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 $\label{eq:Germany-Review of Progress on Policy Measures Relevant for the correction of Macroeconomic Imbalances$

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Executive summary

This report is the first specific monitoring report under the Macroeconomic Imbalance Procedure (MIP) for Germany, reflecting the strengthened monitoring of all Member States with imbalances¹. Germany had been found to experience imbalances already in the previous years. The imbalances relate in particular to the large and persistent current account surplus, reflecting excess savings and weak private and public investment. This report reviews the latest developments and policy initiatives to correct those imbalances which were identified in the 2016 Country Report and which were addressed by the 2016 country-specific recommendations. The cut-off date for this report is 25 November 2016.

The German economy is set to maintain its growth momentum. Consumption, housing investment and exports are expected to be the key growth drivers. Geopolitical uncertainty may result in weaker equipment investment growth. Stable domestic demand growth will strengthen imports, thus a gradual decline in the trade surplus is projected. Fading out of oil-price related positive terms of trade effects will also weigh on the trade surplus. For 2016, however, import growth has been revised downward due to a weaker-than-expected outturn in the first half of the year, resulting in a further widening of the current account surplus. Over the forecast horizon, the current account surplus is expected to remain very high, above the MIP threshold, and to decline only gradually.

While the level of public investment is still relatively low, measures have been taken to improve the conditions for additional public investment at all levels of government. The federal government has agreed to further relieve federal states and municipalities of expenditure related to asylum seekers and refugees and other social spending. Moreover, key elements of a reform of federal fiscal relations have been agreed. They include inter alia extra revenue for the federal states at the expense of the federal budget and establishing a transport infrastructure company at the federal level that will be in charge of investment in federal motorways. In addition, consulting services with respect to infrastructure investment will be extended to the whole public sector, including in particular also municipalities.

Some measure have been taken or announced to simplify taxation, facilitate access to venture capital and improve competition in services markets. Investment fund taxation and taxation procedures have been reformed with a view to promoting simplification and increasing efficiency. Further steps have been initiated to improve the regulatory framework for venture capital, by improving the loss-carry forward for corporations and extending support instruments for start-up companies. Moreover, a revision of regulation for selected liberal professions and business services has been announced.

Some steps have also been taken to improve incentives to work. A law has been adopted to make the transition of older workers into retirement more flexible, by promoting the combination of early retirement and part-time work and incentivising employment above retirement age. Increases in the basic personal income tax allowance and child allowances as well as adjustments in the income tax brackets have been announced to offset the impact of fiscal drag and ensure that the subsistence level remains tax-free. These measures tend to benefit in particular low and middle income groups.

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¹ COM(2016)95 final, 8.3.2016.

Overall, while public investment should benefit from the measures taken, only a limited impact can be expected with respect to the efficiency of the tax system, competition in the services sector and incentives to work. The financial relief of federal states and municipalities and the reform of federal fiscal relations should contribute to improving the conditions for public investment especially at municipal level. However, the reform falls short of a more fundamental overhaul of fiscal relations. While some simplification in certain areas of taxation and better conditions for venture capital can be expected, no initiatives have been taken to review business taxation. There is still no comprehensive strategy to improve competition in the services sector. The measures taken or announced to make the transition of older workers into retirement more flexible and to adjust personal income tax rates and allowances can be expected to have only a limited impact on improving incentives to work.

Table 1: Key findings on the implementation of policy reforms²

On track	Wait-and-see	Action wanted
 Relieving federal states and municipalities of expenditure related to asylum seekers and refugees and other social spending. Agreement on key elements of a reform of federal fiscal relations. Reforms of investment fund taxation and taxation procedures. Law to improve the loss-carry forward for corporations. Adjustments to the personal income tax rates and allowances aimed at safeguarding the minimum subsistence level and compensating for fiscal drag. 	 Further legislative initiatives and constitutional changes related to the reform of federal fiscal relations. Extension of consulting services with respect to infrastructure investment of the existing consulting firm to promote public private partnerships (ÖPP Deutschland AG) to the whole public sector, including municipalities. Initiatives to revise regulation for selected liberal professions and business services. Law on facilitating the transition of older workers into retirement ('Flexi-Rente'). 	 Measures to review corporate taxation and the local trade tax. A more comprehensive strategy to modernise regulated professions and adapt them to new economic challenges. Measures to reduce the high tax wedge for low-wage earners. Measures to reduce disincentives to work for second earners and facilitate the transition from mini-jobs to standard employment.

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² The table classifies reforms under review on the basis of their respective adoption and implementation process and their credibility and level of detail. "On track" are measures for which the legislative or implementation process has been completed or is progressing well according to the foreseen timeline, and which are expected to be sufficiently effective. "Wait and see" are measures for which the legislative process is on-going, but is still in a relatively early phase, or measures for which there is still uncertainty on the complete implementation and effectiveness. "Action wanted" are measures for which limited or no action has been taken, or measures that have been announced but which are not sufficiently detailed yet to be assessed.

1. Introduction

On 26 November 2015, the European Commission presented, in the context of the Macroeconomic Imbalance Procedure (MIP), its fifth Alert Mechanism Report³ to underpin the selection of Member States requiring an in-depth investigation into the existence and extent of macroeconomic imbalances. The subsequent In-Depth Review in the Country Report – published on 26 February 2016⁴ – examined the nature, origin and severity of macroeconomic imbalances and risks in Germany. In the accompanying Communication⁵, the Commission concluded that 'Germany continues to experience macroeconomic imbalances'. In particular, the Commission emphasised that the large and persistent current account surplus in Germany has cross-border relevance and reflects excess savings and subdued investment in both the private and public sectors. The Commission also noted that weak domestic investment hampers potential growth and strong reliance on external demand entails macroeconomic risks in a context of subdued foreign demand.

In April 2016, Germany submitted its Stability Programme⁶ and National Reform Programme (NRP)⁷, respectively outlining the fiscal targets and the policy measures to improve its economic performance and to unwind imbalances. On the basis of an assessment of these plans and taking into account the Country Report analysis, the Commission proposed a set of three country-specific recommendations (CSRs)⁸, which were adopted by the Council on 12 July 2016⁹. These recommendations concern increasing public investment, the efficiency of the tax system, the regulatory framework for venture capital, competition in the services sector and improving incentives to work. All CSRs were considered to be MIP relevant.

Moreover, the euro-area recommendation number one calls for pursuing policies that support the recovery, foster convergence, facilitate the correction of macroeconomic imbalances and improve the adjustment capacity¹⁰. For this purpose, a specific monitoring mission to Germany was conducted on 26-28 October 2016, in combination with the overall fact-finding mission in the context of the European Semester. The present report assesses key policy initiatives¹¹ undertaken by the German authorities also in the light of the findings of the monitoring mission. This report does not reflect the content of Germany's 2017 Draft Budgetary Plan. The Commission published its opinion on the Draft Budgetary Plan in November 2016, taking into account the outcome of the Commission's 2016 Autumn Forecast.

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³ http://ec.europa.eu/europe2020/pdf/2016/ags2016 alert mechanism report.pdf

⁴ http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_germany_en.pdf

⁵ http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_comm_en.pdf

⁶ http://ec.europa.eu/europe2020/pdf/csr2016/sp2016_germany_en.pdf

⁷ http://ec.europa.eu/europe2020/pdf/csr2016/nrp2016_germany_en.pdf

http://ec.europa.eu/europe2020/pdf/csr2016/csr2016_germany_en.pdf

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⁹ http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016H0818%2819%29&from=EN

¹⁰ http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016H0311(01)&rid=2

¹¹ Details on the policy measures taken can be found in the overview table in the Annex.

2. Outlook and recent developments on imbalances

Recent economic developments and outlook

The German economy is set to expand in 2016-2018. The quarter-on-quarter real GDP growth rate slowed from 0.7 % in the first quarter of 2016 to 0.4 % in the second quarter and 0.2 % in the third quarter. The contribution of foreign trade turned negative in the third quarter, as exports declined while imports grew. Private and public consumption picked up further. Investment growth resumed, although only driven by construction. An ongoing improvement in business sentiment and in firms' employment expectations points to sustained activity growth in the coming quarters. The robust labour market, favourable financing conditions and a still sizable expenditure boost linked to immigration should also contribute to growth. Overall, driven by domestic demand, real GDP is expected to increase by 1.9 % in 2016, 1.5 % in 2017 and 1.7 % in 2018.

Consumption growth is expected to remain solid. Employment should continue growing at a steady pace in line with the expansion of the economy. The integration of refugees into the labour market will be staggered over a number of years and is not expected to significantly affect labour market dynamics in the short run. With energy prices no longer depressing price dynamics, real household consumption is forecast to slow down somewhat, but to remain relatively strong thanks to the continued rise in employment and real labour incomes. The latter will also be supported by the first increase of the minimum wage next year. Nonetheless, household consumption as a share of GDP is expected to decline further, as the household saving rate is expected to remain close to its current high level over the forecast horizon, despite the low rates of return. Government consumption should slow as the number of new arrivals of asylum seekers declines.

Geopolitical uncertainty may result in weaker equipment investment growth. Private investment declined in the second quarter of 2016 after positive surprises in the two preceding quarters. The trend in orders of investment goods points to weaker equipment investment in the second half of 2016. This is expected to be overcome over the course of next year, as export growth recovers somewhat and replacement needs become more pressing. However, downward risks related to geopolitical uncertainty could weigh on investment prospects. Construction investment, particularly in housing, is projected to continue growing faster than GDP, as factors stimulating both supply and demand, including rising prices and low interest rates, remain in place.

Headline inflation is expected to pick up. In 2015, the negative gap in unit labour costs with respect to the euro area was closed. Wages and unit labour costs are projected to continue growing faster than in the euro area over the forecast horizon. With the effect of falling oil prices fading, headline inflation is projected to pick up in 2017 (1.5 %) from a projected 0.4 % for 2016. Firming domestic demand and wage growth should ensure that core inflation rises in both 2017 and 2018.

The favourable fiscal position provides scope for additional public investment and/or reductions in taxes on labour, even when accounting for increased expenditure linked to the influx of asylum seekers. The general government budget surplus amounted to 0.7 % of gross domestic product in 2015. Overall, the headline balance is expected to remain in surplus, though decreasing, over 2016-2018. The structural surplus is projected to decrease

by around ¼ % of GDP in 2016, and to stay at around ½ % of GDP in 2017 and 2018. The gross debt-to-GDP ratio is set to fall from 71.2 % in 2015 to around 63 % in 2018.

Developments as regards imbalances

In March 2016, the Commission concluded that Germany was experiencing macroeconomic imbalances. The imbalances were related to the implications of the very high and persistent current account surplus. The following text provides an update of the situation with regard to the imbalances.

The external surplus

The current account surplus has continued to increase. The current account surplus for the 12 months ending in August 2016 stands at 8.8 % of GDP, suggesting a further widening compared to 2015. In price-adjusted terms, the trade balance has however stayed largely stable. The year-on-year growth of imports originating from the euro area has started picking up compared to last year. Exports held up well in the first half of 2016, while imports underperformed due to weaker-than-expected consumption and investment growth. All in all, net exports are thus set to contribute positively to GDP growth in 2016, in contrast to what was expected in spring. Over the course of next year, exports are forecast to pick up again as foreign demand is expected to increase. Together with stable domestic demand growth, improved income expectations should also spur import growth. Overall, net trade is thus expected to detract slightly from growth over the next two years. In addition, the positive terms of trade effects from low oil prices are also set to fade. As a result, Germany's trade surplus should start to decline gradually. Nevertheless, the current account surplus is expected to remain very high, above the MIP threshold, and to decline only gradually over the forecast horizon.

The domestic saving-investment balance has increased further. Private borrowing picked up significantly in 2015. However, it remains below GDP growth, indicating continued passive deleveraging. Likewise, the trend of net asset accumulation by the private sector has continued. Nominal corporate investment declined in 2015 and will likely also in 2016, while corporate savings increased as a share of GDP. As a result, corporations, whose indebtedness is on aggregate already the lowest in the euro area, continued deleveraging. This contributed most significantly to the widening of the savings surplus. The household savings rate increased further in 2015 and is forecast to reach 17.3 % in 2016 – one of the highest household savings rates in the euro area (average at 12.8 %). In 2015 household investment growth continued lagging behind savings growth, while in 2016 housing investment may pick up and households' net lending position weaken marginally.

3. Progress with policy implementation

3.1 Increasing public investment

This section describes the policy measures to address Germany's public investment backlog and to achieve a sustained upward trend in public investment in infrastructure, education, research and innovation, including by improving the design of federal fiscal relations.

Despite last year's increase, the public investment level is still relatively low. In 2015, public investment increased by about 4.9 % in nominal and 3.4 % in real terms. This was predominantly driven by strong growth in machinery and equipment investment, while

construction investment – which should largely reflect infrastructure investment – hardly increased. With 2.1 % of GDP in 2015, overall public investment has remained largely constant throughout the last years and still appears low compared to the euro area (2.7 % of GDP), despite a decreasing euro area trend since 2009. A public investment backlog persists in particular at the municipal level, where net investment remained negative in 2015. Current plans to maintain the quality of transport infrastructure also appear insufficient.

Also the design of federal fiscal relations may have contributed to persistent public underinvestment at municipal level. Despite the available fiscal space to increase public investment in full respect of European and national budgetary rules at the federal level and the level of general government, there seems to be a mismatch between the available resources of the different layers of government and their individual investment responsibilities. This hampers municipalities' investment, in particular. The scope for public investment also tends to be narrowed by limited revenue autonomy of federal states and municipalities. In addition, federal legislation can impose tasks on lower levels of government without providing an adequate financial endowment.

Against this background, the federal government has agreed to further relieve federal states and municipalities of expenditure related to asylum seekers and refugees and other social spending. The transfers to the federal states comprise an annual lump-sum of EUR 2 billion (0.1 % of GDP) over the period 2016-2018 through an equivalent increase of the federal states' share in joint VAT revenue. They also include a compensation of the costs for accommodation allowances for those granted asylum amounting to EUR 400 million in 2016 (0.01 % of GDP), EUR 900 million (0.03 % of GDP) in 2017 and EUR 1.3 billion (0.04 % of GDP) in 2018. Moreover, additional funds are provided for social housing amounting to EUR 500 million (0.01 % of GDP) for 2017 and 2018, respectively. As of 2018, municipalities will be relieved by additional EUR 5 billion (0.1 % of GDP) annually. This will be done through an increase of the municipalities' share in joint VAT revenue as well as an increased contribution by the federal budget to the funding of the accommodation allowance for the long-term unemployed. Additional federal funds amounting to EUR 400 million (0.01 % of GDP) in 2017 and EUR 500 million (0.01 % of GDP) as of 2018 are planned to be provided for expanding pre-school childcare, while no additional measures have been taken to increase expenditure on research and innovation.

The federal government and the state governments also agreed on key elements of a reform of federal fiscal relations that will take effect in 2020. Key element of the agreed reform is to abolish the current equalisation scheme based on transfers between the federal states. Instead, regional differences in the financial capacity will be largely equalised through the horizontal allocation of the federal states' share in joint VAT revenue. An additional allocation of VAT revenue from the federal to the state level allows for a reduction in the contribution of wealthier federal states to equalisation, while ensuring that no federal state is put in a worse position. The extra revenue for the federal states at the expense of the federal budget amounts to about EUR 9.5 billion (0.3% of GDP) in 2020 and is expected to further increase to EUR 13 billion in 2030. In turn, the executive competences of the federal government will be strengthened in some fields. In particular, a transport infrastructure company will be established at the federal level that combines all relevant competences for the funding, planning, construction and maintenance of federal motorways. Moreover, the federal government's competences in the area of tax administration will be strengthened with a view to improving compatibility and cooperation between the federal states' tax administrations. In addition to this reform, the existing independent consulting firm to promote public private partnerships (ÖPP Deutschland AG) will extend its consulting services with respect to infrastructure investment to the whole public sector. In the future, it will in particular also support municipalities in the planning and implementation of infrastructure investment with a view to addressing existing administrative capacity constraints and improving the use of available federal funds.

Overall, the measures recently taken should contribute to improving the conditions for public investment especially at municipal level, even though a more fundamental overhaul of federal fiscal relations has not been achieved. Relieving municipalities from expenditure related to asylum seekers and refugees and other social spending should improve their financial position and increase their scope for public investment. The relief planned for 2016 amounts to about 5 % of gross fixed capital formation of federal states and municipalities in 2015, and increases to about 20 % until 2018. The additional revenue allocated to the federal states as part of the agreed reform of federal fiscal relations should also facilitate public investment both at the federal state and municipal level. Establishing a federal transport infrastructure company as well as a consulting service for municipalities, as already proposed by an independent expert commission on increasing investment in Germany, could alleviate important planning and administrative constraints to public infrastructure investment. However, the reform of federal fiscal relations falls short of more fundamental changes in terms of increasing tax autonomy of federal states and municipalities, which could have further increased the scope for public investment.

3.2 Efficiency of the tax system

This section describes the policy measures to reduce inefficiencies in Germany's tax system, to modernise the tax administration and to improve the regulatory framework for venture capital.

Reforms of investment fund taxation and taxation procedures have been undertaken with a view to promoting simplification and increasing efficiency of the tax system. The law on the reform of investment fund taxation aims at simplifying the taxation of public investment funds and at closing some loopholes for tax avoidance. In the area of tax administration, the law on modernising taxation procedures aims at strengthening the automatic processing of tax returns and places more emphasis on audits based on risk management.

Further steps have been initiated to improve the regulatory framework for venture capital. The federal government has adopted a draft law to improve the loss-carry forward for companies who have experienced a change in shareholders but continue their core business with a view to facilitating access to equity of young and innovative companies.

While the adopted reforms can be expected to simplify certain areas of taxation and to improve conditions for venture capital, no further initiatives have been taken to review business taxation. The reforms should simplify the taxation of investment funds and taxation procedures. Extended possibilities for loss-carry forwards should improve access to venture capital for innovative companies in particular in later start-up stages. However, no further initiatives have been taken to review corporate taxation and the local trade tax.

3.3. Improving competition in services markets

This section describes the policy measures to stimulate competition in the services sector, in particular in business services and regulated professions.

Initiatives have been announced to revise regulation for selected liberal professions and business services, while there is still no comprehensive strategy to improve competition in the services sector. The federal government has announced a limited number of actions for certain liberal professions and business services. Limited modifications are planned in response to national court decisions having declared some existing regulations illegal. This concerns the prohibition of medical doctors and lawyers to offer services in partnership and mandatory tariffs for tax advisors. However, there is no comprehensive strategy to modernise regulated professions and adapt them to new economic challenges, such as online legal and accounting services.

3.4. Improving incentives to work

This section describes the policy measures to increase incentives for later retirement and reduce disincentives to work for second earners as well as to address the high tax wedge for low-wage earners and facilitate the transition from mini-jobs to standard employment, incentivising in particular women to work more hours.

A law on facilitating the transition of older workers into retirement ('Flexi-Rente') has been adopted. The reform mainly aims to make the transition of older workers into retirement more flexible. In particular, it promotes the combination of early retirement and part-time work (lower pension reductions in case of extra income). It also incentivises employment above retirement age for both the employees (can acquire additional pension entitlements) and the employers (do not need to pay any longer unemployment insurance contributions for employees above retirement age).

Limited adjustments to personal income tax rates and allowances have been announced. The federal government adopted a package of measures aimed at safeguarding the minimum subsistence level and compensating for fiscal drag. The basic personal income tax allowance, the child allowance, the child benefit and the child supplement will be increased in 2017 and 2018 in order to align them with the adjusted subsistence level in accordance with existing law. Moreover, the income tax brackets will be adjusted to offset the impact of fiscal drag based on the tax progression report that is published every two years. These measures tend to benefit in particular low and middle income groups.

Overall, the measures taken or announced can be expected to have only a limited impact on improving incentives to work. While the 'Flexi-Rente' could contribute to a more flexible combination of pensions and extra income during the transition into retirement, it may only partly offset the stronger incentives for early retirement introduced by the last pension reform, although further assessment appears required in this regard. Moreover, as the envisaged changes to personal income tax rates and allowances largely aim at adjusting for price developments, only a limited impact on the tax wedge, if any, can be expected. No initiatives have been taken or announced regarding second earners and mini-jobs, in particular with a view to incentivising women to take up full-time jobs.

Annex 1: Overview table of MIP-relevant reforms

MIP objective: Increasing public investment							
Public investment							
Public investment, especially in infrastructure, education, research and innovation							
Announced measures	Adopted measures	Implemented measures	Sources of commitment				
October 2016: The Draft Budgetary Plan includes additional federal funds to be provided for expanding pre-school childcare.			CSR (1) – 2016: Achieve a sustained upward trend in public investment, especially in infrastructure, education, research and innovation, while respecting the medium-term objective.				
Federal fiscal relations							
Announced measures	Adopted measures	Implemented measures	Sources of commitment				
June 2016: The federal government announces that the existing independent consulting firm promoting public private partnerships (ÖPP Deutschland AG) will in the future provide consulting services with respect to infrastructure investment to the whole public sector, including in particular also municipalities. May 2017: Further legislative initiatives and constitutional changes related to the reform of federal fiscal relations are planned to be completed by May 2017.	September 2016: The federal government adopts measures to further relieve federal states and municipalities of expenditure related to asylum seekers and refugees and other social spending. October 2016: The federal government and the state governments agree on key elements of a reform of federal fiscal relations that will take effect in 2020.		CSR (1) – 2016: Improve the design of federal fiscal relations with a view to increasing public investment, especially at municipal level.				
MIP objective: Efficiency of the tax system							
Business taxation, tax administration and venture capital							

Corporate taxation and the local trade tax						
Announced measures	Adopted measures	Implemented measures	Sources of commitment			
	July 2016: The law on reforming investment fund taxation is adopted by the federal parliament and the federal council and published in the Federal Law Gazette.		CSR (2) – 2016: Reduce inefficiencies in the tax system, in particular by reviewing corporate taxation and the local trade tax,			
	Tax admi	nistration	•			
Announced measures	Adopted measures	Implemented measures	Sources of commitment			
	July 2016: The law on modernising taxation procedures is adopted by the federal parliament and the federal council and published in the Federal Law Gazette.		CSR (2) – 2016:modernise the tax administration			
	Regulatory framework of venture capital					
Announced measures	Adopted measures	Implemented measures	Sources of commitment			
	September 2016: The federal government adopts a draft law on improving the loss-carry forward for corporations.		CSR (2) – 2016: and review the regulatory framework for venture capital.			
	MIP objective: Improving competition in services markets					
	Product market					
Competition in the services sector						
Announced measures	Adopted measures	Implemented measures	Sources of commitment			

			1				
January 2016: The federal government announces in its National Action Plan selected minor modifications to existing regulations for certain liberal professions and business services.			CSR (2) – 2016: Step up measures to stimulate competition in the services sector, in particular in business services and regulated professions.				
	MIP objective: Improving incentives to work						
	Labour market						
	Later retirement and second earners						
Announced measures	Adopted measures	Implemented measures	Sources of commitment				
	October 2016: The federal parliament adopts a law on facilitating the transition of older workers into retirement ('Flexi-Rente').		CSR (3) – 2016: Increase incentives for later retirement and reduce disincentives to work for second earners.				
	Tax wedge and mini-jobs						
Announced measures	Adopted measures	Implemented measures	Sources of commitment				
	October 2016: The federal government adopts a package of measures aimed at safeguarding the minimum subsistence level and compensating for fiscal drag, including an increase in the basic personal income tax allowance and child allowances in 2017 and 2018 as well as an adjustment of the income tax brackets to offset the impact of fiscal drag.		CSR (3) – 2016: Reduce the high tax wedge for low-wage earners and facilitate the transition from mini-jobs to standard employment.				