TOWARDS A FORWARD-LOOKING ECONOMIC POLICY

This is a translated version of the original German-language chapter "Für eine zukunfts-orientierte Wirtschaft", which is the sole authoritative text. Please cite the original German-language chapter if any reference is made to this text.

I. TOWARDS A FORWARD-LOOKING ECONOMIC POLICY

1. The **German economy** is experiencing a major upturn as the new legislative term begins. Production capacities are already **overutilised**. ↘ ITEMS 261 FF. The **rest of the euro area**, Germany's main trading partner, is returning to **normal levels of utilisation**, even though unemployment remains high in some countries. ↘ ITEM 233 The opportunities for, and risks to, the economic outlook are more or less balanced, meaning that the upturn could continue for some time to come. As a result, the solid economic situation provides the new Federal Government with an excellent base for reforms that will help to ward off undesirable developments and leave the German economy better equipped to tackle the challenges of the future.

   A reform agenda is all the more advisable as the upturn is still partly driven by **exceptionally loose monetary policy**. The European Central Bank (ECB) recently decided to make further bond purchases worth €270 billion in total in the period leading up to September 2018, slashing its monthly purchase volume in half. The low interest rates and bond purchases could compromise the ECB's price stability objective if concerns over preserving financial stability and the stability of member states' public finances take priority. Also, there are no deflationary risks lurking on the horizon and capacity utilisation is increasing. This means that the stage is set for a normalisation of monetary policy sooner or later. The GCEE outlines a possible exit and communication strategy. ↘ ITEMS 381 F.

2. In addition to the solid economic environment, the formation of a new governing coalition in Germany provides a fresh **opportunity to re-adjust economic policy**. The focus on distributional issues that has dominated the debate in recent years should be replaced by a focus on the challenges of the future. The GCEE already set out the economic policy priorities for a new Federal Government last year (GCEE Annual Report 2016 box 1), calling in particular for using the good economic situation to strengthen the competitiveness and future viability of the German economy.

3. Fiscal policy should use the fiscal leeway generated by buoyant revenues first and foremost to implement **reforms conducive to growth**. There is no need to increase the public spending ratio. Rather, the burden on taxpayers should be reduced. Higher spending in certain areas should be achieved by changing the structure of expenditure. ↘ ITEMS 44 F. Moreover, the federal states (Länder) should take greater responsibility for their municipalities and keep a closer eye on their budget management. ↘ ITEM 600 Finally, more effort should be directed towards preparing the social security systems for the impending acceleration in demographic change. ↘ ITEMS 51 FF.

4. In order to boost the labour potential in times of demographic change, measures that help balance family and work-life and promote lifelong learning could increase **employment levels** among women and older employees. Greater op-

portunities for **labour migration** aimed at specialists with an occupational training background would also help to counteract the increasing shortage of skilled workers. The emphasis should also be on reducing long-term unemployment and integrating recognised asylum applicants into the labour market. Finally, the government needs to step up its education and training efforts in order to prepare the labour force for the digital work environment of the future. ↘ ITEMS 810 FF.

5. Key will be policymakers' response to structural changes from the comprehensive **digitalisation** of business and society. Although some German companies are international leaders in digitalised **production**, they are not leaders in establishing **new business models** in the service industry. There are several ways in which policymakers could support this **structural change**, namely by strengthening general skills in education and training, putting regulations in place that foster innovation, implementing systematic measures to drive the digitalisation of government administration and ensuring that the labour market is flexible enough to handle rapid structural change. ↘ ITEMS 768 FF.

Finally, energy transition policies aimed at **climate protection** should follow a market-oriented strategy based on a uniform CO_2 price, replacing today's fragmented, planned economy approach. ↘ ITEMS 79 FF.

6. At the European level, the initiatives launched by the new French President Macron will provide the new Federal Government with momentum to forge ahead with **European integration**. European partners should remain faithful to two principles in the process: **subsidiarity** and **unity of liability and control.** Over the last few years, the GCEE has laid out how the architecture of the euro area could be strengthened on the basis of these principles. These measures include phasing out the privileges afforded to sovereign debt in banking regulation and introducing a mechanism for the orderly restructuring of government debt as part of the programmes offered by the European Stability Mechanism (ESM). ↘ ITEMS 122 FF. Further integration, such as the introduction of a common deposit guarantee scheme, would only be an option if the risks in the financial system were reduced to an appropriate level. ITEMS 108 FF., 426 FF.

Giving the ESM an additional surveillance role could help promote **consolidation and reform in the euro area**, which is the responsibility of the member states and lies in their own interest. The **creation of safe assets in the euro area** should only be considered under stringent conditions to exclude any implied liability risks. As a first step, the regulatory framework should be amended to facilitate an environment in which, ideally, private players create such assets on their own. ↘ ITEMS 129 FF.

7. The GCEE has also pinpointed areas in which the European Union should take more action. To minimise the damage for all stakeholders, it would **make sense to extend Brexit negotiations** as a one-off measure if, as is likely, negotiations are protracted. Finally, the partners within Europe should join forces to show that isolationism and protectionism are the wrong answers to the challenges created by an increasingly globalised world. Rather, Europe should pur-

sue an economic policy agenda that facilitates structural change and strengthens the **single market**. ↘ ITEMS 629 FF.

II. MAJOR UPTURN, CHANGING COURSE IN MONETARY POLICY

8. The **global economic** upturn has gathered pace, with growth in global gross domestic product (GDP) picking up considerable speed since the second half of 2016. The advanced economies are the main forces behind this development. Developments in the euro area, in particular, have lately proven unexpectedly dynamic. ↘ CHART 1 TOP LEFT The economic situation has also improved in many emerging markets, a trend that can be attributed, at least for oil-exporting countries, to the stabilisation in crude oil prices.

9. The fact that previous **risks to the upturn** either **did not materialise,** or have at least become less pronounced, has contributed to the improved outlook. The Chinese government, for example, managed to limit any capital flight for the time being and ensured continued high growth. The United States has yet to embark on any extensive protectionist measures. The United Kingdom's request to leave the EU and the exit negotiations have not triggered any major economic slump to date. Pro-European parties have prevailed in the national elections of European Monetary Union member states.

10. As sentiment indicators show, economic players **across the globe have revised upward their expectations for the future**. Together with favourable financing conditions, elevated capacity utilisation already prevalent in many countries, expansionary fiscal policy and a more stable oil price, this has boosted investment and revived global trade. This upturn is expected to continue in the forecast period from 2017 to 2018.

    Nevertheless, the **low-interest rate environment continues**, as central bank key rates in the major industrialised countries remain near zero and the supply of liquidity is still increasing, given bond purchases in Japan and the euro area. Despite gradual monetary tightening in the US, the gap between interest rates and their level implied by simple Taylor rules continues to widen as economic activity and inflation increase. ↘ CHART 1 TOP RIGHT

11. The GCEE believes that the **risks** for the global economic outlook are more balanced than in the past. Some of the above-mentioned risks persist, including the risk of increasing protectionist tendencies, the threat of an unexpected growth slump in China and political risks within Europe. These include the risk of a "hard Brexit", given the lack of progress in the United Kingdom's exit negotiations, an exacerbation of the conflict in Catalonia and the potential victory of eurosceptic parties in the upcoming parliamentary elections in Italy. Moreover, low interest rates could fuel exaggerations on financial markets and lead to misallocations in the real economy. Also, the risk of financial market turbulence should

not be underestimated as many central banks begin to exit their prolonged low-interest rate policies. However, there are also a number of upside risks, in particular a stronger-than-expected upturn in investment.

1. Economic upturn in the euro area

12. In the **euro area,** the unexpectedly pronounced **economic recovery** has now reached all member states. Consumption remains the driving force behind the upturn. Investment is also developing very dynamically and exports have made a return to stronger growth. Employment is on a steady upward trajectory, even though unemployment rates in some member states remain very high.

13. The strong recovery is accompanied by exceptionally good sentiment levels among consumers and corporations, and by higher capacity utilisation. This is supported by structural adjustments made during the crisis, lower political risks and the positive development of global economic activity. Adding to the ongoing very accommodative monetary stance, fiscal policy is also expansionary. ↘ CHART 1 CENTRE LEFT As a result, the **euro area economy is growing at a rate well in excess of its potential**. For 2017, the GCEE expects the output gap in the euro area to close for the first time since the financial crisis. ↘ ITEM 345

Inflation has increased again in 2017 driven primarily by energy prices, which bottomed out at the beginning of 2016 and rebounded to a higher level in 2017. At the same time, **core inflation has increased moderately** as the economic situation has started to normalise.

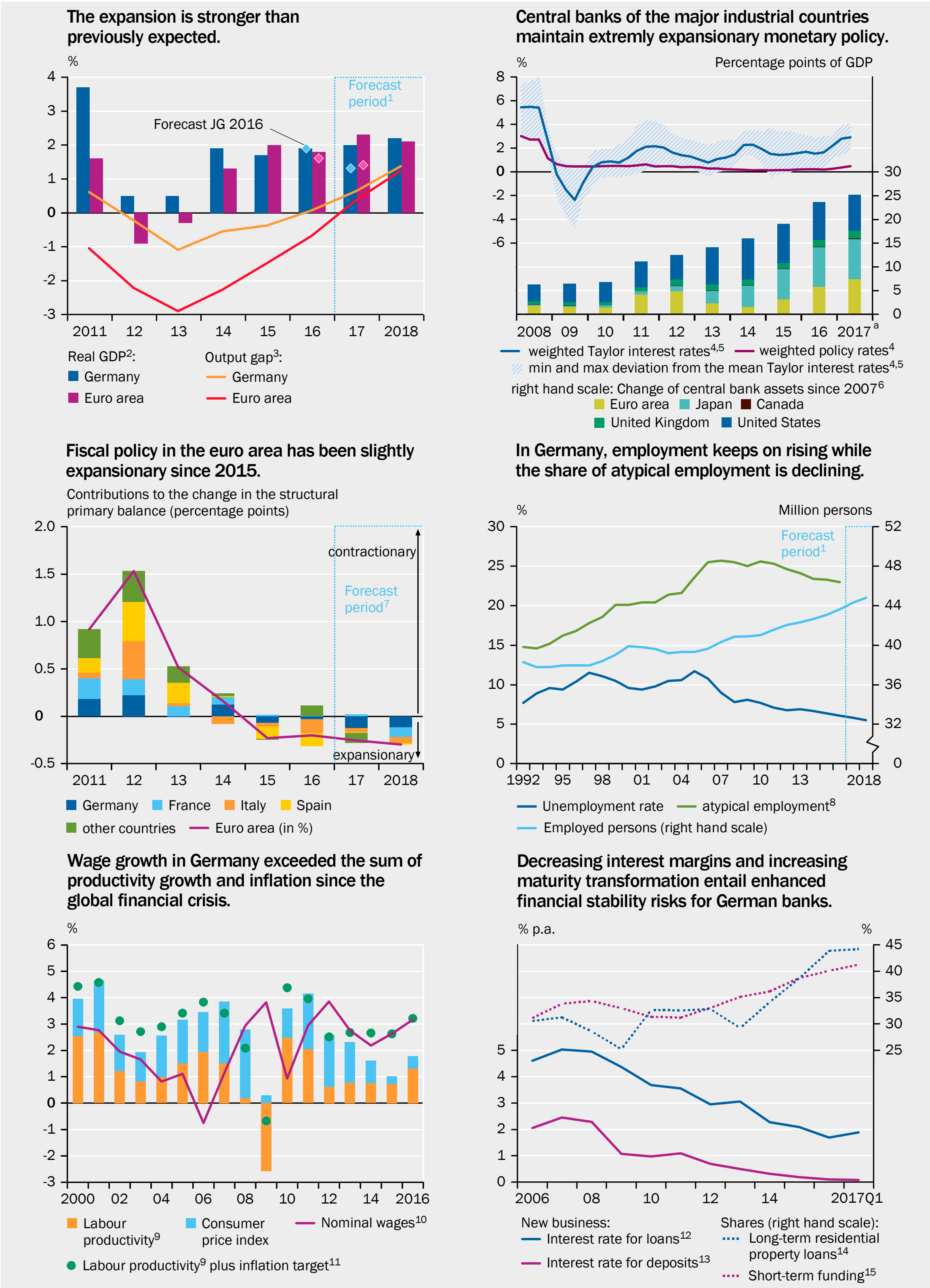
14. The GCEE expects the euro area to report **GDP growth** of 2.3 % and 2.1 % in 2017 and 2018 respectively. **Inflation** as measured by the Harmonised Index of Consumer Prices (HICP) is expected to be 1.5 % in both 2017 and 2018. The GCEE predicts a core inflation rate of 1.1 % for 2017 and 1.4 % for 2018.

15. In **Germany,** the major **upturn**, which was already well underway, has gained further momentum. ↘ CHART 1 TOP LEFT Economic growth outstripped expectations by far in the first half of 2017, with the recovery in the euro area playing a decisive role. The associated increase in external demand meets with **production capacities** in Germany that are already **overutilised** due to robust domestic demand. This environment has prompted companies to invest in additional capacity. It also means that, in addition to gross fixed capital formation in construction, gross fixed capital formation in machinery and equipment and investment in research and development are rising notably.

16. While the upturn is becoming more and more broad-based, the **German economy** is gradually becoming **overstretched**. Employment continues to rise, particularly for standard employment types, and the unemployment rate has dropped to the lowest level since German reunification. ↘ CHART 1 CENTRE RIGHT Companies are finding it increasingly difficult to recruit new staff in order to meet the high demand for goods and services. The German economy is edging closer to a boom.

↘ CHART 1

Overall economic development and challenges



1 – Forecast of the GCEE. 2 – Annual change. Diamond: see GCEE annual report 2016 for 2016 and 2017. 3 – Relative deviation of GDP from its potential. 4 – Policy- and Taylor interest rates are weighted with nominal GDP shares based on PPP of the countries shown. 5 – For a definition of the Taylor interest see Chart 41 and for a calculation describtion see GCEE annual report 2016 chart 60. Taylor rates are based on all combinations among four inflation- and four output measures (CPI, core-CPI, GDP- and consumption deflator, IMF, OECD, hp filter and segmented linear trend). 6 – In relation to nominal GDP of the countries shown. 7 – Forecast by the European Commission. 8 – Share of all dependent employed. 9 – Real GDP per hour worked. 10 – Nominal wages and salaries per hour worked. 11 – For the inflation target a value of 1.75 % is assumed following Bletzinger and Wieland (2016). 12 – Effective interest rate for residential property loans with an initial fixed interest rate for a period of 10 years. 13 – Volume-weighted average interest rate. 14 – Residential property loans with an initial fixed interest rate for a period of 10 years as a share of total newly granted residential property loans. 15 – Short-term funding (sight deposits, fixed-term deposits, and bearer bonds with a maturity up to one year) as a share of total liabilities. a – Results from forecast and monthly values.

Sources: European Commission, Eurostat, ECB, Federal Employment Agency (FEA), IMF, national central banks, Federal Statistical Office, own calculations

17. The GCEE expects the upturn to continue this year and next. It forecasts **German GDP** growth of 2.0 % in 2017 and 2.2 % in 2018. Adjusted for the different number of working days, the growth forecasts are 2.3 % and 2.2 %. This means that the German economy will outperform the estimated potential growth rate of around 1.4 % in both years.

18. In light of the macroeconomic overutilisation, **inflation and wage growth are moderate**. One factor contributing to moderate wage growth is the high level of migration from other EU member states, which has gradually increased the supply of labour in Germany. Over the past few years, this has cushioned shortages on the German labour market. Prices and wages are, however, already showing a moderate upward trend, and the GCEE expects to see a core inflation rate of 1.9 % in 2018. Wage growth has already been exceeding the sum of productivity growth and inflation, its scope for distribution, since the crisis in the euro area. ↘ CHART 1 BOTTOM LEFT

This means that the previous phase of wage moderation is over. Given the weak wage development in many other member states within the euro area, the comparatively strong wage development in Germany is contributing to the convergence of price competitiveness in the member states.

19. The GCEE forecasts a **gradual reduction in Germany's current account surplus** to 7.7 % and 7.6 % of nominal GDP in 2017 and 2018 respectively, after 8.3 % in 2016. This surplus reflects, among other things, the structural effect of demographic change (GCEE Annual Report 2014 items 418 ff.). Part of the consolidation observed in the public sector and among private households can likewise be attributed to this aspect.

20. The rise in corporate savings is also accompanied by strong investment activity abroad. It seems that when making investment decisions, German companies frequently conclude that investment opportunities in Germany are not sufficiently attractive (GCEE Economic Forecast, March 2017). As a result, the GCEE believes that **improving the investment climate** in Germany should be given priority. This could boost potential output and reduce the current account surplus at the same time.

2. A strategy to change course in monetary policy in the euro area

21. The marked economic recovery and higher inflation within the euro area require a reaction of monetary policy to reflect improved macroeconomic conditions. ↘ ITEMS 352 FF. The ECB's monetary policy, however, remains extremely expansionary, and its degree of expansion is still increasing. The expansionary monetary policy could also pose risks to financial stability. This highlights the **need for a normalisation of monetary policy.** Even if the ECB had ended its net bond purchases at the end of the year, its policy would still have been very expansionary given the size of its balance sheet and its policy rates. Yet, the ECB has now decided to continue with its bond purchases until September 2018 at the very least – albeit at a slower pace.

22. Given macroeconomic developments, the Governing Council of the ECB should urgently **communicate a comprehensive strategy for the normalisation of monetary policy**. ↘ CHART 2 This would ensure that market participants could make timely preparations for the end of loose monetary policy and would help to avoid disruptions on financial markets. The ECB should take a symmetrical approach as part of this strategy. This means that it should not only offer market participants the prospect of the larger bond purchases in the event of weaker economic developments, but also promise a reduction and the earlier termination of the bond purchases in the event of better economic developments. The GCEE believes that, based on the information currently available, it would be advisable to end the bond purchase programme early.

In any event, the ECB should **avoid making any unconditional commitment** and instead publish a forecast for the further development of monetary policy. ↘ ITEMS 390 FF. An end to the bond purchases would trigger a return to slightly higher medium and longer-term interest rates, and lending rates would gradually rise as a result. This would likely contain interest risks incurred by banks. Depending on economic developments, the next step could involve first hikes of the policy rate, followed by a gradual trimming of the balance sheet.

23. The ECB's previous communication of forward guidance should be developed into an **extensive projection of its future monetary policy stance**. ↘ ITEMS 391 FF. Forward guidance aims to alleviate uncertainty among market participants regarding the central bank's expectations and to make monetary policy more effective (Praet, 2013).

There are several ways of putting this into practice. The Governing Council of the ECB could, for example – like the central banks of Sweden, Norway and New Zealand – publish its own inflation and growth forecast, together with the corresponding **expected path for bond purchases and interest rates**. This forecast would be adjusted repeatedly to reflect the latest information available, meaning that it would not bind the central bank unconditionally to any particular course of action. Another alternative that would not require a vote in the Governing Council of the ECB would be to publish individual council members' projections, just as the US Federal Reserve has done for many years. Finally, in-

↘ CHART 2

Key elements of a monetary policy normalisation strategy of the ECB

Symmetric reaction of the ECB on macroeconomic developments
– finish monthly asset purchases at an earlier stage
– then gradually raise key policy rates
– reduce longer-term asset holdings

Forward guidance: forecast regarding
– future development of asset purchases, reinvestments and key policy rates
– as well as the sequence of these measures

Comprehensive forecast of the future monetary policy
– publish quantitative forecast on the expected path of asset purchases and key policy rates
– alternatively: publish individual council member forecasts similar to the Federal Open Market Committee of the Fed
– improve Eurosystem staff's forecast by means of own interest rate forecast

Expand communication to
– reduce disruptions on financial markets in the course of monetary policy normalisation and
– avoid the risk of fiscal and financial dominance

Source: Own figure

flation and growth projections published by the Eurosystem staff could be enhanced to include a specific monetary policy projection path.

24. In communicating its normalisation strategy, the ECB could also allay concerns about whether it was actually willing and able to tighten monetary policy if this posed problems for member states or systemically important banks. It could, for example, refer to the institutional **framework provided by the Banking Union** and the **European Stability Mechanism** (ESM). The Banking Union allows ailing banks to be resolved or restructured without triggering any systemic crises. The ESM allows a sovereign debt crisis to be averted and, where appropriate, allows member states to draw loans in combination with effective conditionality for fiscal consolidation and reforms.

25. Implementing **sustainable economic policies** in member states is absolutely crucial **in order to prepare for rising interest rates in the future**, reducing the risk of fiscal dominance. This first requires that individual member states use the temporary interest rate savings for fiscal consolidation in order to reduce their future debt service burden. Secondly, member states should systematically undertake reforms to improve competition and growth prospects.

3. Rising risks within the financial system

26. The **risks within the financial system have increased further** as a result of the sustained period of low interest rates. The marked rise in residential property prices in many European countries has prompted the European Systemic Risk Board (ESRB) to issue warnings to eight member states (ESRB, 2016). ↘ ITEM 472 The **rise in residential property prices** in Germany has **accelerated** further. The Deutsche Bundesbank now assumes that residential properties in cities are between 15 % and 30 % overvalued; in the previous year, it had put the overvaluation at between 10 % and 20 % (Deutsche Bundesbank, 2016a,

2017a). Credit growth, however, remains moderate and private household debt is relatively low, which is why the Financial Stability Commission (2017) still deems risks to financial stability to be on the low side at the moment.

Other asset prices have also climbed to a high level by historical standards. Fixed-income securities, in particular, are at risk of an **abrupt price correction** if interest rates rise. ↘ ITEM 474 Among other things, this would affect the growing **investment fund** sector, which has been investing increasingly in less liquid assets since the low interest rate phase began. A sudden rise in interest rates would come hand in hand with the risk of substantial fund outflows, triggering fire sales and spiralling prices that could spark contagion to the rest of the financial system. ↘ ITEM 497

27. In the German banking system, the **risks of interest rate changes have increased further** because the fixed-interest periods for loans have increased while the share of short-term forms of funding has risen. ↘ CHART 1 BOTTOM RIGHT German savings banks and credit cooperatives have particularly high interest rate risk coefficients, meaning that they would be hit particularly hard by an abrupt rise in interest rates. ↘ ITEMS 475 FF.

28. Given rising interest risk, it would be premature to conclude that the moderate credit growth implies low risks to financial stability. An abrupt increase in interest rates would be particularly problematic following a long period of low interest rates. From a financial stability perspective, a **timely and gradual rise in interest rates** would be associated with much less turbulence. This supports the GCEE's calls for a normalisation of monetary policy in the near future. A gradual increase in long-term interest rates while keeping short-term rates low could help to put a damper on interest rate risks. ↘ ITEMS 383 FF. At the same time, **macroprudential policy** both within and outside of the banking sector will play an important role in limiting the risks to financial stability. ↘ ITEMS 479 FF., 503 FF.

III. SUSTAINABLE ECONOMIC POLICY

29. **Demographic change** in Germany will **accelerate over the coming decade** as the baby boomers of the 1960s reach retirement age. In 2015, there were around three people of working age for each person over the age of 65, while there will be only 1.7 people by 2060. This means that, in addition to digitalisation, ageing will define changes in society and the labour market alike. In addition, the costs of retirement provision, health and nursing care will increase, a trend that will be closely related to both medical technology advancements and ageing. Consequently, a well-functioning labour market with high levels of employment and low unemployment, as well as an efficient healthcare system are crucial for making government budgets sustainable in the long run (GCEE Expertise, 2011).

30. Economic policy has prepared for this development on the one hand by implementing reforms, for example in the statutory pension scheme, and on the other by using fiscal surpluses to reduce the debt ratio. During the last legislative term, **German fiscal policy** was repeatedly **criticised** (European Commission, 2017a; IMF, 2017a). Critics said it wasn't doing enough to support the European and global economy, and was instead contributing to its substantial current account surplus through a restrictive fiscal policy (Economist, 2017). According to the critics, Germany has neglected its infrastructure and urgently requires higher public investment (DIW, 2015). There are calls for greater state redistribution to alleviate income inequality and social disparities (Horn et al., 2017).

31. **Fiscal policy** has not been able to withstand this pressure. Since 2015, fiscal policy in Germany has turned expansionary. ITEM 575 The Federal Government, federal states, municipalities and social security funds have primarily increased consumption and transfer spending, for example by hiring staff or implementing the 2014 pension legislation, which introduced a mothers' pension and pensions from the age of 63 for long-term contributors. Despite fiscal surpluses, the sustainability of public finances did not improve sufficiently.

Based on the S2 indicator, the European Commission, for example, estimates that Germany's **sustainability gap** until 2060 amounts to 2 % of GDP (European Commission, 2016a). This means that the fiscal balance would have to improve by 2 % of GDP in the long run in order to keep the debt ratio steady at today's level. According to GCEE calculations which, unlike the European Commission, applies a projection period to 2080, the sustainability gap amounts to 4.2 % of GDP. ↘ ITEMS 529 FF.

32. This provides the backdrop for the challenges facing economic and fiscal policy over the current legislative term. On the one hand, economic and fiscal policy needs to **boost the labour potential** and help close the sustainability gap. On the other, the Federal Government, the federal states, municipalities and social security funds cannot afford to stray from the **path of sound fiscal policy**.

1. Increasing the labour potential

33. The current record number of unfilled positions can be taken as an indicator that companies are finding it increasingly difficult to fill vacant positions. ↘ ITEMS 769 FF. Some areas of the economy are already faced with a **shortage of skilled workers,** although this is not currently a problem that applies across the board. As the labour force shrinks due to demographic change, however, it will become increasingly important to **exploit the** available **labour potential** to a better extent than has been achieved in the past.

34. Economic and fiscal policy are closely intertwined. For example, **employment among women can be boosted** by taking various fiscal and tax policy measures or by changing the institutional framework to improve the opportunities and incentives for women to start working, or to increase their working hours if they are currently either not working at all or working part-time. The further expansion of childcare or reforms to the way families are taxed are examples of issues currently being discussed. ↘ BOX 1

35. Efforts to **expand childcare** are welcome. The extent of all-day care available to date likely played a role in boosting employment among women in the past. It is, however, important to remember that the quality of care provided is decisive. Early years and pre-school care must be associated with improvements in the level of education. All-day schools must offer meaningful, age-appropriate afternoon programs that aim to both improve the quality of education and support a better work-family balance.

36. Tax policy reforms to increase women's employment are difficult to achieve. **Income splitting in taxation for married couples** is based on the constitutional principle that bans discrimination against marriage, and should be considered a tax policy that supplements social policy based on the subsidiarity principle. In social policy terms, spouses are considered as a mutual support and retirement provision unit. In terms of social policy, welfare assessments are based on the household unit. The social security system first considers whether a household unit can secure the livelihood of its members before granting any social security benefits (GCEE Annual Report 2013 items 634 ff.). In a consistent tax-transfer system, this role of the household unit should have a tax policy equivalent.

This is why existing misaligned incentives for the secondary wage earner in a marriage cannot be easily rectified. Reform proposals such as **"real" family income splitting** only result in a minor improvement in the incentives for the secondary wage earner (GCEE Annual Report 2013 items 640 ff.), making it virtually impossible to justify the increase in the complexity of the tax system associated with such reforms. Reforms of the regulations governing wage tax deductions, such as the abolition of tax classes III and V, are based on the tax-related misinterpretation on behalf of taxpayers and do not, ultimately, result in any material improvement of incentives. Instead, restructuring social security contributions would appear to be a more effective way of increasing the incentives to work. Within this context, the GCEE has suggested, among other things, a **flat-**

rate per capita health insurance premium (*Bürgerpauschale*) including a mechanism for social compensation, which could put an end to the non-contributory inclusion of spouses in statutory health insurance coverage (GCEE Annual Report 2013 box 23; GCEE Annual Report 2016 item 93).

At the moment, spouses are free to choose one of three tax class combinations. While the combination selected has an impact on the monthly wage tax deductions, it does not ultimately change the couple's collective tax liability. Criticism is levelled against the first option (**tax class combination III/V**), which involves the main wage earner making relatively low, and the secondary wage earner making relatively hefty, advance tax payments. This can first of all reduce incentives to work for the secondary wage earner if he or she wrongly interprets the advance payments as the actual tax burden. Second, disadvantages arise in connection with wage-replacement benefits that are based on net salary, such as the parental allowance or unemployment benefit. The monthly deductions correspond to the actual joint tax burden if the main earner earns 60 % of the household income. Back-taxes generally have to be paid in the event of deviations. With the second combination (**tax class combination IV/IV**), both partners are taxed like singles. This involves overestimating the tax burden during the year, meaning that the couple has less money available until the difference is reimbursed. There has been a third combination available since 2010: **the IV/IV combination with a factor**. This factor already reflects the splitting advantage during the year and takes better account of the salary distribution within the household. This option has barely been used. The additional bureaucracy required could be one reason for this, because couples need to request this option at least every two years. The GCEE does not view the possible misinterpretation of substantial monthly deductions for secondary wage earners, who voluntarily choose the III/V tax combination, as a reason to abolish the option. Opportunities to make the "IV/IV with a factor" option more attractive could, however, be exploited.

37. Other tax policy measures to support families are also problematic. An **increase in tax allowances for children** (and, as a result, the child benefit) to the level of the personal tax allowance, or even to an amount that would correspond to double the current amount, would be virtually impossible to justify from the perspective of the tax system. The tax allowance for children is supposed to prevent the taxation of funds needed to cover the basic needs of children. Yet, this amount is substantially lower than those of adults, which is why the tax allowance for children is less than the personal tax allowance. This aspect is also reflected in proposals for a "real" family income splitting. As it is highly questionable whether tax incentives serve to meet family policy objectives, for instance to increase fertility rates, the resulting drop in tax revenue can hardly be justified.

It would be misguided if the debate on **child poverty** were to lead to an excessive increase in the tax allowance for children. Entrenched child poverty calls for targeted measures (Cremer, 2016), whereas child benefits and tax allowances for children benefit everyone, albeit in particular taxpayers with higher incomes. Social policy cannot be improved by distributing benefits indiscriminately.

38. Another key factor for raising labour potential is **immigration**. In order to keep the labour potential at its current level in the long term, the number of people immigrating to Germany every year would need to exceed the number of people

emigrating by 400,000 in the long run (Fuchs et al., 2017). However, it is important to strictly separate the concept of qualified labour migration from migration due to asylum, as the latter can only be justified by humanitarian reasons and not on economic grounds. A **future immigration strategy** could include the following aspects:

– **Controlled immigration** from non-EU countries could be expanded to cover not only university graduates, but also **skilled workers with vocational qualifications who do not have a university degree**. Instead of the current approach, whereby specialists from non-EU countries are only given access to the German labour market if they can prove that they have a job in a designated understaffed occupation, applicants could be granted a fixed-term residence permit allowing them to seek work if they have the required qualifications and language skills.

– In addition, measures should be taken to facilitate immigration by citizens of non-EU countries who want to **embark on vocational training**. A separate residence permit, for example, could be created to cover individuals seeking a vocational traineeship in occupations hit by shortages for a fixed term.

A general **points-based system** inspired by the Canadian model, however, would not be productive, because European migration legislation has already significantly restricted the scope for national legislators to define the terms of labour migration. Rather, the focus should now be on the search for a specific job as opposed to a relatively untargeted points-based system of immigration (Expert Council Migration, 2017).

39. As emphasised by the Expert Council of German Foundations on Integration and Migration (Expert Council Migration), an **immigration act** could help, in view of the increased complexity, to bundle existing regulations on labour migration, admittances for family reasons at a later time, immigration by international students and refugees in a transparent and systematic manner (Expert Council Migration, 2015, 2017). This could also send a signal, both within Germany and to other countries, that Germany has made a conscious decision to open itself to controlled labour migration.

40. Finally, the **establishment of a flexible retirement age** could allow older people to keep working for longer, increasing the labour potential (GCEE Annual Report 2016 items 604 f.). As welcome as this sort of flexibility may be for many employees who want to keep working, it is unlikely to allay fears of a shortage of skilled workers or fix the existing sustainability gap. Many people tend to associate the term “flexible retirement age” more with options for early retirement without any pension reduction. This would be counterproductive. As working life is always associated with a certain degree of stress, too few employees would be likely to make use of greater flexibility in order to extend their working lives. It certainly remains to be seen whether the measures taken in the last legislative period to remove the disadvantages of working beyond the statutory retirement age will significantly boost employment among older workers.

Increasing the labour potential: key messages

- Strengthening the incentives to work by further expanding all-day childcare and abolishing the non-contributory inclusion of spouses in statutory health insurance
- Expanding controlled immigration from non-EU countries to include professionally skilled workers without academic qualifications and simplifying the process whereby people are allowed to come to Germany for a limited period in order to seek work or a traineeship
- An immigration act to boost transparency and send out a signal of openness

2. Need for sound fiscal policy

41. Germany is currently in a comfortable fiscal policy position. **Germany's general government budget surplus** is expected to reach its **highest level since reunification** this year, amounting to €31.3 billion (1.0 % of GDP), as against 0.8 % of GDP (€25.7 billion) last year. ↘ CHART 3 TOP LEFT The debt-to-GDP ratio is likely to have fallen to 61.9 % of GDP by the end of 2018 and could fall below the 60 % of GDP criterion set out in the Maastricht Treaty in 2019 at the latest. ↘ CHART 3 TOP RIGHT

42. In addition to the **pronounced drop in interest expense** and the positive economic environment, structural enhancements have also contributed to the impressive improvement in the fiscal position in recent years. ↘ ITEMS 573 FF. Additionally, the tax and contribution ratio has been on the rise since 2010 due to rising social security contributions and dynamic tax revenue. ↘ ITEM 586 Since 2014, however, the German structural primary balance, i.e. net lending/net borrowing after adjustments to reflect interest expenditure and income, as well as cyclical effects, has been deteriorating. This indicates an **expansionary fiscal policy**. An alternative indicator, the fiscal impulse, has been pointing to an expansionary fiscal policy since as long ago as 2013. In the current situation, this sort of policy has a procyclical effect and provides an additional impulse to a German economy that is already overutilised.

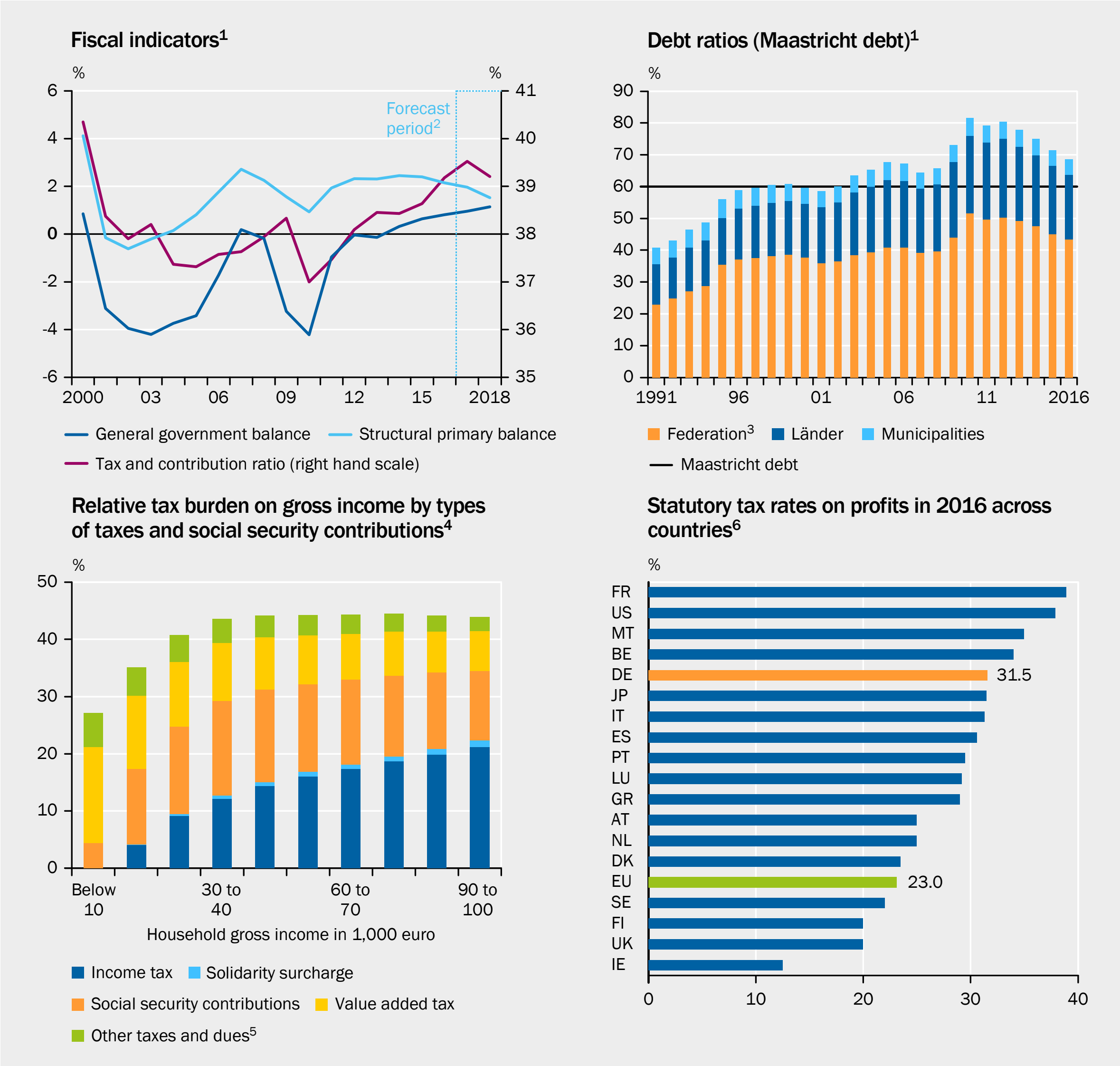
43. The **good fiscal situation** is **unlikely to last.** In the medium term, there is a risk of mounting pressure on public finances as a result of an interest rate hike. ↘ ITEMS 601 FF. Additional challenges from demographic change are already foreseeable. ↘ ITEMS 529 F. Systematic measures should therefore be taken to reduce the debt-to-GDP ratio further in order to create a safety margin for the additional fiscal burden expected in the future. Putting an additional structural burden on public finances should therefore be avoided. Any potential fiscal scope should be used, at most, to implement reforms that could boost the potential growth of Germany's economy. These include a **growth-friendly tax system** and **a reduction in social security contributions**, for example unemployment insurance contributions. ↘ BOX 1

44. Last but not least, warnings regarding increases in structural government spending also apply to **public investment**, which remains subdued despite the fact that the Federal Government, in particular, made available considerable funds for infrastructure in the past legislative term. ↘ ITEM 585 This could be due to the pursuit of the wrong priorities, insufficient planning capacity or full capacity utilisation within the construction industry. In any case, the GCEE does not see any general lack of public funds for infrastructure investment. Additional financing requirements for public investment should be covered **without increasing the public spending ratio** by setting the right priorities.

45. The current low interest rate environment does **not**, in itself, provide **sufficient grounds for a credit-financed increase** in public investment (Board of Ac-

↘ CHART 3

Fiscal indicators, debt ratios and tax burden on income and profits



1 – In relation to nominal GDP. 2 – Forecast of the German Council of Economic Experts. 3 – Including Federal Special Funds. 4 – RWI income tax microsimulation (Bechara et al., 2015) and RWI value added tax microsimulation (Siemers, 2014). 5 – Includes, among others, taxes on energy and electricity, insurance taxes as well as the German renewable energy contribution. 6 – Statutory tax rates on profits at the federal level and, if applicable, at the subnational level. If the tax burden differs across regions, the capital city is considered unless specified otherwise. FR-France, US-United States (California), MT-Malta, BE-Belgium, DE-Germany (a weighted average for the German Länder is considered in case of the trade tax, Wagschal et al., 2016), JP-Japan, IT-Italy, ES-Spain, PT-Portugal, LU-Luxembourg, GR-Greece, AT-Austria, NL-Netherlands, DK-Denmark, EU28-European Union (non-weighted average), SE-Sweden, FI-Finland, UK-United Kingdom, IE-Ireland.

Sources: Deutsche Bundesbank, Eurostat, Japanese ministry of finance, RWI, ZEW, own calculations ademic Advisors to the BMF, 2017). Although the favourable financing conditions are likely to boost the profitability of some investment projects that would not have been profitable in the past, this cannot be a sufficient rationale to pursue such projects without weighing up the benefits and costs involved (Schmidt and Schmidt, 2017). In particular, expected productivity gains are an important criterion. Given the uncertainty of future interest rate developments, the fiscal consolidation objective and the dynamic increase in tax revenue, it would not appear advisable to expand public investment by increasing new borrowing.

↘ BOX 1

Possible courses of action regarding taxes and contributions

In Germany, taxes and contributions put particular pressure on middle-income groups. ↘ CHART 3 BOTTOM LEFT The overall burden from taxes and contributions comprises up to 45 % of gross income for households with annual gross income above €35,700 (Döhrn et al., 2017). In an international comparison, Germany is among those OECD countries with the highest statutory corporate tax rates. ↘ CHART 3 BOTTOM RIGHT As a result, the substantial revenue is not only due to the favourable economic situation, but also to **rising taxes and contributions**. Consequently, the GCEE believes that action is required in some areas.

Returning the increase in tax revenue from bracket creep

The large total burden on gross incomes is due, in particular, to the high statutory tax rates. As soon as taxable income exceeds €54,058, the top marginal income tax rate of 42 % applies (scale for single persons). Incomes of €256,304 and higher are subject to what is known as the “wealth tax”, at a marginal tax rate of 45 %. A **progressive income tax** creates a so-called bracket creep when inflation rates are positive: despite identical real incomes, the tax burden increases without any changes in legislation. This puts strain on middle-income groups in particular. Although taxpayers have received income tax relief in recent years, it has not been enough to compensate for the cumulative additional burden created by bracket creep. Compared with 2010, the additional burden resulting from inflation alone comes to almost €6 billion a year. All in all, tax relief of up to €30 billion can be justified using this argument, without any need to increase the top income tax rate in return. Income tax always burdens the profits of partnerships and the self-employed. Increasing the top statutory tax rate would provide negative investment incentives for small and medium-sized companies.

Abolition of the solidarity surcharge

No debate on reforming income tax should exclude the solidarity surcharge. In 2019, the Solidarity Pact II will expire and thus the **legislation that originally provided the basis** for this supplementary levy. As a result, the solidarity surcharge is at risk of becoming unconstitutional. It is therefore timely to consider its abolition. On the one hand, it should be taken into account that such a reform would only expose the Federal Government to revenue losses. On the other hand, there would be no need to gain the political support of the federal states for this sort of tax reform, because there is no legal requirement to seek their approval. The ideal scenario would, however, be a combination of an income tax reform with the gradual abolition of the solidarity surcharge, ensuring that the federal states and municipalities contribute to the financing of this reform.

No abolition of the withholding tax

The tax policy debate points to the different tax burdens for wage and capital income, which are seemingly a result of the withholding tax. As the GCEE has pointed out, this only applies to interest deductible by the payer of the interest, and that is subject to withholding tax at the level of the recipient (GCEE Annual Report 2015 items 739 ff.; Kronberger Kreis, 2017). Dividends and capital gains, on the other hand, are taxed more heavily than in the past. Within this context, it is important to note that **distributed profits** are subject to corporate and trade taxes before the withholding tax is imposed at the level of the shareholder. In the past, the majority of capital gains were not taxed at all, provided that shareholders adhered to holding periods aimed at avoiding speculative investments. If the capital income currently subject to withholding tax were subject to income tax, then distributed profits would be taxed much more heavily, reducing the incentives for investment. Merely imposing income tax on interest income would also not be advisable due to problems in demarcating such income and the incentives for tax planning. Even if the international exchange of information on tax matters were effective, the withholding tax would still be justified.

Tax incentives for private investment

Rather, the drawback of the withholding tax is that, in its current form, it does not achieve financing neutrality in corporate taxation. Financing neutrality could be ensured through an **allowance for corporate equity** (GCEE Annual Report 2012 items 409 ff.). This would be a further step towards a dual income tax system that was - quite rightly - mapped out with the introduction of the withholding tax. At the moment, such an allowance would only be associated with a slight decline in revenue (GCEE Annual Report 2015 items 714 ff.). At the same time, it would improve tax incentives for investment. The tax burden on profits has increased due to raised multipliers in the trade tax, in particular. ↘ CHART 3 BOTTOM RIGHT As tax competition is likely to become more intense given the tax policy plans set out by the United States and the United Kingdom, the Federal Government should take suitable reform measures.

Taxes on wealth

Taxes on wealth should not be increased. Regarding the inheritance and gift tax, the GCEE abides by its proposal, which combines a broad tax base and low statutory tax rates with generous deferral rules. The recent reform, however, makes inheritance tax law more complex and provides incentives for tax planning. As it distorts investment activity, the idea of a wealth tax should not be revived. A **property tax reform** could resolve existing distortions. Action needs to be taken with regard to property tax primarily due to the outdated calculation of the tax base relying on standardised values (*Einheitswerte*) (GCEE Annual Report 2016 item 91). As it is very difficult to avoid, this type of tax is relatively efficient in economic terms. The reform proposals put forward by the Bundesrat (German upper house) are a step in the right direction. The statutory rates of property transfer tax should at least not increase any further. Rather, the Federal Government and the federal states should agree on a maximum statutory tax rate.

Reduction in unemployment insurance contributions

The encouraging situation on the labour market has considerably increased the reserves of the Federal Employment Agency. ↘ ITEM 588 This is partly due to structural improvements. The GCEE estimates the **sustainable contribution rate** after adjustments to reflect cyclical components **at 2.5 %.** The current contribution rate of 3 % could therefore be reduced by up to 0.5 percentage points. In the current situation, the reserves would not increase any further.

Government grant scheme to support families building homes

The housing policy debate has raised the question of reintroducing the government grant scheme to support families building homes (*Baukindergeld*), which had been replaced by the housing allowance. Many of the proponents of this strategy hope that this would make families with children more likely to choose home ownership. Abolishing the housing allowance and the grant scheme for family homebuilding was justified because it failed to increase home ownership, came hand in hand with **significant free-rider effects** and probably contributed to rising property prices. More recent studies in

Denmark confirm such effects of a similar tax incentive (Gruber et al., 2017). As a result, it would be advisable not to reintroduce the grant scheme to support families building homes.

Other tax incentives

Granting new incentives like **tax incentives for research and development** and those for **energy-efficient building renovation**, does not improve the conditions for growth. They open up possibilities for tax planning in the corporate sector and households alike and create significant deadweight effects. The introduction of **degressive depreciation** produces a shift in the distribution of corporate depreciation over time, which would add to overheating at this stage of the economic cycle. The decline in revenue could be better used elsewhere in the tax system for more productive reforms.

3. Fiscal policy challenges for federal states and municipalities

46. Any analysis at the federal level masks **heterogeneous developments** between individual social security funds and within the sub-national levels of government. Although budget balances have improved overall in virtually all **federal states and the municipalities in aggregate,** ↘ ITEM 590 there are still considerable differences between federal states.

47. The **development in municipal short-term liquidity loans** in the four non-city states of Hesse, North Rhine-Westphalia, Rhineland-Palatinate and Saarland is particularly striking. ↘ ITEMS 597 FF. Short-term liquidity loans (*Liquiditätssicherungskredite*) aim to provide short-term bridge financing that is then repaid in the course of the year or, if carried forward to the next year, covered in the course of that year. Consequently, a sustained high, or even increasing, level of short-term liquidity loans suggests that current expenses are being regularly financed with credit, which is actually prohibited. In addition, the sustained high level suggests that some municipalities are not able or willing to achieve the balanced budget they are meant to aim for.

48. The federal states in which municipalities have high levels of short-term liquidity loans appear to have only insufficiently fulfilled their fiscal oversight duty in the past (Christofzik and Kessing, 2014; Deutsche Bundesbank, 2016b). **Stronger accountability for and fiscal oversight of the municipalities by the federal states** is therefore advisable. This could be achieved by requiring that at least municipal liquidity loans with a term of more than one year be taken out only from the federal state (Deutsche Bundesbank, 2017b; Independent Advisory Board of the Stability Council, 2017). At least these liquidity loans should be included in the federal states' deficits as part of the state debt brake and not be exempted from the debt brake as a financial transaction.

49. In addition, **outsourcing** in the form of public enterprises, which are majority controlled by core budgets yet not attributed to the government sector, **is not included in the debt brake**. A majority of the debt and staff in the public sector can be attributed to such outsourcing. ↘ ITEMS 611 F. There could be an incen-

tive to pass on tasks and debts to the outsourced areas not included in the debt brake. Generally, therefore, stricter regulations based on the European fiscal rules for determining the budget deficit should be applied to the German debt brake (GCEE Annual Report 2016 item 85). Furthermore, better data, for example on municipal minority shareholdings, is needed to assess the public sector's condition. Mandatory municipal consolidated financial statements, together with shareholding reports, which are published promptly, could be useful. The most current data only reflects the situation in 2014.

50. Unlike for employees, local authorities must fund the pensions of their retired civil servants themselves. **Expenditure on pensions for civil servants** comprises a large share of public spending, in particular for the federal states. ↘ ITEMS 605 FF. Although retirement pay has already been lowered and the retirement age gradually increased, **further precautionary measures** are needed in view of increasing life expectancy. For example, all the federal states have pension reserve funds for relieving pressure on their budgets in the future. However, because they have been permitted to freely organise these funds since the 2006 Federalism Reform, some federal states have reduced allocations to the funds based on their budgetary performance, decided to liquidate them or abandoned the aim of fully funding their pension expenditures for civil servants. **Protecting these funds from discretionary and politically motivated influences** is therefore imperative.

Fiscal policy: key messages

- Priority for the further consolidation of the federal budget and the budgets of federal states and municipalities
- Avoidance of structural spending increases: additional financial needs, for example in the area of public investment should be covered through suitable prioritisation on the expenditure side without increasing the public spending ratio
- Stronger accountability for and fiscal oversight of the municipalities by the federal states: the municipalities should only be able to take out liquidity loans with a term of more than one year from the federal state
- Use of fiscal leeway for growth-friendly reforms of the tax and social security system

4. Forward-looking reforms of pension provision

51. The long-term sustainability of public finances amid **demographic change** hinges largely on the organisation of the pension system. This is because the number of retirees will rise in the coming decades as baby boomers leave the workforce, ending the demographic respite.

52. In light of this, the GCEE last year presented reform options to improve the **three-pillar system of retirement provision** in a targeted manner (GCEE Annual Report 2016 items 590 ff.). Firstly, an increase in the statutory retire-

ment age beyond 2030 is necessary. It should be **linked to further life expectancy at age 65**. This would keep the relative duration of pension benefits from increasing further over time. Secondly, the GCEE calls for compulsory pension coverage for the self-employed instead of an obligatory inclusion in the statutory pension scheme. Inclusion in the statutory pension scheme is not likely to contribute to its long-term sustainability, meaning that only a general coverage through pension insurance should be made obligatory.

Some progress has been achieved in **occupational and private pension provision**. For example, double social security contributions in occupational pensions will be abolished. Misaligned incentives will also be reduced, as Riester pensions and occupational pension payments will be partially exempt from deduction from the old-age basic income support through an allowance from next year. If these measures do not lead to further take-up of occupational pensions, a standard product not provided by government could make sense (GCEE Annual Report 2016 item 645).

Instead of expensive “solidarity pension” concepts, an analogous approach for the statutory pension scheme would be an option. **Benefits from the statutory pension scheme** could be made **exempt from deduction up to the level of an allowance** when calculating the old-age basic income support. Thus, individuals in need who have paid into the statutory pension scheme would receive transfer payments higher than the old-age basic income support. The principle of participatory equivalence would be preserved.

53. Increasing the **mothers' pension** for mothers (and fathers) whose children were born before 1992 by an additional earnings point for child-rearing periods is strongly discouraged. The mothers' pension is a relatively expensive measure because of its many beneficiaries. It cannot adequately counter the threat of old-age poverty. The mothers' pension does not contribute in any way to demographic change; in particular, no impact on fertility rates can be expected. Moreover, increasing the mothers' pension would intensify key retirement provision problems because it would increase the sustainability gap. The mothers' pension by itself creates higher statutory pension scheme contribution rates (GCEE Annual Report 2014 item 564).

Pension policy: key messages

- Creation of demographic stability for the statutory pension scheme through tying the statutory retirement age to further life expectancy at age 65 from 2030
- No expansion of benefits, for example through the mothers' pension or forms of “solidarity pension”, instead introduction of an allowance when deducting pensions received under the statutory pension scheme from the old-age basic income support

5. Efficiency potential in healthcare

54. Harnessing **efficiency potential** is key in healthcare, alongside retaining suitable **incentives for advances in medical technology** (Expertise 2011). In light of demographic change, in particular as high-birth-rate cohorts of the 1960s start to retire from the mid-2020s, these two topics will dominate the debate. Moreover, the increasing number of patients may cause staff shortages in future care provision.

55. To address these challenges, an initial starting point is **service providers**. The healthcare system is highly regulated. More efficient organisation of healthcare offerings is often constrained to sectors defined by the regulator, such as the outpatient and inpatient sectors. In particular, sector-specific remuneration systems hinder **cross-sector approaches**. Hence, incentives for service providers to provide cross-sector healthcare and make greater use of outpatient treatment should be expanded (Greß and Schnee, 2017; Schreyögg, 2017).

In addition, considerable efficiency potential remains on the supply side of the hospital sector. The **structural fund** introduced with the Hospital Structures Act (*Krankenhausstrukturgesetz*) provides funds to facilitate greater structural changes. Further steps in this direction should follow. Investments are also needed to maintain hospital **infrastructure**. The federal states have not met their obligations for quite some time. This may have a negative impact on the quality of patient care and the efficiency of service provision in the medium term (Augurzky et al., 2017). One solution would be a transition to single-payer hospital funding, in which the health insurers fund the ongoing operating costs of hospitals and also investment (GCEE Annual Report 2012 item 635).

56. **More effective navigation** of patients within the complex and often opaque healthcare system could prevent patients from visiting hospitals' emergency rooms without acute emergencies, hindering treatment of serious **acute emergencies** and tying up expensive capacities. Following Denmark's example, patients could be directed through a telephone guidance system. In Denmark, emergency patients initially register by telephone. An expert conducts an initial assessment and passes the patient on to a suitable outpatient or inpatient service provider (Quentin et al., 2016).

57. In addition, Germany must get up to speed in the **digitalisation of the healthcare system**. The electronic patient record must be implemented using a standardised nationwide telematics infrastructure. Important information for treating patients could thus be available at any time and any place. Doctors, pharmacists, hospitals and other service providers could – with the patient's consent – access all or part of individual healthcare data. This would reduce the number of tests and examinations, make medication of patients taking multiple drugs more transparent and support diagnosis. At the same time, it would facilitate a significant contribution to healthcare research in order to concentrate scarce resources on good quality services in future (Amelung et al., 2016; Dörries et al., 2017; Lux et al., 2017; Pfeiffer, 2017; Rebitschek et al., 2017).

58. Finally, **openness to innovation** in the healthcare system could generally be improved, particularly in the fields of digital services, telemedicine, robotics and sensor technology (Haucap et al., 2016; Amelung et al., 2017). These approaches would not only help counter the **shortage of skilled workers** in the medium term, they could also provide an important approach to **medical care in rural and structurally weak regions**.

Healthcare: key messages

- Expansion of cross-sector healthcare and better navigation of patients through the complex healthcare system
- Efficiency increases through structural adjustments in the hospital sector and single-payer financing of the hospital sector
- Digitalisation of the healthcare system through expansion of a standardised information and communication infrastructure in order to increase care quality

IV. DIGITALISATION AS AN OPPORTUNITY

59. Great hopes for future **increases in labour productivity** are pinned on digitalisation. The increasing interconnectedness of players, the associated improvements in the provision and use of information and the growing maturity of autonomous systems promise to increase the **efficiency** of production processes and product quality. They also enable **new business models and ways to provide services** better geared to the needs and preferences of users. As a result, established business models and previously successful companies are challenged by start-ups and companies outside the sector, spurring innovation.

60. The German economy can presumably only be successful in the digitalised global economy of the future when this **structural change** is understood as an innovation engine and facilitated as smoothly as possible. The new Federal Government faces three tasks: firstly, it should create conditions to facilitate a **significant increase in the interconnectedness** of players. Secondly, the vulnerability of interconnected systems and the considerably expanded use of sensitive personal data require significant efforts in **data security**, **data protection** and safeguarding privacy. Thirdly, adjusting to a digital work environment requires completely **new skills** for employees.

1. For a regulatory framework open to innovation

61. The German economy reveals deficits in using information and communication technology (ICT) efficiently (GCEE Annual Report 2015 items 647 ff.). The incompleteness of broadband services is often blamed, even though it receives the support of extensive public resources (Federal Ministry for Economic Affairs,

2016). **Overall investment in digital infrastructure is low,** as indicated by the fact that the proportion of GDP spent on ICT has remained unchanged since the mid-2000s. Compared to other EU member states, Germany is only in mid-field with respect to the spread of digitalisation (Baller et al., 2016; acatech and BDI, 2017; European Commission, 2017b). ↘ ITEM 800 For example, according to the European Commission, Germany lags significantly behind on **Internet use** and digital public services. ↘ CHART 4

62. The Federal Government has conducted an intensive dialogue with academics and the public in the past few years, including in the High-Tech Forum. Besides **visions of the future** like Industry 4.0, intelligent services and learning systems, the focus was on how digital markets can be **regulated** (Federal Ministry of Labour and Social Affairs, 2015; Federal Ministry for Economic Affairs, 2017). When establishing regulations, bans and restrictions, increased protection and the resulting hindrances to innovation must be carefully weighed. Guiding principles should be the **openness to innovation and willingness to adapt regulations** in a learning process.

63. Setting communication standards early can secure a high level of interoperability and increase the interconnectedness of players. The **expansion of digital networks** should be driven **by private investment**. Government support programmes to expand broadband networks can offer a fallback option only where private investment is held back by a lack of profitability. However, public support must remain the exception on a case-by-case basis and satisfy the EU's state aid rules (Monopolies Commission, 2013, 2015).

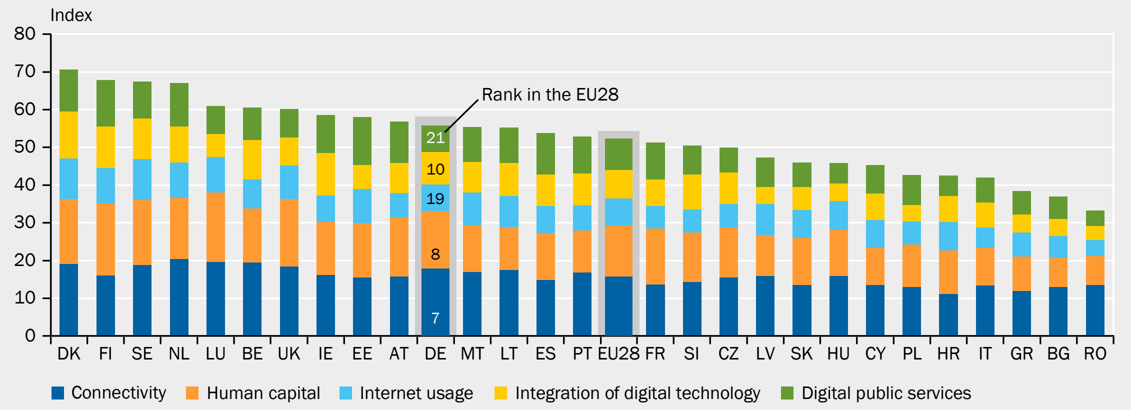
64. A **new Digitalisation Commission** could be tasked with scrutinising regulations hindering innovation, identifying the need for reform in a systematic overall review and giving suggestions for more innovation-friendly legislation in Germany (Kronberger Kreis et al., 2017). The commission could be modelled on the Federal Government's Deregulation Commission set up in 1988 (Deregulation Commission, 1991; Held, 1993). In particular, new digital business models are often hindered by barriers in numerous service sectors (GCEE Annual Report 2016 item 67).

65. Moreover, digitalisation could improve living standard by, for example, increasing the efficiency of public administration through **e-governance** services. Germany lags behind in the provision of digital public services compared to other EU member states. ↘ CHART 4 Besides the patchiness of e-governance offerings, the Commission of Experts for Research and Innovation (EFI) criticises the lack of user-friendliness of online services (EFI, 2017).

Making non-company and non-personal data (“**open data**”) more readily available can also enhance efficiency. Easier accessibility of data can make companies' investment decisions simpler. More accessible administrative data (“open government”) also promotes transparency of government administration and thus allows better investment planning.

66. Furthermore, there is a high level of legal uncertainty in data protection, the importance of which is unquestionable. However, **strict data protection regu-**

↘ CHART 4
Digital Economy and Society Index (DESI) 2017[1]



1 – DK-Denmark, FI-Finland, SE-Sweden, NL-Netherlands, LU-Luxembourg, BE-Belgium, UK-United Kingdom, IE-Ireland, EE-Estonia, AT-Austria, DE-Germany, MT-Malta, LT-Lithuania, ES-Spain, PT-Portugal, EU28-European Union, FR-France, SI-Slovenia, CZ-Czech Republic, LV-Latvia, SK-Slovakia, HU-Hungary, CY-Cyprus, PL-Poland, HR-Croatia, IT-Italy, GR-Greece BG-Bulgaria, RO-Romania.

Source: European Commission

lations – or their strict enforcement – can impede efficiency gains from big data. The General Data Protection Regulation (GDPR), which is intended to guarantee uniform data protection law throughout Europe, will enter into force in May 2018. However, it does not sufficiently ensure legal certainty in areas where corporate interests collide with the interests of privacy. Businesses criticise high expenses for data protection and cyber security associated with modern digital technologies (Arntz et al., 2016).

2. Labour market in good shape

67. In the past few years, the labour market has successfully coped with structural challenges such as technological progress and globalisation. Despite considerable structural changes, employment has benefited. The employment rate has risen in the past few decades to its current **record level**, and unemployment is low. High employment growth is not only a result of increasing atypical forms of employment. In the past few years, the share of atypical employment has decreased slightly. ↘ ITEMS 716 F. Besides wage moderation until the mid-2000s, which enhanced Germany's competitiveness, the reforms of Agenda 2010 contributed to this success (Krause and Uhlig, 2012; Burda and Seele, 2017)

68. In the last ten years, the **distribution of net incomes** has remained largely stable. ↘ ITEMS 824 FF. The intensity of the inequality debate in Germany may reflect, among other things, that the perception of income inequality often differs from the actual situation. Therefore, the GCEE updates its analysis of income distribution and examines differences within and between subgroups defined by the socio-economic features of age, gender, education and migration background. No signs of a substantial increase in income inequality can be seen in either of these subgroups. However, low incomes and higher poverty risks are linked to characteristics such as a lower level of skills or a migration background.

69. Following the example of the Fifth Poverty and Wealth Report released this year, the government strives to **provide fact-based information** and inject more objectivity into the public debate. Furthermore, there is a political need for action. In order to counter low incomes, policymakers should **promote equality of opportunity and social and economic participation**. Education could be a key to this, for example through early childhood education. ↘ ITEMS 852 FF. All-day childcare should be expanded and a free pre-school year should become mandatory (GCEE Annual Report 2013 item 584; GCEE Annual Report 2009 items 454 ff.).

70. The favourable employment situation, higher household incomes and increased final consumption expenditure are contributing to the economic upturn in Germany. Since the global financial crisis, wages in Germany have been increasing faster than the sum of inflation and productivity growth. ↘ ITEM 275 Hence, **wage growth** in Germany is **not unusually weak**.

Nevertheless, various parties have called for the Federal Government to further accelerate convergence in the euro area through higher wage growth (IMF 2017b). However, wages are subject to the negotiations between the social partners. Aside from public sector wages or the minimum wage, policymakers can only set the framework but not dictate wage growth. Undermining the **autonomy of collective bargaining** to the detriment of employees by damaging the competitiveness of German companies and endangering jobs cannot be justified.

71. Despite the encouraging labour market situation, it is important to ensure the stability of the labour market in an **economic downturn** or in the event of **accelerated structural change**. In the past, the labour market's high internal flexibility, i.e. the ability to temporarily adapt the conditions of existing employment relationships, has helped to successfully cushion the impact of downturns, such as during the global financial crisis in 2008 and 2009. This flexibility must be preserved. However, external flexibility, i.e. an institutional framework that enables a rapid shift of jobs between businesses and sectors, does not exist to an equally large extent (GCEE Annual Report 2013 items 447 ff.).

72. In the case of an economic downturn, **regulatory barriers** such as restrictions on temporary employment may curtail companies' options to respond flexibly and increase the risk of redundancies and insolvencies. Higher regulatory hurdles make it harder for the unemployed to return to work and for recognised asylum applicants and low-skilled workers to enter the labour market. In light of the increasing need for skilled workers and the integration of recognised asylum applicants into the labour market, it would be desirable to keep the hurdles to labour market entry as low as possible.

73. When the **Minimum Wage Commission** decides the next adjustment of the minimum wage in summer 2018, it should strictly adhere to the monthly index of agreed hourly earnings excluding extra payments. In order to give employers the necessary flexibility to increase employment – even when production expectations are uncertain – the **unconditional option of offering temporary employment contracts** should be maintained.

3. Digital work environment of the future

74. Although **digitalisation** will permanently change the world of work in the future, no negative macroeconomic impact can be observed so far. On balance, the increasing use of robots in production has had a **positive economic impact** in Germany (Dauth et al., 2017). Machines are not expected to replace the majority of today's jobs. Instead, technological progress brings new employment opportunities and an increase in the standard of living.

75. Nevertheless, structural change caused by digitalisation will increasingly lead to **labour mobility between sectors and occupations**. Some employees will likely face greater individual challenges. Although the German tax and transfer system will compensate a good part of income losses caused by these adjustment processes, the top priority should be to better enable the labour force to cope with digital change and to take advantage of it.

76. Since in the digital age, employees will need to rapidly adjust to many new challenges over the course of their working lives, basic skills and non-cognitive skills in particular should be strengthened. Reservations against digital media should be countered through education. These skills are required for business and academia to innovate, for individual participation and for **societal acceptance** of digital approaches in business and public administration. Digital and economic educational content should receive a higher priority in schools and universities. In addition, it is necessary to establish a culture of lifelong learning. At the same time, the Internet can increasingly be used for education, for example through e-learning.

77. Although **training** is in companies' and employees' own interests, it is often neglected due to incentive problems. In the digital age, employees are keen to gain general skills that they can transfer to a different company when changing jobs. This is likely to reduce companies' incentives to bear the costs of training their staff. Political demands for blanket regulations, such as the legal entitlement to training, cannot remedy this problem.

In contrast, it would be desirable to increase **competition between educational institutions** and thus strengthen the quality of education and training. More transparent information on educational pathways and assessments of educators are needed. Digital technologies facilitate access to knowledge and enable needs-based, more individualised and self-determined learning.

78. As part of reforming the **Working Time Act** (*Arbeitszeitgesetz*), adjusting a daily maximum time to a weekly maximum time could help to spread working hours more flexibly over the weekdays. In addition, it makes sense to permit deviations from the minimum rest period of eleven hours in collective agreements in order to improve the flexibility of working hours and place of work. Demands to further reduce working hours appear untimely in view of the increasing shortage of skilled workers amid demographic change. Refraining from providing a legal entitlement to return to full-time work is the right decision, because this le-

gal entitlement may cause part-time workers to unnecessarily delay their return to full-time employment.

Digitalisation as an opportunity: key messages

Regulatory framework open to innovation

- Expansion of digital networks through private investment, government support only on a case-by-case basis taking account of EU state aid rules
- Significant efforts on data security, data protection and safeguarding privacy, without hampering efficiency gains through overly strict data protection regulations
- Establishment of a Digitalisation Commission in order to scrutinise regulations hindering innovation and identify systematic needs for reform

Digital work environment of the future

- Maintaining the flexibility of the labour market, low regulatory hurdles for labour market entry, making the Working Time Act more flexible
- Making the inequality debate objective and providing more information, as has already happened recently with the Fifth Poverty and Wealth Report
- Empowering workers to adjust to new requirements through strengthening cognitive skills, in particular basic skills, and also non-cognitive skills
- Encouraging lifelong learning and strengthening the quality of education and training through more competition between educational institutions

V. MORE MARKET IN CLIMATE PROTECTION

79. In **Energy Concept 2010**, the Federal Government has set the target of drastically reducing greenhouse gas emissions by between 80 % and 95 % by 2050. The GCEE does not question this target. The current implementation of the energy transition, however, fails to achieve this target or achieves it only at prohibitively high economic costs. Currently, national approaches and fragmented implementation, primarily building on subsidies, restrictions and a planned economy, has proven **expensive and inefficient** (GCEE Annual Report 2011 items 364 ff.; GCEE Annual Report 2016 items 882 ff.; Monopolies Commission, 2017).

All sectors should contribute to climate goals. Not only the electricity sector, which to date has been at the heart of German energy policy decisions, but also the transport and heating sectors. After all, the electricity sector is only responsible for part of final energy consumption. Yet, electricity bears a significantly higher burden of taxes, charges and levies than other sources of energy (Fraunhofer IWES et al., 2015). As a result, it is, for example, cheaper to produce heat with natural gas or heating oil than with electricity.

80. Splitting the energy transition in **separate electricity, mobility and heating strands** is **counterproductive**, not least because the government cannot precisely anticipate future technological advances and thus the ideal intensity and sequence of the individual transformations. Rather, a **uniform price for greenhouse gas emissions** that applies across sectors and regions should be at the heart of the energy transition to ensure an **effective approach to integrated energy**. The uniform price signal decreases the relative price of low-emission sources of energy compared to the price of fossil fuels. The transition to low-emission sources of energy would takes place where the associated costs are lowest (acatech et al., 2017a, 2017b).

81. This price can be established either by creating a carbon tax or by setting an **emissions cap** as part of a trading system for emissions certificates. A uniform CO_2 price would be preferable to the current approach even if it could only be introduced at national level. A global price, or at least a European price, would be preferable to avoid diversion effects. The Federal Government should therefore work more strongly towards strengthening the **EU Emissions Trading System** (EU ETS) and consistently include all emitters and final energy consumption sectors.

Such a system would ensure that greenhouse gas emissions decrease by a predetermined amount. The market mechanism would automatically determine in what sector, with what technology, by which emitter and in what region the next unit of greenhouse gas can be preserved at least cost. Given that it is uncertain which technological advances for decarbonisation will be available by 2050, a market mechanism is the best way to harness the **decentralised knowledge** of all players (GCEE Annual Report 2016 box 29). In contrast, subsidies for specific technologies, sectors or regions and interventions should be reduced and ideally be abolished altogether (acatech et al., 2015).

82. The price of the certificates could be stabilised through interventions if necessary to maintain sufficient incentives. For example, auctions of emissions certificates could be subject to a **price corridor** (acatech et al., 2015). Alternatively, certificates could be bought up and removed from the market to cap greenhouse gas emissions.

83. Because a price for greenhouse gas emissions prioritises emissions reduction, this would automatically decrease the use of fossil fuels, including the currently much discussed **phase-out of coal power plants** in Germany. The economic costs of this approach, including linking energy consuming sectors, would be lower than specifying a set time line for phasing out coal. From the perspective of climate protection, greenhouse gas emissions reduction should be key, not the unnecessarily expensive setting of specific routes towards lower emissions in individual sectors of energy supply.

Integrated energy as a result of a uniform CO_2 price would ensure that the **transport sector** could most efficiently make a contribution to climate protection. Whether the transport sector's contribution to emissions reduction should be greater or smaller than its current proportion of overall emissions would initially remain open. Likewise, the decision would be decentralised, whether emissions reductions take place through behaviour changes, i.e. by decreasing use of individual transport modes or by increasing use of local public transport, or through a switch to electric vehicles or low-emission fuels. Committing to **e-mobility** as the primary solution would at any rate be a far inferior approach to the introduction of a uniform CO_2 price.

84. Similar conclusions can be drawn for the heating sector, including the energy efficient renovation of existing buildings. In the case of effectively integrating energy through a uniform price signal, the extent of **building renovation** to avoid emissions would be left to the market. In any case, empirical studies suggest that subsidies for building renovation bear considerable free-rider effects (Grösche et al., 2013).

85. Although academics have for years pointed to the advantages of a market-based system to avoid emissions (acatech, 2012; acatech et al., 2015), reform of the current system is hard due to **massive resistance from its beneficiaries**. Even parts of industry have evidently given up their resistance to the fragmented implementation of the energy transition because of their need for planning certainty (Agora Energiewende and Roland Berger, 2017). Fundamental reforms have also previously failed because the population has **not** been **sufficiently informed** about the true costs and cheaper alternatives. One example is the proposal to pass on the costs of an inefficiently implemented energy transition to future generations through a debt fund.

It is also unhelpful that unrelated issues are often intermingled in the public debate. This applies, for example, to the calls for a ban on diesel engines on the heels of the **diesel scandal** in the German automotive sector. Prosecuting and penalising illegal agreements and manipulation within an industry and its suppliers falls under the remit of the German legal system, not of climate or industrial policies. Likewise, the particulate pollution in German city centres should be discussed as a local environmental issue, not as an element of global climate change.

Energy and climate protection: key messages

- Understanding the energy transition as a systemic task that uses the electricity, transport and heating sectors to avoid emissions in an equivalent manner
- Uniform price for greenhouse gas emissions through strengthening European emissions trading and including all emitters and sectors (effective integrated energy)
- Avoidance of support measures with a focus on specific technologies, sectors and regions and abstention from establishing specific transformation routes

VI. STABILITY FOR THE EURO AREA

86. The stability of the euro area is a **key concern for Germany**. Preserving stability requires national reform efforts by member states to enable convergence of their economic performance. In addition, reforms to improve the euro area's institutional framework, initiated since the start of the economic and financial crisis, should be completed. For a more stable euro-area architecture, the GCEE developed the concept **"Maastricht 2.0"** (GCEE Annual Report 2012 items 173 ff.; GCEE Annual Report 2013 items 269 ff.; GCEE Special Report 2015). This concept can serve as a blueprint for ensuring the fiscal sustainability of member states, improving financial stability and the integration of the financial markets, and for making crisis management in the euro area more effective.

87. Since the election of Emmanuel Macron as French president, **expectations for a European reform push** have risen. From the GCEE's point of view, further integration must combine a balance between national responsibility and common action with the right sequence of reform steps (Feld et al., 2017). Germany should constructively promote the adherence to fundamental principles such as subsidiarity or the unity of liability and control. These principles avoid misaligned incentives and are likely to increase the acceptance of the European integration process.

1. Convergence of economic performance through reforms

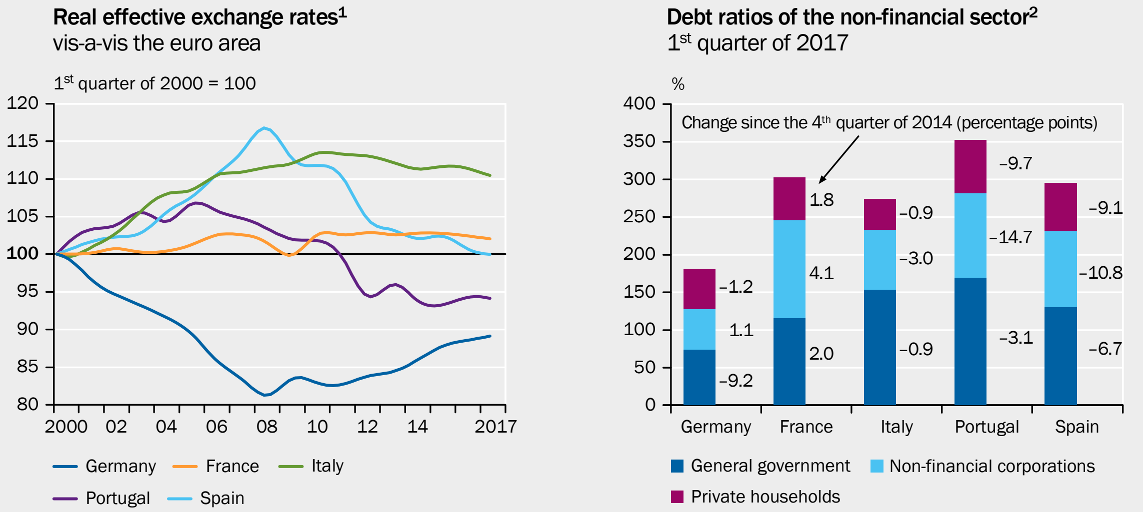
88. Ten years after the start of the global financial crisis, which led to the crisis in the euro area, considerable differences in the competitiveness of the member states persist. ↘ CHART 5 LEFT **Structural reforms are key** to increasing productivity growth and thus the prerequisite for economic growth and convergence of member states' economic performance. In the current economic upturn, which is supported by very expansionary monetary and fiscal policy, it is now high time to accelerate the pace of reform.

89. Structural reforms are the responsibility of the elected **national governments**. They should identify and implement suitable reforms on the basis of the national reform programmes that are coordinated within the framework of the European Semester. In many countries, there is still considerable need for reform. For Germany, the GCEE has also called for numerous reforms (GCEE Annual Report 2016 items 58 ff.).

90. However, a **common monetary policy** is not suited to permanently increase economic growth. Monetary policy has already achieved what it can in the area of macroeconomic stabilisation: It has given the national governments, which are responsible for fiscal and economic policy, considerable time to implement structural reforms and consolidate budgets. During this time, companies and private households in some member states have notably reduced their debt ratios. ↘ CHART 5 RIGHT

↘ CHART 5

Real effective exchange rates and debt ratios of the non-financial sector



1 – Real effective exchange rate based on unit labour costs. 2 – In relation to nominal GDP.

Sources: European Commission, Eurostat, own calculations

2. Priority for a sound national fiscal policy

91. The member states committed themselves to fiscal discipline in the Maastricht Treaty, and to the **principle of national sovereignty in fiscal policy**. Supported by economic expansion in the euro area, many member states now meet the 3 % deficit criterion. ↘ TABLE 1 The number of member states of the European Monetary Union (EMU) subject to an Excessive Deficit Procedure has decreased by two countries (Greece, Portugal) this year to two countries (France, Spain). On the one hand, **compliance with fiscal rules** monitored by the European Commission **has improved**. On the other hand, public debt remained above 60 % of GDP in 13 of the 19 member states in 2016. However, given the complexity of the European fiscal rules and their application, there are justified doubts about whether the current framework can exert a sufficient binding effect and guarantee the sustainability of public finances.

92. Germany has complied with the deficit limits of the Stability and Growth Pact for several years. The Federal Government expects compliance with the debt limit in 2019. At the same time, **criticism of the prioritisation of budget consolidation** is increasing. One accusation is that, in view of weak growth in the euro area, Germany's fiscal policy has a contractionary effect and hinders economic convergence, especially of weaker member states. The European Commission has therefore proposed influencing national budgetary policy within the framework of the European Semester in order to achieve a more expansionary fiscal policy in the entire euro area (European Commission, 2016b). ↘ BOX 17 PAGE 282

93. Calculations based on general equilibrium models provide evidence that a fiscal stimulus would only have **very limited expansionary spillovers** on other countries, although the effect is larger under the assumption that quantitative easing is ineffective (GCEE Annual Report 2015 items 340 ff.; IMF, 2017b). Nevertheless, it cannot be the objective to undermine the stabilising effect of national fiscal policy and to accept the overheating of the German economy in order to

↘ TABLE 1

General government balance of euro area member states[1]

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017[2]	2018[2]
Austria	– 1,4	– 1,5	– 5,4	– 4,5	– 2,6	– 2,2	– 1,4	– 2,7	– 1,1	– 1,6	– 1,3	– 1,0
Belgium	0,1	– 1,1	– 5,4	– 4,0	– 4,1	– 4,2	– 3,1	– 3,1	– 2,5	– 2,6	– 1,9	– 2,0
Cyprus	3,2	0,9	– 5,4	– 4,7	– 5,7	– 5,6	– 5,1	– 8,8	– 1,2	0,4	0,2	0,7
Estonia	2,7	– 2,7	– 2,2	0,2	1,2	– 0,3	– 0,2	0,7	0,1	0,3	– 0,3	– 0,5
Finland	5,1	4,2	– 2,5	– 2,6	– 1,0	– 2,2	– 2,6	– 3,2	– 2,7	– 1,9	– 2,2	– 1,8
France	– 2,5	– 3,2	– 7,2	– 6,8	– 5,1	– 4,8	– 4,0	– 3,9	– 3,6	– 3,4	– 3,0	– 3,2
Germany	0,2	– 0,2	– 3,2	– 4,2	– 1,0	– 0,0	– 0,2	0,3	0,7	0,8	0,5	0,3
Greece	– 6,7	– 10,2	– 15,1	– 11,2	– 10,3	– 8,9	– 13,1	– 3,7	– 5,9	0,7	– 1,2	0,6
Ireland	0,3	– 7,0	– 13,8	– 32,1	– 12,6	– 8,0	– 5,7	– 3,7	– 2,0	– 0,6	– 0,5	– 0,3
Italy	– 1,5	– 2,7	– 5,3	– 4,2	– 3,7	– 2,9	– 2,9	– 3,0	– 2,7	– 2,4	– 2,2	– 2,3
Latvia	– 0,6	– 4,3	– 9,1	– 8,7	– 3,3	– 1,0	– 1,0	– 1,6	– 1,3	0,0	– 0,8	– 1,8
Lithuania	– 0,8	– 3,1	– 9,1	– 6,9	– 8,9	– 3,1	– 2,6	– 0,7	– 0,2	0,3	– 0,4	– 0,1
Luxembourg	4,2	3,3	– 0,7	– 0,7	0,5	0,3	1,0	1,4	1,4	1,6	0,2	0,3
Malta	– 2,2	– 4,2	– 3,3	– 3,2	– 2,5	– 3,7	– 2,6	– 2,0	– 1,3	1,0	0,5	0,8
Netherlands	0,2	0,2	– 5,4	– 5,0	– 4,3	– 3,9	– 2,4	– 2,3	– 2,1	0,4	0,5	0,8
Portugal	– 3,0	– 3,8	– 9,8	– 11,2	– 7,4	– 5,7	– 4,8	– 7,2	– 4,4	– 2,0	– 1,8	– 1,9
Slovakia	– 1,9	– 2,4	– 7,8	– 7,5	– 4,3	– 4,3	– 2,7	– 2,7	– 2,7	– 1,7	– 1,3	– 0,6
Slovenia	– 0,1	– 1,4	– 5,9	– 5,6	– 6,7	– 4,1	– 15,1	– 5,4	– 2,9	– 1,8	– 1,4	– 1,2
Spain	1,9	– 4,4	– 11,0	– 9,4	– 9,6	– 10,5	– 7,0	– 6,0	– 5,1	– 4,5	– 3,2	– 2,6

Exceeding the 3 % deficit limit

Excessive deficit procedure[3]

1 – In relation to nominal GDP. 2 – Forecast of the European Commission. 3 – Based on the publication date of the EU Council decision.

Source: European Commission

stabilise the economy in other member states. This would require national fiscal policy to become an instrument to fine-tune aggregate demand as part of a European stabilisation policy.

94. Aside from automatic stabilisers, fiscal policy in Germany has mostly proven **unsuitable for countercyclical fine-tuning**. This is particularly due to delays in its implementation and to the finding that recessions often have structural causes (Michaelis et al., 2015).

95. The European institutional framework for fiscal policy, including the Stability and Growth Pact, aims at coordinating and supervising national fiscal policies. It comprises a variety of rules at the supranational and national levels with a large number of exceptions and flexibility conditions. ↘ CHART 6 In particular, the reforms in the wake of the financial and sovereign debt crisis (six-pack, two-pack, Fiscal Compact) and the flexible interpretation adopted in 2015 and 2016 **dramatically increased the rules' complexity**. This limits the effectiveness of recent reforms meant to strengthen fiscal rules. With the establishment of the European Fiscal Board (EFB) at European level and the enactment of national fiscal councils, new institutions have also been entrusted with monitoring responsibilities.

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The EU's institutional fiscal framework was reformed between 2010 and 2013 by, inter alia, the regulations of the six-pack, the two-pack and the Fiscal Compact. The **six-pack** regulations added a new option for sanctions, a spending rule and the operationalisation of the debt limit of 60 % of GDP to the Stability and Growth Pact. At the same time, the ex-ante coordination of national budgetary and reform policies in the European Semester and the Macroeconomic Imbalance Procedure were introduced. The signatories of the **Fiscal Compact** covenant pledged to adopt national deficit rules in national legislation and to entrust supervision to independent national fiscal councils. The **two-pack** strengthened the coordination of euro area member states' national budget processes. In addition, the supervision of the budget plans of member states with excessive deficits was expanded and the European Commission was allowed to require a revision of budget plans in the event of serious violations of the rules.

96. The European Commission's Vade Mecum (2017c) is the official handbook on current European fiscal rules. Its current version comprises more than 200 pages of legal norms, explanations and case studies. Overall, this results in an **extreme lack of transparency**, as even experts can barely determine whether member states meet all requirements of the fiscal rules. For policymakers or the public, this is practically impossible. A simple form of assessment is needed, so that the fiscal rules can have a binding effect and serve their function as an anchor for the public, media and financial markets. Only then can a violation of rules have political consequences.

97. The rules must also limit political economic incentives towards excessive deficits and must result in sustainable public finances. However, this is only ensured if **compliance with the rules can be assessed in real time** and if the rules are **not circumvented by exceptions**. Moreover, the use of statistical con-

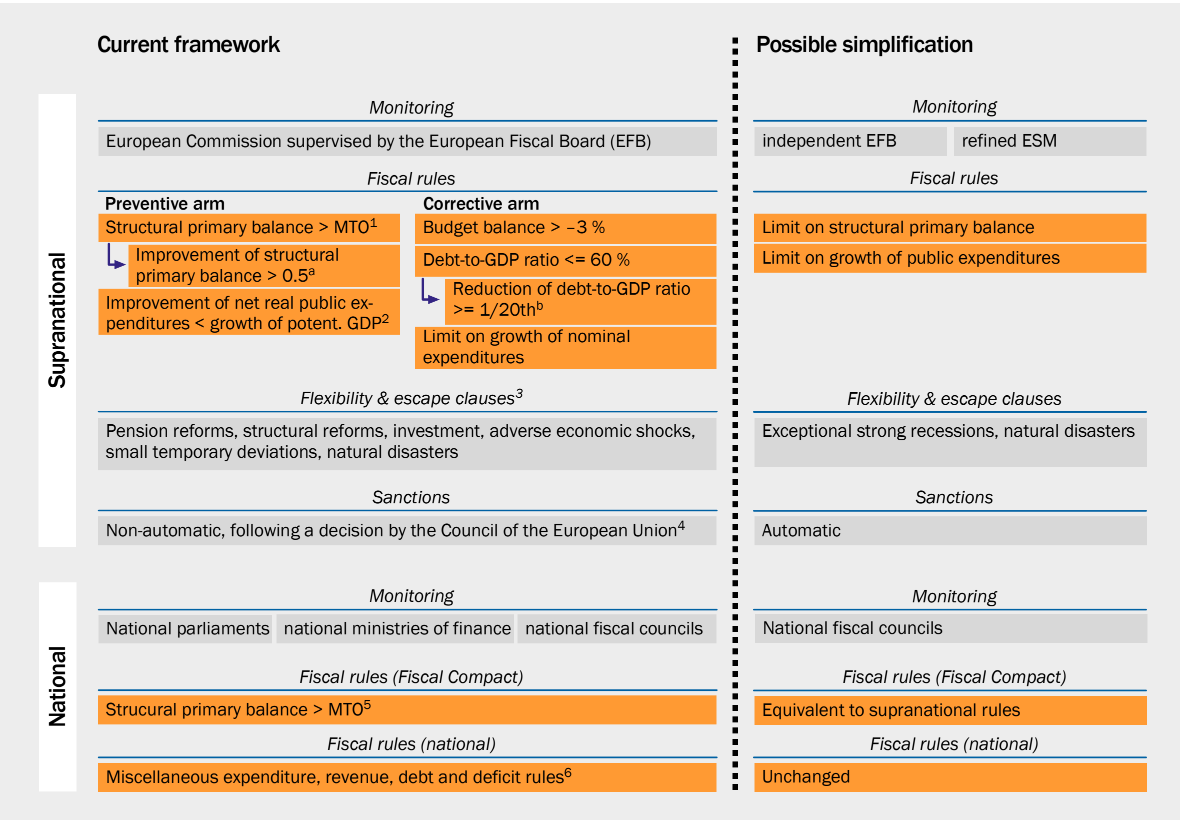
cepts involving the quantification of potential growth complicates the assessment of rule compliance. Potential growth is hard to measure in real time and is revised frequently (GCEE Annual Report 2016 box 6).

98. One option for simplifying the complex set of rules would be to reduce them to **two rules and independent supervision**: an expenditure rule as an annual operational target and a structural deficit rule as a medium-term target. ↘ CHART 6 These fiscal rules could replace the current preventive and corrective arms of the Stability and Growth Pact (SGP) and most exceptions. The current coordination and reporting obligations under the stability and convergence programmes as well as the European Semester would, however, remain in place. Manasse (2014), Andrle et al. (2015) and Claeys et al. (2016), for example, offer alternatives to simplify the current institutional framerwork of fiscal rules.

99. The operational rule could be an **expenditure limit** aimed at the growth of primary expenditure. Primary expenditure in relation to GDP is under direct and discretionary control of the government and consequently easier to forecast. It also reacts considerably less sensitively to the economic cycle than revenue or deficits ↘ BOX 18 and is subject to **fewer revisions**. Measures that depend on es-

↘ CHART 6

Schematic representation of the fiscal rule framework of the euro area



1 – Country-specific Medium Term Objectives (MTO), structural primary deficit below 1 % of potential GDP. 2 – Net public expenditures calculated by netting out interest expenditures, cyclical elements of unemployment spending, spending on programmes funded by the European Union, four year average of investment expenditures as well as one-off measures. 3 – For details see European Commission (2017c). 4 – Sanctions up to 0.2 % of GDP (interest-bearing deposit). Sanctions up to 0.5 % of GDP in the context of the Excessive Deficit Procedure. Other types of sanctions may involve the Suspension of commitments or payments under the European Structural and Investment Funds. 5 – Country-specific Medium Term Objectives (MTO), structural primary deficit below 0.5 % of potential GDP. a – Adjustment path may depend on the current debt-to-GDP ratio and the output gap. b – Fulfilled if the differential of the debt-to-GDP ratio has decreased over the previous three years at an average of 1/20th.

Source: Own representation

timates of the potential output, however, are subject to frequent and substantial revisions (GCEE Annual Report 2016 box 6) and are thus not suitable for assessing real-time compliance. This applies in particular to the existing expenditure benchmark in the preventive arm of the SGP. Depending on its exact design, a rule aimed at the growth of primary expenditures does not necessarily imply a decline in the ratio of public spending to GDP.

The maximium permissible growth in **primary expenditure** under this rule could be **conditional on the amount of public debt exceeding** 60 % of GDP as set out in the Maastricht Treaty. Depending on the extent of the excess, there would be a certain flexibility for discretionary anticyclical measures. If necessary, automatic stabilisers on the expenditure side could be taken into account. Exceptions to the fiscal rule would, in contrast to current rules, only be necessary for exceptionally deep recessions or natural disasters.

A violation of rules would **automatically trigger the excessive deficit procedure**. This procedure, sanctions, and the availability of funding via ESM loans with strict conditionality would all remain in place.

100. An expenditure rule alone, however, cannot guarantee fiscal sustainability given its exclusive focus on only one part of public finances. Fiscal sustainability could be ensured through the Fiscal Compact's **structural deficit limit**, which has already been transposed into national law. Thus the Fiscal Compact's supranational and national rules would be harmonised and would apply to all EU member states without exception. This type of rule is more of a medium-term objective, as measurement errors are associated with the use of structural variables. However, repeated and serious deviations should be sanctioned.

101. The rules must be subject to independent supervision. At the supranational level, a reformed, **independent EFB** that is equipped with sufficient resources could assume this task from the European Commission (Asatryan et al., 2017). An expanded ESM could additionally fulfil this role for member states of the monetary union. At the national level, the competencies of national fiscal councils introduced through recent reforms should be expanded. They should focus on the supervision of national rather than supranational rules.

3. Advantages and disadvantages of fiscal equalisation mechanisms

102. A **common fiscal capacity to balance out cyclical fluctuations** is often proposed as complement to the euro area (European Commission, 2017d). Compared to equalisation via factor or credit markets, a fiscal equalisation mechanism may deliver just limited additional stabilisation (Feld and Osterloh, 2013). On one hand, greater fragmentation of labour and financial markets in Europe **compared to the US** results in lower shock absorption. On the other hand, national fiscal policy of euro area member states plays a much greater role in shock absorption than state transfers in the US, as US states are required to balance their budgets (Milano and Reichlin, 2017).

103. In the euro area, there is also a **significant stabilising effect from the ESM** and related institutions created during the financial crisis (Cimadomo et al., 2017; Milano and Reichlin, 2017b). Milano and Reichlin (2017a) therefore find that, on the whole, that euro area institutions achieve a shock absorption of 28 % compared to 19 % in the US. In any case, there is no reason to doubt the euro area's long-term stability due to the lack of a common budget or an anti-cyclical fiscal capacity.

104. Nevertheless, **discussion of these ideas dominates the public debate**. The European Commission has proposed creating a fiscal equalisation mechanism, for example, in the form of a rainy day fund, a European Unemployment Reinsurance Scheme or a European Investment Protection Scheme (European Commission, 2017d). President Macron has proposed a euro-area budget funded by European taxes (Macron, 2017). Other proposals call for a separate fiscal capacity equipped with its own funding facility.

The analysis by Furceri and Zdzienicka (2015) illustrates the workings and size of a fiscal capacity. In this model, member states make an annual contribution to a fiscal capacity which transfers payments to member states experiencing an economic downturn. The authors calculate, based on a panel of 15 member states for the period 1979-2010, that an annual gross contribution rate of 1.5 % to 2.5 % of gross national income (GNI) would be required to smooth the business cycle to the extent seen in Germany. The aggregated contributions would be transferred to member states based on the deviation of growth from the historical average or excess over a threshold output gap. No payments would be made, however, for persistent or autocorrelated shocks. In this model, a payment constitutes a transfer, all other conditions being equal.

105. All of these proposals indicate numerous **problems from conceptional or political economy perspectives**, with disadvantages likely outweighing the limited benefits for economic stabilisation. The problem with fiscal equalisation mechanisms is that measuring economic cycles in real time is unreliable and the cycles must be isolated from the effects of national economic policy. With mechanisms such as rainy day funds, which are focused on smoothing unusually large shocks, there is the added challenge of ensuring sufficient funding to cover any contingency. This could result in the fund being granted a financing capacity or an ESM credit line. These issues raise the question of whether member states would not ultimately fare better by reducing national debt ratios instead of contributing to such funds.

106. Any form of fiscal capacity must prevent permanent transfers that create undesirable incentives for national economic policy. For example, a **European Unemployment Reinsurance Scheme** could cause major problems if shifting costs of higher unemployment to European level while labour market policy largely remained at national level. Even with a reinsurance scheme, which compensates only part of the costs and allows to recoup costs associated with a structural rise in unemployment, there is the problem that rigid labour markets tend to display larger cyclical swings (Dolls et al., 2015), meaning that incentive problems still remain.

The introduction of such a system thus needs to be accompanied by **harmonisation of national labour market policies**; otherwise there would be a risk that countries with rigid labour markets enjoy greater benefits at the expense of other countries with flexible labour markets. Harmonisation of this kind is currently unrealistic and incompatible with different national labour market preferences, thus undermining the principle of subsidiarity (GCEE Annual Report 2016 item 337).

107. Many proposals aimed at better coordinating economic and budgetary policy include appointing a **euro area finance minister**. France in particular hopes that creation of such a political heavy-weight would facilitate better policy coordination in the euro area. It would like to see a euro area finance minister allocated an own budget with which macroeconomic shocks could be mitigated. The German Federal Government, on the other hand, envisages an entity endowed with the right to intervene in member states' budgetary policy to enforce European fiscal rules. These varying interpretations underscore how different German and French traditions and these countries' concepts of a strong centralised euro area government are (Brunnermeier et al., 2016).

The question also arises as to whether this is even desirable. Having a euro area finance minister would blur fiscal policy responsibilities in the euro area. Effective **powers to intervene** in national fiscal policymaking are unthinkable to achieve, given the budget autonomy of sovereign member states. The euro area finance minister may therefore merely serve as an authority to pursue more expansionary fiscal policy by alleviating consolidation pressure on member states.

4. Completion of Banking and Capital Markets Union

108. Completion of the banking and Capital Markets Union is essential for a stable and resilient architecture for the euro area. For the most part, there is agreement that further **risk-sharing only makes sense if accompanied by risk reduction**. Efforts must be made in particular to prevent legacy debt from the crisis being transferred to the union. For this reason, steps should not be taken to share risk until progress has been made in risk reduction. The risk reduction required mainly concerns three areas: reducing the large holdings of non-performing loans in the banking sector, ending the privileges for sovereign exposures in banking regulation and increasing the credibility of the resolution regime for banks.

109. The banking sectors of many member states, particularly in southern Europe, remain burdened by large holdings of non-performing loans (NPLs). Meanwhile, progress in reducing NPLs has been made in many areas, possibly due to more decisive supervisory action and the economic recovery in the euro area. Efforts to **reduce NPLs** should be **accelerated** as this is key to ending the crisis and a prerequisite for the bank resolution regime to function properly. ↘ ITEMS 444 FF.

110. Banking supervision plays a major role in achieving this aim. **Supervisory targets**, for example, can support NPL reduction. More comprehensive loan loss

provisions should be created for new NPLs as proposed by the ECB. NPL losses should be realised immediately and bank shareholders and creditors be bailed in. If a bank turns out to be non-viable, **resolution should be considered**. Delaying the clean-up of bank balance sheets and the banking sector through excessive regulatory forbearance can lead to zombification of the financial system and the economy, hinder necessary structural change and be accompanied by high economic costs (GCEE Annual Report 2016 item 518).

Transferring NPLs to private **asset management companies (AMCs)** may be appropriate. Publicly funded national or even European AMCs, however, harbour the **risk of hidden public transfers** to the banking sector and are therefore problematic. In addition, the legal framework for in and out of court insolvency proceedings should be improved, and swift execution of foreclosures should be facilitated. This could increase the recovery value and **strengthen the European secondary market for NPLs** (GCEE Annual Report 2016 items 521 f.).

111. The close nexus between banks and governments due to the large volumes of government bonds in banking portfolios remains, in part because of **regulatory privileges for sovereign exposures** in banking regulation (GCEE Annual Report 2016 items 537 ff.). For years, the GCEE has been calling for a phase-out of these privileges and has proposed introducing risk-adjusted large exposure limits and risk-adequate capital requirements on sovereign exposures (GCEE Annual Report 2015 items 52 ff.). Central to the proposal is **reducing cluster risks through large exposure limits**. Capital requirements would also increase the loss absorption capacity and decrease price distortions. It is difficult to envisage the introduction of additional risk-sharing elements without phasing out the privileges of sovereign exposures.

112. **Considerable progress** has been made in **bank resolution**. The Spanish Banco Popular Español, for example, was put into swift resolution via the Single Resolution Mechanism (SRM) without relying on any government funds or triggering any systemic effects. The Italian government, in contrast, used the **exceptions under the new resolution rules** to spare some of the creditors of two smaller banks, at the expense of Italian taxpayers. This is at odds with the spirit of the SRM, which intends to loosen the sovereign-bank nexus by having shareholders and creditors rather than the government bear the losses from bank failure. ↘ ITEMS 431 FF.

113. These events have exposed **loopholes in the new resolution regime**, which cast doubt on the credibility of the new rules. For this reason, exceptions from creditor bail-in need to be limited. Tightening state aid rules could reinforce the liability cascade. It should be clarified that senior creditors should in principle be bailed in. National loopholes should be limited, requiring harmonisation of national insolvency laws. ↘ ITEMS 439 FF.

114. It has become evident that subordinated debt can contribute to better resolvability of banks. At the same time, there is evidence that a creditor bail-in even in comparatively quiet times can be fraught with difficulties. If a systemic crisis looms, the destabilising effects of a bail-in cannot be ruled out, which is why

sufficient bank capital remains essential and should not be replaced by higher requirements for bail-inable debt (GCEE Annual Report 2016 items 534 ff.).

115. A **fiscal backstop for the Single Resolution Fund** (SRF) is necessary to stabilise the financial system in the event of a systemic crisis. The member states have granted the SRF individual national credit lines until creation of a common backstop. In October 2017, the European Commission published new plans for developing a backstop, which envisage the **ESM** for this task (European Commission, 2017e). The plans call for the banking sector to repay the loans. In the past, the GCEE has urged that member states must not be let off the hook completely (GCEE Annual Report 2014 items 349 ff.). In any case, the creation of a common backstop requires **considerable progress in risk reduction**.

116. If member states succeed in appropriately reducing risks, further deepening of integration can be considered. This would include creating a **European Deposit Insurance Scheme** (EDIS). National deposit guarantee schemes result in interlinking banks and the member states in which they are domiciled, thus strengthening the sovereign-bank nexus. EDIS is suitable for weakening such a nexus and creating a European deposit market with similar deposit rates in which the default risk of deposits is largely unrelated to member states' solvency.

117. However, a poorly structured common deposit guarantee scheme harbours **misaligned incentives for member states** to shift risk to the European level, as they can significantly influence the risks of national banking sectors through economic and fiscal policies (GCEE Annual Report 2016 item 549). For this reason, EDIS must be **designed in such a way that it is compatible with incentives**. The GCEE advocated a model in the past in which payouts of the fund would be borne at a proportionately higher rate by banks of the member state in which the failed bank is domiciled (GCEE Annual Report 2016 items 546 ff.). Harmonisation, especially of insolvency laws, could limit the influence of national policy on the banking sector (GCEE Annual Report 2016 item 552).

118. The **European Commission** (2017e) **revised its plans for EDIS** in October 2017, thus partially addressing concerns over premature mutualisation of risks. According to the revised plans, in the first or “reinsurance” phase, only repayable loans can be granted between deposit guarantee schemes if a national deposit insurance fund proved insufficient. The plans do not provide for mutualisation of risk until the second “coinsurance” phase. Moving to the second phase would be conditional on prior risk reduction.

Although greater emphasis on risk reduction as a condition for risk-sharing is welcome, the new proposal leaves many questions unanswered. Above all, no explanation is given of how incentive compatibility can be ensured in the second phase. The question of a **fiscal backstop** in the event that common fund contributions are insufficient to cover the costs of a crisis remains unanswered. A common backstop would only come into question, however, if all conditions for a common deposit guarantee scheme were met. Similar to the case of a backstop for the single resolution fund, the costs should ultimately be borne by the banking sector.

119. Risk-sharing between member states does not necessarily require mutualisation; it can also be achieved by strengthening the common European capital market. This is the aim of the **European Capital Markets Union**. Until the European capital markets are better developed, banking sector crises will strongly impact corporate financing. Expanding capital market-based financing could increase diversification of financing sources for companies and improve the system's resilience (GCEE Annual Report 2015 items 440 ff.). Moves should be made in particular to promote **sustainable forms of cross-border financing** that are durable and capable of absorbing losses in times of crisis.

120. The European Commission's latest proposals (2017f) on reinforcing the European supervisory authorities (ESAs) are welcome. The plans to **expand the direct supervisory powers of the European Securities and Markets Authority** (ESMA) could help to reduce impediments to further capital market integration. Moreover, European supervision can play an increasingly important role as the integration of capital markets progresses and the potential for spillover increases.

121. Reducing risks in the banking system and increasing private risk-sharing, particularly through the European Capital Markets Union, could significantly strengthen the euro-area architecture while also **reducing the need for public risk-sharing**, such as via a fiscal capacity. This would also relieve the ESM.

5. Strengthening the European Stability Mechanism

122. With the creation of the European Stability Mechanism (ESM), the euro area features a **crisis mechanism** since 2012 (GCEE Annual Report 2012 items 173 ff.; GCEE Annual Report 2013 items 269 ff.). To date, the ESM, along with its predecessor, the European Financial Stabilisation Facility (EFSF), has paid out around €260 billion in loans to member states hit by crises. The ESM must request active participation from the International Monetary Fund (IMF) when approving loans. Recently, however, the IMF has not contributed to the latest loan package to Greece, and it is unclear whether the IMF will participate in future programmes. Against this backdrop, there are discussions of a “European Monetary Fund”, centring on whether and how the ESM should be further developed.

123. The GCEE considers the ESM a **key element of the euro-area architecture** that should be neither phased out nor transposed to an EU institution. However, its further development must not turn the ESM into a transfer mechanism. Instead, options should be considered to strengthen member states’ incentives to prevent crises.

124. To this end, adding clear **rules for orderly government debt restructuring** in case of crisis to the ESM's macroeconomic adjustment programme instrument is essential. This will ensure that creditors contribute to crisis resolution and that the ESM only grants loans to solvent member states. This prevents negative incentives of the crisis mechanism for national fiscal policy and rein-

forces market discipline. The GCEE has developed a detailed proposal based on the modification of existing majority voting clauses in standard bond contracts to enable orderly debt restructuring (GCEE Annual Report 2016 box 2).

The GCEE's proposal provides for a gradual phase-in of modified majority voting clauses, called **Creditor Participation Clauses**, into bond contracts of euro area government issuers. In case of an ESM programme of a member state with high public debt, creditors would be required to vote on a **maturity extension** in a first stage. A maturity extension reduces the funding need and enhances the firepower of the ESM's limited financial resources. In a second stage during the ESM assistance programme, a decision would be taken as to whether a **debt haircut** is required. This way, the rules limit credit risk for the ESM and strengthen market discipline.

125. In the GCEE's proposal, the ESM decides on the basis of rules clearly anchored in the ESM programme's guidelines whether a majority approval of restructuring should become a condition for payments under an ESM programme. This approach **does not present an automatism** as demanded by the Deutsche Bundesbank (Deutsche Bundesbank, 2011, 2016c). The Deutsche Bundesbank's proposal calls for bond contracts to contain restructuring clauses that automatically trigger a maturity extension when an ESM programme is agreed. The drawback of rigidity imposed in this manner could however outweigh the gain in credibility (Andritzky et al., 2016b).

126. There is nonetheless the risk that the **ECB's large bond holdings** will undermine a mechanism for orderly debt restructuring through creditor majority voting. The ECB is prevented from voting in favour of a restructuring given the prohibition of monetary financing by the Treaty on the Functioning of the European Union. This could help holdout creditors to form a **blocking minority** (Buchheit and Gulati, 2017). Thus the ECB's large bond holdings limit the possibility of the ESM contributing to crisis resolution in highly indebted member states requiring official assistance.

127. In addition, the ESM could be endowed with an **explicit mandate for crisis prevention**. There are currently discussions regarding assigning the ESM, in collaboration with other institutions, the responsibility of **identifying stability risks** and **supervising member states' fiscal policies**. This may prompt member states to undertake measures for risk reduction. ESM staff could draft regular reports following the IMF's process for Article IV consultations. This would create another instrument for supervising national economic policy, besides the European Commission's country reports. Publishing such reports authored by the ESM staff could strengthen the independence of economic surveillance and provide a stronger political signal.

128. To weaken the sovereign-bank nexus, enhancements to the ESM instrument of **direct recapitalisation of financial institutions** could be considered. On the one hand, strict conditions for direct recapitalisation limit the ability of the ESM to avert distress of a member state when systemic risks warrant the rescue of a financial institution. On the other hand, reforms already undertaken –

above all the introduction of the resolution regime – reduce the need for direct recapitalisation. For this reason, current discussion has not yet focussed to any great extent on this issue.

In any case, the same risk reduction requirements that apply to the common fiscal backstop apply here as well. ↘ ITEM 115 Moreover, use of the instrument should be tied to appropriate economic policy conditionality, such as to improve the framework of insolvency proceedings. Further development of the ESM could ultimately include the functions of a **backstop for the Single Resolution Fund** (SRF) and for a potential **European deposit guarantee scheme**. ↘ ITEM 118

6. Conditions for creating safe assets in the euro area

129. The discussion on creating safe assets in the euro area has continued, with the proposal incorporated into the European Commission's "Reflection Paper on the Deepening of the Economic and Monetary Union" (2017d). The ESRB announced that it would publish a report in December on the creation of **sovereign bond-backed securities (SBBS)** to serve as the basis for continued discussion. The report is a further development of the original proposal by Brunnermeier et al. (2011, 2017), which calls for the creation of a safe European asset based on the principles of **diversification and tranching**.

Under this proposal, a portfolio of euro-area member state government bonds is to be divided into different tranches of varying seniority with the tranching point chosen in such a way that the senior tranche is as safe or even safer than a German government bond. In last year's Annaul Report, the GCEE welcomed the creation of a safe European asset **without mutualisation** but pointed out the **danger of implicit liability risks** (GCEE Annual Report 2016 box 17).

130. There are two motivation factors underlying the creation of safe assets in the euro area: firstly **preventing destabilising capital flows** between member states in times of crisis, and secondly **loosening the nexus between banks and sovereigns**. From the GCEE's point of view, however, it is unclear whether the creation of SBBS is a suitable response to these problems.

131. Brunnermeier et al. (2017) show in a simulation study that, by means of appropriate tranching, it is possible to create a senior tranche that is at least as safe as German government bonds. Standard and Poor's (2017), in contrast, points out that the securitised risks are less granular than in securitisations of property loans, and that the correlation between sovereign bonds in times of crisis is likely to be very high. It will therefore likely be **difficult for an SBBS to obtain a AAA rating**.

132. It is also uncertain whether destabilising capital flows can be prevented during crises. For example, the **demand for junior tranches in times of crisis** could decline abruptly. This would make private players less willing to offer tranched securities, as they would expect difficulty placing the junior tranches on the market. This could exacerbate a crisis because a considerable share of the

demand for government bonds would suddenly disappear. This would not only be a problem for those countries that are already in a crisis, it could also induce contagion to other member states. Thus **safe haven flows** in times of crisis cannot be ruled out.

In such a case, the **pressure would increase on the ECB or the ESM to purchase the junior tranches**, in order to stabilise the market. The necessary application for an ESM programme could possibly be circumvented without such intervention being accompanied by the conditionality otherwise required.

133. Therefore, the following conditions for the design of SBBS need to be fulfilled to limit implicit liability risks:

– SBBS would have to be issued by **private players**, as the pressure on a public institution to accept liability risks in the event of crisis would be too great.

– **The privileges** of sovereign exposures in banking regulation would have to be **phased out before** SBBS were created. SBBS should not be created without removing regulatory privileges.

– **Banks** should be **excluded** from holding junior tranches.

– The criteria for the design would have to be largely independent of short-term political interests.

134. In view of the present uncertainties, it seems advisable to move forward cautiously. For example, the **regulatory bias against securitisation of diversified portfolios of government bonds** should first be **removed** by treating them in the same way as the underlying government bonds. This would eliminate a major obstacle for the private sector in creating safe assets such as SBBS.

If regulatory sanctions were imposed on **holding non-diversified government bond portfolios**, such as by introducing large exposure limits, this would likely considerably increase the willingness to create such assets. Regulation of this kind could force reallocation of government bond portfolios and thus effectively loosen the nexus between banks and sovereigns.

Stability for the euro area: key messages

- Convergence of euro area economic performance through structural reforms which are the responsibility of member states and lie in their own interest
- Simplification of the EU framework to strengthen fiscal discipline by means of an annual expenditure benchmark and a medium-term structural deficit limit with supervision by an independent European Fiscal Board or the ESM
- No need for a common fiscal capacity, European unemployment insurance or a euro area finance minister
- Completion of the Banking and Capital Markets Unions; further integration only after reduction of NPLs in the banking sector, removal of regulatory privileges for government bonds and increasing the credibility of the resolution regime for banks

- Strengthening the ESM by introducing rules for orderly government debt restructuring in case of crisis and extending the ESM’s role in the surveillance of member states' economic policies
- Creation of safe assets in the euro area to prevent implied liability risks only under stringent conditions, particularly issuance by private issuers and simultaneous removal of privileges for government bonds; as a first step ending the regulatory bias against securitisations so that the private sector can create SBBS on its own

VII. RENEWING THE EUROPEAN UNION

135. After mounting concerns about the EU's future, particularly as result of the Brexit decision and the rising popularity of Eurosceptic political parties, there now appears to be an opportunity for **constructive development of the EU and its institutions**. The GCEE has already stated in the past that greater collaboration at European level in many areas would be advisable.

When shifting political competencies to European level, advantages and disadvantages need to be weighed against each other. These include, for example, cost reductions due to economies of scale, elimination of inefficiencies due to information asymmetries or externalities. Also, heterogeneous political preferences and avoiding moral hazard need to be taken into account (GCEE Annual Report 2016 items 329 ff.). Thereby, the principles of **subsidiarity** and **unity of liability and control** should be observed.

1. Many common interests in EU reforms

136. **Subsidiarity** is a fundamental principle anchored in the EU Treaty, determining the distribution of competencies between the EU and the member states. Pursuant to Article 5 (3) TFEU, the EU can only take action in the areas which do not fall within its exclusive competence if and insofar the member states cannot sufficiently achieve certain objectives and these can be better achieved at Union level. In accordance with this principle, the GCEE has identified areas for action in which **greater European responsibilities** appear advisable (GCEE Annual Report 2016 item 336). French President Macron also listed many of these areas in his speech on the EU's future this September.

137. In the area of **foreign trade**, there is widespread support by EU member states for existing multilateral agreements and the negotiation of further free trade agreements. ↘ ITEM 643 In the area of **foreign direct investment**, approaches to reviewing or banning company takeovers from outside the EU – as proposed by European Commission President Juncker (Juncker, 2017) – bear the risk of generally restricting free movement of capital (GCEE Annual Report 2016 items 986 ff.). A general requirement for approval of foreign investments to pro-

tect purely economic interests or economic policy objectives should be rejected. The EU should remain open to foreign investors, even without reciprocity.

138. The **common market** and the related European competition policy are cornerstones of the EU. However, there is still scope for reducing non-tariff barriers to trade, for example in the service sector. The GCEE considers the most recent decision to **tighten the rules under the Posting of Workers Directive** to be a protectionist move. In future, posting companies have to pay their workers not only the existing minimum wage in the host EU country, but also the applicable negotiated wage or standard wage. This decision goes against the freedom of services of the common market and mainly serves to force eastern European competitors out of the market. The Posting of Workers Directive clearly shows that, despite all the talk about free trade, member states tend to support market barriers when push comes to shove.

139. Joint action in the area of **digitalisation** offers high efficiency potential. A joint approach in innovation policy or regulation, for example, can make it easier for digital business models to realise economies of scale. ↘ ITEMS 59 FF. The European Commission has declared the creation of a digital single market one of its priorities for this legislative period. Industrial policies to direct innovation and to support model companies – national or European "champions" – distort competition and can be counterproductive.

140. In the area of **foreign policy and defence**, considerable economies of scale and the political weight of joint action argue for a stronger EU role. The recently agreed Permanent Structured Cooperation and the creation of a European Defence Fund are steps in this direction. Although joint action in many areas touches on sensitive national security interests, closer coordination can facilitate economies of scale in procurement, for example. Such advantages should not be sacrificed in the interest of national industrial policy.

141. In the area of **migration and asylum**, many EU member states share an interest in more secure external borders to prevent illegal border entry. Distribution of recognised asylum seekers is, however, a matter of dispute, even if fairer distribution of refugees and their costs among the member states would be appropriate (Andritzky et al., 2016a). A European approach to tackling the underlying causes of refugee migration as well as to development cooperation could be more effective than purely national action. Related expenses should be funded by reallocating EU budget funds and not, as the French president proposed, through an EU financial transaction tax (GCEE Annual Report 2016 item 47.)

142. In the area of **public security and law enforcement**, an international approach to combating international terrorism and organised crime is advisable, justifying an expansion of EU competencies in this area. The role of the current European police authority Europol could be enhanced, for example (GCEE Annual Report 2016 item 336).

143. A global approach is absolutely necessary in the area of **climate protection**. ↘ ITEMS 79 FF. A European approach is more targeted and adequate than a national one. In order to increase the effectiveness of carbon emissions allowances in the

EU Emissions Trading System (EU ETS), the GCEE advocates a price corridor – similar to the French president's suggested minimum price – or a one-time reduction in the number of emissions allowances in circulation (GCEE Annual Report 2015 items 85 ff.). A carbon border tax, on the other hand, would be a trade restriction and is problematic in regard to WTO rules and existing free trade agreements.

144. A more united approach is not advisable in other areas, however. These include in particular the joint financing of expenditures, which promises benefits to individual member states only. It is therefore imperative that **spending prioritisation within the EU budget be reviewed** (Feld, 2005; GCEE Annual Report 2016 items 351 ff.)

It is generally in the member states' own interests to take appropriate measures to increase economic efficiency. To justify joint financing of structural and cohesion policy, there needs to be a stronger **link between the allocation of financing from the structural funds and the European Commission's country-specific recommendations** (GCEE Annual Report 2016 item 38; German Federal Ministry of Finance, 2016).

145. There is no need for an additional **joint financing instrument for public investment**. There are already numerous European facilities, including the European Fund for Strategic Investments (EFSI), founded as recently as 2015. On the one hand, significant free-rider effects cannot be ruled out (European Court of Auditors, 2016). On the other hand, it is doubtful whether financing is the key bottleneck holding back public investment.

146. Another proposal on budget policy coordination relates to the European Commission's Proposal for a Council Directive on a Common Consolidated **Corporate Tax Base** (CCCTB). The aim of the CCCTB is to make corporate taxation simpler and more transparent, and to improve financing neutrality. The simplification of tax law promises advantages for businesses in the EU with cross-border activity. They would no longer have to comply with 28 divergent corporate tax systems, which often results in double taxation. A common consolidated corporate tax base also offers better conditions for offsetting losses within a corporate group. From the viewpoint of member states, the CCCTB has the benefit of preventing tax-motivated profit shifting to low-tax countries. However, there are disadvantages. In particular, the CCCTB creates new possibilities for tax avoidance. There are also shortcomings in the specific details of the draft directive. ↘ BOX 2

↘ BOX 2

A critical review of the European Commission’s proposal on a CCCTB

Following the initial draft from 2011, the European Commission released an updated version of a draft directive on a **Common Consolidated Corporate Tax Base** (CCCTB) in October 2016 (European Commission, 2016c, 2016d). The proposal opts for a **two-step harmonisation** of the corporate tax base in the EU. The first step is to harmonise the computation of the tax base, and the second step would allow multi-national firms to consolidate their profits and losses. This would involve profits and losses being shared among the member states using a formula-based apportionment on the criteria assets, labour and sales. This is intended to ensure taxation where value is created.

The overall objective is not only to simplify taxation and reduce compliance costs, but also to render profit shifting to avoid taxes pointless. Harmonisation could facilitate **cross-border activities for companies**, as it would eliminate double taxation present in some cases due to 28 different corporate tax systems despite double taxation treaties. Companies could also better account for their losses in consolidated financial statements.

However, there would also be new possibilities for tax planning by multinational companies, and according distortions. Depending on the specific regulations, **formula-based apportionment of profits** among member states would provide **incentives for outsourcing** production factors. The member states could continue to use different corporate tax rates with a CCCTB. For instance, if the labour criterion is given a heavier weight in the formula, there would be an incentive to outsource more staff to a low-tax country in order to pay less tax overall (Riedel, 2010). Moreover, a corporate group still has to prepare a separate balance sheet for minority shareholders. This opens up new **tax avoidance opportunities through suitable ownership structures.** It remains to be seen whether the resulting economic distortions are more favourable than the revenue decline for the member states due to profit shifting (Board of Academic Advisors to the BMF, 2007). In any case, the CCCTB cannot fully eliminate tax avoidance possibilities.

Furthermore, a critical view should be taken of other aspects of the proposed directive. For example, the proposed introduction of consolidation envisages an **implementation in two steps without a fixed time frame**. Various elements of the common corporate tax base would likely result in reduced revenue in many EU member states (Nicolay and Spengel, 2017). There is thus a risk that only the first step will be implemented, in which case the project would not help to combat tax avoidance and would only exhaust a small part of its potential. The **opt-in possibility for companies with a group-consolidated annual turnover of below €750 million** is also problematic. This creates parallel tax structures that make corporate taxation more complicated. Furthermore, there may be a risk of unintended behavioural reactions at the thresholds.

The council directive also envisages equal treatment of **equity and debt financing in tax terms**. Providing an allowance for equity issuance could reduce the distortions in financing decisions. This proposal for achieving financing neutrality is in principle in line with the GCEE's proposed allowance for corporate equity, and is therefore welcome (GCEE Annual Report 2012 items 407 ff.; GCEE Annual Report 2015 items 728 ff.). However, in accordance with the draft directive, only new equity is eligible for the allowance, while the GCEE proposes an allowance for share capital. The proposed directive therefore does not fully eliminated the existing distortions between investments financed through equity and those financed through debt or retained profits. There are also potential distortions in the tax treatment of dividend distributions to shareholders. This highlights another problem with the CCCTB – in some areas it touches on income tax law in the member states, in this case the taxation of investment income. It could therefore open the door for further harmonisation of direct taxes, which is a problem in light of the principle of subsidiarity.

2. Extended deadline rather than disorderly Brexit

147. After a majority of the United Kingdom electorate voted against remaining in the EU in a referendum held in June 2016, the UK government delivered **notification of the country's intention to withdraw** on 29 March 2017. Delivering this notice triggered Article 50 of the Treaty on the European Union (TEU), giv-

ing the country two years until its membership expires ("Brexit"). The European Council can resolve unanimously to extend the deadline. The question as to whether the UK can unilaterally halt the process set out in Article 50 TEU is not entirely clear (GCEE Annual Report 2016 item 289).

148. Article 50 TEU provides for the European Council to resolve a **withdrawal agreement** by the set deadline, which requires the consent of the European Parliament. The EU heads of state and government agreed guidelines in April for exit negotiations (European Council, 2017), which first require a withdrawal agreement to be concluded. The UK has also published a series of papers on its own negotiating strategy.

149. Brexit will be a serious blow to the process of European unification. Given the specialisation in the common market and global value chains, the current degree of integration between the UK and the other EU member states, not least Germany, is so high that **a Brexit has mostly downsides**. The economic costs of Brexit are likely to hit the UK much harder than the rest of the EU (GCEE Annual Report 2016 items 292 ff.). However, a **disorderly hard Brexit** would be tantamount to an economic shock, which would bring immense disruption and possibly affect employment in the entire EU. This worst-case scenario is better avoided.

150. Given the **immense ramifications of the UK's exit** from the EU, the GCEE continues to call for prevention of such a scenario (GCEE Annual Report 2016 item 22). If this is not possible, the objective of the negotiations should be to conclude a follow-up agreement that minimises the damage for both sides (GCEE Annual Report 2016 item 289). This should be as comprehensive as possible and tailored to the special economic relationship, leaving the four freedoms as untouched as possible. Nevertheless, the UK should not be in a better position outside the EU, and should not be allowed to "cherry pick" (GCEE Annual Report 2016 item 23).

151. **More time will likely be needed** to negotiate this kind of agreement than the two-year period specified in Article 50 TEU. For example, the EU took five years to negotiate its free trade agreement with Canada, and four years with Japan. However, these agreements do not even include services that would be of particular importance for trade with the UK.

Prime Minister Theresa May and EU Chief Negotiator Michel Barnier have already indicated their willingness to extend the deadline. The GCEE considers a **one-time extension** that largely maintains the status quo to be prudent. This would also prevent an abrupt "hard Brexit" for the UK, with high and difficult to predict economic costs. Moreover, prolonging the negotiations would ease the tension surrounding a contentious point, i.e. the EU's call for a withdrawal agreement including a settlement of incurred financial obligations.

Renewing the European Union: key messages

- Continued development of the European Union, such as in the digital internal market, procurement in defence policy, public security, asylum and climate protection
- Reinforcing the principle of subsidiarity and the unity of liability and control
- One-time extension of the Brexit negotiation period

VIII. GLOBALISATION

152. The international exchange of production factors, goods and services has enabled tremendous **prosperity growth** that has shaped recent decades. However, public debate often centres on the dangers of international trade and international migration. There are often fears in advanced economies that the local population will lose jobs, whether because of outsourcing to other countries or because domestic workers are crowded out, with negative consequences for the sustainability of social security and the country's standard of living. Turning to protectionism advocated by the populist parties appears to be an obvious and simple solution to address these fears. Yet, these fears are neither justified, nor is protectionism the right answer to the challenges associated with globalisation.

1. Increasing welfare through international trade

153. The expansion of **international trade** has brought about major increases in efficiency and welfare in Germany and around the world, and significantly reduced world poverty. ↘ ITEMS 629 FF. These gains would be at stake if we were to yield to calls for protectionist measures currently heard the world over. **Protectionism** should be **firmly opposed**. This is best achieved by reinforcing the multilateral rule-based trading system. Further trade liberalisation likely translates into **additional welfare gains**. Greater openness in international economic relations can also be achieved by removing trade barriers in services and digital trade, and by concluding new free trade agreements, for instance with China, India or the Mercosur. Negotiations on the Transatlantic Trade and Investment Partnership (TTIP) should be resumed.

154. The **structural change** associated with globalisation should be treated in the same way as other structural changes, such as those due to technological change from digitalisation or changing consumer preferences. Negative effects, such as at regional or sectoral level, are cushioned by existing social security systems and labour market policies. Key is **empowering workers and businesses** to take advantage of the changes. ↘ ITEMS 684 FF.

155. The combination of broad-based advantages and concentration of negative effects from globalisation elicits greater lobbying activity and corresponding state intervention. In particular, **funds or subsidies** for businesses or sectors aimed at treating changes caused by international trade and intended to impede structural change should be **rejected**. This does not mean that all regional policy should be phased out. However, there is no shortage of subsidies motivated by regional policy in Germany. In particular, new regional policy measures should only be considered after an evaluation of the latest measures as part of the Joint Scheme for the Improvement of Regional Economic Structures. Instead of responding to the lobbyists' calls, public communication should place more emphasis on the **benefits of international trade for the population as a whole.** ↘ ITEM 711

2. Migratory pressure on Europe will not ease

156. Vast numbers of refugees have taken **long and treacherous routes to escape to Europe** in recent years. The influx of refugees to Germany has declined significantly since the height of the refugee crisis in autumn 2015. ↘ ITEM 738 Border closures in some EU member states and Western Balkan countries, the EU-Turkey refugee accord and more stringent asylum procedures regarding certain countries of origin contributed to this decline (Andritzky et al., 2016a; GCEE Annual Report 2016 item 682). However, the widely held impression that the refugee crisis is over is misguided. There are still hundreds of thousands of refugees holding out at Europe's borders, waiting for entry. The many fatal attempts by refugees to cross the Mediterranean Sea are a mere indication of **Europe's continued strong appeal** as a safe haven and place to start a new life.

157. The population of Africa doubled between 1987 and 2015 to almost 1.2 billion, and it could double again by 2050 (UN, 2017). In this context, the existing migratory pressure on Europe is unlikely to subside, and in fact is more likely to increase. The EU should therefore draft a European asylum policy that takes account of such developments. The refugee crisis of 2015 revealed the serious deficiencies of the current rules in the European asylum system. However, the EU has failed to date to effect **fundamental reforms to European asylum policy**.

158. This is attributed, among other reasons, to the differing interests among the EU member states. Nonetheless, joint action is urgently needed to meet the challenges of future migratory flows and secure Europe's prosperity for the long term. This includes an assessment of asylum and migration policy as a whole. Most migration in Europe remains internal migration within the EU (GCEE Annual Report 2015 chart 80). At the same time, given demographic change, demand for skilled workers from non-EU countries is likely to rise. ↘ ITEMS 779 F. The following elements should thus be at the forefront of a **joint European asylum and migration policy**:

- The ultimate aim should be to reduce the number of people who feel compelled to flee from their home country. Europe's governments have stepped up their efforts to tackle the **causes of refugee flight** in the countries of origin. However, notable success can only be expected in the medium to long run.

- The **effective protection** of EU member states' **external borders** should be ensured to combat illegal immigration. ↘ ITEM 141 Progress has been made in this area in the past two years. Further efforts are necessary to avoid refugees risking their lives to reach Europe.
- A **fair distribution of refugees within the EU** should be guaranteed in future using a distribution key. It is conceivable that countries taking in an above-average number of refugees receive more money from the EU budget, and vice versa. It must also be made clear to refugees that they will not initially have the right to settle in an EU country of their choice.
- **Information centres** should be established in countries such as Libya, Egypt and Turkey, to inform people of their chances of being recognised as refugees in Europe. In this way, many migrants from Africa, in particular, who are not primarily fleeing persecution, but heading to Europe for economic reasons, could be dissuaded from making a pointless journey.
- Information could also be provided about legal labour migration, which differs between the EU member states. Educational institutions such as the German Goethe Institut and similar institutions in other European countries could be expanded to inform economic migrants about **legal labour migration to Europe**. However, encouraging too high expectations of success in labour migration should be avoided.
- **Asylum seekers** should be **strictly differentiated from labour migrants**. Those seeking asylum do so for humanitarian reasons, and should therefore not be affected by employment prospects or related criteria. On the other hand, these criteria are decisive for labour migration.

Globalisation: key messages

International trade

- Rejection of protectionist trade measures and improved information on macroeconomic benefits of trade
- Removal of trade barriers in the trade of services and digital trade, and conclusion of more free trade agreements
- Empowerment of workers and businesses for accelerated structural change rather than conserving subsidies

Migration to Europe

- Combating of the causes of refugee flight, effective protection of external borders and fair distribution of refugees within the EU
- Improved information on recognition criteria for asylum applicants and legal labour migration routes
- Strict differentiation between asylum seekers and labour migrants

A differing opinion

159. One member of the Council, Peter Bofinger, finds the concept of a "forward-looking economic policy" proposed by the Council majority in this chapter to be unsuitable to strengthen the competitiveness and future viability of the German economy. This applies in particular to

- the "growth-friendly reforms" in fiscal policy that are limited to relieving taxpayers and social security contributors
- the establishment of an insolvency mechanism for the euro area to strengthen "market discipline", and the orientation of euro area fiscal policy to an expenditure benchmark that would result in a declining public spending ratio
- the abandonment of industrial and foreign trade policy activities at EU level to secure and improve the competitiveness of European businesses on the global stage.

All in all, the **economic policy re-adjustment** called for by the majority is aimed at weakening the state's ability to act and exert influence by restricting and reducing its resources.

Economic policies in Germany

160. The majority states that the healthy economic situation in Germany provides an "**excellent base for reforms**". The majority argues that the theme of distribution that has dominated the debate in recent years should be replaced by a focus on the challenges of the future. However, the re-adjustment called for, and the particular necessity for reforms at the present time are not self-explanatory.

161. The extraordinarily positive economic development Germany has enjoyed for some years now, and which is expected to continue until at least 2019, is certainly not an argument for a change of economic policies. Recent years have shown that it is possible for ambitious social policy measures such as the minimum wage and promotion of renewable energies to be combined with strong employment growth and robust economic growth. Moreover, the ECB's monetary policy, which has been criticised by the majority for years, and was classified as "inappropriate" for Germany last year, has so far neither resulted in inflationary tensions in Germany nor undesirable developments in the financial system that pose a systemic threat.

162. The measures proposed by the majority would, however, result in anything but a fundamental re-adjustment of economic policy. This is particularly true of the rather vague calls for enabling work-family balance, establishing lifelong learning, expanding labour migration options for professional workers, strengthening general skills in education and training, innovation-friendly regulation, systematic digitalisation of government administration and ensuring a flexible labour market.

163. Even for fiscal policy, no re-adjustment is apparent in the "growth-friendly reforms" called for. These are limited to **relieving taxpayers and social security contributors**, not least through the proposal repeated in this report for an allowance for corporate equity, which would ultimately result in an asymmetrically negative wealth tax (GCEE Annual Report items 812 ff.).

164. Given the government's limited fiscal space, the question is whether this will meet the **calls for a forward-looking approach**. In particular, it is entirely unclear how the **additional education and training efforts** justifiably demanded by the majority, and needed to prepare the labour force for the digital environment of the future, will be financed. ↘ ITEM 4 Moreover, the decisive factor for the future viability of the German economy will be improving the traditional and digital infrastructures by **expanding public investment**. Investments are still lower than the depreciation of fixed capital and, relative to GDP, were at the lower end of the scale of OECD countries on average between 2010 and 2015.

165. As regards the issue of financing, the majority judges apodictically that an **increase in the public spending ratio is not necessary**. Without going into further detail, it states that "additional financing requirements for public investment should be covered without increasing the public spending ratio by setting the right priorities".

166. Because the scope for spending cuts in other areas of the public budgets are likely to be very limited, not least due to the additional demands for internal and external security, there is a high risk with the "forward-looking economic policy" as the majority understands it, that there will be a lack of significant funds for additional investment in human capital and infrastructure after extensive cuts in taxes and duties. The majority categorically rules out the possibility of financing these forward-looking investments through debt – particularly in the current environment – for which an annual figure of around €10 billion would be available to the Federal Government even under the debt brake.

167. All in all, it is to be feared that the proposals for German economic policy by the majority will **weaken** rather than strengthen the economy's **competitiveness and future viability**.

Economic policies for the euro area

168. The Council majority repeats its calls for a reduction of the privileges afforded to sovereign debt in banking regulation and the introduction of a mechanism for the orderly restructuring of government debt as part of the programmes under the European Stability Mechanism (ESM). Its objective is to strengthen "**market discipline**". However, this mechanism could result in an existential threat to the stability of the euro area, particularly in periods of economic weakness (GCEE Annual Report 2015 items 95 ff.; Special Report 2015 items 112 ff.).

169. This year, the majority supplemented the "Maastricht 2.0" model with the call for an **expenditure benchmark**, which together with the Fiscal Compact's structural deficit limit is to replace all other fiscal rules in the euro area. The

spending of member states should depend on how much their debt-to-GDP ratio differs from the 60 % limit set by the Maastricht Treaty. The majority's remarks on this matter are not specific enough to discuss the proposal in any more depth.

170. However, it immediately presents the problem that it would elevate the **arbitrarily set 60 % limit** to a cornerstone of fiscal policy for the member states. It is therefore to be expected that implementing an expenditure benchmark will **reduce the public spending ratio** in most member states in the medium to long term. Proponents of such expenditure rules clearly see this as an important side effect, which empirical studies show to apply to both highly developed countries and emerging markets (Cordes et al., 2015). The majority's plea for an expenditure benchmark corresponds to its preference for expenditure-side consolidation rather than tax increases.

171. However, the question arises as to whether a **general reduction of public spending ratios** is really the appropriate reaction to the challenges posed by globalisation, digitalisation and ageing in the advanced economies. Countries are actually likely to need more funds than previously to better accept and cope with the structural change caused by globalised markets and technological progress. Greater financial resources are not only needed for spending on education, but also to compensate those groups of people and regions that are adversely affected.

172. It would be irresponsible to make substantial cuts in public spending in these areas, just because an arbitrary limit for government debt was set in the Maastricht Treaty in 1992. When **making the case for evidence-based economic policy**, one has to at least question benchmarks that have no academic evidence for their appropriateness.

173. Raising taxes should not completely be ruled out for the consolidation necessary in some countries. It will in all likelihood be difficult for individual countries to generate additional income through tax increases in light of the current **international tax competition**. However, that is an argument for setting **minimum corporate tax rates** at least in the EU, as called for by French President Macron.

174. If government debt were consistently aligned to the 60 % limit set in the Maastricht Treaty, we would also see the problem in the medium term that the volume of "**safe securities**" would considerably decrease over time. A reduction in the debt ratio from the current level of approximately 90 % to just 60 % would decrease this volume by around a third.

Economic policy for the European Union

175. The majority's proposals for a "constructive development of the EU" are marked by immense confidence in markets. The majority assumes that the populist trends in many European countries can be countered by observing the principles of subsidiarity and of unity of liability and control. This view is the opposite to that of the French president. While the majority is calling for market integration in Europe, Macron advocates a Europe that is "fair, protective and ambitious".

The fundamental differences between these two positions are evident in key policy areas.

176. In trade policy, the majority is against measures in the area of **foreign direct investment** that would enable the EU to prohibit foreign acquisitions from third countries under certain circumstances. It believes that the EU should remain open to foreign investors, even without reciprocity.

177. This position immediately raises the question as to why the majority would apparently not have concerns in allowing European companies to be acquired by **state-owned or quasi-state investors** from China. By contrast, involvement of the French government, for example, in a private company would be criticised as a regulatory transgression (GCEE Annual Report 2007 items 287 ff.).

The GCEE expressed the following basic principle in its Annual Report 2002/03: "The government should withdraw from all activities which the market could perform just as well or better" (GCEE Annual Report 2002 item 380). If you consider this correct, then it should apply both to your own country and to foreign countries.

178. The rejection of **reciprocity in international trade and in international foreign direct investment** advocated by the majority puts domestic investors and asset owners at a considerable disadvantage. At present, a German company is worth less to a German owner than to a Chinese owner, because only the latter has unrestricted access to the Chinese market. Moreover, German companies are deprived of the opportunity of obtaining easy access to the Chinese markets by acquiring a Chinese company (GCEE Annual Report 2016 items 995 ff.).

179. The majority criticises the latest decision to **tighten the rules under the Posting of Workers Directive**. It believes this to be a "protectionist move", because the posting companies have to pay their workers not only the existing statutory minimum wage in the host EU country, but also the applicable negotiated wage or standard wage. But if "populist trends" are to be countered, we cannot call for a Europe that allows the erosion of living standards and social security systems in the more highly developed member states via "social dumping" (President Macron).

180. As for **climate policy**, the Council majority advocates a price corridor – similar to the French president's suggested minimum price – or a one-time reduction in the number of emissions allowances in circulation. Although Macron specified amounts between €25 and €30, the majority does not define a range for the

price corridor. Without any indication of price, this proposal cannot, however, be regarded very highly.

Furthermore, the majority rejects a carbon border tax as proposed by President Macron. It considers this to be a trade restriction and problematic with a view to WTO rules and existing free trade agreements. But if we regard the pollution of third countries as an external effect, it is certainly acceptable in terms of allocation theory to internalise it at least partially via this kind of tax.

181. The majority believes that **industrial policy** to promote innovation and support model companies – national or European "champions" – distorts competition. This view may well be appropriate for an ideal ordoliberal world, but in reality, we are dealing with countries like China, which lend their businesses massive support to make them not only national but global champions. **Chinese industrial policy** is actually so successful in this regard that one of Germany's largest industrial companies announced in September plans to base its global research in new mechatronic systems, collaboration between humans and machines, and the use of artificial intelligence in robotics, in China.

You need a great deal of market confidence in this kind of environment to call for your own country's efforts under industrial and innovation policy to be abandoned because they distort competition. President Macron has brought an interesting suggestion to the discussion; he proposes a **joint research institution** for Europe in the same vein as the Defense Advanced Research Projects Agency (DARPA) in the US. This public research institution was responsible, among other things, for developing the basis for the Internet.

182. The biggest challenge of the future is to secure both the social market economy and the German economy's high level of competitiveness. This will only be possible in a Europe that is able to transform the strengths of globalisation and technical progress into prosperity for all. President Macron has made important suggestions in this regard, such as setting lower limits for corporate taxation and creating a joint budget to be financed via energy taxes. He has also directly offered Germany a "**new partnership**". If we are striving for a re-adjustment of German economic policy, we actually should be striving jointly for a renewal of the EU. But in the words of Macron, it has to be a new model that will not just include the economy but also the society and civilisation at large, that will lead to new thought on inequality and externalities of a society whose main victims of imbalances are the weakest and the most fragile.

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