Deutsche Bank Research

Germany cresting the wave

A reform agenda for the Grand Coalition

September 27, 2007

The German economy has emerged from the doldrums. Germany has become a better-quality business location, its export industry is humming, and new jobs are being created. But it is far from certain that this dynamic can be sustained given still serious impediments to growth.

The Grand Coalition's economic and social policy lacks assertiveness. While government policies have bolstered the upswing, they have done little to strengthen the forces driving growth. A dent in global economic activity would leave the positive trends hanging in the balance.

Lower budget deficits have been achieved, but mostly through higher taxes. The refocus on higher quality and new financing structures is still at a very early stage. A more stringent debt rule for general government is the most important, meaningful objective of federalism reform. The reforms of corporate and investment income tax have been addressed only half heartedly; the tax landscape is a work in progress. In social policy, the only important reform was made to pension insurance, and the lowering of unemployment insurance contributions is laudable. Mooted new transfers – with low-wage earners as one possible recipient category – put budget consolidation at risk.

The Grand Coalition will launch structural reform mainly in energy and environmental policy. Although policy-makers have still not delivered on a comprehensive national energy strategy, a package of measures will significantly curb energy consumption and CO_2 emissions in the long run. The government recently approved an integrated energy and environmental programme focusing on energy conservation, energy efficiency and climate-friendly energies. Continued use of nuclear energy would make it considerably easier to achieve these policy targets. However, the coalition sticks to its phase-out plans for nuclear power.

The higher cost of environmental awareness should be another reason to lighten the tax and contributions load. The extra expense that climate protection involves for households and companies should offer another argument for easing the burden of taxes and contributions in other areas.

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"We must do our utmost to place the upswing on a firmer footing." (German Chancellor Merkel)

1. Germany poised for promotion in the business location league?

Since 2006 the German economy has been notching up rates of growth last seen in the period 1998-2000. In 2006 GDP expanded by 2.9%, and for this year too we expect real growth in the region of 2 ½%. After years of stagnation – between 2001 and 2005 the economy edged up by a mere half percent per annum – this is a very gratifying development.

At long last the rebound has also worked through to the jobs market. After peaking at 11.7% of the dependent civilian labour force in 2005, unemployment had receded to 8.8% by August 2007, its lowest level since 1993; since February, seasonally adjusted jobless figures have been below the EU average for the first time in quite a while.

Growth outlook in Germany

% yoy

	05	06	07	08
GDP	0.8	2.9	2.4	1.8
Private consumption	-0.1	1.0	0.2	2.1
Government spending	0.5	0.9	1.9	1.4
Investment	0.9	6.5	4.3	0.3
Machinery & equipment	6.0	8.3	8.8	3.7
Construction	-3.1	4.3	0.8	-2.9
Exports	7.1	12.5	7.1	3.5
Imports	6.7	11.2	5.3	3.8

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The upswing is most pronounced in external trade, with exports continuing to develop extremely dynamically. Last year alone German shipments soared by 12 ½% in real terms, while 2007 is predicted to turn in an increase "just" above the 7% mark. Meanwhile the economic recovery has also worked through to the domestic economy, and even private consumer spending is stirring from its almost five-year coma. But that is not to say the patient has already found its feet.

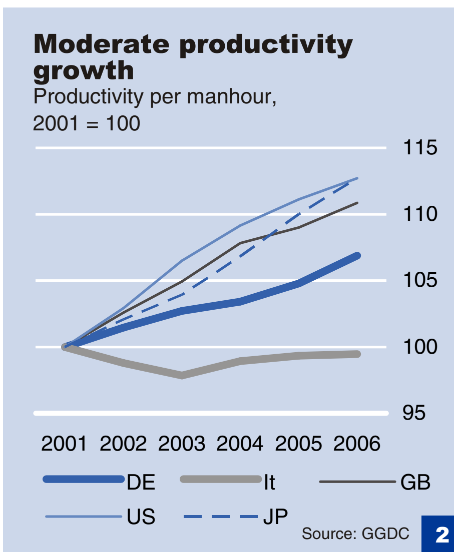
Foreign media have even credited Europe's erstwhile lame duck with a second economic miracle. But there is nothing miraculous about the satisfying progress that has placed Germany considerably higher in international business location rankings and in ratings by international organisations such as the OECD or IMF. Instead, it marks the end of a difficult adjustment crisis for the German economy – caused in no small measure by the country's reunification – and culmination of the time-lagged positive impact of the structural tax and labour market policy reforms launched under the previous government (including a reduction in the personal income and corporate tax burden, labour market reforms and the introduction of more flexible employment conditions) and, most importantly, rigorous restructuring in the corporate sector. Added to this is a slightly procyclical fiscal policy in 2006.

First and foremost, however, the upswing was driven by global demand for German capital goods. The standard-bearers of success were once again instrumental in the upswing. In the past years many German companies have realigned their strategies, tapped into new production and sales markets and slashed costs. While unit labour costs in the euro area climbed by almost 10% between 2000 and 2006, in Germany they held flat as a result of wage restraint, longer working hours and more flexible labour input.

Prices and technology more competitive

This heightened price competitiveness is accompanied by regained technological prowess. Among the EU-15 Germany can boast the highest share, 65%, of innovative industrial enterprises. Added to which, the broad range of high-grade, innovative German capital goods dovetails particularly well with demand from the high-growth emerging markets engaged in the process of economic catch-up. All in all, Germany is thus the only big industrial nation to have maintained its share of the world market. The ratio of exports to

German GDP now stands at 45% – over 10 percentage points more than in 2000.



Even so, the Germans' standard of living cannot seek its salvation in the strength of external trade alone[1] given the persistence of serious growth and performance flaws in the German economy. For instance, the average 1.5% p.a. rise in labour productivity per hour worked since 2000 rests on the good year 2006 alone (previously it averaged a bare 1.2% p.a.); and even this is due solely to exceptional growth rates in industry (+2.8% p.a.) and a few services sectors such as distribution, the hotel and restaurant trade and transport (+1.8% p.a.), while elsewhere the picture is one of snail's pace or, indeed, backsliding.[2] Germany also compares poorly with the major industrial countries. While hourly macroeconomic productivity turned in solid growth between 2001 and 2006 in France (+9%), Japan (+13%), the US (+13%) and the UK (+11%), the comparable reading in Germany ticked up by barely seven percent; Italy posted a downturn and Canada also performed sluggishly (+5%). This simply shows that one swallow certainly does not make a summer. The particularly pressing problems in education (human capital is barely rising!) and in making the markets for labour, goods and services more competitive still give cause for concern over the sustainability of growth and the true extent of structural change.

What part have economic policies by Germany's Grand Coalition of Christian Democrats (CDU/CSU) and Social Democrats (SPD) played in the economic bounceback, in making Germany a more attractive place to do business and in strengthening the forces driving growth? What needs to be done in the second half of the legislative period to achieve the mission formulated by the Chancellor before the summer recess to "…secure the economic upswing…", and what are the chances of the necessary political decisions actually being taken?

2. Economic policy: Riding the wave

Very few avenues of compromise for long-range reforms

The federal government's economic policy during the Grand Coalition's first two years in office does not follow any one clear design. Instead, the November 2005 coalition agreement sets out a long list of to-dos in all policy areas. Voters gave neither of the mainstream parties a clear reform mandate, and the coalition partners saw very few viable avenues of compromise for even a medium-range programme. Effectively, they agreed on comparatively modest projects. The government's programme is thus neither social-democratic nor conservative and can hence hardly meet the expectations of the parties' respective electorates. As matters stand as present, contemporary historians will arguably have a hard time finding convincing, punchy headlines for their studies on this Coalition's economic policy. As Länder (state) election campaigns loom and the parties jockey for position in the general elections in two years' time, there is now very little likelihood that the government will sharpen up its programme of action.

Characteristic of the Coalition's political objectives and actual policy so far is that both parties are opting almost entirely for slight tweaks in priority and gradual adjustments within the respective policy

[1] See Posen (2007).
[2] Data according to Federal Statistical Office. International data according to Groningen (2007), on the basis of the USD in 2006.

areas. Initial speculation that the Grand Coalition would take advantage of comfortable majorities in both the lower and upper houses of parliament (Bundestag, Bundesrat) – a very rare situation in national politics – to address major structural reforms has so far proved unfounded. Nor are there any signs of this happening in the second half of the legislative period. The previous government under Chancellor Gerhard Schröder was more successful in launching structural reform even though it lacked a majority in the upper chamber, the Bundesrat, for most of the time.

Sweeping reform necessary in many areas

Yet Germany needs extensive reform in many areas. In cyclical terms the time is still ripe, but there are already clear signs of a global economic slowdown. The demographic window of opportunity is likely to start closing as from the middle of the next decade; the shortage of skilled staff is already becoming more acute; and the government is far from completing its homework on economic policy.[3]

As problems with growth persist, the Grand Coalition has set its sights too low. Very little appears to have been done so far in education policy.[4] In tax policy, too, the Coalition has failed to put down the necessary basic markers. The deregulation of protected (economic) sectors has not even been placed on the agenda, and at the European level the previous administration applied the brakes on liberalisation of the services markets (EU Services Directive).[5] Social policy remains another seemingly intractable task.

Government motto: "restructuring, reform and investment"

Instead, the Grand Coalition is concentrating most of its energies on budget consolidation. Its only far-reaching structural reform mission is in energy and climate policy. The official government line is "restructuring, reform and investment". And indeed, the greatest progress is evident in budget consolidation ("restructuring"), resulting from positive economic growth, the sharp increase in income taxes and the massive hike in turnover and insurance premium tax coupled with only moderate cuts in contributions.

Public expenditure on transport and research has also been stepped up. Given the investment upswing, the Coalition could have dispensed with the investment incentives granted in 2006 and 2007 for private enterprises and the real estate sector ("investment"), although the pull-forward effects did help boost economic development.

Very limited appetite for reform

The government's appetite for "reform", on the other hand, is very limited. Although it has introduced some new measures, only two limited reform projects stretch beyond the immediate present: gradual extension of the statutory retirement age by 2 years in the period from 2012 to 2029 ("pension at 67") and the reform of corporate income tax in conjunction with the introduction of a flat-rate settlement tax on investment income (see below).

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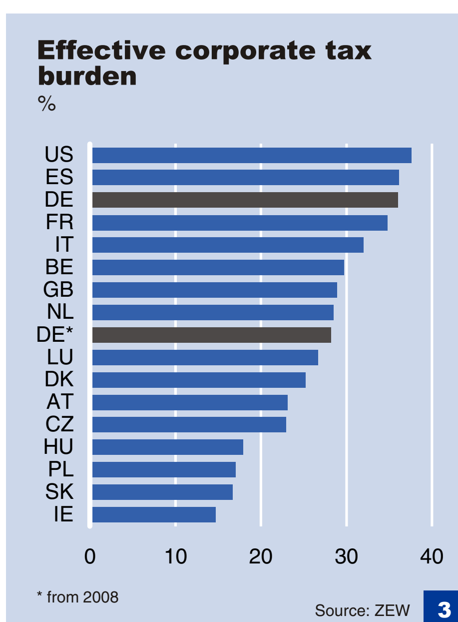
[3] See Walter, Deutsch (2004).
[4] See German Council of Economic Experts (2005), Chapter III.2 and IdW (2006).
[5] See Deutsch, Frank, Gornig (2005).

3. Economic and fiscal policy

1. Tax policy

The overhaul of corporate income tax makes Germany a more attractive location in competition for inward investment. Yet detrimental regulations still remain, for example the many laws that are not EU-proof, or rather unattractive corporate group taxation issues. These should be addressed to raise Germany's appeal for holding companies as well. Implementation of the blueprint for a flat-rate settlement tax falls well short of target. However, a sensible overhaul of inheritance tax seems to be in the offing. Substantially higher tax revenues also call for revision of the income tax burden. Moreover, in the interests of both the corporate and household sectors tax legislation needs to be made more transparent and predictable.



Lightening the tax load on companies to just below 30% (including local business tax) will improve the situation for corporations. It remains to be seen just how much relief this will actually bring businesses, because the impact of the various counter-financing measures is extremely difficult to predict. The aim of equal tax treatment for business partnerships and corporations will probably not be achieved, despite such elements of relief as preferential tax treatment for retained profits or the investment allowance, due partly to the so-called "wealth tax" (higher income tax rate of 45% on incomes above EUR 250,000) and detailed provisions of the flat-rate settlement tax.

On January 1, 2009 a definitive settlement tax will be introduced at a standard rate of 25% (28% plus solidarity surcharge and church tax) on all interest income, dividends and capital gains on securities. While in principle the introduction of such a tax is a welcome development, most of the positive effects hoped for – tax simplification, making investment in Germany more attractive to private and institutional investors – will probably come to nothing because the flat rate is too high. Broadening the tax base will have the greatest impact on capital gains – particularly on shares – that have so far been tax-exempt after expiry of the set holding period (Spekulationsfrist). This runs counter to the aim of encouraging saving through equities by private investors and making stock investments a more attractive means of financial provision for retirement (the exception being investment fund savings plans under the Riester pension scheme). The "half-income system" taxing only half the value of dividend payments is also being abolished, with the result that private investors will be doubly hit by corporate income tax/local trade tax as well as the flat-rate settlement tax. Effectively this means a further increase in the tax burden on equity as opposed to debt capital. Some refinements to these provisions would be desirable, although at present the outlook on this is rather bleak.

The government has announced an inheritance tax bill for the autumn, to take retroactive effect on January 1, 2007. Complete abolition of inheritance tax, as in Sweden, fails to command a majority owing to distributional concerns and fiscal interests on the part of the German Länder. The key political parameter of any reform is to secure the present tax take (almost EUR 4 bn in 2006). A revision could boil down to uniform and near-market valuation of individual assets with low, progressively rising tax rates and high allowances within the family. Following a recent ruling by the Federal

Constitutional Court the government's previous plans on how to regulate inheritance tax in the context of corporate succession will also have to be reconsidered. Various alternatives are currently being debated. For the companies concerned, most of which are SME businesses, it is important to find a practicable solution keeping the tax burden low and ensuring that tax demands do not create liquidity problems.

Action still necessary on tax policy

Besides these specific projects, action still needs to be taken wherever tax regulations make it more difficult for German companies to go international. This includes the "EU-unreadiness" of much legislation, especially the German Foreign Transactions Tax Act (Außensteuergesetz). Moves to particularise the details of taxation in the event of baseshifting, planned as a means of counter-financing in the context of company tax reform, are also likely to run into problems with European law. Attractive group taxation along Austrian lines would likewise be welcome. And given the substantial increase in tax revenues, which the German finance ministry estimates at +25% through 2011, a review of the tax environment should also encompass income tax. The "solidarity surcharge", which has solidified into a permanent fixture, higher basic allowances or a "sideways shift" in the tax scale are potential opening platforms from which to ease the further increase in the personal tax burden resulting from cold progression before the end of this legislative period.

2. Making budget consolidation sustainable

For all the cyclically and tax-driven progress on consolidation, the government has not yet completed its mission. To bring the debt ratio, and not just new borrowing, into line again with the Maastricht Treaty, consolidation of both federal and Länder budgets and the social security systems needs to be pursued further down the line – and more rigorously on the expenditure side. Moreover, fiscal policy should be steered more closely along qualitative criteria for the use of funds and the achievement of political goals; the scene is currently being set for this.[6]

Indicators of Federal budget planning

EUR bn

	Target 2007	Target 2008	BP* 2009	BP 2010	BP 2011
Expenditure	270.5	283.2	285.5	288.5	289.7
(Change, %)	+3.6	+4.7	+0.8	+1.1	+0.4
Tax revenues	220.5	237.1	247.9	252.6	260.3
Net borrowing	19.6	12.9	10.5	6.0	0

*budget plan

Source: Federal finance Ministry 4

Consolidation chiefly from the revenue side

The Grand Coalition has already made good headway on reducing new central government borrowing with a policy of consolidation effective mainly on the revenue side, and is aiming to scale back net borrowing to zero by 2011. In the years up to 2011 the budget is scheduled to grow by an average of 1.7% per annum, which would be consistent with the estimated potential growth rate. In 2007 and 2008 spending will rise at above-average rates of 3.6% and 4.7%

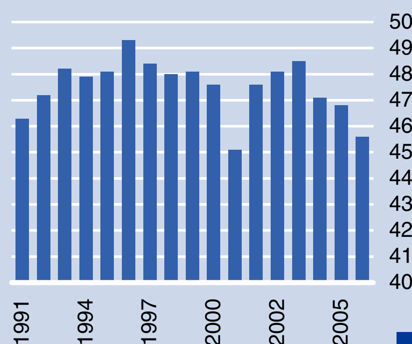
[6] See Böttcher et al. (2007).

Aim to balance the budget speedily

respectively, most of the increase being explained by special factors and one-off effects (e.g. rising proportion of turnover tax as a grant to the Federal Employment Agency; build-up of the tax-funded grant for the statutory health insurance system; parenting allowance). It is planned to reduce the general government deficit to zero in 2010, although it could already hit that level next year; as recently as 2005 Germany overstepped the fiscal reference value set in the Maastricht criteria with a deficit ratio of 3.2%, although that level was halved to 1.6% just a year later. For 2007 the European Commission expects a ratio of only 0.6% (2008: 0.3%), with the possibility of the structural deficit even dipping below one percent of GDP.[7] With this fiscal guideline the debt ratio could, given correspondingly high actual growth, also be lowered step by step from 67.9% in 2005 and 2006 by a few more percentage points towards the reference value of 60 percent. Emphatic debt retirement is the only way to ease the public sector interest burden, which amounted to EUR 64 bn in 2006. On current statistical information almost 7% more is earmarked for interest payments in the 2008 federal budget – despite lower net borrowing. This makes it very plain that, far from being a past project, consolidation is still an urgent task for the present.

Shrinking government spending ratio

Government spending in % of GDP



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What is more, it is increasingly important in the consolidation process to continue raising the quality of government spending and revenues, partly by maintaining investment at the slightly higher level it has held since the Grand Coalition took office. In the medium term the structure of spending, and not only the structure and efficiency of taxation, should be geared more closely to growth and sustainability targets. Driven by restrictive spending guidelines and buoyant economic development, the government spending ratio (2006: 45.6%) has returned to a level that had been constantly overstepped since 1991. Welcome as this may be, it is no substitute for efforts towards structural improvement. The reallocation of budget funds already made to the benefit of education, research and technology points the way here; but considering, for one, the dramatic shortcomings in the level of skills in Germany, particularly among the younger generation, far more still needs to be done.

Federalism Reform Commission II

32 members	Presidency State premier Oettinger (CDU) Parliamentary-group chairman Struck (SPD)
16 Bundestag 5 Government ministers 8 Government coalition 3 Opposition	16 Bundesrat 16 Länder premiers

Representatives of Länder parliaments and municipalities (not voting rights)

Source: DB Research 6

3. Federal fiscal relations – a Herculean task

The Commission on the Modernisation of Federation-Länder Financial Relations should bring about better allocation of remits and funding to the individual layers of government and create an incentive-based fiscal equalisation system among the Länder and an effective debt rule for general government.

The federalism reform designed to regulate the responsibilities of the federal and Länder governments entered into force on September 1, 2006. One aim was to reduce the number of laws subject to approval by the Bundesrat (around 50%). Given that in the present Grand Coalition political conflicts are generally resolved in forums other than the Bundesrat, it is very difficult to assess the reform's success in this respect. But the lack of uniformity in regulations on protection for non-smokers, which is based on a nationwide smoking ban but regulated specifically at the Länder level, does not augur well. Education policy – one of the Grand Coalition's core themes – also raises questions: Although education has in principle been a matter for the Länder since stage I of the federalism reform, old issues of responsibility resurface with

[7] According to the European Commission (2007).

university funding, childcare or debate on a central higher school-leaving exam (Abitur).

The second reform stage, federal fiscal relations, is by far the more important in economic terms. The "Federalism Reform Commission II" constituted on March 8, 2007 and chaired by Günther Oettinger (the premier of Baden-Württemberg) and Dr. Peter Struck (the SPD parliamentary-group chairman) has to address very challenging, issues with considerable potential for conflict. The financial topics – particularly fiscal relations between the federal government and the Länder, and general government debt – will be far more difficult to handle. Lines of conflict are most likely between rich and poor Länder. Smaller-scale reforms of the allocation of certain taxes to the various layers of government should at least come about, one example being the reform of motor vehicle tax.

Basic issues of stage II federalism reform

	Financial topics			Administrative topics
Topic	Fiscal relations between federal Government and Länder	Fiscal equalisation system among Länder	General government debt	Review of remits and improvement in the administration of public finances
Problem	Mixed financing and shared remits blur the boundaries between political responsibilities	Financial strength of Länder seriously levelled, disincentives from supplementary federal allocations	Consolidation of all public budgets not imperative, no uniform standards	Inefficient administrative processes in areas such as labour, tax and trunk road administration
Solutions discussed	Swapping different types of taxes (e.g. insurance premium tax, motor vehicle tax, petroleum tax) and centralised tax collection by the federal authorities	Assumption of old liabilities for poor Länder, Länder mergers	Ban on borrowing, "debt brake", sanctions on indebted Länder	Process standardisation, harmonisation of IT processes, unravelling administrative remits, better cooperation between federal and Länder authorities, Länder mergers

Source: DB Research 7

Debate is also ongoing over new ways of coordination between the federal and Länder governments on budget consolidation, moving away from the focus on Article 115 of the German Constitution. A general ban on borrowing will not be enforceable, but the only way to successful reform will be with effective debt rules and consistent fiscal standards. The signs seem to point towards a cap on borrowing with the aim of a balanced budget across the economic cycle. In terms of financial volume, it makes little difference whether net investment or GDP are taken as the benchmark. The former could be interpreted as following the old Article 115, although with the weakness that politicians will (re-)interpret this definition of net investment to suit their own ends. In politico-economic terms, a more suitable arrangement would be to cap the overall budget deficit at half a percent of GDP. Sanction rules with a (cyclical) equalisation account would hardly be necessary to begin with owing to the repayment commitments. But in the long run sanctions will presumably be inevitable. The reform of budget negotiations should also be pursued further in the medium term with the aim of improving the way in which the employment of public funds is managed.

4. Social policy

1. Retirement provision: Mission addressed

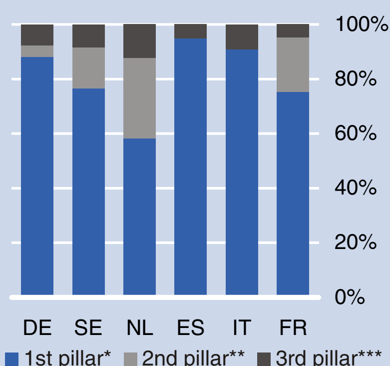
From today's perspective pension funding has been placed on a broadly healthy basis. But in view of demographic trends, government should adhere rigorously to the line already adopted, with more capital market-based, personal pension provision. The decision to continue promoting company pensions is a sensible one. Raising the statutory retirement age to 67 makes allowance for longer life expectancy, at least for the time being. But a battle has been won, not the war, and this must not be jeopardised by a large number of let-outs.

In recent years important policies have been set in motion to make the pay-as-you-go state pension system demographics-proof. The various elements ("demographic factor", pension reductions for people taking early retirement) to raise the actual retirement age in the state pension system are beginning to have an impact. Whereas only a decade ago men retired at the age of 62.1 years, today they do not draw a pension until 63.3 (women 62.4 and 63.2 respectively). The Grand Coalition's decision to put back the regular retirement age to 67 is sensible and should not be watered down by special, target group-specific let-outs such as old/new early retirement schemes. Going forward, the various measures can be expected to push up the de facto retirement age further. But with some experts predicting a steeper rise in life expectancy, in the medium term a further adjustment of the pensionable age could become necessary.

Political flanking measures have also been implemented to strengthen private retirement provision and occupational pensions as alternative pillars, to make up for the cuts in the state pension scheme. However, given the current distribution of retirement income, there is still a long way to go on this, even if state-incentivised schemes have experienced a marked upswing of late. At present nine million employees are covered by private "Riester pension" plans (named for the minister responsible for their introduction); added to this are 17 million workers with entitlements to a company pension. The government's decision to continue exempting payments into occupational pension plans from social security contributions beyond 2008 for an unlimited period (the arrangement was originally limited to six years), in line with their exemption from taxation, is a welcome move. The social security funds should be able to absorb the costs of around EUR 2.5 bn p.a. Another positive aspect is that income from Riester pension plans will not attract the flat-rate settlement tax to be introduced from 2009, meaning that the build up of retirement capital will not be penalised. However, government should keep a watch on whether the willingness to make private provision increases on the necessary scale. If not, it could consider introducing an opt-out solution for occupational schemes and also stipulating mandatory minimum provision by the self-employed to avert the danger of poverty in old age.

Retirement provision off kilter

Shares of retirement income, %

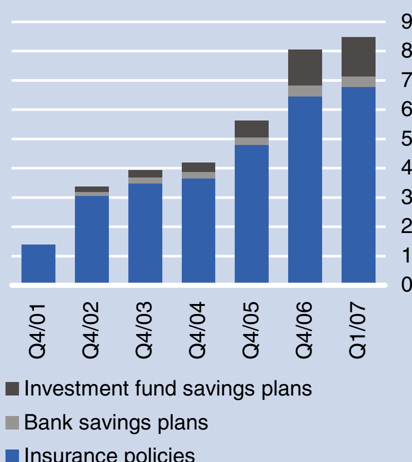


* PAYG state pension systems and other social transfers
** Occupational pensions plans
*** Fully-funded personal provision and earned income

Sources: DIA, DB Research 8

Riester pension on the rise

Number of contracts concluded, m



Source: BMAS 9

2. Healthcare and nursing: Taking the plunge

Demographic development, notably the relentless rise in life expectancy, also makes more personal healthcare provision and the build-up of more private capital necessary to secure sustainable financing. The government's healthcare reform completely misses the mark here. The opportunity to place funding of the nursing care insurance fund on a sorely-needed fresh footing has also been missed with the decision merely to raise the contribution rate. The next German government will have to rake over healthcare policy once more.

More liberal bias for the health system and …

The health reform launched in 2006 falls far short of what would have been necessary to create a more competitive and liberal bias for the health system. The half-hearted changes at the various levels of the system will intensify distributional conflict between the groups involved (e.g. family doctors – specialists), but without really remedying the governance deficits. The same applies to the rather inconsistent opening up of contractual relations between health insurance funds and service providers, which are now being replaced by collective agreements with the joint, newly-established top-level association of statutory health insurers (SHI).

… its sustainable funding not yet in place

The target that the Grand Coalition set itself of putting sustainable funding in place has not been met either. Raising the contribution rate by 0.5 percentage points and gradually increasing federal grants are merely short-term stop-gaps. The so-called health fund (Gesundheitsfonds) scheduled to launch on January 1, 2009 exhibits serious design flaws. In adhering to the wage-related contribution system, the government has passed up the chance of permanently lowering non-wage costs by decoupling healthcare costs from pay, which would have added further growth impetus to the labour market. Given that the coalition partners' concepts of health policy were quite evidently diametrically opposed and they lacked the power to compromise, it would have been more expedient from the outset to confine themselves to smaller adjustments to the existing system with a view to putting a sensible, consistent reform on track after 2009, when parliamentary majorities may have shifted.[8]

Nursing care insurance not demographics-proof either

In nursing care insurance, too, the Grand Coalition is taking the simple route at the expense of third parties, i.e. generations to come, by augmenting insurance benefits and burdening contribution payers with fresh costs (raising the contribution rate by 0.25 percentage points from January 1, 2008). But very soon even these contributions will hardly suffice to finance an ageing society's permanent and constantly rising entitlements. Contribution rates of 4% and more are no longer beyond the realm of possibility. At this point in time, a change of system would be easier to effect than in health insurance. The best reform option for nursing care insurance would be a separate, risk-based premium model.

3. Labour market reforms: when, if not now?

The recent positive development on the labour market is largely cyclically induced, encouraged by longer-range structural reforms and "bottom-up" deregulation, i.e. more flexible employment conditions at company level. By extending the law on the posting of workers, the Grand Coalition has, if anything, sent out signals in the other direction. In principle the upswing holds out the opportunity for

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[8] See Bräuninger (2006).

farther-reaching reforms: adjustments to Hartz IV and a further reduction in non-wage costs are doable. It would be wrong to put further pressure on the Hartz IV architecture with new supplementary welfare benefits. Ideally swift removal of the obstacles to mobility vis-à-vis eastern Europe and a rational immigration policy could help alleviate the shortage of skilled workers and provide fresh impetus for the labour market.

The ossified structures on the German jobs market are gradually softening up. A reversal is now apparent in working hours; the part-time work share has reached 25.5%; the participation rate of women now tops the OECD average at 63.9%; and the economic activity rate of older people has also risen (from 39% in 1998 to 48.5% in 2006). More liberal regulation of temporary employment has also improved labour market flexibility. And Hartz IV is presumably now making people more willing to take up work.

Turnaround in weekly working hours

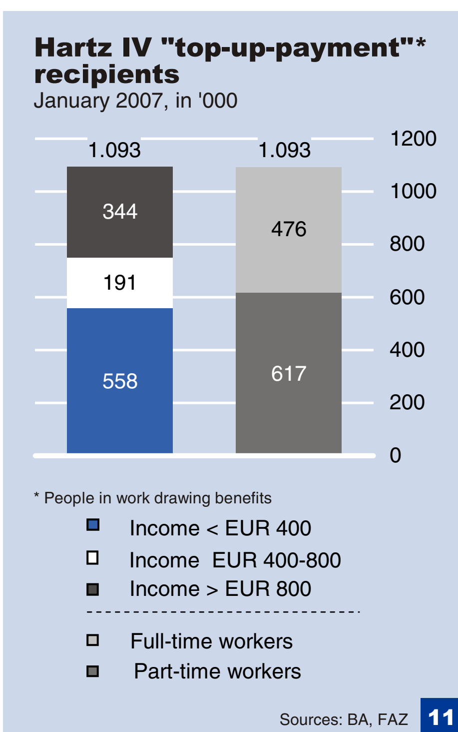
Source: IAB 10

In political terms, however, the Grand Coalition is benefiting from the previous administration's structural labour market reforms. Its own decisions, such as extension of the law on the posting of workers, which opens the door to statutory minimum wage arrangements, appear in a rather more critical light. Agreements in the coalition pact on further adjustments to the regulations governing protection against dismissal have not been addressed.

High surpluses at the Federal Employment Agency (FEA) should be used towards a substantial reduction in unemployment insurance contributions. High incidental wage costs remain a serious obstacle to employment, particularly in the low-wage sector. Mathematically speaking, contributions could be lowered from 4.2% to 3.2%, but so far the government has made a binding announcement only on a small reduction to 3.9 %, although it has said it will examine the possibility of further relief. If the FEA did not have to make higher payments into the federal budget a cut to 3.5% would already be possible, but the government has decided to charge half the costs of support for the long-term unemployed to the labour agency. Shouldering a share of these costs is seen as the FEA's "quid pro quo" for abolition of the so-called "Aussteuerungsbetrag", effectively a performance-linked tax previously levied on the agency. On balance, however, this counter-entry leaves the FEA with a shortfall in the region of EUR 3 bn p.a. Revisiting the entire active labour market policy toolkit is yet another item on the government's ought-to-do list.

Hartz IV "top-up-payment"* recipients

January 2007, in '000



* People in work drawing benefits

Sources: BA, FAZ 11

The government also plans further measures in support of the low-wage sector, but this should be organised in the context of Hartz IV. The fact that nearly 0.5 million people draw unemployment benefit II as a top-up payment, even though they have a full-time job, does not justify any new benefits legislation such as the transfer scheme under consideration. A project of this kind would be a step in the wrong direction, back into the pre-Hartz IV era. For cost and efficiency reasons, the Hartz labour market reforms rightly aimed for basic security benefits in a single package. And the financial burden for the public sector from an allowance of this kind would arguably be considerable, depending on the shape it took. Problematic, too, is the sharp increase in child supplements under discussion. This would intensify the lock-in effect of the supplement. (The effect describes the problem that as from a certain income threshold – around EUR 2,000 gross per month – it is not worth working harder because the supplement is then forfeit.) The outcome would be to make lone parents and families more rather than less dependent on

state aid. Solving the incentivisation problem by gradually tapering the supplement as incomes rise would make the project extremely expensive. Even a family of four with just one breadwinner earning the average statistical gross compensation for employees (roughly EUR 2,700 a month) would then possibly be entitled to a (small) supplement. Were the Coalition to implement both proposals, it would run the danger of writing expenditure commitments in stone that would be very difficult to finance once tax revenues were no longer rising at their present heady pace.

Refining Hartz IV and …

Admittedly, in its present form Hartz IV has unintentionally become a programme encouraging 400-euro jobs, in that any earnings above this level are penalised by drastic deductions. This weakens the incentive to accept better jobs. The basic personal allowance should therefore be abolished and the aspect of "demanding initiative" in the low-income bracket strengthened. Constructive suggestions for this – for example from the German Council of Economic Experts, the Ifo Institute for Economic Research or the Hesse state government – have already been put on the table.[9]

… remedying the shortage of skilled workers deserve priority

While employment for low-skilled workers continues to pose a huge challenge, there is a shortage of skilled staff, notably engineers and research personnel. The German government will therefore facilitate access for specialised personnel from the 12 new EU member states and improve the chances for foreign graduates from German universities to remain in the country. As an effective countermeasure against the shortage of skilled personnel – which is increasingly also the result of demographics – Germany also needs a rational immigration policy geared to longer-term labour market requirements such as has long been successful in other countries. The policy of sealing off the jobs market against eastern Europe should certainly not be extended beyond 2009.

Sense of proportion in family policy

On the issue of work/family balance, which is significant in terms of both labour market and family and population policies, the Grand Coalition has continued the approaches and initiatives of its predecessor while also making its own individual mark, for example with the parenting allowance. A change of mentality in society has probably also been set in motion. Welcome as financial support for young families may be, even family policy must have regard for the strict constraint of budgetary consolidation.

5. Other policy areas

1. Coalition sets out its stall on energy and climate policy

The Grand Coalition is setting the stage for sweeping moves on energy and environmental policy that will curb energy consumption, severely rein in environmentally relevant emissions and move energy supply towards renewables in the medium term. To begin with, energy consumers and property owners will bear the brunt of this, with utilities involved more rigorously only in the medium term.

Energy and climate policy triangle

Germany's energy and climate policy officially pursues the triangular objective of economically efficient, secure and environmentally compatible energy supply. Its comparatively high energy efficiency notwithstanding, in absolute terms the level of emissions is high owing to the country's size and traffic density and the large part

[9] See Mauer (2006).

played by coal. Also, the German government already intervenes actively in the energy market through taxes, subsidies and regulative law, pushing up the price of consumption. What is more, particularly in the electricity market there is a lack of competition and a narrow oligopoly. Last but not least, external developments are causing concern over the future supply of oil and gas.

Key items for an integrated energy and climate programme

Doubling the proportion of electricity from combined heat and power plants to 25% by 2020.

Increasing the share of regenerative energies in power production from 12% in 2006 to 25 to 30% by 2020.

Raising the share of renewable energies in heat consumption from 6% in 2006 to 14% by 2020.

Proof of technical, environmentally compatible and economic feasibility of low-carbon power plant technologies.

Programmes to promote climate protection and energy efficiency outside buildings.

Promotion of energy-efficient products by setting standards for appliances (e.g. ecodesign).

Development and institutionalisation of the existing building refurbishment programme for the energy rehabilitation of residential buildings.

Incentives to reduce the carbon footprint of transportation. The German government aims to push for the competition-neutral inclusion of air transport and shipping in emission trading.

Reduction of emissions of extremely climate-hostile fluorinated greenhouse gases that have up to 20,000 times greater greenhouse potential than CO_2.

Energy and climate policy looks set to become the Grand Coalition's most serious reform work in progress. In the medium term, the government's integrated energy and climate programme (see box in the margin) will change the approach to energy and help ameliorate global climate problems. Initially, private households and the housing and transport sectors will bear the brunt of this as price effects are unleashed on the markets. Already, the energy utilities are affected by restrictions on third-party access fees. Moving forward, they are likely to be involved more rigorously through the reorganisation of their power networks in the course of the EU's drive for greater competition in the energy sector and through long overdue price increases for emission permits no longer issued free of charge.

The German government has carried out the groundwork for an integrated energy and climate policy with an assessment of present energy supply, an external forecast[10] and three “energy summits”. But in the first two years of the current legislative period hardly any concrete decisions have been taken. However, on the initiative of the EU the Allocation Act 2012 (Zuteilungsgesetz 2012) transposing the EU emissions trading system for the years 2008-2012 into German law has been approved. Emissions are set to fall by 21% from 2008, with only just under 10% of allowances being auctioned.[11] Even lignite power plants have not been spared severe adjustments.

The German government is looking to lower emissions by 40% up to 2020 (taking 1990 as the base year). In future, energy is to be used far more efficiently (3% p.a. savings instead of roughly 1.5% p.a. so far since 1990), and the contribution of renewables (primarily wind power, bioenergies) to primary energy consumption is to be almost trebled within 14 years (close on 6% in 2006). A particularly drastic reduction in energy consumption is targeted in the heat sector (buildings), cogeneration installations will receive greater support, appliance efficiency will be raised by setting standards and the transport sector will be made more energy-efficient with an array of measures (including the replacement of engine cubic capacity by emissions for the calculation of motor vehicle tax). The use of renewable energies in buildings and fuels is also to be promoted more strongly and increased by means of compulsory blending.[12] Details are not yet clear on how fleet consumption targets for the automotive industry will be set EU-wide, but it is certain that the aim is to reduce emissions to 120 g CO_2/km or 130 g/km allowing for biofuels, among others. The 3% energy saving target is considered extremely ambitious, so loosening the package of measures would jeopardize its implementation.

Many contentious issues surrounding the future energy mix, particularly with regard to power generation, remain unresolved. The Chancellor has endorsed the coalition agreement to continue

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[10] Federal Economics Ministry/Ministry of the Environment (2006) and Prognos/EWI (2007).
[11] For an in-depth discussion see Heymann (2007).
[12] See Auer (2005).

phasing out the use of nuclear power, which will not make it any easier to achieve the goals of improved energy efficiency and less reliance on energy imports. Renewables and natural gas are likely to gain in importance, whereas petroleum, nuclear power, lignite and hard coal will become relatively less significant. The jury is still out on whether the federal government and EU programmes to create "cleaner" coal-fired power plants really can be a technological and economic success. At any rate, the use of coal seems set to become more difficult as part of an ambitious climate strategy.

More competition needed in the electricity market

What is clear, though, is that competition needs to be given a freer rein through national regulation and EU-wide measures in the electricity market. Yet at the European level the German government has set itself against the Commission's plans for the complete separation of power grids from electricity generation in favour of compromise solutions.[13]

More economical use of energy and the environment a core issue

The fact that the institutional framework for climate policy and the energy industry is not mapped out for the long term in many important respects is leading to delay in renewal of the power station network in particular. In the medium term supply crunches and further price rises for energy carriers cannot be ruled out. In the long term, policy-makers run the risk of severely missing their self-imposed targets on the reduction of carbon emissions in the event that important elements of the strategy do not deliver the projected savings. In the face of the "biggest market failure in the history of mankind" (Stern report), it is evident that private persons and the business community will have to adjust to more sparing use of energy and the environment. The Grand Coalition has taken this "inconvenient truth" on board and is willing to bring financial pressure to bear on the populace to drive conversion ahead – always bearing in mind that in the medium term massive energy savings will bring individuals and companies far lower energy bills. The Federal Environment Agency has calculated that trade and industry and private households could save EUR 9.6 bn a year by using electricity more efficiently. What is more, German technology suppliers, who are among the foremost in their industry worldwide, will benefit from increasing investment in modern energy technologies.

2. Education and research policy: Putting the car on the road

The government's education and research policy must be seen in the light of the EU's Lisbon targets and Germany's consistently mediocre showing in the PISA studies. More resources need to be input by public institutions and the private sector. There is also room for improvement in the coordination of research policy within government.

Recent surging economic growth has caused the goal of raising R&D spending to 3% of GDP to recede again to a somewhat more distant point in time. Although Germany currently ranks in the upper international third with a rate of around 2.5%, government spending accounts for only one-third of this against industry's two-third share. The public sector must thus either spend considerably more on R&D itself or improve the institutional framework for private enterprise. Tax regulations like the interest capping rules or the limitation of inter-periodic loss offset making it more difficult for highly leveraged,

[13] On EU energy policy, see Auer (2007).

fledgling companies in particular to invest, send out the wrong signals.

Looking at the departmental budgets in the overall Federal Budget, the concentration on environmental and climate projects is striking. The Ministry of Education and Research has been allocated a hefty 16% more for environmental and climate technology in 2008. The presentation of a High-tech Climate Protection Strategy is planned for the autumn along the lines of the government's High-tech Strategy. All in all, the education and research ministry's budget rises by nearly 8%; expenditure by the Ministry of Economics and Technology is set to increase at a lower rate than the overall budget.

A welcome development is the streamlining of SME programmes under the title "SME Technology Promotion" (2008: roughly EUR 253 m). In general the economics ministry is focusing on SME issues, also in the energy sector, where advice for SMEs on energy-related topics is scheduled in a ten-point programme. But the government's 20th subsidies report indicates that notwithstanding its aim of promoting cutting-edge technologies and sectors, the biggest cost pools are still accounted for by subsidies for hard coal, the agrarian structure and housing construction.

Regulatory environment for innovation still capable of improvement

Material resources-based R&D policy, although adequately slanted, must nevertheless be accompanied by flanking measures to foster the private sector's innovative capacity: In the climate/environment arena, regulatory relief for green genetic engineering is conceivable; the endowment/foundation system is comparatively underdeveloped in Germany; and opening labour markets to skilled labour and international specialists should be made easier. In general, basic research must be better linked to applied research in Germany – with the development and marketing of the fax machine and the mp3 player or the wrong turns in the Renewable Energy Sources Act (EEG) as cautionary examples.

3. Financial market policy

Germany's standing as a centre of financial activity must be rigorously advanced. The Grand Coalition should waste no time improving the regulatory framework for Public Private Partnerships and private equity, beefing up financial supervision, implementing the EU Payments Directive on time and making appropriate adjustments to public payment practices.

Domestic initiatives

Public Private Partnerships (PPPs) have taken very much of a backseat so far in Germany as a means of financing public infrastructure projects. The establishment of PPP task forces at the Länder and federal level highlights the importance that policy-makers have attached to the subject for some time. Some headway has been made, particularly at local authority level[14], although this is still way below potential. The federal government has set itself the target of lifting the share of PPPs in public fixed investment from around 2-4% at present to a comparable international level of 15%. This would be tantamount to annual PPP investment of roughly EUR 5 bn, unlocking the significant efficiency gains that PPP projects potentially offer (synergy between construction and maintenance, better risk spreading, innovation). The Initiative Finanzstandort

Structural impediments to the PPP market

Contractual	Little standardisation Complicated public procurement law
Tax	Equal turnover tax treatment Fiscal neutrality in tax legislation
Financial market	PPPs as asset class in their own right

13

[14] This pinpoints the distinctive feature of federal systems: Roughly two-thirds of all public investment is carried out at the subordinate level, with the result that central government specifications do not necessarily produce the desired result.

Deutschland (IFD), which is committed to boosting Germany's standing as a financial centre, is moving to provide backing for PPP projects by setting up a privately organised consulting firm, "Partnerschaften Deutschland GmbH" (PDG), to support the public authorities in PPP projects. But this needs to be accompanied by appropriate legislation.

The PPP Acceleration Act laid the initial foundation, dealing mainly with issues of contract standardisation and value for money assessment (PSC). The PPP Simplification Act currently passing through parliament[15] goes further down this road. Special attention should be devoted to examining turnover tax treatment of the PPP method as opposed to the public sector's conventional procurement method and to a more open definition of PPPs as an asset class in their own right.[16] It is likely that the introduction of double-entry bookkeeping (by 2011) at the level of the Länder and municipalities will further increase PPP acceptance. Rising project numbers should bring further standardisation benefits and improve value for money assessments. Politicians should support this process, for example by privatising the Transport Infrastructure Company (Verkehrsinfrastrukturgesellschaft) as a specific project, reversing the burden of proof in value for money assessments and placing PPPs in a fiscally neutral tax framework.

Absence of a competitive regulatory environment for private equity

Private Equity Act: Germany is a mere middle-ranker in terms of private equity investment, which in 2006 amounted to a paltry 0.31% of GDP (roughly EUR 7.2 bn) against a European average of 0.56% of GDP. What is more, over half of all private equity investment in Germany was made by investment funds based abroad. This shows that Germany lacks a competitive regulatory environment, which should be put in place in a new Private Equity Act. However, the bare bones of the project so far suggest it is likely to miss the mark. Taxation at investor and not fund level is a particularly important aspect. Nor should the legislation seek to make any distinction between the different forms of private equity investment (e.g. venture capital vs. buy-out) as this would be neither practicable nor meaningful.

Modernisation of financial supervision: Building on evaluation of the work of the German Financial Supervisory Authority (BaFin) by the financial services industry, the government is currently preparing legislative amendments on the working and structure of financial supervision in Germany. The financial services industry's main concern is to preserve the reputation and capacity for action of the financial watchdog and, most particularly, its executive, and to optimise the way that BaFin and Bundesbank work together. Additionally, non-supervision-related costs should be separated from the banking industry's funding of BaFin and the supervisory authority's liability for misconduct on the part of its employees regulated by law.

EU-wide projects

During Germany's European Council presidency amendments were negotiated to the relevant EU directives governing the procedural rules and evaluation criteria for the prudential assessment of

[15] This addresses such specific issues as hospital financing, the Social Assistance Act, the Trunk Road Privatisation Act and the Investment Act.

[16] As far as the capital market is concerned, restriction to low-risk periods of PPPs (as a rule at the operational stage) adds virtually no value. Complicated regulations are the result. Issuers should also be able temporarily to rule out repurchase of the investment fund shares. And valuation rules must be clearly standardised.

acquisitions in the banking sector. These amendments are intended to prevent the abuse of financial supervision legislation within the EU to protect national markets. Implementation of these amendments into national law should not be a problem.

Implementation of the EU Payment Services Directive

More critical in terms of its timing is implementation of the Payment Services Directive (PSD) into German law. The EU has allowed the Member States up to November 1, 2009 for this. Given that banks cannot offer the new SEPA (Single Euro Payments Area) direct debit scheme until the PSD has been implemented, it is vital for this to be accomplished on time. Beyond the purely legislative aspect, it is incumbent on the public authorities to ensure, by converting their payment systems to the SEPA formats, that SEPA payments reach critical mass in the near future. The investment necessary for this must be budgeted at all layers of government and public institutions, including the social insurance institutions.

Additionally, in the coming months various EU initiatives are in the pipeline. They include a review of the Lamfalussy process for EU legislation, integration of the EU mortgage credit markets, the Consumer Credit Directive and the new regulatory framework for investment funds and insurance companies.

Review of the Lamfalussy Process: Presentation of the Inter-Institutional Monitoring Group's (IIMG) concluding report at the end of 2007 will set a milestone for the review of the Lamfalussy Process. On the basis of this and other reports the three EU institutions will decide whether, and if so how, the process is to be altered. While consensus appears to be emerging that any changes to Levels 1 and 2 (legislative process) and Level 4 (enforcement by the European Commission) are likely to be marginal at most, the European financial services industry in particular has identified substantial need for action to make Level 3 (regulatory convergence) more effective and efficient (see Speyer/Walter 2007 and ERC 2007). Germany has the key role here of creating supervisory structures in the EU that reflect the realities and objective of an integrated single European market in financial services.

Mortgage market integration: The European Commission will publish a White Paper, probably at the end of this year, with proposals on integration of the EU mortgage credit markets. In the subsequent political process the German government should have two main interests at heart. The first is to drive ahead integration of the European mortgage credit markets so that consumers and German banks can benefit from an increase in cross-border business; the suitable means for this is deeper integration of the secondary markets (see Schäfer 2006). Second, steps must be taken to ensure that existing forms of financing which find favour with consumers, while being enhanced by new product variations, are not impaired as a result of regulatory changes. This applies in particular to long-term fixed-rate loans the continued availability of which depend, among other things, on the system of early repayment fees currently applied in Germany not being altered.

Consumer Credit Directive: The Council having approved a compromise on the Consumer Credit Directive this May, the Draft Directive is currently on its second reading in the European Parliament. The financial services industry still perceives the need for further substantial improvement to the bill, firstly because it misses the target of facilitating cross-border transactions in this business segment, and secondly because it would make present national business even more expensive and less attractive from the point of view of consumers and providers alike. If no further substantial improvement can be achieved at the European level, regulators must at least exploit the remaining national scope to prevent changes for the worse.

Investment funds (UCITS Directive): In November 2006 the European Commission presented proposals in a White Paper on revision of the regulatory framework for investment funds. The Commission wishes in particular to simplify procedures for investment funds to obtain a passport to operate throughout the EU, to facilitate the merger of investment funds across Europe and to rework the simplified offering prospectus. In response to the White Paper the European Parliament is presently drawing up its own proposals on revision of the UCITS Directive in an initiative report. The recommendations by the EP are expected to go beyond the Commission's proposals and to identify need for action in respect of private placement regimes, funds of hedge funds and the inclusion of real estate funds in the UCITS Directive. From a political point of view, a two-tier approach would make sense: In 2008 the Commission's proposals should initially be adopted, while the more extensive proposals by the European Parliament should be taken as the basis of the political agenda over the next five years.

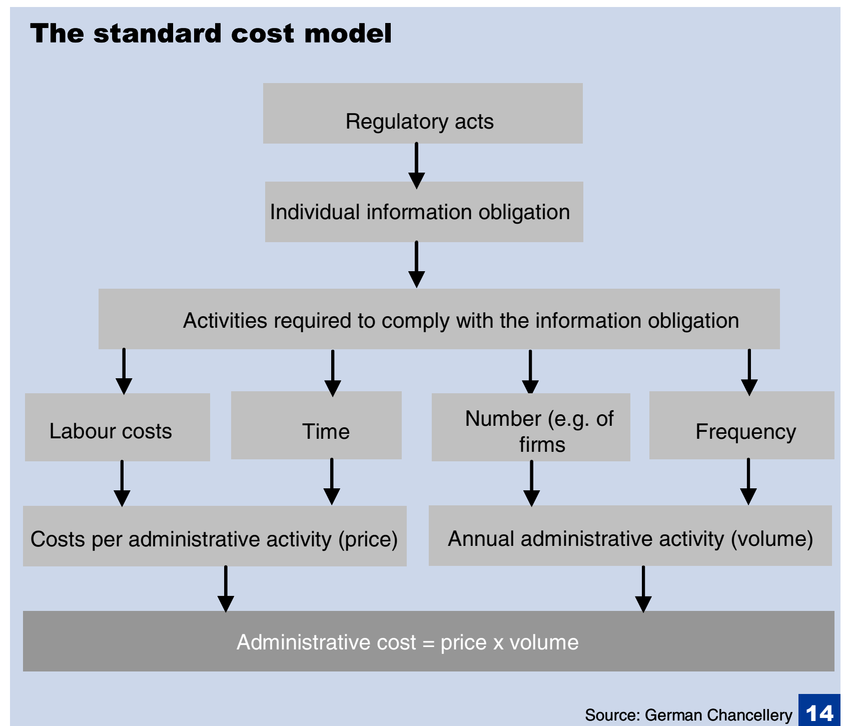
Solvency II: The European Commission recently presented a draft Framework Directive on new solvency regulations for the European insurance industry. The new body of legislation follows the structure of the new capital adequacy standards for banks ("Basel II") and, like these, it will establish a more risk-based equity capital regimen in the insurance industry. Expanded regulations on risk management and provisions to tighten up market discipline complement the solvency regulations as the second and third pillars of the new rulebook. The Commission also plans to set up a lead supervisor regime for insurance companies. Should it succeed in pushing this proposal through, this would deliver a further argument, in terms of competitive neutrality between the financial sectors, for setting up this regime for banks as well.

4. Cutting red tape: Only just begun

Implementation of the Normenkontrollrat and application of the standard cost model point in the right direction. However, a regulatory impact assessment (RIA) should be added to the review mandate. In particular, the bodies tasked with cutting red tape must be assigned a stronger position in the political decision-making process.

Government has set itself the task of rigorously reducing the administrative burden in Germany with its government programme “Bureaucracy Reduction and Better Regulation”. For this the Normenkontrollrat (NKR) watchdog serves as an independent review and advisory body for new legislation, the bureaucratic costs of which (information obligations) are measured using the standard cost model (SCM).

The standard cost model



Source: German Chancellery 14

Press ahead with the reduction of bureaucratic costs

The Act for the Creation of the National Normenkontrollrat (NKR) came into force in August 2006 as part of the government’s Bureaucracy Reduction programme. To begin with, up to the end of 2006 all government departments recorded their entire information obligations resulting from German and EU legislation. These include almost 11,000 official information obligations for businesses, comprising obligations concerning applications, forms, statistics and the like or documentation for official bodies. Since December 2006 the various government departments have had to calculate the probable bureaucratic burdens arising from information obligations for draft legislation using the SCM and specify this in a cover sheet.[17] To lend concrete form to its programme, the government passed a Cabinet resolution in February 2007 setting a target for the

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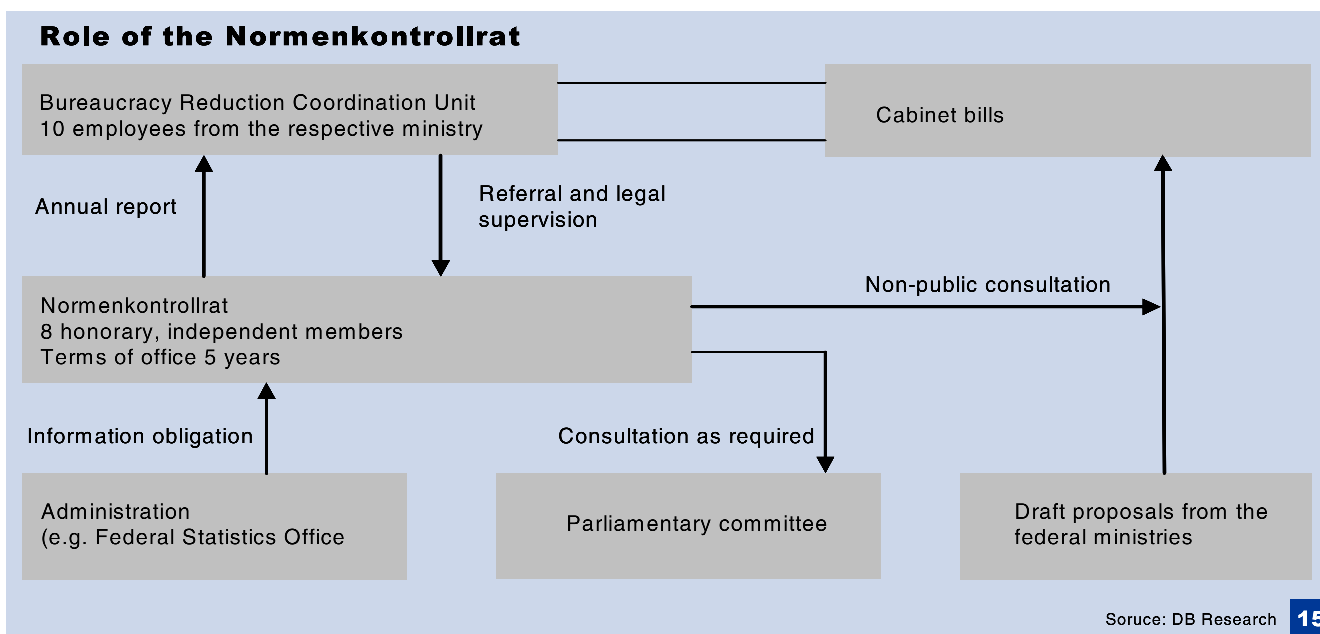
[17] By June 1, 2007 the NKR had reviewed 135 draft bills and ordinances which together contained 253 information obligations. Its review activity led to a total of 66 information obligations being modified and 45 dropped, while 142 new information obligations were enacted. All in all, the NKR’s work thus lowered the aggregate level of bureaucratic costs by EUR 227 m net. See Brok/Dieckmann (2007).

reduction of bureaucratic costs by 25% by the year 2011. The measures in the initiative are being flanked by two laws to reduce administrative burdens for small and medium-sized businesses (SMEs). Basically, these refer to the reduction of information obligations. Further legislation in this direction is to be expected in the coming months.



The NKR's institutional integration into the legislative process and systematic measurement of the administrative costs imposed by legislation using the SCM method are a generally welcome step. They are an important precondition for successfully cutting red tape. But a key weakness of the NKR's work is that is has no mandate to review legislation initiated by the Bundestag, which makes up about 30% of all legislative initiatives.

Extend the NKR's mandate to regulatory impact assessment

Whether the political determination to close this gap at the end of the NKR's initial test phase will be strong enough is, at the very least, questionable. Another criticism of the NKR's assignment is that the review mandate is too narrowly defined and fails to take into account bureaucratic burdens that do not result from information obligations. In the mid term, the government should extend the watchdog's mandate to include the review of regulatory impact assessments.[18]

5. Sundries

Invested pay

The ruling political parties wish to improve ways for employees to share in capital assets. Capital sharing is meant to strengthen employees' commitment to the company they work for while also allowing for the fact that corporate profits and capital gains have risen considerably faster in recent years than employee remuneration. Capital sharing by workers in Germany is indeed

[18] A regulatory impact assessment (RIA) goes significantly beyond the scope of bureaucratic cost measurement (information obligations). A comprehensive RIA aims to quantify all the consequences of a regulation by discounting the potential ensuing costs and benefits to their present value using the net present value method. This effectively calculates the net benefit of a regulation.

underdeveloped, partly because it is easier to arrange in countries in which corporations are the predominant legal form in the corporate landscape. While all the coalition parties agree on the goal, at present they still differ on how to achieve it. The SPD favours a non-company-specific solution with a so-called "Germany fund" to serve as a nationwide accumulator of capital for employees to share. Whilst this would permit broad inclusion of non-corporations as well, it would not achieve the aim of strengthening workers' loyalty to their individual firms. The CDU/CSU, on the other hand, proposes "company-specific alliances for social capital partnerships", a consistent, liberal set of rules to strengthen existing capital sharing models. However, these do not solve the problem that risk is concentrated on the side of the employees and only a small proportion of workers (an estimated 15%) would be covered.

Different approaches to more employee capital-sharing

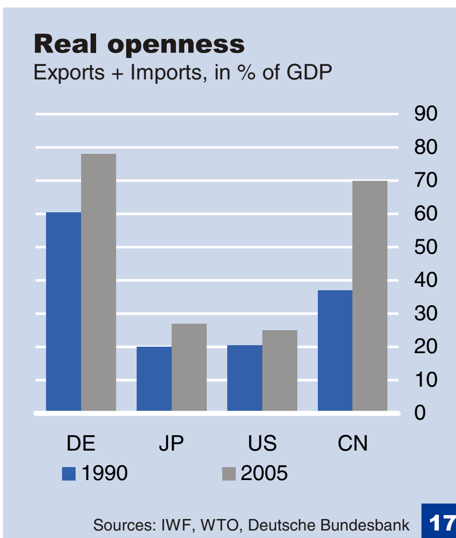
Employee capital-sharing: Low incidence

Company size by number of employees	Profit participation Total	West	East	Capital-sharing Total	West	East
			- % -			
1 to 49	8	8	8	2	2	1
50 to 249	23	24	20	3	3	3
250 to 499	28	30	22	4	5	-
500 +	34	36	21	7	8	-

Source: IAB-Betriebspanel 2005 **16**

A suitable path for political compromise could lie with sector funds rigorously administered along private-sector lines, offering attractive yields with broader risk diversification and the active promotion and support of both employers and employees – the parties that would have to arrange for the conversion of earnings. The employee loyalty effect is, of course, less than in the case of direct capital sharing, but the intention is at least evident.

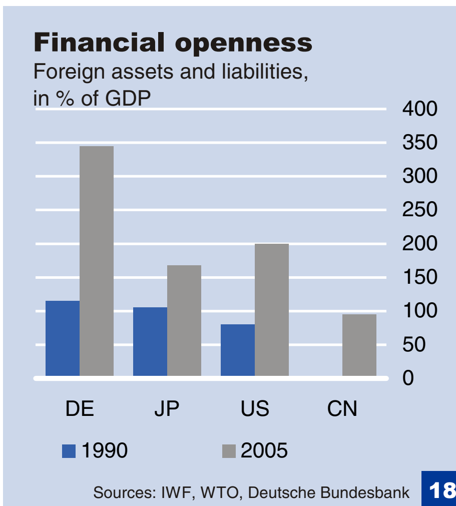
Greater regulation of foreign investors?



Sources: IWF, WTO, Deutsche Bundesbank **17**

Potential growth-inhibiting repercussions on Germany's status as an investment location must also be considered in the context of political action-taking in a broad arena, namely on the issue of the treatment of foreign sovereign wealth funds, which already manage substantial assets.[19] Germany is one of the few big industrialised countries with no systematic monitoring of, or "subject to statutory approval" caveats on, foreign investment (with the exception of the armaments sector). The degree of openness of the German economy has resulted in comparatively close trade and financial investment ties with other countries. This has stood Germany in good stead so far. Foreign investors' recently renewed interest in commitments in Germany (foreign direct investment in 2006 surged to EUR 35 bn compared with barely EUR 17 bn p.a. on average for 2003-2005) has underpinned the refocus of German companies from the SME segment in particular and created additional impetus to growth. The distinction made in public debate between "good" and "bad" capital is therefore not particularly helpful – all the more so, since the view that foreign sovereign capital pursues strategic rather than yield-oriented investment aims has proved misplaced on the basis of experience so far and as a general rule. And finally, fears of

[19] See Kern (2007).



quasi-monopolistic structures can be countered with the argument that foreign investors are also bound by – German and European – antitrust regulation and can be made to abide by the rules of play under pressure from the respective competition watchdog.

International transparency rules make sense

For these reasons the German government should retain its liberal stance and make only very cautious modifications to the Foreign Trade and Payments Act. General pronouncements on Germany's industrial policy interests are preferable to singling out so-called "key industries" by name. Similarly, a general reporting requirement for company acquisitions as from a certain threshold value or the establishment of an intervention fund should be considered very carefully. The initiative mooted by the German government to press internationally for an understanding on transparency rules for state-controlled investment funds is a good idea. These funds operate worldwide, and many governments are taking an increasingly critical view of their investment behaviour. International transparency regulations could prevent this situation turning into a new protectionist spiral that would culminate in prosperity losses all round. A common European position on this issue would be a good thing, although the member states' very different mindsets on the subject suggest this will be rather difficult, at least in the shorter term.[20] Greater pressure from the EU to observe reciprocity would, however, presumably be an option that all could subscribe to.

6. Agendas and outlook

Germany on the right road

Germany is on the right road, although it must be said that the work of government was made easier for the Grand Coalition in the first half of its term by the powerful impetus to the German economy from a dynamic global economic environment, which had the effect of glossing over many a structural weakness. For the coming years this constellation is not a reliable given. The risks are growing. What is more, the pace of reform in Germany can ultimately only ever be judged relative to other countries. Other "rivals" – be they industrial countries or emerging markets – are also bestirring themselves, and some are moving faster.

Take advantage of positive scenario for reforms

That is why it is so important for policy-makers to take advantage of the still-positive scenario at present to set further reforms in motion and strengthen the self-sustaining forces driving growth. The biggest political and economic dividend is likely on the labour market and in education. Adjustments to Hartz IV and a marked reduction in unemployment insurance contributions are measures that can be launched in the short term. That said, given the political circumstances at present it may be better for the government to sit on its hands as regards labour policy than to do the wrong thing (with minimum wages as an example). The same can be said of health policy including nursing care, where the administration seems to lack the strength to set the necessary signals. Moves on education must focus on the very young (primary education) and on older generations (lifelong learning). Agreement on new debt rules and better control over the quality of government expenditures would ring in an extremely welcome paradigm change in fiscal policy resulting in more efficient and growth-enhancing employment of public funds and fewer "inherited burdens" for future generations. And precisely on the federalism issue, a "coalition of new

[20] For a detailed discussion see Wruuck 2006.

possibilities", as the chancellor described it in her 2005 policy statement, should have the courage to take more sweeping strides forward.

Coherent growth strategies wanted

The greatest threat to the medium-range growth outlook lies in an undercurrent in politics and society, namely the misplaced desire for greater government. As society – individuals and the corporate sector – call for more political "cotton-wooling" in the present era of globalisation, politicians feel increasingly inclined to accommodate them. Surveys show topics such as social justice and distributional concerns moving to the fore, and government is expected to come up with answers. But the political parties in Germany still have a long way to go on producing convincing growth and distribution strategies.

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[21] The authors would like to thank their colleagues for the following contributions: Sascha Brok on federalism, education, bureaucracy reduction; Bernhard Speyer on financial market policy; Frank Zipfel on taxes.

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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-314X / ISSN Internet and e-mail: 1612-3158