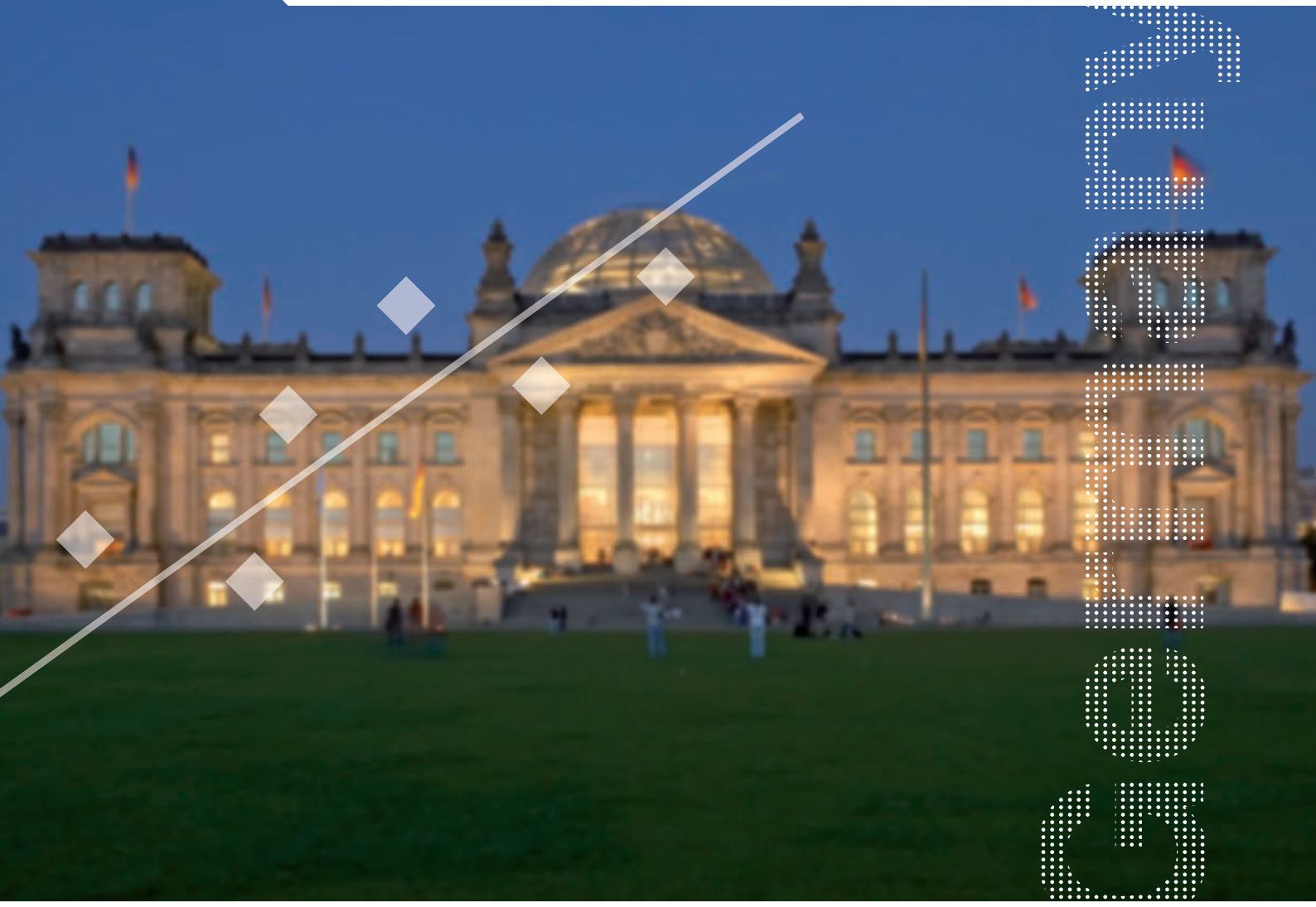
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GERMANY

MAY 2014



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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Germany were reviewed by the Committee on 25 February 2014. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 9 April 2014.

The Secretariat's draft report was prepared for the Committee by Andrés Fuentes Hutfilter and Andreas Kappeler as well as André Eid, seconded from the German Ministry of Economic Affairs and Energy, under the supervision of Andreas Wörgötter. Research assistance was provided by Seung-Hee Koh.

The previous Survey of Germany was issued in February 2012.

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BASIC STATISTICS OF GERMANY, 2012

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	81.2		Population density per km^2	227.4	(34.3)
Under 15 (%)	13.2	(18.4)	Life expectancy (years, 2011)	80.8	(80.0)
Over 65 (%)	20.9	(15.3)	Men	78.4	(77.3)
Foreign-born (%, 2011)	13.1		Women	83.2	(82.8)
Latest 5-year average growth (%)	-0.3	(0.5)	Latest general election	September 2013	

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	3 430.3		Primary sector	0.8	(2.5)
In current prices (billion EUR)	2 668.0		Industry including construction	30.5	(27.4)
Latest 5-year average real growth (%)	0.7	(0.6)	Services	68.7	(70.0)
Per capita, PPP (thousand USD)	42.3	(37.2)			

GENERAL GOVERNMENT

Per cent of GDP

Expenditure	44.7	(43.0)	Gross financial debt	88.3	(108.0)
Revenue	44.7	(36.8)	Net financial debt	50.3	(68.1)

EXTERNAL ACCOUNTS

Exchange rate (EUR per USD)	0.8		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.8		Machinery and transport equipment	46.9	
In per cent of GDP			Chemicals and related products, n.e.s.	14.4	
Exports of goods and services	51.9	(53.8)	Manufactured goods	12.6	
Imports of goods and services	45.9	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	7.1	(-0.5)	Machinery and transport equipment	31.9	
Net international investment position	42.1		Mineral fuels, lubricants and related materials	14.8	
			Manufactured goods	12.5	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year-olds	72.8	(65.0)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	5.5	(7.9)
Men	77.6	(73.1)	Youth (age 15-24) (%)	8.2	(16.2)
Women	68.0	(57.0)	Long-term unemployed (1 year and over) (%)	2.5	(2.7)
Participation rate (%) for 15-64 year-olds	77.1	(70.9)	Tertiary educational attainment 25-64 year-olds (%, 2011)	27.6	(31.5)
Average hours worked per year	1 397	(1 766)	Gross domestic expenditure on R&D (% of GDP)	2.9	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe)	3.8	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	9.2	(10.0)
Renewables (%)	10.7	(8.5)	Water abstractions per capita (1 000 m^3, 2010)	0.4	
Fine particulate matter concentration (urban, PM10, µg/m^3, 2010)	15.6	(20.1)	Municipal waste per capita (tonnes, 2010)	0.6	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2010)	0.286	(0.304)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2010)[b]	8.8	(10.9)	Reading	508	(497)
Public and private spending (% of GDP)			Mathematics	514	(494)
Health care (2011)	11.3	(9.5)	Science	524	(501)
Pensions (2009)	11.3	(8.7)	Share of women in parliament (%, January 2014)	35.6	(26.5)
Education (primary, secondary, post sec., non tertiary, 2009)	3.3	(4.0)	Net official development assistance (% of GNI)	0.4	(0.4)

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

b) The threshold is set at 50% of the mediane disposable income.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

Executive summary

- *Main findings*
- *Key recommendations*

Main findings

In the face of recent crises, the German economy has proved remarkably resilient. Unemployment has reached post-unification lows even as job losses mount across Europe, reflecting ambitious reforms in the past decade and Germany's status as a "safe haven" in the euro area crisis. Germany is set for a recovery, backed by a strong manufacturing sector and a robust labour market. Domestic demand has contributed substantially to growth, but the current account surplus remains large. While income inequality is lower than in most OECD economies, the share of low-paying jobs has risen considerably. Potential growth is estimated to fall on account of demographic changes over the next 20 years.

Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies. The tax system depends heavily on the taxation of labour, which weighs on growth prospects. The government's plans to raise pension entitlements, if implemented, will make it more difficult to lower the relatively high labour tax wedge further and are not targeted at alleviating future poverty risks among the elderly. The exemption of housing from capital gains tax biases household investment decisions in the context of rising prices and benefits high-wealth households. Public investment is low and government spending on key services to support inclusive growth, notably childcare services, needs to rise further. On unchanged policies, targets for CO_2 emission reductions will be missed.

Improving financial sector resilience. The German banks have weathered the euro area crisis well but remain vulnerable. Potential risks arise from the low interest-rate environment and large derivative exposures. These potential risks are aggravated by high leverage of the country's largest banks and persistent perceptions of government guarantees to banks. Lending growth remains weak. The upcoming EU-wide stress tests and the Asset Quality Review will provide guidance on action needed to shore up the banking system.

Strengthening the contribution of the services sector to economic growth. The contribution of the services sector to value-added growth in Germany has been relatively small over the past 10 years. Product market competition has become sharper overall. Nonetheless, in some domestically oriented service sectors, notably some network industries and professional services, regulation protects incumbents from competition. While export oriented manufacturing is exposed to international competition and responds with productivity-increasing innovation and human capital accumulation, service sector productivity is lagging.

Making economic growth more socially inclusive and reducing disparities in well-being. Inequality and relative poverty in Germany have risen since the mid-1990s, as elsewhere, although income inequality has not increased since 2004 and has remained lower than in most OECD countries. Poverty risk has increasingly affected employees with relatively low employment protection or limited access to unemployment insurance, as well as many part-time and self-employed workers. Youth who have not graduated from upper secondary education face poor lifetime employment prospects and education outcomes continue to depend strongly on socio-economic background.

Key recommendations

Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies

- Make the tax system more supportive of inclusive growth. Broaden tax bases by updating property tax valuations and extending capital gains taxes on residential real estate, except for owner-occupied housing. Lower social security contributions, especially for low-pay workers.
- Focus additional pension entitlements on reducing future old age poverty risks. Fund such spending from general tax revenue. Prioritise spending on growth-enhancing items such as infrastructure and childcare.
- Phase out tax expenditures for activities that damage the environment while avoiding harming international competitiveness, and better align environmental taxation with negative externalities. To this effect maintain high support for international solutions.

Improving financial sector resilience

- Ensure that banks are adequately capitalised. Introduce a leverage ratio requirement as a complement to capital ratios in line with international agreements. Give consideration to introducing a leverage ratio requirement for systemically important banks before 2018.
- When transposing the European Union's Bank Recovery and Resolution Directive into German law, aim for enabling the authorities to include bank debt as comprehensively as possible in the future bail-in instrument. Clarify the priority for financial stability objectives over creditor rights when resolution legislation is applied.
- Micro- and macroprudential regulation should address remaining risks emanating from *Landesbanken*. The *Länder* should continue restructuring the *Landesbanken*, including through privatisation.

Strengthening the contribution of the services sector to economic growth

- Reassess regulation with respect to unintended entry barriers and abandon price regulation in some professional services.
- Strengthen the regulator's powers in the railways and broaden rights to issue SIM cards in mobile communications.

Making economic growth more socially inclusive and reducing disparities in well-being

- Provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic backgrounds. Provide more support for disadvantaged youth to complete formal upper secondary education, in particular mainstream VET. Continue reducing the assignment of pupils to special needs schools and make sure assignment to such schools does not reflect the socio-economic background of pupils.
- Reduce the gap in employment protection between permanent and temporary workers. Introduce a minimum wage, set by an expert commission, across all economic sectors. Better target the preferential tax treatment of *minijobs* towards low-wage workers.

Assessment and recommendations

- *Economic growth is strengthening but medium-term prospects need to be improved*
- *Strengthening financial sector resilience*
- *Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies*
- *Strengthening the contribution of the services sector to economic growth*
- *Further labour market reforms can partly offset the impact of demographic change on labour supply*
- *Making economic growth more socially inclusive*

Economic growth is strengthening but medium-term prospects need to be improved

The German economy has continued to outperform most euro area economies, backed up by a large, competitive and innovative manufacturing sector, a robust labour market and its status as a "safe haven". Its real GDP per capita has risen above pre-crisis levels. Nonetheless, economic recovery from a drop in output at the end of 2012 has been slow, as euro area financial tensions have diminished only gradually (Figure 1).

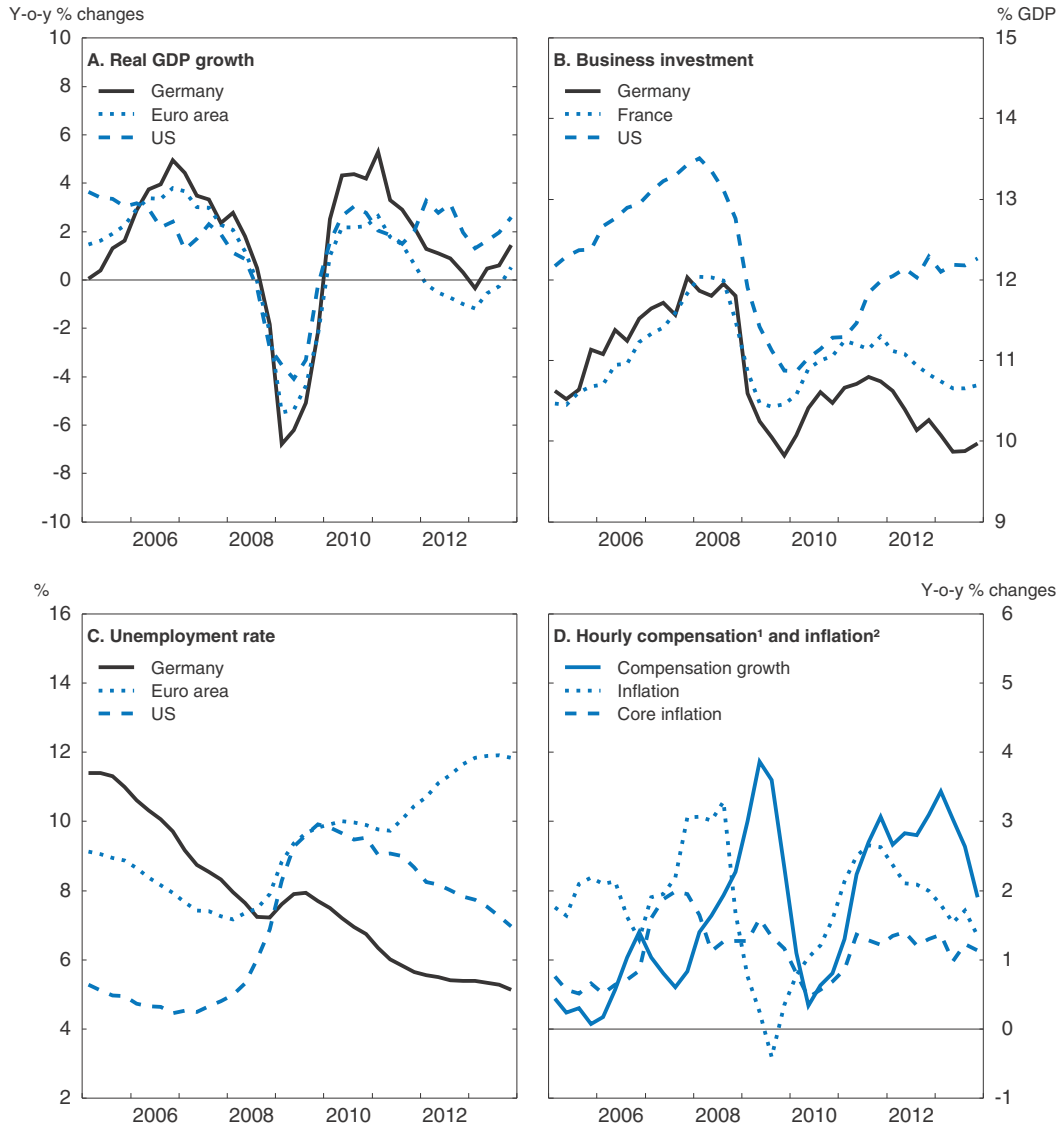
Weak demand from the euro area and decelerating demand from emerging economies damped export growth over the last two years. Domestic demand growth has held up partly because of strong labour market performance with unemployment now being below its equilibrium rate. Real wage growth has boosted consumer confidence. Financial instability and weak growth in the euro area appear to have constrained domestic demand growth. Indeed, business investment spending has been damped by uncertainty about the evolution of the euro area debt crisis and related policies (Federal Ministry of Economy and Technology, 2013). Surveys indicate that German businesses are increasingly willing to shift investment abroad (DIHK, 2013) and to create new production capacity closer to the more dynamic, more distant markets. Inflation remains subdued, reflecting the decline of import prices and a still negative output gap, which the OECD estimates to amount to ¾ per cent of GDP in 2013. The output gap may however be larger, as the estimate does not include the impact the recent increase in immigration (see further below) may have on potential output.

Reflecting these developments, the current account surplus has remained close to record highs (Figure 2). The structural surplus could be slightly larger because of the larger negative output gaps in major trading partners in the euro area (Ollivaud and Schwellnus, 2013). The goods trade surplus with other euro area countries has fallen from 4% to 2% of GDP. As a counterpart to current account surpluses, net foreign assets have continued to increase. The Bundesbank accounts for most of the increase in recent years, reflecting the build-up of the *Target 2* claims, while the banking sector reduced its foreign assets, notably with respect to euro area crisis economies.

The recovery is projected to continue on the basis of further gradual expansion of domestic demand. Private consumption will continue to be underpinned by solid labour market performance while gradual recovery in the euro area is expected to strengthen investment spending, reducing the current account surplus somewhat (Table 1). GDP may rise above its potential level in 2015 while unemployment is expected to edge down by a small amount. Budgetary measures planned by the new government may reduce the budget surplus somewhat (see below).

Risks surrounding the outlook remain substantial. As demand growth from emerging economies has weakened, the economic recovery is likely to depend to a larger extent on a recovery in Europe than in the previous expansion phase. Renewed financial tensions, notably within the euro area, could lower exports and investment and push up

Figure 1. **Key economic indicators**



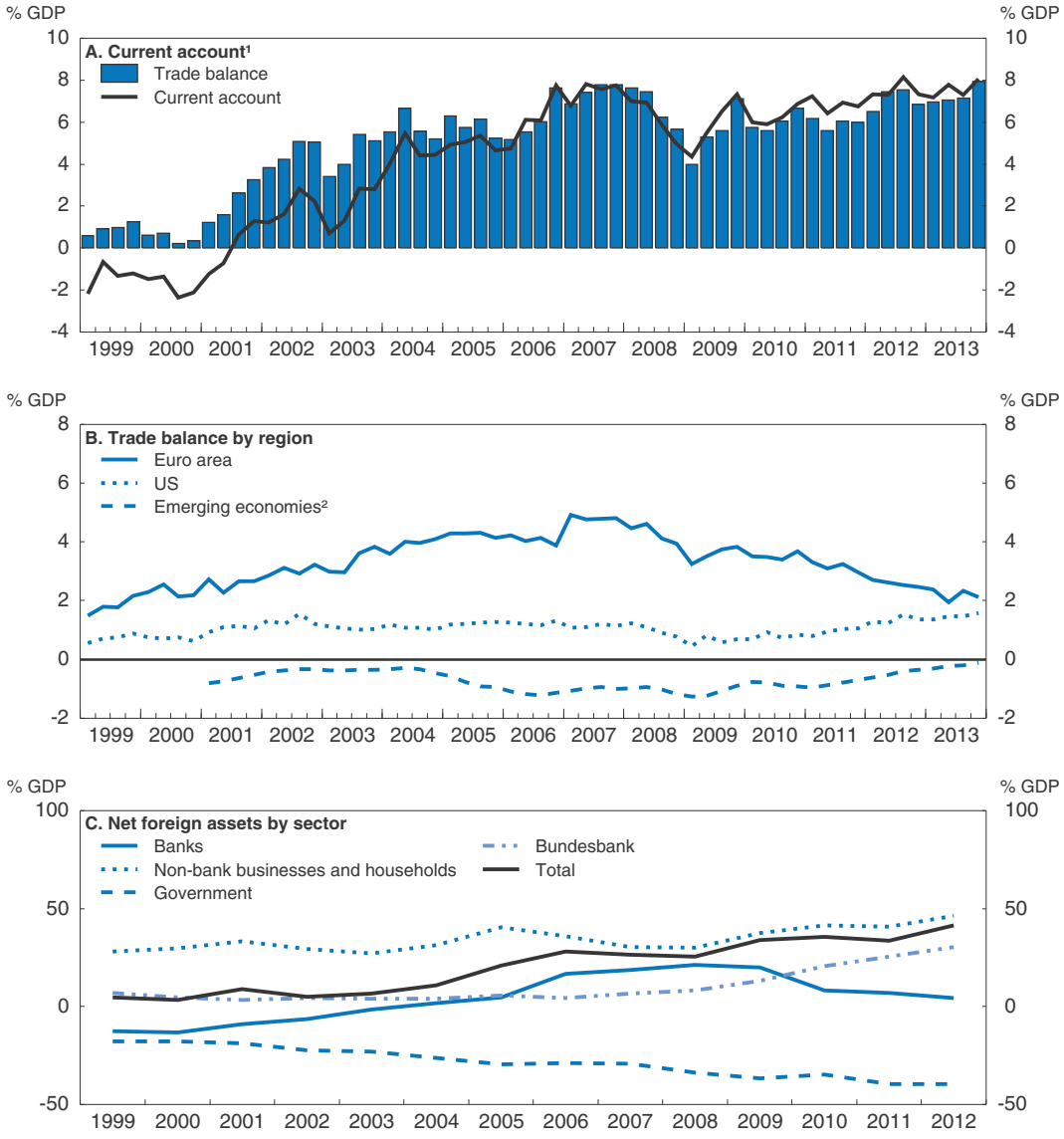
1. 3-quarter moving averages of working days adjusted nominal labour costs for the industry, construction and services except activities of households as employers and extra-territorial organisations and bodies.
2. Harmonised consumer price index (2005 = 100), seasonally adjusted. Core inflation excludes energy, food, alcohol and tobacco.

Source: *OECD Economic Outlook Database* and Eurostat.

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unemployment, which would also weaken growth of private consumption. Renewed financial tensions could also affect German financial intermediaries. Such tensions could have an adverse impact on lending and raise financial risks to taxpayers, especially among banks with relatively weak capital buffers. On the other hand, improving confidence in the euro area recovery could boost GDP growth beyond projected levels. Progress in creating a banking union in the euro area, including a common fiscal backstop, would help reduce feedback loops between government finances and banking sector health in the euro area and contribute to financial stability, with economic benefits for Germany, including by

Figure 2. **The current account, the trade balance and net foreign assets**



1. Net current account, seasonally adjusted.
2. 12-month moving average of trade balance with BRIICS countries: Brazil, Russia, India, Indonesia, China and South Africa.

Source: Deutsche Bundesbank, *OECD Economic Outlook Database* and DataStream.

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strengthening its attractiveness as a location to invest. Germany should therefore support efforts to build such a banking union as soon as possible.

In the absence of further structural reforms the potential growth rate is expected to decline in the next 20 years as a result of population ageing (Figure 3). While past pension reforms have reduced the budgetary impact of demographic change, lower GDP growth will reduce the capacity of the economy to finance public services which contribute to well-being, notably health and long-term care services, for which demand is likely to rise. Against this background, the challenge is to strengthen medium-term growth prospects, broaden its sectoral basis and make the economy more resilient to financial sector shocks.

Table 1. **Macroeconomic indicators and projections**
Annual percentage change in volume terms unless specified otherwise

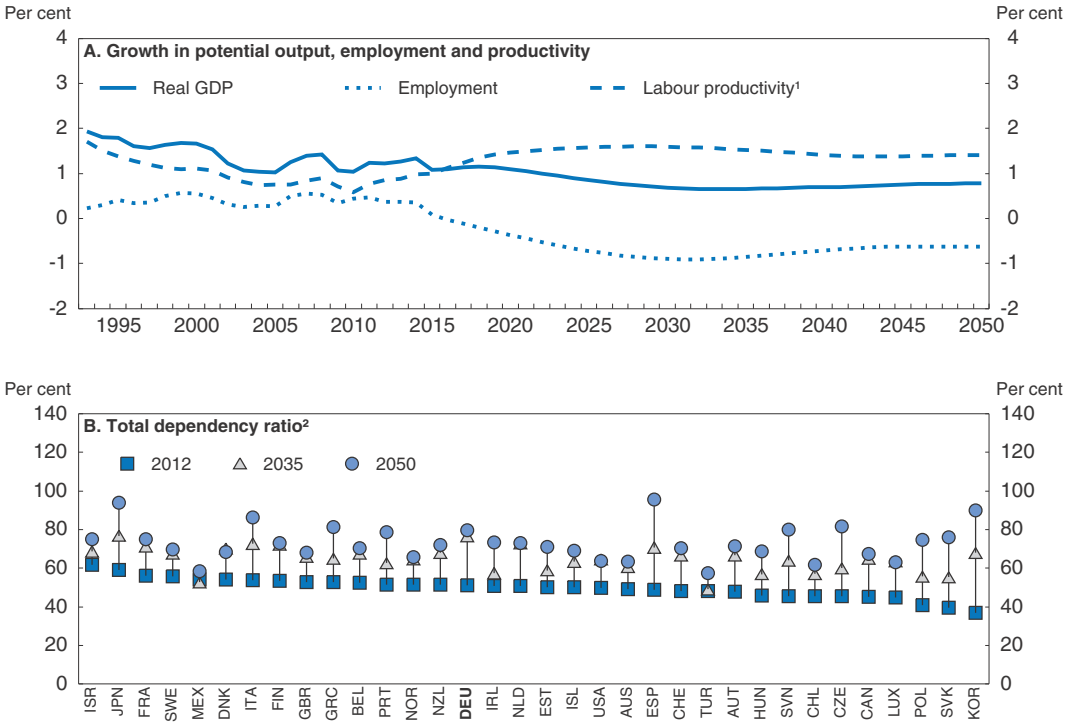
	2010 current prices (EUR billion)	2011	2012	2013	2014	2015
GDP without working day adjustment	2 495	3.3	0.7	0.4	1.9	2.3
Working-day adjusted GDP	2 490	3.4	0.9	0.5	1.9	2.1
Private consumption	1 435	2.3	0.7	1.0	1.4	2.0
Government consumption	487	1.0	1.0	0.7	1.6	1.7
Gross fixed capital formation	432	7.1	-1.3	-0.5	5.7	4.8
Housing	132	9.1	1.9	0.9	6.9	4.2
Business	259	6.8	-2.2	-1.7	4.7	5.4
Government	42	2.6	-7.1	2.0	7.7	2.5
Final domestic demand	2 354	2.9	0.4	0.7	2.2	2.5
Stockbuilding[1]	-2	-0.1	-0.6	-0.1	-0.6	0.0
Total domestic demand	2 352	2.8	-0.2	0.5	1.6	2.5
Exports of goods and services	1 183	8.1	3.8	1.0	5.1	4.6
Imports of goods and services	1 045	7.5	1.8	1.0	4.8	6.0
Net exports[1]	138	0.7	1.1	0.0	0.4	-0.3
Other indicators (growth rates, unless specified)						
Potential GDP	..	1.2	1.2	1.2	1.3	1.2
Output gap[2]	..	0.3	0.1	-0.6	0.1	0.9
Employment	..	2.3	1.0	1.0	0.6	0.4
Unemployment rate[3]	..	6.0	5.5	5.3	5.0	4.9
GDP deflator	..	1.2	1.5	2.2	1.3	1.7
Harmonised index of consumer prices	..	2.5	2.1	1.6	1.1	1.8
Core HICP	..	1.2	1.3	1.2	1.3	1.8
Household saving ratio, net[4]	..	10.4	10.3	10.0	9.9	9.7
Current account balance	..	6.8	7.5	7.6	7.9	7.4
Government financial balance[5]	..	-0.8	0.1	-0.1	-0.2	0.2
Underlying government primary balance[2]	..	0.8	1.4	1.2	0.8	0.7
Government gross debt (Maastricht definition)[5]	2 057	80.1	81.0	78.4	76.4	72.3
Government gross debt (national accounts definition)[5]	2 146	85.8	88.5	85.9	83.9	79.8
Government net debt[5, 6]	1 232	50.5	50.5	49.1	47.8	45.8
Three-month money market rate, average	..	1.4	0.6	0.2	0.1	0.1
Ten-year government bond yield, average	..	2.6	1.5	1.6	1.7	2.2

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of the labour force.
4. As a percentage of household disposable income.
5. As a percentage of GDP.
6. Gross debt (national accounts definition) minus assets.

Source: Federal Statistical Office and *OECD Economic Outlook 95 Database*.

The new government which took office in December 2013 has presented a programme for the next 4 years. It foresees some steps which will help raise labour supply and improve human capital utilisation, strengthening potential growth. These steps are welcome and address some of the recommendations made in previous *Economic Surveys* (Annex). Some of these measures will also improve well-being and help make economic growth more socially inclusive. Key aspects of the government programme are discussed further below. However, the programme also includes measures raising pension spending. These measures make earlier retirement more attractive and are not targeted at alleviating future poverty risks among the elderly.

Figure 3. **Potential growth and ageing effects**



1. Labour productivity is calculated as real GDP divided by total employment.
2. Total dependency ratio is population aged under 15 or 65 and over divided by population aged 15-64 (working age).

Source: OECD Population Statistics Database and *OECD Economic Outlook 93 long-term Database*.

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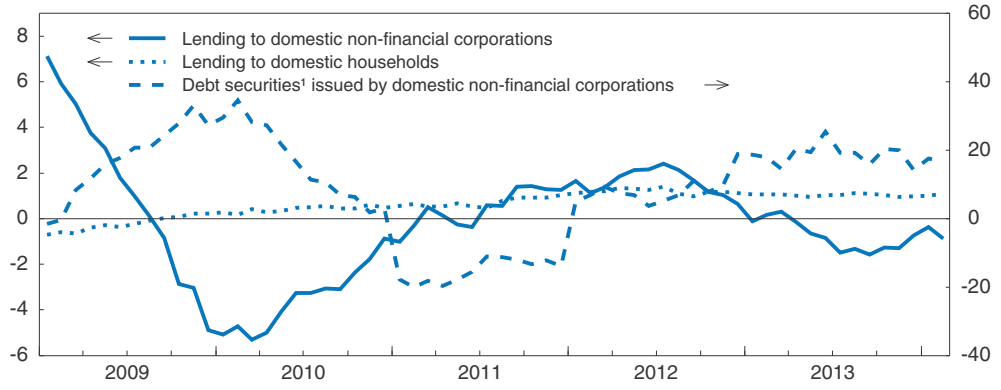
Strengthening financial sector resilience

Funding conditions for non-financial firms are favourable. Nonetheless, despite low interest rates and the "safe haven" status of German financial assets, domestic lending growth has been negative (Figure 4). Business surveys point to weak demand for loans notably among firms. According to the ECB's SAFE survey and the survey of the German Ifo Institute of Economic Research, access to finance is comparably easy for German firms. However, the euro system bank lending survey suggests that the tightening of the supply conditions of bank lending that took place in 2008 and 2009 has not been significantly reversed. Corporations have increasingly gone to the bond markets, thereby taking advantage of low interest rates. Credit supply standards could become more binding as the recovery gains momentum if loan demand picks up strongly and banks do not soften their lending standards in line with improving economic developments.

Although German banks have reduced their claims on euro area periphery economies in recent years, financial ties with the euro area remain strong. Some banks may also suffer losses related to other cross-border activities, such as shipping and foreign commercial real estate. While these exposures are modest relative to the sector as a whole, they are concentrated in a few banks (Deutsche Bundesbank, 2012a and 2013a). Recognising risks and losses early on through transparent and conservative valuation of assets helps reallocate loanable funds to their most productive use (e.g. IMF, 2002; Bouis et al., 2013). The euro area bank asset quality review will be useful in this regard. Moreover, low interest rates in Germany and elsewhere reinforce incentives for risk taking. The housing market

Figure 4. **Growth of bank loans and corporate bond issuance**

Year-on-year percentage changes



1. Outstanding amounts.

Source: Deutsche Bundesbank.

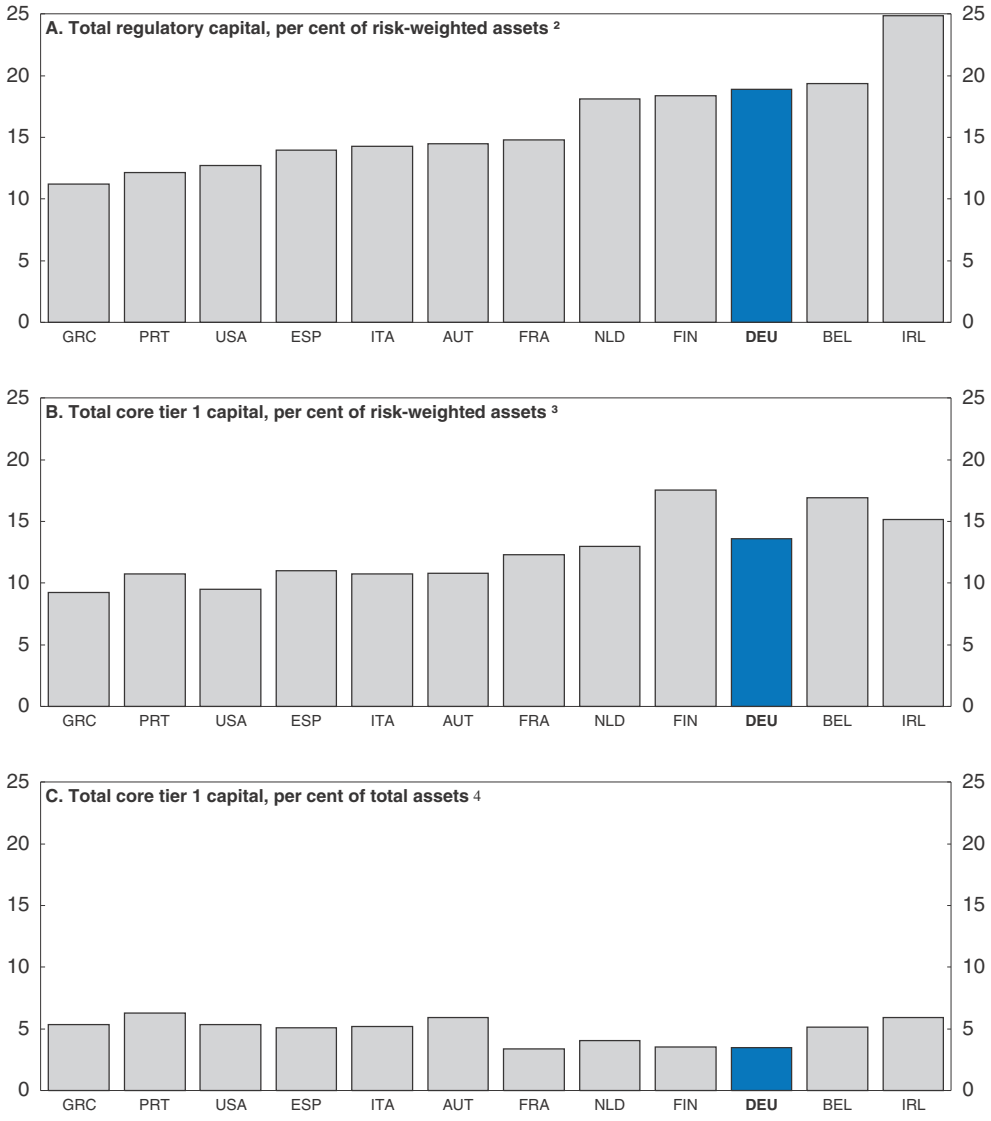
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does not seem to be a risk for the financial sector at present, although developments need to be monitored carefully. House prices may have risen above fundamentals in some urban centres, but overall price increases still appear aligned with fundamentals (Deutsche Bundesbank, 2013a).

The government has taken important steps ahead of the future EU resolution regime to lower financial risks to the economy and to government finances. Legislation was introduced in 2011 giving the authorities more extensive powers to resolve non-viable banks. More recently the supervisor has received further powers to require banks to cooperate in preparing contingent restructuring and resolution plans. Further reforms include strengthened macroprudential regulation and managerial liability. The new macroprudential framework is timely, as Germany's cyclical position is stronger than the euro area's. It includes a new Committee for Financial Stability with voting representatives from the Bundesbank, the Federal Financial Supervisory Authority, and the Ministry of Finance. The Committee can issue recommendations to public sector agents on the basis of the comply-or-explain principle. The large banks will fall under direct bank supervision by the European Central Bank when the Single European Supervisory Mechanism is introduced in the fall of 2014.

German banks have raised their capital ratios in recent years and mostly meet European Union and Basel III capital requirements, reflecting improved profitability, which is close to pre-crisis levels (Deutsche Bundesbank, 2013b). Some banks have strengthened capital ratios ahead of the euro area asset quality review and stress tests and ahead of stricter Basel III rules. However, Core Tier 1 capital relative to total assets (as measured by IFRS) remained below 3% in some of the biggest, internationally active banks in 2013. Stock market assessments of net worth of the largest private banks, where available, were similarly low (Chapter 1). This is of particular concern, as these banks are particularly interconnected and may be too big to fail. The central importance of the German banking system argues for a strong capital position. While average regulatory and Core Tier 1 capital relative to risk-weighted assets of the banking system are higher than in many OECD economies, Core Tier 1 capital relative to unweighted assets is relatively low (Figure 5). Basel III envisages a leverage ratio requirement, to be calibrated in 2017 based on

Figure 5. **Capital ratios and leverage ratios**[1]



1. Averages, weighted by individual banks' total assets.
2. Total regulatory capital is defined under the latest regulatory guidelines at period-end. For European banks, this excludes transitional capital adjustments when available. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
3. Total Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
4. Based on quarterly data as of December 2013; where these are not available the most recent available data are taken, extending back to December 2012. The leverage ratio relates banks' Core Tier 1 capital to total assets, in book values. Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Data for total assets are adjusted to reflect the International Financial Reporting Standard (IFRS).

Source: SNL Financials, Bloomberg, DataStream and OECD calculations.

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the experience during the previous observation period. The authorities could consider introducing a leverage ratio requirement for systemically important banks before then to complement capital ratios (which weight assets by risk). More generally, to durably limit risks emanating from financial intermediaries it is also important to ensure high ethical standards in the industry and strengthen corporate governance.

While higher capital requirements raise the private funding costs for banks, historic experience and empirical evidence suggests that these higher costs mostly reflect the reduced value of implicit government guarantees for banks and the reduced scope to deduct capital costs from taxable profits. These do not raise funding costs from a social point of view. The damping impact on domestic lending growth and activity is therefore likely to be limited in the long-run and is offset by the benefits of improved stability and lower risks for taxpayers (Admati et al., 2010). In the short term, stricter capital requirements may result in lower lending as banks may shorten balance sheets to meet stricter requirements. To mitigate the risk of reduced lending growth in the short term, the authorities could require profits to be retained or define additional required capital in nominal terms, rather than relative to the balance sheet.

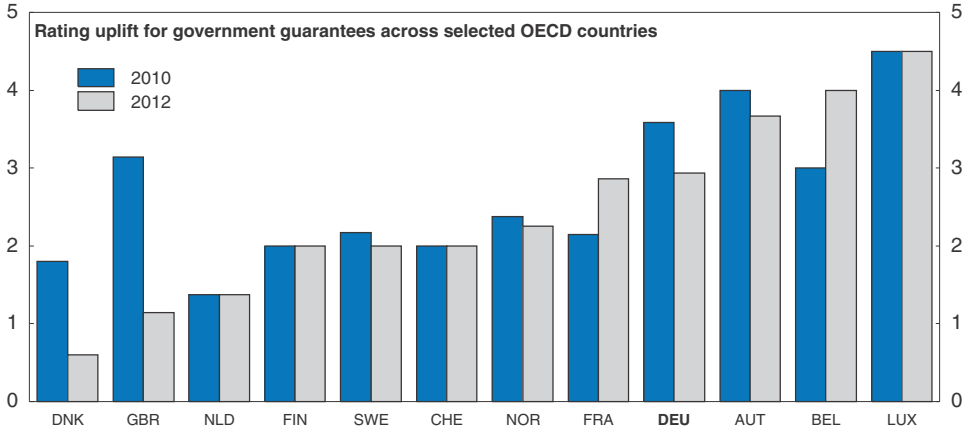
Effective resolution tools are important to remove failing banks from the market

With the implementation of the Bank Restructuring Act 2011, Germany moved ahead of many OECD countries in giving authorities more powers to facilitate the reorganisation of weak banks and the resolution of non-viable banks (Financial Stability Board, 2012). This framework establishes a mechanism which allows the authorities to ensure that bank debt absorbs losses in banks which need to be restructured and recapitalised ("bail-in"). However, this mechanism applies only if systemically important activities are transferred to a bridge bank. The EU Bank Recovery and Resolution Directive will require a more flexible bail-in tool from 2016. When transposing the directive Germany should aim for enabling its authorities to include bank debt as comprehensively as possible in its future bail-in instrument. Germany is one of few countries in which resolution authorities have the power to depart where necessary from the general insolvency principle of equal treatment of creditors of the same class. German legislation respects the protection of creditors' rights as a fundamental feature of financial markets. However, with respect to resolution legislation some financial market experts have criticised that the objective of financial stability is given priority over the protection of creditors' rights only under certain conditions (Hellwig, 2012). The Bank Restructuring Act may not have succeeded in convincing market participants that banks would not be bailed out. Indeed, perceptions of implicit guarantees of bank liabilities by the government are high compared to other European economies with high sovereign credit rating (Figure 6).

To limit incentives for excessive risk taking in investment banking, parliament has approved legislation which requires banks to separate certain trading activities and other risky activities from deposit-taking. Separation of risky proprietary trading activities and asset positions from deposit banking can mitigate the too-big-to-fail problem, making it easier to wind a failing bank down. It also helps remove cross-subsidisation from the implicit guarantees of being part of a large insured deposit bank with access to central bank lending (Blundell-Wignall and Atkinson, 2011).

The large German banks have built up particularly large derivative positions relative to GDP in international comparison over the past 15 years in the context of strong global growth of such positions. The interconnectedness of these positions exacerbates systemic risk. However, market participants pointed out that banks are in the process of entering into netting arrangements across a variety of deals with the counterparties to reduce their gross derivative exposures and hence the systemic risk resulting from this interconnectedness. Recent empirical work at the OECD suggests that, in contrast to primary securities, derivative positions raise default risk (Blundell-Wignall and Roulet, 2012). A large share of the large

Figure 6. **Perceived government guarantees for major banks across countries**



Note: Average uplift, calculated as the difference in notches between all-in credit rating and the adjusted stand-alone credit rating, which already factors in parental and co-operative support; hence the difference reflects regional government and systemic support only. Sample consists of 123 large European banks.
Source: S. Schich and S. Lindh (2012), "Implicit Guarantees for Bank Debt: Where Do We Stand?", *OECD Financial Market Trends*, Vol. 2012/1.

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banks' derivative business appears to serve the purposes of tax and regulatory arbitrage, for example to change the risk weights applied to primary assets in the bank balance sheet (OECD, 2011a). In these cases derivatives trade is of no social value. It therefore is particularly desirable to avoid cross subsidisation of this business. Owing to their interconnectedness and their significance in raising default risk, separating derivative business from retail banking, which supplies the key payment and lending services, may also be particularly useful for stability reasons. These arguments suggest that derivatives should play an important role in determining separation requirements (Blundell-Wignall and Atkinson, 2013).

Reforming the public banking sector further

Germany's public banks account for more than 40% of banking sector assets, mainly in the local savings banks and the regional *Landesbanken*. The savings banks are sectorally diversified but locally specialised. This "regional principle" has brought economic benefits in terms of keeping coverage of the population with basic financial services high and in terms of access to loan finance for small and medium-sized businesses. It has encouraged regional economic development in relatively poorly developed regions (Hakenes et al., 2009). Savings banks appear to be at least as efficient as commercial banks (Kötter, 2006; German Council of Economic Experts, 2008; Altunbaş et al., 2001). They operate a bottom-up mutual guarantee system covering all liabilities. Such guarantees create moral hazard, although cooperative and savings banks have created internal auditing procedures to mitigate that risk and over the last 40 years few savings banks have required support from the guarantee system.

By contrast, the *Landesbanken* have frequently received financial support from the *Länder* governments (German Council of Economic Experts, 2008) to compensate heavy losses. Since the outbreak of the global financial crisis the *Landesbanken* have reduced their balance sheets and made efforts to shift their business model towards lending to bigger SMEs. Nonetheless only 20% of their assets consist of loans to the domestic non-financial private sector (Chapter 1). A substantial share of assets consists of securities, foreign loans,

as well as loans to other banks and to the German government sector. Some *Landesbanken* are majority-owned by the *Länder*, the rest by the savings banks. One *Landesbank* has a minority private stake. Their limited relationship to the regional economy makes it more difficult for the *Länder* owning these banks to control their activities. Some observers (Hellwig, 2010) have argued that the *Landesbanken* finance their regional governments in a non-transparent way, which generates conflicts of interest. The track record of some *Landesbanken* with regard to technical efficiency and allocation of lending is also relatively poor, in part reflecting poorly defined business models (OECD, 2010).

Most *Landesbanken* have close financial relationships with the savings banks. These links are encouraged by regulatory settings which provide privileged treatment to savings banks' loans to *Landesbanken*. Moreover they are integrated in the mutual guarantee schemes of the savings banks. If financial problems were to recur among the *Landesbanken*, they could spread to the savings banks. During the global financial crisis, such spreading was limited by government bail-outs which are undesirable and are being curtailed by EU legislation. The *Landesbanken* may also pass on systemic financial risks because of their significant role in interbank lending. Since savings banks cannot generally raise capital externally any losses the savings banks may suffer from financial exposure to *Landesbanken* could result in contraction of their balance sheets to meet capital requirements. These arguments suggest that the *Länder* should continue restructuring the *Landesbanken* including through privatisation. Those *Landesbanken* whose business models generate excessive risks could be subject to additional micro- and macroprudential requirements. Such steps could also help encourage *Länder* governments to push needed restructuring of *Landesbanken*.

Recommendations on strengthening the resilience of the financial sector

- Ensure that banks are adequately capitalised. Introduce a leverage ratio requirement as a complement to capital ratios in line with international agreements. Give consideration to introducing a leverage ratio requirement for systemically important banks before 2018.
- When transposing the European Union's Bank Recovery and Resolution Directive in German law, aim for enabling the authorities to include bank debt as comprehensively as possible in the future bail-in instrument. Clarify the priority for financial stability objectives over creditor rights when resolution legislation is applied.
- Micro- and macroprudential regulation should address remaining risks emanating from *Landesbanken*. The *Länder* should continue restructuring the *Landesbanken,* including through privatisation.

Fostering better balanced, socially inclusive and greener long-term growth with fiscal policies

Fiscal policy is expected to remain broadly neutral in 2014 and 2015. The coalition agreement foresees new spending commitments of about 0.4% of GDP in 2014 and an additional 0.2% of GDP in 2015 which may be partly offset by other budgetary measures and by declining interest payments. Public debt relative to GDP will continue to fall, as the general government budget is expected to remain close to balance, both in headline and structural terms, and legacy portfolios acquired from banks in the global financial crisis are being reduced. Fiscal policy should remain neutral, as the output gap is expected to close in 2015 and public debt is still high. Appropriately the government has committed to

reducing the public debt burden below 70% in 2017, a target which will be reached with a neutral fiscal stance provided the reduction of legacy portfolios from banks continues.

More generous pension entitlements to be enacted in 2014 account for most of planned higher spending. In particular, higher pensions will be paid to women who gave birth before 1992, and workers with long contribution records will be able to retire on a full pension 2 years before the legal retirement age (see Chapter 3 for the details of the plans). In the medium term, these measures will be funded by payroll contributions, which are projected to be 0.4 percentage points higher as a result of the planned measures by 2030. The tax burden needed to finance these measures will tend to damp employment. Moreover, the reforms do not address future old-age poverty risks. Further pension spending pressures may arise if these poverty risks materialise and existing means-tested benefits for the elderly are considered insufficient. Funding increased redistributive spending for the elderly from general tax revenue rather than from social security contributions could be more employment and growth friendly (see also further below) and share the burden more broadly and equitably among all tax payers.

Other spending projects of the new government, amounting to about 0.2 percentage points of GDP annually, are mostly devoted to transport infrastructure investment, improvement of formal childcare facilities and education. These spending plans are broadly aligned with growth and welfare-enhancing priorities. Over the past 15 years, budgetary constraints have damped government investment spending, which has dropped below estimated depreciation of government-owned capital (Table 2). According to an estimate by the German *Länder,* making up for the past shortfall of replacement investment in transport infrastructure alone would require an overall spending effort of 1½ per cent of GDP. Ensuring investment keeps up with future maintenance could, in addition, require raising spending by 0.2% of GDP per year (Daehre Kommission, 2012). These estimates cover transport infrastructure that is financed by all level of governments. Higher public spending to improve the availability of full-day childcare facilities would have large benefits by raising female labour supply and educational achievements of children from disadvantaged backgrounds later in life.

Table 2. **Government financial indicators**

% of GDP

	1997	2007	2012	2013
General government current receipts[1]	45.0	43.5	44.3	44.2
Government current disbursements excluding interest[1]	42.8	40.4	41.8	41.9
Gross government interest payments	3.4	2.8	2.4	2.2
Social security benefits paid by general government	18.5	16.5	16.1	16.0
Government fixed capital formation	1.9	1.5	1.5	1.5
Government consumption of fixed capital	1.8	1.7	1.7	1.7
Government financial balance[1]	-2.0	-0.4	-0.2	-0.1
Government gross debt (Maastricht definition)	59.7	65.1	81.0	78.3

1. Cyclically adjusted. Per cent of potential GDP.
Source: OECD Economic Outlook 95 Database.

Room to fund higher spending on growth-enhancing policies could be made by reducing fiscal support for activities that damage the environment (OECD, 2012b). For example, tax breaks for company cars and commuting allowances should be reconsidered. Furthermore, exemptions and reduced tax rates in the VAT should be removed, although

necessary compensating measures for low income households would reduce the net revenue of this measure. There also is scope to redirect family support away from measures which have proven harmful to labour supply and provide little benefit in terms of reducing poverty risk (see below). Efficiency gains could also be made on the revenue side through the re-allocation of the tasks of administrating and collecting tax revenues from the *Länder* to the federal government (OECD, 2012a). The current assignment of tax administration responsibilities reduces incentives for effective tax collection. While the *Länder* bear the costs, each *Land* keeps only part of the revenues from raising tax collection effort, because the federal government receives up to 50% of revenues of major taxes and because the financial equalisation among the Länder redistributes revenues from *Länder* with high tax revenues to *Länder* with low tax revenues.

Tax reform can raise potential growth, make it greener and socially more inclusive

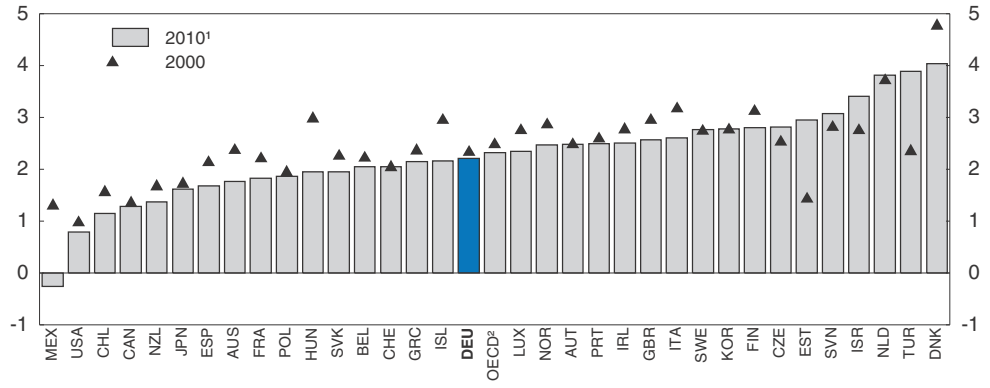
Revenues are heavily dependent on the taxation of labour income (OECD, 2012a) despite a reduction of social security contributions by 0.6 percentage points in 2013. The effective labour tax burden is particularly high for low-wage earners. As recommended in the *2012 Economic Survey,* the tax system should be made more growth friendly by reducing the tax burden on labour income, especially for workers on low pay. Such a reform should also include measures on the expenditure side of the social security system. More revenues could be raised from real estate taxes, including by updating underlying valuations although the scope for higher taxes is reduced by municipal fees.

More effective environmental taxation would also raise more revenue. At 2.2 % of GDP in 2011, revenues from green taxes in Germany are in line with the OECD average. Energy taxes in Germany are raised primarily for budgetary reasons and therefore do not always consistently reflect all environmental externalities. For instance, diesel is taxed at a lower rate than petrol, although it has a higher carbon content and emits more local pollutants harmful to human health. Parts of the energy-intensive industries are exempt from energy taxation or benefit from tax reductions which are motivated by competitiveness considerations and these exemptions are not always aligned with participation in European carbon emissions trade (OECD, 2012b). Nominal energy tax rates have remained virtually unchanged since 2003 although some are, especially concerning motor fuels, significantly above rates in other European countries. This has resulted in a declining share of taxation in fuel prices. The motor vehicle tax could also be revised to further encourage the adoption of energy efficient cars. The emission-based highway toll for heavy goods vehicles, which has helped increase the uptake of low-emission freight vehicles, could be extended to light duty vehicles or to passenger cars. The new government is considering introducing such tolls for foreign-registered passenger cars, which will generate a considerable administrative burden.

There is also scope for removing tax advantages and exemptions in the taxation of capital gains and bequests. Households are fully exempt from capital gains tax on housing property held for more than 10 years, including on dwellings not inhabited by the owner. Housing ownership is highly concentrated in wealthy households (Deutsche Bundesbank, 2013c) who therefore benefit the most from this exemption (Frick and Grabka, 2009; European Central Bank, 2013). The tax exemption risks biasing investment decisions towards residential housing, especially in the current low interest rate environment which may encourage expectations of rising prices.

Figure 7. **Revenues from environmentally related taxes**

As a percentage of GDP



1. 2009 for Canada, Greece and Slovak Republic.
2. Unweighted average.

Source: *OECD/EEA Database* on instruments used for environmental policy.

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Wealth held in enterprises benefits from preferential inheritance tax treatment under certain conditions. This tax regime generates incentives for wealthy households to transform private into business property (Bach and Beznoska, 2012a). The conditions for such transformations have recently been tightened. Compared to wealth taxes, inheritance taxation has relatively small distortionary effects on economic activity and entails lower administrative costs (Bach and Beznoska, 2012b). To avoid liquidity problems for businesses their inheritance tax payments can already be stretched over ten years. Over this period the government's claim could be subordinated to other claims in the business' balance sheet.

Recommendations on fiscal policy

Key recommendations

- Make the tax system more supportive of inclusive growth. Broaden tax bases by updating property tax valuations and extending capital gains taxes on residential real estate, except for owner-occupied housing. Lower social security contributions, especially for low-pay workers.
- Focus additional pension entitlements on reducing future old age poverty risks. Fund such spending from general tax revenue. Prioritise spending on growth-enhancing items such as infrastructure and childcare.
- Phase out tax expenditures for activities that damage the environment without harming international competitiveness, and better align environmental taxation with negative externalities. To this effect maintain high support for international solutions.

Other recommendations

- Maintain the fiscal stance in line with budget rules and continue reducing the public debt-GDP ratio.

Strengthening the contribution of the services sector to economic growth

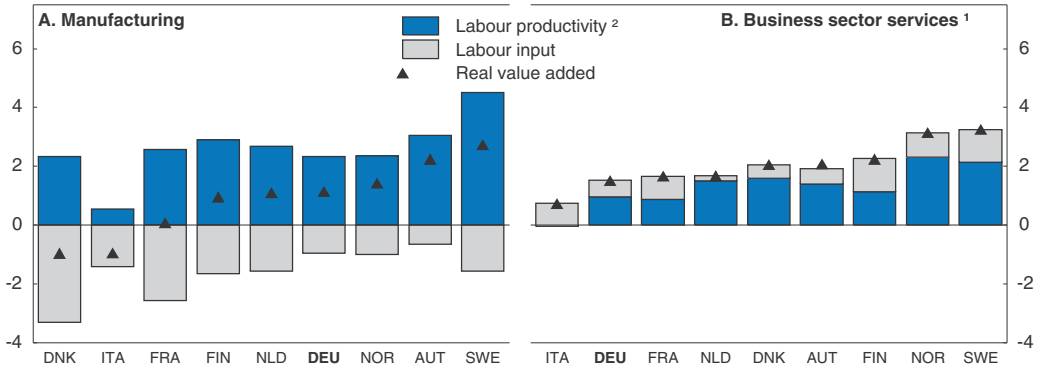
As in all high-income OECD countries, services contribute most to economy-wide value added although the manufacturing sector remains relatively large and accounts for

the economy's export orientation. More than 70% of manufacturing value-added was export-oriented in 2008. The business services sector is mostly oriented to serving domestic demand, with 25% of its value-added export-oriented. According to OECD trade in value-added data, a large share of German exports to neighbouring European countries, notably France, the Netherlands and Austria are inputs to final exports from these countries to outside Europe. Strong performance of firms in these countries therefore also supports competitiveness of the German economy.

Hourly labour productivity has developed favourably in manufacturing in the past decade, whereas in business services it has been weak in international comparison (Figure 8). Competition-friendly product market regulation has a marked impact on productivity performance in the services as well as in downstream industries that use services as inputs, including manufacturing (Barone and Cingano, 2011; Bourlès et al., 2010). Over the last 5 years, Germany made considerable progress in making product market regulation more conducive to competition. However, the regulatory protection of incumbents remains substantial in sectors which are not exposed to international competition, notably in some services.

Figure 8. **Real value-added and productivity growth in manufacturing and services**

Average annual growth rates, 2000-11 or latest year available



1. Business sector services comprise the following ISIC Revision 4 categories; Wholesale and retail trade, repair of motor vehicles and motorcycles; Transportation and storage; Accommodation and food service activities; Information and communication; Financial and insurance activities; Professional, scientific and technical activities; Administrative and support service activities. They exclude real estate activities.
2. Labour productivity is calculated as real value added divided by total hours worked.

Source: OECD STAN Database.

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Further efforts to increase competition and productivity in the services sector would have a positive economy-wide impact on potential growth and broaden its sectoral basis (Chapter 2). Thereby it could also strengthen demand for foreign goods and services, generating positive international spillover effects. While the effect of structural reforms of the services sector on the current account position is ambiguous from a theoretical point of view (Fournier and Koske, 2010) empirical studies suggest that they contribute to lowering current account surpluses (Ollivaud and Schwellnus, 2013; Coricelli and Wörgötter, 2012). This can happen also in the short term if boosting service sector reforms stimulates domestic investment (OECD, 2013a).

Regulatory barriers hold back competition in network industries, professional services and the crafts

Machine-to-machine communication is expected to be the market's main growth driver in the future, and automated communication will increasingly make use of mobile telecom infrastructure. In Germany, only mobile spectrum holders (and, for testing purposes, manufacturers) can issue SIM cards, including for machine-to-machine applications (CEPT, 2013). A large potential lies in breaking up this exclusive right. Permitting third parties to issue their own SIM cards would enable businesses and consumers in all sectors to seamlessly switch providers. This would increase competitive forces and reliability (OECD, 2012e).

Competition in the railway sector has slowly increased. Further efficiency gains in the railway market and downstream industries could be reaped. Vertical integration generates incentives for the incumbent to give its own transport service providers preferential access to the rail infrastructure which is owned by the incumbent. After almost 20 years of market liberalisation the incumbent still provides most freight, short and long-distance passenger transport services. The regulator has undertaken numerous interventions against the apparently discriminatory behaviour of the incumbent (FNA, 2012). The authorities should strengthen the regulator's powers by granting it more investigative and interventional competences, which will help ensure a level playing field between the incumbent and market entrants. A further liberalisation in the railway market on a European scale would stimulate cross-border transport, where growth potential for long-distance passenger and freight transport is considerable.

In some professional and other services, regulation in different forms has been accumulating over time to meet different objectives, like consumer protection or other societal preferences. These regulations should be examined with respect to the establishment of unintended entry barriers. It should be assessed whether the objectives can also be achieved in a more proportionate and equally effective way. For instance, in the crafts, it should be examined if the entry conditions could be further liberalised without jeopardising the dual vocational education system. Price regulation for some professions could be abolished without compromising consumer protection. Certain exclusive rights could be opened to a broader range of providers. The economic impact of deregulation would be significant as professional services account for around 10% of GDP.

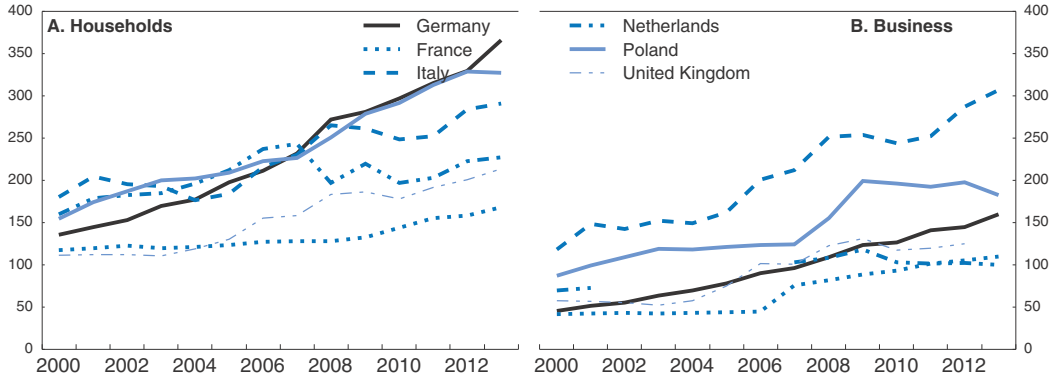
Making support for renewable energy more cost effective

Globally, net carbon emissions will need to be reduced to close to zero in the second half of the century to limit climate change to manageable levels. Appropriately, the government has targeted a reduction of CO_2 emissions of at least 80% by 2050, although they rose in 2012 after many years of decline. Lower prices for CO_2 emission certificates in the European Emissions Trade System (ETS) have reduced the cost of high-emission lignite and coal-based power generation, which has crowded out low-emission gas-fired power plants. In the context of uncertainty about long-term climate policies, low CO_2 prices can reinforce investment decisions in high-emission technologies creating lock-in effects, which may prove costly to unwind at a later stage when more demanding targets will need to be reached. Government projections as of 2012 indicate that the objective of reducing emissions to 40% below the 1990 level by 2020 will be missed on current policies. This outlook reinforces the need to apply tax instruments more consistently to price CO_2 emissions in sectors not covered by ETS (see above).

Government support for renewable energy thus remains necessary to meet its targets, especially given the decision to phase out nuclear power generation by 2022. The German system of renewables support, based on guaranteed subsidised feed-in tariffs funded by a surcharge on electricity prices, has provided reliable incentives for long-term CO_2 emission-reducing investments. It has compared favourably with support systems in other OECD economies (OECD, 2012a and b; IEA, 2013). However, the costs have risen strongly recently and are set to reach 0.8% of GDP in 2014. This reflects the rapid expansion of renewables production, in part encouraged by generous feed-in tariffs in some cases, as well as low wholesale electricity prices, which have increased the gap between guaranteed feed-in prices and market prices. These costs have been born by the electricity consumers. Households now face electricity prices which are considerably higher than in most neighbouring economies (Figure 9). Firms can be partially exempt from the surcharge if they use electricity intensively and face international competition. At the same time such firms have benefited from very low wholesale prices.

Figure 9. **Electricity prices in households and business**

USD/MWh converted using PPPs



Source: IEA (2014), *Energy Prices and Taxes, Quarterly Statistics*, 1st Quarter 2014.

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Reform options to limit costs of renewable support would be to link feed-in prices for all new plants to market developments, as recommended in the *2012 Economic Survey*. In particular, costs could be more effectively controlled by substituting guaranteed feed-in tariffs by tendering renewable production capacities (OECD, 2012b; IEA, 2013). Moreover, the burden of the costs of renewables support could be broadened, phasing out exemptions, which are granted to businesses on the grounds that they face international competition. The government envisages a number of steps in the right direction. It proposes reducing tariffs and introducing tenders in 2018. It also envisages broadening the range of electricity users paying the surcharge. The government should also support initiatives to reduce the supply of emission certificates in the European Union's trading scheme.

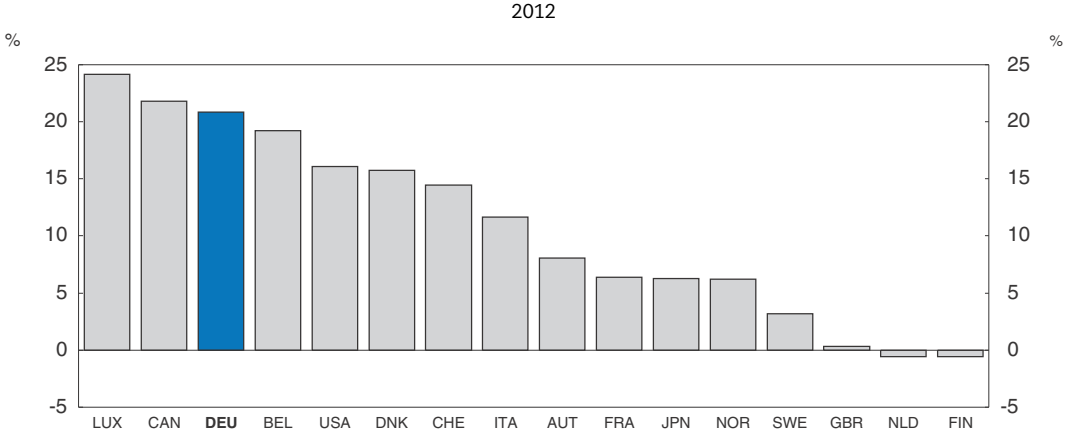
Further labour market reforms can partly offset the impact of demographic change on labour supply

Labour force participation increased between 2010 and 2013, partly driven by the continuing rise among older workers and women. Labour supply has also increased on account of higher immigration flows, mostly from Central and Southern European

countries. Nevertheless, shortages in numerous specific skills, notably in medium level skills, are holding back employment growth (OECD, 2013b). The number of hours worked per person employed is one of the lowest among OECD countries. One key factor is the relatively low incidence of full-time female labour participation. Only 62% of employed women work full-time compared to 74% OECD-wide in 2012, even though overall female labour market participation is above the OECD average. Women with school-age children have a particularly low propensity to work full-time.

The mix of tax and benefit policies favours single-earner over dual-earner couples and thereby provides disincentives for full-time employment of women. The difference between the tax rate on the main earner and the secondary earner is one of the largest among OECD countries (Figure 10). This is due to both the joint taxation of couples and the free health insurance of married spouses who do not have their own health insurance coverage. As recommended in previous *Economic Surveys*, the joint taxation should therefore be reformed, although full mandatory individual taxation of couples is not possible in Germany for constitutional reasons. Consideration should also be given to ending free health insurance for non-working spouses while ensuring that low-income households are compensated. The childcare subsidy paid to families who choose not to use childcare and to care for their one- and two-year-old children themselves discourages labour market participation and should therefore be abolished, as suggested in the *2012 Economic Survey*.

Figure 10. **Difference in average tax wedge between primary and secondary earners**



Note: The bars show the difference between the tax wedge of a worker if the spouse does not work and the tax wedge on the spouse's earnings if the spouse also decides to work. The main earner earns the average earnings and the secondary earner earns 67% of the average earnings in a family of a married couple with two children. The tax wedge is labour taxes (income taxes plus employee and employer social security contributions) in per cent of labour costs. For second earners, it also includes possible changes in family-based benefits and taxation as a result of the second earner entering employment.
Source: OECD (2013), *Taxing Wages*.

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The effective age of retirement has been increasing over the past 10 years, largely following the phasing out of early retirement and special unemployment benefit schemes for older workers. The employment rate of workers aged 55-64 increased from 52.3% at end-2007 to 62.0% at end-2012, 6 percentage points above the OECD average but below the best performing countries, where older worker employment rates are above 70%. There is

still room, therefore, for improvement through reforms to eliminate remaining financial disincentives to work longer, to promote greater training opportunities, and to improve the health of workers at all ages. Government plans to allow individuals with contribution records exceeding 45 years to retire 2 years before the legal retirement age (currently 65 years) without pension deductions should be reconsidered. If implemented, they provide an incentive to retire earlier.

Germany is making progress in expanding childcare and has guaranteed access for all parents, if only for a few hours per day. However, enrolment rates remain low and access to full-day care is limited, including for pupils more than 5 years old, who usually attend school only in the morning (OECD, 2012c; OECD, 2014). Enrolment rates for children below 3 years of age reached 28% in 2012, much less than coverage implied by current estimated demand of 39% (Federal Statistical Office, 2012). Attendance of formal childcare for very young children is particularly low among children from low income households or with a migration background. While 33 % of children without a migration background attend childcare at the age of zero to 3 years, only 16 % of children with a migration background do so (Federal Statistical Office, 2012). A sufficient availability of formal childcare would encourage labour supply decisions particularly strongly among single parents and second-earners in low income households (Rainer et al., 2011) and thereby contribute to reducing child poverty. Moreover, children attending early childcare reap large cognitive and non-cognitive skill gains (Heckman and Raut, 2013). There also is scope to improve the quality of childcare and early childhood education, with a view to provide more education benefits especially for these children. While it is welcome that parents have a legal claim for a public care unit for children aged one year or more since August 2013, efforts should continue to expand affordable and high quality early childcare provision and to expand the supply of full-day care, including for pupils over 5 years old (OECD, 2012c and 2014). Efforts are also needed to encourage the participation of children with weak socio-economic background in early childcare and early childhood education. Additional resources should be made available to increase the staff-child ratio, to provide more integrated education and care, and to ensure childcare workers have better qualifications (OECD, 2012c and 2014), as planned by the government.

Labour migration can help meet future labour demand and address skills shortages caused by a shrinking working-age population (OECD, 2012a). Recent reforms have put Germany among the OECD countries with the fewest restrictions on labour migration for highly skilled occupations. However, the recommendations of the *2012 Economic Survey* to set up an institution tasked with designing, assessing and coordinating labour immigration policy remains relevant. The recent initiative to allow employers to retain foreign graduates of the dual system is a positive step. However, the government could expand its efforts to support German language and preparatory training for recruiting young people into the apprenticeship system (OECD, 2013b).

Difficulties in the recognition of professional and vocational qualifications obtained abroad hold back earnings prospects of immigrants. The Federal Recognition Act, entered into force in April 2012, has proved effective; the first official data, published in October 2013, show that in most cases equivalence of foreign professional qualifications was established and recognition granted. Differences across the *Länder* in the recognition of such qualifications continue to limit the capacity of immigrants to move to locations where their skills are in highest demand (OECD, 2013b). It is welcome that the new government is considering steps to further facilitate the recognition of qualifications obtained abroad,

including non-formal qualifications. This should include easing and harmonising the recognition of professional and vocational qualifications from abroad across *Länder*.

Recommendations to strengthen potential growth and to mitigate the impact of demographic change on living standards

Key recommendations

- Reassess regulation with respect to unintended entry barriers and abandon price regulation in some professional services.
- Strengthen the regulator's powers in the railways and broaden rights to issue SIM cards in mobile communications.

Other recommendations

- To reduce barriers to full-time work by women, expand the supply of full-time childcare, reform joint taxation of couples and give consideration to ending free health insurance for non-working spouses while ensuring that low-income households are compensated.
- Expand support for German language training and foster immigration. Continue to improve the recognition of foreign qualifications.

Making economic growth more socially inclusive

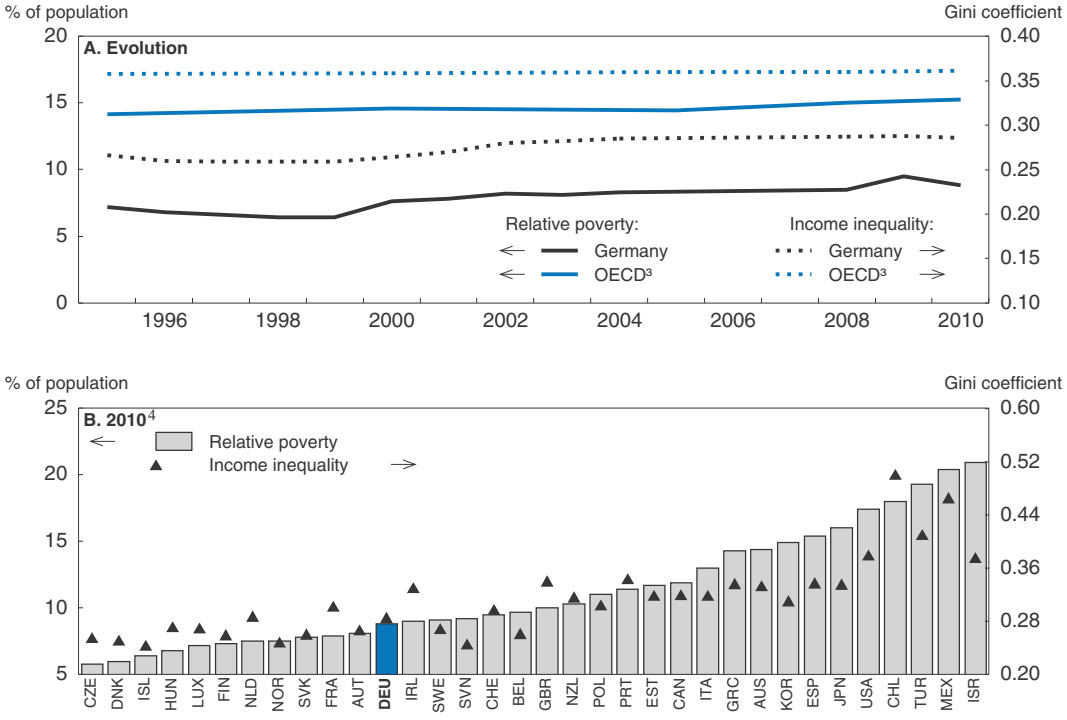
Inequality and relative poverty in Germany are below levels observed in many OECD countries. They have risen since the mid-90s, as elsewhere, although income inequality has not increased since 2004 (Figure 11). Past increases in inequality were driven by gains by high income earners and the rising share of dependent and self-employed low-income workers (Chapter 3). German households enjoy a relatively high level of economic welfare according to the OECD well-being framework. However, differences in self-reported health status vary strongly between high and low-income households and the link between socio-economic background and education attainment is also relatively strong (OECD, 2011b).

Sustained employment growth and a large drop in unemployment since 2005, largely brought about by labour market reforms in the mid-2000s (OECD, 2012a), have not resulted in a marked decline of relative poverty. At the same time the share of low wage earners and workers in non-regular employment has increased. These developments suggest that low-wage earners have not been able to take a commensurate share in the economic gains of these reforms. Indeed upward mobility of low-income and low wage workers has fallen (German Council of Economic Experts, 2013).

Avoiding labour market duality

Poverty risk has increasingly affected workers in non-regular employment, in particular employees with relatively low employment protection or limited access to unemployment insurance, as well as many part-time and self-employed workers (Table 3). In part, this is because successful past labour market reforms have put more unemployed workers into jobs, but many workers are paid low wages, suffer from low wage mobility, face higher risks of repeated unemployment spells, and 3% of the labour force have to rely on in-work benefits. A high incidence of low-pay and part-time work also raises future old-age poverty risks, as many low-pay workers may not accumulate pension entitlements above the level of subsistence benefits.

Figure 11. **Relative poverty[1] and income inequality[2]**



1. Relative poverty is measured as the percentage of the population whose equivalised household disposable income (after taxes and transfers) is below 50% of the median income.
2. Income inequality is measured as the Gini coefficient using household disposable income. It ranges from zero (perfect equality) to one (where one individual receives all).
3. Population-weighted average for 20 countries.
4. 2011 for Chile; 2009 for Hungary, Ireland, Japan, New Zealand, Switzerland and Turkey.

Source: OECD Income Distribution and Poverty Database.

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Table 3. **Exposure to poverty of workers in non-regular, part-time and self-employment**

	Risk of poverty		Share of total workers (in %)		
	1998	2008	1998	2008	2011
Total employment	4.6	6.2	100.0	100.0	100.0
Dependent	4.4	6.0	89.6	88.4	88.7
Dependent permanent full-time	3.1	3.2	73.2	66.1	66.5
Dependent non-regular					
Temporary	10.8	16.5	5.8	7.9	7.9
Marginal (*minijobs*)	13	23.2	4.7	7.4	7.5
Temporary agency		8.5		1.8	2.2
Part-time	9.9	15.3	10.9	14.1	14.1
Self-employed	6.7	7.7	10.4	11.6	11.3
Self-employed without employees	9.3	10.3	5.1	6.5	6.3

Note: The table refers to individuals aged 15-64, not in education or training. The risk of relative poverty is assessed on the basis of the mean equivalised disposable household income, at the 60% threshold. Non-regular employment consists here of temporary employees, workers in marginal employment (*minijobs*) and temporary agency workers. Overlaps among the different forms of non-regular employment and part-time employment exist.
Source: Federal Statistical Office.

A general minimum wage can be an effective instrument to raise wages at the bottom of the wage distribution while preserving employment prospects (Garloff, 2010). This applies especially in the context of precarious employment, in which workers are more likely to accept wages below their marginal product, for example because they receive wage subsidies or because their bargaining power is weaker than that of the employers. Minimum wages can also raise incentives for individuals to work and improve their skills (Acemoglu and Pischke, 2001). At present minimum wages are set for individual economic sectors, generally at the initiative of the social partners and on the basis of extending collective bargaining agreements. Such minimum wages apply to construction and several service sectors. Setting minimum wages on the basis of the extension of collective wage agreements incurs the risk of harming employment prospects of outsiders and generates barriers for firms entering the market (OECD, 2006, 2008b and 2012f). However, an extensive evaluation study commissioned by the German Ministry of Labour in 2011 covering all sectors with minimum wages failed to find any substantial negative effects on employment and market entry.

The government's plans to introduce a general minimum wage are welcome. The minimum wage will be phased in between 2015 and the end of 2016 at an initial level of EUR 8.50. The government plans to create a commission of representatives from the social partners to propose future adjustments of the general minimum wage. However it should be ensured that the minimum wage is not set too high initially to avoid substantial negative employment effects. At EUR 8.50 it would amount to about half of the median wage, placing the German minimum wage at a level similar to those of other European countries, such as Belgium, the Netherlands and the United Kingdom, but below France. It would affect about 15% of all employees nation-wide and 23% in Eastern Germany. Some researchers have argued that a minimum wage of EUR 8.50 may significantly harm employment prospects of workers with little experience or low skills and in some regions (Brenke, 2014).

The mandate of the commission should be to set the minimum wage at a level which balances potential employment losses against the social benefits. The social partners alone may not sufficiently take the interests of the unemployed into account. It could therefore be desirable to involve independent experts or government representatives in the commission's decisions. Moreover, given the introduction of the nationwide minimum wage, cautious use should be made of higher sectoral minimum wages set on the basis of collective agreements.

Marginal employment contracts up to EUR 450 (so-called *minijobs*) benefit from tax subsidies, are only partially covered by the mandatory public pension system and are fully exempt from unemployment insurance. *Minijobs* were intended as a stepping stone to regular employment and to avoid high marginal tax rates for low-wage earners, but have proven little effective as such (Freier and Steiner, 2007; Körner et al., 2013; Fertig and Kluve, 2007). The tax subsidy is not targeted to low income individuals, as many *minijobs* are taken up by second earners to avoid high taxation in the context of the joint income taxation of couples. Also, they can be held in addition to a standard job. Some workers on *minijobs* are exposed to a rising risk of relative poverty once they retire or in case of losing their job (Hohendanner and Stegmaier, 2012) because they acquire low pension entitlements and are not entitled to unemployment insurance benefits. The preferential tax treatment of *minijobs* should be better targeted towards low-wage workers.

The gap between employment protection of permanent workers with long seniority and temporary workers is large in Germany. While employment protection for permanent workers is among the most stringent in the OECD, temporary contracts were broadly liberalised in 2002. International evidence shows that this often generates hurdles for the transition from temporary to permanent employment. It can result in workers getting trapped in frequent moves between temporary work and unemployment and diminish access to firm-provided training, which in turn raises income inequality and lowers wage mobility (Koske et al., 2012). Nonetheless, permanent employment has contributed strongly to employment growth in Germany in recent years. Thirty nine per cent of workers on temporary contracts moved to a permanent contract within one year (Walwei, 2013). The large gap in employment protection between workers on permanent and temporary contracts should be reduced to further improve the transition of workers in temporary employment relationships into permanent jobs (de Serres et al., 2012).

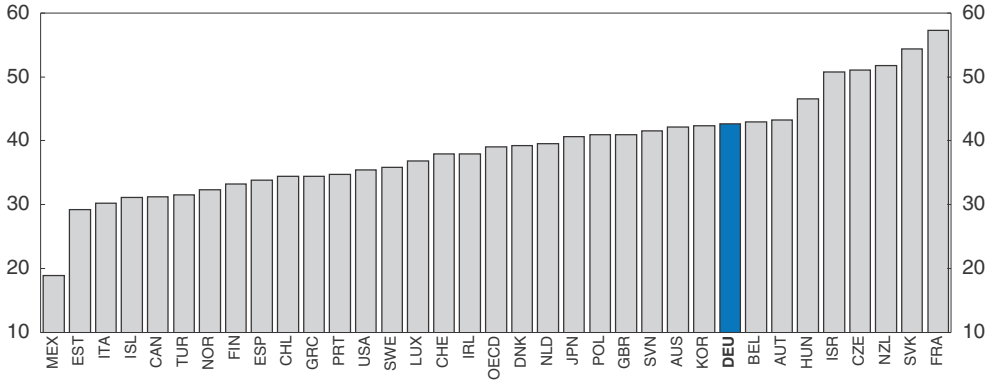
Poverty risks are particularly concentrated among households affected by unemployment spells, despite relatively high unemployment benefit replacement rates, in part because long-term unemployment is unusually high in comparison to other low-unemployment OECD countries. There is scope to make active labour market policies better targeted to improve the employment prospects of the long-term unemployed (Heyer et al., 2011; Kluve, 2013). For example hiring subsidies could be more targeted and be combined with incentives to acquire education qualifications.

Providing more education support for the disadvantaged

Considerable progress has been made in enhancing both the quality and equity of the education system (OECD, 2013c and 2014). In particular education outcomes in Germany have improved in all three PISA domains, and are above the OECD average. These improvements were mostly due to better results among students coming from a lower socio-economic background and immigrant backgrounds. Nevertheless, the link between socioeconomic background and performance remains strong (Figure 12) and childcare and

Figure 12. **Impact of socio-economic status on the average difference in performance in mathematics**[1]

2012



1. The average difference in mathematics score between students whose socio-economic status differs by one unit of the PISA index of economic, social and cultural status. The lower the value the smaller the difference in performance (or the more equal performance between advantaged and disadvantaged students).

Source: OECD (2013), *PISA 2012 Results: Excellence through Equity, Giving Every Student the Chance to Succeed?*, Vol. II.

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early childhood education (see above) would be particularly effective in reducing this link. As recommended in the 2008 Economic Survey, the impact of socioeconomic background on education attainment could be lowered further by reducing stratification of the school system. There is also scope to provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic background (OECD, 2013c). Efforts should also continue to reduce the share of individuals who do not obtain at least upper secondary education degrees, many of them with weak socio-economic background. Plans to strengthen support for disadvantaged youth to complete school and make the transition from school into vocational education and training (VET) are welcome. In this context, comprehensive support and training programmes (education chains) are focused on bringing participants quickly into mainstream VET programmes. In 2013, the Länder have jointly made proposals to improve school based training programmes in the transition system. Some of these policies to make economic growth more socially inclusive also require additional public funding.

A relatively large share of pupils with learning difficulties is placed in classes or schools for children with learning difficulties or disabilities, which undermines their career prospects in many cases (OECD, 2009 and 2012d). Pupils are more likely to be assigned to such schools if their socio-economic background is disadvantaged, including if they have an immigrant background. In this context, the initiative by the *Länder* to promote integrated education is welcome (Kultusministerkonferenz, 2010).

Making health and old-age pension insurance more inclusive

The segmentation of health insurance into a private sector, which covers about 10% of the population, and a public sector, which covers the remaining 90%, raises equity and efficiency concerns (OECD, 2008a; German Council of Economic Experts, 2006). Low and middle income earners and individuals with poorer health status are generally covered by public health insurance, where contributions are independent of health risks and are proportional to wage income up to a ceiling. Employees with a wage income above EUR 53 550 per year can opt out of public insurance and choose private insurance instead. High income earners with good health status have incentives to choose private insurance because private insurance premia do not depend on income and because insurers can adjust the terms of contracts they offer to new insurees in line with their perceived health risks. Moreover, private insurers do not participate in the central health fund, the purpose of which is to redistribute insurance contributions of public insurers on the basis of risk-adjusted transfers, thereby reducing selection on the basis of risk. Private insurers can therefore compete on the basis of risk selection rather than on the basis of efficiency.

Private insurance can also result in poverty risks for some individuals when they experience a drop in income. These risks affect older workers because insurance premia tend to increase with age and because they cannot return to the public insurance system. They also affect the self-employed, who do not generally have access to public insurance and may face high income uncertainty. While special tariffs are available for persons in private insurance having difficulties to pay, they can be fairly expensive or provide only limited coverage. While the dual health insurance system in Germany has a long tradition, it generates difficulties in today's labour market, in which employment histories often include changes in employment status and earnings.

The German Council of Economic Experts (2006) and the *2008 Economic Survey of Germany* therefore suggested integrating private health insurance providers in the central

health fund. The German Council of Economic Experts (2006) also suggested imposing the obligation to contract on all insurers and limiting the cost of mandatory health insurance for all low-income households with government transfers. This would imply that all insurance companies provide mandatory health insurance packages to all individuals on equal terms, as public insurance companies already do. Such a reform would remove incentives for risk selection and reduce poverty risks. However, it would give rise to substantial transitory challenges. In particular, it requires dealing with the reserves accumulated in the private health insurance system.

The mandatory public pension system covers employees only, although about one quarter of the self-employed are covered by alternative mandatory pension schemes. The self-employed workers who are not covered often include those most vulnerable to poverty risks (German Council of Economic Experts, 2011). This coverage gap raises the risk that self-employed workers have to rely on social assistance benefits during retirement. It also generates incentives for firms to outsource work to self-employed workers in order to avoid pension contributions, raising precarious self-employment and weakening government finances.

Recommendations to make economic growth more socially inclusive

- Provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic backgrounds. Provide more support for disadvantaged youth to complete formal upper secondary education, in particular mainstream VET. Continue reducing the assignment of pupils to special needs schools and make sure assignment to such schools does not reflect the socio-economic background of pupils.
- Reduce the gap in employment protection between permanent and temporary workers. Introduce a minimum wage, set by an expert commission, across all economic sectors. Better target the preferential tax treatment of *minijobs* towards low-wage workers.

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ANNEX

Progress in main structural reforms

This annex reviews action taken on recommendations from previous Surveys. They cover the following areas: labour market, competition in product markets, the funding of health care, education, public finances, the banking sector, potential growth in a globalised world, as well as climate change mitigation and green growth. Each recommendation is followed by a note of actions taken since the November 2010 Survey. Recommendations that are new in this Survey are listed in the relevant chapters.

This annex presents under each theme:

- Past recommendations
  - ***Actions taken and current assessment***

Improve labour market performance

- Reduce fiscal work disincentives for second earners by reforming joint income taxation of couples and by considering introducing contributions for public healthcare co-insurance of nonworking spouses.
  - **No action taken.**
- Raise pension discounts for drawing a pension before the statutory pension age towards an actuarially neutral level and discourage low-income workers from early retirement.
  - **No action taken.**
- Continue shifting from seniority towards performance remuneration in the public sector and encourage social partners to assess in how far current wage schemes inhibit older worker employability.
  - **No action taken.**
- Continue plans to expand the supply of childcare facilities and further increase the availability of full-day schooling. Consider introducing a voucher system for childcare. Lower regulations for the set-up of childcare facilities to encourage more private supply.
  - **Since August 2013 parents have a legal claim for public care for children aged one year or more. The federal government is providing investment funds to the *Länder* for 30 000 places. It will also pay for some operating costs, reaching EUR 845 million in 2015.**
- Move towards a unified job contract with the degree of protection rising with tenure. Ease employment protection legislation for regular job contracts by shortening the notification procedure, by reducing the notice period for workers with long tenure and, in case of dismissals for economic reasons, by giving employers the right to choose between paying a severance payment or paying a higher unfair dismissal compensation which would replace the court route.
  - **No action taken.**
- If a minimum wage is deemed necessary, it should be set on a nationwide basis at a sufficiently low level that will not lead to job losses and be determined by an independent commission.
  - **The government plans a nation-wide minimum wage of EUR 8.5 by 2015 with sectoral exemptions remaining possible until the end of 2016. The commission deciding about future adjustments to the minimum wage level will consist of representatives of social partners.**

Improve competition in product markets

- Raise competition in the railway sector, for example by fully privatising the transport service subsidiaries while retaining state ownership of the tracks, by eliminating

exemptions from tendering of regional railway services and strengthening the role of the regulator.

- ❖ **The regulator will be strengthened with the implementation of EU directive 2012/34.**

- Establish an advisory body tasked with identifying and reviewing regulatory hurdles to higher productivity.

  - ❖ **No actions taken.**

- Make domestic service markets in the liberal professions and crafts more open to competition by further reducing restrictions on the co-operation between professions, by further liberalising prices and by reassessing the need for restrictions on advertising. Simplify entry conditions by rethinking compulsory chamber memberships. Reduce the number of activities over which certain professions have exclusive rights and further lower education requirements.

  - ❖ **The profession of chimney sweepers was further deregulated in 2012/13.**

- Apply the "silence is consent" rule for issuing licenses and allow points of single contact to issue or accept notifications and licenses.

  - ❖ **Implemented as part of the EU Service Directive.**

Make health care financing more sustainable

- Include private insurers in the financing system based on the central health fund.

  - ❖ **No action taken.**

- Relaxing the requirement that pharmacies can only be owned by a pharmacist who has to work personally in one out of a maximum of four branches he/she is allowed to own.

  - ❖ **No action taken.**

Make the education system more efficient

- Continue to reduce the stratification in the school system, notably by delaying the tracking decision beyond age 10 and reducing the number of school tracks across all *Länder*.

  - ❖ **Some *Länder* have started to combine different tracks in one school type.**

- Improve teacher quality, for example by holding schools and teachers accountable for the progress of students and by making greater use of financial incentives for good teaching in those *Länder* which have not yet introduced such measures.

  - ❖ **All *Länder* have established a system of external and internal quality management. Schools with bad performance get support. To increase quality in teacher training is a priority field of action in education policy.**

- Make tertiary education more attractive and responsive to labour-market requirements by increasing universities' input flexibility.

  - ❖ **No action taken.**

- Ensure sufficient and diverse financing of higher education and overcome the free-rider problem between *Länder* in the financing of university education.

  - ❖ **No action taken.**

- Further reform the vocational education and training (VET) system by considering reducing the variety of VET qualifications and providing continuing education offers of

general skills (mathematics, German, foreign languages, computer skills) according to labour market needs. Let vocational schools and chambers jointly prepare and carry out the final examination of dual VET programmes.

- ❖ **Training regulations are updated regularly according to labour market needs. The government plans to introduce job families for VET qualifications.**

- Raise participation in lifelong learning. Improve transparency in the adult education market and facilitate access to guidance on adult training (incorporation of non-formal and informal activities in the Qualifications Framework for Lifelong Learning). Carefully monitor the outcome of financial support programmes for adult learning and education.

  - ❖ **No action taken.**

Maintaining public finances on a sustainable path

- Monitor the implementation of the debt brake rule and adjust the new framework where necessary.

  - ❖ **Germany has developed its fiscal framework further in line with evolving European rules. A maximum general-government structural deficit of 0.5% of GDP was enshrined in the Budgetary Principles Act. The Stability Council is tasked with monitoring compliance with this limit, supported by an independent council.**

- Review the structure of the tax system by shifting taxation from mobile bases to immobile bases. Phase out reduced VAT tax rates. Reduce social security contributions, notably for low income workers.

  - ❖ **Social security contributions were reduced from 40.35% in 2011 to 39.45% in 2013.**

- Consider increasing taxation on land and buildings by linking the tax base to actual prices or by raising the tax rates, while reducing the liquidity constraints related to the tax for people with low incomes and illiquid assets. Consider raising environmental taxes further.

  - ❖ **The advisory board to the federal ministry of finance has conducted research on linking the tax base to actual prices. Different tax models are tested for feasibility by the *Länder*. The results will be evaluated.**

- Go further in cutting statutory corporate tax rates.

  - ❖ **No action taken.**

- Improve public sector efficiency. Cut grants and government consumption expenditures further.

  - ❖ **No action taken.**

- Strengthen the stability council by providing additional inputs from independent experts or institutions. Ensure transparency in the determination of the output gap by the *Länder*.

  - ❖ **In the context of the transposition of the Fiscal Compact, a new, independent council was established. This council will assist the Stability Council in monitoring compliance with the medium term budgetary objective which is codified into domestic law as part of the Budgetary Principles Act.**

- Consider strengthening the tax autonomy of the *Länder* by allowing them to levy a surcharge to the income tax.
  - ❖ **Strengthening the tax autonomy of the *Länder* is on the agenda of the government. The administration of tax collection is one of the topics to be discussed.**
- Consider lowering or abolishing the local trade tax.
  - ❖ **No action taken.**
- Ensure a stricter enforcement of the law on short-term borrowing by municipalities.
  - ❖ **Excessive short-term borrowing by the municipalities is a problem in some *Länder*. These *Länder* have taken measures to reduce short-term debt and achieve balanced budgets including closer monitoring by municipal supervisory authorities.**
- Increase tax collection efficiency by considering the introduction of self-assessment of tax payers.
  - ❖ **The contract for a research project on "Legal and administrative implementation of self-assessment in the field of corporation tax" has been awarded.**
- Re-design inter-governmental transfers so as to reduce the disincentive effects for states to develop their own tax base and tax revenue collection efforts. Compute equalisation transfer positions of the states on the basis of notional rather than actual revenue.
  - ❖ **No action taken.**
- Re-allocate administration of tax collection, which accrue to the federal government or are shared between the different layers of government from the *Länder* to the federal government.
  - ❖ **The review of the fiscal relations between the federal government and the *Länder* is on the agenda of the government. The administration of tax collection is one of the topics to be discussed.**

Stability of the banking sector

- Ensure adequate bank capitalisation and further clean bad assets from banks' balance sheets.
  - ❖ **The European Union's rules on capital requirements implementing Basel III apply.**
- Restructure the *Landesbanken* through privatisation, consolidation or focusing on core activities according to a viable business model.
  - ❖ **Balance sheets have been reduced and activities have been focused on lending to small and medium-sized enterprises to some extent.**
- Strengthen the macroprudential elements of supervision. Clearly address the risks related to certain business strategies. Consider introducing a binding overall leverage ratio.
  - ❖ **The authority in charge of macroprudential oversight is the Financial Stability Committee (FSC), established in 2013. The foundation of the FSC was intended to assure a concentration of macroprudential powers within one single authority.**

Lift potential growth in a globalised world

- Improve the framework conditions for innovation by ensuring sufficient exit possibilities for venture capitalists. Improve transparency by placing venture capital and capital investment companies under unified supervision. Consider introducing tax incentives to complement grants.
  - ❖ **A common regulatory framework for venture capital and capital investment companies has been created and transparency improved. In May 2013, Germany introduced an investment grant for Business Angels (*Investitionszuschuss Wagniskapital*).**
- Monitor whether the recent legislation to recognise foreign credentials is effective in supporting integration.
  - ❖ **The first monitoring report will be presented in spring 2014. Federal statistics on the Recognition Act provide the main basis for the evaluation and monitoring. The first data for 2012 have been available to the public since 15 October 2013. The government plans to facilitate the recognition of foreign credentials.**
- Enhance immigration of high-skilled workers by reducing the income threshold for obtaining a permanent settlement permit. Consider establishing an institution tasked with designing, assessing and coordinating labour migration policy. Consider engaging more actively in foreign recruitment policy.
  - ❖ **The wage threshold for high skilled non-EU migrants has been lowered with introducing the Blue Card EU with effect from 1 August 2012. The "Welcome to Germany Portal" (website) has been launched.**

Climate change mitigation and green growth: make ambition pay

- Contribute to discussions at EU level about possible measures to maintain an effective carbon price signal in the EU ETS in line with medium and long-term EU emission reduction targets. Consider creating an effective carbon tax in the sectors not covered by the EU ETS and ensure that other, non-carbon related, externalities are adequately priced.
  - ❖ **Germany has decided to support the so-called "Backloading"-proposal of the EU Commission and the amendments suggested by the European Parliament.**
- Eliminate exemptions and reduced energy tax rates (except if they are designed to avoid double taxation, notably in sectors covered by the EU ETS) and accelerate the removal of coal subsidies. Revise environmentally harmful tax expenditures.
  - ❖ **Tax relief for industries (*Spitzenausgleich*) has been linked to energy efficiency measures since the beginning of 2013. According to the closure plan for German coal mining from 2011, German coal mining production is to be phased out by 2019.**
- Target subsidised loans to low income households or credit constrained firms and implement changes in rent regulation which can further remove obstacles to energy savings investments in rental housing.
  - ❖ **An amendment to the rent regulation to remove obstacles to energy savings investments in rental housing has entered into force on 1 May 2013. Energy efficient refurbishment must be tolerated by the tenant and for a period of three months does not allow him to lower the rent.**

- Continue to monitor the generosity of feed-in tariffs and adjust them in line with market developments. Implicit CO2 abatement costs related to feed-in tariffs should be maintained at reasonable levels.
  - ❖ **Feed-in tariffs are regularly monitored and adjusted. The government is planning a reform, reducing the generosity of some feed-in tariffs and plans to introduce auctions to set subsidy levels from 2018 onwards.**
- Provide adequate incentives for the transmission systems operators to invest in the most efficient technologies while extending the grid. Further implement measures which aim at more transparency and public involvement in the decision process of grid extension.
  - ❖ **No action taken.**

Thematic chapters

Chapter 1

Strengthening financial sector resilience

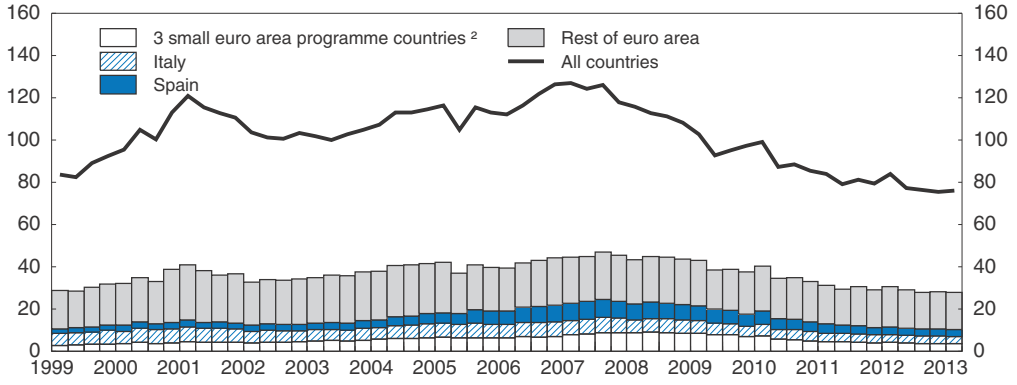
The German banks have weathered the euro area crisis well thanks to the solid fundamentals of the economy and the "safe haven" status of German financial assets. Nonetheless, lending growth has fallen in real terms in recent years, reflecting weak demand. The banks are vulnerable to any sharpening of financial market tensions in the euro area and the low interest rate environment. Large derivative exposures among the country's largest banks, high leverage and market perceptions of strong implicit government guarantees add to these risks. While the public savings banks have performed well and help sustain activity in relatively poor regions, performance among the public Landesbanken has been weak both before and after the global financial crisis. In some respects, the government has moved ahead of many other OECD countries with reforms to reduce risks in the financial sector. Nonetheless, further steps to make the banks more robust would reduce financial risks to the government and improve incentives for banks to take advantage of low interest rates to finance strong, sustainable economic growth. Such steps should include reducing high leverage, ambitious implementation of EU requirements for the reform of resolution legislation and addressing governance problems in the public banking sector.

German banks have weathered the euro area crisis well but domestic lending growth remains weak

The strong labour market performance and competitiveness of the German economy, as well as modest gross debt burdens of businesses and households relative to GDP, have kept banks' non-performing loan ratios low. Low interest rates, which reflect expansionary monetary policy and "safe haven" effects, have also helped, reducing firms' debt servicing burdens and lowering banks' funding costs. Since 2011, profits have been close to pre-crisis levels. While German banks expanded lending to countries mostly affected by the euro area debt crisis markedly between 1999 and 2007 (Figure 1.1), losses on exposures to euro area crisis countries have been modest, in part because crisis countries received funding in the context of EFSF programmes and ample liquidity from the ECB.

Figure 1.1. **Foreign claims[1] of German banks**

As a percentage of German GDP



1. Immediate borrower basis. Bi-annual data for 1999.
2. Greece, Ireland and Portugal.

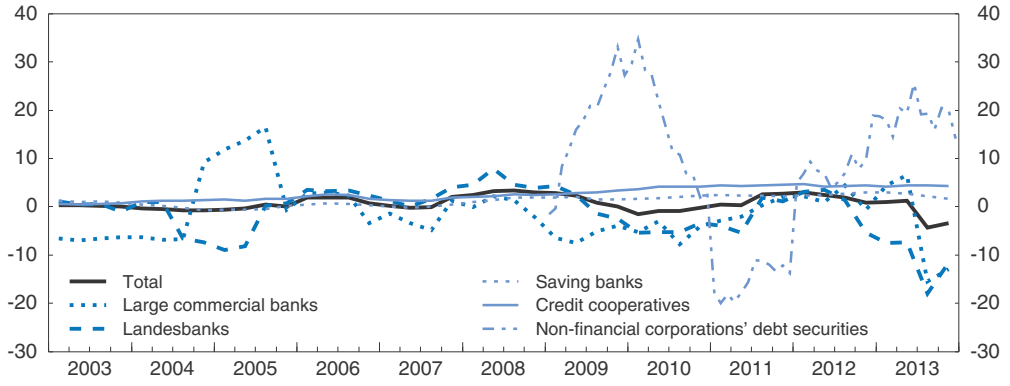
Source: BIS and *OECD Economic Outlook Database*.

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Lending to domestic households and non-financial firms has declined in real terms since the outbreak of the global financial crisis. Lending has also remained subdued more recently, in 2012 and 2013 (Figure 1.2) although the output gap is modest. Nonetheless, business surveys indicate that weak lending is largely attributable to weak demand, notably among firms. For example, according to DIHK (2013), 46% of businesses saw financial conditions as good and 40% as adequate in early 2013. About a quarter of non-financial firms reported they did not need external funding, reflecting sound balance sheets and the favourable impact of low interest rates on their cash flow. According to the ECB's SAFE survey and the Ifo survey, access to finance is comparably easy for German firms. However, the Euro system bank lending survey suggests that the tightening of the supply conditions of bank lending that took place in 2008 and 2009 has not been significantly reversed, even though

Figure 1.2. **Lending to domestic non-financial businesses and private households by bank sector**

Year-on-year percentage changes



Source: Deutsche Bundesbank.

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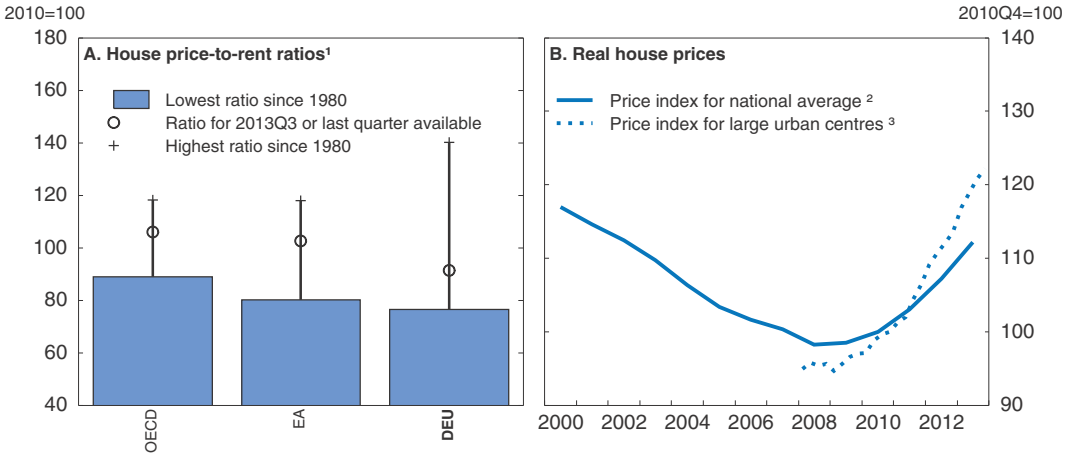
domestic lending standards did not appear to be lax in the preceding years (German Council of Economic Experts, 2008). Credit supply standards could become more binding as the recovery gains momentum if loan demand picks up strongly and banks do not soften their lending standards in line with improving economic developments.

Throughout the global financial crisis and the euro area crisis, lending growth has been the most robust among the co-operative banks and the savings banks, whose lending business is oriented to local markets, whereas lending by the large commercial banks and the regional public *Landesbanken* has tended to contract when financial conditions in the euro area tightened. The large commercial banks and the *Landesbanken* also built up large cash reserves in their accounts with the ECB when financial tensions inside the euro area reached a peak in the summer of 2012, suggesting that these banks may be particularly likely to keep lending subdued as financial tensions rise. These banks are more directly exposed to international activities and are more strongly leveraged (see below).

House prices have risen broadly in line with fundamentals

House prices have risen by about 10% in real terms between 2010 and 2013 (Figure 1.3). Improved labour market outcomes and higher real incomes have raised the demand for housing services, which has pushed up rental prices as well. Prices are also boosted by low long-term interest rates. Price-to rent and price-to income ratios have risen recently but remain below historical averages. Econometric analysis conducted by the Bundesbank (2013c) suggests that house prices remain aligned with fundamentals nationwide, although prices for apartments in the largest urban centres may have risen 20% above their fundamental determinants. Moreover, in line with subdued overall lending, mortgage lending growth barely grew in real terms in 2013 and the level of household debt is moderate. Lending standards in the real estate market have not eased in response to rising house prices (Bundesbank, 2013d). For example, almost half of commercial real estate loans granted in Germany have a loan-to-value ratio (LTV) of no more than 60%. Therefore, while the authorities need to remain vigilant concerning mortgage lending and the domestic real estate market, developments do not warrant macroprudential action to curb lending at this juncture. The developments in the German real estate market are

Figure 1.3. **Housing market developments**



1. Ratio of nominal house prices to rent prices index, based in 2010. Countries are arranged in a decreasing order of their price-to-rent ratio in 2013Q3 or last quarter available.
2. Urban residential property prices in 125 cities. Deflated using the consumer price index.
3. Prices for owner-occupied apartments in 7 cities: Berlin, Düsseldorf, Frankfurt-am-Main, Hamburg, Köln, München and Stuttgart. Deflated using the consumer price index.

Source: OECD (2013), *Policy Considerations in the Current Economic Situation*; *OECD Housing Price Database* and Deutsche Bundesbank.

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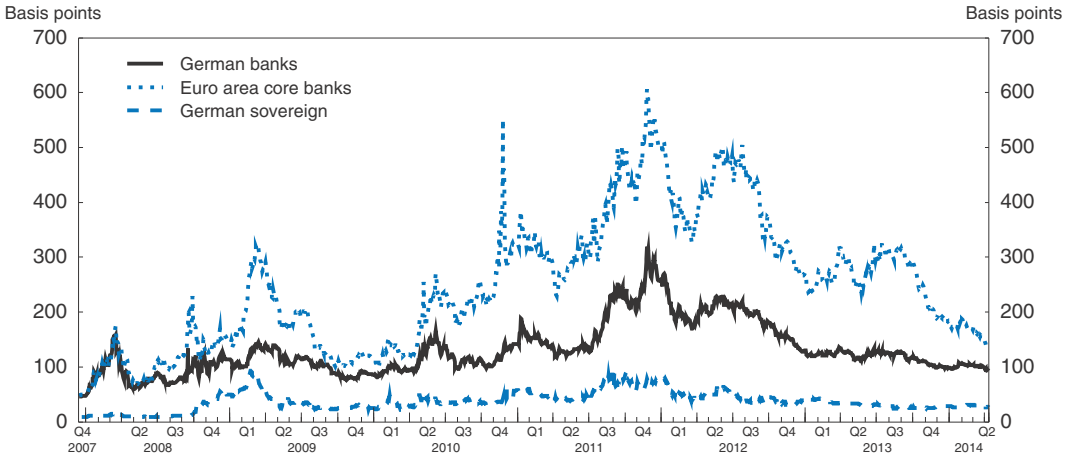
monitored closely by the Financial Stability Committee as part of macroprudential supervision (see below).

Risks mainly relate to international activities and low interest rates

The euro area remains vulnerable to economic and financial shocks, to which German banks remain exposed. Although German banks have reduced their claims on euro area economies in recent years, financial ties remain substantial. Claims to euro area crisis countries have fallen particularly strongly but still amount to about 10% of GDP compared with a peak exposure of about 20% in 2008. Indeed, default risks for major German banks have fluctuated in line with market tensions in the euro area although they remained well below the average across euro area core banks (Figure 1.4). The ECB's announcement of the Outright Monetary Transactions programme (OMT) in the summer of 2012 has helped reduce perceptions of default risk among euro area banks and German banks. Credit default swap rates for the German sovereign have also been lower since the 3rd quarter in 2012 than in preceding quarters. This development may reflect diminished perceptions of risks of break-up of the currency area and diminishing risks of default among debtors in euro area crisis countries. Hence, it may also have reduced financial risks to German financial intermediaries and the German government.

Some banks have built up large exposures to the freight shipping business and have created internal "bad banks" to hold impaired assets (Box 1.1). While these exposures are modest relative to the banking sector as a whole, they are concentrated in a few banks (Deutsche Bundesbank, 2012). Banks have considerable discretion in valuing impaired exposures. For example, they can determine the value of collateral underlying impaired assets by discounting expected income streams or by using market prices. Using the discounted income method leaves considerable scope for discretion. Several banks have expressed a preference for valuing exposures to shipping using this method. Reporting of

Figure 1.4. **Credit default swap rates of banks[1] and the German sovereign[2]**



1. Credit default swaps, 5-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve. German banks are an unweighted average of the six biggest German banks. The Euro area core banks are a weighted average of individual banks in the Euro area calculated by DataStream.
2. Credit default swaps, 10-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve.

Source: DataStream.

StatLink http://dx.doi.org/10.1787/888933033954

Box 1.1. **Legacy assets in German banks**

Several German banks have created internal "bad banks" in which they have bundled legacy assets at risk of loss. The assets of the bad banks of 5 large and medium-sized banks amounted to EUR 350 billion (12% of GDP) as of the first quarter 2013. These include foreign residential mortgage-backed securities, funding for shipping, real estate and government loans. Among the 12 largest German banks, problematic exposures to securitised loans, shipping, foreign commercial real estate amount to 5½ per cent of their balance sheets (Bundesbank, 2013d).

Shipping makes up an important part of legacy assets at risk of impairment. Exposures to ship financing of the seven most important German banks amount to EUR 86 billion (3½ per cent of GDP; Bundesbank, 2013d) and are concentrated among the large commercial banks and the public *Landesbanken*. German banks financed 45% of the freight shipping fleet world-wide before the global economic and financial crisis (Hellwig, 2012a). Relatively weak world trade in recent years has raised impairment. Owing to technical progress in shipping, prices of earlier vintages of ships are expected not to recover even if world trade accelerates. About half of outstanding shipping loans have an LTV of 100% or more and a large share of shipping loans have become non-performing. Several *Landesbanken* were heavily involved in this business. They are mostly owned by the *Länder* along the coastline, where the shipping industry is located. One *Landesbank* is the world's biggest provider of financing for freight ships. Few ships have been auctioned, which may have slowed the decline in prices. Banks have been said to refinance loans. Provisioning may be too low because it may be based on past performance of shipping loans.

non-performing loans appears subject to long lags and a relatively small share of non-performing loans is provisioned (IMF, 2011b). Recognising risks and losses early on through transparent and conservative valuation of assets helps reallocate loanable funds to their most productive use (e.g. IMF, 2002; Bouis et al., 2013). It also increases the chances that new

shareholders will be found, as they benefit from improved transparency and can expect higher returns (Blundell-Wignall and Atkinson, 2012). As a result the likelihood rises that banks will seek to strengthen their capital rather than reduce lending to meet capital requirements. In the current German context, this point may be particularly relevant because profit margins are low in international comparison in part owing to intensive competition (see below), limiting the scope for raising capital buffers through retained earnings.

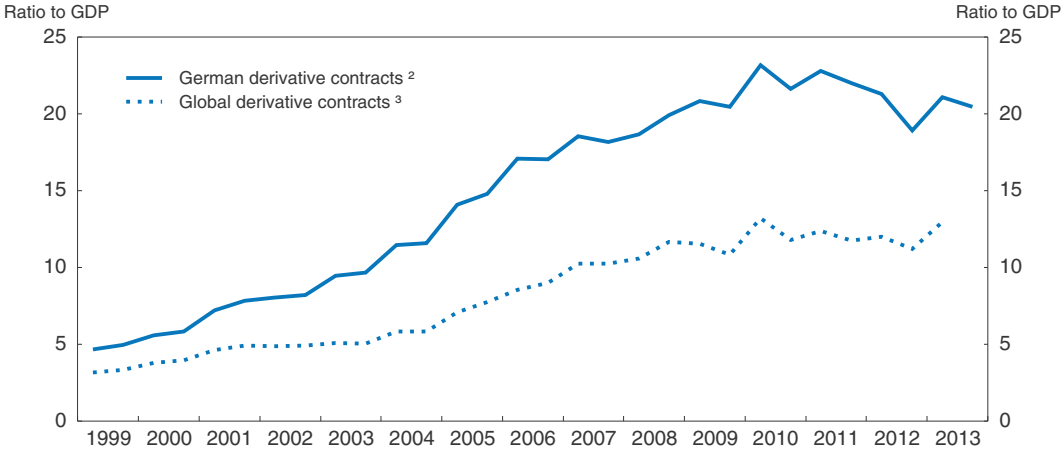
During the global financial crisis the government provided large-scale support to German banks, notably to some of the large commercial banks quoted on the stock exchange and to the public *Landesbanken* (see the chapter on the banking system in the *2010 Economic Survey of Germany*). In 2013, the government remained exposed to assets taken over from German banks worth about 10% of GDP. Losses to the federal government from exposures and equity participations have so far amounted to EUR 22 billion since 2008 (0.8% of annual GDP). Overall costs to the taxpayer are estimated to amount to between EUR 30 and 50 billion (1.2-2% of GDP).

A wide ranging reform agenda has been launched to avoid the need for future large-scale rescue packages financed by taxpayers' money, both at the level of the European Union and in Germany. Nonetheless, as argued below, many of the potential risk factors that contributed to the exposure of German banks to the global financial crisis remain present. These include large exposures to derivatives, high leverage in systemically important banks, governance issues in part of the public banking sector and persistent market perceptions of government guarantees, which raise moral hazard and limit the scope to remove failing banks from the market. Low interest rates in Germany as well as in many other OECD economies reinforce incentives for risk taking, encouraging search for yield at the expense of higher risks, although until 2013 there was no sign of a pronounced search for yield among German banks. One reason for this is the fact that banks remained under pressure to reduce their debt and expand their capital buffers (Deutsche Bundesbank, 2013d). Low interest rates also strengthen incentives to delay loss recognition. These incentives are reinforced if banks are highly leveraged.

Large derivative exposures raise systemic risks

Derivatives exposures of German banks have increased strongly over the past 15 years (Figure 1.5). This period was also characterised by strong world-wide growth. German banks hold a global market share of approximately 10% in this business. Since the outbreak of the global financial crisis, banks in several OECD countries have suffered unexpected large-scale losses from their derivative positions. Losses on derivative positions can reach a large share of their market value in the context of a systemic crisis (OECD, 2009). Moreover, derivatives exposures have also been a key factor in generating systemic risks, as they raise interconnectedness (Box 1.2). The systemic risk is aggravated by the concentration of derivative positions in too-big-to-fail (TBTF) banks. Market participants pointed out that banks are in the process of entering into netting arrangements across a variety of deals with counterparties to reduce their gross derivative exposure and hence the systemic risk resulting from the interconnectedness.

Figure 1.5. **German and global notional derivative exposures**[1]



1. All positions should in principle be reported on a gross basis according to the existing BIS reporting guidelines. Reporting of "net positions" is allowed only if the national accounting practice allows netting of multiple matching swaps (by currency and maturity) with the same counterparty, provided they are covered under a legally enforceable netting agreement. This may reduce international comparability.
2. Six German banks.
3. Approximately sixty leading banks located in thirteen countries (eleven countries before the first semester of 2012).

Source: Deutsche Bundesbank and OECD *Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888933033973

Box 1.2. **Systemic risks from bank derivative positions**

Derivative contracts are usually set with respect to the reference assets associated with primary securities, credit, commodities and currencies. Most are interest rate-based. While they shift risks inherent to the underlying assets among the contractual parties, the payment promises they generate are subject to the risk of default of a contractual party (counterparty risk), as is the case in a debt contract. There are several objectives for using derivatives: to hedge risks; to arbitrage prices, to gamble; as well as to reduce tax and regulatory costs (OECD, 2011).

Systemic risk that could endanger financial stability rises as a result of large derivate positions because derivatives require each participant in the chain of counterparties to be able to perform their obligations in order for others to be able to perform their own. Losses from large derivatives positions might exceed individual market participants' capacity to absorb losses, resulting in their default. Derivative contracts may then become worthless for counterparties. In addition, the uncollateralised counterparties of the defaulter might also suffer lossses because their risks are no longer hedged by derivatives, which could also lead to knock-on effects. The derivatives business has become increasingly concentrated among globally systemically important financial intermediaries (GSIFIs) in part because their too-big-to fail status reduces perceived counterparty risks, giving them a competitive advantage over smaller banks. Large derivative positions in turn reinforce the TBTF status because of increasing interconnectedness. Counterparty risks from derivative contracts with GSIFIs are underpriced as a result. Regulatory rules in Basel II and Basel III allow the netting of positions for the purpose of calculating required capital. Such netting provides incentives not to diversify counterparties. Large banks are also well-placed to take advantage of derivatives for the purposes of regulatory arbitrage (OECD, 2011). In addition, fewer parties are involved in the determination of prices, which can

Box 1.2. **Systemic risks from bank derivative positions** *(cont.)*

encourage mispricing of risk (OECD, 2011). As in other product markets, increasing concentration has also increased profit margins. The result has been strong profits from derivatives business for TBTF banks.

Derivatives have grown far more quickly than primary securities since the late 1990s. Therefore it appears unlikely that the growth of derivatives is mainly explained by the motivation to hedge risks in primary securities or other assets (OECD, 2011). The other motivations, notably regulatory arbitrage, tax arbitrage and gambling are likely to play important roles, which have no social benefit. For example, banks use derivatives to reduce the risk weight of assets, which lowers the amount of capital they are required to hold.

To reduce counterparty risks in derivatives, several countries are introducing the requirement to clear derivatives through central counterparties (CCPs). For example, EU legislation, expected to be fully in force from the third quarter 2014 onwards, foresees a requirement to clear standardised derivatives through a central counterparty. Indeed, CCPs can reduce risks resulting from individual derivative exposures. CCPs can help spread risks through mutualisation and pooling (Biais et al., 2012). They also raise transparency of pricing and strengthen competition, driving down bid-ask spreads. However, CCPs are insufficient to deal with systemic risks resulting from derivatives exposures (Blundell-Wignall and Atkinson, 2011). Clearing requirements are necessarily subject to exemptions, as customised, illiquid derivatives are less suited for clearing. Exemptions are indeed foreseen in the EU rules. The exchange of collateral and the use of other risk mitigation techniques are required for such exempted transactions. Nonetheless, large players have a vested interest to avoid clearing by customising contracts. CCPs may themselves be subject to competition, which may reduce their capitalisation (OECD, 2011). In addition, they may become themselves large, interconnected and concentrate derivative risks and become TBTF (Biais et al., 2013). An insolvent clearing house would aggravate systemic risk (Allen, 2012). Hence, clearing houses can generate moral hazard among contracting partners, especially if they are TBTF.

Profitability has varied across banking sectors

The German banking system consists of a diverse set of institutionally different banks (see the 2010 chapter on the banking system in the *Economic Survey* for a description). Profitability has varied substantially across sectors, both before and after the global financial and economic crisis (Table 1.1). It has been low among the *Landesbanken* in both periods, mostly reflecting lower income, even though *Landesbanken* and savings banks benefited from explicit government guarantees on their liabilities before they were phased out starting in 2006. This result also applies if revenues are assessed in risk-adjusted terms. By contrast, the savings banks and co-operative banks do relatively well also in risk-adjusted terms (IMF, 2011b). The *Landesbanken* compare unfavourably also with the regional institutions of co-operative banks. Both the regional institutions of the co-operative banks and the *Landesbanken* provide central services for locally oriented co-operative and savings banks, respectively ("apex institutions"). Indeed, low profitability has been endemic in the *Landesbanken* since their inception (Hellwig, 2012).

Analyses of technical efficiency suggest that savings banks are at least as efficient as commercial banks (Koetter, 2006; German Council of Economic Experts, 2008; Altunbas et al., 2001). Savings banks operate a bottom-up mutual guarantee system covering all

Table 1.1. **Bank profitability by sector**

As percentage of assets

	Commercial banks		*Landesbanken*	Savings banks	Regional institutions of credit co-operatives	Credit co-operatives
	Big banks	Regional and other commercial banks				
2003-07[1]						
Net interest income	1.01	2.06	0.63	2.27	0.47	2.39
Net non-interest income	0.52	0.84	0.12	0.57	0.15	0.65
Net profit or loss on financial operations	0.23	-0.04	0.00	0.02	0.11	0.01
General administrative expenses	1.25	1.89	0.44	1.92	0.47	2.26
Net profit for the financial year after tax	0.18	0.23	0.06	0.23	0.17	0.35
2008-12[1]						
Net interest income	0.87	1.66	0.69	2.13	0.49	2.23
Net non-interest income	0.42	0.71	0.08	0.56	0.13	0.59
Net profit or loss on financial operations	0.01	0.01	0.00	0.00	0.11	0.00
General administrative expenses	1.02	1.65	0.44	1.77	0.38	1.92
Net profit for the financial year after tax	-0.19	0.11	-0.15	0.53	0.27	0.48

1. Unweighted average.
Source: Deutsche Bundesbank.

liabilities. Such guarantees create moral hazard, although savings banks have created internal auditing procedures to mitigate that risk. Over the last 40 years few savings banks have required support from the guarantee system. By contrast, efficiency shortcomings have been marked among the *Landesbanken*. They also stand out for a weaker efficiency in the allocation of capital and have proven to be less stable (German Council of Economic Experts, 2008). Savings banks have proven less prone to solvency risk and stress than private banks and *Landesbanken*, before and during the global financial crisis, while co-operative banks perform best with respect to solvency risk (Beck et al., 2009). The savings banks and co-operative bank sectors proved the most immune to aggravating solvency risks in the 2008-09 crisis even though they did not receive any direct government support (Schmielewski and Wein, 2012).

For the banking sector as a whole, profit margins are low in international comparison, which may reflect more intensive competition, due to the presence of two banking networks with local business models (savings banks, co-operative banks) providing extensive geographic coverage. Some observers have argued that low profit margins are the result of excess capacity of the banking sector (Bundesbank, 2013d; Hellwig, 2012). Employment levels in the banking sector are indeed relatively high, close to levels observed in countries hosting major international financial centres, such as the United Kingdom. Low profitability makes it difficult to attract more high-quality capital from external sources, or build capital up internally through retained earnings while providing an adequate return to existing owners (IMF, 2011b). Persistently low long-term interest rates also risk diminishing interest margins and therefore profitability, especially for co-operative banks and savings banks, which are relatively specialised in long-term domestic lending (Deutsche Bundesbank, 2013d).

Capital ratios exceed requirements but leverage is high

Most of the 42 biggest German banks included in the Basel III monitoring exercise (7 large internationally active banks and a representative sample of the banking sector) already reach the Common Equity Tier I capital ratio which Basel III rules and

European Union regulation require to be met by 2019, including the capital conservation buffer. Some banks still show a shortfall. Including the supplementary capital buffer for systemically important banks, which must be met by 2021, and on the basis of current risk-weighted assets they will need to raise EUR 14 billion additional capital. To improve capital ratios, banks reduced risk-weighted balance sheets in 2012 (Bundesbank, 2013e).

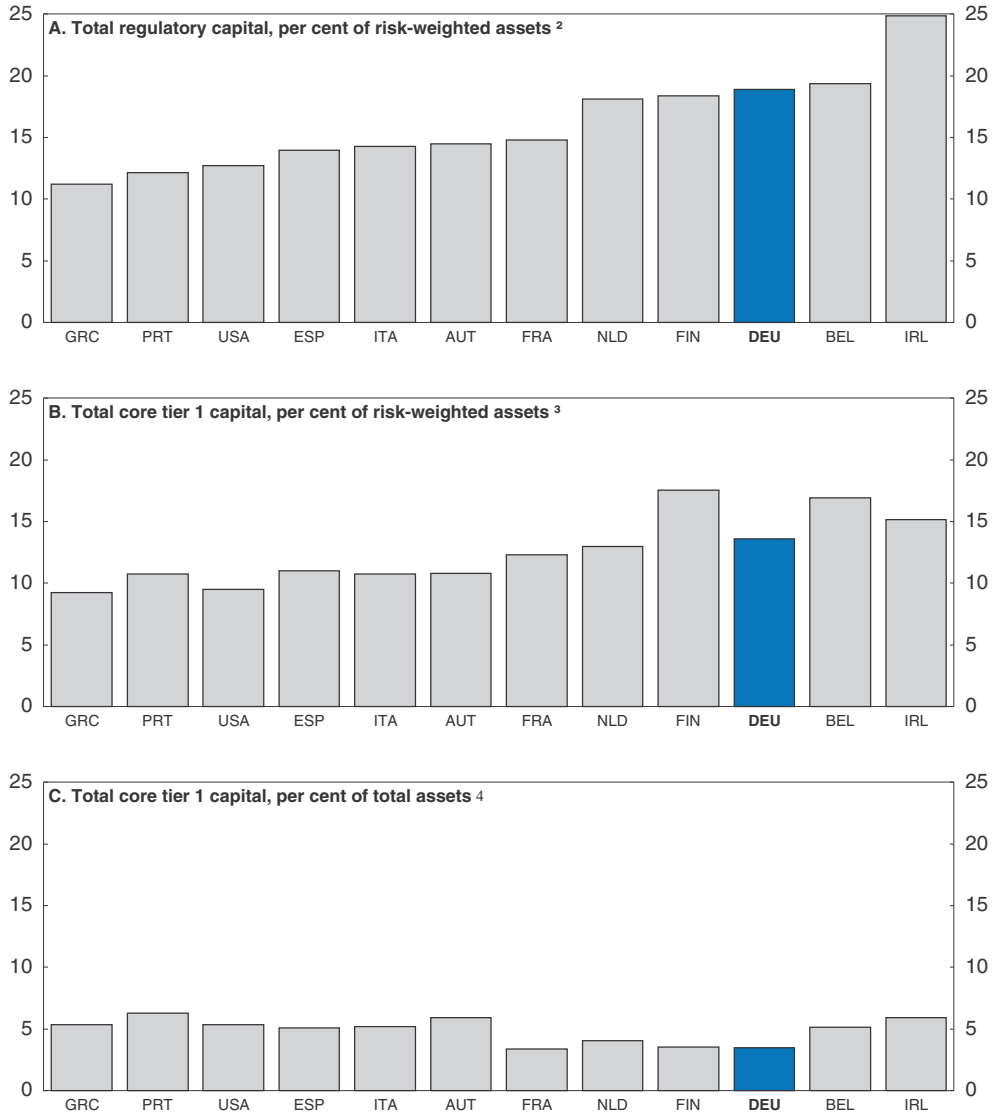
Assessing capital buffers relative to risk-weighted assets alone has shortcomings. Some assets are assigned a risk weight of zero and risk weights are assumed to be independent of the portfolio composition of banks' assets. Moreover, under the internal ratings-based approach, the choice of risk weights of assets to assess capital positions is determined by using models which are subject to considerable discretion on the part of bank management. Especially large banks can invest in the modelling technology to develop internal risk-based models. Acting in the interest of shareholders, bank managers have incentives to minimise risk weights. There is evidence that risk-weights for comparable assets differ markedly across banks (e.g. BIS, 2013). Nonetheless, these risk models have to be approved by the supervisory authority and are regularly monitored.

Risk-weighted capital ratios should be complemented by a leverage ratio requirement. A leverage ratio has been shown to have predictive power for the default risk (measured as distance to default) of a bank, whereas the ratio of capital to risk weighted assets has not (Blundell-Wignall and Roulet, 2012). However, to some extent this finding might reflect "Goodhart's law" which states that when a statistical measure becomes a target, its predictive power declines. For reference, Figure 1.6 shows some capital and leverage ratios, aggregated by country. These are not all computed on a consistent basis and so should not be compared across charts. Indeed, there is no clear agreement on how to best compute such ratios. Research by the OECD suggests that a leverage ratio in which derivatives are not netted on the asset side, as in panel C of Figure 1.6, is the best predictor of distance to default (Blundell-Wignall and Roulet, 2012).

Ratios of Core Tier 1 capital to total balance sheets have recently been below 3% in some of the biggest, internationally active German banks (Figure 1.7). Stock market assessments of net worth, where available, have been similarly low. Moreover, Core Tier 1 capital as currently published by banks, may still include items which are not loss absorbing, in particular deferred tax assets and the goodwill from past mergers and acquisitions. Deferred tax assets include tax deductions banks expect to make as they offset past losses against future gains. Goodwill represents the estimated present value of future profits of a company which has been taken over. Neither can absorb losses if a bank becomes insolvent. The sum of deferred tax assets and goodwill amounts to about 1% of total assets in several of the biggest German banks.

Low levels of loss-absorbing capital in large banks are of particular concern, first, because these banks are particularly globally interconnected, generating important spillovers which affect global stability. Deutsche Bank in particular, has been classified as one of the most globally systemically important financial intermediaries by the Financial Stability Board. Second, owing to the global scope of their activities, they remain unlikely to be wound down, raising the risk of a government bail-out and aggravating incentives to take excessive risks. Despite very low capital buffers relative to total assets, banks paid out dividends to shareholders, such as Deutsche Bank in 2012. By contrast, among the savings and co-operative banks, Core Tier 1 capital exceeds 5% of total assets, although this is not true for their apex institutions, which belong to the biggest banks in Germany.

Figure 1.6. **Capital ratios and leverage ratios**[1]



1. Averages, weighted by individual banks' total assets.
2. Total regulatory capital is defined under the latest regulatory guidelines at period-end. For European banks, this excludes transitional capital adjustments when available. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
3. Total Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Total risk-weighted assets are reported according to appropriate accounting or regulatory standards.
4. Based on quarterly data as of December 2013; where these are not available the most recent available data are taken, extending back to December 2012. The leverage ratio relates banks' Core Tier 1 capital to total assets, in book values. Core Tier 1 capital is the actual amount of core common capital as defined by regulatory guidelines. Data for total assets are adjusted to reflect the International Financial Reporting Standard (IFRS).

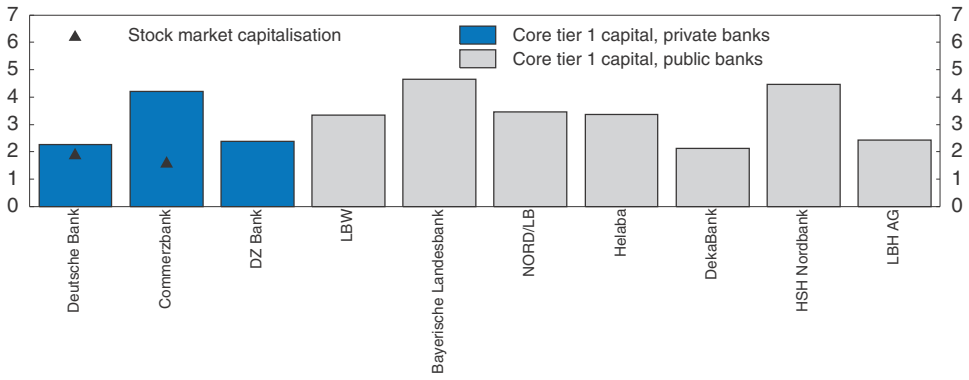
Source: SNL Financials, Bloomberg, DataStream and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933033745

Stricter capital requirements raise funding costs for banks. However, the secular decline in capital as a share of balance sheets in banks in the 20th century was not accompanied by marked decline in the spread between banks' borrowing and lending rates. The impact of more stringent capital requirements on borrowing costs and activity is therefore likely to be limited in the long-run and is offset by the benefits of improved

Figure 1.7. **Core Tier 1 capital in the 10 biggest German banks**

As percentage of total assets, third quarter 2013[1]



Note: Banks are ordered by balance sheet size.
1. Or latest quarter available.
Source: OECD calculation and balance sheets.

StatLink http://dx.doi.org/10.1787/888933033992

stability and lower risks for taxpayers. Given that some large banks are highly leveraged suggests that the relative benefits of reduing their leverage with a leverage ratio requirements are large. The higher funding costs for banks are likely to mostly reflect the reduced value of implicit government guarantees and the reduced cope to deduct capital costs from taxable profits (Admati et al., 2010). Hence, to a large extent, the higher funding costs for banks do not imply higher social costs.

The Basel III agreement foresees introducing a leverage ratio requirement to be calibrated in 2017 based on the experience during the previous observation period. A 3% minimum ratio is currently being tested. Blundell-Wignall and Atkinson (2012) and Blundell-Wignall and Roulet (2012) argue that a 5% leverage ratio significantly reduces default risk. Calomiris (2013) argues that a leverage ratio requirement of 10% would be appropriate and that such a requirement should be complemented with the obligatory issuance of conditional convertible bonds, to be triggered when the market value of the bank falls below a threshold set by regulators. Admati et al. (2010) have suggested leverage ratios in the range of 20% to 30%.

While EU capital requirements do not include a leverage ratio requirement yet, the rules leave some scope for national governments to set a leverage ratio requirement, for example for the largest banks. Denmark, Poland and the United Kingdom have set such requirements. Requiring banks to hold more capital relative to assets could in principle reduce lending growth in the transition until the required ratio is reached. However, this risks may at present be limited in view of the weak demand for loans (see above). In any case, to avoid such a risk the authorities can require the banks to take specific actions to reduce such risks. They could require profits to be retained and define additional required capital in nominal terms, rather than relative to the balance sheet. More generally, to durably limit risks emanating from financial intermediaries it is also important to ensure high ethical standards in the industry and strengthen corporate governance.

The co-operative banks and the savings banks benefit from an exemption from the rule that participations in other banks must be deducted from regulatory capital with respect to their ownership of their apex institutions. There is no capital surcharge for

guarantees of these banks for their apex organisations, either, even though they have been historically subject to relatively large shocks. These guarantees raise interconnectedness (IMF, 2011b). Therefore, there is a case for deducting participations of savings and co-operative banks in their apex institutions, assimilating their regulatory treatment to that of banks' participations in other banks generally.

The savings banks have supported inclusive growth but the public banking sector requires reform

The German banking system stands out for the large weight of public banks, which contribute more than 40% of total banking sector assets and domestic credit supply. They mostly consist of the local savings banks and the regional *Landesbanken* (Box 1.3).

Box 1.3. **The *Sparkassen* (savings banks) group**

The *Sparkassen* group comprises 421 savings banks, 7 *Landesbanken*, as well as several building societies, a number of service providers and other financial and non-financial institutions. Each bank is independent and has distinct public owners. The establishment of the group began approximately 200 years ago with the formation of the first savings banks.

The savings banks

The local authorities (municipalities or associations of municipalities) have in most cases founded and govern the savings banks. The savings banks' status is a public entity under the jurisdiction of local governments (Bülbül, 2013). The *Länder* impose legal requirements on their business. In all *Länder* their business must be directed to their respective local community for which they are required to provide universal access to basic banking services and ensure local credit supply. They are typically required to contribute to the economic, social and cultural objectives of their municipalities. They are not profit-maximising but are required to seek profits to strengthen their capital base and be able to expand. Remaining profits are disbursed for social and cultural activities according to rules set out by the *Länder*. The savings banks are organised in a "bottom-up" fashion, with the savings banks governing their regional associations. These also own and control their federal head institution which supplies payment services as well as other central financial services, including investment banking and the design of common savings products. They also own stakes in the *Landesbanken*, which are in some cases majority stakes.

The *Landesbanken*

Initially, the main function of the *Landesbanken* was to provide centralised facilities to savings banks, notably centralising funding (such as bond issuance), as well as providing economies of scale for the provision of standardised services by savings banks (see e.g. Noack and Schrooten, 2009). Today they are run like private banks and conduct wholesale and retail banking. Their activities include investment banking, project finance, real estate and agricultural banking, corporate and investment consulting. In most cases, they do not act as development banks for which most *Länder* have created separate institutions. In most cases, *Landesbanken* are majority-owned by the *Länder*, although a few are majority-owned by the savings banks of the region covered by the *Landesbank*. One *Landesbank* has a minority private stake.

Mutual guarantees

The savings banks, *Landesbanken* and the building societies guarantee each other's liabilities and equity. They are applied as soon as financial problems become apparent at

Box 1.3. **The *Sparkassen* (savings banks) group** *(cont.)*

the discretion of the savings banks' association concerned. There are 11 regional mutual support funds for regional savings banks' associations as well as a fund for the *Landesbanken* and a fund for the building societies of the group. The members of each fund are responsible for supporting each other. If a fund cannot supply enough support it can turn to other funds for further support. The mutual guarantee schemes are partially funded and are supervised by the Federal Agency for the supervision of financial services (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) but is not publically disclosed. To limit moral hazard monitoring committees are attached to the support funds. They are supervised by a "transparency committee", which oversees monitoring standards and reviews risk-adjusted contributions to the funds. Support provided is subject to conditionality. Over the last 40 years less than 1 support case a year has occurred on average while four cases have required supra-regional compensation.

Banking supervision applies to them in the same way as for private banks, including "fit and proper tests" for the management board. Competence requirements for members of the supervisory boards, which also apply to public and private banks equally, were sharpened in 2009. In particular, they must be able to understand the bank's business and to assess its risks. Such skills can be proven by previous experience, including in non-banking sectors, for example, in public administration or political appointments, provided it includes significant economic or legal responsibilities (BaFin, 2010). Elected local and regional politicians are often members of the supervisory boards.

The savings banks, like the privately owned co-operative banks, are sectorally diversified but locally focused. In the case of the savings banks, this results from their public service obligations. Despite a relatively good track record on profitability, savings banks' pay-outs to owners and for social spending have been small, as most profits are used to increase capital. The savings banks disbursed 0.02% of GDP worth of social spending and dividends to their owners in 2009. Implicit subsidies disbursed via cheaper lending are also small, estimated at 0.05% of GDP (IMF, 2011b). The level of payouts is determined by the level of profits, the capital and an assessment of risks of each savings bank (IMF, 2011b).

The local focus appears to have brought economic benefits. It has helped to keep broad coverage of the population with basic financial services, and has fostered access to loan finance for small and medium-sized businesses. Thereby, it appears to have encouraged regional economic development in relatively poorly developed regions. In the absence of local banking, credit rationing may result in poor regions having fewer projects to be financed than rich regions, because of lower initial endowments, which may, for example, restrict available collateral (Hakenes et al., 2009). The savings banks may also raise welfare by a more long-term orientation, allowing profits and losses to be smoothed over a longer time period (IMF, 2011b). A higher share of their lending is long-term than in the commercial banks.

Like the co-operative banks, the savings banks operate a bottom-up mutual guarantee system covering all liabilities. Such guarantees create moral hazard, although co-operative and savings banks have created internal auditing procedures to mitigate that risk. Over the last 40 years, few savings banks have required support from the guarantee system. The mutual guarantees of the savings banks group provides for some geographic risk

diversification, offsetting risks from the geographic concentration of exposures which result from the regional principle.

There has been some progress in restructuring the Landesbanken but risks could resurface

The *Landesbanken* bore heavy losses during the global financial crisis (OECD, 2010). Since 2007, the number of *Landesbanken* has fallen to 7, mostly reflecting mergers. Only one was wound down and no loss was imposed on its creditors. Since then the *Landesbanken* reduced their balance sheets by about 30% and made efforts to shift their business model towards lending to small and medium-sized enterprises. They reduced their proprietary trading activities and international activities. These changes reflect the restructuring requirements of the European Commission, imposed as a condition for the approval of government support. The European Commission has also required changes in their governance. Nonetheless they remain less anchored in the real economy of their respective regions than the savings banks. Only 16% of their assets consist of loans to the domestic non-financial private sector (Table 1.2). In some cases the savings banks have taken control over the *Landesbank* in their region, while in others the *Land* has majority ownership.

Table 1.2. **Total assets and lending by *Landesbanken* and savings banks**

2012

		Landesbanken[1]	Saving banks
Assets (per cent of GDP)		53.1	41.1
Lending (per cent of assets):			
Total lending[2]		81.0	95.5
Lending to:			
Banks		34.6	22.8
The German government		12.1	6.6
The German non-bank private sector:[3]	Business sector	16.8	30.5
	Household sector	2.2	27.1

1. According to the definitions of the Banking Statistics of Deutsche Bundesbank, including *DekaBank Deutsche Girozentrale* (the national savings banks' apex institution).
2. Lending to banks and to non-banks.
3. The business sector comprises enterprises and the self-employed; the household sector households and employees and It excludes securities portfolios.

Source: Bundesbank.

Schmielewski and Wein (2012) attribute the weak and volatile performance of the *Landesbanken* to weak control of the banks by their public owners, notably regional governments, as well as to pressure to make short-term profit, although widely-held, publicly quoted banks faced similar problems. Lack of control was aggravated by their involvement in investment banking. By contrast, the savings banks' narrower business model facilitates control by their owners. It also limits outside options of bank managers, facilitating sanctions if loan misallocations occur, and thereby reducing the adverse consequences of incomplete control. Apart from their public service mandate, the *Landesbanken* operate like private banks. The large weight of lending to the public sector and to other banks also casts doubt as to the sense of government ownership of *Landesbanken*.

The *Landesbanken* have frequently received financial support from the *Länder* governments both before and during the global financial crisis (German Council of Economic Experts, 2008). In 2013, a *Land* government issued guarantees for a *Landesbank* to raise its regulatory capital. However, the guarantees hide costs of the resulting risks in the regional budgets, diminishing transparency and accountability. Some observers (Hellwig, 2010) have argued that the *Landesbanken* finance their regional governments in a non-transparent way. The financial relationships between regional governments and their *Landesbanken* may soften perceived budget constraints which can result in larger financial risks as well as poor performance of the public banks concerned.

The *Landesbanken* have close financial relationships with the savings banks. Savings bank funding for the *Landesbanken* is encouraged by regulatory settings which provide privileged treatment to savings banks' loans to *Landesbanken*. In particular, savings banks' lending to *Landesbanken* is not subject to size limits which normally apply to banks' individual exposures and no risk weights are attached to such lending. Moreover, the *Landesbanken* are integrated in the mutual guarantee schemes of the savings banks, although they are less subject to geographic concentration of risks than the savings banks. If financial problems were to recur among the *Landesbanken*, they would spread to the savings banks. During the global financial crisis, such spreading was limited by large-scale bail-outs by the federal government and the *Land* governments, which have tended to provide support on more favourable terms than the federal government (Hellwig, 2010). Such bailouts are, however, undesirable and are being curtailed by EU legislation. The *Landesbanken* may also pass on systemic financial risks because of their role in interbank lending. Since savings banks cannot generally raise capital externally, any losses the savings banks may suffer from financial exposure to *Landesbanken* would be relatively likely to result in contraction of their balance sheets to meet capital requirements. While the savings banks are financially exposed to the *Landesbanken*, their scope to control them is limited, as the regional governments own controlling stakes in most of them (Box 1.3). The guarantees the savings banks provide for the *Landesbanken* are also likely to aggravate governance problems among those *Landesbanken* which are controlled by governments of the *Länder*.

These arguments suggest that the *Länder* should continue restructuring the *Landesbanken* including through privatisation. Micro- and macroprudential regulation should address remaining risks from the *Landesbanken* and prevent them from spreading to the savings banks.

The government has stepped up efforts to improve regulation of the banking sector

The German authorities have taken significant steps to improve bank regulation in recent years, including the introduction of macroprodudential regulation, rules to separate investment banking from deposit-taking in 2013 and resolution legislation in 2011. These are discussed below. The large commercial banks and the *Landesbanken* will fall under direct bank supervision by the European Central Bank when the Single European Supervisory Mechanism is introduced in the fall of 2014. However, most co-operative banks and savings banks will continue to be supervised by the Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin) and the Bundesbank.

The government has also introduced legislation to sharpen rules concerning the liability of managers of financial intermediaries. To this end minimum standards for risk management have been set. Moreover, rules on remuneration have been tightened to avoid incentives for

excessive risk-taking among key bank staff in major banks. For example, the rules require bonus payments to be spread over several years. Bonus payments for staff working in control units must not conflict with their control functions. However, in a first review of remuneration schemes of major German banks BaFin found German banks had not satisfactorily complied with these rules. The government plans to review the new remuneration rules. Nonetheless, these findings suggest that underlying causes for incentives of banks to take excessive risks need to be addressed. A higher leverage ratio and steps to reduce perceptions of implicit guarantees (discussed further below) can help in this regard.

Germany plans to introduce a broad-based financial transactions tax on all financial transactions together with 10 other European Union countries. Such a tax has been argued to be too blunt as an instrument to help reduce financial market risks and requires international co-ordination to be effective (Schich and Kim, 2011). Views differ as to whether such taxes reduce volatility in financial markets (see e.g. ul Haq et al., 1996). In Germany, the tax is intended as an instrument to achieve a contribution by the financial sector to the cost of the crisis rather than as a regulatory tool.

The new framework for macroprudential regulation is timely

In 2013, a new institutional framework for macroprudential supervision and regulation was introduced, involving BaFin, the *Bundesbank* and the Federal Ministry of Finance. A new Committee for Financial Stability has been created consisting of 3 members from each institution as well as non-voting representatives from the *Federal Agency of Financial Market Stabilisation* which is in charge of unwinding legacy assets transferred from banks to the government. The committee can issue recommendations to any governmental entity if it considers that action is needed to safeguard financial stability. In general, decisions are taken by consensus. In case of disagreement decisions on warnings and recommendations cannot be taken against the view of the *Bundesbank* (Deutsche Bundesbank, 2013a). The work of the new committee is based on the ongoing macroprudential oversight by the *Bundesbank*, which analyses financial market developments and is required to identify financial market risks. When it identifies such risks it proposes warnings and recommendations to be issued by the committee. It has access to all data available to BaFin but can also require additional data from financial intermediaries. Once a recommendation has been issued, the addressee must either comply with it or explain why it does not. The committee reports to parliament annually.

The new macroprudential framework is welcome. With the cyclical position of the German economy stronger than the euro area's, a persistent low-interest rate environment could generate risks of excessive lending and price bubbles in the housing market. National macroprudential competencies will remain important once the "Single Supervisory Mechanism" takes up its functions, which is expected in November 2014. For example, national authorities decide on cyclical capital buffer requirements and can change sectoral risk weights for the calculation of capital requirements (Bundesbank, 2013b). They can also set additional capital requirements, within specified limits, to mitigate system risks.

Perceived government guarantees remain substantial despite reform of resolution legislation

The bank restructuring law introduced in 2011 grants powers to the authorities to facilitate timely and effective resolution of systemically-important problem banks before

they are in breach of liquidity or solvency requirements, provided the banks concerned are deemed systemically important. In particular, the authorities can transfer selected assets and liabilities of a failing bank to another institution, such as a bridge bank (IMF, 2011a), so as to protect systemically important functions of the bank. Such a transfer is a discretionary decision and possible whenever it is expected that regulatory capital or liquidity will fall to 90% of the minimum when a risk for the financial system is generated as a result and when other mechanisms cannot be employed to stabilise it. Further legislation, introduced in 2013, requires large banks to develop contingent recovery plans to ensure the bank's survival in situations of financial stress while avoiding costs to taxpayers. BaFin can order banks to execute actions foreseen in these plans. BaFin has been required to develop contingent resolution plans for these banks.

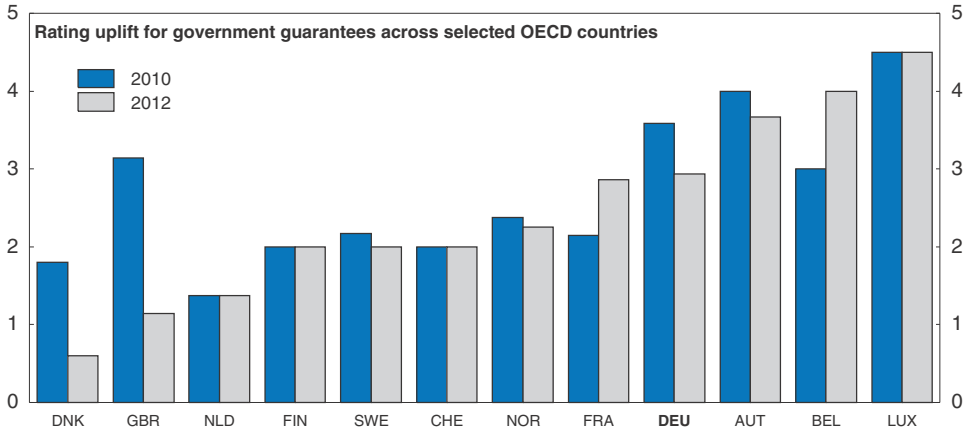
The bank restructuring law has also set up a restructuring fund with a target size of EUR 70 billion, with annual revenues of up to EUR 1.3 billion. As a contingency funding mechanism, special assessments may be imposed on banks and the government can make higher payouts which it then recovers from the fees. Subject to an overall ceiling linked to the banks' annual profit (over a multi-year period), the levy rises with the amount of bank liabilities (excluding deposits) from 0.02% if they exceed 300 million to 0.06% when they exceed 300 billion. A lower flat rate applies to derivatives. It is planned to integrate this restructuring fund in the euro area's resolution fund once the European Single Resolution Mechanism has been set up.

This framework establishes a mechanism which allows for bank debt to absorb losses in banks by means of a partial transfer of assets and liabilities to a bridge bank. The EU Bank Recovery and Resolution Directive will require a more flexible bail-in tool from 2016. Germany is one of few countries in which resolution authorities have the power to depart where necessary from the general insolvency principle of equal treatment of creditors of the same class. German legislation respects the protection of creditors' rights as a fundamental feature of financial markets. However, some financial market experts have criticised that the objective of financial stability is given priority over the protection of creditors' rights only under certain conditions when the bank restructuring law is applied (Hellwig, 2012b). A leading financial market expert has argued that this generates the risk that the resolution legislation will not be applied (Hellwig, 2012b). The restructuring law has never been applied in practice, although there was an opportunity to do so in 2012. The law stipulates that the bank restructuring fund will ultimately deal with any resolution costs that cannot be borne by the resolved banks' owners and creditors. However, the bank fund will be overstretched in a systemic crisis affecting large parts of the banking sector (Hellwig, 2012a, 2012b).

The new bank restructuring law notwithstanding, the perception of government guarantees remains strong, more so than in some other European Countries with favourable credit rating for government debt (Figure 1.8). These perceived guarantees reduce pressure on weakly-performing banks to restructure or exit the market.

The European Union is planning to introduce a Bank Recovery and Resolution Directive setting minimum requirements on member states for their national resolution legislations, which will further enhance the credibility of the German resolution regime. For example, it will require to bail in shareholders and creditors when a bank needs to be recapitalised. Current plans foresee that the Directive takes effect from 2016 onwards. The authorities should aim for comprehensive inclusion of bank debt in the planned bail-instrument required by EU legislation.

Figure 1.8. **Perceived government guarantees for major banks across countries**



Note: Average uplift, calculated as the difference in notches between all-in credit rating and the adjusted stand-alone credit rating, which already factors in parental and co-operative support; hence the difference reflects regional government and systemic government support only. Sample consists of 123 large European banks.
Source: S. Schich and S. Lindh (2012), "Implicit Guarantees for Bank Debt: Where Do We Stand?", *OECD Financial Market Trends*, Vol. 2012/1.

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Separation of banks' proprietary trading activities from deposit-taking can help reduce excessive risks

Parliament has approved legislation which requires banks to separate certain trading activities from deposit-taking from July 2016 onwards if the bank's balance sheet exceed EUR 90 billion (which currently equals to 3½ per cent of GDP) in three consecutive years, or if other thresholds are exceeded. These banks have to transfer trading of some securities and other financial instruments carried out with the bank's own funds into legally separate entities. Loans and guarantees provided to hedge funds or to other highly leveraged businesses, including high-frequency trading, are generally also covered by the separation requirement. The separated trading entitity must be funded externally, with funding from the deposit-taking bank in the holding only being allowed at arm's length. The separation requirement also applies if the volume of the assets subject to the requirement exceeds 20% of the balance sheet or EUR 100 billion. The two largest commercial banks and the biggest *Landesbanken* are expected to fall under the legislation.

Some exemptions apply. Trading that is carried out as a service to a third party is excluded from the limit. For example, market-making trades do not generally fall under this requirement although BaFin can require separation of such activities if they pose a threat to the solvency of the institution, for example because of their size or risk profile. As argued in the Liikanen Report (2012), market-making activities are difficult to distinguish from other trading activities. Relying on supervisory judgment instead of a general separation requirement may therefore weaken the effectiveness of separation.

Separation of proprietary trading activities from retail banking can mitigate the too-big-to fail problems. It allows activities which may generate large systemic risks to be separated from those which need to be preserved in a banking crisis, notably deposit-taking and lending, making it easier to wind down a failing bank. Interconnectedness of retail banking with trading activities diminishes because retail banks reduce proprietary trade (notably with derivatives, which particularly increase interconnectedness) and

because their exposures to other banks would be curbed by existing large exposure limits. The separation may also reduce cross-subsidisation from the implicit guarantees of being a part of a large insured deposit bank with access to central bank lending (Liikanen et al., 2012; Blundell-Wignall and Atkinson, 2011). The advantages of separation include more transparency for investors and regulators. Since trading activities may be less transparent to external investors they may also be a barrier for external recapitalisation of banks if trading activities are not separated. Regulators are also able to intervene in a more targeted and therefore more rapid fashion in risky trading banking activities with less concern about implications of interventions on lending and deposit-taking (OECD, 2009). This and the fact that separated investment banks may become smaller (and thus less systemically important) may help change the strategic relation between the supervisory authorities and the bank, with the supervisor being less under pressure to stand behind a systemically important bank when it faces problems. Such behaviour has often contributed to delays in addressing banking sector problems.

Assigning these trading activities to separate ring-fenced subsidiaries but keeping them within a banking group maintains the advantages of the universal bank model to a large extent, minimising losses in economies of scale and scope in financial institutions, via shared technology platforms, for example (OECD, 2009). In any case, the introduction of limitations on investment banking activities of deposit-taking banks in the United States (such as in 1956 and at the end of the 1980s) appears not to have been followed by periods of weaker economic growth than in preceding years but appears to have been followed by periods of more stable intermediaries (OECD, 2009).

The legislated separation does not distinguish between primary securities held for trading and derivative positions. Primary securities fund economic activity in the same way as bank loans. In fact, recent empirical work at the OECD suggests that such assets make banks safer, whereas large derivative positions raise the risk of default (Blundell-Wignall and Roulet, 2012; and Box 1.2 above). Primary securities also help banks meet liquidity requirements. Focusing thresholds for separation requirements on derivatives would therefore also help to make separation requirements consistent with tighter liquidity requirements on banks. These arguments suggest that derivatives should play an important role in determining separation requirements.

Recommendations to strengthen financial sector resilience

- Ensure that banks are adequately capitalised. Introduce a leverage ratio requirement as a complement to capital ratios in line with international agreements. Give consideration to introducing a leverage ratio requirement for systemically important banks before 2018.
- Accelerate loss recognition of impaired assets. To this end consider requiring valuing impaired loans in line with market prices of underlying collateral and to value bonds according to market values, including those not held in the trading book.
- Micro- and macroprudential regulation should address remaining risks emanating from *Landesbanken*. The *Länder* should continue restructuring the *Landesbanken*, including through privatisation.
- When transposing the European Union's Bank Recovery and Resolution Directive into German law, aim for enabling the authorities to include bank debt as comprehensively as possible in the future bail-in instrument. Clarify the priority for financial stability objectives over creditor rights when the legislation is applied.

Recommendations to strengthen financial sector resilience *(cont.)*

- Improve corporate governance in the *Landesbanken* and savings banks, for example, by requiring members of the board to be more independent from elected regional and local governments.
- Consider ways to improve the effectiveness of requirements to separate investment banking activities from retail banking. For example, give consideration to including securities held for market-making purposes in separation requirements and to focusing such requirements on derivatives exposures.

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Chapter 2

Raising the potential of the domestically oriented sector

Germany's manufacturing sector, which plays an important role for exports, has been performing well over the past decade in terms of labour productivity growth and international competitiveness. However, the services sector has had much slower growth rates. Competition often appears to be hindered by protection of incumbents. Reforming and deregulating the domestically oriented sectors, including network industries, crafts and professional services would release hidden growth potential and prove beneficial to the economy as a whole. It could also help strengthen domestic demand and reduce dependence on exports.

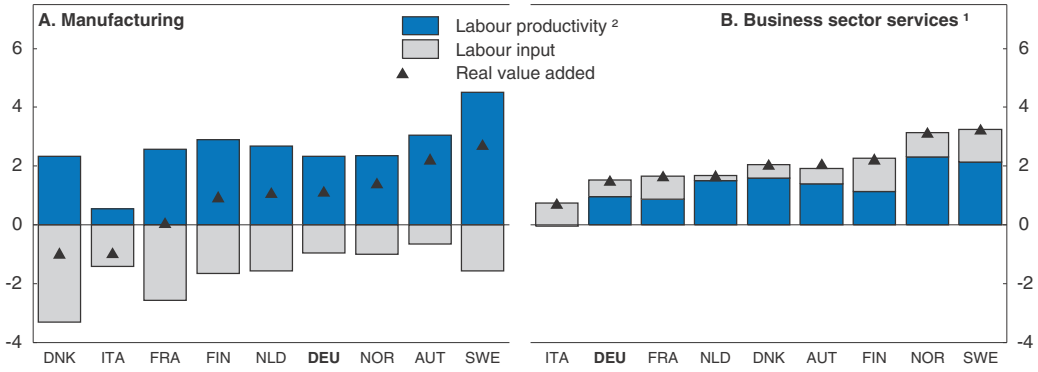
This chapter covers regulatory policies in a variety of markets, mainly in the services sector. Some of these issues have been addressed in previous *Economic Surveys of Germany*. In this chapter, they will be discussed in more depth and with the objective of providing more detailed proposals for regulatory reform.

As in all high-income countries, services contribute most to economy-wide value added. However, at 69%, the services share in Germany was the smallest among the 10 largest economies in the euro area in 2012, mirroring the relatively large contribution of manufacturing activities. The services share increased from 62% to about 70% in the last decade of the 20th century and has been relatively stable since. Labour productivity, measured in total hours worked, has developed favourably in manufacturing, rising at an annual growth rate of 2.6% between 2000 and 2011. At the same time, measured labour productivity growth in the service sector has been slightly below 1%. In comparison to other OECD countries, telecommunication services as well as professional, scientific and technical services have performed especially poorly. Measured labour productivity for the latter actually decreased, at an annual growth rate of -2.0%.

Seen from a different angle, both manufacturing and the business services expanded their real value added between 2000 and 2011 by about one fifth. However, in manufacturing the workforce fell by 7.3% (or 570 000 jobs), while in business services it rose by 12% (or 1.9 million jobs). The resulting differences in labour productivity growth between both sectors (Figure 2.1) also have implications for job quality, skill patterns and education requirements, if one assumes that workers are paid according to their marginal product.

Figure 2.1. **Real value-added and productivity growth in manufacturing and services**

Average annual growth rates, 2000-11 or latest year available



1. Business sector services comprise the following ISIC Revision 4 categories: Wholesale and retail trade, repair of motor vehicles and motorcycles; Transportation and storage; Accommodation and food service activities; Information and communication; Financial and insurance activities; Professional, scientific and technical activities; Administrative and support service activities. They exclude real estate activities.
2. Labour productivity is calculated as real value added divided by total hours worked.

Source: OECD STAN Database.

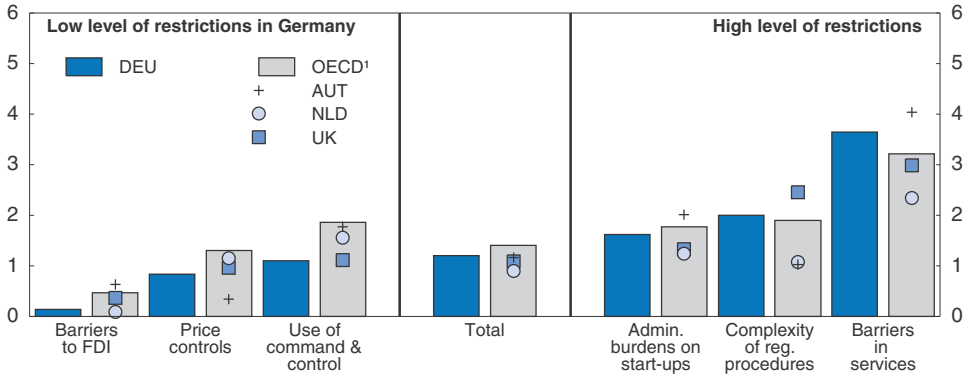
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Product market regulation has become more conducive to competition but barriers remain in some services

Germany has considerably improved its product market regulation (PMR) over the past 15 years and ranked among the top 5 out of 33 reporting countries in 2013 according to the overall score of the OECD's PMR indicator. In international comparison, Germany has relatively low barriers to trade and investment and resorts little to price controls and command and control regulation (Figure 2.2). Since 2008, the German authorities have expanded the availability of single contact points, and lowered the administrative burdens for corporations, for instance by introducing a "light" version of a limited liability corporation.

Figure 2.2. **Product market regulation**

Scale 0 (least restrictions) to 6 (most restrictions), 2013



1. Unweighted average of 29 countries except Luxembourg, Mexico, Poland, Turkey and the United States.

Source: OECD (2014), *Production Market Regulation Database*.

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Nevertheless, Germany's regulatory protection of incumbents in service sectors not open to international competition remains elevated. Lacking or incomplete ownership separation holds back competition in most network industries. Professional services continue to be quite strongly regulated in international comparison and the complexity of regulatory procedures is one of the highest among OECD countries.

How to make services more innovative and productive

Opening new markets by removing entry barriers and unnecessary regulatory restrictions, as well as allowing more competition in existing markets, is a prerequisite to promote innovation, job creation and investment in the service sector. A strong and productive service sector could be an economically stabilising factor in two dimensions. Most importantly, internally it would establish a reliable second pillar to the German growth model, where economic activity is based strongly on manufacturing and exports. In addition, empirical evidence shows that competitive service regulation also has positive effects on employment and productivity of downstream industries that use services as inputs (Bourlès et al., 2011). With regard to the second dimension, the benefits of a strengthened domestic economy would also be felt externally and could contribute to a more balanced economic growth path *vis-à-vis* trading partners by strengthening domestic demand growth in Germany.

Incumbents could be exposed to more competition from market entrants in network industries

Telecommunication

Machine-to-machine (M2M) communication, also called the "internet of things", is expected to be the market's main growth driver of the future. Machines and devices will increasingly communicate autonomously via mobile networks. M2M communication is rapidly gaining significance in the automotive and in the energy sector (e.g. smart metering) or in applications related to smart-city technologies (traffic light regulation, toll systems). Initiatives to ensure competitive market conditions in this sector would have large benefits to consumers and unleash significant potential for innovation, economic and social development.

Research conducted by the OECD indicates that an enormous potential lies in breaking up exclusive rights of issuing SIM cards (OECD, 2012). Germany is one of only few EU countries where issuing SIM cards remains limited to mobile spectrum holders and to manufactures for testing purposes (CEPT, 2013). This is mostly a regulatory issue as it is technically feasible to permit third parties like mobile virtual network operators (MVNO) and non-telecom operators to do the same. For example, manufacturers of cars wishing to install SIM cards for mandatory safety services or manufacturers of smart meters are locked into their initial choices of a mobile network operator once their products have been distributed to consumers. Prohibitively high costs to change these SIM cards effectively rule out competition afterwards. The possibility of rerouting the built-in SIM cards could generate savings that amount to EUR 1-2 billion in the automobile sector alone and considerably widen applications of IT services in moving vehicles.

Similarly, a German MVNO, such as a large retailer, can only resell SIM cards of a mobile operator. Wanting to switch the operator would mean resending thousands of new SIM cards to end-consumers. By contrast, a large Dutch or French retailer can simply reprogramme all its SIM cards to a new network operator once the contract ends and for the end-consumer nothing changes. As M2M communication is spreading, the impact of liberalisation would be beneficial to businesses and consumers in various fields throughout the economy. Enabling businesses in all sectors to seamlessly switch network providers, to purchase mobile roaming at lower cost and to increase reliability would generate large cost savings and lower the barrier for introducing new products and services (OECD, 2012).

Privatisation of the remaining 32% of shares of the incumbent operator, Deutsche Telekom, would strengthen market perceptions of the neutrality of government with respect to the incumbent and its competitors.

Railways

Continuing vertical integration through a holding company generates incentives for the incumbent, Deutsche Bahn (DB), to give its own transport service providers preferential access to infrastructure over competitors, as 98% of all train services depend on infrastructure provided by Deutsche Bahn (FNA, 2012). According to the Federal Network Agency (FNA, *Bundesnetzagentur*) market shares of competitors have more or less stagnated since 2009. The incumbent still provides three quarters of all freight transport, 87% of short-distance and over 99% of long-distance passenger transport services. This is unlikely to be sufficient to drive costs, service quality and tariffs to efficient levels. Competition in short-distance transport is slightly more common, as local public transport services are usually assigned through tenders.

Several cases of discrimination against competitors have been reported. For example, anti-competitive elements of the track fee system of DB have repeatedly been declared illegal by the courts, or have been banned by the Federal Network Agency. Following a recent investigation of the EU Commission, DB Energie, the sole supplier of traction power in the market, committed to introduce a new price system this year and to partially separate its traction network from traction supply. Discrimination against competitors can also occur through denying access to information and operating systems. It is only since 2011, and again through the intervention of the regulator, that all competitors have enjoyed proportionate access to operations control centres, the main decision making units for railway track utilisation. Providers of passenger transport services, in particular, still do not have equal access to an integrated ticketing system. There are some indications that the current ticketing system of the incumbent's affiliate, DB Vertrieb may obstruct competition via high user fees for third parties or via the non-transparent revenue distribution system used to assign competitors their shares from joint ticket revenues. In January 2014, the German competition authority (*Bundeskartellamt*) initiated proceedings against DB in this matter.

Ownership separation between infrastructure and transport operators, which is advocated by the German Monopoly Commission (2013a) and in the EU Fourth Railway Package (2013a), is a promising route towards more competition. This could be achieved by privatising the transport services of the vertically integrated incumbent, while maintaining public ownership of the infrastructure. The public network operator could also keep all services characterised by natural monopoly, including infrastructure and traffic management and an integrated ticketing system. However, the coalition agreement of the governing political parties from November 2013 voices the intention to maintain the integrated structure of Deutsche Bahn.

If the holding structure of DB were to be maintained, the limited powers of the regulator must be strengthened to avoid discrimination against competitors. As the draft Railway Regulation Law (ERegG-E) failed to be adopted in July 2013, the regulator FNA can still only engage in market surveillance upon a substantial suspicion of malpractice and not for simply collecting market information, for which participation is voluntary. It has no regulatory competencies to investigate market abuse for traction power and ticketing (Monopoly Commission, 2013a). Within the *ex ante* price-regulation procedure, the FNA must screen proposed pricing schemes for potential violations within the insufficient time span of only four weeks. Later amendments can only be imposed *ex post*. Currently, requests to access company records must be individually justified and mandated.

The authorities should aim to reinforce the regulator by assigning it more investigative and interventional competences. As in other regulated network sectors, market participants should face a clear set of binding rules to regularly furnish specific documents and information. It is desirable to change the price regulation system, introducing real *ex ante* regulation, where pricing schemes have to be fully approved in advance. This would reduce scope for the incumbent to discriminate against market entrants.

Access of market entrants to rolling stock should also be facilitated. Economies of scale in the production of rolling stock and high investment costs can deter market entry of newcomers. The fact that licensing periods for public concessions (not more than 15 years) are much shorter than life expectancies of rolling stock generates a substantial remaining-value risk. Evidence suggests that the German incumbent prefers scrapping its

discarded rolling stock over selling it to competitors (EU, 2013b). This is profitable if the incumbent's anticipated decline in monopoly rent is larger than the remaining value of the used rolling stock. Therefore, regulatory authorities should consider requiring the incumbent to auction used rolling stock before scrapping it.

Postal services

Market entry and competition in postal services could be increased by creating equal conditions in value added taxation for all service providers. Nation-wide provision of universal postal services is exempt from VAT. This effectively shields the incumbent from potential competitors, who would have to ask for higher prices during market entry. Equal taxation of equal services could best be achieved by abolishing the privilege of VAT exemption for postal services, although such a change would contravene current EU legislation. A second-best solution would be to drop the requirement of "nation-wide provision" from the national VAT law, thereby granting the same privilege also to local and regional competitors (Monopoly Commission, 2011).

The public authorities should sell all remaining shares of Deutsche Post (21% of total shares, held by KfW bank) in order to minimise the potential of conflicting interests.

Renewable energy

The new governing parties have committed in their coalition agreement to reducing greenhouse gas (GHG) emission by 80-95% below the 1990 level until 2050. Price mechanisms, as the CO_2 emission certificate trading scheme, are insufficient to reach these long-term targets due to market failures associated with external effects from innovation spillovers and emission reduction in general. Markets also lack CO_2 prices for the long-term horizon due to uncertainty and high discount rates among businesses. Therefore, a support scheme for renewable energy sources (RES) can be appropriate. The dependence on RES has been reinforced by the decision to phase out nuclear energy generation by 2022.

A major challenge is to make the German support scheme more cost-effective. Subsidies for feed-in tariffs (FIT) will reach 0.8% of GDP in 2014 and are projected to rise further under the current setting. The new governing parties have announced their intention of comprehensive reform of the RES Act (*Erneuerbare Energien Gesetz*, EEG). This reform should include both a clear vision of how to integrate renewable energies into the market in the long run and the corresponding milestones and measures to be implemented in the short and medium-term horizon.

The coalition agreement envisages a number of steps. The direct marketing model for RES, which is currently optional, will become mandatory for all new plants. This model sets incentives for RES producers to incorporate market prices into their feed-in decision. New RES plants must be controllable by network operators to enhance grid stability. And crucially, auctions are planned to determine subsidy levels from 2018 onwards.

Both auction and quota models are alternatives to the status quo, and would help to reveal market prices and allocate resources more efficiently. However, a technology-neutral quota model (Monopoly Commission, 2013b) has drawbacks such as long-term inflexibility and large windfall profits for the suppliers of comparatively cheap technologies (Bofinger, 2013), raising the cost of the subsidies. It would also constitute a

drastic change to the current system involving substantial transition and adjustment costs (Löschel et al., 2013).

It therefore seems more pragmatic to open the existing system to market mechanisms. To encourage network stability and minimise the cost of network expansion, subsidies should be designed to reflect local costs of limited network capacities. Gradually, the feed-in tariffs could be transformed into an auction system, where investors bid on a fixed premium, which is paid over a plant's life span (Kopp et al., 2013). A competitive setting such as an auction system is important to incorporate market developments and price signals into decisions on investment and energy production.

Professional services regulation remains restrictive

The PMR sub-indicator for barriers in services, in which professional services such as lawyers, notaries, tax consultants, architects and engineers make up 50% of the weight, ranks Germany 19 out of 33 OECD countries in terms of regulatory restrictions, related both to strict conduct regulations and to elevated market entry barriers. This relatively high level of regulation for professional services may have contributed to poor productivity performance in this sector. The economic impact of deregulation could be significant as professional services account for around 10% of GDP (IFB, 2012) with an uncounted potential for additional services, which are currently subject to a variety of regulations.

In some professional and other services, regulation in different forms has been accumulating over time to meet different objectives, like consumer protection or other societal preferences. An example is the mandatory membership in chambers, which was motivated by the advantages of self-regulation to carry out regulatory tasks in a cost-effective way as well as their specific role in vocational training. It affects more than 3.6 million enterprises in chambers of commerce, 484 000 liberal professionals (IFB, 2012) and about one million enterprises in chambers of crafts (DIHK, 2012; StBA, 2013). The professional and crafts chambers each represent specific sectors and activities. Self-regulation in these chambers may result in the risk that entry barriers are established. Therefore, compulsory membership and self-regulation in these chambers should be examined with respect to the establishment of unintended entry barriers. It should be assessed whether the objectives can also be achieved in a more proportionate and equally effective way.

The crafts sector plays an important role for the vocational and educational training (VET) system. The ratio of trainees in the total work force is twice as high as in other sectors. About 95% of apprentices in the crafts are trained in the 41 professions, where self-employment is restricted to holders of tertiary level vocational diplomas (*zulassungspflichtiges Handwerk*). These crafts accounted for 480 000 enterprises in 2010, employing 10% of the total work force and generating a turnover of EUR 435 billion (StBA, 2013). Alternatively, businesses can be managed by holders of a certificate of apprenticeship who have a minimum work experience of six years, four of which in a managing position. These restrictions are generally justified by appealing to consumer protection and the hazardous nature of these activities. In all other crafts entrepreneurs are exempt from professional qualification requirements. The safety criterion is vague and should be reviewed for some crafts such as hairdressers, painters and plasterers. Linking the employment status to education requirements is unique to crafts and professional services and does not exist for other business activities (IT, trade). The requirement of a master craftsman's diploma (*Meisterbrief*) in certain crafts such as hairdressers and painters also aims at sustaining the particularly large number of apprenticeships these crafts contribute to the VET system. It

should be examined whether entry conditions could be further liberalised without jeopardising the VET system.

Price regulation

Price competition is restricted in some professional services due to the existence of partially binding prices set by government or, as in the case of lawyers and notaries, legislated by parliament. The chambers play an important role in determining price regulation as interest groups in practice. They are likely to support their members' interests. These interests include higher prices. Arguments used in favour of price regulation include non-discriminatory access of consumers to public goods and consumer protection through high service quality. The argument of non-discriminatory access may hold in the case of lawyers, where low-value legal cases are cross-subsidised by high-value claims, which is used to determine reimbursements from the defeated party as well as legal aid. Nonetheless binding prices were abolished for extrajudicial services of lawyers. However, the argument seems less obvious in the case of architects and building engineers, where prices are also set by government.

The argument of consumer protection is usually employed to maintain price regulation for architects and engineers. It is based on the assumption that an appropriate compensation of providers translates into a higher service quality (BAK, 2013). Since Germany is the only member country in the European Union with price regulation for architects and engineers, there must be other and probably more market-oriented solutions to ensure service quality. Already existing legislation, for instance education and certification requirements for professionals, construction law or consumer protection law, are much better suited to address service quality. The authorities should, therefore, abolish price regulation for architects and engineers. Notaries in Germany act as public authorities. Therefore, prices of notaries' services are also regulated. The Netherlands abolished price regulation for notaries in 1999. Subsequently, fees for property conveyancing dropped by 30-40% and were only partially offset by increasing fees in previously cross-subsidised services (Schmid and Pinkel, 2007). The German government should give consideration to liberalising prices of notary services too.

For services related to representation in court, lawyers could be given greater flexibility in pricing. For example, they could be given room to deviate from the principle of effort-based charges for specific tasks. This could include extending lawyers' possibilities to charge all-inclusive or "flat" fees and lowering the restrictions on outcome-based remuneration.

Exclusivity of rights

Lawyers with three years of work experience and with top scores in a specific examination can eventually become notaries through appointment by the administration. Exclusive rights of notaries include authentication of documents, services related to the conveyance of property, and entries or changes in official company registries.

For some of these exclusive rights it would be possible to open the market to a broader range of providers without harming service quality or endangering consumer protection. Lower fees for consumers can thereby only be achieved, if such services were no longer subject to minimum price settings in the respective price regulation. Notary services like drafting the articles of association could be referred to regular lawyers or even to certified jurists with only the first state exam (*Diplomjurist*). Using the example of real estate

transactions, preparatory and auxiliary services like pre-examination of the cadastre, draft of contract and changes of ownership in the cadastre after signing the contract could also be opened to related professions. Indeed, the United Kingdom introduced licensed conveyancers in 1985, who are subject to lower qualification requirements than notaries but exercise all activities related to the conveyance of property. As could have been expected from contestable market theory, they put pressure on tariffs just prior to their introduction (Domberger and Sherr, 1987) and to a lesser extent also afterwards (Stephen et al., 1994). Furthermore, the exclusive rights of notaries for all matters related to the commercial registry (*Handelsregister*) could easily be abolished. This would be especially beneficial to start-ups and would significantly lower their costs of market entry.

According to the World Bank's recent Doing Business Report (2013) Germany ranks only 111th out of 189 economies for the ease of starting a business despite the recent introduction of one-stop shops for new entrepreneurs. In comparison to the OECD average German start-ups face longer delays, more procedures and higher costs, the latter two being directly related to notary services. Instead, the registration process could be carried out by the companies themselves since they are also deemed capable of filing their own business registration (*Gewerbeanmeldung*) and tax reports. In addition, the authorities should consider opening legal counselling and representation in court to other professionals, for instance certified jurists with a certain amount of work experience.

Other restrictions

All remaining restrictions on advertisement in the Federal Lawyers Act and in the Rules of Professional Practice could be abolished. All advertising is in any case regulated in general competition law. Shareholder requirements for limited liability companies of lawyers, tax consultants, architects and engineers, demanding that the majority of shares and voting rights rest with the respective professions, represent an entry barrier. Consideration should be given to dropping them.

Recommendations for raising the potential of the domestic sector

Network sectors

Telecommunication

- Liberalise the issuance of SIM cards.
- Sell the remaining government shares of Deutsche Telekom.

Railways

- Consider separating ownership of infrastructure from train operation. A public infrastructure manager could be responsible for all services subject to monopoly conditions, including traffic management and an integrated ticketing system.
- Facilitate access of market entrants to rolling stock.
- Strengthen the role of the regulator by improving its investigative and interventional competences. Move to full *ex ante* regulation of access conditions.

Postal services

- Ensure equal treatment in value added taxation for all service providers.
- Sell the remaining government shares of Deutsche Post.

Recommendations for raising the potential of the domestic sector *(cont.)*

Renewable energy

- Make feed-in tariffs more cost-effective by linking them to market developments. Consider reforms to advance the current support scheme into a competitive auction system.

Professional and handicraft services

- Scrutinise compulsory membership and chamber self-regulation in the professional and crafts chambers for entry barriers and lower entry requirements where possible.
- Examine if entry conditions to crafts could be further liberalised without jeopardizing the vocational education and training system.
- Abandon price regulation in some professional services. Abolish the price regulation for architects and engineers and consider liberalising price regulation for notaries. Give lawyers more options to deviate from the principle of effort-based remuneration, e.g. allow all-inclusive fees for certain tasks and extend outcome-based payments.
- Reduce exclusive rights. For example, allow companies to register in the commercial registry without notary services and open the provision of auxiliary services in property conveyancing to other related professions. Reduce exclusive rights of lawyers in providing legal advice and representation in court.
- Review restrictions on business conduct. Abolish all remaining restrictions on advertisement for lawyers. Give consideration to abolishing restrictions on shareholders for limited liability companies of lawyers, tax consultants, architects and engineers.

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Chapter 3

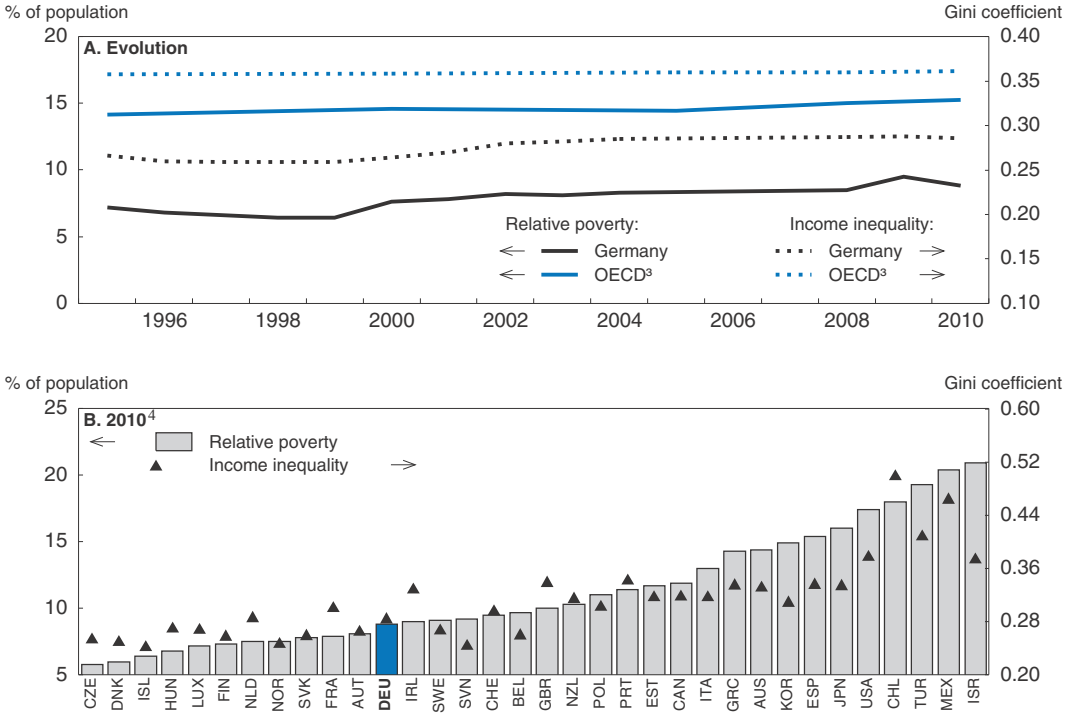
Making economic growth more socially inclusive

While past labour market reforms have been successful in terms of employment, the relative poverty risk and income inequality have remained broadly unchanged in recent years. Some social groups remain particularly vulnerable, including individuals in non-regular employment, the unemployed and the low skilled. If in employment, their jobs tend to be unstable and wages and income mobility low. Continued efforts are needed to foster economic growth in a more inclusive manner, such that the most vulnerable groups benefit from and contribute to economic growth more strongly and such that the gaps between the rich and the poor in terms of income and wellbeing are reduced. These efforts should include enhancing the labour market outcomes of the most vulnerable and increase upward income mobility among disadvantaged individuals; strengthening skills at the lower end of the skills distribution; revising the tax and benefit system to improve incentives and ensure efficient and well-targeted redistribution; and to make health and old-age pension insurance more inclusive.

Strong labour market performance has had little impact on relative poverty risks and inequality

Inequality and relative poverty in Germany are below levels observed in many OECD countries They have risen since the mid-90s, as elsewhere, although income inequality has not increased since 2004 (Figure 3.1, bottom panel). GDP growth has benefited households with high incomes more than those with low incomes since the mid-1990s. The ratio of the top 10% to bottom 10% of disposable incomes has increased more than in many other OECD economies, especially before 2005. Relative poverty increased particularly in East Germany, affecting 20% in 2009, which is almost twice as much as in the West. While real disposable household income inequality in East and West Germany did not converge much in the early 2000s, some convergence has occurred since 2005 (Grabka et al., 2012).

Figure 3.1. **Relative poverty[1] and income inequality[2]**



1. Relative poverty is measured as the percentage of the population whose equivalised household disposable income (after taxes and transfers) is below 50% of the median income.
2. Income inequality is measured as the Gini coefficient using household disposable income. It ranges from zero (perfect equality) to one (where one individual receives all).
3. Population-weighted average for 20 countries.
4. 2011 for Chile; 2009 for Hungary, Ireland, Japan, New Zealand, Switzerland and Turkey.

Source: OECD Income Distribution and Poverty Database.

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Thanks to the robust labour market, and in stark contrast to many other European countries, German household income has increased since 2007, benefitting incomes at both ends of the scale (OECD, 2012 and 2013a). Nevertheless, despite sustained employment growth and a significant drop in unemployment, largely brought about by far-reaching labour market reforms in the mid-2000s (OECD, 2012a), income inequality has not declined markedly over this period, either in absolute terms or relative to developments in OECD countries on average. The risk of relative poverty has, if anything, increased (OECD, 2013a). Kierzenkowski and Koske (2012) have identified a number of determinants of income inequality, some of them being particularly relevant for Germany (Box 3.1).

Box 3.1. **Determinants of rising income inequality and risk of relative poverty**

Skill-biased technological change: In many OECD countries, labour markets have become polarised, with computer technology depressing the middle of the wage and employment distributions where workers perform skilled but routine tasks, which leads to an increase in income inequality at the top end and a decrease at the low end. This pattern also appears in Germany (Dustmann et al., 2009; Spitz-Oener, 2006).

Education: Wage inequality is negatively correlated with the average level of educational attainment. In Germany returns to education have been broadly stable over time (Prasad, 2004; OECD, 2013d). Higher educational attainment is also positively correlated with well-being, in part because of more rewarding jobs.

International trade: Globalisation seems to have important implications for at least some groups of workers. In particular, offshoring appears to reduce employment and wages of medium-skilled workers performing routine tasks, thus reinforcing labour-market polarisation.

Immigration: Immigration has a small impact on native workers and sizeable adverse wage or employment effects on the cohorts of previous immigrants are found for Germany, implying only small effects for overall labour income inequality (D'Amuri et al., 2010; Steinhardt, 2011).

Labour market regulation: It has been relaxed over the past 20 to 25 years in many OECD countries. The impact of declining unionisation and of the lower relative minimum wage, observed in many countries, is most pronounced at the lower end of the wage distribution. However, many such institutions (e.g. employment protection legislation, minimum wage) have opposite effects on employment and wage dispersion leaving the final impact on inequality undetermined (OECD, 2011). For Germany, there is little evidence that the labour market reforms in the mid-2000s have raised inequality.

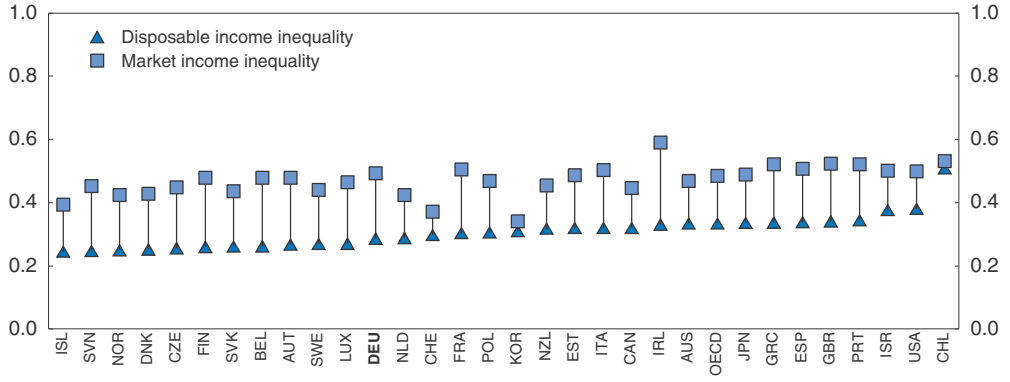
Household structure: Changes in the household structure, driven by a tendency towards more single households, are an important trigger for poverty at the microeconomic level (OECD, 2008a). Among others, the labour market reforms in the mid-2000s have generated incentives for subsistence payment beneficiaries to form single-households (Peichl et al., 2010). The formation of smaller households due to separation is likely to affect spouses with low earnings and their children most.

Inequality is marked in market incomes, wealth and well-being indicators

Inequality in market incomes is higher than in many other OECD economies (Figure 3.2). The long-term increase in inequality of market incomes has been driven by rising disparities in labour incomes, and a particularly uneven distribution of self-employment incomes (OECD, 2012b). However, taxes and cash transfers play a larger role in

Figure 3.2. **Effect of net taxes and transfers on income[1] inequality[2]**

Gini coefficient, 2010[3]



1. Income refers to cash income excluding imputed components such as home production and imputed rents regularly received over the year. Market income (i.e. before taxes and transfers) includes earnings (broken down into those of the household head, of the spouse and of other household members); self-employment income; and capital income (rents, dividends and interest).
2. Income inequality is measured as Gini coefficient for equivalised household market income and disposable income for the total population. It ranges from zero (perfect equality) to one (where one individual receives all).
3. 2011 for Chile; 2009 for Ireland, Japan, Switzerland and New Zealand. Market income Gini coefficient is not available for Hungary, Mexico and Turkey. The OECD average is calculated as a population-weighted average of 26 countries available for 2010.

Source: OECD Income Distribution and Poverty Database.

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mitigating market income inequality and risk of relative poverty than in most other countries. According to most recent data, the German tax-benefit system reduces inequality among the working-age population by almost 30%.

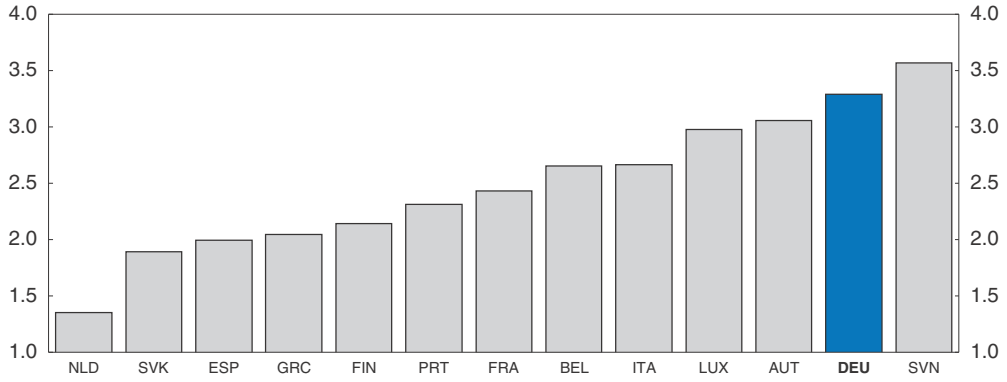
Besides income inequality at any given point in time, the likelihood of an individual to move up or down the income distribution (income mobility, often measured in moves across quintiles) also matters for life-time inequality. Workless and low-income households suffer particularly from low upward income mobility as it raises the likelihood of long-lasting or repeated spells of poverty (OECD, 2008a) and prevents them from benefiting from and contributing to more economic growth. It is therefore worrisome that equivalised disposable income mobility has declined particularly for low income households since the late 1990s (German Council of Economic Experts, 2011 and 2013), with income mobility being especially low in East Germany. Wage mobility also steadily declined between 1976 and 2008 (Aretz, 2013), raising the risk of relative poverty for workers in the low wage sector. Changes in job stability and employment characteristics, including unemployment history, tenure and type of industry, explain a significant share of this decline (Riphahn and Schnitzlein, 2011).

In-kind benefits paid for by governments, notably health and education services have an important redistributive effect, but they are not reflected in the monetary measures of income inequality and risk of relative poverty. Although government spending on in-kind benefits is comparatively high as a share of GDP, its redistributive effect is estimated to be relatively small, which may suggest poor targeting (OECD, 2011; Verbist et al., 2012; Adema et al., 2011).

Wealth is less evenly distributed than income and has become more uneven (German Council of Economic Experts, 2009). It is also less evenly distributed across households than in other European economies (Figure 3.3). At 37%, the share of households without

Figure 3.3. **Distribution of household net wealth**[1]

Ratio of top to bottom quintile, 2009[2]



1. Net wealth is the difference between total household assets and total household liabilities.
2. 2010 for Italy; 2007 for Spain.

Source: European Central Bank (2013), "The Eurosystem Household Finance and Consumption Survey – Statistical Tables", April.

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any property or wealth is comparatively large. The 10% wealthiest households earn 31% of gross incomes and own 59% of net wealth (Deutsche Bundesbank, 2013).

A relatively large number of small households in Germany may account to some extent for the larger share of households with low wealth. Home ownership, which is the most important component of household net wealth, is highly concentrated among the wealthiest (Deutsche Bundesbank, 2013; Andrews and Caldera Sánchez, 2011). The tax regime may have encouraged wealthy households to invest in residential real estate (see below). The divergence of wealth between East and West Germany also contributes to the uneven distribution of wealth (Frick and Grabka, 2009).

According to the OECD well-being framework, which encompasses eleven domains covering both material and non-material living conditions, German households enjoy a relatively high level of economic welfare and perform well in most domains (OECD, 2013g). However, well-being outcomes for individuals with high income/high education are considerably better than for individuals with low income/low education in several domains. For instance, individuals with high income report a considerably better health status than individuals with low income. The strong impact of socio-economic background on education attainment also points towards inequalities in well-being outcomes (Figure 3.4). Moreover, 25% of individuals live in households where the total housing costs – net of housing allowances – represent 40% or more of their disposable income (10% OECD wide; OECD, 2013g).

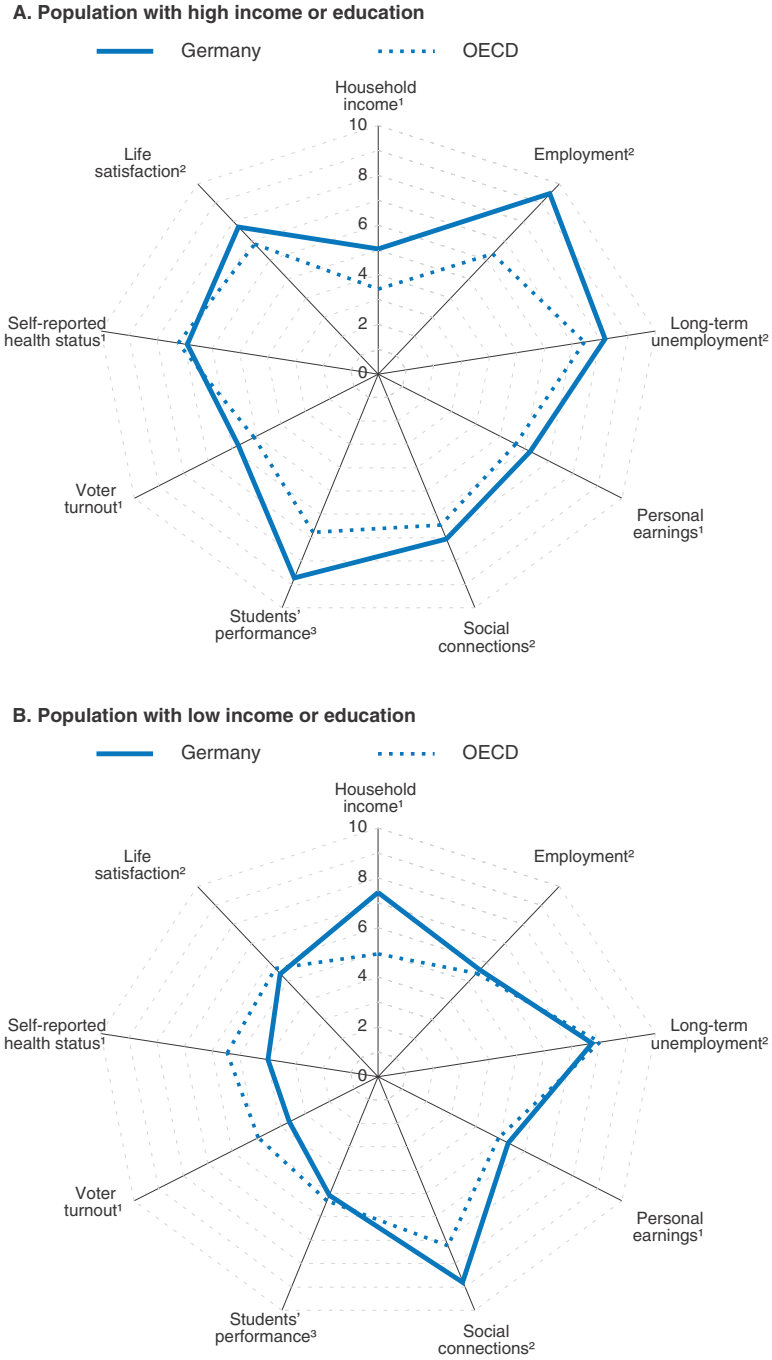
Identifying the most vulnerable to risks of poverty

Some social groups – including low skilled, individuals in non-regular employment and unemployed – are particularly vulnerable. They face a high risk of relative poverty and, if in employment, their jobs tend to be unstable, their wages low and their income mobility subdued.

The low wage sector is large and includes many low skill workers

Low-wage employment increased between 2006 and 2010 and is particularly widespread among low skilled workers and women (Figure 3.5). While the share of low

Figure 3.4. **Average well-being outcomes, 2013**



Note: Indicators are normalised to range between 10 (best) and 0 according to the following formula: (indicator value – minimum value)/(maximum value – minimum value) multiplied by 10.

Panel A:

1. Adult population in the top income or earnings quintile.
2. Adult population with a tertiary education degree (ISCED 5-6).
3. 15-year-old students in the top quintile of the PISA index of economic, social and cultural status.

Panel B:

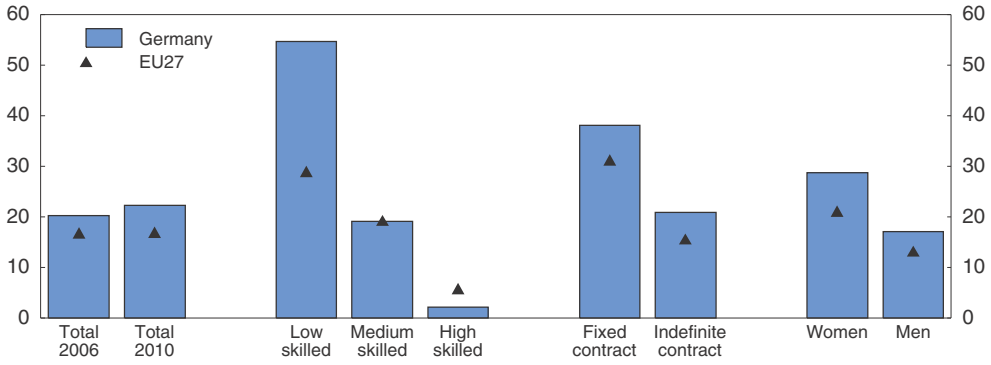
4. Adult population in the bottom income or earnings quintile.
5. Adult population with at most a lower secondary education degree (ISCED 0-2).
6. 15-year-old students in the bottom quintile of the PISA index of economic, social and cultural status.

Source: OECD Better Life Index.

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Figure 3.5. **Low-wage earners[1] by educational attainment level,[2] employment contract and gender**

As a percentage of employees,[3] 2010



1. Low-wage earners are defined as those employees earning less than two thirds of the median gross hourly earnings.
2. Low skilled, medium skilled and high skilled are defined respectively as educational attainments of below upper secondary (ISCED 0-2), upper and post-secondary (ISCED 3-4) and tertiary (ISCED 5-6).
3. All employees excluding apprentices working in enterprises with more than 10 employees and which operate in all sectors of the economy except: agriculture, forestry and fishing (NACE Rev. 2, section A); and public administration, defence and compulsory social security (NACE Rev. 2, section O).

Source: Eurostat.

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skilled individuals in the population is low, a relatively large share of low wage earners has low skills. This suggests that job matching is effective, but also that better targeted efforts to improve skills could considerably improve the income prospects of these workers. The large share of women in the low wage sector partly reflects the large gap between men and women in hourly wages. This may partly be due to more frequent and extended interruptions in working careers, a larger share of women who work part-time and differences in occupation (OECD, 2012h). The gender gap in full-time earnings is one of the largest among OECD countries. This is also true for the bottom quintile of full-time earners (OECD, 2013f).

Workers in non-regular employment are exposed to high poverty risks

While past labour market reforms have put more workers into jobs, poverty risks are high for workers in non-regular employment (defined here as employees with relatively low employment protection or limited access to unemployment insurance), as well as many part-time and self-employed workers, especially those without employees (Table 3.1). As in other OECD countries, such workers are often paid low wages, suffer from low wage mobility and are less well protected than workers on permanent contracts (OECD, 2012a).

Part-time work is particularly widespread among women: only 62% of employed women work full-time compared to 74% OECD-wide in 2012. Part-time work is characterised by a high risk of relative poverty. Also, their prospects of moving to full-time, permanent employment are often limited. They often face unstable employment, they tend to receive less in-work training and have poor chances to move up the income ladder. A considerable number of vulnerable part-timers is in marginal employment (*minijobs*, see Box 3.3 below). These vulnerabilities are attenuated to some extent at the household level, as many part-time workers are secondary earners. Nonetheless, even for secondary earners in high-income households part-time employment may entail the risk of falling into relative poverty in the future, for example in the case of changes in the household, possibly as a result of separation.

Table 3.1. **Exposure to poverty of workers in non-regular, part-time and self-employment**

	Risk of poverty		Share of total workers (in %)		
	1998	2008	1998	2008	2011
Total employment	4.6	6.2	100.0	100.0	100.0
Dependent	4.4	6.0	89.6	88.4	88.7
Dependent permanent full-time	3.1	3.2	73.2	66.1	66.5
Dependent non-regular					
Temporary	10.8	16.5	5.8	7.9	7.9
Marginal (minijobs)	13.0	23.2	4.7	7.4	7.5
Temporary agency		8.5		1.8	2.2
Part-time	9.9	15.3	10.9	14.1	14.1
Self-employed	6.7	7.7	10.4	11.6	11.3
Self-employed without employees	9.3	10.3	5.1	6.5	6.3

Note: The table refers to individuals aged 15-64, not in education or training. The risk of relative poverty is assessed on the basis of the mean equivalised disposable household income, at the 60% threshold. Non-regular employment consists here of temporary employees, workers in marginal employment (*minijobs*) and temporary agency workers. Overlaps among the different forms of non-regular employment and part-time employment exist.
Source: Federal Statistical Office of Germany.

The number of workers in employment receiving top-up subsistence benefits increased to 3% of total employment in 2011. Most are in marginal employment and 18% are single parents (Bruckmeier et al., 2013). Some 44% of individuals receiving subsistence payments who find a job continue to depend on top-up benefits and 45% are in employment for 6 months or less, which may reduce their income mobility (Koller and Rudolph, 2011).

The unemployed face a very high risk of relative poverty

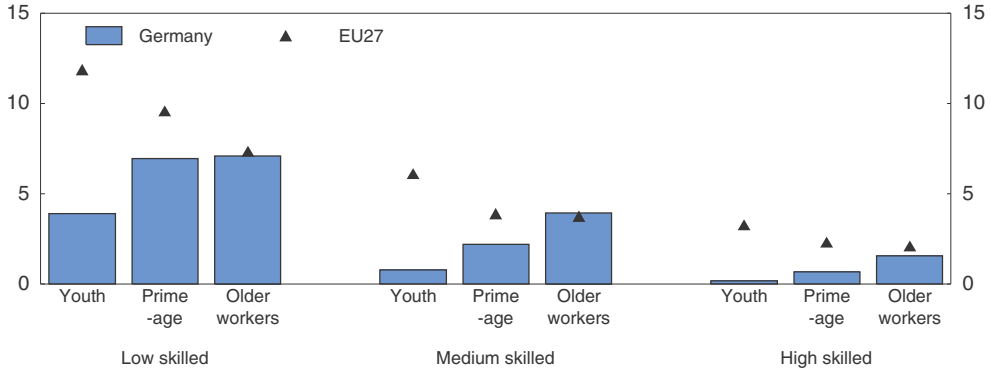
Many workers in non-regular employment acquire little or no unemployment insurance benefit entitlements, but face a high risk of unemployment. Lack of employment is particularly widespread among single parent households, which represent 5.9% of total households. Sixty-five per cent of single parents were in employment in 2008, less than in most other OECD countries, and labour market participation is particularly low for mothers with children aged 4 or less (Federal Ministry of Finance, 2012). Also individuals approaching retirement age are characterised by low employment and a high risk of relative poverty.

While long-term unemployment has decreased sharply in recent years, it continues to account for more than 40% of total unemployment. The long-term unemployed are particularly vulnerable to poverty risks, because longer unemployment spells reduce employability and workers lose their unemployment insurance benefit entitlement. Low skilled workers are more likely to face long-term unemployment (Figure 3.6). Also older works face a high risk of long-term unemployment which, unlike for youth and prime-age individuals, is close to the EU average. The high incidence of long-term unemployment among older workers, including those with medium vocational qualifications, suggests that older workers with a narrow set of skills have difficulties to adapt to structural changes in the economy that may occur during their working life.

The risk of relative poverty for immigrants is almost twice as high as for German nationals, in part because unemployment among immigrants is about twice as high. Moreover, the incidence of long-term unemployment is high, also in international comparison (OECD, 2012f). The high share of the low skilled among immigrants reduces their

Figure 3.6. **Long-term unemployment[1] by demographic group[2] and education[3]**

As a percentage of labour force, 2012Q4



1. Unemployed for more than one year as a three-month moving average.
2. Youth, prime-age and old workers are defined respectively as persons aged 15-24, 25-54 and 55-64 years.
3. Statistics by education refer to persons aged 15-64 years. Low skilled, medium skilled and high skilled are defined respectively as educational attainments of below upper secondary (ISCED 0-2), upper and post-secondary (ISCED 3-4) and tertiary (ISCED 5-6).

Source: OECD (2013), *Employment Outlook*.

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wages and employability (Koske et al., 2012). To some extent this is also true among second generation immigrants indicating the need to make integration policies more effective.

Structural reforms to promote inclusive growth

Continued efforts are needed to foster economic growth in a more inclusive manner, such that the most vulnerable groups benefit from and contribute to economic growth more strongly and such that the gaps between the rich and the poor in terms of income and wellbeing are reduced. As discussed below, more inclusive growth, requires enhancing the labour market outcomes of the most vulnerable and improving skills at the lower end of the skills distribution, as well as reforms of the tax and benefit system to ensure efficient and well-targeted redistribution. The focus should be on policy instruments which entail a double dividend by reducing income inequality and boosting GDP growth at the same time. *Going for Growth 2012* has benchmarked a number of policy instruments against these two objectives (Box 3.2; OECD, 2012g).

Reducing market income inequality through labour market reforms

There is scope to help the most vulnerable to improve their labour market outcomes, which would boost growth and at the same time address the uneven distribution of market incomes. Three reform areas deserve particular attention: avoiding low employment and low pay traps, avoiding a dual labour market and strengthening active labour market policies (ALMP).

Removing barriers to full-time employment would reduce poverty risks

Policies that discourage full-time employment should be carefully reviewed as they tend to reduce upwards income mobility of vulnerable individuals and growth. This section argues that the high incidence of part-time employment is favoured by the tax treatment of marginal employment and the limited supply of full-time childcare facilities, which also makes it difficult for families with children to fully participate in economic activity.

Box 3.2. **Policy instruments and their impact on inequality and economic growth**

General policy trade-offs and complementarities between growth and income distribution objectives as identified in *Going for Growth 2012* are summarised in Table 3.2.

- Policies which reduce income inequality and at the same time boost long-run GDP per capita include instruments to raise human capital while making it less dependent on personal and social circumstances, reducing labour market duality, promoting the integration of immigrants and fostering female labour market participation. Some tax policies, notably to reduce tax expenditures, contributes to equity objectives while also allowing a growth-friendly cut in effective marginal tax rates, in particular for lower income recipients.
- Several policies may entail a trade-off between reducing income inequality and raising GDP per capita. For instance, administrative extensions of collective wage agreements may reduce wage earnings dispersion among workers, but they may harm competition and productivity and possibly reduce employment. Shifting the tax mix to less-distorting taxes – in particular away from labour and corporate income taxes towards consumption, proper pricing of environmental externalities and real estate taxes – would improve incentives to work, save and invest, but may require additional steps to address adverse implications for equity.

Table 3.2. **The impact of structural reforms on inequality and GDP per capita**

A rise in:	Earnings equality	Total labour income equality	GDP per capita
Initiatives to increase the tertiary graduation rate	+	(+)	+
Initiatives to increase the upper-secondary graduation rate	+	(+)	+
Initiatives to promote equity in education	+	(+)	+
The minimum wage (as share of the median wage)	+	~	(0/-)
Legal extensions of collective wage agreements	~	(-)	(-)
The overall level of EPL	+	~	-
The gap between EPL on regular versus temporary work	-	(-)	-
Replacement rate and duration of unemployment benefits	+	~	-
Spending on active labour market policies	~	+	+
Initiatives to foster the integration of immigrants	+	(+)	(+)
Initiatives to raise female labour force participation	+	(+)	(+)

Note: The term "earnings inequality" refers to inequality among the working population and the term "total labour income inequality" refers to inequality among the working-age population, thus accounting for both employment and earnings inequality effects. +, -, 0 denote respectively a significant rise, a significant fall, or no impact on the variable of interest. In cases where some studies find a significant effect while others don't, this is indicated by combining the symbols. A tilde means that the sign of the effect is unknown. When the sign of the total labour income inequality effect is unknown but can be deducted from the signs of the employment and earnings equality effects, the results are reported in brackets.
Source: Koske et al. (2012).

Avoiding low employment and low pay traps

Marginal employment (so-called *minijobs*) refers to low income employment contracts of up to EUR 450 per month, which benefit from tax subsidies, are partially exempt from the mandatory public pension system and fully exempt from unemployment insurance (Box 3.3). *minijobs* were intended as a stepping stone towards permanent full-time employment relationships but a success has not been proven. Reduced income tax and

Box 3.3. ***Minijobs* – characteristics and incidence**

*Minijobs** refer to employment contracts for earnings of currently up to EUR 450 per month with reduced income tax and social security contribution rates and entitlements. Mandatory social security contribution rates amount to roughly 29%, compared to 39% or more for permanent full-time employment. Unlike the case of permanent full-time employment, compulsory social security contributions are fully paid by employers. Since 2013, individuals can opt out of full pension coverage by not paying the employees' pension contribution rate of 3.9%, on top of the employer's mandatory contribution of 15%. In practice, this option leaves a considerably share of individuals in marginal employment with limited entitlements once they retire. Workers in marginal employment do not contribute to unemployment insurance and are not entitled to unemployment insurance benefits. They are subject to income tax at a flat-rate of 2%. Many individuals in marginal employment, about 5.5 million in total, are students, pensioners or second earners (Table 3.3).

Table 3.3. **Persons exclusively on a *minijob*, 2010**

	%
Total	100.0
Students	20.1
Second earners	35.2
Pensioners	22.4
Subsistence benefit receivers	11.1
Others	11.2

Source: Körner et al. (2013).

* *Midijobs*, referring to earnings between EUR 450 and EUR 850, are subject to reduced social insurance contributions as well, but with rates increasing gradually to the standard rates. There were 1.37 million *midijobs* in 2011.

social security rates are phased out between EUR 450 and EUR 850 via so-called *midijobs*, thereby implying high marginal tax rates for individuals willing to work more (Freier and Steiner, 2007; Körner et al., 2013; Fertig and Kluve, 2007). Workers in *minijobs* tend to suffer from low in-work training opportunities and low wage mobility, locking them into their marginal employment status (Voss and Weinkopf, 2012). Some workers on *minijobs* are exposed to a rising risk of relative poverty once they retire or in case of losing their job (Hohendanner and Stegmaier, 2012) because they acquire low pension entitlements and are not entitled to unemployment insurance benefits. As the tax subsidy is not targeted to low income individuals, many *minijobs* are taken up by second earners to avoid high taxation in the context of the joint income taxation of couples. *Minijobs* also create an additional tax advantage for workers with more than one job, one of them being marginal employment, as income from other jobs does not count towards the *minijob* income ceiling. The number of individuals using marginal employment as side job has almost doubled since 2004 and accounted for 34% of all individuals with a *minijob* in 2011 (Hohendanner and Stegmaier, 2012). *Minijobs* should be better targeted towards low-wage workers. For example, tax subsidies should not be provided for combining jobs, one of them being a *minijob*.

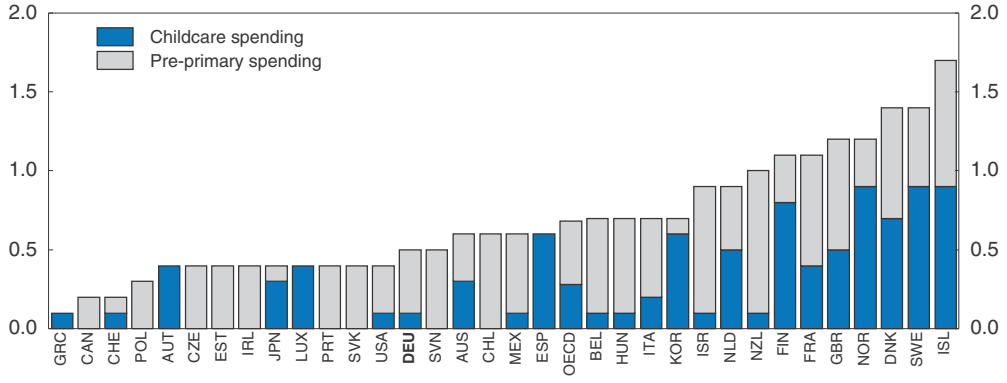
Further expansion of childcare to facilitate full-time employment

Sufficient and affordable formal childcare facilitates the labour market integration of single parents and improves earnings prospects, especially for low income households (Rainer et al., 2011; Rainer et al., 2013). A lack of childcare facilities is of particular concern for single parents as they and their children are subject to high poverty risks in Germany (Zabel, 2011). Formal childcare also favours other family policy goals, such as increasing fertility and improving work-life balance.

Germany is making progress in expanding childcare and has guaranteed access for all parents, if only for a few hours per day. However, enrolment rates in early childcare (one-to-two-year-olds) remain low and access to full-time care is limited. One reason is comparatively low total public spending on childcare and early education (Figure 3.7), although it has increased in recent years. Since August 2013, parents have a legal claim to public care for children aged one year or more. In practice, however, several conditions may prevent parents from enforcing this right. For instance, they cannot reject offered places, even if they imply longer commuting distance. Moreover, the availability of full-time care remains limited, also for pupils more than 5 years old (Blossfeld et al., 2013; OECD, 2014). Efforts should continue to expand early childcare, notably full-time care and all-day school provision.

Figure 3.7. **Public expenditure on childcare and early education services**

As a percentage of GDP, 2009



Note: Aggregate spending for Spain.
Source: OECD Family Database.

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Attendance at formal childcare is particularly low among children from low income households or with a migrant background (Spieß et al., 2008; Blossfeld et al., 2013; Authoring Group Educational Reporting, 2013). While 33 % of children without migration background attend childcare at the age of zero to 3 years, only 16 % of children with migration background do so (Federal Statistical Office, 2012). These households are often less informed about the benefits of formal childcare and may particularly be discouraged by high fees. However, early childcare and childhood education is an important determinant of learning outcomes later on (Heckman and Masterov, 2007). The most seriously disadvantaged children reap particularly large cognitive and non-cognitive skill gains (Heckman and Raut, 2013). Children with migrant background also benefit by acquiring language through education (OECD, 2008a). Further efforts and resources are needed to raise the participation of children with weak socio-economic background in

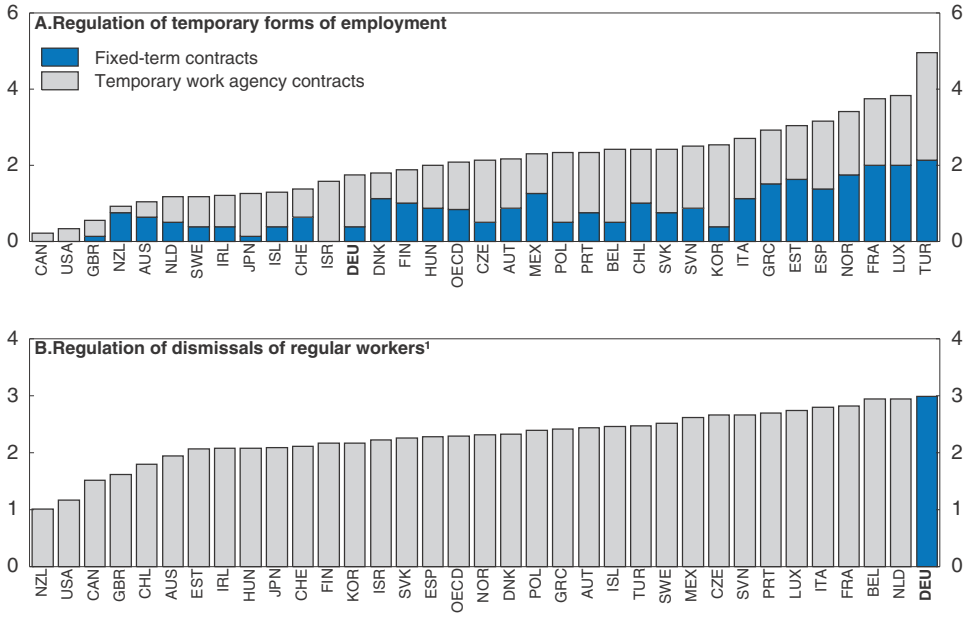
early childcare and early childhood education. Fees are set by municipalities and thus vary considerably across regions (Gathmann and Sass, 2012). Equal access to affordable high-quality childcare should be ensured independently of place of residence and socio-economic background.

Avoiding a dual labour market

The gap between employment protection of permanent workers with long seniority and temporary workers is large in Germany (Figure 3.8). One reason is that Germany is the OECD country with the most far-reaching employment protection legislation for workers with open-ended contracts. A reform in 2011 tightened regulation of temporary agency workers and the 2013 coalition agreement spelled out plans to go somewhat further in this direction by requiring equal pay between in-house workers and temporary agency workers with equal tasks after 9 months. In contrast, the use of fixed-term contracts has been eased substantially since the late 1990s and regulation of temporary contracts is now among the least restrictive among OECD countries (Eichhorst and Tobsch, 2013). For example, it is under certain conditions possible to use multiple successive fixed-term contracts with the same employee (European Court of Justice, 2012), generating incentives to substitute regular work contracts with fixed-term contracts.

Figure 3.8. **Protection of temporary and regular workers**

Scale 0 (least restrictions) to 6 (most restrictions), 2013



1. Aggregate contributions of employment protection for regular workers against individual dismissals and additional cost of collective dismissals.

Source: OECD (2013), *Employment Outlook*.

StatLink http://dx.doi.org/10.1787/888933034144

Permanent employment has contributed strongly to employment growth in Germany in recent years. Thirty nine per cent of workers on temporary contracts moved to a permanent contract within one year (Walwei, 2013). However, international evidence shows that a large gap in employment protection between permanent and temporary

workers often tends to thwart employability (de Serres et al., 2012), increases inequality (Box 3.1 above) and hampers the transition from non-regular employment to permanent full-time employment. It thereby also lowers wage mobility (Riphahn and Schnitzlein, 2011; Koske et al., 2012). Against this backdrop, the gap in employment protection between permanent and temporary workers should be reduced to further improve the transition of workers in temporary employment relationships into permanent jobs. The strict regulation of regular employment should be reviewed along the lines suggested in the *2012 Economic Survey of Germany*. Simultaneously the regulation of fixed term contracts should be reviewed as well. In particular, the use of multiple successive fixed term contracts with the same employee should be limited in scope.

A minimum wage consistent with preserving employment

A minimum wage may be an effective instrument to reduce the dispersion of wages while preserving employment prospects (Garloff, 2010; Card and Krueger, 1995). It may also limit the need for benefit top-ups the government pays to low-wage recipients. Negative employment effects are less likely to occur when employers' bargaining power is high and workers' bargaining power is low (Koske et al., 2012). In such cases there is potential for redistribution of rents without reducing employment. For example, low wealth and low income (especially in the absence of unemployment benefit entitlement) can push job searchers to accept jobs paying below the marginal product in order to avoid the costs of continuing searching. Search models show that a minimum wage may even generate positive employment effects, as a minimum wage raises incentives for individuals to work and improve their skills (Acemoglu and Pischke, 2001; OECD, 2008b). The experience of the United Kingdom, which implemented a fairly low minimum wage relative to the median wage in 1999, but subsequently increased it substantially in several steps, shows that employment has not fallen due to the introduction of a nationwide minimum wage (OECD, 2004), and was also not affected by the increase in minimum wage during the recent economic and financial crisis (Bryan et al., 2012).

Currently, a minimum wage can be set for individual sectors, which has been done in several cases in Germany, mostly on the basis of extending collectively bargained wages. Two procedures exist to set a sector specific minimum wage (Box 3.4). The extension of collective wage agreements incurs the risk of harming employment prospects of "outsiders". For instance, legal extension of sectoral wage agreements can reduce incentives of social partners to set wages low enough for unemployed to have a reasonable chance of finding a job, as no employer can compete by reducing costs with a lower wage. Raising wages via the legal extension of collective wage agreements may also be a way for incumbents to prevent the entry of firms and thereby thwart competition and employment. Moreover, sectoral minimum wages can be circumvented by outsourcing activity to firms in other sectors or to the self-employed, which are then more likely to generate precarious job conditions. These substitution efforts will reduce in-house training activities and further contribute to the risks of a dual labour market (OECD, 2008a, 2006 and 2012g). An extensive evaluation study commissioned by the German Ministry of Labour in 2011 covering all sectors with minimum wages failed to find any substantial negative effects on employment and market entry in the sectors concerned. However, employment losses may have resulted due to indirect effects on other sectors (van Suntum, 2014).

The government plans to phase in a general minimum wage of EUR 8.50 between 2015 and the end of 2016 and to create a commission to propose future adjustments of the

Box 3.4. **Procedures to set sector specific minimum wages**

There are two main procedures to implement a sector-specific minimum wage.

If 1) a minimum of 50% of employees are covered by collective agreements and 2) there is a public interest, a collective agreement can be declared as generally binding for all employees in the region and sector. To introduce such a sectoral and regional minimum wage, employers' associations and trade unions of the sector have to file a joint application for legal extension with the Federal Ministry of Labour and Social Affairs, specifying the agreed minimum wage. Once accepted by the Federal Ministry of Labour and Social Affairs, the agreement is binding for all employees and employers in the sector. If the government of a *Land* contests a proposal for legal extension, consent by the federal government is needed.

If less than 50% of all employees in a sector are employed by employers who are bound by collective agreements a permanent council can propose a sectoral minimum wage. The permanent council consists of two representatives of employers of the sectors concerned, two representatives of labour unions of the sectors concerned and three representatives from the Federal Ministry of Labour and Social Affairs. Alternatively, an expert commission, composed of three representatives of employers and three from labour unions, and, optionally, experts without voting rights, can propose a minimum wage, which can be introduced by the federal government.

Sectoral minimum wages are in place in several branches and occupations, e.g. in construction and related crafts (safety services, cleaning services, long-term care, vocational education and further training services and waste management). A minimum wage also exists for temporary agency workers. Sectoral minimum wages in Germany varied between EUR 7.50 per hour and EUR 13.70 per hour in 2013. Many of these minimum wages vary across regions.

general minimum wage. The members of the commission will be nominated by social partners, with the possibility to consult independent experts, who will have no voting power. Sectoral minimum wages above the general minimum wage will continue to apply and the government plans to make it easier to legally extend collectively bargained sectoral minimum wages above the general minimum wage. At present, several of these sectoral minimum wages are higher than EUR 8.50.

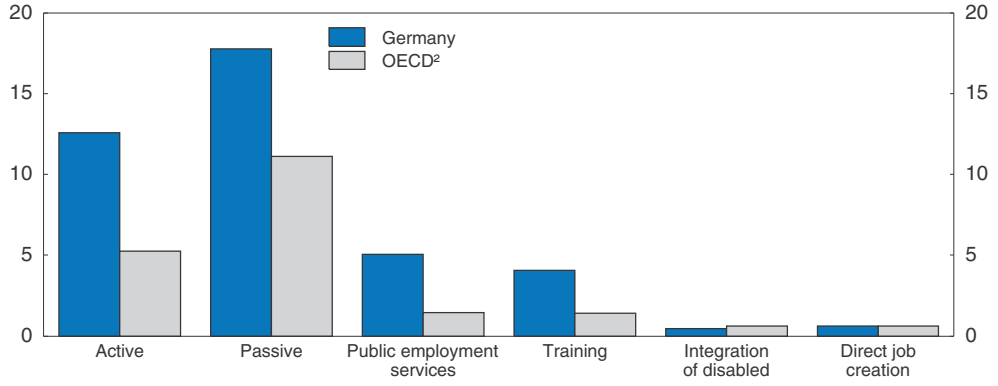
The government's plans to introduce a general minimum wage are welcome. However it should be ensured that the initial level does not entail considerable negative employment effects. A minimum wage of EUR 8.50 would amount to about half of the median wage, placing the German minimum wage at a level similar to those of other European countries, such as Belgium and the Netherlands, but below France. It would affect about 15% of employees nation-wide and more than 23% in Eastern Germany. It may harm the employment prospects of workers in some regions and with little experience or low skills (Brenke, 2014). A useful strategy would be to introduce the minimum wage at a lower level and make adjustments in the light of its impact, as was done in the United Kingdom. The mandate of the expert commission should be to set the minimum wage at a level which balances potential employment losses against the social benefits. The social partners alone may not sufficiently take the interests of the unemployed into account. It could therefore be desirable to involve independent experts or government representatives in the commission's decisions. Moreover, given the introduction of the nationwide minimum wage, cautious use should be made of higher sectoral minimum wages set on the basis of collective agreements.

Active labour market policies and in-work benefits could be improved

Total spending on ALMPs is relatively high (Figure 3.9) and spending per unemployed has increased by almost 50% since 2007. Spending increased particularly for training and integrating the disabled, in line with recommendations in the *2012 Economic Survey of Germany*. However, spending per unemployed on public employment services increased sharply as well and is now unusually high. While in many cases ALMPs are found to be counterproductive, i.e. rather extending the time of unemployment (Federal Government, 2006), placement services and hiring subsidies are found to be particularly effective in the short-term, whereas instruments aiming at improving education outcomes take more time to unfold their effects but are considered to be more beneficial in the long-term (Kluve, 2013).

Figure 3.9. **Spending on labour market programmes**[1]

USD thousands at PPP per unemployed person, 2011



1. Spending per unemployed person for a country is adjusted for national income by multiplying this number by the ratio of US over each country's GDP per capita.
2. 28 OECD countries available for 2011, except Greece, Iceland, Ireland, Norway, Turkey and the United Kingdom.

Source: OECD Labour Market Programmes Database, *OECD National Account Database* and *OECD Economic Outlook Database*.

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Many ALMPs benefit mostly those with a comparatively strong socio-economic background within their respective target groups. Vouchers – including for education and private job placement services – as well as hiring subsidies are more often taken up and actually used by individuals with a comparatively strong socio-economic background. Self-selection effects within target groups may persist, in part because better educated individuals are often better informed and less discouraged (Heyer et al., 2011).

Hiring subsidies (*Eingliederungszuschuss*), which are considered to be effective in bringing long-term unemployed and migrants back to work, could be targeted more towards the neediest (Butschek and Walter, 2013; Heyer et al., 2011). For example hiring subsidies could become more generous for the most disadvantaged individuals with the longest unemployment spells. Hiring subsidies could be accompanied to a larger extent by incentives to achieve higher general education to ensure a lasting integration of disadvantaged individuals in the labour market and increase income mobility (Kluve, 2013).

Steps have been taken to raise the incentives of public employment service offices to direct efforts more towards bringing the most disadvantaged individuals into work in 2014, including the long-term unemployed and low skilled. These steps are welcome. However, continued assistance and guidance following placement, during the initial period in work,

is also needed to ensure lasting integration into the labour market. Also incentives of providers of private job placement services should be reviewed, as these vouchers benefit mostly job searchers with relatively high employability (Heyer et al., 2011).

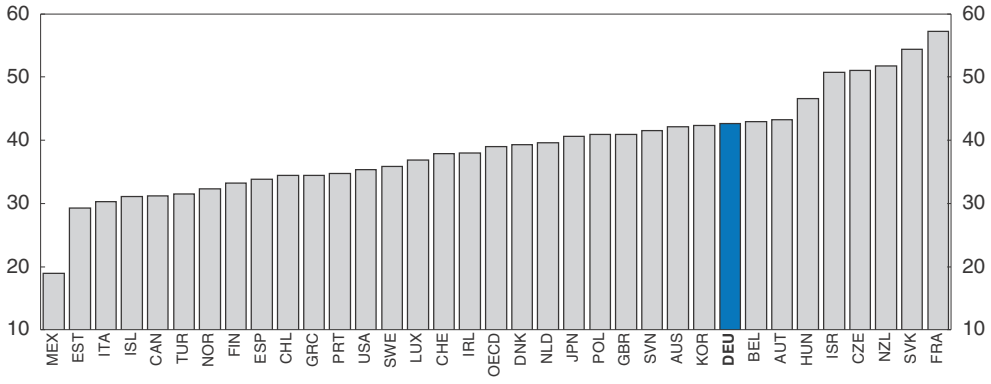
There is scope to further review in-work benefits to ensure that the most vulnerable receive sufficient support while minimising disincentives to work. For instance, means-tested subsistence benefits are currently phased out as earnings rise above EUR 100. While the phasing out is already slower for families with children, the benefits could be phased out more slowly for particularly vulnerable individuals, such as single parents (Meister, 2009). Child benefits paid to parents receiving a housing allowance could also be phased out more slowly to remove disincentives to work. Currently they are discontinued abruptly at a certain income level.

The education system could provide more support for the disadvantaged

PISA results in Germany have improved in all three PISA domains and are now above the OECD average. These improvements were mostly due to better results among students coming from a lower socio-economic or immigrant background (OECD, 2013i and 2014). However, the link between socioeconomic background and mathematics performance remains strong compared to the OECD average and immigrants remain more disadvantaged than nationals (Figure 3.10). A strong link between socio-economic background and learning outcomes undermines employment prospects and income mobility of the most vulnerable.

Figure 3.10. **Impact of socio-economic status on the average difference in performance in mathematics**[1]

2012



1. The average difference in mathematics score between students whose socio-economic status differs by one unit of the PISA index of economic, social and cultural status. The lower the value the smaller the difference (or the more equal performance between advantaged and disadvantaged students).

Source: OECD (2013), *PISA 2012 Results: Excellence through Equity, Giving Every Student the Chance to Succeed*, Vol. II.

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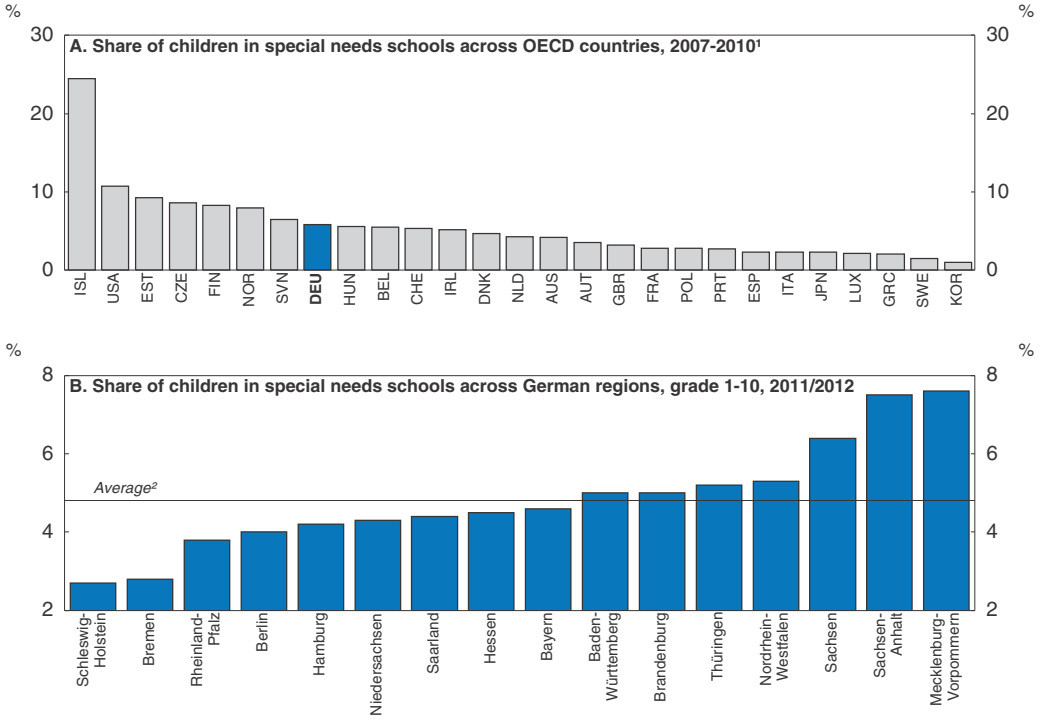
Reviewing system level policies

Further reforms are needed to improve learning outcomes and facilitate access to upper secondary and tertiary education among disadvantaged youth. Performance variation between schools is relatively large, reflecting in large part stratification of the school system (OECD, 2012c) and a high share of disadvantaged students going to disadvantaged schools (OECD, 2013i). Efforts should be made to continue to reduce

stratification of the school system as recommended in the *2008 Economic Survey of Germany*. Also, grade repetition, which is particularly widespread in Germany, should be reduced. It widens inequity, increases the likelihood of dropping out and does not improve education outcomes (OECD, 2012c). Moreover, grade repetition raises total expenditure on primary and secondary education by 7%. Moreover, efforts should continue to remove financial barriers to access to tertiary education. The main federal means-tested student support scheme provides grants and loans with income contingent repayments of up to EUR 8 040 per year for needy students. However, consideration should be given to raising the maximum amount of support and to making all loan repayments contingent. While an additional preferential student loan scheme provides loans of up to EUR 7 200 per year, their repayment is not contingent on income.

A relatively large share of pupils with learning difficulties is separated from the mainstream and placed in classes or schools for children with learning difficulties or disabilities (Figure 3.11, top panel; OECD, 2012c). Pupils are more likely to be assigned to such special needs schools if their socio-economic background is disadvantaged. For example, children with migrant background are overrepresented in special needs schools. Also, the share of pupils in special needs schools varies considerably across *Länder* (Figure 3.11, bottom panel). Assignment of pupils to special needs schools undermines their career prospects early on, as many of them leave school without having completed

Figure 3.11. **Special education needs**



1. Academic school year 2007/08 for Germany, Portugal and Spain; 2008/09 for Austria, Belgium, Denmark, Finland, France, Hungary, Iceland, Ireland, Italy, Luxembourg, Sweden, Switzerland, the United Kingdom and the United States; 2009/10 for Australia, Czech Republic, Estonia, Greece, Japan, Korea, Netherlands, Norway, Poland and Slovenia.
2. Unweighted average of sixteen German regions.

Source: OECD Family Database; and Berkemeyer (2013), "Chancenspiegel 2013 – Zur Chancengerechtigkeit und Leistungsfähigkeit der deutschen Schulsysteme mit einer Vertiefung zum schulischen Ganztag", Bertelsmann Stiftung.

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even lower secondary education. Instead, integrating children with learning difficulties in mainstream classes and schools raises their education outcomes and is less costly (OECD, 2009). In this context, the initiative by the *Länder* to promote integrated education is welcome (*Kultusministerkonferenz*, 2010). A coherent strategy should be developed for integrated education across *Länder*, limiting assignment of children to separate special needs education, and avoiding that children with disadvantaged socio-economic background are assigned to them on account of their weak socio-economic status.

Most young people who do not obtain at least upper secondary education face a high risk of unemployment or, if in employment, low wages (OECD, 2013b). In Germany, 10.6% of youth aged 18-24 have at most lower secondary education and are not in education or training, many of them with migrant background, according to Eurostat; about 8% do not complete lower secondary education. While special training measures exist to integrate these youth into vocational education and training (VET), they are often not successful. Around 260 000 youth (26 % of all youth entering VET per year) attended special training programmes in 2012 (Federal Statistical Office of Germany, 2014). Half of them is expected to not successfully complete formal VET (Authoring Group Educational Reporting, 2013; Klemm, 2012). Against this backdrop greater efforts are needed to help early school leavers to achieve at least upper secondary education. Guaranteeing direct access to VET to all school leavers, an idea also spelled out in the 2013 coalition agreement, would require additional resources of about EUR 1.5 billion per year, according to Klemm (2012). However, this cost is likely to be partially recovered through higher tax revenues in the long-term. To achieve this goal, existing training programmes need to be tailored more towards bringing youth quickly into mainstream VET programmes in close co-operation with private companies (Plicht, 2010). The federal government and governments of the *Länder* are setting up a programme (*education chains*) to streamline the existing initiatives in vocational orientation and to strengthen the transition from school into mainstream VET. In 2013, the *Länder* jointly made proposals to improve school-based training programs in the transition system. Some of these policies to make economic growth more socially inclusive also require additional public funding.

Efforts should also continue to raise the employability of older workers and immigrants. Lifelong learning can help to improve employability among experienced workers, thereby reducing poverty risks as suggested in the *2012 Economic Survey of Germany*. Specialisation early on should be avoided as older workers, who face a high risk of long-term unemployment (Figure 3.5 above), are particularly vulnerable to structural changes. Despite recent reforms, difficulties in the recognition of professional and vocational qualifications obtained abroad hold back earnings prospects of immigrants. The Federal Recognition Act, in force since April 2012, has proved effective. The first data show that in most cases the equivalence of foreign professional qualifications was established and the recognition was granted. However, differences continue to exist in the recognition of foreign credentials across *Länder*. This limits the capacity of immigrants to move to locations where their skills are in highest demand (OECD, 2013e). The recognition of professional and vocational qualifications should be furthered facilitated, as planned by the government, and harmonised across *Länder.*

Providing more targeted support to disadvantaged pupils

The share of public spending on compulsory schooling directed to children of low-income families is lower than in most other OECD countries (Verbist et al., 2012). As in

many OECD countries, there is scope to provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic background (OECD, 2012c). For instance, considerable differences exist in spending per pupil across school tracks with spending per pupil being lower in middle schools (*Realschule*) than in high schools (*Gymnasium*). Also modern secondary schools (*Hauptschulen*) have difficulties in attracting qualified teachers (Authoring Group Educational Reporting, 2013), indicating that their employment conditions need to be improved. More financial and career incentives should be provided to attract and retain high quality teachers and leaders in schools attended by disadvantaged children also with regard to the large share of older teachers currently on active duty (OECD, 2014). It should be ensured that teachers earn the same across different school tracks. To address learning gaps and avoid grade repetition, which is relatively high, it should be ensured that an adequate environment for learning is made available to the most disadvantaged children, including for counselling, mentoring and smoothing transitions between the different levels of education (OECD, 2012c).

To further increase the benefits of existing early childhood education and care additional resources should be made available: to increase the staff-child ratio; to provide more integrated education and care; and to ensure early childhood professionals (e.g. educators, pedagogues, etc.) have better qualifications, more professional development opportunities and better working conditions, as planned by the government (OECD, 2012e; Federal Ministry for Labour and Social Affairs, 2013). The *Länder* have developed a competence-oriented qualification profile for childcare workers in order to enhance and harmonise the quality of training programmes (*Kultusministerkonferenz*, 2011) and have made efforts to establish training courses at tertiary level. In the short term, however shortages of qualified staff need to be addressed.

The education package (*Bildungspaket*) is an initiative by the federal government to help children from poor households to participate in social activities and receive learning support. However, it may fail to reach the most vulnerable, despite means-testing, because of self-selection (Krug and Popp, 2008). Disadvantaged parents, including those with migrant background, are less likely to be aware of education support programmes for their children (Apel and Engels, 2012) and they tend to underestimate the long-term benefits of such activities. Therefore, continued effort is needed to ensure that the neediest children benefit from the programme, for example by continuing to tailor information and assistance towards these families. It should also be ensured that more funds are allocated to tutoring of disadvantaged children to improve their learning outcomes. Currently, this is only possible if a teacher certifies that a child is at risk of repeating a school year. Only 4% of children from families receiving subsistence payments or housing subsidies receive such support (Apel and Engels, 2012). Providing more funding for tutoring to disadvantaged children independently of whether they are at risk of repeating a school year could help them to perform better at school, which might encourage them to aim for higher education later on.

Reforming health insurance to tackle inequalities

The segmentation of health insurance into a private sector, which covers about 10% of the population, and a public sector, which covers the remaining 90% (Box 3.5) raises efficiency concerns (OECD, 2008b; German Council of Economic Experts, 2006). Low and middle income earners and individuals with poorer health status are generally covered by public health insurance, where contributions are independent of health risks and proportional to wage income up to a ceiling. Employees with a wage income above

Box 3.5. **The German health insurance system**

Healthcare coverage is provided through a mix of public health insurance, which covers about 90% of the population, and private health insurance for eligible individuals who opted out of the public system, including many civil servants.

Public health insurance: Employees with gross yearly earnings currently below EUR 53 550 must be insured in the public health insurance system. Non-profit public insurers are funded mostly via the central health fund, which collects 15.5% of labour income from all insured (14.6 percentage points are equally shared by employer and employee and 0.9 percentage points are paid by the employee alone) and then distributes funds to insurers as risk-adjusted transfers. Individual insurers compete mainly via additional lump-sum surcharges which they can levy on their clients (up to a limit of 2% of the income of the insured individual). The federal government contributed 7.4% to the central health fund's revenues in 2012 (Federal Ministry of Health, 2013a). Non-working spouses and children up to a certain age are insured at no extra cost if they have no income above EUR 395 (or EUR 450 out of a *minijob*). Public insurers are subject to the obligation to accept every individual fulfilling the criteria for access to the public scheme and wishing to conclude a contract with them and cannot vary premia according to individual risk. The 2013 coalition agreement stipulates abolishing the lump sum surcharges which can be levied by individual insurers, replacing them by income dependent surcharges to be paid by the employee.

Private health insurance: Employees with gross yearly earnings currently exceeding EUR 53 550 can opt out of the public health insurance scheme. The self-employed must insure themselves in the private sector unless they were insured in the public sector before becoming self-employed, in which case they can choose between public and private insurance. Civil servants are reimbursed 50% of their healthcare costs by their employers if they take out private insurance. Premia do not depend on income and, in general, insurers can charge higher fees to new clients depending on their perceived health risks. Private health insurance companies are obliged to build up old age reserves for their clients, which are in principle portable if switching between private health insurance providers (Commonwealth Fund, 2012). However, switching between private insurance providers is costly because the scope of portable ageing reserves is restricted to that of the basic tariff and to insurees who joined private health insurance after 2008. Therefore, in practice competition among private health insurance companies is limited to attracting new entrants to the private system.

Private insurers are obliged to offer special tariffs for individuals having difficulties in paying for their health insurance. The basic and the standard tariff provide coverage comparable to the one of public insurance, but these tariffs cost up to EUR 610 per month in 2013 regardless of income. Income support is provided by the government only if the privately insured's income risks falling below the subsistence threshold. For individuals who fall behind with their contribution payments, an emergency tariff (*Notlagentarif*) was introduced in 2013 with a premium not higher than EUR 125. However, it provides considerably less coverage than public insurance (Federal Ministry of Health, 2013b).

The transition from private health insurance back to public health insurance is only possible under certain, narrow circumstances. Employees whose income falls below the income threshold can switch to the public system if they are less than 55 years old. In principle switching is not possible for the self-employed.

EUR 53 550 per year can opt out of public insurance and choose private insurance instead. High income earners with good health status have incentives to choose private insurance because insurance premia do not depend on income and because private insurers can adjust the terms of contracts they offer to new insurees in line with their perceived health risks. Moreover, private insurers do not participate in the central health fund, which redistributes insurance contributions of public insurers on the basis of risk-adjusted transfers. The central health fund helps to avoid selection on the basis of risk (Box 3.5; OECD, 2008b). Private insurers can therefore compete on the basis of risk selection rather than on the basis of efficiency. Moreover, competition within the private insurance sector is de facto limited to attracting new entrants to the private system. New insurees can be selected on the basis of risk in most contracts, making individuals reluctant to switch, for example, after facing chronic conditions. Moreover, switching between private insurance providers is costly due to the restricted portability of ageing reserves (Box 3.5).

Private insurance can also result in poverty risks for some individuals when they experience a drop in income. These risks affect older workers, because insurance premia tend to increase with age and because they cannot return to the public insurance system. They also affect the self-employed, who do not generally have access to public insurance and may face high income uncertainty. It is therefore possible that the current health insurance system discourages risk-averse workers from becoming self-employed, especially if their business plans imply uncertain income prospects, as may particularly be the case for innovative start-ups. While special tariffs have to be provided by private health insurance companies for individuals who have difficulties in paying, they can be fairly expensive or provide only limited coverage (Box 3.5; Federal Ministry of Health, 2013a). While the dual health insurance system in Germany has a long tradition, it generates difficulties in today's labour market, in which employment histories often include changes in employment status and earnings. The German Council of Economic Experts (2006) and the *2008 OECD Economic Survey of Germany* therefore suggested integrating private health insurance providers in the central health fund. The German Council of Economic Experts also suggested imposing the obligation to contract on all insurers and limiting the cost of mandatory health insurance for low-income households with government transfers. This would imply that all insurance companies provide mandatory health insurance packages to all individuals on equal terms, as public insurance companies already do. Such a reform would remove incentives for risk selection and reduce poverty risks. However, it would give rise to substantial transitory challenges. In particular, it requires dealing with the reserves accumulated in the private health insurance system.

While the introduction of the central health fund (Box 3.5) has raised efficiency and transparency, it should be developed further (Drösler et al., 2011). As only a limited number of 80 diseases are considered to determine risk-adjusted transfers, public health insurance companies continue to have incentives to discriminate against clients with diseases not included in the adjustment, for example including some forms of mental ill health. Despite an obligation to contract, public insurance companies can influence their client structure to some extent, for instance by advertising their services to selected groups. Therefore, the current risk-adjustment should be reviewed and include a larger number of diseases.

Unlike in other countries with central health funds, the treatment costs of deceased individuals are not annualised when determining disease specific transfers. For higher age groups and diseases with high death tolls costs are systematically underestimated and thus transfers from the central health fund too low (Buchner et al., 2012). It should be ensured that risk-adjusted transfers are set high enough for clients with cost-intensive diseases characterised by high morbidity as also spelled out in the 2013 coalition agreement.

Limiting the risk of rising old age poverty

Although old age poverty is not a major concern in Germany today, this is expected to change as population ageing and past pension reforms will reduce the level of pensions in the public system relative to income earned during active life (German Council of Economic Experts, 2013). Net pension replacement rates for future retirees are among the lowest across OECD countries, especially for workers earning half the average wage and retiring after a full career (OECD, 2013h). One reason is that pension claims are more closely related to income than in most other OECD countries. In this context, the rise of low pay-jobs, low wage mobility and emerging labour market dualisation aggravate risks of old-age poverty. Helping workers to acquire sufficient pension claims over their working life by improving earnings prospects of workers subject to low-pay and part-time work is the best way to tackle the risk of old age poverty. In this context labour market reforms to boost permanent full-time employment as outlined above are particularly helpful.

The 2013 coalition agreement includes several measures to extend pension claims for selected groups. Workers with a contribution record of at least 45 years will be able to retire with a full pension at age 63 initially, rising to 65 years, in line with the increase of the standard legal pension age from 65 to 67 years. If implemented, they provide an incentive to retire earlier. Pension top-ups will also be paid to mothers whose children were born before 1992 and invalidity pensions will be raised. In the medium term, these measures will be funded by payroll contributions, which are projected to be 0.4 percentage points higher as a result of the planned measures by 2030. There are also plans to implement a minimum pension for people with a contribution record of at least 40 years and low pension entitlements at a later stage. The plans are not specifically targeted at addressing old-age poverty, which could become a problem in decades to come, and thus may generate more spending pressures in the future. If pension entitlements for workers with a low earnings record are deemed too low, a cost effective way of raising incomes for pensioners with low entitlements while safeguarding incentives to work would be to phase out means-tested subsistence benefits more slowly as pension entitlements rise.

The mandatory public pension system generally covers employees only. Only about one quarter of the self-employed, mainly in professional services, are covered by alternative mandatory pension schemes (German Council of Economic Experts, 2011). The remaining self-employed workers, often including the most vulnerable, are not covered (German Council of Economic Experts, 2013). They may not sufficiently price in future pension requirements to offer their goods and services at a low price. This creates a coverage gap raising the risk that self-employed workers have to rely on social assistance benefits during retirement. Firms have incentives to outsource work to these self-employed workers at low cost in order to avoid pension contributions, raising precarious self-employment and weakening government finances. Against this backdrop, all self-employed should be included in the mandatory public pension scheme.

Making the tax system more inclusive

The labour tax wedge is high in international comparison, including for low income families and single parents (Table 3.4). While income tax rates are low, especially for families with children, social security contributions are high.

Lowering social security contributions, notably for low income workers with full-time earnings, should be a priority. Such a step should be placed in the context of a broader

Table 3.4. **Tax wedge by family type and wage level**

% of gross wage earnings, 2012

Family type		Single	Single	Single	Single	Married	Married	Married	Married
Children		No	No	No	2	2	2	2	No
% of average wage		67	100	167	67	100-0*	100-33*	100-67*	100-33*
Income tax	DEU	14.2	19.2	27.8	-2.5	0.8	6.5	10.8	14.2
	OECD	11.2	15.3	21.3	5.9	9.9	10.4	12.2	12.3
Employee soc. Sec. contributions	DEU	20.7	20.7	16.0	20.5	20.5	20.5	20.5	20.7
	OECD	9.9	9.8	9.2	9.5	9.7	9.5	9.8	9.6
Employer soc. Sec. contributions	DEU	19.6	19.6	15.3	19.6	19.6	19.6	19.6	19.6
	OECD	17.5	17.8	17.2	17.5	17.8	17.4	17.7	17.4
Total	DEU	45.6	49.8	51.2	31.4	34.2	39.0	42.5	45.6
	OECD	32.0	35.6	39.9	16.8	26.1	27.9	30.8	32.7

* Two earner couple.

Source: OECD Taxing Wages.

reform to make the tax system more conducive to economic growth. In particular this involves continued efforts to reduce the tax burden on labour income, especially for workers on low pay. Such a reform should also include measures on the expenditure side of the social security system. More revenues could be raised from taxes on consumption, real estate and environmentally harmful behaviour, as suggested in the *2012 Economic Survey of Germany*.

Some sources of capital income benefit from preferential tax treatment. Households' capital income (interest payments, dividends) is generally taxed at a rate of 26.4% at the household level, although households' interest income benefits from a tax-free allowance up to EUR 801. The general tax rate for capital income is, in many cases, below the marginal income tax households pay on their other income, as capital income is particularly concentrated among high-income households. These reduced tax rates have in the past helped to reduce tax evasion through capital flight. However, efforts have been made to improve international co-operation to prevent tax fraud. A moderate increase in capital income taxation may therefore not lead to more tax evasion (Bach and Beznoska, 2012b). Consideration should be given to align the taxation of capital income to the taxation of other personal income. Moreover, households are fully exempt from capital gains tax on housing property, held for more than 10 years, even if the owner does not live in the dwelling concerned. This tax exemption risks biasing investment decision towards residential housing, especially in the current low interest rate environment which may encourage expectations of rising prices and benefits high-wealth households the most (Frick and Grabka, 2009; Deutsche Bundesbank, 2013; European Central Bank, 2013). Realised capital gains on housing should be taxed, except for owner-occupied housing.

Inheritance taxes have less distortionary effects and entail a lower administrative burden than other forms of taxation of wealth (Bach and Beznoska, 2012a). There is scope to further increase revenues from inheritance taxes by removing exemptions. Wealth held in small and medium sized enterprises is subject to lower inheritance taxation than other forms of wealth under certain conditions. Households therefore have incentives to transform private into business property to lower their tax burden (Bach and Beznoska, 2012b). The conditions for such transformations have recently been tightened. The remaining tax advantages provided to small firms in inheritance taxation should be reconsidered. To avoid liquidity problems for

businesses subject to inheritance tax, tax payments can already be stretched over ten years. During this period, the tax liability could be subordinated to other claims on the business (see e.g. the *2004 Economic Survey of Germany*).

Regional pockets of poverty risk could be addressed more effectively

Although dispersion of GDP per capita across *Länder* continued to decline over the past decade and is now lower in Germany than in most other EU countries, the risk of relative poverty has risen to a considerably higher level in East than in West Germany and continues to diverge (Grabka et al., 2012).

The current revenue-sharing system including fiscal federal transfers is based on population as well as on multipliers which only reflect differences in population density (Söllner, 2001). Although, additional discretionary transfers exist, in part to account for differences in long-term unemployment rates, they do not take into account additional socioeconomic and demographic characteristics, such as migrant status, or age composition, in the population structure across the *Länder,* which contribute to different levels of demand for public services provided by *Länder* and municipalities on their territory (Feld et al., 2013; Heinemann, 2012). It should be considered to enlarge the set of criteria based on which transfers are provided, e.g. by including differences in age composition, socio-economic or migrant background. The advantage of including such demographic indicators in the determination of fiscal federal transfers is that they can help align such transfers with demand for social services more effectively without harming incentives of the poorest jurisdictions to strengthen their growth potential (Joumard and Kongsrud, 2003).

Subnational government levels may also face disincentives to provide adequate provision for key services that can help to boost inclusive economic growth. For example, municipalities may not fully take into account the benefits provided by childcare facilities and early childhood education, for which they have funding responsibilities, because they partly accrue to neighbouring jurisdictions or even nation-wide. Special grants from state to local governments are available to address such externalities. However they are provided on a discretionary basis with rules (for local grants) differing considerably across the *Länder* (Dombert, 2006). The government should consider assuming funding responsibilities for key social services provided by subnational governments subject to geographic externalities, which are particularly important for inclusive growth. For example, the federal government could finance vouchers for families with young children which they could use to pay for the services of accredited childcare facilities.

Recommendations to foster inclusive growth

Labour market

- Continue to expand early childcare provision, notably for full-day care. Ensure equal access of the most vulnerable to affordable high-quality childcare independently of their place of residence and socio-economic background. Extend the supply of all-day schools.
- Reduce the gap in employment protection between permanent and temporary workers by reducing protection of permanent workers and by limiting the use of multiple successive fixed term contracts with the same employee.
- Introduce a general minimum wage at a sufficiently low level that will not lead to job losses, determined by an expert commission. Cautious use should be made of higher sectoral minimum wages set on the basis of collective agreements.

Recommendations to foster inclusive growth *(cont.)*

- Target the preferential tax treatment of *minijobs* towards low-wage workers.
- Make active labour market policies more targeted by monitoring self-selection problems within target groups. Continue to review in-work benefits to ensure that the most vulnerable receive sufficient support while minimising disincentives to work. For instance, phase out more slowly means-tested subsistence benefits for particularly vulnerable individuals earning more than EUR 100. Also phase out additional child benefits paid to parents receiving a housing allowance more slowly.

Education

- Reduce stratification of the school system and provide more financial resources to schools with a comparatively high share of pupils with weak socio-economic background. Reduce grade repetitions. Provide more support for disadvantaged youth to complete formal upper secondary education programmes, in particular mainstream VET. Continue reducing the assignment of pupils to special needs schools and make sure assignment to such schools does not reflect the socio-economic background of pupils.
- Improve the quality of early childhood education and care, including by improving the staff-child ratio in accredited facilities; by better integrating education and care; and by ensuring early childhood professionals have better qualifications, more professional development opportunities and better working conditions.

Tax and transfer system

- Extend compulsory pensions to the self-employed.
- Focus additional pension entitlements on reducing future old age poverty risks, for example, by phasing out subsistence benefit entitlements more slowly as pension entitlements rise. Fund such additional spending from general tax revenue instead of higher payroll taxes. Strengthen incentives to retire later.
- Extend capital gains taxes on residential real estate except for owner-occupied housing. Raise the tax rates applying to household capital income towards marginal income tax rates applying to other household income.
- Equalise the inheritance tax burden for different forms of wealth.
- Further improve the determination of risk-adjusted transfers within the health fund, by considering a larger number of diseases and by ensuring that transfers for higher age groups and diseases with high death tolls are high enough.

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