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Recommendation for a

COUNCIL RECOMMENDATION

on the 2018 National Reform Programme of Germany

and delivering a Council opinion on the 2018 Stability Programme of Germany

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 5(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances[2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission[3],

Having regard to the resolutions of the European Parliament[4],

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

(1) On 22 November 2017, the Commission adopted the Annual Growth Survey, marking the start of the 2018 European Semester of economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 22 March 2018. On 22 November 2017, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it identified Germany as one of the Member States for which an in-depth review would be carried out. On the same day, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was endorsed by the European Council on 22 March 2018. On 14 May 2018, the Council adopted the

[1] OJ L 209, 2.8.1997, p. 1.
[2] OJ L 306, 23.11.2011, p. 25.
[3] COM(2018) 405 final.
[4] P8_TA(2018)0077 and P8_TA(2018)0078.

recommendation on the economic policy of the euro area ('recommendation for the euro area').

(2) As a Member State whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Germany should ensure the full and timely implementation of the recommendation on the economic policy for the euro area, as reflected in recommendations (1) and (2) below.

(3) The 2018 country report for Germany[5] was published on 7 March 2018. It assessed Germany's progress in addressing the country-specific recommendations adopted by the Council on 11 July 2017, the follow-up given to the recommendations adopted in previous years and Germany's progress towards its national Europe 2020 targets. It also included an in-depth review under Article 5 of Regulation (EU) No 1176/2011, the results of which were also published on 7 March 2018[6]. The Commission's analysis leads it to conclude that Germany is experiencing macroeconomic imbalances. In particular, the persistently high current account surplus has cross-border relevance and reflects a subdued level of investment relative to saving in both the private and the public sector. The surplus, which is largely with non-EU countries, has slightly narrowed since 2016 and is expected to gradually decline due to a pick-up in domestic demand in the coming years whilst remaining at historically high levels over the forecast horizon. While there is currently a shift towards more domestic demand-driven growth, both consumption and investment remain muted as a share of GDP despite the favourable cyclical and financing conditions and the infrastructure investment needs for which there is fiscal space. While a number of measures have been taken to strengthen public investment, these efforts have not yet resulted in a sustainable upward trend in public investment as a share of GDP. Progress in addressing recommendations in other areas has also been limited.

(4) On 30 April 2018, Germany submitted its 2018 National Reform Programme and its 2018 Stability Programme. To take account of their interlinkages, the two programmes have been assessed at the same time.

(5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds for the 2014-2020 period. As foreseen in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council[7], where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking the effectiveness of the European Structural and Investment Funds to sound economic governance[8].

(6) Germany is currently in the preventive arm of the Stability and Growth Pact and subject to the debt rule. In its 2018 Stability Programme, the government plans a

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5 SWD(2018) 204 final.

6 COM(2018) 120 final.

7 Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

8 COM(2014) 494 final.

budget surplus of between 1 and 1 ½ % of GDP over 2018-2021. The medium-term budgetary objective — a structural deficit of 0.5 % of GDP — continues to be met with a margin throughout the programme period. According to the Stability Programme, the general government debt-to-GDP ratio is expected to gradually decline to 53 % in 2021. While the Stability Programme lists and describes several planned measures of the March 2018 coalition agreement, amounting to around broadly 1½ % of GDP over the period 2018-2021, those are not yet included in the Stability Programme's projections as they are not yet adopted. The macroeconomic scenario underpinning those budgetary projections, which has not been endorsed by an independent body, is plausible.[9] Based on the Commission 2018 spring forecast, the structural balance is forecast to register a surplus of around 1.2 % of GDP in 2018 and 1.0 % of GDP in 2019, above the medium-term budgetary objective. General government debt is forecast to remain on a firm downward path. Overall, the Council is of the opinion that Germany is projected to comply with the provisions of the Stability and Growth Pact in 2018 and 2019. At the same time, while respecting the medium-term objective, there remains scope to use fiscal and structural policies to achieve a sustained upward trend in public and private investment in particular on education, research and innovation.

(7) Real public investment increased robustly in 2015-2017. This trend reflects the government's efforts to strengthen investment. Public investment is picking up, but as a proportion of GDP the increase is still modest, and a significant backlog at municipal level, estimated at 4 % of GDP, remains. The public capital stock is still declining as a proportion of GDP, due to negative net investment at municipal level (around EUR 6 billion annually in 2010-2016). Clearing the investment backlog at municipal level would require additional annual public investment of 0.3 % of GDP over the next decade. Investment as a percentage of the capital stock in the government sector, and public investment as a percentage of public expenditure are below the euro area average. A service agency set up to support public investment at municipal level became operational in 2017, but additional efforts are needed to address the investment backlog. Together with the favourable budgetary position this indicates that there is scope to increase investment at all levels of government, notably at regional and municipal levels.

(8) Public expenditure on education remained at 4.2 % of GDP in 2016, below the EU average of 4.7 %. Spending on education and research remained at 9.0 % of GDP in 2016, falling short of the national target of 10 %. This corresponds to an estimated investment gap of about EUR 33 billion. While education expenditure has increased in real terms, a considerable investment backlog remains. At the same time, challenges such as growing student numbers, teacher shortages and further expansion of early childhood education and care will require appropriate public financing. Additional spending on education and on research and innovation is crucial for Germany's potential growth.

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9 According to the Regulation on the Economic Projections of the Federal Government (*Vorausschätzungsverordnung*) passed by the Ministry of the Economy and Energy in agreement with the Ministry of Finance and effective from July 2018, the Joint Economic Forecast project group (*Gemeinschaftsdiagnose*) has been declared the independent body in charge of assessing the economic projections underlying the Draft Budgetary Plans and the Stability Programmes in the sense of the Law on the Economic Projections (*Vorausschätzungsgesetz*).

(9) Digitalisation of the German economy is progressing slowly and the country faces considerable challenges. There is an obvious urban-rural digital divide with regard to fast internet (next-generation access up to 30 Mbit) coverage (only 54 % in rural areas). Germany is lagging behind on very-high-capacity broadband (> 100 Mbit) deployment. Only a small proportion of Germany's territory (7.3 %) is covered by high-performance fibre-based access networks, as compared with an EU average of 26.8 %. Instead, upgrading existing copper cable networks (*vectoring*) continued to be the dominating incumbent's preferred technological solution. Many services rely on very–high-speed connectivity and in 2017 25.3% of German enterprises found their internet connections too slow for their actual business needs. A lack of such connectivity holds back investment, especially by small and medium-sized businesses, many of which are located in rural and semi-rural areas. Performance in digital public services and in e-health is also far below the EU average.

(10) Business research and development investment is growing and Germany is close to achieving its Europe 2020 research and development intensity target. However, investment is increasingly concentrated in large firms and in medium/high-tech manufacturing, while the contribution of small and medium-sized enterprises is declining. A number of measures have been taken to strengthen entrepreneurial activity, especially by attracting private investments in risk capital. However, Germany's venture capital market remains less developed than those of other international innovation leaders.

(11) Despite some improvements in recent years, Germany's tax system remains inefficient, in particular because it is complex and distorts decision-making, e.g. on investment, financing and labour market participation. Germany places a relatively strong emphasis on direct taxes to raise revenues and there is potential to reduce distortive direct taxation or for a shift towards less distortive taxes on property, inheritance and consumption. The levels of taxes and social contributions on income from employment were the sixth highest in the EU in 2015. The cost of capital and the effective average corporate tax rate, which differ across regions, are among the highest in the EU (28.2 % as a national aggregate, as compared with an EU average of 20.9 %). Due to the interplay of corporate income tax, local trade tax and the solidarity surcharge, the corporate tax system is complex, involves high tax administration costs and distorts the level and location of investments. In addition, the corporate income tax distorts financing decisions, with a bias towards debt financing. This bias is the seventh highest in the EU. Lowering the capital costs on equity could strengthen private investment and the relatively under-developed venture capital market. Furthermore, loss carry-forward provisions remain relatively strict, limiting the amount to 60 % of taxable income for a given year.

(12) Regulation in Germany is still highly restrictive, especially as regards business services, regulated professions and administrative formalities for the cross-border provision of services. Key restrictions concern *inter alia* legal form and shareholding. Churn rates in key business services sectors such as legal, accounting, architectural and engineering activities are below the EU average, while gross operating rates in those sectors are above average, suggesting lower competitive pressures. Because of services' role as intermediate inputs, less restrictive regulation of services increases productivity in downstream service-intensive industries.

(13) Germany's labour market performance has been very strong. Unemployment fell to a record low of 3.6 % in the fourth quarter of 2017 and employment reached 79.8 %. The level of youth unemployment (6.7 % in 2017) is among the lowest in the EU.

Germany is experiencing increasing shortages of skilled labour, while certain groups' labour market potential remains under-used. The proportion of people working part-time, particularly women and those with a migrant background and caring responsibilities, is among the highest in the EU. For women, key factors include disincentives to work longer hours, coupled with a lack of sufficient childcare and all-day school facilities. Specific tax rules, particularly for second earners and low-wage workers, and the lock-in effects of the mini-job earning threshold of EUR 450 generated further disincentives to work longer hours. Germany has one of the highest tax wedges on low earners, most of whom are women. The high rate of women working part-time is accompanied by one of the widest gender gaps in part-time employment in the EU (37.5 % vs EU average of 23.1 %). This contributes to a very wide gender pay gap in Germany.

(14) Nominal wage growth remained moderate in 2017, at 2.4 %, despite record low unemployment and high job vacancy rates. This relatively subdued rate is partly due to slow productivity increases in services, low collective bargaining coverage in some sectors and a reduction in structural unemployment. The reaction to the pick-up in inflation was limited, with real wage growth declining from 1.8 % in 2016 to 0.7 % in 2017. Collective agreements from early 2018 may lead to some wage acceleration; developments in this area are worth monitoring. The proportion of low-wage earners remains high and there is scope for increases in the number of hours worked in lower wage deciles. Increased immigration did not prevent wage growth in lower wage segments. The introduction of the statutory general minimum wage in 2015, and its subsequent rise in 2017, increased wages at the bottom of the distribution. On top of wage increases, social partners are focusing on working time flexibility in the current round of wage negotiations.

(15) Germany has a solid social protection system overall. However, the at-risk of poverty rate for the total population rose steadily from 2005 to 2015 (16.7%) before the trend was slightly reversed in 2016. Income inequality has also begun to decline in 2015, showing a modest reduction in the S80/S20 ratio owing to an improvement in the incomes of poorer households. The recent improvement of in-work poverty in 2016 was also modest and only benefitted men.

(16) Germany can improve the attachment of older workers to the labour market, which would increase old-age income, boost potential output, help adapt to a tight labour market, and reduce the need for precautionary savings for old age. Fiscal sustainability risks are currently low, due in large part to a relatively high primary surplus. Still, Germany is expected to have one of the largest increases in pension expenditure in the EU up to 2070 according the 2018 Ageing Report. At 17.6 % in 2016, the risk of poverty in old age (i.e. above 65) was above the EU average of 14.7 %. The future deterioration of pension adequacy in the statutory first pillar is expected to increase the risk of poverty in old age, particularly for low-wage earners, people with atypical contracts and those with interruptions in their employment histories. The gender pension gap is one of the widest in the EU. At the same time, while the employment rate for workers aged 60-64 (58.4 % in 2017) was among the highest in the EU, the employment rate for workers aged 65-69 was in the middle third of Member States (16.1 %).

(17) Socio-economic background remains a considerable determinant of educational outcomes and labour market integration. In science, it contributes to a performance difference of 3 years of schooling between the lowest and highest social quartiles according to the Programme for International Student Assessment in 2015. National

data confirm the substantial correlation also for primary education. Particular challenges exist for students with a migrant background. Compared with native-born students, they are much more likely to underachieve in basic skills and leave school early or drop out of university. Also the labour market potential of people with a migrant background is not fully used. In 2017, the employment rate among non-EU nationals (aged 20-64) was more than 27 pps. lower than that for German nationals (almost 33 pps. lower in the case of female non-EU nationals). It is a concern for future labour market performance of workers that adult learning is below the EU average and remains a particular challenge for the low-skilled adult population of 7.5 million people who lack basic reading and writing skills.

(18) In the context of the 2018 European Semester, the Commission has carried out a comprehensive analysis of Germany's economic policy and published it in the 2018 country report. It has also assessed the 2018 Stability Programme and the 2018 National Reform Programme and the follow-up given to the recommendations addressed to Germany in previous years. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Germany but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.

(19) In the light of this assessment, the Council has examined the 2018 Stability Programme and is of the opinion[10] that Germany is expected to comply with the Stability and Growth Pact.

(20) In the light of the Commission's in-depth review and this assessment, the Council has examined the National Reform Programme and the Stability Programme. Its recommendations under Article 6 of Regulation (EU) No 1176/2011 are reflected in recommendations 1 and 2 below.

HEREBY RECOMMENDS that Germany take action in 2018 and 2019 to:

1. While respecting the medium-term objective, use fiscal and structural policies to achieve a sustained upward trend in public and private investment, and in particular on education, research and innovation at all levels of government, notably at regional and municipal levels. Step up efforts to ensure the availability of very high-capacity broadband infrastructure nationwide. Improve the efficiency and investment-friendliness of the tax system. Strengthen competition in business services and regulated professions.

2. Reduce disincentives to work more hours, including the high tax wedge, in particular for low-wage and second earners. Take measures to promote longer working lives. Create conditions to promote higher wage growth, while respecting the role of the social partners. Improve educational outcomes and skills levels of disadvantaged groups.

Done at Brussels,

For the Council
The President

[10] Under Article 5(2) of Council Regulation (EC) No 1466/97.