

## TO CATCH ON GERMAN REFORMS FOLLOW THE MARCH HARE!

*You might just as well say, added the March Hare  
that "I like what I get" is the same thing as "I get what I like!"  
(Alice's Adventures in Wonderland, chapter 7 a Mad Tea-Party)*

- Since the Chancellor Schröder has launched the idea of reforming German social market economy on March 14th 2003, it has been very difficult to understand the accurate content of a day-to-day changing reform package. Looking back on the chronology, the Agenda 2010 looks like an attempt to restore the credibility of the newly re-elected SPD-Greens coalition (which obtained a majority of only 9 seats in the Bundestag, versus 21 in 1998 and lost the majority in the Bundesrat following major setbacks in the Hesse and Lower Saxony elections on February 2nd 2003). After struggling to gain support from his own party at the SPD extraordinary meeting on June 1st, the Chancellor then ran into opposition when the Bundesrat rejected his latest reform package focused on greater labour market flexibility and bringing tax cuts forward.
- On December 15th 2003, the government and the CDU/CSU opposition finally reached a compromise that prevented the reform process from coming to a standstill. Failure to reach an agreement would have seriously knocked confidence. For its vote in the Bundesrat, the opposition managed to obtain that recourse to new borrowing in order to finance tax rebates (brought forward from 2005 to 2004 and lowered by half) would be limited. The new year is the occasion to take stock of the tortuous March Hare race.

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### ***The compromise of December 15th should help to strengthen consumer and business confidence ...***

The compromise mainly concerned the tax cuts. Only half of the 3<sup>rd</sup> stage of tax reforms will be brought forward to 2004, i.e. 7.8 billion euros which, added to the 7 billion from the 2<sup>nd</sup> stage, equates to 0.7% of GDP compared to the previous 1%. The remaining 7.8 billion will be allocated to tax cuts in 2005. The opposition won the case for their first request: that less than 25% of tax cuts brought forward (1.8 billion euros) be financed through new borrowing (versus 80% in the government plans). The rest is to be financed by:

- a change in deduction regulations on past losses: at least 60% of company profits will be subject to taxation and life and health insurance companies can offset 80% of their losses against taxes after 2001 (gain: 0.24 billion euros);
- cuts in subsidies to individuals: 30% reduction in subsidy for homebuyers/builders (gain: 0.1 billion); 30 cents/km reduction of the allowance for commuters (gain: 0.4 billion);
- 5.3 billion euros in privatisations (1 billion from the airports of Cologne-Bonn, Frankfurt, Munich and Duisburg; 2.3 billion in Deutsche Telekom holdings, etc.), versus the previously forecast 2 billion.

The compromise also provides for a 12% cut in tax rebates for businesses (only in 2004), and a 4% cut in direct subsidies in 2004, 2005 and 2006 (Korb II Act). Businesses with less than 10 employees are no longer subject to the law on redundancies (for new employees). The government wanted to maintain the limit at 5 employees, while the opposition wanted it extended to 20 employees. The government's proposal to extend business taxes to freelance professionals was dropped. Under exceptional circumstances, local authorities in dire financial straits will be able to keep a share of their tax returns (usually transferred to the Federal State and the Länder).

The compromise of 15 December should also help to support consumer confidence, which has failed to recover since plummeting in early 2003. From an economic standpoint, the compromise is quite beneficial to households: the tax cuts are still fairly substantial and the cut in subsidies is marginal (especially in comparison to the drastic cuts jointly proposed by members of the SPD and CDU in September). Consumers will start to lower their savings rate (at its highest level since 1996), giving a considerable boost to German growth, which is traditionally held back (especially now) by low consumer spending.

Among employer organisations, those representing the retail trade (who hope that tax cuts will boost their sales from their current all time low) and craft trade sectors (who, thanks to the CDU, have managed to keep the requirement for a vocational diploma in 41 trades versus 20 in the government's original proposal) welcome the compromise. Generally, German business leaders support the Agenda 2010 labour market reforms, even though they are not considered far-reaching enough. Increased labour market flexibility can only be positive for an economy that structurally creates fewer jobs than its European neighbours. The tightening of benefit regulations has already had an impact on unemployment, which has been stable since the summer and the increase in employment incentives should help to reduce pockets of inactivity, of which there are many in Germany. Manufacturers, such as Michael Sommer, DGB Chairman, warned against the grave consequences that blocking the reforms would have had on the business climate. No doubt bolstered by the compromise on December 15th, the IFO index and PMIs were back at the levels seen in 2000 by the end of the month, with the Dax rising to 4,000 points, the same level reached prior to the September 2002 elections.

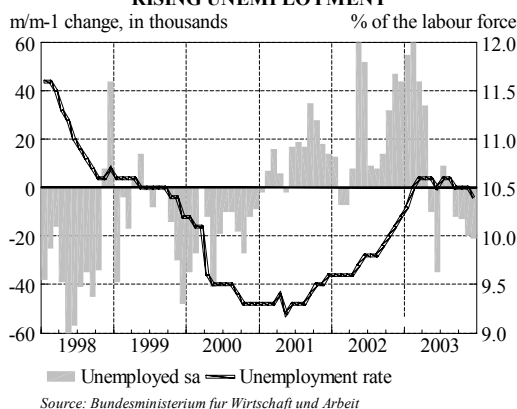
## AGENDA 2010 SCORECARD

Sector	Act	Bundestag	Bundesrat	Date of effect	Expected impact (see graphs on next page)
Labour Market	'Capital for work': KfW interest-subsidised loans of 100,000 euros for employing an unemployed person	Vote not required	Vote not required	1st Nov. 2002	8,000 unemployed people are already said to have been employed under this scheme: the government's unrealistic target is 50,000
	'Modern services in the labour market' Act, known as Hartz Acts I and II: - <i>Mini-jobs</i> (the ceiling was raised from 325 to 400 euros/month on 1st April 2003) - <i>Ich-AG</i> (business start-up subsidies) - Establishment of job placement agencies ( <i>Personal Service Agenturen</i> ) for long-term unemployed	Voted on 20th Dec. 2002	Vote not required	1st Jan. 2003	In October 2003: - The number of <i>Mini-jobs</i> has risen by 1.7 million compared with January 2003 (reaching a total 5.9 million), 740,000 of which through the revision of the ceiling on 1st April - 72,500 unemployed people set up their own business - 952 PSA "took on" 25,400 unemployed people (out of a total 42,700 places)
	- Support programmes for 100,000 long-term unemployed people between 1st Sep. 2003 and 31st August 2005  - <i>Jump Plus</i> support programmes for 100,000 unqualified young people under 25 between 1st July 2003 and 31st Dec. 2004, a simple replacement of the <i>Jump</i> programme launched in 1999	Vote not required	Vote not required		- Temporary measures aimed at those persons in most difficulty to compensate for the reduction in benefits. - Standard measure in unemployment management: in October 2003, 80,000 young people participated in the <i>Jump</i> programme
	Hartz III Act: gradual restructuring of the Federal Labour Office (renamed the Federal Job Agency) which is to be completed in 2005: - Separation of benefits and placements now covered by job centres - Gradual transformation of PSAs into temporary job agencies for the unemployed - Step-up in requirements for registering as unemployed (registration date, mobility, wages)	19th Dec. 2003 (17th Oct. 2003)	Vote not required	1st Jan. 2004	Swifter placement of unemployed people (Florian Gerster hopes to reduce the average time spent looking for work by a week) Increase in employment incentives
	Increased exceptions in the dismissal protection law for SMEs with under 10 employees (previously under 5)	19th Dec. 2003 (26th Sep. 2003)	Vote not required but incorporated in the compromise of 15th Dec. 2003	1st Jan. 2004	Support to employment through greater labour market "flexibility"
	Hartz IV Act: merger of unemployment compensation and welfare benefits into a single <i>Arbeitslosengeld II</i> (345 euros/month in Western Germany, 331 in Eastern Germany)	19th Dec. 2003 (17th Oct. 2003)	19th Dec. 2003 (compromise of 15th Dec. 2003)	1st Jan. 2005	Increase in employment incentives Improvement in the financial situation of local authorities providing social welfare assistance
	Reduction in entitlement to unemployment benefits from 32 to 12 months (18 months for over 55s) <i>pro Mittelstand initiative</i> : - Increase in the tax threshold (turnover of 350,000 euros and profits of 30,000) - Establishment of a bank to act as a financing institution for all SMEs: <i>Mittelstandsbank</i> through the merging of <i>KfW</i> and <i>Deutsche Ausgleichsbank</i> on 1st July 2003. - As of 1st March 2004, the <i>Mittelstandsbank</i> will launch micro loans for up to 500,000 euros for business start-ups and 2 million for SMEs over five years old - Requirement of a vocational diploma in 41 jobs versus a previous 94 - Reduction in bureaucracy for setting up businesses	26th Sep. 2003	Vote not required	1st Feb. 2006	Increase in employment incentives
Taxation	- Tax cuts brought forward: drop in the marginal bracket (19.9% - 48.5% to 16% - 45% in 2004, then 15% - 42% in 2005) and increase in tax relief (from 7 235 to 7 664 euros in 2004)  - Tax amnesty (fixed rate of 25% on capital repatriated before 31st Dec. 2004 then 35% until 31st March 2005)	19th Dec. 2003 (17th Oct. 2003)	19th Dec. 2003 (compromise of 15th Dec. 2003)	1st Jan. 2004	- Financial boost to households whose purchasing power has been flat for two years, combined with a 'confidence effect'. Wolfgang Clement forecasts that it will add between 0.2 and 0.6 points to growth. Our forecast is at the lower end of this scale.  - The government expects an additional 5 billion in tax returns which will help to reduce public deficit
Municipalities	Rescue plan for local authorities finances: they will be allowed to retain 2.5 billion in tax returns in 2004 and 3 billion in 2005	19th Dec. 2003 (17th Oct. 2003)	19th Dec. 2003 (compromise of 15th Dec. 2003)	1st Jan. 2004	Restoration of the financial situation of the poorest municipalities and increase in their investment (which dropped to 15% of the municipalities budget in 2003 versus 30% in the 80's) already boosted by 7 billion in <i>KfW</i> subsidised loans
Pensions	Emergency plan: pension freeze, payment in full of long-term care insurance for pensioners, drop in health insurance reserve funds	17th Oct. 2003	6th Nov. 2003	1st Jan. 2004	Stabilisation in pension contributions at 19.5% and long-term care insurance at 1.7% in 2004
Healthcare	Increase in personal contributions, decline in reimbursements, new contributions for false teeth (0.35%) and daily health care allowances (0.50%) for employees	26th Sep. 2003	17th Oct. 2003 (compromise reached on the draft proposal)	1st Jan. 2004	Health contributions lowered from 14.40% in 2003 (7.20% employers; 7.20% employees) to 12.15% in 2007 (6.075% employers; 6.075% employees + 0.85% new employee contributions), which is believed to be a realistic assumption

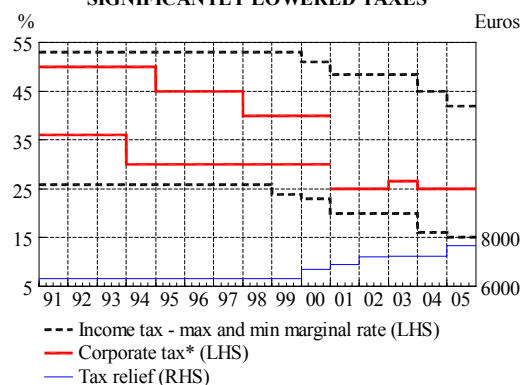
In brackets: the voting date of the 1<sup>st</sup> draft proposal

Sources: Bundesregierung, Bundesanstalt für Arbeit, Minijob-Zentrale

### AGENDA 2010 AIMS TO STOP RISING UNEMPLOYMENT



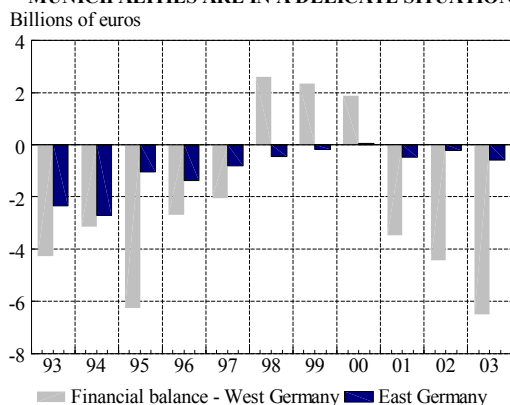
### IN 10 YEARS TAX REFORMS HAVE SIGNIFICANTLY LOWERED TAXES



Source: Bundesministerium der Finanzen

\*Before 2001, there were two types of corporate tax: one on retained earnings and one on redistributed earnings

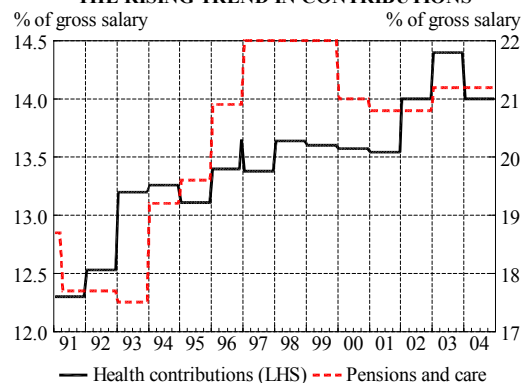
### MUNICIPALITIES ARE IN A DELICATE SITUATION



Source: Bundesministerium der Finanzen

Balance in the first semester of 2003. For the entire year and for all communes put together, the Finance Minister forecasts a record deficit of 9.5 billion euros

### AGENDA 2010 AIMS TO STOP THE RISING TREND IN CONTRIBUTIONS



## ... and paves the way for more reforms

The compromise of December 15th paves the way for Agenda 2010:

- The delicate issue of the **compulsory pension system** has still not been resolved, having gotten as far as two reports with radically opposing views on the reform of Germany's social security systems: the government's Rürup report and the CDU's Herzog report;
- The reform of **federalism** is up for debate: since October 17th a joint commission has been working on the division of legislative competencies and tax revenues between the federal State and the Länder and is due to publish its conclusions this summer;
- **Tax** reforms (like the government, the opposition wants a new tax reform based on cutbacks in subsidies) and **labour market** reforms (a law to reinforce the prevention of illegal labour is due at the beginning of the year and the issue of *Tarifautonomie*, which has already been the subject of debate within the joint commission, could once again take centre stage) could go deeper but no firm proposal has yet been put forward.

Schröder's government, which has been suffering a credibility crisis since its re-election, can only battle on with the reforms - the only way to stop the SPD from losing in the numerous elections in 2004 (apart from the nine communal elections, European elections will be held in June, regional elections are to be held in Hamburg in February, in Thuringen in June and in Brandenburg, the Sarre and Saxony in September). We can only hope that the recovery that will boost the German economy in 2004 does not prompt the government to revise its position as to the urgency of the reforms. The coming together of politicians, businessmen and economic professors (*Initiative Neue Soziale Marktwirtschaft*) which also comprises SPD member Florian Gerster, (head of the Federal Labour Office and author of its modernisation), to tackle the issue of modernising the social market economy - an issue that has become the opposition's political flagpole, particularly within the CSU - should urge the government to continue with reforms. The Chancellor has already announced that the 2<sup>nd</sup> phase of Agenda 2010 will comprise an *Innovationsoffensive* (a small task in comparison to the reform of federalism and the pension system) to support research (promotion of cutting-edge technologies such as nanotechnologies and biotechnologies), education (development of childcare structures, setting up of high-level universities) and training. The government hopes to increase government spending on R&D from 2.5 to 3% of GDP, a measure financed by reform of the social security system. The first concrete proposals are likely to be put forward as soon as the elections have been held on 29th February in Hamburg (the SPD is counting heavily on these elections to steal support from the opposition).

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