



German election campaign: Close contest dominated by myopic debates

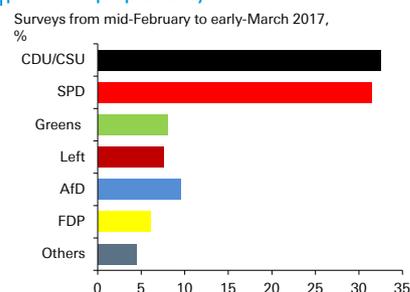
- The campaign for the German federal election on September 24 has speeded up. Since Mr. Schulz' nomination the SPD seems to experience a new heyday. The party was able to nearly completely reduce the then huge backlog in the popularity ratings, i.e. from about 15pps to about 2pps at present.
- In the political debates the major parties primarily build upon their traditional issues, i.e. the CDU/CSU will focus on internal security, a sustainable fiscal policy and tax relief for the middle class and families while the SPD will campaign for enhanced "social justice". Mr. Schulz calls for higher wages, corrections of the Hartz reforms and extended worker rights.
- Thus the parties could fail to address the looming problems of the German economy, namely reform backlogs especially on the labour market and in the education system. At present only the FDP and parts of the CDU/CSU seem to take care about these issues.
- The importance of EU issues will depend on the number of refugees and the result of the French election, e.g. Given the CDU/CSU's and the SPD's pro-European attitude their commitment to the euro area and the EU will remain strong but conditionality will still play an important role. Large-scale stimulus or a decisive call for a substantive institutional build-out (risk-sharing via fiscal union or deposit insurance scheme) remains unlikely as the public seems to be unlikely to accept a more open transfer union.
- While polls still point to a renewed grand coalition lead by Chancellor Merkel as the most likely election outcome, other options including a red-green coalition have become more likely. Thus the prospects for an end of the Germany's reform fatigue and for the implementation of the necessary policies for enhanced flexibility are very limited. Instead the risk of short-sighted policies prepared to rollback past decade's labour market reforms and to switch to an expansionary, unsustainable fiscal policy stance has increased.

German election campaign: Close contest likely dominated by myopic debates

Campaign is speeding up

In recent weeks the campaign for the German federal election on September 24 has speeded up. Unofficial starting points were the SPD's hasty and surprising nomination of Martin Schulz as chancellor candidate on January 25 and the CDU/CSU meeting in Munich on February 5 to 6 where the two sister parties' grandees unemotionally nominated Chancellor Merkel as their common candidate. Since Mr. Schulz' nomination the SPD seems to experience a new heyday. According to major surveys the party was able to nearly completely reduce the then huge backlog in the popularity ratings, i.e. from about 15pps to about 2pps at present. Thus the CDU/CSU's options for coalition building have decreased markedly. If elections were held next Sunday neither the CDU nor the SPD would have a clear alternative to a renewed

Figure 1: Major German political parties' popularity*



* Average of major surveys (Allensbach, Infratest Dimap, Forsa, Forschungsgruppe Wahlen, TNS Emnid). Source: Wahlrecht.de



grand coalition. Even a three party alliance among the CDU/CSU, the Greens and the FDP would fail a majority, according the latest surveys. However, this is only a snapshot. In the remaining six and a half months much can change, e.g. also as a reflection of the election results in the Netherlands and especially in France

Performance of top candidates important

Past weeks changes in the public sentiment have again demonstrated the key role of the parties' top candidates at least with regards to the two big parties. While it is open whether Schulz' popularity rating will remain at its present high level – neck and neck to and in some surveys even above Merkel's rating – it is obvious that the voters have a clear alternative now. Angela Merkel who has been chancellor for more than 11 years represents continuity while Martin Schulz is a new face in German politics albeit as the former President of the European parliament he belonged to the establishment in Brussels.¹ The more personalized the campaign will become the harder it could be for the smaller parties as their candidates are less known and less popular. Both opposition parties have nominated two top candidates for gender and political reason. The Greens' party members have elected Katrin Göring-Eckardt and Cem Özdemir. This was astonishing as both belong to the party's pragmatic wing while the fundamentalist more leftish wing got nothing. However, the fundamentalists have owned the debate on the party's election platform, so far (Fig 2).

For the Left party their parliamentary party leaders Sahra Wagenknecht and Dietmar Bartsch will run. While Wagenknecht belongs to the party's strong left arm Bartsch is said to support the more pragmatic wing. The Left will campaign for a "policy change". So far the Left party did not advocate a coalition with the SPD and the Greens, however, recently Wagenknecht has stated that such an alliance would be possible if it re-establishes the welfare state and peruses a peaceful foreign policy.

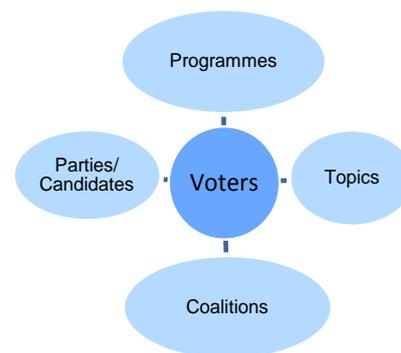
The FDP, too, wants to bring an end to the grand coalition. Party leader Christian Lindner will run twice as top candidate, namely for the important state election in North-Rhine Westphalia on May 14 as well as for the federal election. "We want a strong result in North-Rhine Westphalia and thus at the same time a strong signal for a political change in the whole republic", Lindner stated to rationalize his double role (source: WDR).²

The AfD will decide on the top personnel and its campaign platform only in late April. According to press reports the party will present a team of campaigners instead of a single person or a duo. However, it is open whether such a team will be able to hide the party's ongoing leadership conflicts.

Security and social justice likely to dominate the campaign

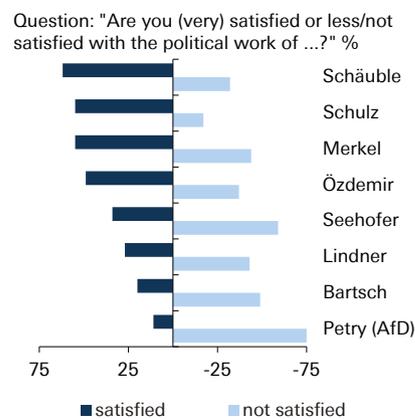
While especially the big parties' candidates have already attracted ongoing public interest the political debate has only gradually picked up pace, so far. This also reflects the absence of a mega topic at present. According to surveys the German public still considers refugees and integration by far as the most

Figure 2: The election puzzle



Source: Deutsche Bank

Figure 3: Germans' assessment of major politicians



Source: Infratest dimap ARD Deutschland-Trend, Feb. 2017

¹ See Focus Germany, dated January 30, 2017: The view from Berlin. Martin Schulz' unexpected nomination likely to push the SPD's campaign but unlikely to derail Merkel.

² <http://www1.wdr.de/nachrichten/landespolitik/fdp-landesparteitag-neuss-100.html>



pressing topic (in January mentioned by 50% of those asked) followed by the issues of social justice (10%) and pensions (9%). But compared to the situation one year ago the immigration issue has lost brisance given the strong decline in the refugee influx from about 900.000 in 2015 to 280.000 in 2016 with a further drop likely in 2017. Therefore, the political actors have the opportunity to set their own agenda.

Here the parties' election programmes have a role to play. At present, however, the major parties have only presented buzzwords and guidelines for their campaigns while details are still debated. (See table on the margin for the dates of the major parties election programme launches.) This is especially true for the major parties' proposals on tax policy. This vagueness is astonishing given the tax policy's marked impact in the context of the social justice issue as well as its potential impact on the economy. Of course, exactly this could be the reason behind the parties' hesitation.

Notwithstanding missing details it is already obvious that the major parties primarily build upon their traditional issues, i.e. the CDU/CSU will primarily focus on internal security, a sustainable fiscal policy and tax relief for the middle class and families while the SPD will campaign for enhanced "social justice". Thus the two big parties, the CDU/CSU and the SPD, will try to serve their traditional constituencies to fully exploit their potential at the ballot. With this approach the two parties aim at attracting those voters who have migrated to the smaller parties or refused to vote at all in the past (state) elections. In addition, especially the AfD will try to keep European topics high on the agenda. The prominence of this issue, however, will primarily depend on the course of the Brexit negotiations in Brussels, on the result of the French election and on the number of refugee entering Germany, i.e. on the stability and of the EU-Turkey agreement.

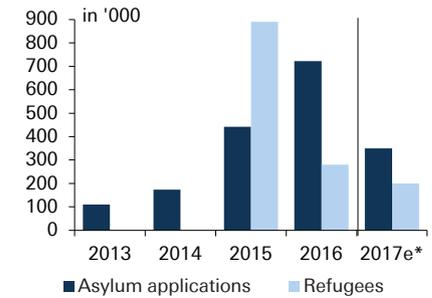
Reform fatigue insufficiently addressed

The more the campaign will focus on the traditional issues the higher the risk that the parties will fail to debate the looming problems of the German economy. This risk is all the more virulent as the impressive stability of the German economy and especially the upswing in employment in the past few years have masked reform backlogs. To improve the employment prospects of the several hundred thousand migrants who will enter the labour market in the next few years, to prevent job losses and to strengthen productivity in the era of intensified digitalization Germany should enhance the flexibility of its labour market, increase (public) investment in the education system and take further measures securing the competitiveness of Germany as a location for production and invention. However, at present only the FDP and parts of the CDU/CSU seem to insistently address these important issues.

Parties' agendas cannot be taken at face value

Notwithstanding the mentioned constraints it seems reasonable to take a closer look at the parties' agendas and priorities.³ These will not only influence the election campaign but also the policies of the next government. However, with regards to the latter aspect the election programmes should not be taken at face value, instead their impact is limited compared to countries with a majority voting system. In the German system usually even the big parties are not able to reach a majority in the Bundestag so that they need a partner to form a coalition. As coalitions result from political compromises among the parties involved their election platforms are hardly a blueprint for their government programme. One the one hand this calls into question the value of

Figure 4: Asylum applications & refugees



*our estimate Source: BAMF, BMI

Figure 5: Dates for launches of the major parties' election platforms*

Party	Event	Date
CDU/CSU	Strategy meeting	June
SPD	Party convention	end-May
Left party	Party convention	June 9 - 11
Greens	Party convention	June 16 to 18
FDP	Party convention	April 28 to 30
AfD	Party convention	April 22 to 23

* The parties have already established processes to debate their programmes. Party members are invited to participate actively in the debate. Source: Parties' homepages, media

³ Here we only deal with parties likely to pass the 5%-threshold and to get seats in the Bundestag.



exegeses of the parties' campaign platforms. On the other hand it rationalizes the following exercises, namely to compare the forthcoming programmes without knowing all their details.

CDU/CSU

Security, an agenda for jobs and tax relief for the middle class are major topics

Up to now the refugee crises, asylum policy and internal security have dominated the debates among the conservatives. Statements at the joint meeting of the CDU and CSU executive committees in Munich on February 5 to 6 indicate that this will remain conservatives' key issue in the election campaign. Both sister parties argue for a lasting reduction in the number of refugees albeit the CDU has not adopted the CSU's request for an upper limit of 200,000 refugees per year. To reach its common goal the CDU/CSU advocates an enhanced protection of the EU's external borders and measures to fight the causes of emigration in the countries of origin. In contrast to the upper limit the CDU has agreed to the CSU's demand for transit camps at the German borders for proper control and registration of refugees.

Another major pillar of the two sister parties' campaign will be an Agenda 2025 with measures to secure existing jobs, to create new jobs and to strengthen the German economy in the era of digitalisation. As Chancellor Merkel und CSU leader Seehofer have announced this agenda only a few days ago without giving further details it is still a black box at present. In the Munich declaration the two politicians have already advocated a stepwise increase in public spending on education, on R&D and other infrastructure investment, especially to meet the challenge of digitalization, but without giving concrete numbers.

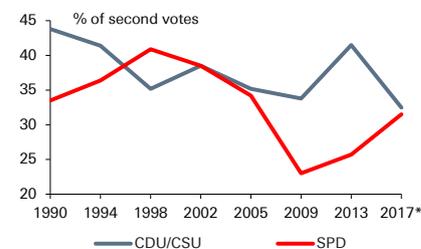
These and other spending proposals, however, will likely be subject to the availability of funding as maintaining a balanced federal budget in the next years, too, is a top fiscal policy priority of the conservatives. In case a balanced federal budget is granted, the federal government shall be allowed to spend funds from additional tax receipts. According to broadly accepted but not yet decided proposals these funds shall be used for three purposes (i) tax relief for people in lower and middle income brackets and transfers to families, (ii) infrastructure as just mentioned and (iii) unscheduled spending obligations and debt reduction. Furthermore, the CSU similar to Finance Minister Schäuble and other influential CDU politicians calls for an (a stepwise) abolishment of the income and corporation tax surcharge (5.5% on the respective tax dues).

In addition a senior official from the CDU parliamentary group presented the prospect of a corporate tax reform, but he added that plans will be elaborated only after the election. Such a reform would primarily aim at enhancing the businesses' competitiveness. It also would be a precondition for the realisation of Finance Minister Schäuble's and the SPD's proposal to abolish the withholding tax on capital gains and to (re-)integrate the taxation of individual capital income into the income tax scheme. Without a suitable corporate tax reform the proposal would result in a high double taxation of dividends, e.g.

Commitment to the Euro will remain high

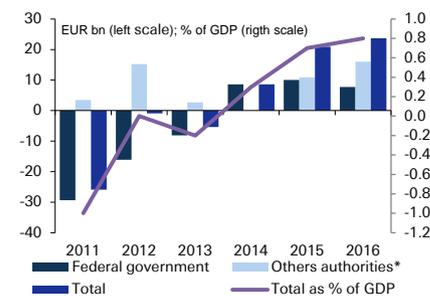
To benefit from Chancellor Merkel's experience and international reputation the CDU/CSU is also likely to address European politics and Germany's role in geopolitics. Merkel and her CDU/CSU have shaped European politics – though with varying coalition partners – over the last decade. There will be no significant change to the observed policy even though the position of the two sister parties on future European politics has not yet been spelled out in detail. Commitment to the EU and the euro will remain high. However, the preparedness for further risk sharing is low as indicated by the reluctance to

Figure 6: Big parties' performance in the past 6 elections since German unification



* Average of the latest surveys. Source: Wahrecht.de

Figure 7: Total state and federal government budget balances in Germany



* State (Länder) governments, municipalities and public social insurance schemes Source: Federal Statistical Office



move on with banking union (deposit insurance) and discussions around certain elements of a fiscal union. Fiscal support for ailing euro area member states will only come with conditionality, the increasing uneasiness of the conservative MPs in voting for Greek bail-outs proves this conviction. Chancellor Merkel has started to talk about a two-speed EU more recently as an answer to the diverging preparedness of the EU-27 to move on with integration. Apart from the fact, that this concept is already reality in certain areas of European integration, she did not elaborate on the topic.

All in all the CDU/CSU will likely continue to highlight the need for continuity, stability, order and trust in difficult times of permanent global change as they already did in the Munich declaration.⁴ It is surely not by chance that these days Chancellor Merkel often uses the buzzword “disruptive changes”.

SPD

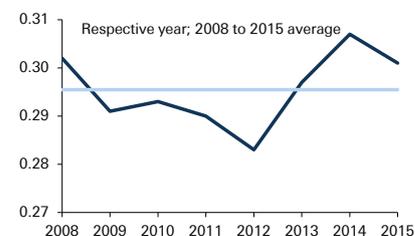
Mr. Schulz' campaign focuses on social justice

Given the impressive recovery in the latest polls, Mr. Schulz and the SPD seem to have hit the mark with their focus on “social justice”, albeit this is not the general public's major concern. The data, too, hardly indicate growing inequality in Germany, at least not in the past few years. In 2015 the Gini coefficient for the net income distribution was about the same as in 2008 (0.301 vs. 0.302). However, in the interim period the coefficient hovered between 0.283 in 2012 and 0.307 in 2014.⁵ Obviously, much depends on the basis year, and of course, critics from the left side tend to refer to the extremes. In international comparison these figures are relatively low, anyway. They contrast the relatively high Gini coefficient for the market income distribution in Germany (OECD 2013: 0.508). The increase in gross income inequality, however, is an almost global phenomenon visible even in the Scandinavian countries. In Germany, the huge difference between the Gini coefficients for disposable income and for market income distribution demonstrates the already intensive income redistribution in this country.

Plea for higher wages, corrections of the Hartz reforms and extended worker rights

Nevertheless Schulz addresses the issue with respect to many areas, especially to the labour market and tax policy. Concerning the first issue the SPD advocates higher wages and “good jobs”. „We have a considerable backlog with regard to wage income”, Mr. Schulz told the media. This was astonishing, as German politicians usually refrain from commenting on the wage setting as the latter is exclusively the bargaining partners' job. (In the past three years wages have increased solidly at 2% p.a. real and 2.6% p.a., albeit the momentum has declined somewhat in 2016 due to the immigration among others.⁶) The catch word „good jobs” summarises demands for extended labour protection like the right to switch back from part-time to full-time work at the same workplace, the right for further training and the call for re-regulation of the dismissal law, i.e. substantial restrictions on companies' option to offer part-time contracts.

Figure 8: Gini coefficient* for the distribution of the net equivalence income in Germany



* The coefficient varies between 0 for a complete equality and 1 for maximal inequality: One person alone gets all income (Here net income adjusted for family size) Source: Federal Statistical Office

Figure 9: Distribution of households' disposable income in selected OECD countries



* The coefficient varies between 0 for complete equality of the distribution and 1 for maximum inequality Source: OECD

⁴ See the CDU/CSU's common Munich declaration, dated February 6, 2017

⁵ Respective OECD figures for the households' disposable income: 2008: 0.285 and 2013: 0.292.

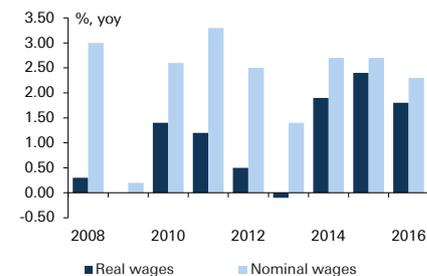
⁶ See Focus Germany, dated October 28, 2016: Subdued industry outlook dampens wage growth



In addition Schulz argues for a prolongation of the benefit periods in the statutory unemployment insurance scheme, especially for elder workers. Thus the SPD applies the axe on one of the major and most efficient elements of its former Chancellor Schröder’s Hartz IV reforms. Schröder substantially reduced the maximum benefit period for beneficiary aged 45 or more – e.g. for the 58+ from 32 months to 18 months (at present up to 2 years again) and for those below 55 to 12 months (at present up to 15 months for those aged 50 to 55). Studies show that due to this measure the unemployed’s willingness to accept a job, especially a job in the low-wage sector, has significantly increased.⁷ There is broad agreement that this has contributed to the substantial decline in the unemployment rate in recent years.

Recently Schulz has modified his proposal by specifying that only unemployed persons participating in a qualification programme shall be eligible for an extended benefit period. The statutory unemployment insurance shall pay the new benefit, called benefit Q (for qualification), for up to one year to those aged below 50 and up to two years for the 58+.⁸ This new proposal is likely to propel the cost but hardly to diminish the negative impact. According to experts the new proposals which also include a dilution of the eligibility requirements for the unemployment benefit could cost up to EUR 1 bn per year. To animate benefit Q the state will likely have to offer qualification programmes. The track record of such public programmes, however, is unsatisfactory. They often primarily resulted in revolving door effects, instead of higher employment. Training on the job proved to be a better alternative. The Hartz IV reforms rightly aimed at bringing the unemployed back into employment as early as possible. Furthermore, for elderly employees benefit Q will also open a new misguided way to early retirement.

Figure 10: Wage development in Germany



Source: Federal Statistical Office

Higher taxes for higher incomes and fight against tax evasion

While the SPD like the CDU/CSU is still vague with respect to important details, the guidelines of its tax proposals have already emerged from such discussions and party grandees’ statements. On the one hand the SPD will reduce the tax burden for low- and middle-income earners. This sounds similar to the CDU’s plan. But one should notice that the SPD will likely use narrower definitions of these groups so that a smaller group of the society would get relief. Given the already relatively low tax burden for low-income earners, ex party leader Gabriel advocated reductions in the contributions rates to the social security schemes for this group. Astonishingly, Schulz has not repeated this demand, so far. In addition the family taxation/subsidisation system shall be altered in favour of families with low income, especially single parents.

Figure 11: Benefit periods in the statutory unemployment scheme

Eligibility restriction, i.e. minimum scheme membership period required	Age	Maximum benefit period
	Months	Years
12	below 50	6
16	below 50	8
20	below 50	10
24	below 50	12
30	50 to 55	15
36	55 to 58	18
	58+	24

Source: BMAS

On the other hand the tax burden on higher incomes shall be increased moderately. This is likely to entail (moderate) increases in the income tax top rates (at present 42% for income above EUR 54,058 and 45% for income above EUR 256,304). Furthermore, the taxation of capital gains shall be changed fundamentally, i.e. the withholding tax with its 25% flat rate shall be abolished (see Schäuble’s proposals above). Albeit – in contrast to the 2013 campaign – the SPD does not argue for the (re-)introduction of a wealth tax it advocates the taxation of very huge private assets. According to Schulz fighting company tax evasion will be another major topic. In line with plans from the European Commission and the OECD he advocates an obligatory country by country reporting for multi-national companies so that they shall pay the taxes where they generate their profits. Although Schulz seems to

⁷ Lo, Simon et al. (2013). Stellschraube Arbeitslosengeld. Kürzere Bezugsdauer zeigt Wirkung. IAB Forum 2/2013.

⁸ While today it is up to the labour agencies to send unemployed persons to training programmes in future the unemployed shall have the right to participate in such programmes.



make this a cornerstone of his election-platform, he simply jumps the EU's bandwagon.

Schulz advocates solidarity in the EU

Fairness and solidarity is also the slogan for Schulz' previous métier European politics. While Schulz and his party have taken almost all decisions in the course of the euro crisis in line with its conservative coalition partner, they recently have become more critical regarding the CDU/CSU's strong focus on consolidation in the euro crisis taking a swipe at the lack of investment and growth orientation that has – in their view – fuelled divergence and social problems. Tolerance with the Greek situation seems to be higher than within the CDU/CSU. Following the Brexit referendum, Gabriel and Schulz published a paper calling for a re-foundation of Europe.⁹The ten-point plan calls for more growth orientation of the EU (including giving more flexibility to the stability pact and the EU's fiscal rules), an institutionalised mechanism for debt restructuring and an upgrade of the EFSI both in terms of design as well as volume for investment spending. While this certainly cannot be taken as the overall position of the SPD, it gives some hints to where the two influential SPD leaders would like to set the priorities.

The Greens

Balancing leftist ideas and centrist candidates

In mid-November 2016 the Greens party convention has agreed on guidelines for the party's politics. These guidelines are amongst the pool of ideas for the Greens' election platform. On June 16 another convention shall approve the final version. Beforehand party members will be asked to comment and contribute. Last November the party delegates have agreed the rather leftist proposals which we summarise here. However, the party members who have already surprisingly elected two moderate centrist candidates as the frontrunners in the elections might water down some of these ideas. If not the candidates will have to cope with a programme at odds to their own ideas.

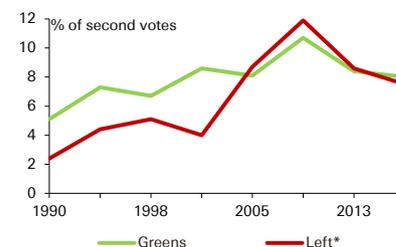
Notwithstanding future corrections the Greens are likely to campaign for an open and fair society. The first attribute refers to their refusal of a more restrictive asylum policy and marked increases in the funds for internal security (and also in defence spending). "Fair society" euphemises the strong call for intensified redistribution in the party's present leftist agenda.

Major elements thereof are (i) the (re-)introduction of a wealth tax, especially on "very rich" people's assets, (ii) an increase in the income tax top rates and (iii), the abolishment of the withholding tax on capital gains in line with the SPD's proposal. In addition, the Greens advocate a fundamental reform of the taxation of (married) couples and families. The present the equalization of spouses' income in the income tax that usually markedly reduces the respective couples' taxable income shall be abolished. For the time being, however, only newly married couples shall be subject to the new rule. Instead transfers for families/children with low and medium income shall be increased.

More restrictive labour market regulation

Under the label of fairness the Greens also favour stiffer labour market regulation, e.g. equal pay for contract and regular staff from the first day of hiring, additional restrictions on the companies' options to hire staff temporarily and the abolishment of the mini-jobs. The demand for the Introduction of a basic pension (with benefits above welfare level) for the

Figure 12: Performance of the Greens & the Left party in the past 6 Bundestag elections



* Until 2002 PDS; ** Average of the latest surveys
Source: Wahlrecht.de

⁹ "Europa neu gründen", <http://www.spiegel.de/media/media-39397.pdf>



public pension scheme's long-term members can be interpreted as a first step towards the Greens pet project for the future, the introduction of a basic income scheme.

Strong commitment to the EU

The Greens consider the EU the best entity to cope with the major economic, social and political questions of today and actively promote more competences for the EP and a stronger role of the EU in many policy areas.¹⁰ They support the euro and back the fiscal rules with at the same time calling for the implementation of a debt redemption fund to smoothen the negative repercussions of the austerity policy. Also, in the context of a review of the budgetary framework of the EU they support the idea of a fiscal capacity for the euro area. Banking union as well as a capital markets union is seen as necessary.

The Left

Tax hikes and public spending spree

Unsurprisingly, the Left tops the SPD's and the Green's demands for intensified redistribution and more restrictive labour market regulation. In contrast to the latter the Left has already published a detailed draft election programme. It advocates substantial tax hikes, an enormous expansion of public spending especially on pensions and welfare and a hike of the minimum wage, among others. Neither of these proposals have serious consideration for the need of the German business that has to perform on global markets with intensive competition.

Proposals for taxes hikes include (i) introduction of a wealth tax (5% for assets higher than EUR 1m), (ii) substantial increase in the inheritance tax and (iii) in the corporation tax (10pps increase in the tax rate to 25%). Furthermore, the income tax scale shall be altered fundamentally to shift the tax burden further on to people with higher income.¹¹

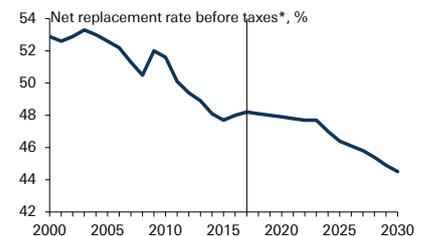
The funds from the tax hikes shall be used to finance intensified public spending on education, infrastructure and housing (e.g. 250,000 public dwellings p.a.). The Hart IV welfare system shall be replaced by a kind of basic income scheme with benefits (for singles) of EUR 1050 per month. The benefits from the public pension scheme shall be increased markedly (replacement rate of 53% instead of 48% at present, retirement at the age of 65 – or at 60 after a working career of 40 years).

The Left is also in favour of massive state interventions, especially in the labour and the housing market. Among others: increase in the minimum wage from EUR 8.85 to EUR 12, introduction of a strict principle of equal pay, strong restrictions on contract work and on temporary work contracts, strong limits on rent increases.

Overhaul of the EU

The Left acknowledged the EU in principle (no call for euro/ EU exit) but wants to see a complete overhaul of the Union. A broad investment and spending

Figure 13: Replacement rate of pensions from the statutory public pension scheme



* Pension of a person with average work & salary income who has paid contributions to the scheme for 45 years
Source: BMAS

¹⁰ Green Declaration on the Future of Europe, https://www.gruene-bundestag.de/uploads/tx_ttproducts/datasheet/reader_Europaerklärung-web.pdf

¹¹ The draft programme provides for an increase in the basic allowance to EUR 12,600 p.a. from EUR 8,820 in 2017, an increase in the top tax rate by 11pps to 53% for income above EUR 70,000 p.a. (at present EUR 54,058) and in the special rate for very high income to 60% and 75% for income above EUR 260,000 and EUR 1m p.a., respectively, from 45% for income above EUR 256,304 p.a. in 2017.



programme should address social inequality and shortcomings in education and social security. Sahra Wagenknecht, one of the party's top candidates, is rather critical in her statements on the development of the euro area. She proclaims that the euro has divided Europe and that the austerity policy forced by Germany has aggravated this development.

FDP

Enhancing the economy's flexibility

As far as is known today the FDP's ideas are likely to follow party leader Lindner's dictum, that income has to be generated first before it can be redistributed, i.e. that the government should be more concerned about the production side of the economy and less about redistribution. In line with this guideline the FDP is likely to campaign for a business-friendly tax policy, for more efficient public authorities and enhanced flexibility of markets, especially the labour market.

The FDP's focus in tax policy is on the reduction of the complexity of the different taxes as well as on the reduction of the citizens' and the businesses' tax burden. The liberals, e.g., want to amend the income tax scheme by a flexible tax schedule to prevent the taxation of income which (in Germany's progressive tax scale) solely results from an increase in inflation. The income and corporation tax surcharge (5.5%) shall be abolished by 2019. A comprehensive corporate tax reform shall provide for a level playing field among different legal forms as well as among different methods of financing, e.g. equity vs. bonds. The rules for profit assessment shall be simplified.

Red tape shall be reduced across-the-board, especially to make it easier to start a business. The party also calls for initiatives, e.g. in the education system, to make Germany fit for the age of digitalization.

The EU should stick to its rules

Party leader Christian Lindner favours a debt restructuring for Greece followed by a euro area exit of the country. It should be kept in the EU, though, and enjoy the (fiscal) solidarity of the Union in terms of transfers from the structural and regional funds. More general, any rescue package for a euro area member should be linked to strict conditionality. To avoid a slide into over-indebtedness, the FDP calls for an insolvency regime for states. In the context of banking union the FDP rejects the Commission's proposal for a deposit insurance scheme as this would lead to an acceptable risk sharing.

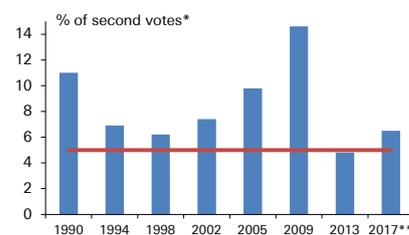
AfD

Largely populist agenda

The AfD has a similar agenda as other conservative and right wing populist parties in Europe. It is characterised by strong reservations about immigration, especially of refugees and against the EU and especially the euro. The AfD, e.g., advocates a restrictive asylum policy and more deportations and refuses double citizenship. To prevent inflows of refugees and migrants the party calls for the restoration of controls at German borders as well as the complete closure of the EU external borders.

The AfD rejects the building of a European federal state, advocates the shift of competences from the EU level back to the individual member states and demands the "orderly" dissolution of the euro area. Should this not be possible in the normal process of the parliamentary decision process they call for a referendum on Germany's exit of the monetary union (the German constitution

Figure 14: The FDP's performance in the past 6 Bundestag elections



* Red line = 5% threshold which a party has to pass to get seats in the Bundestag; ** Average of the latest surveys Source: Wahlrecht.de



does not foresee referenda, however). Until then, the target2 balances should be squared by year-end. Banking union is seen very critical and any deposit insurance scheme is rejected.

Another main topic is fiscal and tax policy including calls for public debt reduction to enhance the sustainability of public finances, for an income tax reform to reduce the tax burden for families and low- and medium-wage earners and to simplify the tax scale. In contrast to the fundamental fiscal policy aim the party also argues for increased transfers to families/children, e.g. higher pensions for mothers/fathers.

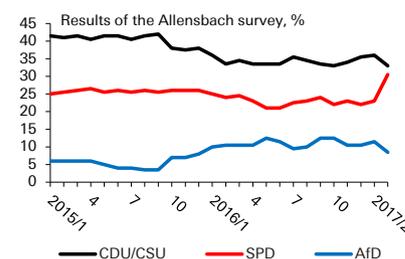
On paper a r2g alliance with obvious overlaps ...

While each party has its own priorities none will be able to run the country without at least one coalition partner. Therefore a short comparison of the main ideas with respect to feasible future government coalitions might be useful. Such an exercise shows obvious overlaps between the SPD's, the Greens' and the Left party's ideas. This holds especially for four areas:

- Fiscal policy: The three parties want to get rid of Finance Minister Schäuble's credo for a balanced budget in favour of an expansive fiscal policy stance. Given Germany's debt brake, the leeway for deficit spending would be rather limited, however. Nevertheless the three parties argue for an increase in public spending on infrastructure, education, social housing and on transfers for families with low income, especially single parents.
- Intensified redistribution. While the income tax burden for people with low and medium income should be reduced they want to increase it for those with higher and especially with very high income. Capital gains shall be subject to the income tax, i.e. the withholding tax shall be abolished. Multi-national companies shall pay taxes in those countries where their profits are made. The Left party as well as the left wingers among the Greens and the SPD also favour the introduction of a wealth tax.
- Rollback of former Chancellor Schröder's Hartz IV reform. In contrast to Schröder's carrot and stick approach, the SPD, the Greens and the Left tend to damage the approach by abolishing the second part, i.e. the sanctions and social benefit reductions which were meant to enhance the unemployed persons' incentives to take a job. In addition, worker protection shall be intensified and stronger equal pay rules established.
- Introduction of a uniform (semi-public) health care insurance scheme by merging the (funded) private insurance providers with the (semi-public) providers in the statutory scheme (details open).

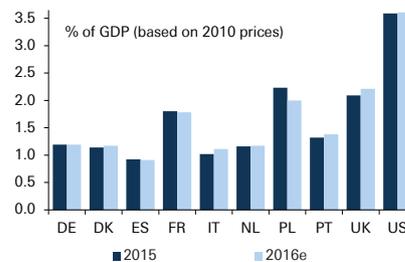
In contrast to the fit of major ideas in fiscal, labour market and social policy the three parties are divided on internal security issues and on international and European politics. Especially, the dividing lines between the SPD and the Greens on the one hand and the Left on the other hand with regards to the latter two issues could become a stumbling block for the formation of a red-red green (r2g) coalition. Controversial subjects are the foreign relations with Russia given the Left's refusal of the sanctions against Russia as well as with Turkey as the Left also opposes the EU-Turkey agreement. The Greens' and the Left's reservations against higher defence spending could make it difficult for such an alliance to agree on a common basis for the relations with Germany's NATO partners.

Figure 15: AfD's vs bigger parties' popularity



Source: IfD Allensbach

Figure 16: Defence spending in selected NATO states



Source: NATO



... but a grand coalition still the most likely outcome

Although Mr. Schulz' and his party still fly high in the polls a renewed grand coalition is still our best guess as the SPD's upswing has come at the cost of the Greens' and the Left's popularity ratings, too. Thus, the much debated r2g alliance would lack the majority of Bundestag seats from the present point of view.

A renewed CDU/CSU-SPD coalition would mean continuity in major areas, especially in European, in defence and in international politics where these parties' ideas still match up. In addition, calls for increased public spending on infrastructure and education and on pensions (for low-wage earners with a longer working career) can be heard from all three parties.

Conflicts, however, would become more likely in fiscal and labour market policy. The SPD obviously would demand a more expansionary fiscal policy stance. As the balanced budget is part of the CDU/CSU's brand essence the conservatives are unlikely to give in here or only if the SPD became a very heavy weight due to a similar number of seats in the new Bundestag as the conservatives.

Reform standstill could erode Germany's competitiveness

If the present programmes were the basis of a new grand coalition's government programme the business would have no prospect for tax relief in contrast to families and people with small and medium income. The abolishment of the withholding tax on capital gains and/or a slight increase in the income tax top rates as well as a stricter taxation of multi-national companies would become likely.

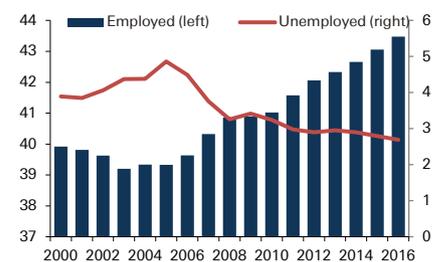
With regards to labour market policy a standstill was the most likely outcome as the CDU/CSU's business wing strongly opposes the SPD's proposals so that they would block each other. Furthermore parts of the CDU as well as the SPD seem to follow a paternalistic idea of the state and thus to be satisfied with the status quo. But a standstill in times of intensified technological change would mean a setback, in effect.

While all this was hardly good news for Germany as a location for invention and production it is encouraging that recently Chancellor Merkel has praised her predecessor Schröder's Agenda 2010 reforms. She rightly emphasised that the creation of 2.5 million new jobs and the reduction of the unemployment by a half since 2005 was unthinkable without these reforms.

A Jamaica coalition would need much give-and-take

In Late November 2016 Chancellor Merkel answered to the then growing speculations about a future coalition with the Greens, that the Greens were not a favourite coalition partner. And the Chancellor pointed to "a number of difference" that could be recognised easily.¹² In the meantime such speculations have lost substance. According to the polls such a coalition is no longer feasible. If the CDU/CSU becomes the strongest party in the September election again its sole alternative to a renewed grand coalition will likely be a three party alliance including the Greens as well as the FDP.

Figure 17: German labour market: impressive upswing since 2005



Source: Federal Statistical Office

¹² <http://www.spiegel.de/politik/deutschland/angela-merkel-die-gruenen-sind-kein-bevorzugter-partner-a-1123864.html>



To work properly such an alliance would need the strong willingness to consent from all sides. From the present point of view the CSU's and the Greens' asylum policy approaches, e.g., are as different as fire and water. Also the Greens' leftish tax policy proposals – i.e. the introduction of a wealth tax, fundamental reform of spouses/family taxation – and their proposals for stricter equal pay regulations would not fit to the conservatives' and even less the liberals' ideas.

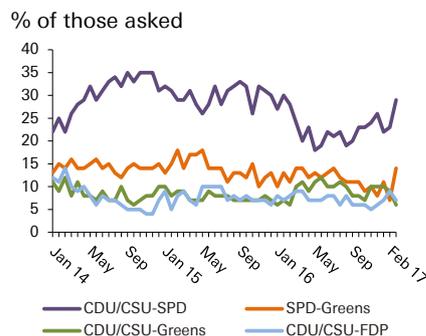
While it would be difficult to reconcile the different ideas on taxation an agreement on the general fiscal policy stance should be possible immediately as the parties have high preferences for a sustainable fiscal policy. Public spending would likely be more focussed on infrastructure and education and less on social benefits. Tax payers and contributors to the statutory pension scheme would benefit from the Greens' and the FDP's opposition against new pension benefit increases.

Under a black-green-yellow (Jamaica) coalition the commitment to the euro area (and the EU more generally) would remain strong but conditionality will still play an important role. Large-scale stimulus or a decisive call for a substantive institutional build-out (risk-sharing via fiscal union or deposit insurance scheme) remains unlikely given the overall reluctant sentiment in the public to accept a more open transfer union as well as the apparent performance of the AfD.

Conclusions

Political fragmentation is on the rise in Germany, too. (Taken the sisters CDU/CSU as two parties) Seven parties are expected to be represented in the Bundestag (much less though than e.g. in the Netherlands or Italy) and coalition building will be required to secure a parliamentary majority. As a result of the SPD's upswing following Mr. Schulz nomination as chancellor candidate it has become hard to tell which of the two big parties will lead a new government. While we still think that a renewed grand coalition is the most likely election outcome (and the Germans' favourite result), other options including a red-red green coalition have become much more likely recently. The play of (political) colours and the composition of the new governing coalition will in the end define the policy measures to be implemented. However, the prospects for an end of the Germany's reform fatigue and for the implementation of the necessary policies for enhanced flexibility are very limited. Instead the risk of short-sighted policies prepared to rollback past decade's labour market reforms and to switch to an expansionary, unsustainable fiscal policy stance has increased. While such a scenario might in the short run ease tensions with the EU and the EMU, Germany might possibly stop being the beacon of stability within Europe.

Figure 18: The Germans' favourite government coalitions



Source: Forschungsgruppe Wahlen; ZDF Politbarometer



Appendix 1

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David Folkerts-Landau

Group Chief Economist and Global Head of Research

Raj Hindocha
Global Chief Operating Officer
Research

Michael Spencer
Head of APAC Research
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Dave Clark
Head of APAC
Equity Research

Pam Finelli
Global Head of
Equity Derivatives Research

Andreas Neubauer
Head of Research - Germany

Stuart Kirk
Head of Thematic Research

International Locations

Deutsche Bank AG

Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG

Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG

Filiale Hongkong
International Commerce Centre,
1 Austin Road West, Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.

2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London

1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.

60 Wall Street
New York, NY 10005
United States of America
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