

## THE GRAND COALITION: THE HARDEST IS YET TO COME

- ⚡ *The Grand Coalition achieved part of its governmental programme in the first half of 2006:*
  - *As the reform of the federal system was backed by a broad consensus, the Coalition was able to push through the bill to reduce the legislative powers of the Bundesrat (Germany's upper house of parliament) in return for further changes to the respective jurisdiction of the Federal State and the Länder.*
  - *Measures to bolster public finances did not meet with major opposition within the government and virtually all these initiatives will have come into force by the beginning of 2007. The related plan for growth should help to offset the recessionary impact of fiscal tightening.*
- ⚡ *However, the proposed healthcare system reforms are a clear illustration of the difficulties that the SPD (Social Democrats) and the CDU/CSU (Christian Democrats/Christian Social Union) are having in reaching an agreement on more politically-sensitive structural reforms. The planned measures are focused on revenues and will have little impact on healthcare spending. The corporation tax and Kombi-lohn (combi-wage) reforms are still under discussion and are likely to spark tension in the second half of this year.*

### Consensual reforms already adopted

#### The "mother of all reforms" was approved rapidly

The reform of the federal system was passed by the Bundestag on June 30th and by the Bundesrat on July 7th. It will come into force from January 2007 onwards. The constitutional overhaul is aimed principally at speeding up the legislative process at a federal level, at clarifying the respective responsibilities of the Federal State and the Länder, and at the implementation of a national stability pact:

⚡ Only 35% to 40% of federal laws will need the approval of the Bundesrat, where Länder representatives have their seats, as opposed to 60% previously. As a result of the new provisions, the Bundestag majority will be able to reduce the risk of having legislative texts thrown out should the Bundesrat majority differ.

⚡ The allocation of responsibilities between the Federal State and the Länder has been clarified. The Länder's jurisdiction has been broadened substantially in the fields of higher education, the environment, civil servants' remuneration and assistance for the elderly. In addition, the Länder will have greater management autonomy as they will receive the entirety of taxes on property transactions (currently in the region of 3.5% of the total consideration) and will be able to set the rate.

⚡ Lastly, the cohesion between the Bund and the Länder, in terms of fiscal rigour, has been strengthened: the Länder have joint responsibility in the event of sanctions by Brussels pursuant to Stability and Growth Pact rules. Furthermore the cumbersome mechanism of joint Bund/Länder financing has been abolished.

#### Fiscal consolidation via increased revenues

##### FISCAL CONSOLIDATION MEASURES FOR THE 2006/2009 (EUR BN)

Increase in VAT and insurance tax	70
Withdrawal of tax concessions	19
Savings from Hartz IV benefit system	15
Halt on subsidies to health insurance funds	11
Bund Administration	2
Tax on high incomes	3
<b>Total</b>	<b>120</b>

The draft budget for 2007 was approved by the Federal Cabinet. This budget supplements the budget for 2006, which was passed by both houses of parliament. The texts propose major fiscal consolidation measures, virtually all of which will become effective in 2007. The target is to cut the federal fiscal funding requirement to EUR 22bn in 2007 (vs. the EUR 38.2bn estimated for 2006), followed by annual reductions of EUR 0.5bn between then and 2010. This should enable Germany to undershoot the 3% of GDP fiscal deficit requirement on a long-term basis (Bund projections are for 2.5% in 2007 and 1% in 2010). Tax revenues will be the main instrument used: the budget for 2007 plans a EUR 20.5bn increase on 2006. In addition, investment spending will hold stable at some EUR 23.5bn. As a result, the Federal Budget can be

expected to respect the constitutional golden rule (art. 115 of the Federal Constitution), whereby the funding requirement must not exceed investment spending.

The shake-out in public finances ought to result in a EUR 120bn reduction in the debt servicing costs of all public administrations (the Federal State, the Länder and the communes) during the term of office. Most of the measures concern tax increases or withdrawals of tax concessions.

⚡ The VAT hike. The standard rate (which applies to 80% of consumption – but not to newspapers, basic food products and healthcare services) is to be increased from 16% to 19%. Insurance tax is to be increased in the same proportion. The government estimates the extra revenues generated in 2007 at approximately EUR 22.3bn.

⚡ The halt on payments of subsidies to healthcare insurance funds. This measure will be phased over 2007 and 2008.

⚡ The Christmas bonus paid to Federal civil servants is to be halved from this year on (est. saving of EUR 511m per annum).

⚡ Tax concession cutbacks (reduction in tax allowances on biodiesel vehicles, lower relief on housing, cut in the exoneration threshold on savings income) representing volume of EUR 19bn between 2006 and 2009.

⚡ The budget plans savings of EUR 4bn on benefit payments to the long-term unemployed (the Hartz IV amendment) from 2007 and savings of EUR 3bn have already been budgeted for 2006.

⚡ The Tax on high incomes has been adopted. The marginal tax rate on high incomes (EUR 250,000 for a single person and EUR 500,000 for a family) is to be raised from 42% to 45%. This measure only concerns private individuals, as SPD failed to convince the other members of the coalition to extend it to the business sector. The total amount saved is expected to be close to EUR 1bn per annum.

#### The plan for growth ought to offset the recessionary impact

The Grand Coalition has also launched a EUR 25bn impetus program. Furthermore, one third of the new VAT revenues will be used to finance a 2-point reduction (from 6.5% to 4.5%) in unemployment insurance contributions. This will cost EUR 6.5bn in 2007 and EUR 21.8bn over three years.

#### MEASURES TO BOOST GROWTH AND REDUCE MANADATORY CONTRIBUTIONS

##### 2006/2009 (EUR BN)

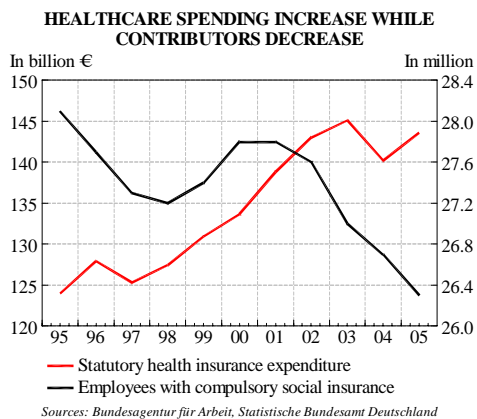
Incentives for R&D	6
Boost to the economy and support for the middle classes	9
Investment in transport	4
Aid for families	3
Households as employers	3
Reduction in unemployment insurance contributions	22
<b>Total</b>	<b>47</b>

In addition to measures to reduce mandatory contributions, the program also includes a new initiative to underpin the birth rate. A "parental wage" is to be introduced in 2007. This measure is aimed principally at the middle classes. The "parental wage", equivalent to 67% of net income (EUR 300 for a jobseeker), with a ceiling of EUR 1,800, is to be allocated to the parent who stays at home. The "wage" is payable for a maximum of 12 months to the parent who stops working. Another two months can be granted to the other parent. This means that the "wage" can be received for a maximum of 14 months. In 2007, the government will be spending approximately EUR 1.6bn on the "parental wage" and EUR 1.94bn on the parental education allowance.

### Difficulty in reaching an agreement on structural reforms

#### "A minima" agreement on healthcare reforms

The Grand Coalition reached an agreement on a series of measures aimed at restoring the viability of the public healthcare system. The reform will be put before Parliament when it resumes after the summer break and should come into force in 2007.



The crux of the reform is the gradual transition from tax-funded child healthcare. The measure is aimed at separating the costs of the healthcare system from those of the employment system. From 2008 on, EUR 1.5bn will be financed by the federal budget and, from 2009 on, the figure will be increased to EUR 3bn. As there are no plans to finance the new measures by tax increases, the brunt will be borne by the public finances shake-out proposed in the budget for 2007. Despite the fact that private healthcare insurance will have to bear part of the burden, transfers of tax revenues still remain well below the estimated cost of the child healthcare system (EUR 16bn per annum).

Contrary to the original intentions of the Grand Coalition, health insurance contributions will be increased by 0.5 points in 2007 (to an average rate of 13.8%) in order to cover the healthcare insurance deficit before the tax revenue transfers take full effect (2009). Moreover, as expected, the government has increased statutory pension contributions by 0.4 points to help to offset the state pension scheme's deficit. As a result of the 2-point reduction in unemployment insurance contributions, which will offset the 1% VAT hike, welfare contributions will fall by 1.1% in 2007.

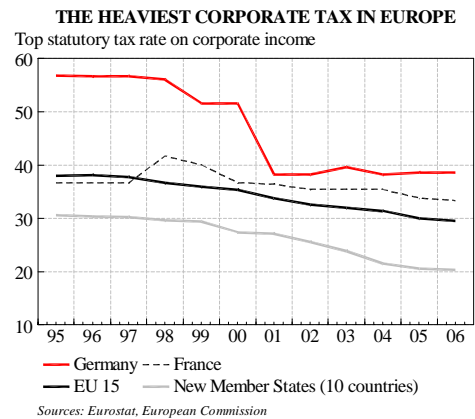
	HEALTHCARE SPENDING (% OF GDP)		
	1990	2004*	2050
United States	11.9	15.3	16.5
Germany*	8.3	10.9	13.6
France	8.2	10.5	13
OECD	7	8.9	na
Italy	7.8	8.4	10.7
United Kingdom	6	8.3	11.3
Spain	6.5	8.1	10.9

Sources: OCDE, OFCE-DREES  
\*Germany: 2003

Measures aimed at reducing healthcare spending barely feature in this reform. The level of service is broadly unchanged and the introduction of competition into the system remains limited.

### Corporation tax is expected to be reduced sharply

Proposed corporation tax reforms are to be examined closely in the second half of 2006 with a view to their becoming effective in 2008. The SPD and the CDU/CSU have reached an agreement on the broad lines. The objective is to combat intra-EU tax competition and make Germany a more attractive destination for international investment.



The general plan is to gradually reduce the corporation tax rate from the current 39% or so (25% tax on profits, plus a special solidarity contribution and local taxes) to less than 30%, which is equivalent to the current EU-15 average. The cost of the cuts will be offset by the withdrawal of tax concessions.

The parties have failed to agree on which concessions should be withdrawn. However, if the proposed reduction in corporation tax clips tax revenues by more than EUR 5bn, despite the withdrawal of concession, it will be scaled back or even shelved.

### It is essential that the combi-wage is reviewed by the SPD

At the end of May, the CDU/CSU unveiled its project for the Kombilohn (low wage complemented by a Federal State subsidy). The objective is to improve employment conditions for lowly-qualified workers. According to the OECD, the employment rate for lowly-qualified service industry workers in Germany is below the EU average (17% of total civilian jobs, as opposed to 19%). The project is thus targeted at the two categories of the population that are having the greatest problems in finding work: jobseekers aged under 25 and the long-term unemployed aged over 50. The state subsidy would be equivalent to 40% of a gross wage that does not exceed EUR 1,600, for the over 50s, and EUR 1,300, for the under 25s. The subsidy would be paid directly to the employer for a period of 2 to 3 years. The CDU/CSU estimates that the measure would give rise to 200,000 job creations and cost between EUR 550m and EUR 1,250m.

Unless the SPD amends the project substantially, it might prove to be highly counterproductive: for instance, a low wage trap resulting from the lack of a transition system for wages slightly above the ceilings (EUR 1,600 and EUR 1,300). If the wage paid by the employer overshoots the ceiling (for instance EUR 1,601 instead of EUR 1,600) the cost of labour rises from EUR 1,280 (EUR 1,600 - 0.4\* EUR 1,600 = EUR 1,280) to EUR 1,921, which represents an increase of 50%.

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