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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 fourth specific monitoring report under the Macroeconomic Imbalance Procedure (MIP) for Germany, reflecting the strengthened monitoring of all Member States with imbalances[1]. Germany has been found to experience imbalances already in previous years. The imbalances relate, in particular, to the sustained large current account surplus reflecting subdued investment relative to saving, both in the private and public sector. This report reviews the developments and policy initiatives taken to tackle the imbalances identified in the 2019 Country Report, which were addressed by the 2019 country-specific recommendations. The cut-off date for this report is 15 November 2019.

Economic growth has weakened sharply this year, while the external surplus is coming down only slowly. With the important manufacturing sector exposed to an increasingly challenging external environment and going through structural change, exports have weakened and are weighing on sentiment and growth. Business investment also shows signs of weakness. Growth is still supported by a relatively resilient labour market, solid consumer demand and a booming construction sector, but is set to remain subdued at around 1% over the next two years. The decline in the current account surplus has paused in 2019, on the back of cheaper energy prices. Whereas the corporate sector is not contributing any more to the current account surplus, the high household and public savings remain high.

Public investment has been increasing faster than GDP and further measures are planned for 2020, reflecting policy efforts in various areas. Yet, more progress is needed to reduce the investment backlog and to support the long-term prosperity of the country. The federal government is continuing to intensify efforts to enable investment at regional and municipal levels. As a result, the public investment rate has increased by 0.1 pp of GDP to 2.4% of GDP in 2018[2], and is increasing further in 2019. Still, net investment at municipal level remains negative, thus further adding to a significant investment backlog. The take-up of funding earmarked for investment remains limited, which may be partly related to capacity constraints in planning and implementing projects. In this context, the fact that professional services, including architects and civil engineers, remain highly regulated, may not be helpful. Important steps have been taken to improve investment in various areas, in particular in education, R&D, digitalisation, sustainable transport, energy networks and affordable housing – yet, there is scope to do more and these efforts should continue. Beyond their impact on the savings-investment imbalance, these investments are crucial for improving potential growth. Thereby they can counteract, at least to some extent, the drag that demographic developments may have ahead on the long-term welfare of Germany.

Some steps were taken in other policy areas than investments, but progress is uneven and their scope, overall, relatively limited. The implementation of the coalition treaty of spring 2018 has contributed to addressing macroeconomic imbalances of the German economy. The 2020 budget shows increasing investment expenditure for digital and transport infrastructure as well as additional funds for education, research and innovation. Some measures are being taken to reduce taxes on labour, in particular the abolition of the solidarity surcharge for most taxpayers after 2021 is a sizeable change. There are signs of shifting some of the fiscal burden in order to support more sustainable growth in the medium term. Still, despite these measures, the most important distortions in labour taxation, including for secondary earners, remain in place, while there remains potential to

[1] COM(2016)95 final, 8.3.2016.

[2] The average public investment rate of the euro area and the EU also increased by 0.1 pp in 2018.

reduce taxes on low incomes, by shifting taxes to sources less detrimental to inclusive and sustainable growth. Wages have so far remained relatively resilient to the economic slowdown, while some deceleration is expected. A reform reinstating qualification requirements is threatening to reverse earlier progress in stimulating competition in business services and regulated professions – potentially contributing to increasing barriers to competition in the construction sector, at a time when removing barriers could help expanding the sector's strained capacities. Lastly, the pension system remains an area with a need for further policy attention to safeguard its long-term sustainability, while preserving its adequacy.

Table 1: Key findings on the implementation of policy reforms[3]

On track	Wait-and-see	Action wanted
• Public investment has been increasing faster than GDP.	• The current upward trend of public investment needs to continue, and further efforts are required to clear the public investment backlog. This concerns the municipal level in particular. • Further efforts to focus investment-related economic policy on the specific areas of education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities. • From 2021, the almost full abolition of the solidarity surcharge will reduce taxes on labour	• Further efforts to shift taxes from labour to sources less detrimental to sustainable and inclusive growth. • Policy actions to stimulate competition in business services and regulated professions. • Measures to safeguard the long-term sustainability of the pension system, while preserving its adequacy.

[3] 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.

	and thus may lower wage costs. However, major disincentives to work remain in place, including for second earners. • The labour market and wages have been relatively resilient to the economic slowdown, thus far, while wages may decelerate in the near future.	

1. Introduction

On 21 November 2018, the European Commission presented, in the context of the Macroeconomic Imbalance Procedure (MIP), its eighth alert mechanism report[4] 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 27 February 2019[5] – examined the nature, origin and severity of macroeconomic imbalances and risks in Germany. In the accompanying Communication[6], the Commission concluded that Germany is experiencing imbalances, as 'the current account surplus remains high and is decreasing only slowly while more efforts are needed to fill the investment gaps particularly as regards public investment in infrastructure and education'.

In April 2019, Germany submitted its Stability Programme[7] and National Reform Programme (NRP)[8], 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, the Commission proposed two country-specific recommendations (CSRs)[9], which were adopted by the Council on 9 July 2019[10]. These recommendations include MIP-relevant policy action concerning: increasing public and private investment, improving investment-related economic policy on education; research and innovation; digitalisation and very high capacity broadband; sustainable transport as well as energy networks and affordable housing, shifting taxes away from labour to sources less detrimental to inclusive and sustainable growth, as well as strengthening the competition in business services and regulated professions and reducing disincentives to work more hours and creating conditions for higher wage growth.

A specific MIP monitoring mission to Germany was conducted on 5-7 November 2019, in combination with the fact-finding mission in the context of the European Semester. The present report assesses key policy initiatives[11] undertaken by the German authorities also in the light of the findings of the monitoring mission. This report does not assess the content of Germany's 2019 Draft Budgetary Plan – on this the Commission published its opinion on 20 November 2019, taking into account the outcome of the Commission's 2019 Autumn Forecast.

4 https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1547734121275&uri=CELEX%3A52018DC0758
5 https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-germany_en.pdf
6 https://eur-lex.europa.eu/legal-content/GA/TXT/?uri=CELEX:52019DC0150
7 https://ec.europa.eu/info/sites/info/files/business_economy_euro/economic_and_fiscal_policy_coordination/documents/2019-european-semester-stability-programme-germany-en.pdf
8 https://ec.europa.eu/info/sites/info/files/2019-european-semester-national-reform-programme-germany-de.pdf
9 https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1560258115481&uri=CELEX%3A52019DC0505
10 https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1572476865576&uri=CELEX:32019H0905(05)
11 Details on the policy measures taken can be found in the overview table in the Annex.

2. Outlook and recent developments on imbalances

Germany's economy is expected to see muted growth amid weak foreign demand but supported by a resilient labour market and private consumption. Germany's economy contracted by 0.2% in the second quarter of 2019 as the weakened external environment took its toll on exports. Manufacturing continued to decline for the fourth consecutive quarter. The car manufacturing sector is undergoing a structural transformation while equipment manufacturers are suffering from the impact of trade conflicts on investment demand. The second quarter also showed declines in construction and key services. Whereas in construction this reflects a particularly strong first quarter, in services this may be signalling weaker demand from industries and consumers. Moreover, business confidence has been deteriorating since early 2018 and may have affected consumer sentiment. Still, consumption should continue benefitting from stable employment and ongoing wage increases. Even if constrained by capacity, construction activity is expected to continue expanding, while equipment investment should strengthen as export activity normalises as expected in a few quarters. These prospects are subject to downside risks, particularly as recent wage growth has boosted savings rather than consumption growth. Downside risks on investment relate to global trade uncertainty, sectoral structural issues (e.g. in the auto sector), but not least also to the planning and implementation capacity of the public sector. The flash estimate for the third quarter came in better than expected with a slightly positive growth. If confirmed, this could signal some stabilisation in the growth outlook. All in all, after a nine-year expansion, GDP is expected to increase by only ½% this year, and by just 1% in 2020 and 2021 according to the Commission Autumn 2019 economic forecast.

Inflation should remain moderate. Consumer price inflation has been running below wage growth, which is supportive of purchasing power. Having been around 2% for most of 2018, HICP inflation declined to just 1% in the third quarter of 2019. Not taking into account volatile energy and unprocessed food prices, it hovered around 1.5% between January and September 2019. Domestic demand is not expected to exert strong inflationary pressure and core inflation is not expected to exceed 1.5% before 2021.

Public investment has continued increasing against a backdrop of a significant investment backlog, and is likely to increase further with the 2020 budget. Gross public investment increased by around 6% annually in 2015-2017 and by close to 9% in 2018 in nominal terms and close to 4.5% on average in real terms, as price inflation for construction works accelerated in 2017 and 2018. This brought the public investment rate from 2.1% of GDP in 2015 to 2.4% of GDP in 2018. In 2017 and 2018, total government net investment has turned positive for the first time since 2012 (0.12% of GDP, compared to 0.03% for the euro area). In 2018, this development has been driven by municipal investment, where, however, net investment is still negative and needs to catch up with depreciation. The investment gaps identified by municipalities remain high at EUR 138.4 billion.

The budget surplus has increased further, but is set to decline as growth weakens and automatic stabilizers and fiscal measures come into play, while public debt is projected to continue declining. The budget balance peaked at 1.9% of GDP in 2018 and is expected to decline to around 1.2% in 2019, 0.6% in 2020 and 0.2% of GDP in 2021. On the revenue side, measures lowering the personal income tax burden and the abolition of the solidarity levy in 2021 for more than 90% of taxpayers will dampen tax revenue. On the expenditure side, increased social transfers will provide additional support to household disposable income. Public investment is forecast to continue growing faster than GDP. The measures in the recent climate package should lead to additional spending of around 0.1% of GDP compared to 2019. Government spending is set to increase over the forecast period, reducing the budget surplus. All measures together imply a modest fiscal expansion of around 1 pp. of potential GDP from 2018 to 2021. The structural surplus peaked in 2018 at about 1½% of GDP and is projected to decline by about 1 pp. over the forecast period. Government debt is projected at 59% of GDP in 2019, falling below the 60% Maastricht threshold, and to decline further to around 55% of GDP in 2021. Overall, the fiscal space for 2018 was 1.9% of GDP compared to the medium-term budgetary objective (MTO) of -0.5% of GDP, and is expected to decline to 1% of GDP in 2021.

Developments as regards imbalances

In February 2018, 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.

The external surplus

The gradual decline in the current account surplus since its peak in 2015 appears to have paused in the third quarter of 2019. The current account surplus has been on a steady declining path from 8.6% of GDP in 2015 to 7.4% of GDP in 2018. According to balance of payments data, this downward adjustment appears to have paused in the third quarter of 2019, when the current account surplus for the 12 months ending in September 2019 increased to 7.5% of GDP. Compared to 2018, the trade balance for the 12 months ending in September 2019 rose by 0.2 pps of GDP on account of an increase in the goods export ratio while the goods import ratio remained unchanged. The primary income balance increased by 0.1 pps. The services balance and the secondary income balance decreased by a combined total of 0.2 pps. The developments of the seasonally adjusted quarterly trade balance show a widening since the third quarter of 2018 (from 5.7% to 7.2% of GDP). This is largely driven by terms of trade effects as import prices declined by 2.4%, driving the import ratio to GDP down, while export prices and the export ratio stayed largely stable.

The high current account surplus reflects Germany's strong trade orientation and competitiveness but also is a result of excess savings over investment. Until recently, all sectors of the economy contributed to this imbalance. However, the corporate sector turned into a net borrower as of 2018 and is now contributing to reducing savings surplus. In the 12 months ending in September 2019, the corporate investment share was at 12.4 % of GDP, just below that of 2018 (12.6% of GDP, compared to 12% in 2017 and 11.5% in 2016), while corporate savings' share of GDP continued to decline (11.7 % compared to 12.1% for 2018, 12.7% in 2017 and 13.1% in 2016). At the same time, households and the public sector continue to be net lenders. The household savings rate increased further to 18.8 % in 2018 and for the 12 months ending in September 2019, propped up by rising labour incomes while the consumption share of GDP remained unchanged. The household savings rate is expected to stay high in coming years, the highest in the euro area (average at 11.9% in 2018), also taking into account the precautionary savings motive related to ageing population. While household investment also kept increasing, the household net lending position stayed high throughout 2018 and until September 2019. The public sector net lending position peaked at 1.9% in 2018. Public savings remained high until September 2019. The fiscal surplus has remained significant at 1.6 % for the 12 months ending in September. Going forward, the public sector is expected to reduce its net lending position with fiscal surplus declining to 0.2% of GDP by 2021.

A gradual decline of the current account surplus is expected to resume going forward. According to the Commission 2019 autumn forecast, the current account surplus is set to decline to 6.4% of GDP by 2021. With the external environment becoming increasingly uncertain, growth is expected to be driven primarily by domestic demand, also supported by an increase in fiscal transfers. Private sector investment is also expected to be supported by strong housing demand and, more importantly, the need to adopt new technologies. The resilient labour market should support private consumption, although less than in the past, as employment growth has been moderating and wages are expected to converge towards the euro area average in the coming years. The public sector is expected to continue increasing investment.

3. Progress with policy implementation

3.1. Supporting domestic demand and increasing public investment

This section describes the fiscal policy measures taken in 2019 to achieve a sustained upward trend in public and private investment (especially in education, research and innovation, digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing) at all levels of government, in particular at regional ('*Länder*') and municipal levels.

Public investment is increasing faster than GDP, yet more efforts are needed to clear the investment backlog. Public investment in 2018 grew by 8.7% nominally and 4.8% in real terms. In the first half of 2019, it increased by 8.6% in nominal terms and by 4.4% in real terms. This represents a noticeable increase compared to past years and the long-term average. However, given the backlog especially at municipal level, public investment still needs greater efforts to maintain the capital stock. As in the years before, net investment at municipal level remained negative in 2018 and in the first half of 2019, due to a faster depreciation of existing infrastructure than new replacements. The investment gaps identified by municipalities slightly declined in 2018, yet they remain high at EUR 138.4 billion, with particularly high investment needs signalled in education (EUR 42.8 billion) and roads (EUR 36.1 billion).

Implementation of investment projects is lagging behind allocated funding. Absorption of investment support funds appears to be an issue. For example, from the 2018-2019 support program for school refurbishment (*Schulsanierungsprogramm*), 31% of the available EUR 3.5 billion were allocated at end March 2019. While municipalities in 2018 planned investment expenditure of nearly EUR 35 billion, they actually spent only around EUR 23 billion, a fraction of the estimated infrastructure backlog. In general, absorption and investment are lagging where they would be particularly needed, which is in financially constrained municipalities. To tackle this, in July 2019, the federal government expressed its readiness to participate in alleviating the burden of over-indebted municipalities, in its reaction to the report of the Commission on Equal Living Standards. Länder-level initiatives include the Hessenkasse, a two-layered fund established by the Land Hesse to improve the financial standing of vulnerable municipalities. The first layer is a debt relief scheme, which took over EUR 4.9 billion of debt from 179 municipalities in its first year of existence. The second layer is an investment programme where municipalities have to provide 10% of own funds and receive 90% co-financed – this facilitated close to EUR 200 million of investment in its first year of existence. Apart from such initiatives as in Hesse, progress has been more limited elsewhere, also as some Länder wait for the federal level to increase its engagement.

The government announced an additional investment budget for structural change in coal mining areas as well as measures to support structurally weak regions. As coal mining will be phased out in Germany, the government announced that it would provide additional funds worth up to EUR 40 billion to support the transition of coal mining areas by 2038. Planned measures include infrastructure investment in roads and railway lines, support for research and development, as well as establishment of research institutes and federal government institutes. More generally, reflecting recommendations of the Commission on "Equal Standards of Living", funding programmes will start as of 2020 to support structurally weak regions. Already existing funding programmes to support weak regions in former Eastern Germany will be extended and stretched out to cover the whole country. These programmes focus on improving the transport situation in municipalities as well as access to basic services in rural areas. Moreover, very-high capacity broadband connections for internet and mobile telephone communication are to be extended to areas normally not profitable for business and to further close remaining coverage gaps throughout the country.

Further measures contribute to investment in education, research and innovation. The Digital Pact for Schools supports investment in education and the transition into the digital era. Financial assistance will be provided for improving digital infrastructure and equipment at schools, as well as for training teachers and developing suitable digital learning tools. Introduction of a tax incentive for research is planned to increase research and innovation activities. This tax incentive basically allows for deducting staff costs related to research and development activities from 2020 onwards. The funding rate is 25%, with a maximum of eligible costs of EUR 2 million per company. The objective is to encourage especially small and medium-sized companies to increase their investment in research and development. As in previous years, the federal government announced the creation of further investment-related innovation initiatives and agencies, such as in the areas of ‘Breakthrough Innovations’, ‘Artificial Intelligence’ and ‘Blockchain’. Measures promoting digital solutions are expected to favour digital investments and slightly improve the business environment.

The act on the acceleration of the power grid expansion entered into force in May 2019 and is expected to speed up the extension of energy networks. The core element of this act is to simplify and accelerate planning and approval procedures for optimising and upgrading existing power grids and to invest in new ultra-high voltage transmission systems. Moreover, the government agreed to implement internal auditing procedures on grid expansion to monitor the progress according to schedule and to avoid delays. Regarding networks of liquefied natural gas, an ordinance entered into force in June 2019 that aims to improve construction and access of the liquefied natural gas network to the existing gas transmission system.

Several housing measures have been adopted, however the impact on housing investment may not necessarily be positive. A mechanism to control the increase in rents is planned to be extended until 2025, while some Länder are considering further accelerating rent controls. A new regulation regarding commission fees of real estate agents is intended to lead to a fairer distribution of the costs between the selling and buying parties. An act to strengthen housing benefits will enter into force in 2020 and will increase the reach and level of housing benefits including regular updates, with the next update scheduled in 2022. Taken together, it is not clear that these measures will improve housing investment. While they may have a temporary mitigating effect on rental price dynamics, in the longer run, prices and investment are also shaped by supply-side policies, and longer term outcomes are intimately linked to incentives to invest in housing.

3.2. Shifting taxes from labour to sources less detrimental to inclusive and sustainable growth

This section describes the policy measures taken in 2019 to shift taxes to sources less detrimental to inclusive and sustainable growth. Some further measures that impacted on the tax burden on labour are listed under point 3.4. that covers the tax wedge.

Immovable property tax (*Grundsteuer*) is being reformed in response to the ruling on its unconstitutionality, without aiming for additional revenues. In its ruling of 10 April 2018, the Federal Constitutional Court declared the way in which properties are valued for the purposes of the immovable property tax to be unconstitutional, as the tax had been calculated based on outdated property values.[12] In principle, the amounts of immovable property tax due will continue to be based on these outdated property values, although regional governments (*Landesregierungen*) may opt out and apply a different valuation method. As the immovable property tax is a relatively socially inclusive tax, and it has limited distortive effects, it could have been used to a greater extent to facilitate a tax shift from labour. However, the government aimed at a revenue-neutral reform, not going beyond ensuring compliance with the court ruling to base the valuation on a fairer basis.[13]

It was decided to abolish the solidarity surcharge for large parts of the population from 2021. The solidarity surcharge (*Solidaritätszuschlag*), representing 5.5% tax on top of the personal/corporate income tax rate, was introduced in response to additional fiscal needs stemming from the German unification. In November, the Bundestag decided to fully abolish the surcharge for about 90% of taxpayers currently paying this tax by substantially increasing the threshold from which the solidarity surcharge becomes due, and reduce the tax burden of an additional 6.5% of current taxpayers. As the solidarity surcharge is planned to remain unchanged for corporate and capital income (e.g. interests and dividends), this measure will noticeably contribute to shifting taxes away from labour. However, this tax wedge will be reduced rather for higher wage earners, who have a higher propensity to save, while having only a limited impact on low-wage and second earners, the target group specifically mentioned in the country-specific recommendation.

3.3. Strengthen competition in business services and regulated professions

This section describes the policy measures taken in 2019 to stimulate competition in the services sector, in particular in business services and regulated professions.

Barriers to competition in business services remain high in comparison with other EU Member States. The level of regulatory restrictiveness in Germany remains high and is above the EU average for many sectors including architecture, engineering, legal, tax advice and accounting services as well as above the OECD average for lawyers, notaries, accountants and civil engineers (OECD PMR, 2019). These services play a particular role in the "capacity constraints" affecting the implementation of public-sector investment projects. Changes in the regulation of services could boost the speed of investment set-up phases both for the private and public sector.

[12] The assessed values date from 1964 in the states (Länder) of former West Germany and 1935 in the states (Länder) of former East Germany.

[13] Even if the objective and the result is not a tax shift away from labour, some new climate-related measures may result in higher tax burden on polluting activities, and contribute to sustainable growth, while some compensating measures partly alleviate negative impacts on poorer groups. As part of the 2030 Federal Climate protection programme (Klimapaket), a CO2 price will be introduced in the transport and heating sectors – the so-called National Emission Trading Scheme (nETS). The CO2 price will be phased in gradually between 2021 and 2026. There are some flanking measures, partly compensating the negative social implications for lower income groups, including an increase in the commuters' allowance (Pendlerpauschale), and a 10% increase in housing benefits. Still, in some cases targeting was not optimal, e.g. better-off commuters look overcompensated by the reform of commuters' allowance. In addition, further small measures will result in marginally higher taxation of environmentally more damaging behaviour. These include the motor vehicle tax, which as of 2021 will be related to the CO2 emissions per kilometre for new registrations, as well as a minimum price on the airline tickets (to prevent the price to go below the levels of charges and taxes). In exchange, the VAT rate on rail tickets will be substantially reduced. This climate package may thus contribute to a more inclusive and sustainable growth in the mid-term but as its financing is planned to be budgetary neutral it will not have any discernible effect on the taxation of labour. In addition, there remain unused potential to further increase revenues in a sustainable way, including by phasing out of subsidies for fossil fuels.

Measures under preparation may bring some improvements. In July 2019, the European Court of Justice ruled (Case C-377/17)[14] that maintaining fixed tariffs for the planning services of architects and engineers was not compatible with the Services Directive. The government is currently reviewing the statutory fee schedule for architects and engineers (HOAI) and the basis for statutory authorisations in the Act regulating Services of Engineers and Architects (ArchLG), after which a legislative answer is expected. In addition, the government is planning an amendment to bring Section 146 subsection 2a of the Fiscal Code (*Abgabenordnung*) in line with EU Free Flow of Data Regulation (Regulation 2018/1807). Progress in this respect can facilitate the exchange of non-personal data in the EU and thus to some extent increase competition in the provision of corporate services.

Some policy action is expected to reduce competition in certain professions. On 13 November 2019, the government presented a draft law that conditions practicing 12 craft professions on having obtained a Master Craftsman's Certificate (*Meisterpflicht*). The new measure reverses the 2004 deregulation, and was criticised by the competition supervisor Monopoly Commission (*Monopolkommission*) which expects a significant decline in newly established companies for the crafts professions concerned. The necessity and proportionality of this reform merits to be analysed thoroughly.

3.4. Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners

This section describes the policy measures taken in 2019 to reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners. The elimination of the solidarity surcharge to most taxpayers also reduces the tax wedge – this measure is explained under point 3.2. on "Shifting taxes from labour to sources less detrimental to inclusive and sustainable growth".

Reducing disincentives to work more hours can increase labour supply and alleviate short-term labour shortages as well as the impact of demographic ageing. Despite the production decline in manufacturing, the labour market remained relatively strong, supported by the continuing boom in construction and a service sector benefitting from resilient domestic demand. While there are signs of labour hoarding, reflected in increases in short-term work arrangements (*Kurzarbeit*), lack of skilled labour remains a restricting factor on production, with the number of vacancies registered at the public employment service remaining at 748,000 (seasonally adjusted) in October 2019, well above its long-term average. Reducing disincentives to work would help to better employ human capital and thus contribute to alleviating short term labour shortages and to some extent alleviate the longer-term challenge of demographic ageing. In addition, to the extent these measures increase take-home pay, they could also boost private consumption.

Reduction of personal income tax and of social security contributions are to benefit particularly low- and middle-income earners. Several changes in the tax law in the period 2019 to 2021 lower the personal income tax by measures such as granting a higher basic personal allowance, offsetting of fiscal drag by increasing the thresholds of tax brackets and increased family benefits. The return to the equal financing of social security contributions by employers and employees for the health system and cuts in the contributions to the

[15] Productivity per employee increased by only 0.1% in 2018 and actually declined by 0.6% in the first half of 2019

unemployment insurance, although partly counterbalanced by higher long-term care contributions, will benefit particularly low- and middle-income earners.

Major disincentives to work remain in place. The interplay of high income taxes, the relatively high level of social-security contributions, the minijobs, and transfer withdrawals lead to a market equilibrium where the labour potential is not fully used. High effective marginal tax rates of 100% and more affect certain income categories, particularly those with low incomes. This results in strong disincentives for people to increase working hours, or for the unemployed to start working. There continue to be high marginal tax rates on take home pay for the second earner due to the current setup of the joint income taxation for married couples (*Ehegattensplitting*), and there is no evidence that the use of the alternative factor method (*Faktorverfahren*) materially changed the situation. All in all, there remains considerable potential for further progress in this area.

3.5. Safeguard the long-term sustainability of the pension system, while preserving adequacy

This section describes the policy measures taken in 2019 to improve the pension system.

The newly announced basic pension scheme is expected to introduce a contribution-based minimum pension. In November, the coalition government agreed on the introduction of a "basic pension" (*Grundrente*) - a contribution-based minimum pension that is aimed at being higher than the means-tested basic income to which persons without adequate income are entitled to. People with a contribution record of 35 years who paid at least 30% of the contribution of the average earner will see their pension doubled, up to a pension ceiling of 80% contribution record, accounted for maximum 35 years. The basic pension is expected to reach between 1.2 and 1.5 million people and start from 2021. The government expects it to cost annually between EUR 1 to 1.5 billion, which would be about EUR 1,000 per beneficiary. While the measure follows a number of specific pension adjustments that increased pension for certain groups (pensions with 63, mothers' pensions I and II), its fiscal impact is comparatively limited. In addition to the basic pension, the government decided on measures to strengthen the use of occupational and private/supplementary pensions. The draft bill is yet to be presented and would need to be approved by the Parliament.

The Pension Commission continued its deliberations in 2019. Ageing is expected to strongly affect the labour market already as of 2023. In addition, it is also expected to start having a negative fiscal impact in the next few years. Given the above, the recommendations of the Pension Commission **(***Rentenkommission***)** on guaranteeing adequacy, sustainability of the pension system as well as a fair intergenerational contract, due by March 2020, appear very timely.

3.6. Strengthen the conditions that support higher wage growth, while respecting the role of the social partners

This section describes the policy measures taken in 2019 to create conditions for higher wage growth.

Overall wage growth has been so far resilient to the slowdown, yet it is expected to decelerate and converge closer to the euro area average. Growth of nominal compensation per employee has accelerated, from 2.9% in 2018 to 3.1% in the first half of 2019 (year-on-year), even if employment growth gradually decelerated and productivity declined[15]. While higher nominal compensation growth also benefitted from a shift of 0.5 pp of employees' social security contributions to employers' social security contributions, gross wages and salaries were also relatively resilient, as gross wages and salaries per employee increased by 3.2% in 2018 and by 3.0% in the first half of 2019. Wage increases in services contributed considerably to overall wage dynamics, while manufacturing wages slowed along the declining production, posting an increase of 2.5% in 2018 and 1.7% in the first half of 2019. In general, wage growth will likely decelerate in the near future as some employers may see their bargaining power increasing due to a softer labour market and might also react to low productivity growth and suppressed profit margins. Effective collective bargaining may be a tool for finding the right balance between wage increases and maintaining employment – in this respect, the situation is broadly unchanged, as the share of workers covered by collective bargaining agreements has stagnated in 2018 (latest year available), at a relatively low level compared to the past.

Minimum wage updates have been tied to negotiated wage increases and lagged general wage developments. In 2018, the Minimum Wage Commission (*Mindestlohnkommission*) proposed to increase the minimum wage to 9.19 euros per hour for 2019 (a nominal increase of about 4% as compared to 2018, after no increase from 2017) and to 9.35 euros per hour for 2020 (a nominal increase of about 1.7%). These increases that the Government endorsed, were based on developments in negotiated wages in 2016-2017 (for the 2019 increase) and the first half of 2018 (for the 2020 increase). Linking minimum-wage increases to past developments in negotiated wages appears to have resulted in a gradual erosion of the relative level of the minimum wage since 2015. While in 2015 the minimum wage was about 48% of the median and 43% of the average wage, by 2018 it had decreased to 46% of the median and 40% of the average wage (OECD).

Wages in the long-term care sector are supported by new law. Long-term care is a relatively low-paid sector. In November 2019, an act was adopted to improve wages and working conditions in long-term care (*Pflegelöhneverbesserungsgesetz*). The act enables the Ministry of Labour and Social Affairs (*BMAS*) to extend a wage agreement between social partners to the whole sector, and also to extend a wage or working condition recommendation of the Long Term Care Commission (*Pflegekommission*) for the whole sector in aspects not covered by collective agreements. The Commission has now been convened and is expected to recommend higher minimum wages for the period after 1 May 2020. This recommendation is expected then to become part of a new ordinance.

[15] Productivity per employee increased by only 0.1% in 2018 and actually declined by 0.6% in the first half of 2019

Annex: Overview table of MIP-relevant reforms

MIP objective: Increasing public and private investment			
Public investment			
Use fiscal and structural policies to achieve a sustained upward trend in public and private investment			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		January 2019: The 2019 federal budget increased allocations for investment spending (EUR 38.9 billion, up from allocation EUR 37.4 billion in 2018), excluding investment allocation to the investment fund for digital infrastructure of EUR 2.4 billion. A priority has been placed on transport infrastructure, funding for the construction of social housing, and child benefits for homebuyers. A total of EUR 24.3 billion has been earmarked for education and research spending in 2019, some EUR 1.4 billion more than the set amount in 2018. In addition, the burden on the Länder and local authorities is being reduced, enabling additional investment measures to be taken at these levels and thus education and research to be strengthened.	CSR (1) – 2019: While respecting the medium-term budgetary objective, use fiscal and structural policies to achieve a sustained upward trend in private and public investment, in particular at regional and municipal level.
	November 2019: The federal budget for 2020, as agreed by the government and the Bundestag, shows plans for increasing overall investment spending to EUR 42.9 billion (close to 1.3% of GDP), by an increase of		CSR (1) – 2019: While respecting the medium-term budgetary objective, use fiscal and structural policies to achieve a sustained upward trend in private and public investment, in particular at regional and municipal level.

	EUR +5.0 billion (0.15% of GDP). This includes education and research investment at EUR 18.3 billion. The newly established fund for digitalising schools (*Digitalfond*) receives an allocation of EUR 9 billion.		
September 2019: The Commission 'Competition Law 4.0' presented its recommendations to adapt competition rules to the digital economy, including ways to empower consumers to dispose of their own data, clarifying rules for dominant platforms, and enhancing legal certainty for cooperation in the digital sector. The federal government studies how the recommendations can be integrated in national competition law, and expects that the overhaul of the competition framework will make it easier to attract private investment. Relatedly, a draft act is expected to modernise Germany's competition law (*Gesetz gegen Wettbewerbsbe-schränkungen*), particularly the supervisory scheme to prevent abuses of market power, and to provide adequate answers to the challenges posed by the digital transformation.			CSR (1) – 2019: While respecting the medium-term budgetary objective, use fiscal and structural policies to achieve a sustained upward trend in private and public investment, in particular at regional and municipal level.
Focus on higher public investments on regional and municipal levels			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	July 2019: The federal government adopted a number of measures as a follow-up to the work of the 'Equal Standards of Living' Commission		CSR (1) – 2019: While respecting the medium-term budgetary objective, use fiscal and structural policies to achieve a sustained upward trend in private and

	(*Kommission Gleichwertige Lebensverhältnisse*). Measures include extending the pan-German funding programme from covering only eastern Germany to covering all structurally weak areas, to be implemented from January 2020. Further measures are topping up the Federal Government's investment aid for improving transport in municipalities and promoting investment in basic services in rural areas. In addition, these measures also include expanding the optical fibre network in areas where this would be unprofitable for businesses.		public investment, in particular at regional and municipal level.
August 2019: The federal government decided to propose an act on structural development in coal mining areas (*Strukturstärkungsgesetz Kohleregionen*), following the recommendations provided by the Commission for Growth, Structural Change and Employment. Up until 2038, up to €40 billion will be provided by the federal government for transforming former lignite mining areas.			CSR (1) – 2019: While respecting the medium-term budgetary objective, use fiscal and structural policies to achieve a sustained upward trend in private and public investment, in particular at regional and municipal level.
Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.			
September 2019: The federal government adopted the Third Act to Reduce Bureaucracy (*Bürokratieentlastungsgesetz III*), with which it expects to relieve the German economy of more than €1.1 billion of costs per year. Key measures include introducing an electronic sick leave			CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.

certificate, improved rules for the retention of tax-related data processing systems, and creating an option to use a digital registration form in the hospitality sector.			
		May 2019: The Digital Pact (*Digitalpakt*) for Schools was launched, with a duration of five years. Financial assistance is provided for improving digital infrastructure and equipment at schools but also for training teachers and developing suitable digital learning tools.	CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
	November 2019: The Bundestag adopted the Act on tax allowances for research (*Forschungszulagengesetz, FZulG*), allowing for the tax deduction of staff costs related to research and development activities from 2020 onwards. The funding rate is 25%, with a maximum of eligible costs of EUR 2 million per company. The objective is to encourage especially small and medium-sized companies to increase their investment in research and development.		CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
In 2018 the federal government decided to create the Agency for Breakthrough (*Innovations Agentur für Sprunginnovationen*) to fund disruptive innovations that have the potential to transform the market. In 2019, a founding commission was set up, and it was decided to have the agency's seat in Leipzig, with a staff number of about 30-50. The earmarked funding is about EUR 1 billion for ten years.			CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.

		May 2019: The Act on the acceleration of power grid expansion (*Netzausbaubeschleunigungsgesetz, NABEG revision 2.0*) entered into force and is expected to speed up the extension of energy networks. The core element of this act is to simplify and accelerate planning and approval procedures for optimising and upgrading existing power grids and to invest in new ultra-high voltage transmission systems. Moreover, the government agreed to implement internal auditing procedures on grid expansion to monitor the progress according to schedule and avoid delays.	CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
	May 2019: Forward-looking internal planning and auditing of grid expansion was agreed by the energy ministers of the Länder, the federal government, the electricity network regulator Bundesnetzagentur and the directors of the transmission system operators.		CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
		June 2019: An ordinance entered into force, aimed at improving construction and access of the liquefied natural gas network to the existing gas transmission system. This allows covering costs of creating such facilities without delay by gas grid fees, and passed on to the users of the grid.	CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
		November 2018: In its Artificial Intelligence Strategy, the federal government set out a framework for taking a holistic approach to the future development and use of AI in Germany.	CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy

		The funding for this strategy started in 2019 and until 2025, EUR 3 billion are earmarked.	networks and affordable housing, taking into account regional disparities.
		November 2018: Following adoption of the 'Shaping the course of digitisation' implementation strategy, a number of measures started, including the 'Mittelstand 4.0' initiative: 26 regional and thematic centres of excellence that drive forward digitalisation in SMEs, the 'Go digital' advisory programme targeted at SMEs, 'Digital investments' grant programme to be launched at the beginning of 2020, IT security in the business sector: establishment of an IT security contact point for SMEs, Digital innovations competition for business start-ups, Digital Hub Initiative: Strengthening the digital ecosystem at 12 sites across Germany.	CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
October 2019: The federal government has adopted a mobile communication strategy, aiming for comprehensive coverage of 4G (fourth-generation) technology by 2024, including through simplifying planning rules. The government will also set up a mobile infrastructure company to support the expansion.			CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
	August 2018: Broadband funding programme was adjusted to focus on the expansion of broadband networks, to connect areas with no broadband coverage (white spots). In November 2018, a programme to connect schools,		CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking

	business parks and hospitals to the broadband network was launched. Funding directive on ‘grey spots’ (connections at speeds of more than 30 Mbit/s, but not gigabit-ready) is under preparation.		into account regional disparities.
September 2019: The federal government has adopted the Blockchain Strategy in order to make use of the opportunities offered by this technology and to harness its potential for driving forward the digital transformation. The strategy includes 44 measures across five fields of action, including a framework for innovation using blockchain technology, blockchain in the financial sector and digital public services.			CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.
September 2019: A Housing and rental package, containing various measures on rent control, tenants’ rights, housing benefits, real estate agent fees aims at supporting and providing affordable housing.			CSR (1) – 2019: Focus investment-related economic policy on education; research and innovation; digitalisation and very-high capacity broadband; sustainable transport as well as energy networks and affordable housing, taking into account regional disparities.

MIP objective: Tax shift for an improved tax system			
Tax policy			
Shifting taxes from labour to sources less detrimental to inclusive and sustainable growth[16]			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	November 2019: From January 2021, the solidarity surcharge (*Solidaritätszuschlag*) will be abolished for low and middle incomes, i.e. for around 90% of all people currently paying, and partially abolished for another 6.5% of taxpayers.		CSR (1) – 2019: Shift taxes away from labour to sources less detrimental to inclusive and sustainable growth.
	November 2019: A majority of the climate-related measures announced in September (*Klimapaket*) was adopted in the Bundestag (Lower Chamber). Measures include the introduction of a CO2 price in the transport and heating sectors – the so-called National Emission Trading Scheme (nETS). The CO2 price will be phased in gradually between 2021 and 2026. In addition, further measures that will result in higher taxation of environmentally more costly behaviour include that as of 2021, the motor vehicle tax will be related to the CO2 emissions per kilometre for new registrations and it will not be possible to sell air tickets below a minimum price (to prevent the price to go below the		CSR (1) – 2019: Shift taxes away from labour to sources less detrimental to inclusive and sustainable growth.

[16] Regarding shifting away taxes from labour, some further measures are listed under MIP objective Improving incentives to work

	levels of charges and taxes).		
	October 2019: The immovable property tax (*Grundsteuer*) is being reformed in response to the ruling on its unconstitutionality, without aiming for additional revenues. In its ruling of 10 April 2018, the Federal Constitutional Court declared the way, in which properties are valued for the purposes of the immovable property tax to be unconstitutional, as the tax had been calculated based on outdated property values. In principle, the amounts of immovable property tax due will continue to be based on these outdated property values, although regional governments ("Landesregierungen") may opt out and apply a different valuation method.		CSR (1) – 2019: Shift taxes away from labour to sources less detrimental to inclusive and sustainable growth.

MIP objective: Improving competition in services markets			
Product market			
Strengthen competition in business services and regulated professions			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
The government is reviewing the statutory fee schedule for architects and engineers (HOAI) and the basis for statutory authorisations in the Act regulating Services of Engineers and Architects (ArchLG). This follows ruling of the European Court of Justice (Case C-377/17) that maintaining fixed tariffs for the planning services of architects and engineers was not compatible with the Services Directive. After the review, a legislative answer is expected.			CSR (1) - 2019: Strengthen competition in business services and regulated professions.
The government is planning an amendment to bring Section 146 subsection 2a of the Fiscal Code (*Abgabenordnung*) in line with EU Free Flow of Data Regulation (Regulation 2018/1807). Progress in this respect can facilitate the exchange of non-personal data in the EU and thus to boost competition in the provision of corporate services.			CSR (1) - 2019: Strengthen competition in business services and regulated professions.
November 2019: The government presented a draft law that conditions practicing 12 craft professions on having obtained a Master Craftsman's Certificate (*Meisterpflicht*). The new measure partly reverses the 2004 deregulation.			CSR (1) - 2019: Strengthen competition in business services and regulated professions.

MIP objective: Improving incentives to work			
Labour market			
Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners [17]			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		January 2019: From 2019, employers and employees are required again to pay equal contributions to statutory health insurance. This results in an average reduction of 0.5 percentage points in contributions for employees and pensioners, thereby increasing take-home pay and unit labour costs.	CSR (2) - 2019: Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners.
		July 2019: Low-income earners “midijobbers” are granted greater reductions in social security contributions/granted reductions. The existing sliding scale is expanded to include wages from €450 to €1,300 (previously €850) and act as a transitional scale for employment subject to social security contributions.	CSR (2) - 2019: Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners.
		January 2019: The contribution rate to unemployment insurance was reduced by 0.5 percentage points.	CSR (2) - 2019: Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners.
		January 2019: The contribution rate to long-term care insurance was increased by 0.5 percentage points as of January 2019.	CSR (2) - 2019: Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners.
	November 2018: The basic allowance,	The measures that were due in 2019 have	CSR (2) - 2019: Reduce disincentives to

[17] The elimination of the solidarity surcharge for most taxpayers also reduces the tax wedge – this measure is listed under “Shifting taxes from labour to sources less detrimental to inclusive and sustainable growth”.

	child allowance and child benefit are increased and bracket creep is offset, through measures taking effect in January 2019 and January 2020 (increase of basic allowance and child allowance) and July 2019 (increase of child benefit).	been implemented already.	work more hours, including the high tax wedge, in particular for low-wage and second earners.
November 2019: Coalition agreement to reduce the contribution rate to the unemployment insurance system by 0.1 percentage points to 2.4%.			CSR (2) - 2019: Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners.
MIP objective: Improving the pension system			
Pension system			
Safeguard the long-term sustainability of the pension system, while preserving adequacy			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
		May 2018: The Pension Commission (*Rentenkommission*) was appointed to propose measures for further ensuring the sustainability and development of the public pension pillar, as well as occupational and private pension pillars, after 2025. The Commission's report is due by March 2020.	CSR (2) – 2019: Take measures to safeguard the long-term sustainability of the pension system, while preserving adequacy.
November 2019: The coalition government agreed on the introduction of a "basic pension" (*Grundrente*); a contribution-based minimum pension that is aimed at being higher than the means-tested basic income to which persons without adequate income are entitled to. People with a contribution record of 35 years who paid at least 30%			CSR (2) – 2019: Take measures to safeguard the long-term sustainability of the pension system, while preserving adequacy.

of the contribution of the average earner will get their pension doubled, up to a pension ceiling of 80% contribution record, accounted for maximum 35 years. The basic pension should reach between 1.2 and 1.5 million people and start from 2021. It is expected to cost between EUR 1 to 1.5 billion, or annually about €1.000 per beneficiary.			
November 2019: It was decided to reduce the tax burden of occupational pensions. This is expected to increase income of pensioners and create some incentives to contribute to occupational pensions. Since 2004, elderly had to pay from their occupational pension not only the employees', but also the employers' healthcare contribution. A newly introduced allowance of EUR 157.75 will effectively reduce contributions, by EUR 1.2 bn. About 57% of workers are covered through occupational pensions.			CSR (2) – 2019: Take measures to safeguard the long-term sustainability of the pension system, while preserving adequacy.
MIP objective: Higher wage growth			
Wages & wage setting			
Strengthen the conditions that support higher wage growth, while respecting the role of the social partners			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	June 2018: The Minimum Wage Commission (*Mindestlohnkommission*) proposed to increase the general statutory minimum wage from EUR 9.19 in 2019 to EUR 9.35 as of 2020. The federal government adopted a corresponding		CSR (2) – 2019: Strengthen the conditions that support higher wage growth, while respecting the role of the social partners.

	ordinance.		
	November 2019: the Act to Improve Wages of Those Providing Long-term Care (Pflegelöhneverbesserungsgesetz) was adopted, aimed to improve working conditions in the long-term care sector; increase the standing of the the Long-term Care Commission. These initiatives are expected facilitate the nation-wide adoption of higher minimum wages. The Fourth Commission has now been convened on schedule, and is to recommend higher minimum wages in particular for the period after 1 May 2020. This recommendation can then become part of a new ordinance.		CSR (2) – 2019: Strengthen the conditions that support higher wage growth, while respecting the role of the social partners.