Finanzgruppe
Deutscher Sparkassen- und Giroverband

Herausgeber:
Deutscher Sparkassen- und
Giroverband (DSGV)
Charlottenstraße 47
10117 Berlin
Telefon +49 30 20225-5115
Telefax +49 30 20225-5119
www.dsgv.de

Wirtschaftspolitische Positionen

A Social Agenda for Germany

Summary

The Chief Economists of the Savings Bank Finance Group advocate a social-policy agenda which will help to strengthen productivity and defuse conflicts between growth and inequality. Such an agenda is decisive when it comes to strengthening the German (and the wider European) locations and to reinforce cohesion in European societies.

Against this backdrop, the Chief Economists call for the following:

→ Adjustment of the tax and fiscal-charge system in order to promote fair wealth and income structures. In this context, it is also imperative to reduce existing disincentives depressing the participation rate of women.

→ Lightening the problematically high (marginal) tax and social-security-contribution burden, especially from the point of view of the gross incomes of low-paid workers.

→ Expanding targeted investment on education and ongoing further training; both quantitative and qualitative improvements are needed particularly in the early-childhood-education domain.

→ Targeted infrastructure investment, especially as a prerequisite for digitalisation, is required.

→ Measures designed to mobilise the domestic workforce potential, especially the reintegration of the long-term unemployed into the work process via further training and activation, remain an overriding priority.

→ The statutory pension system needs to be configured in a manner conducive to stabilising democracy. To this end, all features of a complex policy mix (pension level, retirement age, contribution liability, contribution level, tax subsidy) need to be discussed. What will be necessary will be to strike an equitable balance between burdens and new flexibilities from the point of view of the labour market and the retirement age.

A Social Agenda for Germany

The economic emergence of the Federal Republic of Germany in the aftermath of World War II and the welfare gains reaped by broad swathes of the population are inseparably connected with the Social Market Economy principle. In recent years, the principle of a market economic system involving a strong degree of social equity has increasingly come under pressure in many developed economies as a result of economic, societal and political developments. In addition, a number of decidedly persistent problems in the lower income segment - despite the recent increase in social expenditure - are fuelling doubts about the effectiveness and efficiency of individual social-welfare measures.

This paper will sketch current and future challenges facing the welfare state and provide a concise presentation of important empirical foundations needed to move the political discourse forward. These empirical findings definitely urge that reform endeavours be made in the social-policy and economic-policy spheres, some of which have already been addressed by the political class. In the following, we will adumbrate the most prominent political concepts and discuss them from the viewpoint of their economic implications. The paper concludes by outlining a number of reform areas which are particularly pressing from an economic perspective and by taking a critical look at some of the current programmatic political positions in this field.

1. Social policy is facing new challenges

Social-welfare measures are aimed at correcting undesired market outcomes. In this respect, an excessive degree of social inequality is frequently regarded as a source of political instability and - if a certain threshold is exceeded - as an obstacle to growth. In the long term, an overly unlevel playing field can cause support for the existing economic order to erode. But what are the current, and what will be the future, drivers of social inequality and what are the challenges facing the social policy of the future?

1.1 Economic challenges

The progressive **digitalisation** of the economy and of society in general necessitates new answers from policymakers in the economic-policy and social-policy fields. Due to blisteringly fast technological change, many observers fear progressive crowding-out, in terms of the factors of production, of labour by capital.[1] Particularly at risk, for example by robotics, are routine lines of work whereas new analytical jobs involving high qualification requirements could definitely come into existence on balance. Education and further training thus morph into key factors. Even today, educational and wage disparities are closely correlated with one another, a particularly problematic aspect here being intergenerational immobility. Public-sector investment on education strengthens equal opportunities and safeguards future prosperity in the economy as a whole.

In the light of this, it is imperative that targeted investment on education and the ongoing pursuit of knowledge (lifelong learning“) should be expanded. Further quantitative and qualitative improvements are necessary in the domain of early childhood education in particular - such investments will pay off in the long run (cf. Krebs/Scheffel 2017).

Progress in such spheres as Artificial Intelligence (AI) could jeopardise higher-qualified jobs as well in the medium term. It is true that new jobs will undoubtedly come into existence in parallel in the services sector, but such jobs are, as a rule, more poorly paid. On the other hand, companies can boost their competitiveness by deploying modern digital technologies, thereby making a contribution to securing or even increasing employment (Arntz et al. 2018). Wage differentials therefore look destined to widen further. This, in conjunction with the existing income ceilings for social-security contributions, may lead to a situation in which the contribution-oriented financing of social benefits comes under further pressure.

A particular challenge regarding the financing of social-security systems is the **further decline in the macroeconomic wage ratio** which is on the cards, even though this downward trend seems to have been temporarily interrupted in 2018 and 2019. This downtrend, which can be expected to reassert itself in the long term, is not only an upshot of technological progress, and of the higher degree of capital intensity associated with this, but also of the waning power of collective bargaining agreements in a globalised economy and of the dwindling capacity of employees to push through their claims (IMF 2017a). In addition, the digital economy is inducing further change via the networking / sharing economy, inter alia through concentration effects. In our globalised economy, this can lead to job migration or tax-substrate shifts, which will likewise have significant knock-on effects on the financing of national welfare benefits.

Further major challenges are the demographic trend, Germany's low potential growth rate, and **accumulated indebtedness** (including the public sector's implicit debt commitments). Admittedly, Germany's public-debt ratio, formerly at a shade over 80 per cent of GDP, has rapidly been chipped away at over the past few years, and is likely to dip to below the 60-per-cent threshold during 2019. On the other hand, this metric does not capture implicit burdens such as pension entitlements, meaning that it remains necessary to pursue a solid and sustainable fiscal policy. True, such fiscal rectitude does not rule out taking on new debt - especially in cyclical downswing phases or to fund investment designed to boost the potential growth rate. However, it is always important to aim to find lasting countervailing financing for public-sector social expenditure on consumption.

It should also be recalled that **the process of demographic change** is set to become a good deal more palpable in the coming years as more and more baby boomers reach retirement age. Where employment grew significantly in recent years thanks to higher workforce participation and a high degree of immigration, with the potential growth rate stabilising as a result, demographic developments can be expected to have a negative impact on underlying growth potential, at the latest from the middle of the next decade onwards. If a shortage of skilled workers is to be prevented and underlying growth potential stabilised, a combination of factors is needed: increasing the size of the potential domestic workforce (participation rates, length of working lives), immigration and rationalisation. To that extent, technological progress in general and digitalisation in particular can be a source of hope from a social-policy point of view as well.

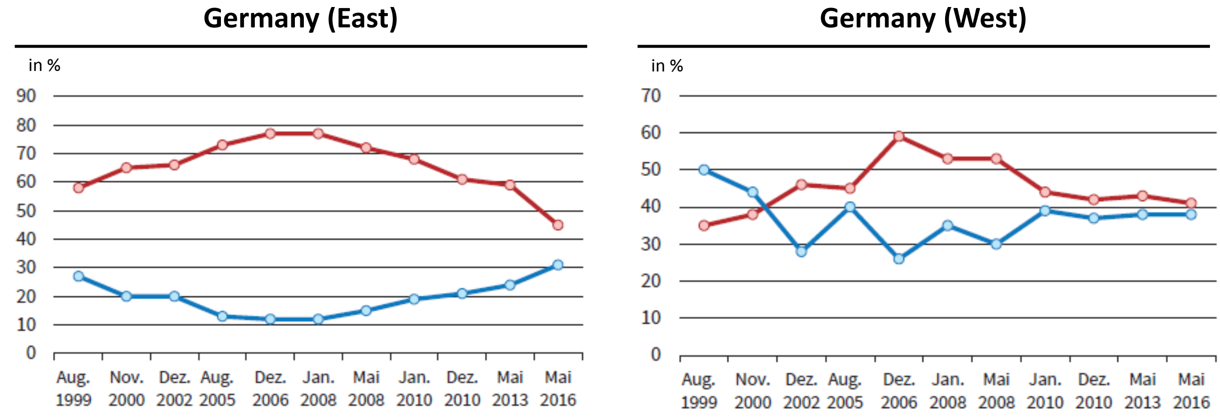
However, considerable problems can also be expected to crop up as a result, especially if redistributional measures are not used to correct the trend. The development described directly challenges the financing of social-security systems. The blunt fact is that social-security spending is doomed to grow further in future in response to a double dose of demographic aging (low birth rates coupled with rising life expectancies) while the ratio between beneficiaries and contributors is slated to deteriorate further. Above all the pension-insurance and nursing-care-insurance systems reveal an additional need for reform, but demographic effects are also expected to affect the health-insurance system after a time-lag (cf. Boysen-Hogrefe 2019).

1.2 Political aspects

Th emergence of populist parties derives, amongst other things, from growing dissatisfaction among the population. Digitalisation and globalisation have not been simply a win-win scenario, giving rise to mounting fears among those who are less technology-savvy. In Germany, for example, anxiety about losing one's social status has proliferated in spite of the flourishing labour market. Such apprehensions are causally linked not least to the recent decline in pension levels (for the lowest strata of pension recipients) at a time when rents are spiking sharply. In surveys, a small majority in both eastern and western Germany still evaluate the market-economy system as being "not really social" despite the multi-year economic upswing (cf. the chart - the latest survey dates from mid-2016). This is in keeping with the narrative touted by many politicians that the principles of the social free-market economy no longer apply, at last not to everyone, and that many people are no longer benefiting from the cyclical upswing.

[1] There is no consensus on the potential effects of digitalisation on the job market. Although admittedly taking a positive view of pronounced digital structural change in individual vocational groups and sectors, the Nuremberg-based Institute for Employment Research (IAB) is only expecting very slight repercussions on the overall level of employment (cf. Zika et al. (2018)). Yet the process of digital structural change can increase income and wealth polarisation, and at the same time erode the current financing basis of social-security systems by reducing the proportion of jobs subject to social-security contributions.

German population's view on social market economy



Question: Would you agree that we have a social market economy or is our market economy not really a social one?

Yes
No, not really

Source: Allensbach Institute for Public-Opinion Research, surveys from 1999-2016, quoted in Hampe, P. (2018): "Wie sozial ist die deutsche Marktwirtschaft?"? ifo-Schnelldienst 15/2018, pp.11-17.

Populist parties are only too glad to cater to and canalise the fears of social relegation voiced in this way. Over the past few years, this breeding ground has been exploited by populist groupings in many Western states promising to provide "simple answers to complex problems." A certain loss of trust in the existing parties of government or government coalitions - an indisputable disenchantment - has played into the hands of the populists. The key question, however, is whether there is a connection between increasing economic inequality and the electoral successes scored by right-wing and left-wing parties. Developments in other Western democracies (Trump, Brexit, Italy) arouse the suspicion that the (alleged) losers of globalisation, technological change, and so on, are venting their anger at the ballot-boxes. This could be a wake-up call leading to political measures geared to more inclusive growth. Current political proposals, such as the SPD's "respect pension" plan, do indeed seem aimed at counteracting fears of social exclusion, not least in order to put a brake on the ascent of populists and to actually reverse this trend in the long term.

1.3 Inequality versus inclusive growth: Piketty, the IMF and the OECD raise the distribution question

Almost every standard textbook of economic science postulates a systematic trade-off between economic efficiency and equality ("trickle-down economics"). Not every form of inequality is a problem of justice because differences can definitely result from normatively legitimate factors. What is more, a certain degree of inequality is necessary in order to create the right incentives for economic agents. Surveys in Germany demonstrate that the broad population likewise regards a certain degree of inequality as being justified (Adriaans/Liebig 2018). If at all, it is very low incomes which are seen as being unjustified. However, there is a reciprocal relationship between income inequality and equality of opportunities. For example, it can be shown that success at school at Germany hinges to a disproportionate extent by international standards on a child's socioeconomic background (cf. Brunori et al. 2018, Hufe et al. 2018). In this way, inequality becomes unjustly entrenched over generations.

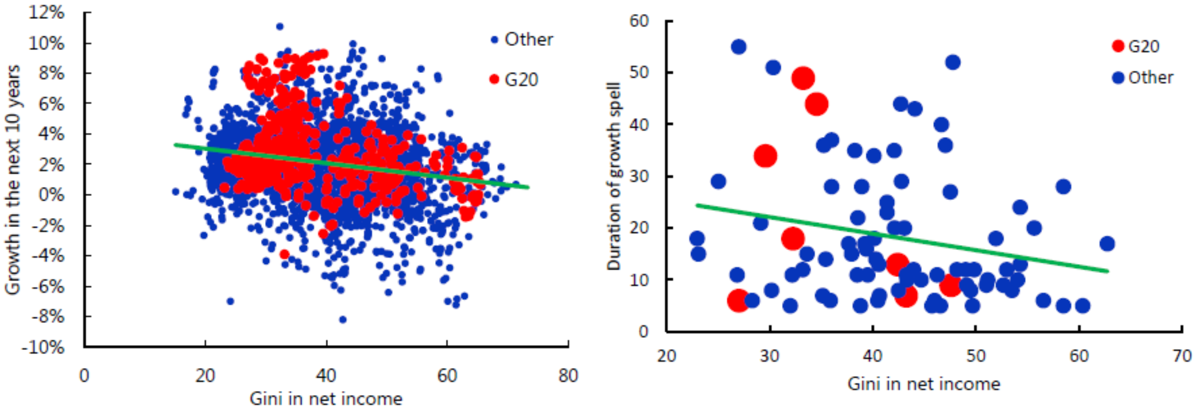
Since French economist Thomas Piketty published his bestseller "Capital in the 21st Century" (2014), an intense debate has revived among economists about distributional questions, and especially about the possible problems entailed by growing wealth and income inequality. Various organisations such as the IMF and the OECD are likewise emphasising the importance of "inclusive growth."[2] In 2016, the G20 once again pledged to adopt a package of political measures designed to secure strong, sustained, balanced and inclusive growth (IMF 2017b). These approaches are predicated on a more holistic view of economic expansion and prosperity. They also take account of the complex interlinkages between economic growth and inequality, which may involve trade-offs.

Empirically, the evidence on the trend in inequality is not uniform, especially since there turn out to be relatively pronounced disparities between income distribution and wealth distribution. Across country borders, income inequality declined markedly between 1988 and 2013. The global Gini index fell from nearly 70 to 62.5, principally on account of the catch-up effect in emerging markets and developing countries. Conversely, income inequality rose within national boundaries in most developed economies, including Germany, from 1990 until the middle of the 2000s. On top of this, virtually half of global wealth is concentrated in the hands of the top percentile of the global population.

Concepts such as "inclusive growth" are based on the hypothesis that socioeconomic disparity puts a brake on economic growth. Supporting themselves on research findings in IMF publications and other papers, some economists infer from a mildly negative correlation that a high degree of inequality can negatively influence the extent and duration of growth (Ostry et al. 2014, cf. the chart below).[3]

Growth and Inequality (1960-2010)

Panel A: Medium-term growth and inequality **Panel B: Duration of growth spells and Inequality**



Source: Ostry, Berg, and Tsangarides (2014), using data from Penn World Tables version 7.1, SWIID 3.1, and authors' calculations. Note: Simple correlation between length of growth spells, and the average net income inequality and transfers during the spell. Spells that end in-sample are included; minimum spell length is 5 years.

The inferences and recommendations for political action stemming from the results of the studies referred to are not particularly convincing. It can be shown, for instance, that there is only unambiguous empirical evidence for the negative correlation postulated between inequality and growth in the case of low-income countries.[4] On the other hand, theoretical arguments can be found not only in favour of a trade-off between equality and efficiency but also of a trade-off between inequality and efficiency. Ostry et al. (2014) and Dabla-Norris et al. (2015) put forward various supply-side arguments. According to this view, persistent income and wealth inequality can:

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[2] The IMF defines inclusive growth as follows: "Inclusive growth, on the other hand, is defined as growth which is not associated with an increase in inequality […]. In particular, we define growth as inclusive when it is not associated with reduction in the income share of the bottom quantile on the income distribution." Balakrishnan et al. (2013), p. 8. The OECD has a similar formulation: "Inclusive growth is an economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society." OECD (2014), p. 80.

[3] It should be noted, though, that a number of distortions are possible in the case of the Gini coefficient, meaning that only cautious arguments should be advanced on the basis of this concept. For a discussion of various problems such as composition effects, the impact of the system of taxes and fiscal charges or adjustment for pension entitlements cf. for example Peichl/Stöckli (2018).

[4] The already available studies estimating the correlation between inequality and growth reveal - in some cases, considerable - discrepancies, which can be explained to a large extent by the inequality indicators used, the respective assessment period, the countries assessed and the statistical estimation method employed. Cf. on this score Fuest et al. (2018), pp. 22-23.

- Put a damper on productivity, especially if long-term unemployment leads to a loss of skills or if poor people are deprived of the possibility of investing in human capital (or of the incentive to do so). They are frequently deprived of the incentive if their financial means are limited, which is why broad provision of the population with banking and financing services plays an important role in strengthening inclusiveness (cf. IMF 2017b, p. 9);
- Lead to inefficient rent-seeking behaviour by persons with a large degree of economic power, leading in turn to political corruption and social conflicts as a result of the fight for public resources;
- Endanger political stability, with heightened uncertainty possibly spawning negative economic consequences such as a deterioration in the investment climate or productivity losses. Such a scenario may also reduce resilience to economic shocks.

2. Point of departure: Empirical basis for the current debate about the welfare state

2.1 Inequality in Germany

At first glance, the German economy looks to be in very good shape: Germany weathered the severe global financial and economic crisis of 2008/09 very well and is currently enjoying the longest economic upswing phase in history. Despite the costs triggered by the financial crisis, public finances are in a considerably better state than 15 years ago, and price competitiveness is not a pressing problem for German companies. At 5.0 percent,[5] the unemployment rate has fallen to a post-Reunification low - the second-lowest on a pan-EU comparison. At the same time, the number of gainfully employed persons has been boosted to a record level of over 45 million. This stands in marked contrast to the point of departure some 15 years ago when the jobless rate had climbed to as high as 12 percent and there were less than 40 million persons in the workforce. The list could easily be extended. Undoubtedly, the labour-market reforms initiated by former Chancellor Gerhard Schröder ("Hartz I-IV") have played their part in this development, even though there has subsequently been a keen debate among economists about what contribution the "Hartz" labour-market reforms have made and how they should be assessed overall (cf. Börsen-Zeitung 2013).

Despite Germany's impressive macroeconomic performance, economic inequality and the at-risk-of-poverty rate have scarcely budged from their earlier levels and are therefore proving to be intractable. More than 10 percent of aggregate income is currently concentrated in the hands of the top percentile of the income-distribution range. Furthermore, wealth in Germany is distributed much less equitably than income: the Gini coefficient for net wealth is more than twice as high as the Gini coefficient for disposable income (IMF 2017b).[6] Admittedly, the data on distribution have to be treated with caution: for example, the Gini coefficient falls from 0.765 to 0.511 if the definition of wealth is extended to include existing pension entitlements. When looking at the trend in income inequality too, the Gini coefficient produces a skewed result if composition effects are not taken into account (cf. Peichl/Stöckli 2018). Overall, the empirical findings for Germany confirm a certain degree of inequality, with wealth being very unequally distributed. Inequality initially increased to a palpable extent in the first ten to fifteen years after German Reunification. However, it is not possible to ascertain a dramatic rise in inequality over the past ten years.[7]

[5] According to the Federal Employment Agency (BA) definition.
[6] Data for 2000 because a reliable data basis has no longer been available since that time in Germany because wealth tax has not been levied since 1997.
[7] Cf. on this score the Advisory Council of the Federal Ministry of Finance (BMF) (2017). The authors emphasise in particular that various inequality indicators (adjusted for the effects of state redistribution measures) imply that the welfare state is continuing to perform its compensatory function.

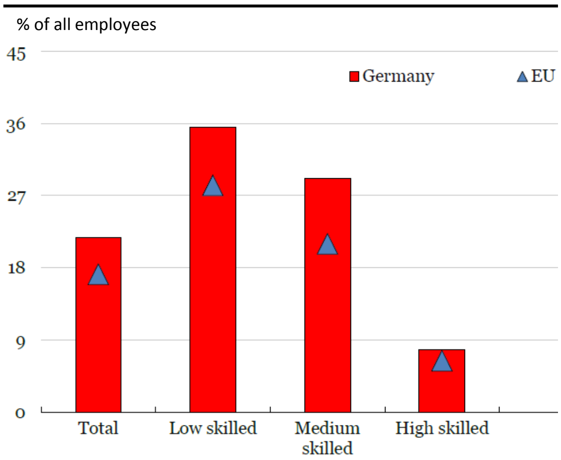
2.2 The German labour market with potential for further improvement

As already argued, benchmark indicators such as jobless and employment rates show that the German labour market has shaped up very positively since 2005. However, there continue to be structural problems and potential for improvement in a number of micro areas:

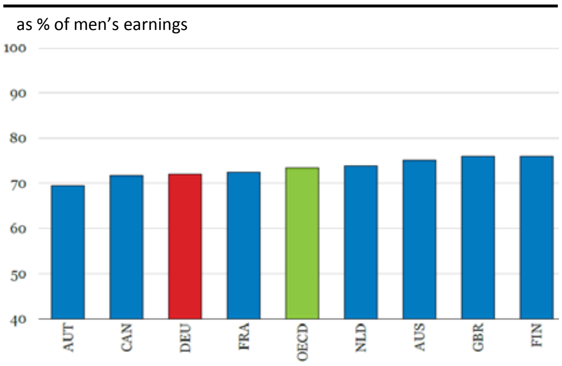
- The number of persons in Germany with atypical or precarious employment relationships (part-time work, subcontracted work, temporary work, marginal work) has increased further in spite of the positive economic development.[8]
- The proportion of low-wage earners[9] is significantly above the EU average in Germany, especially in the case of workers with lower-level or intermediate-level educational qualifications (cf. OECD 2018). Originally, it was assumed, and hoped, that the expansion of the low-wage sector might enable employees to use low-wage jobs as a springboard to better-paid work.
- Yet Germany has established a relatively large low-wage sector involving a negative “sticking effect“ for many employees.
- Not only the female participation rate could be boosted; pay for very well-educated women is also comparatively low in Germany, by comparison with other OECD countries. Admittedly a large portion of this “gender pay gap” can be explained by fundamental factors (e.g. career interruptions).

German labour market: Historic employment peak, but…

Employees earning low wage



Women’s earnings, Tertiary education graduates (2014)



Source: OECD (2018). Data: (2018), Employment and working conditions (database); OECD (2016), Education at a Glance 2016: OECD Indicators.

Germany implemented a statutory minimum wage in 2015 which, in the intervening period, has risen progressively from an initial figure of EUR 8.50 to EUR 9.19 in 2019. As yet, though, the minimum wage appears to have had only a slight impact on the risk of becoming mired in poverty, even though the German minimum wage is already the sixth-highest in the EU.

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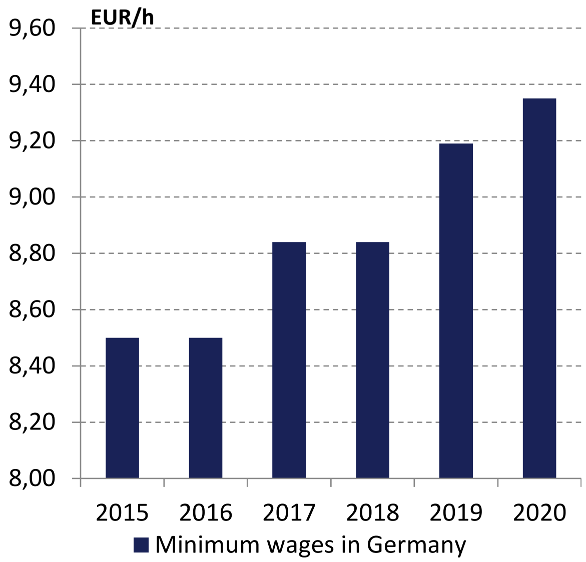
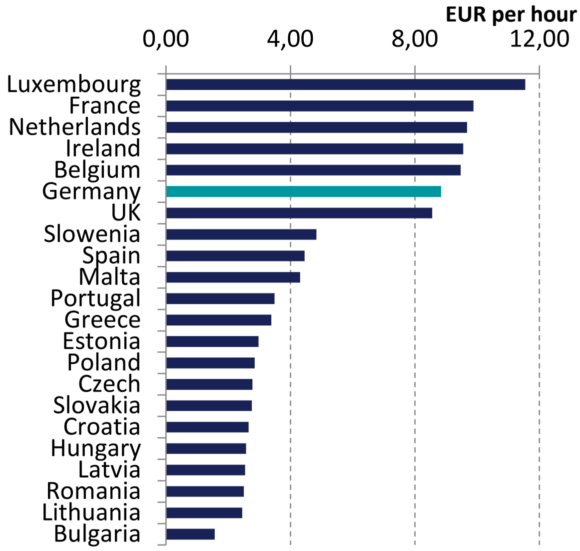
[8] Atypical employment is, at first glance, only a problem when it is involuntary. It needs to be taken into account, however, that “choice“ is often also decisively influenced by misguided incentives (e.g. in the tax and fiscal-charge system).

[9] “Low-wage earners” are defined as employees whose gross hourly earnings undershoot two-thirds of the median wage. Cf. OECD (2018). Data: Eurostat; OECD (2016), Education at a Glance 2016: OECD Indicators.

Minimum wage in Germany 2015-2020



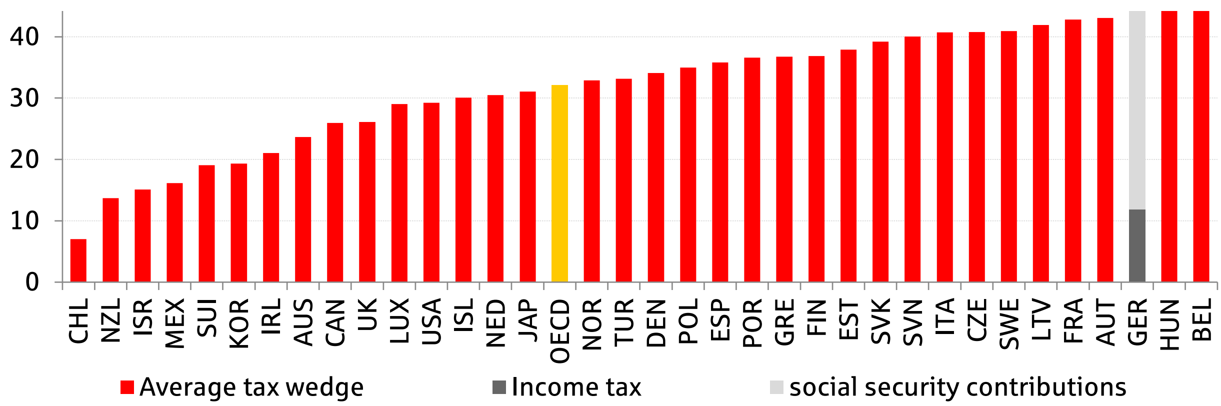
Minimum wages in the EU



Source: WSI-Mindestlohnbericht (minimum-wage database) 2018.

However, the slightness of this effect is easily explicable if the tax and fiscal-charge burden and (in some cases) very high and incentive-hostile transfer withdrawal rates are taken into account. The fact is that German employees on low incomes are subject to an overall tax burden which is onerous by international standards. In 2017, the average tax and fiscal-charge burden (tax wedge[10]) accounted for a shade over 45 percent of labour costs in the Federal Republic - the third-highest in the OECD. This is attributable above all to the high ratio of social-security contributions. The heavy burden weighing on those with low and middle incomes necessitates a modification of the system of taxes and fiscal charges so as to promote fair wealth and income structures. In this context, disincentives in the tax and fiscal-charge system obstructing the workforce participation of women need to be reduced.

Income tax & social-security contributions as a percentage of labour costs, 2017



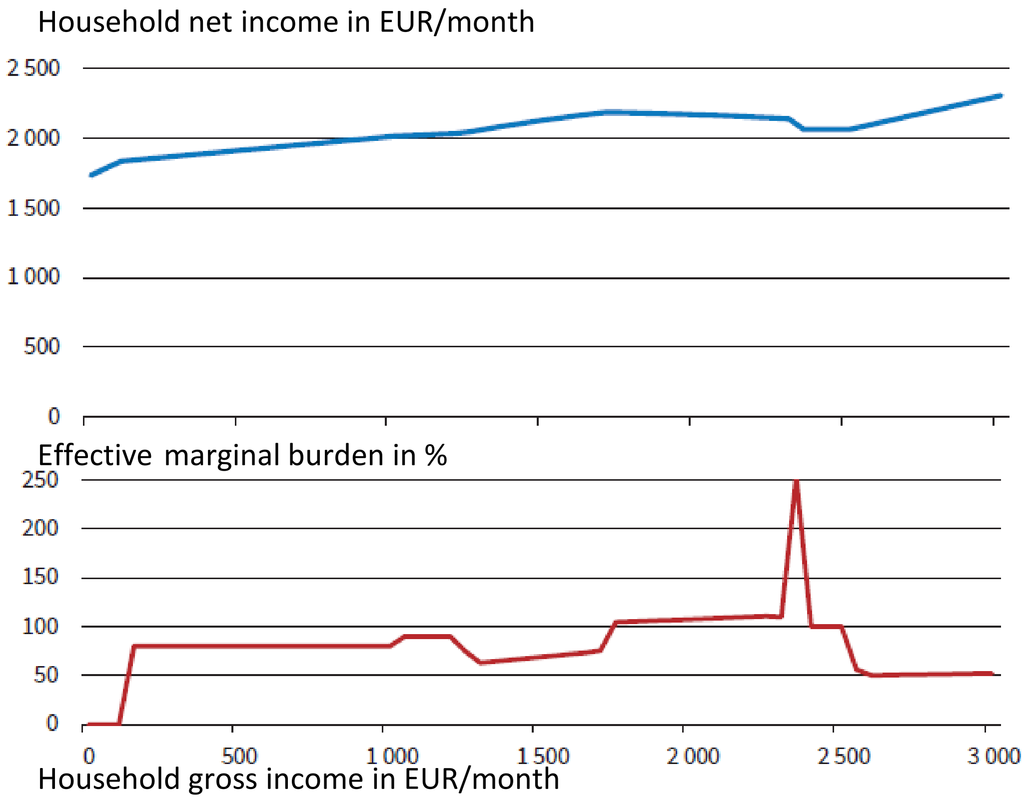
Source: OECD (2018), Taxing Wages Statistics. Data for 2017.

[10] The tax wedge is defined as the ratio between the amount of taxes and fiscal charges (incl. social-security contributions) paid by an average single worker (without children, 67 percent of median income) and the corresponding total labour costs for the employer. The tax wedge measures the extent to which taxes on labour income diminish employment incentives.

The second root cause is the high transfer withdrawal rate for employees on low incomes. The chart below illustrates that the improvement in net income is, at most, slight when gross income increases. In many areas, the net effect is, if at all, at most marginally positive in the case of gross incomes of up to around EUR 2,600. This gives rise to a dire incentive effect: for example, employees are discouraged in this way from increasing the number of hours per week worked or from making efforts to find a better-paid job. Ultimately, this also undermines investment in human capital (e.g. training and further-training measures) designed to enhance qualifications so that workers become eligible for better-paid work.

Net income and effective marginal burden according to gross-income level

(using the example of a single parent with two children aged 8 to 12, assuming rent (incl. heating costs) of EUR 510)



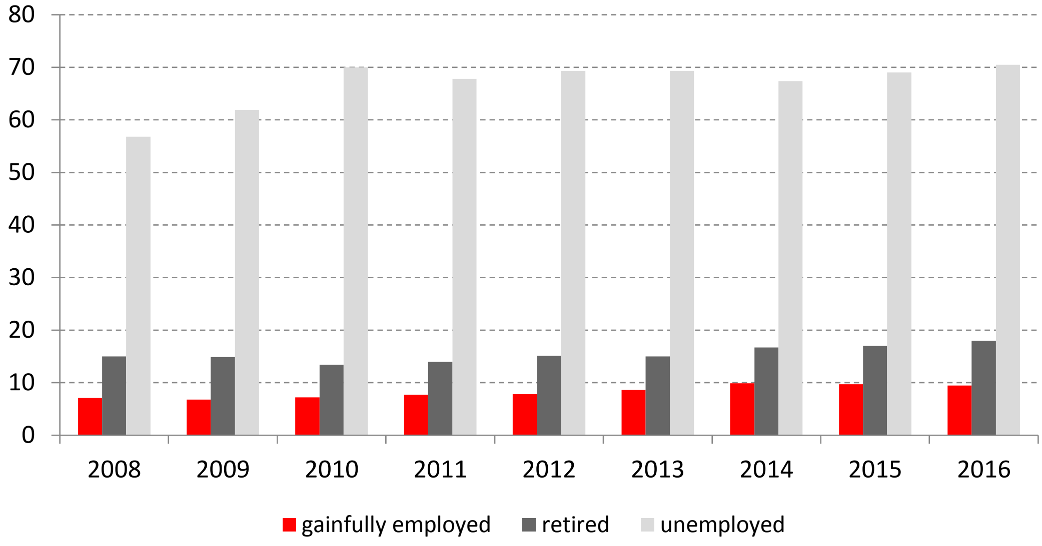
Source: Peichl, A. / Stöckli, M. (2018), Inequality and Redistribution in Germany: Trends and options for action. In: ifo-Schnelldienst 2018:15, pp. 18-22.

It is therefore imperative to relieve the problematically high (marginal) burden of taxes and social-security contributions, especially in the case of the gross incomes of low-wage earners. Such relief could be provided by reducing transfer withdrawal rates - fresh proposals are now available from scholars in the field (cf. Blömer et al. 2019). At the same time, admittedly, it is important not to lose sight of the rising financial burden for the government budget arising from the increasing number of beneficiaries. Alternatively, it could make sense to envisage a fading-in phase or a deduction from social-security contributions.

2.3 The poverty risk in Germany

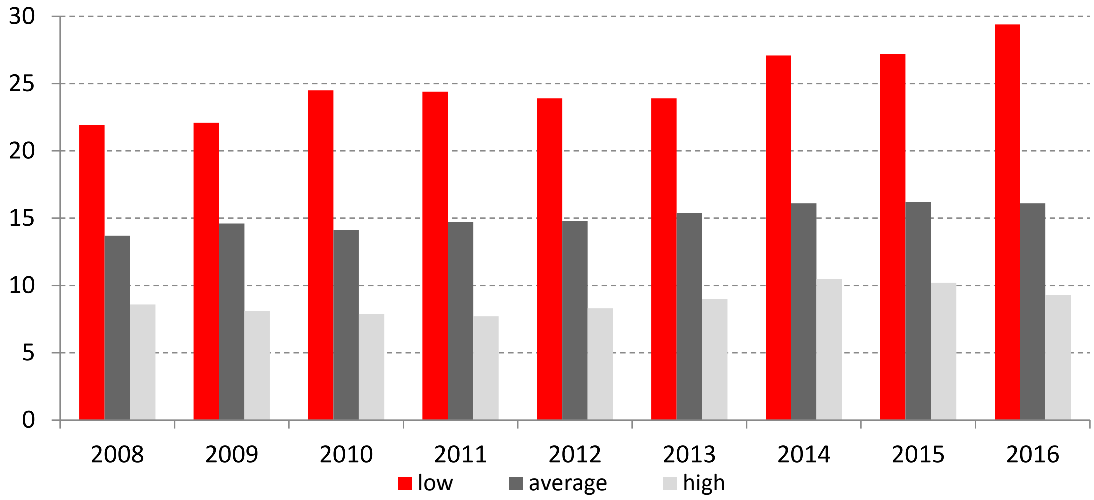
The poverty risk in Germany is slightly below the European average but still higher than the French figure. A sharp increase in the at-risk-of-poverty rate[11] could be observed in the phase from 2005 to 2008, followed by only a marginal further increase and slight improvements. The sharp increase from 2005 onwards coincides with the amendments to the social-security legislation implemented during that period. More specifically, a large proportion of the poverty risk can probably be traced back to the decision to combine unemployment assistance (AGL I) and social assistance ("Sozialhilfe," i.e. welfare) to form unemployment benefit II (ALG II, "Hartz IV").

Poverty risk and employment status



Source: Destatis (2018), LEBEN IN EUROPA (Life in Europe) (EU-SILC).

Poverty risk and educational status



Source: Destatis (2018), LEBEN IN EUROPA (Life in Europe) (EU-SILC).

[11] The at-risk-of-poverty rate indicates the share of the total population that is in danger of becoming mired in poverty. According to the EU standard, it is defined as the proportion of the population whose equivalised disposable income is below 60 percent of the national median equivalised disposable income after social transfers (at private households). Equivalised income is need-weighted per-capital income per household member computed on the basis of net income. Cf. Destatis (2018).

Over the past few years, the risk of poverty has risen particularly dramatically in the case of persons with relatively low educational levels and is especially high in general for those who are unemployed. In the light of this, measures designed to mobilise the domestic workforce potential - and especially to reintegrate the long-term unemployed into the job process via further training and activation - remain an overriding priority.

These data sets also confirm that higher income inequality (ex post) is correlated with greater inequality of opportunity (ex ante) as well as with less economic mobility across generations. The upshot is a vicious circle of high income inequality, a high at-risk-of-poverty rate, low intergenerational mobility and unequal opportunities, ultimately resulting in even greater income inequality. The consequence is that the inequality trap may snap shut

for generation after generation. It should be noted too that the gap between eastern and western Germany continues to be the main determinant of inequality in Germany. The educational and professional status of parents continues to determine their children's chances. From an economic perspective, inequality attributable to such circumstances is hardy justifiable, as well as being macroeconomically harmful.

Given that education is a critical determinant for both equal opportunities and prosperity, Germany ought to further increase its (to date, below-average) spending on education in a carefully targeted manner. Despite a number of improvements, German schoolchildren mostly only put in a mediocre performance on an international comparison. If progress is not made in this sphere, the Federal Republic threatens to fall further down the international league-table, thereby jeopardising its currently high degree of competitiveness.

2.4 The social-benefit ratio on a European comparison

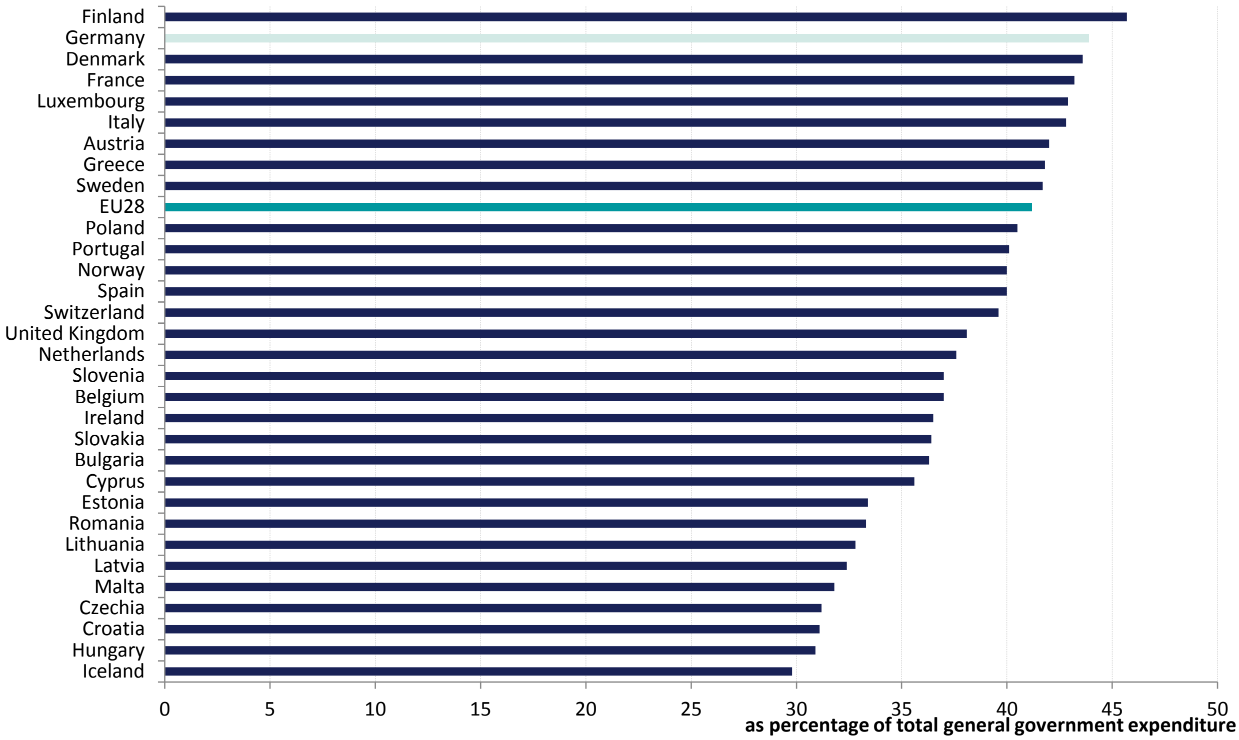
Germany's welfare state has a clear cushioning effect on inequality. However, a number of weak points still make themselves manifest, which comes as a surprise considering that the social-benefit ratio is high by international standards. The social-benefit ratio is defined as the ratio between the nominal gross domestic product (GDP) and overall social benefits. This ratio has risen each year since 2011, standing at 29.6% in 2017. The steady rise in the social-benefit ratio is a function of the fact that social benefits have usually increased somewhat more strongly than GDP in percentage terms since 2012.

Aggregate social expenditure amounted to EUR 965.5 billion in 2017, rising by as much as 3.9 percent relative to the previous year. The figure would rise further if the SPD's "respect pension" (a pension increase for those who have worked at least 35 years out of respect for their life performance) is passed into law, by approximately EUR 6 billion per annum, depending on how it is concretely configured. At constant prices, German GDP totalled EUR 3,386 billion in 2018; an assumed social-benefit ratio of 30 percent would correspond to expenditure of EUR 1,016 billion. In other words, even if the additional social benefits proposed by Germany's Social Democrats become law, and even taking into account that social benefits have been on a slightly above-average trajectory in recent years, Germany's social-benefit ratio would probably still only marginally exceed 30 percent.

Looking at this the other way round, though, a social-benefit ratio in the vicinity of 30 percent already puts Germany in the top half of the European table. The average ratio in the euro area in 2016 was 29.3 percent, the frontrunner here being France (34.3 percent) and the country with the lowest social-benefit ratio being Greece (26.6 percent).

Public-sector spending on social security is, as a rule, the largest item in government budgets. In 2016, social-security expenditure accounted for 42.1 percent of cumulative outgoings in the euro area and for 41.2 percent in the wider European Union (EU). Ratios ranged from 30.7 percent in Hungary to 45.8 percent in Finland - almost every second euro thus flows into social security in the Scandinavian country.

Public-sector social-security expenditure in the EU, 2016



Source: Eurostat (2018): Annual Government Finance Statistics. Sozialpolitik-aktuell.de.

In Denmark and Germany, ratios - at 43.6 percent in each case - were distinctly above average. Were Germany to decide on additional social benefits, it would therefore move further away from the European average.

2.5 The investment logjam dampens potential growth and endangers international competitiveness

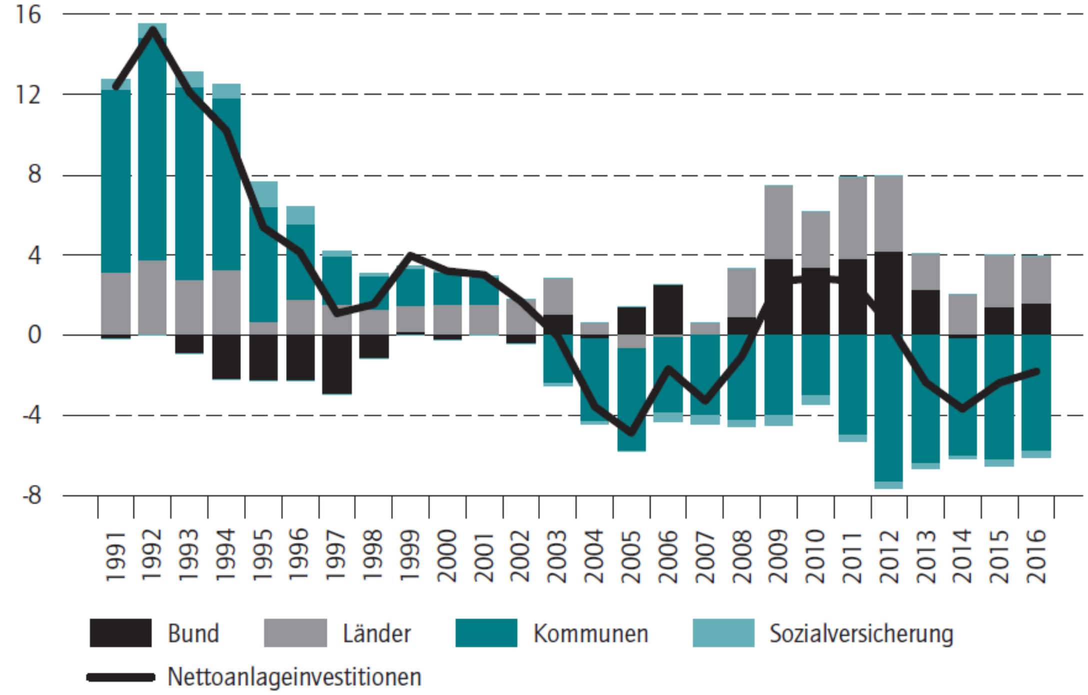
In view of the decline in potential growth which is in the pipeline, Germany urgently needs to unblock its investment logjam and strengthen long-term competitiveness. Provision of venture capital is below-average - as a proportion of aggregate economic output - in the European Union's leading economy. Smaller nations such as Denmark invest significantly higher proportions of GDP on innovation and entrepreneurship. Small and medium-sized enterprises (Germany's "Mittelstand") also needs to get its act together with respect to innovation and digitalisation.

Germany's federal government, along with several federal states, is intent on strengthening public-sector investment.[12] And this would appear to be urgently required. Public-sector net investment has declined to a noticeable extent since German Reunification and has actually turned negative in recent years (cf. Gornig/Michelsen 2017). Above all local authorities have significantly scaled back their investment activity. The degree of modernity has deteriorated further over the past decade, causing a modernisation logjam to build up. Yet Germany is also lagging behind by international standards when it comes to digital infrastructure. At the beginning of 2017, Germany was only in 45th place regarding average fastest internet connection speeds and 25th regarding average internet connection speeds (15.3 mbps) (cf. Akamai 2017).

[12] A conceivable alternative would involve redoubling efforts to mobilise private capital (e.g. through PPPs) for the purpose of infrastructure investment. Quite apart from the question of financing, it is, in principle, to be welcomed that federal and regional governments have recognised the need for infrastructure spending and intend to act accordingly.

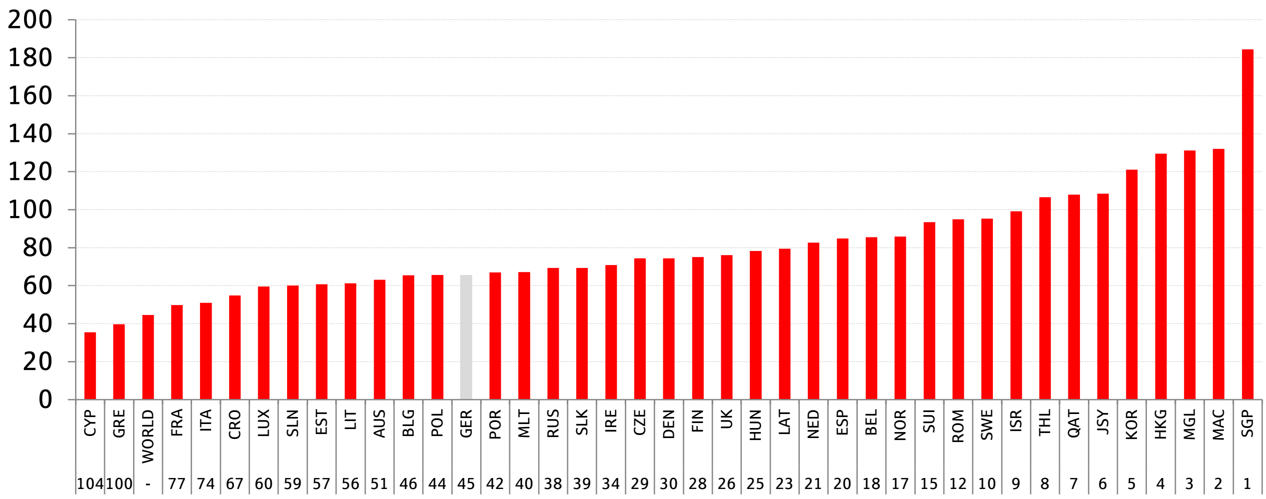
In view of how far the country has fallen behind, it seems doubtful whether the measures resolved in the coalition agreement will be sufficient to close the gap within a reasonable period of time. Carefully targeted investment on infrastructure, especially as a prerequisite for digitalisation, is therefore a matter of urgency.

Public-sector net fixed capital investment by level of government (in billion euros)



Source: Gornig Michelsen (2017), p. 213.

Average fastest internet connection speeds in selected countries, in mbps (data for Q1 2017)



Source: Akamai (2017), Akamai's state of the internet report Q1 2017; OECD (2018).

3. Social-policy reform proposals and initiatives currently being debated

3.1 Initiatives for inclusive growth

In 2017, the federal government took up the idea of more inclusive growth, with the Federal Economics Ministry describing this as one of the principal objectives of economic policy (BMWi 2017). In view of the new conflicts that are emerging between social inclusion and economic expansion (digitalisation, further integration into world trade and global value-added chains), this move looks to be appropriate. What is striking about this concept is the breadth of the political agenda involved (e.g. health and education as well as growth). Such breadth of focus does, however, make the concept susceptible to arbitrariness and conducive to poorly focused policy measures. Above, we have already discussed the - sometimes considerable - discrepancies between empirical conclusions about the trades-off between inequality and growth. It is, in fact, impossible to define an optimum level of socioeconomic inequality, which means that the effects of measures adopted always need to be carefully weighed. The following guideline can therefore be formulated for an economic policy aspiring to strengthen inclusive growth: “Measures which have a positive effect on economic growth but, at the same time, lead to a persistent increase in inequality (…) are as unsustainable as redistributional policy measures which turn out to put a massive drag on growth.” (Fuest et al. 2019, p. 24)

3.2 Unconditional basic income

The unconditional basic income (BCE in German) has vanished from the public debate to some extent in the interim. This social-policy reform proposal finds advocates among both conservatives, liberals and those of a left-wing persuasion. That alone makes it clear that very different models are, in fact, being debated. Finland has had initial sobering experiences with an unconditional basic income. Such a shift to unconditionality would entail a radical transformation of the welfare state. In view of path dependencies, such a model would appear to be difficult to implement, as well as being associated with uncertain consequences for those involved. What is more, it does not seem very helpful if everyone receives the same basic income unconditionally (without any means-testing) via a redistribution machine of Leviathan-like proportions. This would certainly not involve what would be desirable - to redirect the welfare state’s interventions in such a way as to make them better-targeted - and therefore deserves to be treated sceptically.

3.3 Bolstering promotion of private asset formation

In a bid to meet social-policy challenges, proposals to bolster public promotion of private asset formation - either through direct subsidies or else through tax incentives - have recently come from various quarters. Ultimately, this is reckoned to activate self-reliance. But however meaningful measures promoting asset formation may be, they scarcely help to solve problems connected with excessive inequality. The fact is that it is not only the willingness to save which is absent in the lowest quintile of the distribution especially; the sheer *capacity* to accumulate savings is virtually non-existent because the lion’s share of monthly income is eaten up by basic needs. Precisely in the case of population strata especially affected by inequality, greater incentives would hardly increase the propensity to save. Furthermore, there is a great likelihood that returns on conventional savings products are extremely low in the current entrenched low-interest-rate environment, and this constellation is hardly about to change very much in the foreseeable future. Alternative forms of saving via investment in higher-risk asset classes are often thwarted by the low risk-bearing ability, shock-absorption capacity and risk appetite of low-wage earners. Incentives for long-term asset formation via higher-risk assets, specially geared to those on low and medium incomes, could help here, although it would be important to stringently avoid deadweight effects.

3.4 Pension law as recently reformed: Mothers' pension, early retirement at 63, double stop line until 2025

The federal government has resolved to make a number of changes on the pension-insurance front. The "mothers' pension" is a thoroughly defensible social-policy measure but should be financed through taxes instead of through pension-insurance contributions. What applies to the "mothers' pension" also applies to the early-retirement-at-63 plan: these social-policy approaches are too broad-brush because the paramount problem - being at risk of poverty in old age - is not addressed, or at best addressed accidentally. Moreover, early retirement at 63, in particular, looks to be anachronistic in view of the threatening shortage of skilled workers, longer working lives and deteriorating old-age dependency ratios.

In addition, Germany's governing coalition has decided on a so-called "double stop line" in the pension-insurance area: pursuant to this, the pension level is to be kept at 48 percent through to 2025 while the contribution rate for the statutory pension-insurance scheme is not to exceed 20 percent. This decision does not carry conviction either: either it is rendered superfluous by a favourable macroeconomic trend or it necessitates a higher tax subsidy. Since a fundamental long-term stabilising strategy for statutory pensions has yet to be elaborated and agreed on, it is important to be cautious about dishing out additional benefits. The demographic tipping-point will increasingly encroach on pension funds from 2025 onwards. A more comprehensive approach needs to be taken in the pension-policy debate, and a distinctly longer-term perspective needs to be adopted.

3.5 New welfare state concepts in discussion

The debate about social-policy reform is currently being spurred by proposals from Germany's Social Democratic Party (SPD). The new alignment is reflected in this February's reform proposals "A new welfare state for a new age" ("Sozialstaat für eine neue Zeit"). These, in turn, are the basis for the labour-market and social-policy reforms decided on by the SPD's party executive. The thematic fields encompassed are:

- Opportunities and protection in the new world of work;
- Safeguarding children;
- Citizen's income.

These new strategies are supplemented by a basic income styled "respect pension." The authors of the SPD's welfare-state conception argue that the world of work is changing rapidly, with this paradigm shift being accelerated by digitalisation. The process is producing not only winners but also many losers. The SPD therefore believes a fundamental overhaul of safeguards for work to be indispensable: it is not that we will run out of work, the SPD argues, but the nature of work is going to change significantly and ever more rapidly.

The SPD's answer to this challenge is a "right to work" but not an unconditional basic income. To quote the authors directly: "We consider an unconditional basic income to be wrong because it will not meet the needs of the majority." The party argues that a "right to work" implies a large number of concrete entitlements for individuals. In the final analysis, the SPD writes, the welfare state needs to create instruments meeting people's individual requirements and heterogeneous problems, adding that there needs to be greater recognition of people's lifetime achievements.

Opportunities and protection in the new world of work

In the SPD's eyes, the most important task is to enhance the status of work and to strengthen the position of employees. Fair wages and favourable work conditions will, the authors state, remain the key to a self-determined life in future too. It is also necessary, they argue, to reconcile the interests of employees and employers. Finally, they call for the minimum wage to be raised to EUR 12 per hour in future and for a convergence in labour conditions between eastern and western Germany.

The SPD identifies new types of work in the platform economy, arguing that platforms are employers just like any others and ought to be treated like regular firms. The authors also note that hybrid jobs on the borderline between self-employment and dependent employment are coming into being and demand that labour rights, minimum labour conditions, minimum fees and social protection need to be safeguarded in this borderline zone too.

According to the German economic-research institute DIW, 40 percent of employees in Germany could theoretically work from home; the current figure is a mere 12 percent. Against this background, the SPD wishes to enshrine in law the right to mobile and home-office work to enable more employees of both genders to benefit from the advantages of digitalisation. In addition, it is argued, the state should set up a “personal time account” for each citizen so that overtime is not lost and can be carried over if a worker moves to another company.

According to an OECD study, more than 35 percent of professions will undergo radical changes by 2030, the inference being that it is necessary for the entire workforce to undergo further training in order to widen their professional prospects. The SPD therefore demands a legal right to further training and a qualification guarantee. In addition, the party calls for a labour insurance based on the principle of solidarity; this should give greater recognition to a person’s life achievement while promoting targeted further-training measures within the framework of a proposed Unemployment Benefit Q (Q = qualification). The principle here is that those who have paid into the unemployment scheme for longer should have a claim to higher unemployment benefit for longer.

Guaranteed basic income for children

The SPD is calling for the current child allowance, child benefit supplement and education / participation package to be combined to constitute a basic income for children. This would take its bearings by the financial needs of a child but would also, at the same time, take account of the infrastructure services provided by day-care facilities, schools, all-day supervision and support programmes. Like existing benefits, such a basic income for children would continue to be geared to parental income.

General lump-sum instead of “Hartz IV”

The SPD’s plans envisage the existing basic income (AGL II, popularly known as “Hartz IV“) being replaced in future by a citizen’s income. The SPD therefore wishes to alter the existing rules governing basic income support / welfare. Although the “Hartz IV“ concept introduced in 2005 supported the upswing in the labour market observed at the time, the SPD has not been able to capitalise politically from this.

The citizen’s income envisioned by the SPD is meant to contain an entitlement to social protection and social inclusion (right to work). “Right to work“ is to be understood in the sense that citizens of both genders receive tailor-made offers of work or further training/qualification. Recipients of citizen’s income without formal vocational qualifications should also receive a statutory right to financial assistance to enable them to complete a professional qualification. This citizen’s income concept includes a monthly bonus for further training. In addition, nobody who works should need to supplement their income with welfare top-up payments. The low-wage sector is to be shrunk and sanctioning options reduced.

A basic pension by the name of “respect pension”

“Those who have worked for a whole lifetime, have raised children or looked after relatives need to be looked after better in old age than someone who has never worked” is how German Labour Minister Heil justified the creation of a basic pension going by the name of “respect pension.”

Those who have paid into the statutory pension scheme for 35 years or more and are still only entitled to a pension in line with basic income support / welfare (”Hartz IV”) would be eligible for a monthly bonus of up to EUR 447 within the framework of this “respect pension.” Annual costs are estimated to total anything up to EUR 6 billion. These are not to be paid out of the state pension fund but instead, on a tax-financed basis, out of the federal budget. Such a basic income is admittedly provided for in the coalition agreement between the CDU/CSU and the SPD but the SPD-run Labour Ministry has further-reaching plans. To the ministry's mind, there should, for example, be no means-testing, at least not in the first two years - eligible pensioners would receive the "respect pension" without disclosing their financial circumstances. This, however, is rejected by the SPD's coalition partner. A compromise could involve a partial disclosure of eligible persons' financial circumstances, leaving out any residential property.

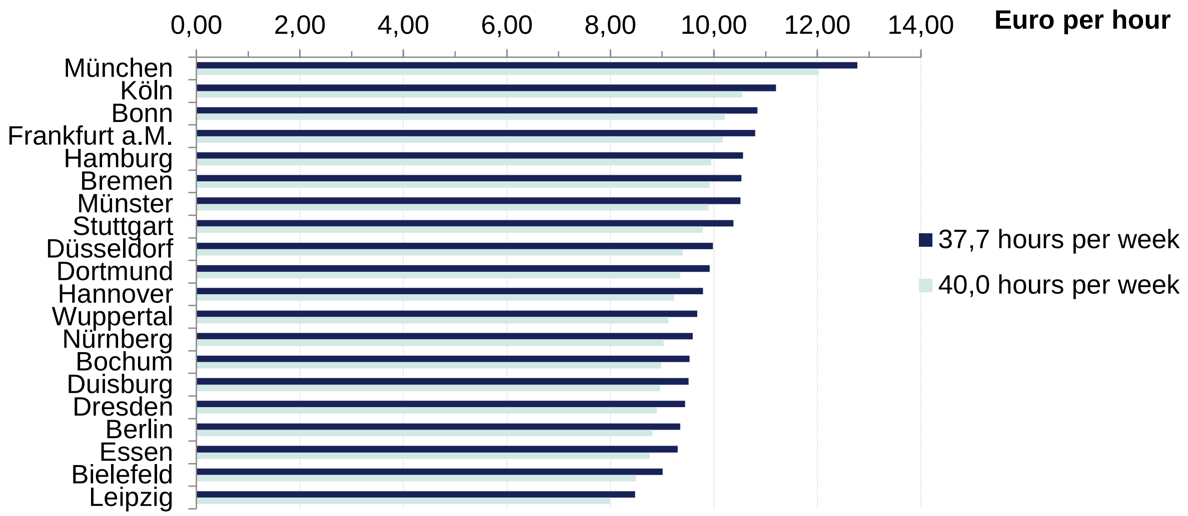
4. Economic discussion of current reform proposals

Numerous reform proposals are structural in nature and could have long-term as well as short-term repercussions on the macroeconomic trend.

4.1 A distinctly higher minimum wage and a new basic income

The SPD has proposed that the statutory minimum wage should be raised in future to EUR 12 per hour. In most major cities, this would be sufficient to allow employees to cover the cost of living without needing, ceteris paribus, to fall back on welfare top-ups from AGL II ("Hartz IV"). Such welfare top-ups would only continue to be necessary in Munich, although the calculation here depends not only on the minimum-wage level but also on the number of hours worked per week. Such comparative calculations are problematic for other reasons as well, not only because of the price effects which would have to be expected - leading to an increase in the cost of living - if the statutory minimum wage were to be raised substantially.

This is how high the minimum wage would need to be (Minimum hourly wage for full-time employees to prevent them needing welfare top-ups.



Source: Herzog-Stein et al. (2018), S. 7.

Overall, the introduction of the minimum wage has noticeably increased the (gross) income of those on low salaries. Nevertheless, the disposable income of such workers has frequently only risen modestly because relatively high transfer withdrawal rates currently apply. What is more, the number of gainfully employed workers supplementing their income with welfare top-ups has hardly fallen because the surge in rents has, in most cases, made up for the increase in the minimum wage.

A higher minimum wage can feed through to higher consumer prices. Given, however, that inflation expectations for the coming years are, on the whole, subdued, it is not to be assumed that raising the minimum wage would result in significant upside risks for inflation. Depending on which transfer withdrawal regime was in force, a higher minimum wage would cause incomes in the lowest income brackets to rise. In view of the fact that the consumption ratio - i.e. the ratio of consumer expenditure to disposable income - is very high precisely in those income brackets, almost all of the wage increase would probably become effective on the demand side, supporting aggregate growth through a rise in private consumer expenditure.

All the same, the minimum wage is not only a social-policy instrument designed to generate income. It can only produce the positive effect described if a significant amount of employment opportunities are not lost as a result, e.g. through a shift to greater automation. Further upward adjustments to the minimum wage are certainly a possibility, but should take place gradually and be carefully monitored to guard against possible negative effects. Wage policy can make a contribution to addressing the underlying problem of too low pension entitlements. In conjunction with longer eligibility periods for unemployment benefit (i.e. for ALG I, which is higher than “Hartz IV”) and reduced sanctioning options within the framework of the citizen’s income proposal, the reservation wage of the unemployed would be likely to increase again. To that extent, whether the incentive effect on labour supply deteriorates significantly as a result will crucially depend on the concrete configuration of, and interplay between, all the measures adopted. A certain loosening of the sanctions currently in operation under “Hartz IV” appears justifiable in view of the considerable improvement on the labour market and of “further training” measures which sometimes appear rather abstruse in the interim.[13] In the case of the proposed basic income as well, there is no economic justification for tying recipients up in a straitjacket of formalistic regulations; on the other hand, it will not be possible to completely dispense with sanctioning options in future either.

What is certain is that children should not be subject to sanctions, although concrete implementation of this principle will be difficult. In the case of a guaranteed basic child allowance, much will depend on how it is structured. Simplifications are to be welcomed, not least to combat “shamefaced poverty.“ However, child allowances are not purely a social-policy measure but should rather serve to ensure a tax-free minimum subsistence level, and should help to ensure a largely homogeneous playing field for all children, independent of their parents’ taxable income and personal marginal tax rate.

4.2 Welfare programmes cost money

Additional social benefits cost money. According to estimates, the “respect pension” alone will cost anything up to EUR 6 billion per year. Yet additional government expenditure runs counter to the federal finance minister’s wish to keep the budget balanced (“black zero”) even when the years of plenty are over.

Germany’s grand coalition has come up with other costly proposals as well. Mention should be made here of the suggestions to phase out the solidarity surcharge completely (EUR 20 billion), to reduce health-care contributions on occupational pensions (EUR 3 billion) and to introduce Unemployment Benefit Q (EUR 1 billion).

If the budget is not (or is no longer) running a structural surplus, additional government expenditure needs to be funded by means of reallocations within the budget (lower spending and / or additional revenues, e.g. from taxes). It would not be sustainable to take on new debt to permanently finance higher social spending, and such a course of action should be rejected.

The measures envisaged in the SPD’s welfare-state concept are one-sidedly skewed towards consumption and will lead to a one-time increase in consumer expenditure at private households. There will be no significant

[13] We refer here, by way of example, to the “qualifying measure“ *Check up* offered by the Hanover job centre which involves unemployed persons colouring in a Father Christmas or a Flower Mannikin picture and building a bridge out of the material received as an exercise in relaxation and concentration. Cf. HAZ, 23rd February 2019, p.19.

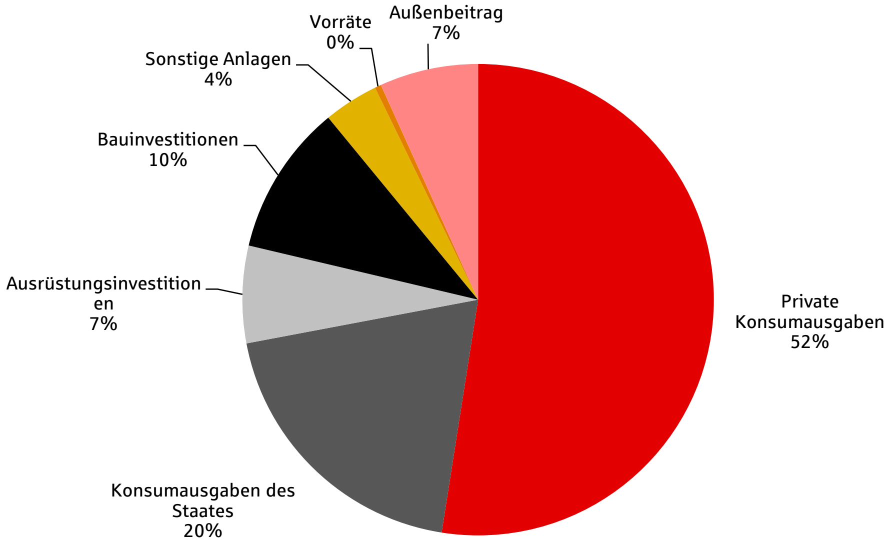
multiplier effects, as would be the case if there were additional investment. Financing additional social expenditure by taking on higher debt should therefore be ruled out. What remains, then, are budget shifts or else the generation of additional revenues. It is true that budget reallocations running into the middle single-digit billions ought to be possible with an overall budget volume in excess of EUR 350 billion, but shifting items like that will probably become more difficult in view of the cyclical downswing. Generating higher government receipts is likely to prove a problem as well, especially since the coalition agreement does not provide for any higher taxes.

4.3 Critical discussion of the basic pension proposal

One argument advanced by those advocating a basic income is that it will strength domestic demand. Cyclically speaking, Germany is currently in a downswing phase - in real terms, the gross domestic product (GDP) only inched up by 1.4 percent in 2018, having registered growth rates of 2.2 percent in each of the two preceding years. It would therefore be opportune if the demand side could be strengthened.

The most important GDP component by a long chalk is private consumption expenditure - more than half of GDP is accounted for by private household spending on consumption. Depending on how they were financed, growth-boosting stimuli could, in principle, be decidedly expedient, especially since they would be translated comparatively quickly into final macroeconomic demand. The only problem is that pension measures with a structural, long-term alignment are not suitable for providing short-term economic stimulus.

German GDP: Private consumption bulks large



Source: Federal Statistical Office (Destatis), own chart.

Private consumption expenditure expanded by 2.6 percent in 2018 (at respective prices) to EUR 1,777 billion. Additional government expenditure in the form of a higher basic pension would probably flow virtually entirely into final demand because the consumption ratio of those on low incomes is very high. A “respect pension“ costing EUR 6 billion per annum would probably add roughly one-third of a percentage point to private consumption. In terms of the growth rate for the gross domestic product as a whole, somewhat less than 0.2 percentage points would be added.

However, the basic income in the form proposed at present would also threaten to unleash some detrimental incentive effects and its efficiency and effectiveness need to be examined critically. The proposal looks to be a relatively ineffective way of tackling the problem of old-age poverty. Only those pensioners who have clocked up 35 years of contributions are to receive a transfer payment rewarding them for their life achievement. It would therefore appear that the “respect pension“ is not aimed at preventing old-age poverty in general, which threatens many through no fault of their own e.g. because of illness, unemployment or as a result of the transformation process in eastern Germany. Many of those affected in this way will not be eligible for a “respect pension,” barred by the 35-year qualifying requirement stipulated. On the other hand, the measure also looks relatively inefficient because dispensing with means-testing creates a situation in which payments are also disbursed to pensioner households with a high wealth level or with high revenues from other sources. It is being overlooked here that high revenues from other sources or a high wealth level can be causally connected with the fact that such individuals only paid low contributions into the statutory pension-insurance scheme during their working lives. At least a certain form of means-testing therefore appears to be necessary for reasons of efficiency.

Other problems, such as the “demographic kink,“ can admittedly be cushioned, but there is a threat of a whole series of constellations emerging which are perceived to be unjust. On the other hand, the “respect pension“ too may have a dire negative incentive effect, for continuing to pay contributions into the pension-insurance scheme after 35 years have been clocked up may simply no longer seem worthwhile if the gap between the acquired pension entitlement and the “respect pension” becomes too great. There would be a threat of such contributors migrating to the underground economy.

However, the biggest structural challenge facing the statutory pension-insurance system is to configure it in a manner conducive to stabilising democracy. To this end, all features of a complex policy mix (pension level, retirement age, contribution liability, contribution level, tax subsidy) need to be discussed. What will be necessary will be to strike an equitable balance between burdens and new flexibilities from the point of view of the labour market and the retirement age.

At the end of the day, then, the “respect pension“ proposal needs to be debated within the framework of an overall strategy. Otherwise, there would be a danger of the sum of the individual measures excessively restricting the state’s room for manoeuvre in terms of stabilising a pension-insurance scheme based on the principle of equivalence. And that would pose a major risk regarding the public acceptability of the statutory pension-insurance system.

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Co-signed by:
Uwe Burkert - LBBW
Uwe Dürkop - Berliner Sparkasse
Dr. Ulrich Kater - DekaBank
Dr. Jürgen Michels - BayernLB
Dr. Gertrud Traud, Helaba
Prof. Dr. Carsten Wesselmann - KSK Köln

Contact

Christian Lips
Chief Economist NORD/LB
Christian.Lips@nordlb.de

Jochen Intelmann
Chief Economist HASPA
Jochen.Intelmann@haspa.de

German Savings Banks Association
Dr. Reinhold Rickes
Head of Department; Director of the Economics, Financial Markets and Economic Policy Division
Tel: +49.30.20225-5303
reinhold.rickes@dsgv.de

Dr. Holger Schulz
Monetary Policy and Macroeconomics
Economics, Financial Markets and Economic Policy Division
Tel: +49.30.20225-5307
holger.schulz@dsgv.de

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