Germany Monitor

— At first glance Europe looks like the big winner in the coalition agreement. The coalition commits to a more proactive policy course alongside France including the transformation of the ESM and preparedness to spend more money on Europe. However, in large parts, the chapter on Europe allows for different interpretations and the red lines of the coalition – internally, i.e. among the coalition partners, and externally, i.e. vis-à-vis the EU partners - will likely emerge only over time when negotiating concrete designs.

— The pro-cyclical fiscal policy lacks focus. To accommodate all their pet projects, the three parties have produced a potpourri of measures which do not add up to a consistent future oriented policy in our view. Instead, the likely coalition risks to overstretch the fiscal leeway of some EUR 46 bn. The current goldilocks situation with low interest and high growth rates does not allow for longer-term spending obligations in social and pension policy. Demographic trends and the structural changes related to digitalisation and global competition do instead require careful resource management to strengthen Germany’s economic and fiscal sustainability.

— Infrastructure investment high on the agenda. The coalition will spend about EUR 18 bn on education and digitalisation over the next term. The bulk of the funds to finance this initiative (EUR 12 bn) shall be generated from revenues from the allocation of UMTS and 5G licenses. In addition government funds in the total amount of EUR 16 bn are earmarked for investments in housing construction, transportation and refugee integration. Additional pension benefits could amount to about EUR 3.5 bn p.a. initially, but the costs will be much higher in the medium and longer term.

— Disconnect between fiscal and economic policy. Higher investment in education and (digital) infrastructure is a precondition to master the structural challenges ahead. But ever more regulation in the labour market (but also in housing) will likely severely curtail productivity gains.

— Biased tax policy. Despite surging tax revenues, general tax cuts amount to about EUR 18 bn only, and fail to provide relief across the board. While families as well as low- and middle-income earners will benefit substantially, (single) higher-income earners and, in principle, corporate Germany, too, are left out in the cold.

— Political reality does not follow coalition agreements. This grand coalition will need to show its capacity to govern not only in implementing the agreement but also beyond. It might become difficult for Merkel to manage a government with key portfolios held by SPD members or the defiant former CSU boss Seehofer. Centrifugal forces could erupt this year already in the run-up to two important state elections, if Groko parties fear suffering further losses through opposition parties on both sides of the political spectrum.

Groko coalition treaty
More spending than strategy
SPD members likely to accept the draft coalition treaty

As expected, CDU/CSU and SPD have struck a coalition agreement. This brings the four-month deadlock following the inconclusive German federal elections closer to its end. The last hurdle to Merkel’s re-election is now the SPD membership ballot. It will start in the next few days and take until early March, as 463,700 members will vote by mail only after the SPD has provided all of them with a hard copy of the draft coalition treaty.

The ballot is still a major hurdle on the way to a renewed Groko, given the widespread reservation among the SPD. The SPD leadership team will campaign decidedly for the intended coalition and they indeed have something to offer. While the CDU/CSU has largely watered down the implementation of some of the SPD’s heartfelt wishes, like a merger of the private and the public health care insurance schemes, the coalition treaty bears the SPD’s imprint, most visibly in the increased government spending. The SPD can also claim victory regarding the cabinet reshuffle (see below). In addition, the SPD members should be aware of the consequences of a veto, namely a severe SPD leadership crisis and snap elections. The latter would most likely erode the SPD’s role further. In the latest surveys the SPD has lost further compared to the already relatively poor result in the past federal election.

We therefore expect the SPD members to agree to the coalition treaty, albeit with a thin majority. Thus, in a reasonable timeline, Angela Merkel’s re-election as Chancellor could be scheduled for early- or mid-March, at the latest – i.e. before the next meeting of the European Council on March 22 to 23. Still SPD members might not see the party’s stronger representation at the cabinet table as sufficient compensation for the CDU/CSU’s only lukewarm accommodation of the amendments requested at the SPD’s latest party convention.

Draft coalition treaty without major surprises

By and large the draft coalition treaty is just a lengthy, more detailed version of the paper presented as result of the exploratory talks. The three parties now present their ideas and projects in 14 chapters on some 170 pages. After a short preamble the treaty starts with a chapter on Europe followed by statements on the major projects to create “new dynamics for Germany”. The last chapter deals with the distribution of cabinet posts amongst the three parties.

SPD takes over Ministry of Finance

While the number of posts remains unchanged (CDU 5 ministers + Chancellery), the CSU 3 and the SPD 6) the distribution of portfolios is quite a surprise. Probably as concession to the sceptics within the party, the SPD will hold major portfolios in the new cabinet, namely the Foreign Office, the Ministry of Labour and Social Affairs and most important the Ministry of Finance. The Finance Minister has an outstanding position in the cabinet. All the government’s budget relevant projects have to pass his office. Given his role as a member of the Eurogroup and the ECOFIN which prepare and partly decide on euro area and EU reforms, he can markedly shape Germany’s stance on European policy. Albeit these are important competences, it should not be overlooked, however, that according to the German basic law, it is the Chancellor’s power to set all policy guidelines. Especially with regard to European policy, traditionally and even more in Merkel’s past terms, the Chancellery has been the centre of power.
In contrast to speculations in the media about a postponement until the end of the SPD membership ballot, the three parties have also published the full list of the cabinet members. Here the nomination of Olaf Scholz (SPD), at present Governing Mayor of Hamburg dominates the headlines. Mr Scholz belongs to the parties’ moderate, centre wing. As a Finance Minister Scholz is likely to pursue a pragmatic approach, like his party mate Steinbrück, the Finance Minister in Merkel’s first Groko. Martin Schulz will take the Foreign Office. Surprisingly, he announced to resign as the SPD party leader in favour of Andrea Nahles, the SPD party whip in the Bundestag who will become the party's most powerful person.

Also, in contrast to speculations, the CDU’s cabinet member list does hardly offer a hint to a solution for the “Chancellor Merkel’s successor” conundrum. Ursula von der Leyen will remain Defence Minister and Peter Altmaier, at present head of the Chancellery and temporarily Finance Minister will become Minister for Economic Affairs and Energy. The outgoing Bavarian Prime Minister and CSU leader, Horst Seehofer, one of the most outspoken critics of Chancellor Merkel’s once liberal asylum policy, will join the cabinet as Interior, Construction and Homeland Minister and represent the CDU/CSU’s traditional conservative camp.

European policy – a paradigm change?

SPD leader Martin Schulz has underlined that European policy will take centre stage in the work of the new government. The Groko devoted the first chapter of the agreement to the EU (5 out of some 170 pages). As hoped by Germany’s partners, Europe looks like the big winner of a grand coalition government especially compared to a potential Jamaica coalition. But in large parts, the chapter is sufficiently vague so that one can read whatever one wants into it and is more a declaration of intent than a commitment. The European focus – a pet project of Schulz - will not make the Groko agreement an easier sell to the party basis. Europe is no vote winner in Germany. Further, most Germans do not share the view that the euro is still in a vulnerable situation and the euro area requires further stabilisation measures, especially given their concerns that they will end up picking the tab. In the regular monthly survey on the most pressing political issues for Germans, the topic of reforming the euro area does not register (Forschungsgruppe Wahlen: ZDF Politbarometer).

However, the wording in the coalition treaty together with the allocation of the Foreign Office and the Finance Ministry to the SPD can be seen as an indication of some change of minds. While (euro) crisis management has dominated the last years, not least under the grand coalition 2005-2009, the next government emphasises its will to join with France in providing a fresh start for Europe and improve the resilience of the euro area. The benign economic environment and the favourable European election calendar with less national elections ahead should help to take decisions on EU-level. The coalition parties CDU/CSU and SPD are signalling that Germany is prepared to constructively contribute to compromises on the various challenges ahead. While the positive language will be welcomed in European quarters, the devil will be in the detail when it comes to balancing the priorities.

Compared to other policy chapters, the coalition agreement does not add much more substance to the E(M)U policy part than had been laid down in the sounding paper a week ago. The coalition partners commit themselves to reform the euro area in close partnership with France. They want to advance fiscal control and economic cooperation in the euro area and review the presented proposals accordingly. None of the usual – controversial – catchwords in this context, e.g. an EA budget or finance minister, are mentioned, though. Instead, the coalition agreement clarifies that the Stability and Growth Pact will remain
the guiding principle and that stability and growth have to be seen as complementary.

The coalition parties call for a transformation of the European Stability Mechanism (ESM) into a European Monetary Fund (EMF). They state the preference that this body should be subject to parliamentary control and included into Union law which reflects the proposal put forward by the EU Commission but it appears to be a clear divergence from the German position under former FM Schäuble. This succinct sentence leaves a number of questions open, though. So far, the ESM is an intergovernmental institution run by the finance ministers of the euro area members (Germany has a capital share of 27% which gives it a veto position) with national parliaments having a say over bail-out programmes and distribution of respective tranches (see table).

Would anchoring in the union law imply that the EU Commission takes the decisions on granting loans to member states and secure conditionality? Or would it rather mean that the director of the ESM/EMF will be accountable to the EP – comparable to the arrangements for the ECB president – and the Bundestag keeps its control rights? But a transfer into union law technically only makes sense if the decision making procedures in the ESM/EMF will be changed significantly. And how could this be in compliance with the ruling of the German Constitutional Court? After all, the highest German court ruled on the ESM in 2014 that the Bundestag cannot approve a guarantee or transfer automatism on which it has no control anymore. Merkel faced critical questions by her party fellows in this regard and stated that a future EMF will not become “an agency” of the EU Commission and that control rights of the Bundestag “will not be touched” (FAZ 02.02.2018). This debate was not least triggered by Otmar Issing, the former chief economist of the ECB, who published a very critical assessment of the coalition’s plans on euro area reforms (FAZ 26 January 2018). The concerns did not go down unheard: In contrast to the sounding paper, the coalition agreement clarifies that the rights of the parliament remain unaffected by the envisaged transformation of the ESM. In any case, while it might make economical sense to have a broader constructed EMF for the euro area, its design remains crucial to avoid moral hazard and procrastination of national reform.

Implementing broader Banking Union remains a long term commitment

Banking union does not appear in the chapter even though it forms a major pillar in efforts to make the EA more resilient. At the most recent EcoFin meeting, the German caretaker finance minister Peter Altmaier (CDU) adopted a more conciliatory tone on the contentious issue of a common European deposit insurance (EDIS) and did not rule out that the EU could decide on a (medium) roadmap on implementing EDIS. However, he stressed that the German

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Source: ESM

1 Average annual payment appropriations under MFF 2014-2020
position has not changed in substance and that a significant risk reduction remains a precondition for an agreement. Often quoted as criteria for assessing risks in the banking sector are the level of NPLs and sovereign concentration in banks’ balance sheets, a convergence of insolvency regimes and certain bail-in buffer (MREL) for banks. It seems less likely that the would-be SPD finance minister Olaf Scholz will embark on a significantly different course.

Preparedness to spend more money on Europe

Beyond that, the coalition parties are explicitly prepared to spent more money on Europe. To a certain extent this is stating the obvious given the need for partial compensation of Brexit related revenue losses (UK being the second largest net contributor to the EU budget) or stronger efforts in defense and external border management resp. migration policy but weakens the chances of a significant reform of the EU budget structure. The parties also back specific budgetary means for economic stabilisation and social convergence as well as the support for structural reforms in the EA that could form the nucleus for an investment budget for the EA. This relates to the demands by the French President for a better absorption of asymmetric shocks but also to earlier German proposals for so-called partnership contracts (2013) that could provide fiscal incentives for structural reforms.

The EU Commission has already announced that its proposal for the next Multi Annual Framework 2021-2027 will likely exhaust the legal ceiling for the EU budget of 1.2% of EU-GNI (compared to currently 1% of GNI). With the UK leaving the EU, this would result in an increase to EUR 150 bn p.a. versus EUR 147 bn currently. While this does not appear to be much it needs to be born in mind that the post-Brexit budget has to be financed without the EU’s second largest economy (see chart). Keeping the budget at 1% of EU27 GNI (i.e. without UK) would lead to a substantial drop of the EU’s budget to EUR 123 bn annually. But it can be assumed that there have been supporting signals from Berlin for raising the budget towards the 1.2% ceiling beforehand. The rise in (gross) contributions to the EU, however, is not accounted for in the budgetary planning of the new government. Following Brexit, we estimate the German share in EU members’ national gross budget contributions to rise from currently around 21% to 25% which might sum up to additional spending of around EUR 7bn towards the end of the grand coalition’s term.

Overall, the proposals on European politics are rather far-fetching but at the same time inconsistent. While the coalition strives for a Europe of competitiveness and investment it calls for a common framework for minimum wages and basis national security benefits as well as minimum corporate tax rate and the implementation of the financial transaction tax. While the coalition commits to the inextricable link between risk and accountability some of the proposals raise concerns over this principle being observed consequently. The EU Commission and the EU President expects the European Council meeting in June to take decisions on EA reforms – not much time left for the new government to make up its mind and convince a broad majority of MPs of its respective European policy course.

Myopic pro-cyclical fiscal policy ignoring demographic challenges

Fiscal and tax policy which is supposed to demonstrate a new government’s vision reflect the three parties’ lack of common values and orientation. Instead the endeavour to accommodate the three parties’ pet projects has resulted in a potpourri of measures which besides serving clientele interests might address

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2 Average annual payment appropriations under MFF 2014-2020
some of Germany's problems but do not add up to a consistent future oriented policy, in our view. Thus, we see the fiscal policy stance as behind the curve, the intensified social spending lacks sustainability, tax policy is half-hearted and the whole approach shows a paternalistic attitude and unease with regard to market solutions.

Despite stable, broad-based economic growth, the fiscal policy stance will remain expansive and thus pro-cyclical. The federal government's additional spending and tax reductions will add up to about EUR 46 bn in the current term 2018 to 2021. This would by and large equate to the government's fiscal leeway in the total estimated amount of about EUR 46 bn without providing reserves for presumably higher payments to the EU and possible financial obligations from extended subsidies to the public pension and the statutory health insurance schemes.

In a fair weather scenario the new government will be able to proceed without taking on new (net) debt and thus to stick to its (especially the CDU's) respective goal. But ignoring major budget risks is problematic. The current benign environment with low interest and high growth rates by nature does not allow for longer-term spending obligations in social and pension policy. Demographic trends and the structural changes related to digitalisation and global competition would require careful resource management to keep the German economy on track.

Although subject to a high degree of (policy) uncertainty, we expect the fiscal surplus to decline from a record high 1.2% of GDP in 2017 (Maastricht definition) to below 1% of GDP in 2018/19 due to an increasing pro-cyclical fiscal policy. This notwithstanding, the government-debt-to-GDP ratio should fall further rapidly, from an estimated 64.4% in 2017 to clearly below 60% by 2019, primarily due to solid economic growth.

The resulting fiscal impulse has been largely discounted in our 2.3% GDP forecast for this year. The lengthy government formation will probably shift the implementation more into 2019 than we initially expected, i.e. potential upside risks could be more relevant with regard to our 2019 forecast (1.8%). However, given scarcity of resources in particular in the construction sector and the potential windfall gains likely to result from many of the planned subsidies, a substantial part of the impulse could end up in higher prices.

EUR 18 bn for digitalisation and education

The new Groko aims at “stability and social cohesion as well as innovation and security” in Germany via intensified public spending on education, infrastructure and on social security. Government funds of about EUR 22 bn are earmarked for investments in education, R&D, housing construction, transportation and for extended subsidies for regional and municipal agencies, e.g. for refugee integration. The improvement of the digital infrastructure ranks high on the agenda, too. The Groko intends to spend about EUR 12 bn on this headline project, primarily for the establishment of comprehensive region-wide broadband networks, and also including EUR 3.5 bn for better digital equipment in schools. The respective funds shall be generated outside the budget from revenues from the allocation of mobile communication (UMTS and 5G) licenses.

Tax policy: corporate Germany left out in the cold

Especially, the tax policy lacks ambition in our view. Despite surging tax revenues (2013 to 2017: +18.5% in total; 2017 to 2021: 17% or EUR 93.6 bn in total to EUR 858 bn under present law, according to official estimates), planned
general tax cuts amount to about EUR 18 bn only (without the measures to tax incentivize private investment in housing construction, R&D and digitalisation). Furthermore, there is a marked bias in the allocation of the tax cuts. While families as well as low- and middle-income earners will benefit substantially, (single) higher earners and, in principle, corporate Germany, too, are left out in the cold. Increased family benefits (child benefit, child allowance) will amount to EUR 8 bn. The first step of the abolishment of the solidarity surcharge (soli) shall reduce the tax burden by EUR 10 bn (in total 2020 and 2021). However, this measure is again focused on middle-class taxpayers, as only 90% of all taxpayers shall benefit. People in the top decile are more or less excluded in the first step, albeit they have to pay the bulk (about 55%) of the income tax. Thus, while the head of single earner family with two children who has a (gross wage or salary) income of EUR 108,000 p.a. can look forward to a EUR 1,951 reduction of his tax bill, a single with the same income can only expect EUR 293.

In contrast to the CDU/CSU’s election campaign promise not to raise taxes, the 25% flat-rate withholding tax on interest income shall be abolished so that the respective earnings will be subject to the (individual) income tax. However, the flat-rate withholding tax on dividends and on realised capital gains will not be affected. Nevertheless, a thorough and systematic reduction of the tax burden would look different.

Above all a sensible correction of the disincentives resulting from the strongly increasing marginal income tax rates in the lower- and middle-income brackets is missing. Instead the Groko’s half-hearted Soli abolishment adds to the problem in our view. Taxpayers with higher income (in the bracket of about EUR 61,000 to 76,000, according to the FAZ) will receive increasingly less tax relief, only. This means that in the respective bracket the marginal tax rate (at present 44.3% including the soli) will jump up to up to 50.5%. These shortcomings are all the more problematic as for many partnerships the income tax is a major element of company taxation.

Corporate taxation, in general, is proof of the Groko’s tax policy’s inadequacy. While President Trump’s reform started a new round in the international competition for corporate investment, the draft coalition treaty does not provide for systematic tax relief to strengthen Germany as location for private (real capital) investment. Of course, the enhanced tax incentives for corporate investment in digitalisation and for intensified R&D spending in SMEs are a glimmer of light. A thorough corporate tax reform including a deregulation of complicated rules as well as a reform of the local business tax is still to come. The French-German initiative for harmonisation of the tax base (see above) could be a step in the right direction.

Labour market policy: more instead of less regulation

While the buzzword digitalisation seems to be omnipresent in the draft treaty sensible labour market policy measures to cope with the challenges from this technological revolution are rare. Instead the new Groko continues to tighten labour market regulation, a trend which started in the last Groko. Albeit high-profile projects similar to the introduction of the minimum wage in 2015 are not on the new agenda, this trend is counterproductive, as employers and employees need more flexibility to adapt to the structural changes. Instead the Groko will not relax the restrictions on the daily working time (usually 8 h, max. 10h (if compensation is granted), after-work resting time 11h). At least unions and employers will have the right to introduce more flexibility with regard to the maximum weekly working hours. Furthermore employees will be granted the right to temporarily switch to part-time work. This rule which, in general, shall
apply to enterprises with more than 45 employees will make the respective companies' personnel planning more difficult and probably more expensive.

Against warnings from business associations the parties agreed on additional restrictions on fixed-term contracts. While the CDU/CSU has rejected the SPD’s demand to abolish the rule that (new) employment contracts can be limited to up to two years without a material reason, the three parties agreed on bureaucratic measures aiming at reducing the number of such contracts. Especially, the new government will prevent that individual employees will have to accept a longer series of temp contracts.

The prospective law on the immigration of qualified labour seems to be a sensible project. But the draft treaty does not specify the new rules that shall be oriented on the German economy’s demand, instead it solely stipulates that the law will consistently and transparently combine the rules already existing and provide for more efficiency where necessary.

The federal labour agency’s funds for the labour market integration of long-term unemployed shall be increased by EUR 4 bn in total in the years 2018 to 2021. This demonstrates that a new Groko’s policy will count on paternalistic approaches instead of market-oriented solutions.

### Increased benefits undermine the pension schemes' sustainability

Social policy projects demonstrate the Groko’s propensity to spend generously. Ignoring the demographic challenges the three parties have agreed on extended pension benefits which unrealistically presuppose lasting dynamic economic growth. This is especially true for the stabilisation of the replacement rate at present level of 48% (of the average wage and salary income per capita) until 2025. In fact, in a fine weather scenario the replacement rate will remain at this level until 2024, anyway. Once the number of workers who have to pay the pensions will decline, however, this measure’s costs will increase markedly, as at present the replacement rate is inversely tied to the old-age dependency ratio (pensioners/workers-ratio), among others. Therefore, under the new regime, pension policy will be in for a shock in about 8 to 10 years when more and more baby boomers will retire (and thus the ratio will probably rise dramatically).

The financial burden from the extended pension for mother with more than 3 children born before 1992 is already clear, namely EUR 3.4 bn p.a. (in 2019). The new supplementary (minimum) pension for low-wage earner who have contributed to the scheme for at least 35 years will cost only EUR 0.1 bn initially. In contrast to the shrinking costs of the additional benefits for elderly mothers, the costs of the latter measure will increase substantially over time. For the time being the bulk of the additional expenditure will primarily be financed from the scheme’s reserves, thus preventing possible further reduction of the contribution rate.

Employers shall pay higher contributions to the public health insurance (so that they would have to pay the same contributions as the employees). While this will reduce the employees’ payroll tax (by EUR about 7 bn, as of 2018) it will burden the employers and the public pension scheme (contributions for pensioners) with about EUR 5.6 bn and EUR 1.3 bn, respectively.

Employees as well as employers will obviously welcome the reduction of the contribution to the public unemployment insurance from 3% to 2.7% which will reduce the payroll tax burden for each of the two groups by about EUR 0.7 bn p.a. This lends – at least in the short term – some credence to the Groko’s stipulation to keep the total rate of contributions to all social insurance schemes (at present 39.75%) below the 40% threshold. While under present economic conditions it will be easy to fulfil this declaration it will be a challenge in case of
slower growth and/or more unfavourable demographic conditions, i.e. in the next terms.

Asylum policy in line with CSU requests
The number of newly arriving refugees shall be kept in the range of 180,000 to 220,000 per year as the CDU and the CSU has requested. The right for family unification for migrants with the status of subsidiary protection will remain restricted. This CDU/CSU request was very much debated in the talks for a Jamaica coalition as the Greens were strongly opposed to such restrictions. The compromise will make life easier for the CSU which is heading towards state elections in Bavaria in autumn. In addition, the next government will establish new rules for the immigration of qualified labour from third countries outside the EU to enhance Germany’s attractiveness in the global completion for talents.

No answer to the challenges ahead
This coalition feels to us like an uninspired arrangement of one party where “ownership” of the chancellery is the number one priority for which if push comes to shove everything else can be sacrificed, while the other party just does not have the heart to quit as earlier promised. Still, the widespread perception that the SPD – if the treaty gets the approval from its members – has been the winner in this tug-of-war is probably correct, as is evident by the distribution of the portfolios. Higher expenditures on infrastructure and education are certainly overdue. But most of the good deeds confirm the increasingly paternalistic policy approach of both parties, with increasing regulation on the labour market watering down the potential positive effects of more public investment. Self-responsibility and self-initiative, the cornerstones of “Soziale Marktwirtschaft”, hardly play a role in the Groko’s plans for Germany in our view. Given the massive challenges from globalisation, digitisation and demography such an ever expanding role of a redistributive state, fostering the illusion that the cosy status-quo can be maintained or that any adjustments lie in the government’s responsibility, is hardly the right way to go.

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