduced further to below 43 % as of around 2030 in order to balance the statutory pension scheme's budget. However, higher contribution rates and the resulting increase in labour costs have a negative impact on employment.

95. While it is not possible to resolve the implications of demographic change for the statutory pension scheme entirely, it is possible to soften the blow. In order to achieve this, the GCEE is of the view that the **statutory retirement age will have to be raised further after 2030**. ↘ ITEM 599 FF. In view of increasing remaining life expectancy at age 65, it would make sense to tie the retirement age to life expectancy to prevent a further increase in the relative pension payment period. This would bring the statutory retirement age to 71 by 2080, based on a life expectancy of 88 for men and 91 for women. This retirement age would first apply to people born in or after 2009. By way of comparison: in 2010, life expectancy was 78 for men and 83 for women, with a statutory retirement age of 65.

96. This kind of increase in the retirement age should be supported by education and labour market policy measures. For example, the **more flexible retirement** rules resolved by the Federal Government are likely to encourage some people to extend their working lives voluntarily. These rules are also important to make the transition to retirement easier for employees who cannot work up until the standard statutory retirement age. Moreover, older workers in particular could perform activities that suit their skills thanks to lifelong learning. Employers should also develop working hours models for older employees.

97. Expanding the group of people contributing to the statutory pension scheme by making such contributions mandatory for the self-employed does not present any solution to the sustainability problem. This could result in an increase in benefits for today's generation of pensioners, while exacerbating the sustainability problem for future generations. By contrast, the GCEE is in favour of **compulsory pension provision for the self-employed**, although there should be a choice between statutory and private provision to meet this requirement.

98. In addition to the financial stabilisation of the statutory pension system in the long term, harmonising **pension legislation in western and eastern Germany** is also on the political agenda. The distribution and cost-neutral rebasing of the parameters for determining pension benefits proposed in the Annual Report 2008/09 of the GCEE would be a good solution (GCEE Annual Report 2008 items 624ff.). If the required political courage to achieve this cannot be found, the better solution may be to keep the current system, which is based on automatic adjustments, in place for a while instead of opting for the cost-intensive solution of increasing the parameters for eastern Germany to match those in the west. Pension legislation should be harmonised at the latest once the current pension value (East) has reached the current pension value (West).

99. Further efforts are also required outside of the statutory pension scheme to allow employees to build up adequate pension provision in the long term. In this context, moves to **strengthen the second and third pillar of pension provision** in Germany would be advisable. Attaching more weight to company and private Riester-incentivised pension provision will make the system more resilient against crises while cushioning it against various risks. ↘ ITEM 570

In the current difficult period of demographic change, the right course of action is **not**, despite the low interest rates, **to label the fully funded pension system a failure** and implement temporary increases in statutory pensions, putting additional pressure on the long-term sustainability of the statutory pension scheme. Instead, measures should be taken to eliminate obstacles that prevent a greater take-up in the second and third pillars.

100. For occupational pensions, there is a need to act in particular with regard to small and medium-sized enterprises (SMEs) and low earners. To make government-subsidised occupational pension provision more attractive for low earners, it would be necessary to **abolish double contribution** as part of the Riester pension within the occupational pension system. Greater take-up of occupational pension provision among SMEs could be achieved through a reduction of information and administration costs. Business associations could play a more ac-

tive role to this end. In addition, the wage-negotiating parties could offer a standard product.

101. In private pension provision, the level of take-up of the private **Riester pension** particularly among low earners should be increased. Lack of knowledge of incentive entitlement, the (false) assumption of being dependent on the means-tested minimum pension, lack of market transparency and lack of financial education are likely to be responsible for the low take-up. An improvement of financial knowledge, a general incentive entitlement and more transparency would therefore be helpful.

102. In addition, individuals' payments to government-incentivised pension provision, if applicable provided in a lump sum through an allowance, **should be exempted from deduction from the means-tested minimum pension**. Finally, a non-government standard product could be conducive to higher take-up. Since uninterrupted periods of employment are the best form of protection against pension gaps in old age, low unemployment is the best remedy for old-age poverty.

V. OUTLOOK: TIME FOR REFORMS

103. The positive economic development offers a chance to conduct efficiency enhancing structural reforms which lay the groundwork for lasting welfare improvements. Now is the **time for reforms** that boost the potential growth of the German economy, help in meeting the challenges of demographic change, globalisation and digitisation, and reinforce stability and economic strength in Europe. Instead of resting on the laurels of past reforms such as the Agenda 2010, or even diluting them, politicians should act decisively to implement necessary reforms.

104. In **Europe,** the allocation of tasks between national and European levels should adhere to the principle of subsidiarity. More integration is desirable in areas such as climate and asylum policy and internal security, but not fiscal, labour market and social policy. Promoting free trade, shaping climate policy and strengthening the stability of the euro area are key European projects that should be vigorously pursued.

In **Germany,** economic policy should focus more on securing the German economy’s competitive standing and future viability. To achieve this, the growth-friendly consolidation of state finances remains an important element. Tax policy, the structure of social security systems and regulation in the service sector offer further potential for reform. In order to counter entrenched long-term unemployment and improve income and wealth mobility, the flexibility of the labour market must be maintained and equal opportunities made a priority.

A differing opinion

105. One member of the Council, Peter Bofinger, holds a different opinion with respect to the economic policy reform proposals for Germany and Europe presented by the majority of the Council members in this chapter.

106. The majority asserts the government has a "**disappointing reform track record**". The government should have aimed much more at strengthening market forces and promoting structural change through suitable reforms. The governments decisions would erode the basis for future welfare gains to the detriment of future generations. This conclusion is consistent with the majority's finding of 2013 that "backward-looking economic policy" would threaten to ruin the reform steps that Germany had made.

107. This criticism stands in contrast with the overall **economic development from 2014 to 2017**. Measured by the objectives that are expressed in the Act on the Appointment of a Council of Experts on Economic Development, the current legislative period has to be evaluated as very positive:

- The forecast of average **economic growth** for the period from 2014 to 2017 is 1.7 % and thus expected to be higher than potential growth as well as the average growth rates for 2000 to 2013 and 2005 to 2013. ↘ CHART 5 Even productivity growth, which slowed significantly during the past decade, grew slightly.
- The **number of people in employment** is expected to increase by an average of 1 % per year in the period from 2014 to 2017, thus increasing significantly more sharply than in the reference periods. No negative effect from the minimum wage can be observed.
- The price development shows no **inflationary tensions**. ↘ CHART 5
- Extraordinary is just the enormous **current account surplus**, which indicates a substantial divergence between aggregate supply and aggregate demand in Germany. However, the majority does not identify this as a problem for the overall economy.

According to existing forecasts (Projekt Gemeinschaftsdiagnose, 2016) for 2018, this positive picture will not change fundamentally in and even **beyond 2017**.

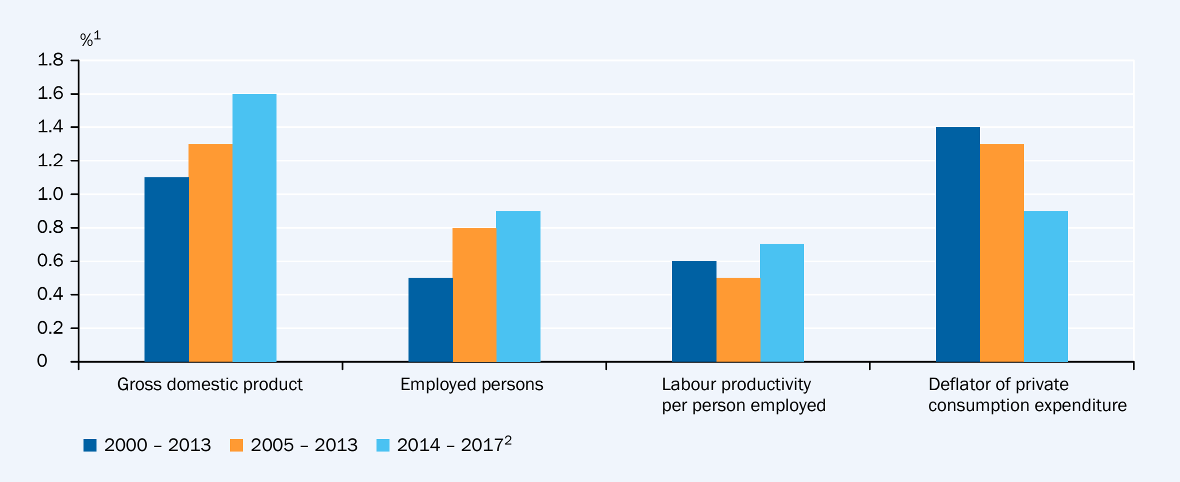
108. The **ECB's expansionary monetary policy** made an important contribution to these positive developments. ↘ ITEM 203 FF. However, the majority of Council members criticises the policy strongly. They regard it as "**inappropriate**", not just for Germany, but also for the entire euro area. ↘ ITEM 374 FF. The returning growth dynamic in the euro area, which was not least due to the abandonment of the consolidation course of 2011 to 2013, was also beneficial for the German economy. The majority also takes a critical view of this.

109. With a German economic policy and an European monetary policy that are seen as inappropriate by the majority of the Council members, it was still possible an-

yhow to increase employment by **more than one million jobs in Germany** and to reduce the number of unemployed people in the euro area by three million. This is in clear contrast to the tight consolidation policy at the start of this decade and the ECB's monetary policy under the former ECB president Trichet, which was initially very conservative by international standards.

↘ CHART 5

Economic development in Germany over time



1 – Average annual change. 2 – Forecast of the German Council of Economic Experts for 2016 and 2017.

Source: Federal Statistical Office

110. As in previous years, the majority of Council members argues in favour of an economic policy framework that aims to strengthen market forces and promote structural change through suitable reforms. With respect to the suggested measures it is questionable if the gains from stronger market orientation will prevail over the disadvantages of a correspondingly weaker position of the government.

- **Promoting free trade**, particularly through CETA and TTIP, will lead to the creation of special courts for various groups, which are neither legally grounded nor necessary (Deutscher Richterbund, 2016). The question is whether reducing welfare-decreasing biases, such as different product norms, and the potentially resulting welfare gain justifies the corresponding reduction of protection norms.
- An **insolvency regime** for the euro area and the phase-out of regulatory privileges of public debt on banks' balance sheets, as called for by the majority, are supposed to increase market discipline. However, this could lead to an existential threat to the stability of the euro area during periods of economic weakness (GCEE Annual Report 2015 items 95 ff.; GCEE Special Report 2015 items 112 ff.). The experience during the euro crisis in 2010 to 2012 showed that financial markets tend towards self-destructing spirals, which can only be stopped by an courageous intervention of the central bank.
- By forgoing credit financed public investments, as called for by the majority, the government looses the possibility to use the particularly fa-

vourable zero interest rate environment for investments in infrastructure, education as well as research and development. Such investments would increase demand on capital markets and thus contribute to higher long-term interest rates. The current setting weakens the basis for future welfare gains to the disadvantage of future generations.

– **A tax cut for companies** in the specific form of an asymmetric negative wealth tax (GCEE Annual Report 2015 items 813 ff.), which is called for by the majority of Council members under the term "allowance for corporate equity", would take financial ressources away from the government without guaranteeing higher investment activity as a consequence. After the massive reduction of corporate taxes in 2009, investments as a share of GDP are on a historically very low level.

– By **abolition of the "Renewable Energy Act"** the government would lose the opportunity to promote investment in renewable energy and make an important contribution to reducing the cost of such a form of energy production. As those national efforts are accounted for when setting the targets of the European emissons trading system, the inconsistency of the two instruments as noted by the majority does not occur. ↘ ITEM 908 FF.

– Retaining the **incentivisation of occupational pension provision** in the form of exemption from social security contributions drains contributions from the already strained statutory pension scheme. Furthermore, it is a problem that the implied return in the statutory pension scheme is currently significantly higher than the implied return for German government bonds on the capital market. Supporting occupational pension schemes at the expense of the statutory pension scheme would worsen the position of the insured. ↘ ITEM 670 FF.

– The call of the majority for compulsory pension insurance to be established for **the self-employed not previously covered by social security**, but not through the statutory pension scheme, would also have a detrimental effect on the statutory pension scheme and its insured. The profits earned at the introduction of the compulsory insurance would financially strengthen the statutory pension scheme system for decades and thus enable a higher pension level with lower contributions.

111. The majority of the Council members generally advises to have "greater trust in market processes in order to enable social participation not by way of redistribution further down the line, but by allowing broad-based participation in economic success in the first place." "Participation in prosperity should be enabled primarily by giving individuals the chance to take part in the economic process. This is why efforts should focus on employment growth."

112. Broad **participation in society's increased prosperity** however is not automatically guaranteed. For example, the prosperity of the overall economy in Germany, as measured by gross domestic product per capita, rose by 29 % in real terms from 1991 to 2013. Median household income (households with at least one member in the labour force), by contrast, increased by only 8 %. The trend

at the lower end of the income distribution is particularly problematic. Incomes fell by 10 % and 4 % respectively in the 1st and 2nd deciles. **Incomes stagnated up to the 3rd decile**. The bottom 20 % did not even see an improvement in their income situation by 2013 compared to the economic recession year of 2005 with more than 5 million unemployed.

113. If globalisation leads to a larger proportion of households no longer being able to participate in the general rise in prosperity for a whole generation, and they at the same time face greater uncertainty regarding their jobs and social security, it is not surprising that the **consensus for open markets** is disappearing worldwide. This can be observed in **Germany** on the basis of a recent analysis of attitudes of the supporters of different parties (Köcher, 2016). Supporters of Alternative for Germany (AfD) consider themselves particularly detached from the development of society's prosperity. At the same time the majority of them – in contrast to the supporters of other parties – take the view that leaving the EU would be more advantageous for Germany than EU membership. For the **United Kingdom**, a similar finding can be shown (Zoega, 2016; ↘ BOX 8).

114. For the EU to succeed in "achieving widely recognisable gains of prosperity", as called for by the majority, an agenda based solely on strengthening market forces seems to be wrong headed. Instead, it runs the risk to erode the consensus for open markets even further.

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