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888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Germany's Economic Non-Miracle

How Finance Minister Hans Eichel's policies have hurt the Schroeder government.

BY PAUL WELFENS

When the Kohl government fell after 16 years in 1998 there was hope that the red-green coalition government under Chancellor Schroeder would overcome the gridlock in economic reforms concerning taxes, the social security system, labor market institutions, and prudential supervision. Germany's economic growth had fallen to 1.5 percent in the period 1993-98. Once the reunification boom of 1990-92 was over, fuelled largely by generous tax benefits for investors in eastern Germany, a reunited Germany faced serious problems, the least of which was a shocking 4.5 million unemployed.

The politico-economic heritage of the conservative government

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Prof. Dr. Paul J.J. Welfens holds the Jean Monnet Chair in European Economic Integration and is president of the European Institute for International Economic Relations at the University of Potsdam.

was very difficult because high deficit-to-GDP ratios–close to 7 percent in the early 1990s–had become a serious problem during the early years of German unification. Of course, the Maastricht Treaty stipulated that the deficit-to-GDP ratio should not exceed 3 percent and the debt-to-GDP ratio 60 percent. While the latter ratio had barely been met in 1999 with the beginning of the Euro and the ECB, the deficit-to-GDP ratio was a more crucial issue particularly because the Stability and Growth Pact adopted by the Euro starter countries required member countries of the euro zone to achieve a nearly balanced budget in the medium term. Hans Eichel, Germany's Minister of Finance, thus emphasized the need for a reduction of the deficit-to-GDP ratio in his first days in office. Indeed, in the first year at the top of the ministry he achieved a solid public profile as a savvy political hero; the deficit ratios under Eichel were between two and three percent. High extra revenues from auctioning off licences for the mobile telephone industry translated into a modest budget surplus. Unfortunately, in less than two years it became clear that Eichel did not really have a consistent concept to combine fiscal consolidation with the need to raise output growth and stimulate employment.


AP WIDE WORLD

Finance Minister **Hans Eichel***: Gained huge international respect as a fiscal conservative, but did he then fail to ease the brakes after September 11th?*

Mr. Eichel had initially boosted his public profile with a broad tax reform which combined a reduction of income tax rates with a reduction of the corporate tax. Regarding the latter, Eichel abolished the previous split tax rate arrangement which had been 40 percent for profits withheld in the company and 30 percent for profits disbursed. The regime applied to both stock companies and limited liability companies. The split of rates implied a curious balance sheet item for Germany's firms since firms had an option to retroactively change historically withheld profits into disbursed profits and then claim a tax bonus which reflected the effective switching to the lower corporate tax rate. Retroactive changing of withheld profits into disbursed profits in practice occurred rarely unless a firm was taken over by another firm. For the acquiring firm the charm of switching withheld profits of the acquired company into disbursed profits mainly stemmed from the fact that this maneuver allowed partial finance of the acquisition out a welcome tax bonus cashed in with the tax authorities. When government switched to a uniform lower corporate tax rate of 25 percent, the new law allowed firms a transition period: withheld profits of the period 1994-2000 could be switched into disbursed profits over 15 years starting in 2001. The Ministry of Finance roughly calculated that some Euro 36 billion in tax bonus payments might occur over these 15 years, but the ministry clearly had no idea of the time profile of bonus payments to be made. Nor did the law stipulate any limits on tax bonuses to be received per annum.

Much to the unpleasant surprise of the government, corporate tax revenues sharply declined in 2001 and 2002. While corporate tax revenues amounted to roughly Euro 20 billion in 1999 and 2000, the net revenue turned slightly negative in 2001: the swing in the corporate revenue position which largely was due to a sudden wave of tax bonus payments to be made amounted to 1 percent of Germany's GDP. Worse, a similar development, based on figures for tax collection for the first half year, is anticipated for 2002. Failure to enact a revenue-smoothing transition regime in the tax reform was a major blunder.

A sloppy corporate tax reform has not been the only problem of Eichel's policy strategy. The most fundamental problem is Eichel's total failure to understand the inherent dynamics of economic growth, the deficit ratio, and the debt-to-GDP ratio. In a growing economy, the long-term government debt-to-GDP ratio is determined by dividing the deficit ratio by the growth rate. Consequently, a country which would aim at a debt ratio of 0.5 could achieve this ratio either by combining a long-term deficit ratio of 0.75 percent with 1.5 percent economic growth, or by combining a deficit ratio of 1.5 percent and 3 per-

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cent growth. Ignoring these basic economic dynamics, Eichel–a politician with no background in economics (a teacher in German language, political science, and philosophy)–emphasized simply cutting the deficit ratio while ignoring the role of growth policy. Indeed, he cut the deficit ratio mainly by reducing public investment so that Germany's public investment outlays relative to GDP reached only 1.9 percent in 2000/2001 which, together with Belgium, meant that Germany had the lowest ratio among all countries in the Euro zone. Put another way, Eichel's failure to switch government expenditure priorities to growth-enhancing categories such as public investment, support for research and development, or education contributed to a weakening of Germany's growth.

Germany's economic growth in the five years after 1992 was only about 1.5 percent. The growth rate has remained at this weak level in the period 1998-2002 so that Germany did not even reach half the U.S. growth rate in the 1990s. Moreover, in the period 1993-2001 Germany's growth rate was almost a full percentage point behind that of the 11 partner countries in the Euro area. The German Ministry of Finance prefers in its publications the opaque comparison of Germany and Euro-12 countries where the latter, of course, include Germany so that the growth gap does not look as bad as it really is. Worse, the Annual Report of the Ministry of Finance published in early 2002 naively anticipates that Germany was about to return to an economic growth rate of roughly 3 percent provided that the U.S. economy recovered. As a matter of fact, even if U.S. growth were 3 percent in 2002, Germany's economic growth would not even exceed 2 percent. The official government forecast for 2002 is a modest 0.75 percent which implies a further increase of unemployment and a critical rise of the budget deficit. Since Eichel was neither willing to strongly cut Germany's very high subsidies to ailing industries nor to raise value-added tax rates or impose taxes on wealth, the German government failed to combine the requirements of achieving fiscal consolidation and stimulating efficiency and economic growth, respectively.

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Eichel had masterminded another strange law in 2001 when he changed the accounting rules for insurance companies. In the law, which was adopted against clear warnings from most experts, insurance companies are allowed to use acquisition prices of shares in their balance sheet instead of lower market prices determined at the date of submitting their balance sheet. In other words, insurance company X might thus have acquired Deutsche Telekom shares at a historical market price of Euro 110 while the actual market price is only a modest 11. This new accounting standard is a favor to insurance companies, but it strongly undermines transparency in the financial sector and actually undermines the stability of financial markets. After its painful experience with poor accounting standards, the United States is improving its supervision while Germany continues to undermine the transparency of its balance sheets.

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In essence, Eichel embraced an accounting regime which Japan's banks have been known to have used to their own detriment for decades? One cannot rule out the fact that the German Minister of Finance listened much too much to his favorite advisers–a group of German, British, and U.S. bankers–who inevitably saw little problem in recommending that inflated share prices in insurance companies' balance sheets are a sign of wisdom and progress in the twenty-first century.

The bottom line is that Germany's Social Democratic Party, which had a proud tradition of selecting highly competent personalities for the Minister of Finance in the 1970s, has shot itself in the foot with the selection of the layman Hans Eichel. No continental EU country except Germany has appointed a layman as the Minister of Finance. Indeed, a country facing such difficult problems as Germany–stubborn unemployment, low growth, problems with German unification, EU eastern enlargement, and the euro (implying that Germany's old privileged position of having the lowest capital costs in Europe is gone)–should not entrust anybody without proven economic credentials to take over the helm at the Ministry of Finance. Unless a new approach is developed, reunified Germany will likely move from its present 4 million unemployed to more than 5 million which in turn is bound to undermine economic and political stability in the largest EU economy. ◆