

Germany is taking over the initiative in reforming the eurozone

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European Union leaders met at a summit on 4–5 February in Brussels. Energy issues were to be at the top of the agenda. However, Germany and France caused the reform of the eurozone to become the main topic of the discussion. The two countries presented their joint proposal of comprehensive reforms under the title 'Competitiveness Pact'.

The reforms are to deepen the economic coordination of the eurozone member states, especially in such areas as fiscal and social policies and the labour market. The solutions proposed are mainly based on the reforms which have already been implemented in Germany, which in fact means adjustment of the other of the eurozone's economies to the German model. Contrary to its name, the pact as yet does not offer many solutions to improve competitiveness, failing to mention the issues related to improving the operation of the internal market and banking system reform, instead focusing on the reduction of budget deficits in eurozone member states.

Germany's stance on the reform of the eurozone has been evolving for some time and reaches far beyond its initial appeal for reinforcing the Stability and Growth Pact. Two new elements have been added to it recently. Firstly, Chancellor Angela Merkel approved the French proposal for focusing reform activities on the eurozone member states and not on the entire EU. Secondly, the reforms are to be introduced under a joint intergovernmental agreement, with a marginal role assigned to the European Commission (EC) and the European Parliament (EP), which will weaken the influence of those institutions on the economic policy of the eurozone.

The German-French proposals

The summit of the Council of the European Union was devoted to a discussion on the German-French proposal for overcoming the debt crisis in the eurozone. Germany and France presented the 'Competitiveness Pact', a set of general reform guidelines aimed at standardising the economic policy in the eurozone. The wording of the document is so general that plenty of room for further negotiations has been left. The most important change is to be the harmonisation of the fiscal system and the taxation base for all business entities. In practice, this could be a reference to the proposal the European Commission put forward three years ago, according to which all Corporate Income Tax (CIT) revenues from the countries participating in the pact would be centrally distributed, depending on the turnovers, assets or the number of people employed by a company in a given country. It has not been stated explicitly whether this would mean introducing a single

CIT rate. However, the course of the summit and especially the French criticism of Ireland's low CIT rate indicate that such a solution is very likely. Additionally, the pact provides for an adjustment of the pension systems in the eurozone member states to the current demographic situation, which would mean that most of them would have to raise the retirement age. A 'budget brake' is also to be introduced. It may be based on the German solution, setting the limit of structural deficit at the level of 0.35% of GDP. In practice this means much fewer possibilities for countries to get into debt. Apart from that, Germany and France have proposed liquidating wage indexing (an automatic increase in wages according to the inflation rate), introducing recognition of professional qualifications and national systems for overcoming bank crises. The two countries have also suggested to establish minimum rates of investment in education, science and development, determined as a percentage of GDP.

Internal and external factors affecting the change of the German stance

The motives underlying Germany's efforts for the intensification in the coordination of the eurozone are partly linked to its domestic policy, proof of which are the kinds of the reforms proposed, the heavy schedule of their implementation and the kind of publicity they have been given in the media.

First of all, Germany hopes that the introduction of the 'budget brake' and the raising of the retirement age will improve the situation in the other countries. This way German taxpayers will have to pay less because the other countries will have to make greater efforts to reduce their debt levels and to increase tax revenues. Furthermore, Angela Merkel took over the initiative in the debate on rescuing the euro before – what she sees as – important local elections in Hamburg (this February) and in one of the largest federal states, Baden-Württemberg (this March). The German chancellor hopes that the discussion on specific proposals as part of the pact, planned for March, will provide an occasion for presenting herself as the eurozone's leader and wipe out the impression left after last year that she is lacking ideas for concrete reforms. The CDU/CSU presented their stance on the eurozone's crisis on 5 February in the Bundestag for the same purpose. It was stated that consent to increasing the European Financial Stability Facility (EFSF) has to be dependent on the reduction of debt levels in eurozone member states and the introduction of sanctions for excessive indebtedness because, in the opinion of both parties, the meaning of solidarity may not be reduced only to sacrifices by German society.

Additionally, Chancellor Merkel hopes that the pact will improve the condition and the image of the eurozone as an economic union which is still strong and capable of coping with the debt problem. Germany wants member states to play a greater role in reforming the eurozone, thus reducing the significance of the European Commission (and also of the European Parliament), whose proposals are sometimes contrary to German interests. For example, the EC has supported the strengthening of the EFSF as soon as possible and has been lobbying for the imposition of limits aimed at reducing the imbalance in the eurozone (trade surpluses and deficits) to 4% of GDP, which would also adversely affect Germany. France and Germany also insist that the pact should take the form of an intergovernmental agreement, in which the EC would only perform an administrative function and would not decide on the shape of the reforms.

The political and economic evaluation

1. The Competitiveness Pact is merely opening the way to negotiations of specific reforms in the eurozone. It is still uncertain whether it will be possible to push through the proposed solutions due to opposition from some eurozone member states and also differences of opinion between France and Germany. The ideas regarding fiscal harmonisation (see Appendix 1) and pension system reform are seen as especially controversial by member states of the eurozone. France and Germany do not agree on all issues, either. For example, France has announced that it will not agree to liquidate its wage indexing (which concerns the minimal wage). France is also unlikely to agree to raise its retirement age to the German level (since 2012, the retirement age in Germany will be gradually increased to 67 years, while the retirement age in France has been recently raised to 62 years). Additionally, the two countries have not determined a mechanism of the pact's implementation control. Judging from previous experience, unless the pact is supported with adequate sanctions, its effectiveness may be rather limited.

2. The solutions proposed so far in the pact may motivate eurozone member states to make efforts to achieve a healthier budget situation at home but at the same time fail to eliminate the causes of the financial crisis, such as: the insufficient integration of the EU's internal market, under-capitalisation of the banking sector or the inflexibility of the labour market. In a worse case scenario, eurozone reforms carried out according to the German model may cause a slowdown in economic growth as was the case with Germany in the first decade of the 21st century. This would also have an adverse effect on German exports, around 41% of which go to the eurozone.

3. Germany, which unlike France had been lobbying strongly for searching for ways to overcome the eurozone crisis in the EU as a whole, decided to focus activity on the eurozone member states, thus minimising the role of the EC and the EP. On the one hand, this may deepen the divide in the EU, but on the other, it cannot be ruled out that a closer co-operation between eurozone member states will in the long-term give rise to an intergovernmental agreement regarding economic coordination, which may become part of EU legislation (as was the case with the Schengen Agreement).

4. If as part of the German-French reforms the CIT rate is harmonised and the budget brake is introduced, the accession of new members to the eurozone may be delayed. In effect of such solutions, having the single currency will seem less attractive to them, which has been proven by cool reactions from the new member states already participating in the eurozone (see Appendix 2).

Appendix 1

CIT rates in eurozone member states in 2009

Country	CIT rate (%)
Austria	25
Belgium	33.99
Cyprus	10
Estonia	21
Finland	26
France	33.33
Germany	29.44
Greece	25
Holland	25.5
Ireland	12.5
Italy	31.4
Luxembourg	28.59
Malta	35
Portugal	25
Slovakia	19
Slovenia	20
Spain	30

According to KPMG's Corporate and Incorporate Taxes Rate Survey 2009 and the Ministry of Finance of Slovenia

Appendix 2

Reactions to the Competitiveness Pact from the Central European member states of the eurozone

Slovakia

In the opinion of Slovakia's Prime Minister Iveta Radicova, EU member states agree that it is necessary to search for ways to improve the competitiveness of the European economy but they disagree over the form in which this should be done. She believes that the German-French proposal is an attempt at interfering with national markets, which may be dangerous

to the entire EU. Slovakia's centre-right government has been consistently rejecting the idea of tax rate harmonisation. A realisation of this idea would adversely affect the competitiveness of the Slovakian economy inside the EU. The regulations imposing the requirement to keep the expenses on research and development at a certain level may also pose a challenge to Slovakia. According to a recent EC report, Slovakia is ranked last in terms of economic innovativeness in the eurozone.

The Slovakian government also disapproves of the proposal for the standardisation of the pension systems. Prime Minister Radicova has promised not to raise the retirement age until 2014, when the gradually increased retirement ages of women and men are to reach the equal level of 62 years.

According to the Slovakian government, a recipe for recovery from the crisis in the eurozone includes setting stricter rules as part of the Eurozone's Stability and Growth Pact, introducing concrete sanctions for breaking the rules and preparing a controlled bankruptcy mechanism for eurozone member states. Slovakia highlighted those issues in August 2010, when it was the only eurozone member state to have refused to lend money to Greece as part of the EU and IMF rescue package. <grosz>

Slovenia

Slovenia supported the French-German proposal for deepening co-operation to improve competitiveness. Prime Minister Borut Pahor says that the direction of the changes set in the pact fits in with the reforms the Slovenian government has been pushing through. Last December, the parliament in Ljubljana decided to gradually raise the retirement age to 65. As an effect of trade union protests, the government referred the bill to the Constitutional Court. It cannot be ruled out that a referendum will be held to decide on reform of the pension system. Slovenia, where in 2010 the CIT rate was levied from 21% to 20%, is only slightly below the EU average in terms of innovativeness. <grosz>

Estonia

The Estonian government has not commented officially on the specific proposals for closer integration of eurozone member states' economic policies presented by France and Germany. It only expressed its satisfaction that Tallinn was able to participate in important processes affecting the future of the eurozone as a consequence having adopted the euro on 1 January 2011.

The Estonian government has so far on many occasions expressed its support for increasing the coordination and supervision of public finances within the currency union, which would prevent excessive debt levels in individual countries (at present, Estonia has the lowest public debt in the EU). Tallinn supports the imposition of sanctions on countries which fail to meet the commonly agreed criteria regarding, for example, budget deficit levels. However, Estonia is likely to be sceptical about the French-German proposal of fiscal harmonisation. In Estonia, companies' profits which are allocated for development are exempt from tax. This helps the country attract foreign investment.

The government in Tallinn has also not commented on the idea of coordination in raising the retirement age in the eurozone. Estonia decided to gradually increase the retirement age last year, which is to reach 65 years in 2026 (at present, the retirement age is 60.5 years in

the case of women and 63 years in the case of men) and is likely to support a more individualised approach, taking into account the demographic situation in each country.

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