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GERMANY – REVIEW OF PROGRESS ON POLICY MEASURES RELEVANT FOR THE CORRECTION OF MACROECONOMIC IMBALANCES

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Executive summary

This report is the second specific monitoring report under the Macroeconomic Imbalance Procedure (MIP) for Germany, reflecting the strengthened monitoring of all Member States with imbalances[1]. 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 2017 Country Report and which were addressed by the 2017 country-specific recommendations. The cut-off date for this report is 15 November 2017.

The German economy is expected to maintain a strong growth momentum driven by domestic demand and supported by a robust export outlook. Germany's quarter-on-quarter real GDP growth rate came out at a strong 0.8% in the third quarter, preceded by 0.9% in the first and 0.6% in the second quarter. Growth has been driven by exports and investment in the first and third quarter and by private consumption in the second. The foreign demand outlook is expected to be favourable and to fuel German exports. At the same time, strong domestic demand is expected to keep import growth above that of exports, resulting in a further reduction of the current account surplus ratio to GDP.

Several measures to increase public investment are being implemented, but they take some time before becoming effective. The federal government has agreed to further increase the municipal investment promotion fund to support investment at the local level. However, given the accumulated investment backlog, the current public investment growth appears still too low to maintain and modernise the existing capital stock, especially at municipal level. On the positive side, investment in transport infrastructure is slowly increasing, also supported by the recent establishment of an infrastructure company for transport. Moreover, the service agency to support municipalities with their investment projects did take up its work in 2017 and the act on restructuring fiscal relations between the federal government and the Länder has been adopted.

No new measures have been announced to simplify taxation and improve competition in services markets. Nevertheless, the already adopted act on the modernisation of taxation procedures became effective at the beginning of 2017. Additionally, the German action plan for the service sector that was adopted in January 2016 has partly progressed.

Labour market conditions remain favourable, but there have been only limited policy measures to address remaining weaknesses. Some smaller tax disincentives for second earners have been reduced, but the high tax wedge remains broadly unchanged. No further measures were adopted for reducing the tax wedge for low wage earners albeit implementation of measures to address the fiscal drag are ongoing. Only limited measures have been taken to support real wage growth.

Overall, more needs to be done to tackle macroeconomic imbalances. While the investment situation is improving slowly, but still requires more effort, only a limited impact can be expected with respect to the efficiency of the tax system, competition in the services sector, incentives to work and real wage growth. The further financial relief of federal states and municipalities and the succesful establishment of the infrastructure company for transport

[1] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-reports-comm-en.pdf

and the service agency to assist municipalities with their investment projects are likely to support public investment. While some simplification in certain areas of taxation has been achieved, there is still no comprehensive strategy to strengthen competition in the services sector. The measures taken to reduce tax disincentives for second earners 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 reforms[2]

On track	Wait-and-see	Action wanted
• Establishment of a service agency to support municipalities with their infrastructure investment projects. • The Act on restructuring the fiscal relations between the federal government and the Länder has been adopted.	• Several measures to increase public investment are being implemented, but they may take some time before becoming effective. • Initiatives to revise regulation for selected liberal professions and business services. • Further legislative initiatives and constitutional changes related to the reform of federal fiscal relations.	• Efforts to further increase public investment, especially at the municipal level. • A more comprehensive strategy to modernise regulated professions and adapt them to new economic challenges. • Measures to simplify taxation and to reduce the high tax wedge for low-wage earners. • Additional measures to reduce disincentives to work for second earners and facilitate the transition to standard employment. • Measures to support real wage growth.

[2] The table classifies reforms under review on the basis of their respective adoption and implementation process, uncertainty and their 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 16 November 2016, the European Commission presented, in the context of the Macroeconomic Imbalance Procedure (MIP), its sixth Alert Mechanism Report[3] 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 22 February 2017[4] – examined the nature, origin and severity of macroeconomic imbalances and risks in Germany. In the accompanying Communication[5], the Commission concluded that 'Germany is identified with imbalances reflected in its large current account surplus'.

In April 2017, Germany submitted its Stability Programme[6] 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 11 July 2017[9]. These recommendations concern increasing public investment, the efficiency of the tax system, competition in business services and regulated professions, improving incentives to work and creating conditions for higher wage growth. All CSRs were considered to be MIP relevant.

On this overall background, a specific monitoring mission to Germany was conducted on 18-20 October 2017, in combination with the overall fact-finding mission in the context of the European Semester. The present report assesses key policy initiatives[10] 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 on 22 November 2017, taking into account the outcome of the Commission's 2017 Autumn Forecast.

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[3] https://ec.europa.eu/info/publications/2017-european-semester-alert-mechanism-report_en

[4] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-germany-en.pdf

[5] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-reports-comm-en.pdf

[6] https://ec.europa.eu/info/sites/info/files/2017-european-semester-stability-programme-germany-en.pdf

[7] https://ec.europa.eu/info/sites/info/files/2017-european-semester-national-reform-programme-germany-de.pdf

[8] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-germany.pdf

[9] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017H0809(05)&from=EN

[10] 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 expected to maintain a strong growth momentum over the forecast horizon driven by domestic demand and supported by robust world trade and a firming recovery in the euro area. Germany's quarter-on-quarter real GDP growth rate came out at a strong 0.8% in the third quarter preceded by 0.9% in the first and 0.6% in the second quarter. Growth was driven by exports and investment in the first and third quarter and by private consumption in the second. Economic sentiment remains very positive. In the manufacturing sector, it points to a sustained expansion in the coming quarters based on improving orders and output expectations, including for exports. Capacity utilisation has continued to increase, which bodes well for investment. The strong labour market, favourable world trade developments and a steady growth in the euro area should help to sustain an enduring upswing. Overall, real GDP is expected to increase at an average pace of around 2.1% per year over 2017-2019.

Steady domestic demand growth is expected to slowly reduce the high external surplus. The export outlook is expected to be favourable and to fuel German exports. At the same time the strong domestic demand could keep import growth above that of exports and result in a further easing of the current account surplus ratio.

Although public investment is increasing, it is not sufficient to clear the investment backlog. Public investment in 2016 increased by around 3.9% nominally and 2.8% in real terms. Given the backlog especially at municipal level, public investment growth appears still too low to maintain and modernise the existing capital stock. Even in 2016 net investment at municipal level was negative, pointing to a stronger depreciation of infrastructure than new constructions. This declining trend has been going on for several years now.

A boost in private investment is expected as a result of the positive demand outlook in combination with high capacity utilisation. Equipment investment is overcoming last year's soft patch and is likely to strengthen amid favourable demand prospects, not least from the euro area and the rest of the EU. Consistently increasing capacity utilisation should also spur the effort for renewing and expanding the capital stock. Housing investment posted strong growth in the first two quarters of 2017 and is expected to continue increasing, even if at a moderating rate, given ample order book backlogs and a steady flow of building permits.

Core inflation is expected to average 1.5% this year and to pick up to 1.7% over the forecast horizon, in the context of strong demand and higher nominal wage growth. Overall headline inflation dynamics are projected to be in line with those of the euro area. Dampened by the expected stable energy prices this moderate inflation should support households' purchasing power.

The favourable macroeconomic outlook supports the positive trend in the budget balance. The budget surpluses of recent years are expected to increase further over the forecast period, despite the repayment of a nuclear fuel tax in 2017 amounting to around 0.2% of GDP. Due to the recent elections, the 2018 budget is still to be prepared by the new government. Under the given no policy change scenario, the positive structural balance is projected to remain stable at around 1% of GDP over the forecast horizon. Government debt, for the first time since 2002, would be expected to fall under the 60% Maastricht-threshold by 2019, decreasing from 68.1% of GDP in 2016 to 57.9% of GDP in 2019.

Developments as regards imbalances

In February 2017, the Commission concluded that Germany was experiencing macroeconomic imbalances, reflected in its large current account surplus. The following section provides an update of the situation with regard to the imbalances.

<u>The external surplus</u>

The driving forces behind the German current account surplus have been relatively stable between 2014 and 2016. While the increase in the current account around 2014 was mostly driven by terms-of-trade effects (especially oil price decrease), the later reduction was mostly due to the correction of those price effects. The current account surplus for the 12 months ending in September 2017 stood at 7.8 % of GDP, suggesting a further decline compared to 2015 (8.5%) and 2016 (8.2%). The narrowing in 2016 came mostly from a slightly weaker investment income balance (1.7% compared to 1.9% in 2015). The secondary income balance widened from -1.3% in 2016 of GDP to -1.5% for the 12 months ending in September 2017 due to higher private sector transfers abroad and accounts for half of the decline of the current account surplus. Roughly stable at around 8.5% in 2015 and 2016, the trade balance has come down to 8.2% for the 12 months ending September. The services balance has stayed roughly unchanged at around 0.6% since 2015. In line with domestic demand strengthening in the course of 2017, and with some degree of reversal of positive terms of trade, imports have rebounded by more than exports since 2016.

The domestic saving-investment balance has also stabilised in 2016. Private borrowing picked up further in 2016 slightly above GDP growth and the rate of net asset accumulation by the private sector stabilised. Nominal corporate investment increased in 2016 and will likely pick up significantly in 2017 in response to high capacity utilisation, while corporate savings are set to slightly decline as a share of GDP. As a result, corporations, whose indebtedness is among the lowest in the euro area, contributed to reducing the savings surplus. The household savings rate further increased to 17.1% in 2016, propped up by low consumer price inflation, but is forecast to decline to 16.6% in 2017 as consumer demand remains robust and inflation picks up. Still, the household savings rate will likely remain the highest in the euro area (average at 12.3 %). In 2016, the household investment growth rebounded and households' net lending position weakened marginally. It is expected that household investment will grow strongly in 2017 thus further lowering the net lending balance.

The adjustment of the imbalance has been marginal so far, but the outlook is positive. As expected, domestic demand has improved and become the key growth driver in 2016. It has spurred import growth and narrowed the surplus in savings and foreign trade slightly. These trends are expected to continue in 2017-2019, as laid out in the Commission Autumn 2017 Forecast. Nevertheless, the current account surplus is expected to remain above the MIP threshold, and to decline only gradually over the forecast horizon.

3. Progress with policy implementation

3.1 Supporting domestic demand and increasing public investment

This section describes the fiscal policy measures taken in 2017 to support domestic demand and to accelerate public investment at all levels of government, especially in education, research and innovation, and address capacity and planning constraints for infrastructure investments.

Although public investment is increasing it is not sufficient to clear the investment backlog. Public investment in 2016 increased by around 3.9% nominally and 2.8% in real terms. Given the backlog especially at municipal level, public investment growth appears still too low to maintain the capital stock. Net investment at municipal level was negative also in 2016, resulting from a stronger depreciation of exisiting infrastructure than new construction investment.

To support investment at the municipal level, the federal government has agreed to further increase the municipal investment promotion fund. The framework of fiscal relations between the different levels of government might have contributed to this situation as lower levels of government do not have full financial autonomy and might receive tasks from the upper level without adequate financial resources. For this reason the federal government has doubled the existing municipal investment promotion fund to 7 billion euro (0.2% of GDP) to provide additional funding for modernizing and expanding school buildings, including digital infrastructure. The first funding of EUR 3.5 billion, which was launched in 2015, was already well received and approximately 87% of these funds have been earmarked for investment projects by mid-2017.

An Infrastructure Company for Transport has been established. The federal government is reorganising its task of constructing and maintaining the national highway system establishing a private company held by the federal state. The aim is to increase competency, efficiency and speed in the organisation and financial management of transport infrastructure projects. Investment in transport infrastructure is increasing but still is deemed not to be sufficient given the overall maintenance needs.

A service agency to support municipalities with their investment projects became operational in 2017. To support public investment at municipal level, the service agency "Partnerschaft Deutschland – Berater der öffentlichen Hand GmbH" was set up in 2017, which is organised in the form of a privately run company. The idea is to pool competencies and capacities for organizing and managing public investment projects in order to provide support to municipalities. This company is now "up and running" and is offering its services to municipalities. It needs to be seen if this set up will be succesful, as it is a voluntary service to be requested and paid for by the municipalities.

The Act on restructuring the fiscal relations between the federal government and the Länder has been adopted. The reforms on the national fiscal equalisation system will take effect in 2020 and will relieve the budgets of the Länder by shifting more responsibilities to the federal level. Competencies between the different levels of government will be distributed more clearly and the financial autonomy and self-responsibility will be strengthened, including compliance with the national debt rules. 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.

Overall, the investment situation is improving slowly, but requires more effort. The measures taken are expected to support public investment and help to address the bottlenecks and shortcomings identified. The private companies for national transport investment and for municipal investment will likely help to improve planning and management capacities. However, additional measures will be needed to stop the capital stock from decreasing. Apparently, increasing the available funding may not be sufficient, as the main challenges seem to be the lacking staff and professional skills for managing investment projects. In such a situation, a national long-term investment strategy may be warrented that provides the longer term certainty and predictability allowing for hiring and training the required additional staff.

3.2 Efficiency of the tax system

This section describes the policy measures taken in 2017 to improve the efficiency and investment-friendliness of Germany's tax system.

No additional measures have been taken to improve the efficiency and investment-friendliness of the tax system. Most provisions of the Act on the Modernisation of Taxation Procedures (adopted in May 2016) became effective at the beginning of 2017 and allow a better resource allocation and use of digital tools and automated processes for making tax collection easier and more efficient. The roll-out is planned over a period of six years so that the actual impact can only be observed when fully implemented.

Adopting a simpler and fairer taxation system could help improving investment. The complexity of the tax system renders investment decisions more challenging and creates incentives for enterprises to create overly complex and often non-transparent legal constructions. A simpler taxation system with less exemptions and lower tax rates has the potential to support investment and therefore also positively contribute to enhanced employment and overall growth. No such action was taken in 2017.

3.3. Improving competition in the services sector

This section describes the policy measures taken in 2017 to stimulate competition in the services sector, in particular in business services and regulated professions.

Regulatory restrictions and administrative formalities for cross-border provision of services in Germany continue to be high, in particular for business services. Manufacturing industries use services as a significant input. The share of services in the manufacturing value chain is estimated at about 40 % in Germany. Moreover, churn rates in key business services sectors such as legal, accounting, architectural and engineering activities in Germany are below EU average, whereas gross operating rates in these sectors are above EU average, suggesting lower competitive pressures.

Germany submitted an action plan to the European Commission in January 2016, but has only partly followed up with adopting or implementing the described measures. The action plan includes a range of measures, such as modifying the provisions for some specific professions: lawyers and patent attorneys, tax advisers, auditors. The implementation of the action plan has only partly progressed and the Commission assessment is that limited progress has been made in this field.

3.4. Improving incentives to work

This section describes the policy measures taken in 2017 to reduce disincentives to work for second earners and facilitate transitions to standard employment, as well as to address the high tax wedge for low-wage earners.

The dynamics on the labour market remain favourable, but there have been only limited policy measures to address remaining weaknesses. Seasonally adjusted, employment increased by 320,000 between February and September 2017. On the backdrop of the good labour market situation, labour shortages have been gradually increasing, with the number of vacancies reported to the public employment service having climbed to 735,000 by October 2017. This reinforces the need to improve work incentives in order to (re)activate labour force participation and reduce underemplyoment.

Some smaller tax disincentives for second earners have been reduced, but the high tax wedge, mainly driven by social security contributions, remains broadly unchanged. The decision[11] to promote the use of more work incentivising tax class combination for married couples (both spouses using tax classes IV), and to adopt this as the default option for monthly tax payments, might tackle some disincentives. As the choice of tax class combinations of couples does not influence the overall tax liability, which is only calculated after the annual tax declaration, the resulting tax wedge for second earners remains unchanged. However, evidence from behavioural research suggests that some combinations led to a perception bias, where the marginal tax rate of second earners' was perceived to be overly high. No further measures were adopted for reducing the tax wedge for low wage earners, although the implementation of measures to address the fiscal drag are ongoing. This, however, only mitigates the risk of the tax wedge rising further.

3.5. Creating conditions for higher real wage growth

This section describes the policy measures taken in 2017 to create conditions for higher real wage growth.

Despite the tightening labour market aggregate real wage growth decelerated. While employment has continued to rise and unemployment has fallen to historically low levels, real wage growth remained muted. As inflation increased more than nominal wage growth, real earnings growth decelerated from 1.8% in 2016 as a whole to 1.2% in Q2 2017.

Only limited measures were taken to support real wage growth. Earlier policy measures, such as the introduction of the general statutory minimum wage in 2015 and its update in 2017 had a substantial impact on wage growth. However, the reforms that have been introduced since were much smaller, mostly updating earlier arrangements. Following consultations with social partners, an ordinance updated the minimum wage applicable for temporary workers[12], covering the period June 2017 – December 2019, while another ordinance updated the minimum wage in long-term care, covering the period November 2017-April 2020[13].

[11] Including by the Act for Combating Tax Avoidance (23 June 2017)

[12] BAnz AT 31.05.2017 V1. The implied sectoral minimum wage increase from June 2017, compared with mid 2016, is 2.6% for the old Laender and 4.8% for the new Laender, while the overall nominal wage dynamics was 2.9% in Q2 2017 compared to the year before.

[13] The implied sectoral minimum wage increase is 4.6% for the old Laender and 5.6% for the new Laender, while the overall nominal wage dynamics was 2.9% in Q2 2017 compared to the year before.

Annex: Table 2: Overview table of MIP-relevant reforms

MIP objective: Increasing public investment			
Public investment			
Supporting domestic demand and increasing public investment			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	June 2017: The federal government decided to invest additional funds in transport infrastructure in 2018. **August 2017:** Additional funding of the Municipal Investment Promotion Fund for modernizing school buildings including digital infrastructure.		CSR (1) - 2017: While respecting the medium-term objective, use fiscal and structural policies to support potential growth and domestic demand. Accelerate public investment at all levels of government, especially in education, research and innovation.
Address capacity and planning constraints for infrastructure investments			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		January 2017: To support public investment on municipal level, the service agency ("Partnerschaft Deutschland – Berater der öffentlichen Hand GmbH") became operational in 2017.	CSR (1) - 2017: Address capacity and planning constraints for infrastructure investments.
MIP objective: Efficiency of the tax system			
Improve the efficiency of the tax administration			
Efficiency and investment-friendliness of the tax system			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*

			CSR (1) - 2017: Further improve the efficiency and investment-friendliness of the tax system.
MIP objective: Improving competition in services markets			
Product market			
Stimulate competition in business services and regulated professions			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	May 2017: DE adopted a law which also transposed Directive 2013/55/EU for patent agents and faciliated the recognition of professional qualifications for patent agents from other EU Member States. **June 2017:** DE has modified its law on tax advisors ("Steuerberatungsgesetz") in order to take account of the judgment of the ECJ and ensure transparency and legal certainty in particular as regards the provision of tax consultancy services by companies established in another EU Member State.		CSR (1) - 2017: Stimulate competition in business services and regulated professions.
MIP objective: Improving incentives to work			
Labour market			
Reduce disincentives to work for second earners			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	June 2017: Measures to tackle the perceived tax disincentives for second		CSR (2) -2017: Reduce disincentives to work for second earners

	earners. It is decided to make tax class combination IV/IV the standard from 2018, while also to promote the factor-based method helps to expand the supply of labour.		
facilitate transitions to standard employment			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		April 2017: the law on temporary agency work and work contracts enters into force, after its adoption autumn 2016. This provides equal pay after nine months of working in the sector and the introduction of a maximum transitional period of 18 months after which temporary agency workers must be hired by the company.	CSR (2) - 2017: […] facilitate transitions to standard employment
Reduce the tax burden on labour			
Reduce the high tax wedge for low-wage earners			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	December 2016: For 2017 and 2018, the Federal Government has adopted further steps to increase the tax-free basic and child allowance, child benefit, supplementary child allowance and measures to combat the fiscal drag.		CSR (2) - 2017: Reduce the high tax wedge for low-wage earners.
MIP objective: Higher real wage growth			
Wages & wage setting			

Create conditions to promote higher real wage growth, respecting the role of social partners			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		May 2017: The federal government adopted an ordinance, setting out minimum wages for agency workers, following up on earlier rules, with entry into force from June 2017. **July 2017**: The federal government adopted an ordinance setting out minimum working conditions including minimum wages in the long term care sector, updating the existing regulation, with entry into force from November 2017.	CSR (2) - 2017: Create conditions to promote higher real wage growth, respecting the role of the social partners.