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Germany

Macroeconomic Assessment

Briefing Note

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1. Executive Summary

The current report aims to provide an assessment of the German economy focussing on macroeconomic issues. The list of policies analyzed is by no means exhaustive, but attempts to reflect (at least in part) the remit of the European Parliament's ECON Committee.

- **Growth performance:** After several years of slow growth, a cyclical recovery is underway with strong export growth beginning to feed into investment strengthening domestic demand. Private consumption will pick up in the run-up to the VAT increase on 1 January. Growth will be dampened in 2007 as the result of said VAT rise.
- **Inflation:** HCPI inflation is estimated at 1.1% for October 2006. Inflation will accelerate substantially as the result of the VAT hike.
- **Employment:** As a result of the cyclical upswing the employment situation is improving. Wage developments are expected to remain moderate and labour market reforms should remain on the agenda.
- **Eastern Germany:** GDP growth in the new Länder is currently below that in the western part of the country. At the same time, unemployment in the east is almost double that in the west. The further development of the new Länder will remain a major challenge for Germany for the foreseeable future.
- The **fiscal situation (deficit)** is relatively healthy in 2006 after many years of high deficits. Debt levels however remain high and are unsustainable in the light of future ageing-related spending.
- The **German tax system** is widely regarded as inefficient and distortive. High tax rates do not bring about high tax revenue due to wide variety of exemptions and tax breaks.
- The pan-European strive **from direct to indirect taxation** is also working in Germany: VAT-rates are increased (2007) and corporate tax rates will be decreased (2008).
- **Social security systems** remain one of the main challenges and most controversial issues as contributions need to be decoupled from wages.
- The **federal fiscal structure** is in need of reform, especially regarding the tax redistribution mechanisms and subnational revenue independence.
- **Financial Services:** Following implementation of CRD fine tuning may be needed to apply to specialties of the German market with particular focus on the Mittelstand.
- **New mortgage legislation** should stimulate the market.
- **Pension products** and savings products for older population segment will need to be developed.
- **Solvency II** should follow-through issues of supervision, capital calculations especially in the case of conglomerates (CRP + Solvency II). IAS/Solvency II dialogue is needed.

Federal Republic of Germany
Key Forecast Figures

	2004	2005	2006 (a)	2007 (a)
Percentage change over previous year [b]				
Private consumption	0,1	0,1	0,9	0,0
Government consumption	-1,3	0,6	1,2	0,7
Gross fixed capital formation	-0,4	0,8	3,9	3,4
Machinery and equipment,	4,2	6,1	6,8	5,8
Buildings	-3,8	-3,6	1,6	1,2
Other investment	1,2	4,7	4,4	4,8
Domestic demand	0,0	0,5	1,7	0,7
Exports of goods and services	9,6	6,9	10,0	6,2
Imports of goods and services	6,9	6,5	9,7	5,2
Gross domestic product (GDP)	1,2	0,9	2,3	1,4
West Germany and Berlin	1,6	1,0	2,3	1,4
East Germany	1,9	-0,1	2,1	1,2
Employment (1.000 persons)	38792	38726	38945	39184
West Germany	31298	31301	31440	31649
East Germany and Berlin	7494	7425	7505	7535
Unemployment (1.000 persons)	4381	4861	4523	4308
West Germany	2783	3247	3037	2868
East Germany and Berlin	1599	1614	1486	1440
Unemployment rate[c] (in %)	10,1	11,2	10,4	9,9
West Germany	8,2	9,4	8,8	8,3
East Germany and Berlin	17,6	17,9	16,5	16,0
Consumer prices[d] (% change on the previous year)	1,6	2,0	1,7	2,3
Unit wage costs)[e] (% change on the previous year)	-0,4	-1,1	-1,2	0,1
General government financial balance[f]				
- EUR billion	-82,5	-72,6	-55,4	-32,9
- in % of GDP	-3,7	-3,2	-2,4	-1,4
memo item:				
USA: Real GDP (% change on the previous year)	3,9	3,2	3,5	2,7
Japan: Real GDP (% change on the previous year)	2,3	2,6	2,7	2,0
Real GDP in the EMU (% change on the previous year)	1,9	1,4	2,6	2,1
Consumer prices in the EMU[g] (% change on the previous year)	2,1	2,2	2,2	2,1

a) Forecast by the Institutes.- a) Price-adjusted.-
c) Unemployment as a % of labour force (employed and unemployed).-
d) Consumer price index.- e) Gross wages and salary income
created in the domestic economy per employee as a % of GDP (price-adjusted) per employed
person.- f) On national accounts definition (ESA 1995).- g) Harmonized index of consumer prices (HICP-EMU).

Quelle: BEA, ESRI, Eurostat, Federal Statistical Office, AK VGR der Länder, Federal Agency of Labor,
Forecast by the Institutes.

Source: Joint Economic Forecast by the six leading German research institutes, 19 October 2006.

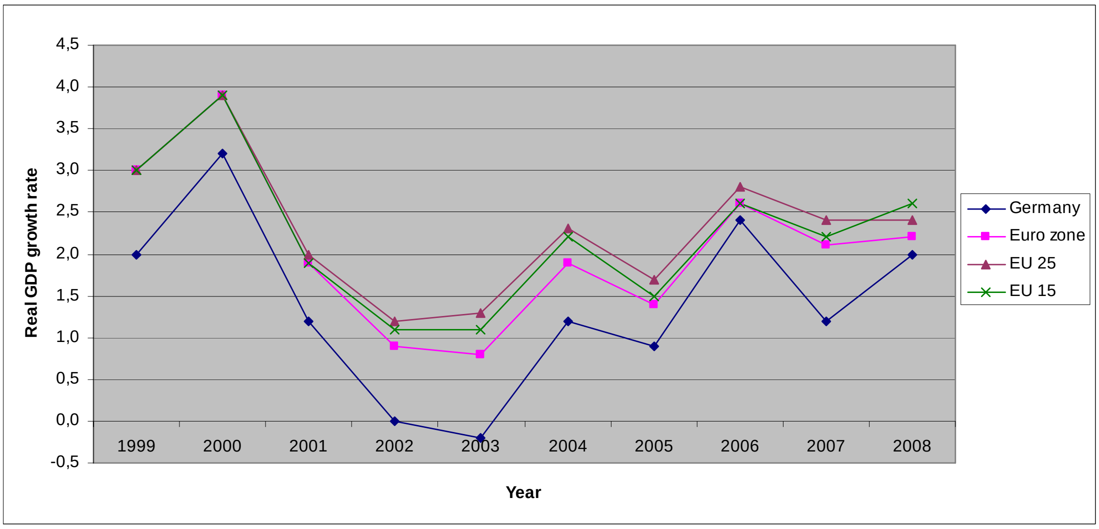
2. General Economic Situation

2.1. Growth

After several years of slow growth, a cyclical recovery is underway in Germany. Corporate restructuring and wage moderation have lowered costs and improved external competitiveness accompanied by important reforms of the labour market and social welfare programs. The recovery has further benefited from an extended period of favourable external conditions, and strong export growth is beginning to feed into investment.

Eurostat estimates that the German real GDP growth rate will be 2.4% this year representing the highest rate since 2000. Growth is then expected to weaken and only reach a rate of 1.2% in 2007 before strengthening again to 2.0% in 2008.

The following graph illustrates real GDP growth rates for Germany in relation to the euro zone, the EU 15 and the EU 25 clearly showing German performance below that of the euro zone and the EU as a whole in recent years:



Source: Eurostat, euro zone data represents 12 countries, 2006-2008 data are forecasts.

The good performance in 2006 is attributed to the following factors:

Domestic demand: The strong growth in the second quarter of 2006 was largely driven by domestic demand which in turn was largely the result of a surge in construction investment which took up after bad weather in the first quarter. Investment in machinery and other equipment also rose reflecting increased capacity utilisation with the need for replacement elevated due to a lack of investment in previous periods. A rise in inventories also contributed substantially. Private consumption has only recovered hesitantly and was temporarily boosted by sales related to the Football World Cup in Germany in June 2006. However, in light of the VAT rise on 1 January 2007, private consumption is expected to pick up substantially in the run-up to this date.

Strong export growth: Germany's strong export performance is consistent with its comparative strength on price and cost competitiveness and global demand for its products. Exports continue to benefit from Germany's focus on machinery which is in high demand in key emerging economies and oil-producing countries. In view of robust expansion of the world economy, exports of goods and services are expected to grow by 10% this year.

The forecasts for 2007/2008 are based on the following expected development:

VAT hike: The slowdown in 2007 will largely be driven by the effects of the intended VAT hike raising the standard VAT rate from the current 16% to 19% representing, according to the press, the biggest single tax increase in the history of the Federal Republic. The VAT increase will encourage consumers to bring forward into 2006 purchases of durable consumer goods leading to a decline in private consumption in 2007. It is estimated that this effect could lower GDP growth in 2007 by around 0.4 percentage points[1] in relation to 2006. The outlook for consumer demand also remains weak because of low wage rises and a savings quota that, after a slight decline in 2006, is expected to rise again in 2007.

Strong domestic demand: Investment in equipment is forecasted to remain the key driving force of GDP growth in 2007 as it is expected to rise strongly again, also owing to a worsening of appreciation conditions in 2008 which will lead to investments being brought forward into 2007.

Slowdown in exports: German export growth rates are considered unsustainable and the situation has already begun to normalize in the second half of this year. Lower export growth owing to a weaker global environment will drag down growth. In particular, demand from the US is expected to decline owing to the appreciation of the euro and the economic slowdown in the US. Currency appreciation is expected to lead to a further slowdown of exports in 2008.

Tightening of monetary policy: Economic expansion is expected to slowdown somewhat as the recent gradual withdrawal of monetary accommodation, i.e. rising interest rates, are filtering through into the economy.

Both exports and imports slowed down sharply after unsustainably rapid growth in the first half of 2006. Some literature argues that the economic cycle is about to peak. This analysis is derived from comparisons with previous peaks in cycles. Furthermore, the performance of several forward-looking indicators worsened in recent weeks and business expectations have shown a downward trend since April slightly recovering in October.[2]

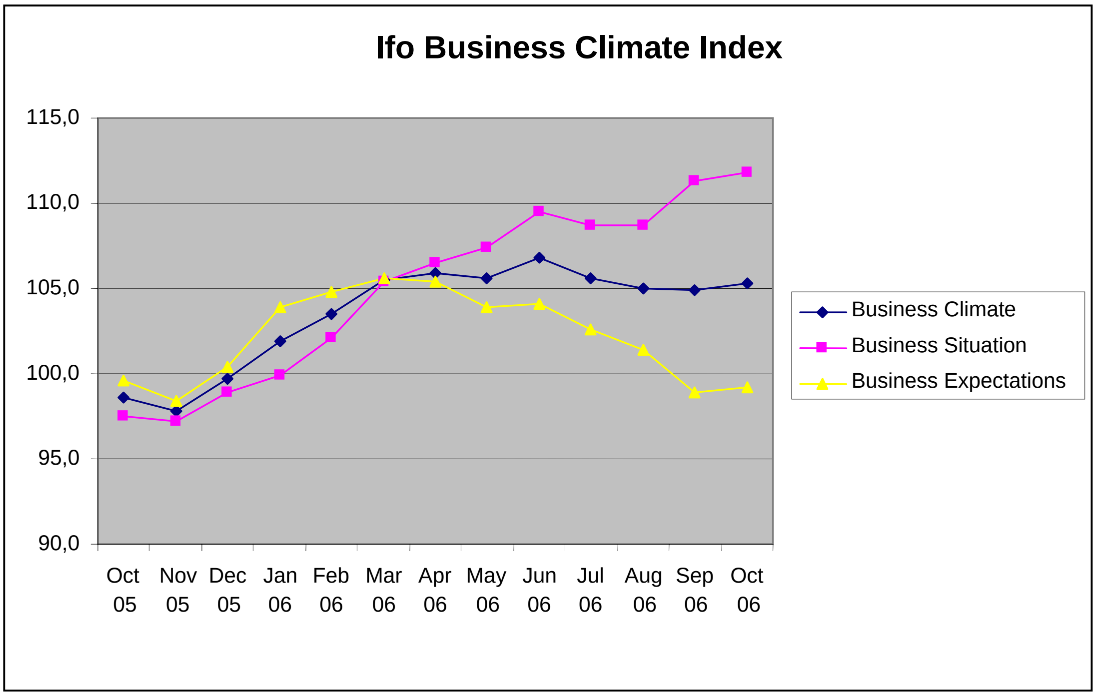
Forward-looking indicators

The **Ifo Business Climate Index** is based on ca. 7 000 monthly survey responses of firms in manufacturing, construction, wholesaling and retailing. The firms are asked to give their assessments of the **current business situation** and their **expectations** for the next six months. The **business climate** is a transformed mean of the balances[3] of the business situation and the expectations. For calculating the **index values** the transformed balances are all normalized to the average of the year 2000.

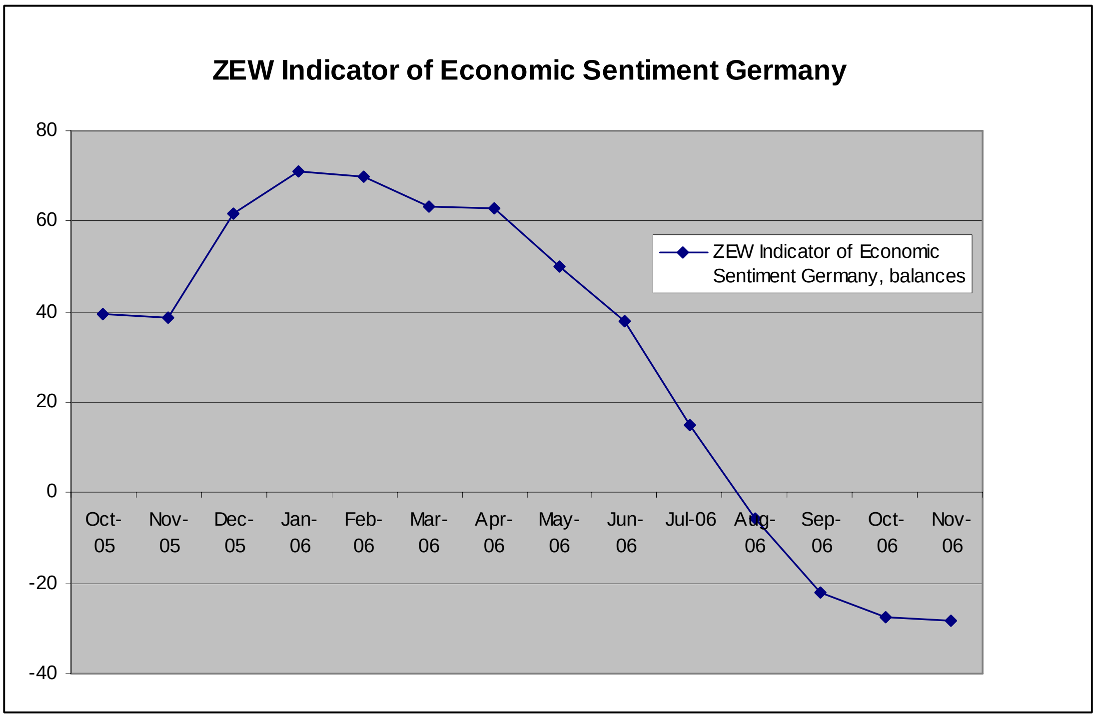
[1] The Kiel Institute of the World Economy. The Joint Economic Forecast of the leading research institutes of 19 October 2006 estimates this effect at 0.25 percentage points.

[2] Boss, Alfred et al: Konjunktureller Höhepunkt in Deutschland wird überschritten; Kieler Diskussionsbeiträge 430/431; The Kiel Institute of the World Economy, September 2006.

[3] The balance value of the current business situation is the difference of the percentages of the responses "good" and "poor", the balance value of the expectations is the difference of the percentages of the responses "more favourable" and "more unfavourable".



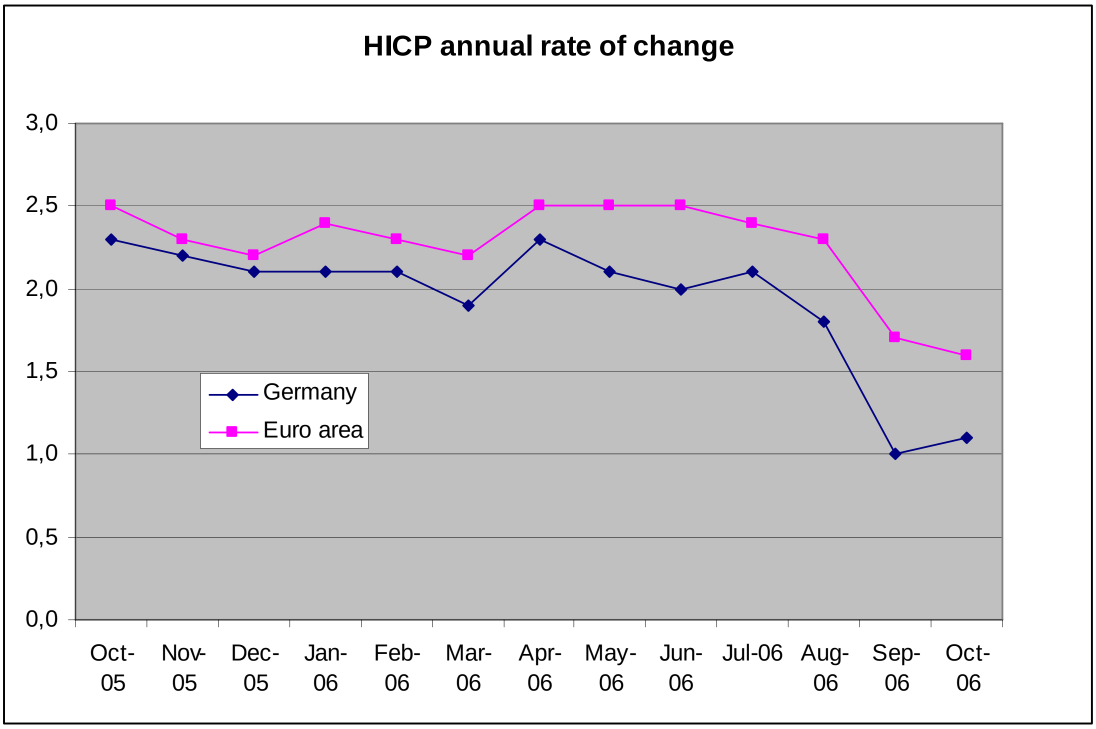
The **ZEW Indicator of Economic Sentiment** is ascertained monthly. Up to 350 financial experts take part in the survey. The indicator reflects the difference between the share of analysts that are optimistic and the share of analysts that are pessimistic for the expected economic development in Germany in six months. The survey also asks for the expectations for the euro-zone, Japan, Great Britain and the US.



2.2. Inflation

HCPI inflation in Germany is estimated by Eurostat at 1.1% for October 2006. The recent decline in inflation is attributed to lower oil prices and the fact that a rise in tobacco taxes in September 2005 fell out of the equation.

The following graph illustrates the development of inflation over the past 13 months in Germany in relation to the euro zone:



The development of oil prices is expected to continue to present substantial volatility although oil prices are by some not expected to have an upward impact on inflation in 2007 and 2008.[4] Upward risks are posed, however, by the indirect impact from higher input costs for non-oil products which will still take time to feed through fully. Wage growth is expected to remain moderate posing no risk of second round effects. Hence domestic cost pressures are expected to remain weak. The expansion of imports of manufactured goods from low-cost countries will probably continue to hold down import price inflation. As private consumption is expected to recover only gradually, retailers will find it difficult to raise prices.

The VAT hike on 1 January 2007 will have a substantial impact on inflation. Estimates of the effect vary. The Bundesbank points to a 1.4% increase in inflation, the Kiel Institute for the World Economy puts the effect at 0.75 percentage points of extra inflation. A further 0.1 percentage point is estimated as the result of a rise in insurance tax. The price increases related to the VAT hike are probably already underway and might explain part of the rise in consumer prices over the summer especially as room to manoeuvre with regard to passing on tax increases into prices has widened with the better economic situation.

[4] Economist Intelligence Unit, Country Report Germany, October 2006.

The conundrum of strong exports and slow growth[5]

Export boom and weak domestic growth are not separated events. They can be linked in a development process which is caused by labour market rigidities. International low-wage competition defines a new labour market equilibrium but factors such as collective bargaining and fixed replacement incomes provided by the state prevent domestic wages from adjusting. The economy reacts by moving from relatively labour-intensive to capital-intensive sectors, by investing capital abroad and by replacing manpower where possible. These reactions can lead to high exports, a large export surplus and mass unemployment at the same time.

Firms adjust to foreign competition by replacing manpower where possible and by having their products prefabricated abroad moving these jobs abroad. Customers are often unaware of this relocation: Labour-intensive upstream activities are moved abroad while downstream stages of production remain in Germany allowing the producer to maintain a Made in Germany label. In the statistics this effect is visible when looking at how value-added in manufacturing fell behind manufacturing output and how the average import share in German exports has increased reflecting an increase in imported intermediate products.

It is primarily the law of factor price equalisation that is at the root of the German problem: The wages of trading partners at similar stages of development converge because capital movements and trade create a single world labour market. If factor price equalisation is resisted, unemployment is the consequence.

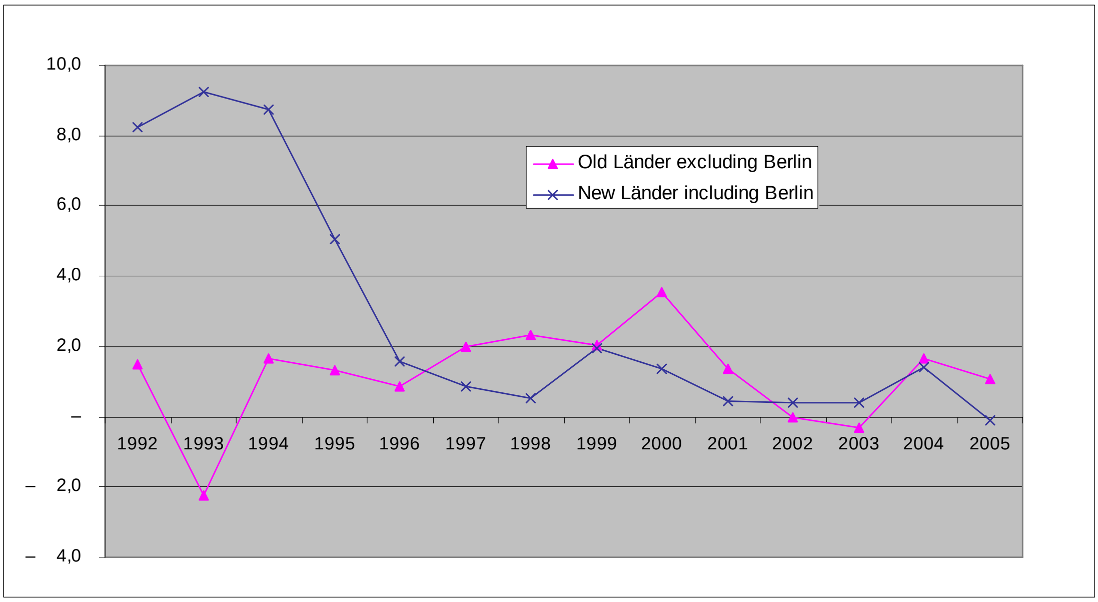
Germany can try to slow down (not avoid) factor price equalisation by increasing its innovation lead. A strengthening of research, innovation and education therefore belong on the agenda, as a long-term response. In the medium term, more flexible labour markets are needed combined with a policy of compensating the losers of the required wage adjustment.

2.3. Growth in Eastern Germany

The catch-up process of Eastern Germany seems to have stalled despite more than 80 billion EUR[6] of transfers from west to east every year. Indicators such as the trend in the catch-up process of per-capita incomes, productivity and especially the development in GDP growth illustrate this development.

[5] This explanation is based on: Hans-Werner Sinn: The pathological export boom and the bazaar economy, CESifo Working Paper No. 1708.
[6] The Kiel Institute for the World Economy.

Annual GDP growth rates for West and East Germany



Some of the reasons for the unsatisfactory growth development in the new Länder are:

- Orientation of the economy towards the domestic market, i.e. Eastern Germany could not profit to the same degree as the west from the strong performance of exports;
- Weak domestic demand, decreasing private consumption due to migration losses and high unemployment as well as loss of purchasing power (higher administrative prices and tax increases);
- Weak overall economic environment;
- Low investment.

An issue of particular interest regard the transfer payments from west to east. In 2003, gross transfers amounted to 130 billion EUR[7] of which the biggest part (45%) is attributable to social policy measures. The net transfer amounted to 83 billion EUR. About 22% of East German demand is attributable to the transfers. Without the transfers, the standard of living as well as output in the new Länder would be substantially lower. However, the flip side is the dependency on these transfers most of which have a base in German law which means that a lowering is only possible to a limited extent. In reality, a substantial lowering of transfers would only occur within the framework of a substantially improved economic performance of the new Länder.[8]

3. Employment situation

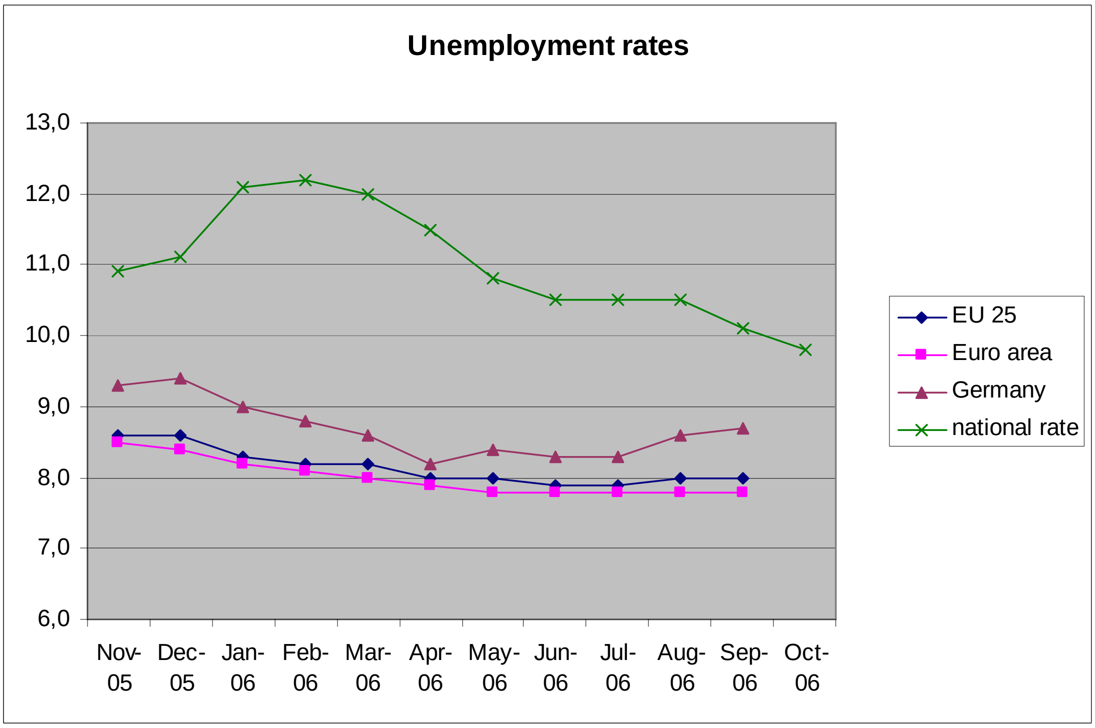
As a result of the cyclical upswing, the employment situation has improved. Employment growth accelerated in the second quarter of 2006 and stood at a rate of 0.8% year on year in July. Contrary to previous developments, the increase was largely due to a rise in regular employment subject to social security contributions. Employment grew strongest in financial and business services, followed by an

[7] As a comparison, the Financial Perspective limits the 2007 EU budget to 120 billion EUR.

[8] IWH-Pressemitteilung 21/2003: Wie hoch sind die Transferleistungen für die neuen Länder? http://www.iwh-halle.de/d/publik/presse/21-03.pdf

increase in government and social services. Employment in trade, tourism and transport services also moderately increased while the downward trend in construction flattened out. However, employment in manufacturing fell.[9]

In October, the seasonally adjusted national unemployment rate fell below 10% and stood at 9.8%. It had not been consistently below 10% since 1995. The EU harmonised unemployment rate also strongly declined. The following graph compares both rates and also gives the EU harmonised rates for the euro zone and the EU 25 as a comparison.



Source: Eurostat; EU25, euro area and Germany rates based on Eurostat methodology, national rate based on national methodology.

In part the decrease in the unemployment is due to the growth in the number of regular jobs, however, part of the decrease has to be attributed to more severe preconditions set by the employment offices for unemployed to register. A part of the unemployed probably subsequently decided not to renew their registration.

3.1. Wage developments

Wage rises have been stronger in 2006 than in previous years, however, they remain relatively moderate and the sectoral developments differ: While employees in banking will receive 3.0% more, remunerations in the retail sector will only rise by 1% and public sector pay remains more or less unchanged.[10]

Interestingly, hourly labour costs in manufacturing accelerated, however, their rise remains below hourly productivity growth. The German manufacturing industry managed to consistently lower costs through wage moderation achieving a lowering of unit labour costs which in turn resulted in a lower real effective exchange rate in

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[9] Economist Intelligence Unit, Country Report Germany, October 2006.

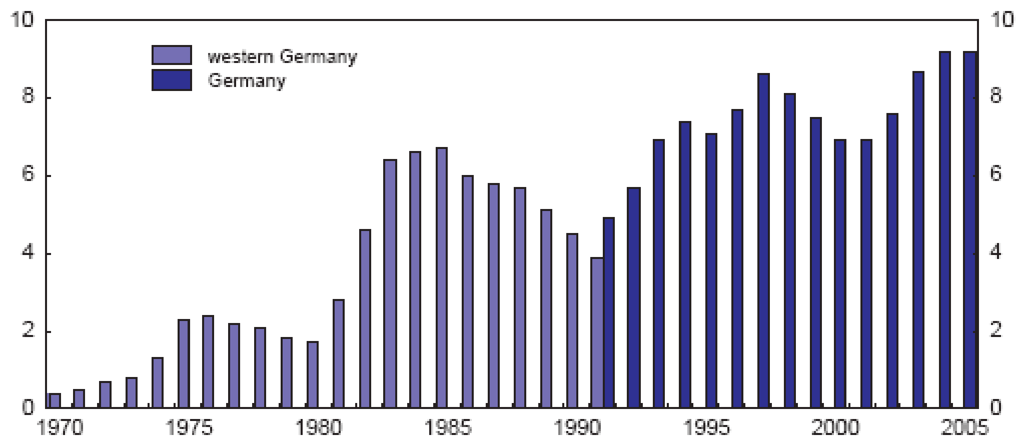
[10] Boss, Alfred et al: Konjunktureller Höhepunkt in Deutschland wird überschritten; Kieler Diskussionsbeiträge 430/431; The Kiel Institute of the World Economy, September 2006.

the euro zone, a development that is currently discussed under the buzz word of "diverging competitiveness".[11]

3.2. Labour market reforms

High levels of unemployment and rising social charges have led to considerable pressure on labour markets and major reform steps have been implemented over the last few years. In fact, unemployment had been drifting upwards since the first half of the 1970s with unemployment rising when shocks occurred but only partially fallen when the shocks subsided.[12]

Development of Unemployment
Unemployment as per cent of labour force



Source: German Federal Statistics Office[13]

In response, aggregate wages moderated and agreements between employers and employees became substantially more flexible. The economic environment lowered the bargaining power of unions. On the policy side, reforms focused on reducing disincentives in unemployment benefits to accept employment and better activation strategies.

Some of the measures taken were:

- Organisation reform of the Labour Office;
- Introduction of new active labour market measures;
- Introduction of tax preferences for small jobs;
- Deregulation of fixed term and temporary contracts;
- Easing of dismissal protection;
- New income replacement scheme for the long-term unemployed.

After its recent mission to Germany in the context of an art. IV consultation, the IMF concluded that many of Germany's labour market regulations and programs are complex, expensive and ineffective, even though recent reforms were path-breaking

[11] See also a series of experts papers commissioned by ECON, http://www.europarl.europa.eu/comparl/econ/emu/20061010/default_en.htm.
[12] Eckhard Wurzel: Labour market reform in Germany: How to improve effectiveness; OECD Economics Department Working Paper No. 512/2006.
[13] In Wurzel: Labour market reform in Germany.

in several respects.[14] Therefore, it would seem prudent to keep reform of the labour market on the agenda.

It is considered that the present tax and transfer system still implies significant disincentives for labour supply and that the activation strategies for the unemployed can be improved. On the demand side, there remains scope to raise the efficiency of the employment protection system and provisions should be made to allow for a higher degree of wage flexibility across qualifications and regions. Furthermore, making growth more employment intensive requires the linking of labour market reforms to policy initiatives in other areas.[15]

3.3. The Lisbon Employment Targets

How does Germany fare in relation to the Lisbon employment targets? The table below gives an indication:

Lisbon Target	Germany	
	2000	2005
Overall employment rate to reach 70% by 2010	65.6	65.4
Female employment rate to reach 60% by 2010	58.1	59.6
Employment rate of workers aged 55-64 to reach 50% by 2010	37.6	45.5

Source: Eurostat

Participation of elderly workers has increased substantially but is still below the target. Measures have been taken to remedy the situation also in light of having to cope with the ageing of society.

Subsidies for part-time employment schemes for older employees (*Altersteilzeit*) will be terminated by 2010. Eligibility for unemployment insurance benefits for workers over 58 years was cut from 32 to 18 months. Both "methods" were used by employers to terminate employment of older workers by-passing the provisions of employment protection legislation and shifting part of the costs of reducing the workforce into the social insurance system. Early retirement schemes will be phased out by 2016 and there are plans to increase the statutory retirement age to 67 years by 2029.

Female participation has been moving up but only slowly. The rate, however, is close to the target. A number of features in the tax and transfer system are deemed to provide disincentives for spouses to take up employment. For instance, the income tax assessment is based on a couple's joint income rather than individual incomes, providing a disincentive for participation of a second earner.

[14] https://www.imf.org/external/np/ms/2006/091106.htm.

[15] See Wurzel: Labour market reform in Germany: How to improve effectiveness. In this paper several areas of reforms with possible policy choices are mentioned: Work incentives for welfare recipients need to be further increased, job search requirements have to be strengthened, new active labour market measures need to be introduced, further institutional reforms of the public employment service is necessary, employment protection remains in need of reform.

3.4. The employment situation in Eastern Germany

The national unemployment rate in the new Länder remains depressingly high with a value of 15.7% for October 2006, almost double the rate for the west of the country which stood at 8.2% at the same time.

The hard economic truth behind the high unemployment rates in the East is relatively simple albeit uncomfortable: Jobs are created when firms find productive opportunities to gain profits. The higher productivity is relative to costs (including wage costs) the more profit can be realized and the higher the demand for labour. In Eastern Germany wages were increased massively after reunification, and the reasons for allowing this are more than understandable, while productivity increased only with time. A combination of the exchange rate between East and West German Marks in the monetary union of 1990 and a rapid rise in wage levels through collective bargaining overpriced Eastern German production. The fact remains until the present day that wages are too high for the underlying productivity.[16]

4. Fiscal Policy and Taxation

The fiscal situation in Germany looks relatively healthy for the year 2006. Due to strong cyclical conditions, tax revenue is set to increase by approx. 8 to 10% year on year in 2006.[17] A reasonable part of the positive situation for 2006 reflects strong consumption spending in anticipation of the VAT rate increase on 1 January 2007. The consolidated general government deficit for 2006 is estimated in the range from 2.6% (Federal Ministry of Finance) to 2.7% (Ifo Institute), thereby conforming with the Stability and Growth Pact. For 2007, a figure closer to 2.0% is targeted by the government. The adoption and further reduction of this target should be possible with the resolute implementation of policies.

The golden rule that net investment must always be higher than the net deficit (Article 115 *Grundgesetz*) will be met in 2006 for the first time in a long time. In the past 5 years, the government had to proclaim "macroeconomic disequilibrium" due to the continuous breach of this constitutional golden rule.

General government deficit and debt

Year	2003	2004	2005	2006	2007
Deficit	-4.0	-3.7	-3.2	-2.6*	-2.0*
Debt Stock	63.9	65.7	67.9	67.8	67.7

Source: European Commission, *Updated government estimate

The government debt stock still remains considerable at approx. 68% of GDP, and has been increasing until this year. Although the present consolidation efforts have been reflected in slightly decreasing debt levels, the sustainability of the debt stock remains questionable, especially in light of foreseeable ageing-related expenditure. The

[16] Dennis J. Snower: Arbeit in Ostdeutschland: Unbequeme Wahrheiten, IfW Fokus Nr. 15/2006, The Kiel Insitute for the World Economy, http://www.uni-kiel.de/ifw/presse/fokus/2006/fokus15_06.htm. Adam S. Posen: A Glum 2015 Scenario – If...; Peterson Institute for International Economics, http://www.iie.com/publications/papers/posen0304.pdf.

[17] Federal Ministry of Finance 2006 and Deutsche Bank Research, 2006.

ageing-related sustainability gap in public finances will equal 4.4% by 2050 in Germany, as calculated by the recent Commission report on the long term sustainability on public finances. Other things equal, maintaining current policies will see government debt increasing to 100% of GDP by 2050.[18] Therefore, fundamental reform is essential.

A related challenge for the German macro-fiscal situation lies in the complexities of the federal structure and certain problems this system has run into. Reforming the federal structure has been quite justifiably proclaimed the "mother of all reforms". This briefing will therefore address this issue in reasonable detail and stress the importance of reform in this area as a central means to achieve better incentives for fiscal prudence across layers of government and achieving a better allocation of resources.

4.1. General Government Finances and Social Security

4.1.1. Revenue – Taxation

The overall sequence of tax reform since 2001 follows the general European tendency away from direct taxation toward indirect taxation.

Indirect taxation: the most prominent issue on the agenda is the increase of the regular VAT rate from 16% to 19%, taking effect on 1 January 2007.[19]

Income tax: The top marginal personal income tax rate is currently 42%. For incomes above 250.000 EUR p.a., the current coalition government has introduced a surcharge resulting in a 45% rate as of 2007, applying only to labour income.

Corporate tax: Effective corporate and income tax rates remain relatively high in international comparison, putting a special burden on company profits and household wage earnings. For example, together with Spain, the German corporate tax burden is currently still highest in the EU.[20] At the same time, Germany has relatively lower tax revenues as percent of GDP than other countries. This apparent contradiction has to do with the erosion of tax bases with numerous tax exemptions and expenditures, which account for 2.5% of GDP.[21] Although recent years have seen the end of some tax exemptions, others have been introduced by the current coalition (e.g. on household services).

Corporate Tax Reform: In October 2006, the government agreed on a reform proposal for the corporate tax bringing down the effective tax rates for corporate profits from approx. 39% to below 30% in 2008. At the same time, to finance this relief, the government is planning to widen the tax base by cutting some of the tax breaks for companies, and especially restrict the tax-deductibility of interest payments. This will probably have some effect on the capital structure choice of companies, especially since it puts debt-financing worse off. The new rule will however only be applied to companies that have interest payments of over 1 million EUR in order to account for the special situation of SMEs in Germany. The resulting tax relief would amount to 5 billion EUR per year.

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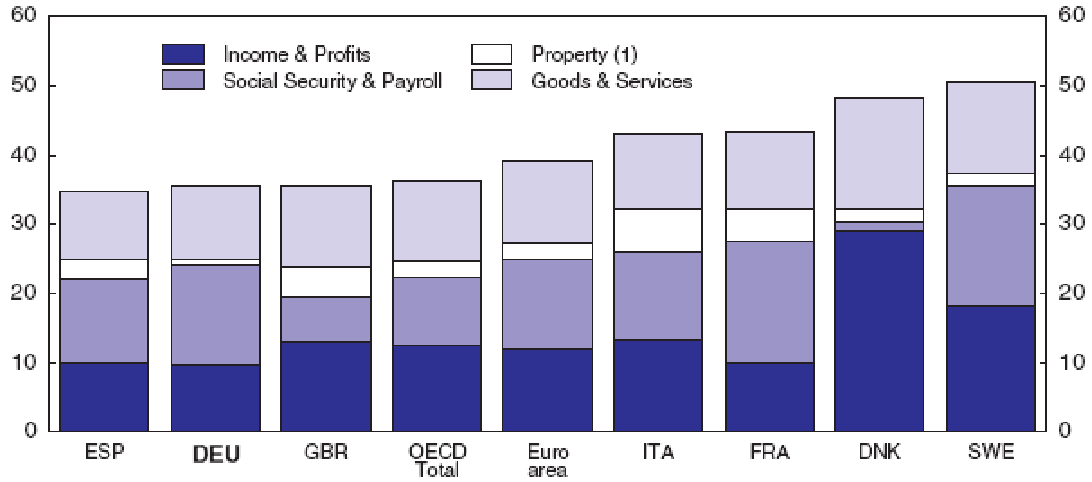
[18] European Economy No 4/2006 and Bundesministerium für Finanzen 2005 estimations.
[19] See above page 7 for a discussion of economic effects.
[20] According to a study by ZEW, Eichner, Elschner and Overesch (2005).
[21] See OECD Economic Surveys: Germany, May 2006.

4.1.2. Sources of Tax Revenue

The following figure shows the composition of general government (all layers) tax revenues as percent of GDP in Germany in an international comparison:

Tax Structure and Tax Revenue (%of GDP) in selected OECD Countries (2003)



Source: OECD Revenue Statistics 2005

As can be seen, German tax *revenues* in total are relatively low in international comparison despite relatively high tax *rates* (see argument above p. 16). German tax revenue in total amounts to approx. 35% of GDP. Taxes on income and profits (lower block) account for about 10% of GDP, and the main relative burden lies on social security contributions with 14.4% (middle block).[22] The latter figure is very high in international comparison. While taxation of property is very low in Germany, the taxation of goods and services is average with 10.4%.

It has to be noted, however, that the above table does not tell the story on recent dynamics. In fact, Germany is the only country in the OECD where the percentage of social security contributions in percent of GDP has gone slightly down in 2005 and 2006, reflecting a certain success of the reform process.

4.1.3 Social security remains the central challenge

The German social security system is organized as a parafiscal body not directly included in the government budget, but closely associated and reported in the consolidated general government statistics.

The "non-wage labour costs" (Lohnnebenkosten) in the form of social security contributions (for example) have been in the centre of the reform debate in Germany as their effect on employment is deemed detrimental and their level is still considered excessive. Some reductions in contribution levels have materialized in the last 2-3 years since the previous government started its Agenda 2010 reforms. In 2003, total social security contributions peaked at 42% percent of gross wages.

The current government has put further efforts into decoupling social security contributions from labour costs, with mixed results. In recent years, the federal government has also had to subsidize the social security insurance system massively as these have been unable to balance their budgets.

[22] Payroll taxes do not exist in Germany.

The reform of the healthcare insurance system has been one of the main stumbling blocks for the current government. The ruling parties have completely diverging views on how healthcare should be organised, and consequently, according to most experts, the current reform has been a weak compromise between more freedom and competition and equal access to healthcare at affordable prices. Reflecting the weakness of the result, the contributions are set to rise well over 14% of gross wages, the opposite of what was intended.[23]

Unemployment insurance funds have been in surplus in 2006 with about 9 billion EUR. This has lead to calls to reduce the unemployment insurance contribution by more than the already planned cut from 6.5% to 4.5% as of January 2007. However, further cuts are unlikely as there is no financial leverage for this. The pension system will also see an increase in the contributions by 0.4 percentage points to 19.9%. The government attempted to push social security contributions under 40% of gross wages, but this goal is very unlikely to be achieved.

4.1.4 Expenditure

Government consumption in general declined in 2005/06, reflecting reductions in public sector employment and low pay rises and slower growth of health care expenditure owing to past small reforms in the system in 2004. Also, stronger growth in 2006 will help to reduce the share of government expenditure as % of GDP by about 1 percentage point.

Social security accounts for the by far largest item on the general government expenditure bill of about 1000 billion EUR, with about 57%[24], and education accounting for about 8% as the two largest functional spending categories.[25] Following excessive debt levels over an extended period, the level of interest payments alone on government debt is extremely high, especially in the federal budget this amounts to about 20% of the total budget (or about 40 billion EUR).

Although faced with numerous challenges, the quality of expenditure is improving gradually, an assessment confirmed by the OECD. Over the medium term, the main burden of fiscal consolidation will fall on the spending side. Empirical evidence suggests that spending reductions are more successful in sustainably consolidating public finances than tax increases.[26]

A critical element here will be linking expenditure reform to general public sector reform, the two crucial items being 1) reforming the federal fiscal relations (addressed below) and 2) improving budgetary techniques in order to better control the budgetary planning process. While the federal fiscal relations will be discussed in the following, the budgetary planning discussions falls beyond the scope of this paper and will not be addressed here.[27]

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[23] As the elements of the system and its reform cannot be discussed in detail here, for details on the German system of health care see e.g. OECD Economic Survey: Germany, May 2006.
[24] While the average for the 1980s was 48%.
[25] Federal Statistical Office, Wiesbaden, data for 2004.
[26] E.g. Alesina and Ardagna (1998) or De Mello et al (2004), available from authors.
[27] Interested readers may consult e.g. the OECD Economic Survey: Germany May 2006.

4.4. Fiscal Policy in a "Unitary Federal State"

The German federation consists of three layers of government: the federal (Bund), the 16 states (Länder) and the municipalities (Gemeinden, numbering 14,643).

4.4.1. "Unitary federal state"

An expression often used to describe modern German policy evolution is the "joint-decision-making-trap" (Politikverflechtungsfalle).[28] Compared to other federal countries, the German system of fiscal intergovernmental relations puts a relatively strong emphasis on redistribution, coordination and cooperation. While assuring a high level of political stability, leading economists in Germany have however called the system a "tax cartel".[29] The system is today widely regarded as highly inefficient and bureaucratic.

The German Basic Law assures the states (Länder) the primary state functions. However, in the wide majority of policy areas, federal mandates and cooperative agreements restrict state discretion in administrative matters and in determining their own policies. Conversely, federal action in crucial areas has been constrained by state interests as these have been able to block policies in the Bundesrat, the states chamber involved in all important legislation. This overlapping structure of responsibilities, sometimes also called "administrative federalism"[30], leads to complex mediation procedures and inefficient allocation of resources.

Less Decentralized Revenue Autonomy than in France

As a consequence of this "administrative federalism", German subnational governments (states and municipalities) are less autonomous in determining their tax revenue than in many more "unitary" states. The following table presents some empirical evidence on subnational tax autonomy across a selection of industrialized countries:

Tax Revenue Decentralization in Selected Countries (average of 1996-2001)

Country	% of Subnational Revenue in Total Govt. Tax Revenue	% of *Autonomous* Subnational Revenue in Total Govt Revenue
UK	5.0	5.0
France	18.6	18.4
USA	35.6	35.6
Belgium	44.7	24.6
Germany	**49.3**	**7.2**
Switzerland	56.9	53.0

Source: Stegarescu, Dan (2005), Public Sector Decentralisation, Fiscal Studies 26 (2005)

The first column depicts the subnational tax revenue as percent of total general government tax revenue, an indicator where the federal states naturally achieve high

[28] A term coined by famous German political scientist Fritz Scharpf.

[29] Blankart, Charles (1999): Die schleichende Zentralisierung der Staatstätigkeit: eine Fallstudie, Zeitschrift für Wirtschafts- und Sozialwissenschaften 119 (1999).

[30] Schwager, Robert (1997): Redistribution and administrative federalism, Canadian Journal of Economics 20, 1997.

figures, and for Germany it is almost 50%. If autonomous subnational revenue is considered, however, (i.e. the revenue subnational units can actually decide upon either through own tax bases or rates), this figure drops drastically in the case of Germany, to 7.2%.[31]

The reason for the above result is that much of the revenue is actually received by the states as a revenue sharing grant. For example, the income tax is shared among the federal, state and municipal level according to the formula “42.5-42.5-15” percent respectively. Similar sharing mechanisms exist for the corporate taxes and VAT. The two most important tax categories, income taxes (personal and corporate) and VAT, make up about 80% of total state tax revenue.

As a consequence, judged by autonomous revenue, Germany is actually less decentralized than France. Widening the scope of subnational tax revenue is one of the central recommendations from various expert organisations (e.g. OECD, IMF). While Germany could in principle certainly profit from a little more fiscal competition on the subnational level, the unification burdens since 1990 and the massive dependency of the former East German states on the Western states restricts political feasibility of reforms to the system.

4.4.2. Risk-sharing and Redistribution

The German system entails a high level of fiscal risk-sharing between subnational authorities, most prominently the states (but also municipalities). Through a complicated system of fiscal redistribution in three steps confronting "fiscal need" with "fiscal capacity", the 16 states share their accrued tax revenue in the federal fiscal equalization mechanism (Finanzausgleich). The system almost "equalizes" tax revenue across German states. The poorest states (mainly new Länder) are heaved up from tax revenue levels of about 35% of the federal average (p.c.) to about 99.5%.[32] This dependency ratio is the main explanatory factor behind objections to reform.

The system is rightly criticised for adverse economic incentives as states have practically no incentive to generate further revenue. On average, 84 cents out of every euro of additional revenue are "lost" to the equalization mechanism. Before the reform of the current system in 2002, taking effect in 2005, this marginal contribution rate was 95% on average. This marginal contribution rate of tax revenue is higher for small states (about 97%) than for large states (averaging at around 60%).[33]

In addition to the new Länder, city states (Bremen) and small states (Saarland) have been very dependent on redistribution funds from other states (mainly Bavaria, Baden-Württemberg and Hessen), but also from the federal government that participates in the fiscal equalization scheme through federal supplementary grants (Bundesergänzungszuweisungen). Some of these grants have been de facto bail-outs of financially weak states. In the 1980s, the states of Saarland and Bremen were bailed out by the federal governments and receive special grants until today. Most recently in October 2006, Berlin's request for a federal bail-out was refused by the constitutional court. This can be seen as an important signal in preventing even more detrimental moral hazard and strengthening fiscal prudence.

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[31] The only flexibility in tax rate exists on the level of municipalities (property tax (Grundsteuer), business tax (Gewerbesteuer)).
[32] Own calculations, available on request from the authors.
[33] Buettner, Thiess (2006), Finances of German States, Catalan Journal of Public Law, No 32.

4.4.3. Reform of Fiscal Federalism

Reforming fiscal federalism was named the "Mother of all Reforms". After a failed attempt in 2004/5, the Grand Coalition succeeded to advance on parts of this important reform project in the beginning of 2006. The recently adopted reform of the federal system has brought more clarity into the issue and disentangled the decision-making mechanisms in many crucial areas. The actual benefits remain to be seen in practice. However, the current reform has not brought any progress in reforming the “tax cartel” and the fiscal equalization scheme.

5. Financial Services Issues

5.1. Banking – Implementation of CRD coming up

By the end of 2005, there were 2,152 banks (this number has considerably declined since the early 1990's when the total was 4,177[34]) broadly falling into 4 categories: lending institutions, savings banks, cooperative banks and other banks. The lending sector includes also private banks and branches of non-German banks. By far the biggest sector in terms of number of banks is the cooperative sector with 1,337 banks.

The wave of mergers in the German banking sector has had far-reaching consequences on their client base as cost income ratios and their effect on profitability became a major concern. In the savings and cooperative banking sector this became a particular cause for concern as these banks traditionally support the Mittelstand sector, the backbone of the German economy.

Between 1993 and 2003, profitability (measured through Return on Equity (ROE)) more than halved for this group.[35] Furthermore, as a general global trend in European Banking, net interest rate margins deteriorated narrowing the margin between borrowing and lending. Thus mergers seemed to be a solution in order to allow for income diversification and portfolio diversification. Has the merger process helped the performance of banking portfolios or has it impacted on the traditional client focus relationship banking that continental banks and especially German Banks have been so strong in?

Empirical studies suggest that a move away from relationship banking to sector or regional concentration can work, but only if the correct risk management procedures are in place. However, in the case of regional mergers of banks, sector or geographic concentration can lead to multiplication of the risk factor. This is especially evident in cooperative bank mergers where in 80% of mergers the partners are from the same Länder which will not help their performance post merger.[36]

Relationship banking which has traditionally been important in Germany fosters concentration risk as banks will play the role of house bank especially in the case of SMEs. Under CRD, concentration risk is liable to be penalised especially for SMEs who have generally below investment grade ratings. Concentration risk can be limited by effective use of the banks in using capital markets products such as securitisation

[34] Deutsche Bundesbank Discussion Paper 12/2005.
[35] ibid.
[36] ibid

which can help in keeping the traditional house bank approach together with a more effective ROE.

Due to the heterogeneous nature of German banking, the German regulatory authority BaFin paid particular attention to developing the minimum risk requirements (MaRisk) following the adoption of CRD. Risk management in small local savings banks is very different to that of internationally active banks. CRD will become binding as from 1 January 2007, however, BaFin will not impose sanctions until 1 January 2008.

In order to provide effective overseeing of the risk management procedures to be put into place, BaFin and the Bundesbank have put into place a matrix system which provides parameters in order to compare the banks to their peers as well as the potential risk to the whole financial sector and the importance of a particular sub-sector e.g. building societies. The flexible modular structure of MaRisk is aimed at making the burden for medium and smaller sized institutions less onerous as it takes into account size, business focus and risk situation of the institution concerned.

In the last three years, as the process evolved, the non-performing loans (NPL) market in Germany has also become more active. Estimations for the total value of NPL in Germany range between 160 billion and 300 billion EUR[37]. A loan is classified as non-performing if a 90 day delay in payment has occurred. In practice, all problem loans e.g. those extremely likely to default, qualify as NPLs.

5.1.1. Pfandbrief legislation

In July 2005, the German Mortgage Bond Act replaced the existing special legislation. Since the introduction of the new act, there is no special bank principle any more and all credit institutions can now issue Pfandbriefe, provided BaFin has given them authorisation. Furthermore, former mortgage banks are no longer restricted to mortgages and have therefore de facto become universal banks.

So far these changes have not yet led to a drastic reorganisation of the market as at the end of 2005 only 64 institutions had a licence to issue Pfandbriefe. For some banks the abandonment of the special bank status has allowed them to combine this area of business with other banking services effecting better cross selling.

5.2. Insurance – Solvency II on the horizon

Since 1995, insurance undertakings have been reporting accounting and portfolio data to BaFin on a quarterly basis. However the preliminary figures tend to vary considerably from the final figures. BaFin now has been establishing supervision based on risk-oriented solvency supervision in preparation for Solvency II.

Until the automated systems are in place, BaFin will base its risk classification process on a systematic survey of the employees responsible for supervision so as to be able to judge market impact. In the case of health, life, retirement and accident companies, BaFin determines market impact primarily on the basis of total investments whilst in the case of property and casualty as well as reinsurance undertakings, gross premium income is the basis for assessment. The quality of a company is assessed on 4 criteria: security, success, growth and quality of

[37] BaFin 2005 Report.

management. This risk classification was applied for the first time in the autumn of 2005.

The Solvency II draft directive is currently expected in mid 2007 and the legislative process on European level to be completed by the end of 2008. Transposition into national law should then be finalised by 2010.

Under pillar 1 the majority of insurance companies will use a risk-based standard approach to calculate their capital requirements with a few using the internal based risk models. It will be essential to have close discussions on the relation between IAS and measures in Solvency II in order for insurance companies to comply with market transparency through greater disclosure.

One important point especially for German conglomerates but also for German insurers is that Basel II measures should be compared and discussed but not adopted blindly into Solvency II, as credit portfolio considerations are of less significance to insurers.

Further issues of concern to German Insurers are:

- the correct establishment of which supervisory level acts where;
- the close analysis of issues on capital used for solvency requirements with a view to remaining flexible using a fair value approach with regards to existing capital as well as for hidden reserves;
- the supervision of capital investments covering actuarial provisions (qualitative rather than quantitative, bearing in mind the profile of the company);
- the harmonization of disclosure requirements.

5.3. Pensions

In a recent article, figures were presented showing that German retail banks and insurance companies risk losing up to 25% of their profitability if they do not overhaul their business models and services by focussing more on the older population segment[38]. Currently 30% of Germany's population is 55 and older and this will increase to 40% by 2050. Furthermore, increased longevity is distorting the calculation of provisions leading to higher expenditures.

In this light, the new Pension Fund Directive is crucial to the development of the sector in Germany. The directive and the amendment to the statute of the Pensionskasse in 2005 is to allow Pensionkassen and pension funds to operate on a cross-border basis by state.

Pension funds now have to report to BaFin on their business operations following the same line as for life insurance undertakings. Increased flexibility in allowing employers to use tax benefit schemes will also promote a more dynamic industry responding to the demographics. The increased flexibility in the calculation of interest will clear the balance sheets of German companies that often have very high pension provisions. This measure will increase competitiveness.

Regarding investments by pension funds, it seems that there is increasing flexibility to invest in private equity and in SMEs, although the total of these investments may not

[38] Booz Allen Hamilton, August 2006

exceed 10% of the share capital including subordinated debt and participation rights) of the company.[39]

5.4. Hedge Funds

The granting of licences to hedge funds was intensively discussed in the German financial markets. In 2005, BaFin granted 13 licences to domestic hedge funds and 9 funds of funds.[40] The number is expected to continue to rise. The application is simple: either an existing investment company applies to have its licence expanded or a new vehicle is formed in order to apply specifically for a hedge fund licence.

BaFin performs preliminary assessments as to risk management structure and identifying shortfalls. Once the company has been approved, BaFin uses on-site inspections in order to check on compliance. The development of this industry in Germany will help SMEs search for cash and should provide capital markets investors with diversification.

6. Challenges Ahead

The currently favourable conditions should be used to tackle fundamental problems, in particular to increase the flat growth path and to reduce the high structural unemployment. A major challenge for Germany is the continued task to improve the situation in Eastern Germany. And in the spirit of the Stability and Growth Pact, good times should not go by wasted in terms of reducing public debt.

In its coalition agreement the parties forming the Federal Government named four areas where fundamental reforms should be tackled in order to improve the situation of the German economy:

- Consolidation of public budgets;
- Reform of company taxation;
- Health care reform;
- Making the labour market more flexible.

On the basis of what is know so far on the government's plans, leading research institute, however, are not impressed and judge in their Joint Economic Forecast of October 2006 that the intended reforms will fall short of what is necessary for a clear improvement of the growth and employment conditions. Clearly, the debate of the options has commenced and it remains to be seen which concepts will win the upper hand.

[39] Investment Circular 15/ 2005 BAFIN

[40] BAFIN 2005 report