Coalition treaty – myopic policy approach

From the start, the negotiations were ill-fated. To begin with, the SPD leadership rejected a revival of the grand coalition (Groko). Then, the partly diametrically opposed interests of the parties involved, seemingly abundant financial scope and a lack of interest in fundamental reforms on the part of the German population led to a – in many areas – mixed bag of measures which, on balance, aims to further increase governmental control of the business sector and society at the expense of individual freedom.

In this respect, the European course of the government also lacks consistency. Competitiveness and growth forces shall be strengthened, whilst, at the same time, a framework for minimum wage regulations and national basic income is to be created and minimum rates for corporate taxes shall be introduced. In addition, when it comes to important proposals such as the transformation of the ESM into an EMF and the push for “fiscal control and economic cooperation” key details are left open.

Social policy is again geared towards the “all-risks-insured mentality” of the German citizens. Here, the trend of tighter labour market regulation is continued which was kicked off by the outgoing Groko, even though the demographic challenges and digitisation call for greater flexibility. Major social policy projects will – at least partly – reverse the reforms of the past decade, which were aimed at making the system more sustainable. Again, as under the previous grand coalition government, the younger generation will therefore be among the losers in this area.

The doubtlessly pressing investment programmes in the areas of education, research & development and digitisation are aimed at putting Germany on a solid footing in the future. This takes more than government funds, though, namely a sufficient degree of confidence in private initiative as well as entrepreneurial freedom.

The next government enjoys fiscal scope for the time being. However, it will be used for spending programmes rather than systematic tax cuts – in line with the paternalistic state concept of the grand coalition partners. Once interest rates and economy start to normalise, though, the federal budget ought to immediately slip back into negative territory.

At present, the predominant feeling is relief that Germany now has a “decent” government. But not only the coalition partners may soon wonder whether the price is too high. Speculations about an early end of the Groko have already started, particularly because the partners are likely to position themselves well in advance for the post-Merkel era. After all, there are enough breaking points.
Waiting for the renewal of the market economy

The positive SPD membership ballot has finally paved the way for the third grand coalition under Chancellor Merkel. For now, it looks set to be the last of its kind – not only because the post-Merkel discussion has already started within the CDU and the SPD sees its survival at risk in this constellation, but because the CDU/CSU and SPD might soon lose the structural majority in the new German party landscape. Economically and politically, the coalition partners are hence embarking on the legislative period that is crucial for shaping the future of Germany, its economy and society with a broad parliamentary majority. The negotiated coalition treaty specifies action – albeit in different contexts – which should address future-oriented policies: digital transformation, the – in „political, economic, and military terms“ – fundamentally changed global balance of power, the essential modernisation of the EU, skilled labour supply, migration and integration as well as climate and environment. Is the negotiated coalition treaty really living up to the partners’ own expectations? We do not think so, not least because content-related conflicts between the coalition partners about the adequate policy paths were often passed on to commissions for further examination. Depending on the policy area (see below), our fundamentally sceptical view of the coalition treaty is, of course, more nuanced.

In the face of robust growth and buoyant tax receipts, the new government programme focuses on the distribution of funds, without taking into account the sustainability of public finances. As a result, the public budgets are characterised by a lack of economic prioritisation, by means of which less important projects could be curtailed or policy failures might be corrected. New goody bags for today’s generation of retirees, whilst the tax regime continues to dig deep into the pockets of workers and businesses, are just one example. Urgently needed public investments in education and infrastructure shall be put into practice, but structural reforms of the encrusted goods and services markets are missing. Germany shall become “a global leader for digital infrastructure”, but greater labour market flexibility owing to the Agenda 2010 – a key reason for the current top performance of the German economy and condition sine qua non for the discovery of the new digital jobs – is to be reversed. Stricter rules and higher costs for businesses counteract enhanced support of innovation and research. Climate and energy policy is an example of where a planned economy approach is prevailing. But instead of shifting the focus to efficient, market-based elements, the partners agreed on even more ambitious targets.

Just as the coalition treaty in general is rooted in the spirit of a paternalistic redistribution government, which gives its citizens the illusion that the state is aware of all future challenges and able to organise the necessary adjustments, ideally without contesting the status quo. As a result, the allocation of roles between government and market is increasingly digressing from the ideas of the social market economy, which laid the ground for prosperity in Germany and rests on a liberal regime, competition, individual responsibility, a high employment level and socio-political measures based on the subsidiarity principle. The new government, however, has its own unique definition of social market economy, as a passage in the coalition treaty illustrates: “Social market economy, which is based on corporate responsibility, social partnership, workers’ participation and the fair distribution of generated prosperity, needs a renaissance, particularly in the era of digitisation.“ (coalition treaty of the CDU, CSU and SPD, February 2018, p.7).
The feeling of unease at the almost complete loss of a regulatory (“ordnungspolitischen”) policy compass seems to have increased, at least within the CDU. At its party convention in late February, the CDU decided to kick off a comprehensive discussion process, hosted by the recently elected Secretary General Annegret Kramp-Karrenbauer, to prepare a new manifesto in time for the next federal election. The renewal of the social market economy, along with the question as to how its future can be secured, shall take centre stage. By then, however, it might be too late to secure the attractiveness of Germany as a competitive business site and to strengthen growth forces beyond the cyclical component.

Which Europe do you prefer?

The allocation of roles between the government and the market should also be taken into account when discussing the necessary adjustments to the Brexit in the EU and the evolution of the EU-27. Centralisation and more bureaucratic control versus subsidiarity and competition would be the relevant catchwords in this context. Given that the remoteness and the democratic deficits of the EU are the subject of increasing criticism, a fundamental debate would appear reasonable, even though the EU and the euro are key drivers of prosperity growth in Germany. In the election campaign and with respect to the positioning of the three parties, however, European policy did not play a major role. Later on, in the exploratory paper and, subsequently, the coalition treaty, the prominent first chapter (5 of some 180 pages) was devoted to the European issue, which above all reflects the prioritisation of Martin Schulz, then SPD Chairman and formerly President of the European Parliament. Urgent calls from Germany’s European partners, particularly France and Italy, for further euro zone integration, as well as the instruments proposed are a matter of dispute among the broad electorate in Germany (and the economic scene). Instead, concerns are that the further integration of the euro zone will ensue rising financial risks and sovereignty losses for Germany, and more risk sharing is expected to result in moral hazard and procrastination of reforms rather than stabilisation and fiscal discipline in the euro zone. These fears are not dispelled by the coalition treaty, not least because key details are left open when it comes to important proposals such as the transformation of the ESM\(^1\) into an EMF and the push for “fiscal control and economic cooperation”. And as regards the dossier on the banking and capital markets union, the new government has not laid out any position at all, an indication of the difficulties to take the necessary decisions, even though their implementation is an important pillar for enhancing the stability of the euro zone – for the capital market union, this holds all the more because of the Brexit and its consequences for EU financial markets. A grand coalition with a broad parliamentary majority should join forces to tackle this challenging issue.

Generally, commitments in the coalition treaty would have inappropriately limited Germany’s room to negotiate on the EU level. On some points, the government is clear, though. Thus, for instance, the coalition partners are prepared to pay higher contributions to the EU budget, a priori reducing pressure to adjust volumes and allocations of funds under the 2021-2027 EU budget to a new environment (exit of the UK, the second-largest net contributor) and re-prioritisation (including expansion of the border regime, more money for migration, defence, innovation and research). Admittedly, the EU should be endowed with additional, including German, funds for taking over new tasks, though this will be difficult, given that even the (wealthier) member states such as

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\(^1\) Focus Europe Special (November 2017): European integration and the role of the ESM.
as Germany are, in practice, calling for preserving the status quo in structural and regional policy. As on the national level, the debate about the allocation of (additional) funds also largely leaves aside an evaluation of the existing measures, economic prioritisation and an evaluation of European added value.2

To give an example: Alongside the budget, funds for youth unemployment and the European investment programme EFSI shall be raised.

From an economic policy point of view, the European course of the government is a mixed bag. Competitiveness and growth forces shall be strengthened, whilst, at the same time, a framework for minimum wage regulations and national basic income is to be established and minimum rates for corporate taxes (on a joint consolidated tax base) shall be introduced. In the face of corporate tax reforms and lower tax rates in key partner countries such as the USA, the discussion about minimum rates in the EU seems to point in the wrong direction. Moreover, none of the above points falls into the category of public European goods, for which the EU should feel responsible. In the final analysis, the new former government coalition wants to also pursue a comprehensive political approach that encompasses structural reforms, as well as budget consolidation, investments in the future and institutional changes. But experience of recent years with the adherence to the respective rules and regulations and the economic policy recommendations raises doubts as to whether this will suffice to put the euro area back on a stable foundation and enhance political acceptance of the EU. A matter of great interest is the concrete design of the announced joint Franco-German initiatives in the individual areas.

Defence and security policy: between aspirations and reality

In the area of defence and security policy, the coalition partners also commit themselves to close European and, in particular, German-Franco cooperation, as outlined in the Permanent Structured Cooperation (PESCO) agreed in 2017 and the European Defence Fund.3 Acknowledging Germany’s NATO commitments, the coalition partners pledge to give priority to higher defence spending and development cooperation on a 1:1 ratio, should additional budgetary funds become available. Whether this will suffice to close the “readiness gaps” of the Bundeswehr – painfully illustrated by the recent report of the Federal Ministry of Defence – remains to be seen. The NATO partners 2024 spending target of 2% of GDP on defence (which means that current expenditures in Germany would have to approximately double) is not explicitly confirmed, but merely incorporated as a non-specified “target corridor” into the budget planning of the next government.

In search of labour market reforms

Tightening regulation in the area of labour policy, the new grand coalition continues a trend which was kicked off by the outgoing Groko, although the demographic challenges and digitisation call for greater flexibility. The prime example of this tendency is restrictions on fixed-term contracts. Plans to reduce the maximum duration of employment contracts that are limited without a material reason to 18 months (from currently 2 years) are indeed substantial.

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2 EU Monitor (March 2018): Post-Brexit EU budget – the next hot button issue.
3 Germany Monitor (August 2017): German defence policy - Towards a more integrated security framework.
Moreover, the second, quasi-quantitative restriction, which stipulates that in companies with more than 75 employees only 2.5% of employment contracts can be restricted without a material reason, seems arbitrary and limits companies' room to manoeuvre. According to the Institute for Employment Research (IAB), the plans of the new government could lower the number of these contracts by, at least, 400,000 or around 30% (latest available data for 2013). It seems doubtful whether all these temp jobs will eventually be converted into permanent ones. Furthermore, the arbitrary thresholds could lead to definition problems and red tape at the corporate level, as well as control requirements at the level of the responsible public authorities. But the re-regulation, which has above all been pushed by the SPD, is even more noteworthy as the share of temporary workers in the public sector (7.4%) clearly exceeds that in the private sector (6.7%, 2014 data).

Moreover, the right to temporarily switch to part-time work also leaves aside the interests of the business sector. Doubtless, the plans to grant employees the right to return to full employment after moving to part-time jobs are also attached to several provisos, which – at least – protect smaller companies. Thus, businesses with less than 46 employees shall be excluded from the regulation, whilst those with 46 to 200 workers have to accept applications for temporary part-time work only if they are reasonably acceptable. But these classifications, in themselves, are likely to create (definition) problems, and the respective companies will face greater organisational and planning challenges, particularly as regards human resources, due to the new regulation.

Whilst provisions on new regulations are relatively detailed, the Groko avoids clear rules in one of the few areas where flexibility is to be enhanced. For employers bound by collective agreements, experimental scope is to be created in the German Working Hours Act. These plans, however, primarily refer to the maximum weekly working time, whereas calls of the business sector for more flexible daily working schedules are not mentioned.

In this legislative period, the coalition earmarks EUR 4 bn for a new instrument promoting employment subject to social security contributions. How these funds will be spent is left open, though. Moreover, it remains to be seen whether the usual shortcomings of public employment schemes (windfall gains, displacement of non-subsidised employment and revolving door effects, i.e. no sustained improvement of employment prospects resp. employability of long-term unemployed beneficiaries) can be avoided.

In the final analysis, one of the few positive aspects in the area of labour market policy is the reduction of unemployment insurance contributions. Given the multi-year strong performance of the labour market, however, it is meagre, at only 0.3%-points – from 3.0% to 2.7%.

The younger generation, businesses and competition are the losers of the Groko’s social policy

Major social policy projects will – at least partly – reverse the reforms of the past decade, which were aimed at making the system more sustainable. Again, as under the previous Groko government, the younger generation should therefore be among the losers in this area. For example, the three parties have agreed on huge new benefits, particularly for recipients of statutory pensions, which will be reasonably affordable only if growth and employment remain dynamic – and then only for a limited period of time. This is especially true for the stabilisation of pensions at the current level (replacement rate) of 48% up to 2025. Provided
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Falling replacement rate for public pensions

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual pension level</th>
<th>Present legally defined minimum level</th>
<th>SPD proposal</th>
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<tbody>
<tr>
<td>2020</td>
<td>54</td>
<td>52</td>
<td>55</td>
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<tr>
<td>2025</td>
<td>54</td>
<td>52</td>
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<tr>
<td>2030</td>
<td>54</td>
<td>52</td>
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</tr>
</tbody>
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*Lock before taxes*, %

Sources: BMAS, SPD

growth remains robust, this objective can probably be achieved without interventions until 2024. But once the number of contributors starts to decline, costs will soar, especially if the number of pensioners picks up markedly. Given the demographic trends, pension policy thus ought to be in for a shock in the second half of the next decade, at the latest.

The financial burden from the extended pension for mothers with more than three children born before 1992 is already clear, namely around 3.4 bn in 2019. Expenditure on the new supplementary pension for low-wage earners who have contributed to the scheme for at least 35 years, on the other hand, will be relatively moderate initially (EUR 0.1 bn p.a.). But – in contrast to the costs of the additional benefits for mothers – the financial burden from the latter measure will increase substantially over time. Against this backdrop, it is all the more important that the Groko agreed on curbing costs somewhat by tying the entitlement to a means test.

The sustainability of health care, as manifested in the reserves of private insurance schemes, seems to be secured (for now). CDU and CSU managed to stave off the SPD’s demand for a merger of statutory and private health insurances. But the revival of equal health insurance contributions, which was enforced by the SPD, is also problematic. Whilst the abolition of the supplemental contribution, which was exclusively shouldered by the employees and pensioners, eases the burden on both groups (by a total of around EUR 7 bn p.a., initially), employers have to pay an extra EUR 5.7 bn. As a result, labour costs will edge up, likely leaving adverse effects on employment. But there is more at stake than disputable redistribution. With the removal of the supplemental contributions, an element of market-based control would disappear. As the amount of these extra payments differs depending on the funding requirements of the individual (public) health insurance schemes, there is some competition among the schemes for customers. Under the current transformation plans, however, the resulting incentives for the efficient use of resources largely fall by the wayside. But healthcare also needs more rather than less competition.

Education finally ranking higher on the agenda

Over the past years, expenditure on education in Germany, as a percentage of GDP, was lower than the OECD average. Meanwhile, “school and education” are also heatedly discussed in public. Against this backdrop, it does not really come as a surprise that the two terms are taking the front seat in the coalition treaty. In principle, it is a positive sign that the GroKo plans to launch an education initiative. In this legislative period, government funds to the tune of around EUR 10 bn are earmarked for this project. Another expedient factor is the envisaged breadth of the initiative. It is aimed at heterogeneous support areas such as all-day schools and universities, vocational education and training, a reform of the BaföG student support system, free nurseries as well as the qualification of teachers for the change related to the digitisation of educational opportunities. Regrettably, the treaty is relatively vague about the concrete design. It was on this very issue that similar initiatives often foundered in the past.

Alongside its current school restructuring programme, the federal government intends to support investment of the Länder in the improvement of the educational infrastructure, in particular all-day school and childcare services, digitisation and vocational schools. It has been far too long that the government and the federal states have been taking cover behind the educational sovereignty of the Länder, in line with the ban on cooperation laid down in the Constitution in 2006. In order to implement the new educational investment
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offensive, the Constitution shall now be amended to also allow subsidisation of municipalities that are not strapped.

As the ban on cooperation comes to an end, the federal government could play a more active part in the state and evolution of schools. For federalism in Germany, this is not a matter of removal but up-to-date design. Joint minimum levels for the respective type of school (e.g. secondary schools) in all federal states would certainly have many advantages, especially with regard to the geographical mobility of employees.

Cross-sectional issue digitisation: no digital ministry, financing of infrastructure a bottleneck?

The increasing role of the digitisation of society and economy is addressed in various sections of the coalition treaty. More than 12 pages are exclusively devoted to this issue. The package of measures ranges from infrastructure to digital administration, autonomous driving, lifelong digital education, cyber security and data protection. The message is clear: Digitisation and its significance for Germany have made it on the radar of the new outgoing government. In fact, the goals are quite ambitious, including plans to transform Germany into a “gigabit society” and a global leader for digital infrastructure. Germany and Europe shall be shaped into role models for the efficiency and luminance of free societies in the digital era.

It remains to be seen whether the coalition treaty lives up to its own expectations. Although digital transformation and its economic and social significance is a top priority, ideas to set up a separate digital ministry were not put into practice. Digital matters thus continue to fall into the realm of the Federal Ministry of Transport and Digital Infrastructure. Hence, conditions are not ideal for the composition and implementation of a long-term and comprehensive strategy on digital transformation, which should go far beyond individual measures. Requiring an inter-ministerial approach, the need for action and coordination is, in fact, huge in this cross-sectional area. According to a study carried out jointly by the Fraunhofer Institute and the Center for European Economic Research (ZEW) last year, Germany is only average in the international comparison when it comes to digitisation (rank 17 of 35), lagging far behind the Scandinavian EU partners and the Anglo-Saxon countries. The risk that German might lose further ground in the years ahead should be taken very seriously.

Still, the coalition treaty does address some of the shortcomings, for example in research & development, digital education and infrastructure. For example, EUR 5 bn are earmarked for a Digital Pact aimed at enhancing the digital infrastructure of schools and the digital qualification of the teachers over the next five years. Another goal of the federal government which is, in principle, to be welcomed is the nation-wide coverage with “gigabit networks” by 2025. Particularly in sparsely populated areas, there ought to be no – or only insufficient – expansion without government subsidies in future, as investments usually do not pay off for private providers due to the relatively small number of users. According to the new federal government, public funding requirements will come to EUR 10 to 12 bn in the current legislative period. Regardless of the absolute volume, the fact that these funds are to be raised via the allocation of UMTS and 5G licences is critical, given uncertain auction proceeds. A concrete and generous budget commitment would put digital infrastructure funding on a more solid foundation. Going forward, the sharp uptrend in commercial and private internet use and hence data volumes is likely to continue. Given that application areas such as connected mobility, Industry 4.0, digital healthcare
and educational programmes or many social media services are at the early stage of a development requiring a high-performance mobile infrastructure, the above budget should therefore not only be stabilised, but ought to rise steadily over the medium to longer term. Against this backdrop, an end to government subsidisation of network expansion is unlikely in the foreseeable future.

Plans to support German start-ups, e.g. via the removal of bureaucratic hurdles and tax breaks in the early stages of the business, enhanced venture capital financing and an overhaul of anti-trust law, are essential to position the German economy as a player that is able to act in a highly competitive global platform economy. Much remains to be done, as the figures below illustrate. Thus, only one German enterprise is ranked among the 20 most valuable tech companies worldwide, and only four made it onto CB Insights’ list of more than 200 so-called unicorn (tech) companies with an (estimated) value of USD 1 bn or more. Improving access of start-ups to capital, for instance by means of the envisaged “Tech Growth Fund” and a large national digital fund set up jointly with industry, are crucial to address these shortcomings, though no concrete numbers are available to date. Planned measures now need to be implemented swiftly and good intentions to be followed up by action, in order to avoid Germany’s digital economy falling further behind its international competitors.

New residential policy is taking shape

The coalition agreement sends a new message. For the first time in the current cycle, which started almost ten years ago, residential policy is clearly aiming at boosting construction. The relevant passages of the current coalition agreement have obviously been shaped by the CDU, which plans to increase the supply of residential space. In 2018, a “summit” on residential construction is to take place, and a total of 1.5 million new residential units are to be built during the legislative period. Both measures already figured in the CDU’s election programme. The dynamics of the last few years suggest that 1.3 - 1.4 million new units would be built if there were no additional residential policy measures. Providing an additional 25,000 - 50,000 units per year is quite an ambitious policy goal. Residential policy will use two main approaches to achieve it: (i) new incentive structures for the construction industry and (ii) a general reduction or abolishment of obstacles to investment.

Investment incentives for families and the middle class

The coalition wants to support families and the middle class. It plans tax relief, the introduction of subsidies for young families who build or buy their own home, state guarantee programmes which will help to reduce the required own capital and perhaps a partial exemption from property transfer taxes. At the same time, investment incentives for landlords will be reduced. A cap on rent increases after renovations will not only reduce the income from rents, but also investment activity. With capacity utilisation in the construction sector being high, investment will be reallocated:

i. Demand will shift from the centres of metropolises to metropolitan regions.

ii. As a result, demand for single-family homes and terraced homes in the metropolitan regions will rise and demand for apartments in the city centres will slightly be dampened.

iii. Support for new construction in structurally weak areas might have a negative effect in future years, as it might lead to oversupply and price declines.
Reduction or abolishment of obstacles to investment

The coalition plans to reduce obstacles to investment. Numerous measures to provide additional plots for residential construction give rise to hopes that residential construction will indeed increase. Additional measures, such as amendments to construction planning law, quicker planning procedures and measures to reduce the lack of qualified labour, will help as well. Moreover, the “rent brake”, which is mostly ineffective and in some cases even counterproductive, is to be reviewed (at least) this year.

Conclusions

The government is moving in the right direction. It plans to build 25,000 - 50,000 additional residential units per year. Many of the planned measures might be helpful. But the lower cap on the amount by which rent may be increased after renovations is the biggest hurdle on this path. In fact, together with high capacity utilisation, this measure will probably keep the number of additional residential units limited to 10,000 per year. The effect of the provision of additional plots is not yet clear. The planned “residential policy summit” might provide some answers to these questions and give additional impulses. While supporting families and the middle class makes sense from a political and social vantage point, there is a danger that a large share of the additional funds goes to building companies and seller’s property, as prices rise. Incentives for new construction should be tailored better to reach tight markets in order to prevent misallocations.

Energy policy: problems identified, albeit not specified

When analysing the chapter on energy policy, the impression arises that, though the new coalition partners have identified many of the problems besetting the German Energiewende, they are hesitant to specify them in the coalition treaty. Repeatedly, objectives are set out, without providing grounds. If a reason were given, it would often be that the (largely non-market-based) measures taken to date have not – or only insufficiently – achieved the energy targets or, worse yet, created new problems. At any rate, a sincere analysis of energy policy in recent years is a different kettle of fish.

Not surprisingly, the coalition partners repeatedly stress the energy policy triangle of supply security, economic viability (affordability) as well as climate and environmental compatibility. What is not mentioned, though, is that the target of economic viability, in particular, has been given too little priority over the past years, given the rise in electricity prices stemming from taxes, public fees and charges. To date, affordability has neither been defined in quantitative terms, nor has the question as to which instruments can secure affordable energy been addressed. One of the few quantitative targets in the coalition treaty is to raise the share of renewable energy sources (in the power sector) to 65% by 2030. It is noteworthy in this context that the word “coal” is not mentioned in the energy chapter of the coalition treaty.

In principle, many of the announced targets are positive, not least because they address past deficits. Examples: The Energiewende is to be integrated more tightly into the European context, the expansion of renewables shall be “more efficient, synchronised with grid capacity and increasingly geared towards market mechanisms”, EEG and system cost shall be minimised, the expansion of power grids shall be accelerated, storage technologies are to be supported.
That is all well and good. But as regards the instruments by means of which – i.e. how – these targets can be attained, the coalition treaty is very vague, lacking a clear regulatory guideline. This also holds for the question as to which Energiewende costs are reasonable from the perspective of the new federal government. Given the huge costs incurred by the Energiewende every year and the massive redistribution effects, this is extremely regrettable. Unless political and media discussions are dominated by other issues (e.g. the refugee problem), energy policy will provide fuel for lively debates in the Bundestag throughout the next legislative period. From the point of view of the Greens, the new federal government’s plan of action ought to be too unambitious. The AfD and the FDP, on the other hand, will likely broach the cost issue, along with the efficiency and the effectiveness of the instruments involved.

Transport policy: investment sustained at high levels, many (reasonable) targets, intense environmental discussions

A fairly long chapter in the coalition treaty of CDU/CSU and SPD is devoted to transport policy, largely due to the relatively high number of targets and projects which were mapped out for the individual modes of transport. It is, in principle, positive that investment in transport and traffic infrastructure shall be sustained at the high levels of the last legislative period, as, in contrast to short-term stimulus packages, chances increase that construction industry will ramp up capacities, which would slow the rise in building costs. Moreover, it is to be welcomed that the next federal government will continue to give priority to the maintenance of transport infrastructure over new construction and expansion and aims to accelerate the planning process for building projects. On balance, higher public spending will help to enhance the capacity of domestic transport infrastructure and remove network bottlenecks in a more timely fashion.

The environmental and climate aspect is taking a front seat in the coalition treaty – not least due to the diesel scandal and the debate about air quality in the cities. Clearly stating that it wants to avoid driving bans, the next government focuses on alternative measures, including technical improvement of vehicles in the existing fleet and the promotion of electromobility or local public transport – all measures that would only become effective in the medium term. To support electromobility, the lump tax rate on company e-cars (and hybrid vehicles) shall be reduced to 0.5% (instead of 1%), which could substantially accelerate market penetration of these vehicles. Evidently, the coalition partners are anxious to give top priority to air quality, whilst minimising the short-term burden on the consumers (e.g. through driving bans) or automotive industry (e.g. through upgrades of the vehicles concerned, regardless of the costs). Here, a grand coalition’s willingness to reach consensus proves to be highly conducive.

Environmental and climate policy

Interestingly, the chapter “Responsible Approach to Conserving our Resources” starts with some traditional environmental issues, though, pushed to the back burner by the paramount climate change, these have played a fairly small role in recent years, at least in the public perception. These issues include marine, flood and water management, biodiversity or closed recycling systems. In principle, it is to be welcomed that these environmental and conservation-related topics are also incorporated into the coalition treaty, the more so as some measures surrounding the Energiewende are in conflict with local
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environmental protection and conservation (e.g. encroachment on forest land through the construction of wind power plants).

With respect to climate protection, the coalition partners remain committed to their established targets. In this context, it is mentioned only in passing that the 2020 national target (of reducing CO₂ emissions by 40% compared to 1990 levels) will be missed. What is lacking is a down-to-earth analysis of Germany’s climate policy performance as well as a discussion of the question as to whether the climate protection targets were, in the end, too ambitious. Against this backdrop, the following statement from the treaty has a somewhat burlesque ring: “We continue to stand for a climate policy that is based on scientific principles, technology-neutral and efficient”. The key issue of how the medium and long-term targets can be achieved, whilst addressing economic concerns and supply security, is passed on to a commission. What a way to buy time and delegate responsibility.

Fiscal policy: Not without risks and side effects

For the fourth time in a row, Germany has achieved a significant overall budget surplus of EUR 36.6 bn or 1.1% of GDP in 2017 (this is the result of the consolidated budget balances of the federal government, the states, the local communities and the social security funds), which once again exceeded the preceding year’s surplus considerably (2016: EUR 25.7 bn or 0.8% of GDP). Another decline in interest payments and higher government revenues from taxes and social-security contributions were the main reasons for this favourable outcome. These favourable developments more than offset fiscal burdens from the considerable increase in government spending – for now. If there were no new fiscal burdens (i.e. if things remained just as they are), the surplus would rise further and the general-government-debt-to-GDP ratio should rapidly decline. This would help to prepare the public finances for likely future burdens (interest rate normalisation, demographic developments). After all, the budgets of the federal, state and local government as well as of the social-security funds will come under significant pressure from the mid-2020s. While policymakers are quite happy about the favourable current fiscal situation, they seem to be ignoring medium to long-term risks to public finances. This short-sightedness will probably lead to considerable financing risks in the medium to long term and make major fiscal adjustments necessary in the future.

Instead of “saving for bad times”, the government plans to increase spending

If the new government sticks to its policy of achieving a “black zero” on the federal government level (i.e. incurring no new net borrowing), it will have c. EUR 46 bn at its disposal (accumulated amounts for the years 2018 – 2021). Part of this total comes from the EUR 5 bn surplus of the federal budget in 2017 (originally, a deficit of EUR 7 bn had been expected) and from the likely increase in tax revenues between 2018 and 2021. While the new “grand coalition” plans significant investments in education and digital infrastructure – which makes sense, since this expenditure will prepare the German economy for the future – it also intends to spend much money on lavish social security benefits (“pensions for mothers II”, basic pensions) and thus increase the demographic burdens, which are significant anyway.

At the same time, the government will remain clearly behind its possibilities in the area of tax policy. In a first, tentative step, the solidarity surcharge, which brought in almost EUR 18 bn in 2017, is to be abolished for c. 90% of income
tax payers from 2021 (this implies revenue losses of EUR 10 bn). However, the top decile of taxpayers, who provide almost half of the income tax intake, will continue to pay the surcharge, as will many companies. Overall, the relief will be largely cosmetic for now. At the same time, large sums of money will be spent on well-intended, but costly subsidies (e.g. for families who buy new homes), even though their effectiveness is questionable. Tables 1 and 2 give an overview on the fiscal burdens stemming from the measures mentioned in the coalition agreement.

Pro-cyclical fiscal policy will harbour significant fiscal risks for the next legislative period

If all measures are implemented as planned, the total fiscal cost will considerably exceed the available EUR 46 bn (and hence the amounts listed in the financial overview section of the coalition agreement), which means that deficits at the federal level will inevitably increase and budget surpluses on the general government level decline.

In a recent study, the German Economic Institute (Institut der Deutschen Wirtschaft; IW) puts the additional burdens on the federal budget (i.e. the expenditure which goes beyond the available EUR 46 bn) at roughly EUR 20 bn. According to the IW calculations, the total fiscal burden for the general government level (i.e. for the consolidated budgets of the federal, state and local governments as well as of the social security funds) will come to an accumulated EUR 88.5 bn during the years 2018 - 2021. This total includes expenditure for planned pension reforms (such as “pensions for mothers II”; c. EUR 10.7 bn), the abolishment of the additional contribution to state healthcare insurance and a reintroduction of matched contributions by employers and employees (c. EUR 4.2 bn), measures to counteract cold progression (c. EUR 21 bn) and the planned reduction in unemployment insurance contributions by 0.3 of a pp (EUR 9.9 bn). At the federal level, the additional EUR 20 bn needed beyond the available EUR 46 bn will mainly be spent on the reform project “pensions for mothers II” (while the financing of this benefit is still unclear, it could require the federal government to make additional contributions of more than EUR 3 bn to the pension system), higher contributions to the EU budget (c. EUR 7 bn from 2021) and revenue losses stemming from the measures to counteract cold progression (an accumulated EUR 9 bn).

In view of these potential additional fiscal burdens, the federal budget might be deeply in the red from 2021 at the latest. Moreover, there is a risk that some measures, such as the broadband roll-out or the digital compact, cannot be fully financed from the extra-budgetary income foreseen for this purpose (revenue from UMTS and 5G licence auctions) and that the government will need to provide additional money from the public coffers for these purposes. Since the fiscal impact of many planned measures, such as subsidies for families who buy a new home, higher child benefits or the abolishment of the solidarity surcharge, will not be felt in full until the last two years of the legislative period, the fiscal situation will not deteriorate significantly before 2021.

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5 The total burden for the federal budget is equivalent to the net total of additional spending, revenue losses and revenue increases.
Table 1: Spending priorities of the grand coalition
(as listed on p. 67 and 68 of the coalition agreement)

<table>
<thead>
<tr>
<th>Accumulated figures for 2018 – 2021</th>
<th>EUR bn</th>
<th>Share of the total</th>
<th>Share of the total (in %; excl. extra funds)</th>
<th>% of GDP (2017)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total (incl. Gigabit investment fund)</td>
<td>60.5</td>
<td>100.00</td>
<td>129.0</td>
<td>1.9</td>
</tr>
<tr>
<td>Total (excl. Gigabit investment fund)</td>
<td>46.0</td>
<td>76.00</td>
<td>100.0</td>
<td>1.4</td>
</tr>
<tr>
<td>Investments for the future: education, research, universities, digitisation</td>
<td>6.0</td>
<td>9.80</td>
<td>12.9</td>
<td>0.2</td>
</tr>
<tr>
<td>All-day schools/childcare</td>
<td>2.0</td>
<td>3.30</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Professional and career training</td>
<td>0.4</td>
<td>0.60</td>
<td>0.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Reform of training assistance (“BAföG”)</td>
<td>1.0</td>
<td>1.70</td>
<td>2.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Follow-up agreement to university compact (from 2021)</td>
<td>0.6</td>
<td>1.00</td>
<td>1.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Federal government contribution to raising R&amp;D expenditure to 3.5% by 2025</td>
<td>2.0</td>
<td>3.30</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td><em>Broadband roll-out, digital compact for schools (infrastructure): to be financed from the Gigabit investment fund</em></td>
<td>14.5</td>
<td>24.00</td>
<td>26.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Families, children, social security</td>
<td>12.0</td>
<td>19.90</td>
<td>26.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Federal government contribution to higher child benefits and child care tax credits</td>
<td>3.5</td>
<td>5.80</td>
<td>7.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Childcare centres (fees and quality)</td>
<td>3.5</td>
<td>5.80</td>
<td>7.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Combating child poverty by higher child benefits</td>
<td>1.0</td>
<td>1.70</td>
<td>2.2</td>
<td>0.0</td>
</tr>
<tr>
<td><em>Measures pursuant to SGB II: social labour market, social participation</em></td>
<td>4.0</td>
<td>6.60</td>
<td>8.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Construction and residential policy</td>
<td>4.0</td>
<td>6.60</td>
<td>8.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Federal support for social housing (2020/21)</td>
<td>2.0</td>
<td>3.30</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Tax incentives for owner-occupied homes (depreciation, energy-efficient refurbishment, subsidies for families)</td>
<td>2.0</td>
<td>3.30</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td><em>Equivalent living standards, agriculture, transport and local communities</em></td>
<td>12.0</td>
<td>19.90</td>
<td>26.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Increase in funds provided in the framework of the Act on Financing Local Transport Infrastructure (GVFG) 2020/21</td>
<td>1.0</td>
<td>1.70</td>
<td>2.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Regional structural policy/structural change for coalmining areas</td>
<td>1.5</td>
<td>2.50</td>
<td>3.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Rural areas/agriculture</td>
<td>1.5</td>
<td>2.50</td>
<td>3.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Continuation of local and state programmes</td>
<td>8.0</td>
<td>13.20</td>
<td>17.4</td>
<td>0.2</td>
</tr>
<tr>
<td><em>International commitments in the framework of security and development policy</em></td>
<td>2.0</td>
<td>3.30</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Increase of the defence budget and the ODA ratio</td>
<td>2.0</td>
<td>3.30</td>
<td>4.4</td>
<td>0.1</td>
</tr>
<tr>
<td><em>Tax relief</em></td>
<td>10.0</td>
<td>16.50</td>
<td>21.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Solidarity surcharge</td>
<td>10.0</td>
<td>16.50</td>
<td>21.8</td>
<td>0.3</td>
</tr>
</tbody>
</table>

*EUR 10 – 12 bn for the broadband roll-out and EUR 5 bn for the digital compact for schools (spread across five years, with EUR 3.5 bn to be spent until 2023) are to come from auction revenues for LM TS and 5G licenses. In addition, funds from the budget will be provided until 2023 to ensure that the total spending volume is reached.

Source: Coalition agreement between CDU, CSU and SPD (7 February 2018), Destatis, MV, Deutsche Bank Research.
We believe that the federal budget might run a deficit of c. EUR 30 bn in 2021 (unless tax revenues surprise to the upside) (see chart 12). This would probably not be in line with the requirements of the “debt brake”. Since the coalition partners have also agreed to stick to the “black zero” on the federal government level, it seems impossible to implement all measures listed in the coalition agreement, unless there are at the same time counter-financing measures in other areas. The “debt brake”, which was adopted in considerably worse fiscal times (in 2009), might indeed prevent a more pronounced deterioration of the fiscal situation.

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