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Reforms, Investment and Growth: An agenda for France, Germany and Europe

Report to:

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27 November 2014

INTRODUCTION.....	2
1. Reforms.....	5
1.1 Reforms: why and how.....	5
1.2 Reforms in France.....	6
<i>Reform Cluster F1: A new growth model.....</i>	<i>7</i>
<i>Reform Cluster F2: Lasting and broad-based competitiveness.....</i>	<i>11</i>
<i>Reform Cluster F3: A leaner, more effective state.....</i>	<i>14</i>
1.3 Reforms in Germany.....	16
<i>Reform Cluster D1: Demographics and the “open labour market”.....</i>	<i>16</i>
<i>Reform Cluster D2: The transition towards a more inclusive growth model.....</i>	<i>19</i>
2. Investments.....	22
2.1 Investments: Why and how?.....	22
2.2 Getting the questions right.....	23
2.3 Investments in Germany.....	26
<i>Proposal D1: A minimum threshold for net public investments (“Mindestdrehzahl für Investitionen”).....</i>	<i>27</i>
<i>Proposal D2: A multilevel financing fund to steer German investment to the right targets.....</i>	<i>28</i>
2.4 Investments in France.....	29
2.5 Investments in Europe.....	30
<i>Proposal E1: Private investment booster.....</i>	<i>30</i>
<i>Proposal E2: Public investment booster.....</i>	<i>32</i>
3. An economic Schengen agreement.....	34
3.1 Borderless sectors.....	34
3.1.1 Energy.....	35
3.1.2 The digital economy.....	36
3.1.3 Professional development, qualification and education.....	37
3.1.4 Other “borderless sectors”.....	38
3.2 Policy-convergence initiatives.....	38
3.2.1 Convergence towards a common minimum-wage standard.....	39
3.2.2 Convergence in labour-market policies.....	40
3.2.3 Convergence towards comparable retirement provisions.....	41
3.2.4 Education.....	41

INTRODUCTION

Europe is falling into a stagnation trap: growth is barely noticeable; current inflation is dangerously low; almost stagnant nominal income makes the weight of public and private debt much too heavy; fear of another lost decade is setting in; expected inflation has started to decline, resulting in a rise in real interest rates; euro-area fragmentation has receded but not disappeared; Europe is losing relevance internally and externally.

France and Germany cannot resign to this state of affairs. For sure, their situations differ. Germany is on several accounts much better off, at least in the short-run. But to focus on these differences would be beside the point. We are approaching a tipping point. The economic, social and political dangers that Europe is facing are a threat to all. Division would hurt everyone. It is the common responsibility of Berlin and Paris to prevent it from happening.

Disagreement on the disease however hampers agreement on the cure. Some blame anaemic potential growth and call for reforms to bolster potential growth. Some blame deficient aggregate demand and call for more supportive monetary and fiscal policies. Others blame fragmentation and put faith in a strengthening of European integration.

We find these controversies pointless. Lacklustre productivity growth is prima facie evidence of supply deficiency. The combination of high unemployment and falling inflation is prima facie evidence of a demand shortfall. Differentials across interest rates within the same currency area are prima facie evidence of fragmentation. The truth is that Europe suffers from multiple ills.

Narrow solutions cannot be the answer to a broad problem. Structural reforms alone would help strengthen potential growth but they would do little, if anything, to support actual growth in the short term; they might even accentuate deflationary trends. Demand support alone would risk being perceived as a short-lived, soon-to-be-reversed endeavour; it would likely not convince investors to bet on Europe's future. Long-term visions for more Europe do not address any of the immediate challenges and national shortcomings; also they might look so distant from current woes that they run the risk of being seen by citizens as irrelevant at best.

So action is needed on all three fronts. The question is how. If Europe were a single country with a single, credible government, the answer would be simple: it would go for what is known as a two-handed strategy, combining ambitious pro-growth reforms and a fiscal policy support in the form of temporary public investment or immediate tax cuts in anticipation of future government spending cuts. The central bank would also make clear that provided the reforms are real and the commitment to later consolidation is credible, it stands ready to serve as a "backstop to government funding" (to quote ECB President Draghi's recent speech at the Jackson Hole conference).

But we are not in this situation. Reforms depend on national decisions. There currently is no "fiscal stance" at the level of the monetary union. Rather, aggregate fiscal policy is a sum of all national fiscal policies. Most governments in Europe suffer from weak credibility. Trust has been dented by failures to deliver on pledges and disagreements over the handling of the euro crisis. The European fiscal framework should in principle be strong enough to make consolidation commitments binding, but its own credibility is flimsy. Asking for a strong

monetary stimulus is economically right, but the ECB cannot commit to stand behind individual national governments.

In this context, there have been calls for a “split” policy-mix. The argument goes: Germany would stimulate demand while other countries, France included, would reform. The problem with this approach is however that debt over and above what is desirable from a national point of view cannot be traded against reforms in other countries.

Another solution would be to establish at the euro-area level a fiscal capacity or in plain words a budget, equipped with a capacity to borrow. While certainly the most straightforward and desirable solution in the long term, it can hardly be regarded as a timely response to the current situation. The main hurdle is the lack of own resources. A joint borrowing vehicle does not make sense without a straightforward financing mechanism attached to it.

In this context investment has emerged as everybody’s favourite response. There is much to say in favour of it, because it contributes both to strengthening supply and to boosting demand. Since 2007 investment weakness in Europe has reduced significantly potential output and aggregate demand. Its resumption would strengthen competitiveness, lift growth and create jobs.

But while underinvestment is a key problem, solving that problem requires more than just throwing money at it. We do not believe that the main constraint to investment is the lack of financing mechanisms. To invest, companies also need to anticipate framework conditions, strong demand perspectives, profitability and regulatory clarity. Absent these components, cheaper and safer financing will simply substitute more expensive and more uncertain one.

What we offer in this report is a pragmatic way out of this impasse. We propose:

1. Reforms in both France and Germany. They are not the same, because the two countries are not facing the same challenges. In France, short-term uncertainties reduce long-term trust, but the longer-term outlook looks better. In Germany, longer-term uncertainties reduce short-term trust, but the short-term situation looks relatively good. In France we fear lack of boldness for decisive reforms. In Germany we fear complacency.
2. Reform clusters. Our reform proposals target priority areas where we see urgent need for action in each country. We propose to group actions serving the same aim into ‘clusters’ and to focus on a small number of such clusters. In France, these are (i) the transition to a new growth model, based on a system combining more flexibility with security for employees (“flexicurity”) and a reformed legal system, (ii) a broader basis for competitiveness and (iii) the building of a leaner, more effective state. In Germany, these are (i) the tackling of the demographic challenges, in particular by preparing German society for higher immigration and by increasing female participation in the labour market, (ii) the transition towards a more inclusive growth model based on improved demand and a better balance of savings and investments. Such reforms are not meant to please the respective neighbour, or anybody else, but to create better domestic conditions for jobs, long-term growth, and well-being in each country and in Europe.
3. A European regulatory initiative. Private investment is a judgment about the future. Investments require trust. In many sectors, public regulation plays a major role in the shaping of

expectations on the long-term. In energy, transport and the digital sector, to name just a few, regulators must set the parameters right and ensure predictability. Investors need to know with certainty that Europe is committed to accelerating its transition to a digital, low-carbon economy. To lift uncertainty about the future price of carbon or the future regime for data protection is a major responsibility of public authorities. This could significantly contribute to increased investments in Europe.

4. Investment. The well-identified investment shortfall in Germany is largely private. Here again, regulatory clarity and a streamlined legal framework for settling disputes over infrastructure projects have a major role to play to unlock investment. But we also consider that Germany has given itself an incomplete public finances framework that rightly attributes constitutional status to keeping debt under control, but neglects promoting investments within the remaining fiscal space. German assets are not sufficiently renewed. Passing on a worn-down house to future generations is not a responsible way of managing wealth. We think the German government can and should increase public investment. In comparison to other European countries, France does not suffer from an acute aggregate investment shortfall. Business non-residential investment has remained at a relatively high level in comparison to other European countries. The allocation of investment efforts, however, is an area for improvement.

5. European private and public investment boosters. We do not believe that lack of funding is the main obstacle to European investment, but we do consider that new European resources are necessary: in a context where authorities are asking banks to take less risk, it is their responsibility to avoid pervasive risk aversion in the financial system. Building on our regulatory initiative, we propose to inject new European public money into the development of risk-sharing instruments and of vehicles in support of equity investment. Public investment has also been severely reduced since 2007. We propose creating a European grant fund to support public investment in the euro area that would support common aims, strengthen solidarity and promote excellence.

6. Borderless sectors. France and Germany should promote deepened integration in a few industries of strategic importance where regulatory borders severely constrain economic activities. Building “borderless sectors”, together with other partners, involves much more than just agreeing on coordination and joint initiatives: it implies going all the way to a common legislation, a common regulatory rulebook and even a common regulator. We think that energy and the digital economy are such sectors and we also propose a similar initiative to ensure the full portability of skills, social rights and social benefits.

7. Rediscover our common social model. Europe is more than a market, a currency or a budget. It was built around a set of shared values. It is time for France and Germany to join forces to rediscover and reinvent the social model of core Europe, starting with concrete initiatives in the fields of minimum wage standards, labour market policies, retirement and education. In these fields, convergence on the basis of effective joint action is needed to transform the Franco-German space into a true union based on economic integration and shared social values.

Our final words are simple: France and Germany spend a lot of time on joint declarations and initiatives. We miss action.

1. Reforms

1.1 Reforms: why and how

Reforms are not an end in themselves. They are means intended to reach collective goals. The design of reform strategies should start from clearly laid-out priorities.

As France and Germany do not start from the same situation, their reform agendas necessarily differ. Three important challenges are, however, common to both countries and the rest of Europe:

- Since the mid-2000s, potential output growth has weakened significantly. Labour productivity gains have declined both as a consequence of lower investment and as a result of a slowdown in overall efficiency gains (what economists call total factor productivity). Caution is necessary here because potential output is not directly observed and its measurement is fraught with difficulty. Nevertheless, there is enough evidence to raise concerns about the pace of future growth. The European Commission puts potential output growth for 2015-2019 at 1.2% annually for Germany and 1.0% for France.
- The euro-area crisis has highlighted the weakness of self-correcting mechanisms within the common currency zone. Divergences in real exchange rates (aka price competitiveness) and external imbalances developed for nearly a decade before the crisis erupted. German wages in particular remained stable throughout the second half of the 2000s when unemployment rates began to fall, and French wages continued to rise in the 2010s in spite of the surge in unemployment. Divergences of this type severely handicap the functioning of a monetary union and the prosperity of the participating countries.
- Our economic and social model is in urgent need of modernisation. Europe's competitiveness should not rely on costs alone but on education, innovation and inclusiveness. The challenges raised by globalisation and the rise of robots are formidable. They do not call for an abandonment of the tenets of the European social model but for its retooling.

While addressing domestic priorities, the reform agendas in France and Germany should therefore also be consistent with the goals of increasing potential growth, strengthening responsiveness to imbalances within EMU and retooling the European social model.

Furthermore, reforms introduced in the years to come should be tailored to suit the current situation. In a context of aggregate demand weakness and abnormally low inflation, some structural reforms that are desirable in the long term may have adverse immediate effects on inflation and growth. Priority should be given to actions that are either neutral in that respect or foster short-term improvements.

The design of a reform strategy also implies prioritising choices among a long series of potential actions. Governments rarely try to do everything at once. They often follow instead what Daniel Rodrik called the "laundry list" approach, choosing whatever options they consider politically or socially palatable. This is not an efficient approach to reforming an economy, because it does not involve choosing reforms that have maximum impact nor does it take into account existing complementarities between decisions pertaining to different fields.

We suggest a more strategic approach based on a distinction between three types of reforms:

- *Quick-win reforms* that address the most important obstacles to growth or employment and have strong effects by themselves.¹ When known, these reforms should be prioritised. Rather, policy initiatives often involve a long list of actions in various sectors, each of which is insufficient to be a game-changer.
- *Catalytic reforms* that change the perceptions of the rules of the game. These may not be of critical importance by themselves, but they do help coordinate perceptions and expectations. Behavioural changes do not only result from mechanical incentives. Perceptions of the rules of the game also matter. Some reforms are important because they help foster a change in perspective among individuals and companies.
- *Enabling reforms* that affect future reform processes themselves, because they affect the way decisions are taken. Electoral reforms or changes in the structure of the government have such an effect. They help to set a new course.

We believe all three types are important and should therefore inform a proper reform strategy. But we also believe that any reform attempt should seek to exploit complementarities that exist across fields and make the impact of a set of actions stronger than the sum of their individual impacts. Specifically, we aim to define *reform clusters* that simultaneously draw on different types of initiatives and aim to reap full benefit from each component.

1.2 Reforms in France

Outsiders often perceive France as a country that is unwilling to reform. French citizens often see their country as being in a state of endless reforms.

There is less contradiction between these two views than it may seem. The big German reform package “Agenda 2010” started in 2003 was based on a “big leap” approach. By contrast, French reforms have been characteristically gradual. For example, pensions have been reformed five times in two decades and vocational training three times in ten years, most recently in 2014.

Over the last 30 months, governments under President François Hollande have introduced a significant number of reforms concerning pensions, collective agreements and layoffs, the building blocks of a flexicurity system, vocational training and SME financing, to name only the main ones. At the time of this writing, the law reforming regional governments is reaching the final stage of parliamentary discussion and discussions between social partners on employee representation within companies and the so-called social thresholds have started. In addition, a new series of laws dealing with product-market competition, Sunday work, the regulation of protected professions and the settlement of labour disputes is to be tabled by the government before the end of the year.

¹ OECD (2013), “Going for Growth 2013, Taking stock of reform action and identifying priorities” gives a view of OECD’s methodology for selecting policy priorities. Hausman *et al.* (2006), “Growth diagnostics”, *Finance and development*, IMF, presents the methodology known as growth diagnostics.

Furthermore, a major reduction of the tax wedge on labour is being implemented within the framework of the so-called Responsibility Pact: cuts worth one percent of GDP have been implemented and another one worth half a percentage point is to enter into force on 1 January 2015. Taken together, labour costs for wages close to the minimum wage will have been reduced by about 8% (5% on average for wages below 2.5 times the minimum).

Last but not least, the government spending growth rate has been curbed, from close to 4% in the mid-2000s to about 2% in the early 2010s. The budget bill for 2015 is based on a decline in central government expenditure and an overall growth in public spending limited to 1.1% in nominal terms.

So far reforms, however, have not broken with the piecemeal approach of the past, which results in two shortcomings:

- First, partial reforms often fail to provide enough clarity to economic agents – primarily employers and employees. As reforms often pave the way for further ones, it is hard to get a sense of the rules of the game, the direction for the future, and what policy initiatives imply for concrete individual decisions. This reduces the effectiveness of reforms.
- Second, external perception of French priorities and directions remains blurred at best. Many outside observers simply see the country as having not reformed at all.

In many respects, France appears to stand at mid-point in its course of transformation. This is a source of both discomfort and uncertainty.

Consistent with the overall priorities set out at the beginning of this section, we suggest that in the years to come, French reform efforts should concentrate on three priorities each associated with what we call a “cluster”. For each cluster, a critical mass of complementary actions should be taken that result in providing clarity and predictability.

Reform Cluster F1: A new growth model

The French post-war economy relied heavily on a relatively stable industry structure and a combination of large, increasingly internationalised world-class companies and nationally oriented subcontractors. This model, which served the country well in the post-war decades, has now reached its limits:

- Larger companies, which have become global leaders in their fields, have reorganised their international value chains without necessarily giving a prominent role to their French subcontractors. This logic of global integration challenges the organisation of the economy.
- Innovation is increasingly taking place within open networks that involve established companies, start-ups and public labs. The potential for productivity gains derives less and less from within-firm improvements and increasingly more from the reallocation of resources across firms. This logic of the network economy requires a different economic, legal and institutional environment.

The new growth model should target an agile economy that rewards innovators bringing new ideas, products and techniques to the market and, at the same time, an inclusive social model that provides opportunities to workers throughout their professional career.

France has formidable assets conducive to embracing this model. As a result of efforts undertaken since the 1980s, its labour force is now much better educated and compares well to that of its neighbours, including Germany.² France can also count on an innovation culture, excellent laboratories, a vibrant start-up scene and dynamic cities. But its scientific, economic, social, territorial and financial institutions have not yet adapted to the new model. These institutions are generally attuned to a more static economy and a more segmented society.

Reforms facilitative of this model cover a wide range of fields, from university policy to finance, but the most catalytic are probably those concerning the labour market and product market competition. We believe two tasks should be prioritised: first, build an effective flexicurity system; second, reform the framework for labour laws.

Task 1: Build an effective flexicurity system

Although significant steps towards internal flexibility have already been taken, French companies have proved less able to respond to economic fluctuation than have their German counterparts. In 2009, German companies reduced working time by 2.8% in response to the Great Recession, which allowed them to retain trained staff. In France, only one-third of all companies engaged in negotiations regarding working time and the corresponding reduction was only 1.2%.³ Furthermore, legal provisions introduced in 2013 that permit companies facing severe economic difficulties to negotiate on wages, employment and working time (the so-called *jobs preservation* agreements) have proved ineffective, in part because requirements were too strict.

As regards external flexibility, the French labour market is still transitioning between two worlds and is characterised by a high degree of dualism. Fixed-term contracts amounted in the second quarter of 2014 to 84% of total hires. New entrants into the labour force as well as the least skilled and most vulnerable workers suffer from high job instability and repeated spells of unemployment, which is both economically inefficient and socially unfair. Transition to an open-ended contract is long and jerky; once employees sign one, they naturally tend to stick to it, which strengthens dualism. And for employees who have lost their jobs, in particular those least skilled, the support offered by search assistance and retraining services is not sufficient enough to materially improve employment opportunities.

We believe that debating those structural features of the French labour market are of much higher economic importance than arguing over political symbols. This is particularly relevant for the 35-hour work week. The headline figure for the working time is a less crucial issue than

² In France, severe educational problems, especially concerning the bottom quintile of the youth cohorts, should not conceal the fact that more than 40% of the new entrants into the labour force had access to tertiary education; for cohorts reaching retirement age, this figure is below 20%.

³ Source : DARES, *Reponse* survey and Herzog-Stein A. and Hartmut S . (2010), "Deutsches Beschäftigungswunder und flexible Arbeitszeiten", WSI.

determining how flexibly the rule is applied and under which circumstances it can be adapted. Several sectors in Germany also have the 35-hour week, but they also feature many rules allowing for agreements rendering the working time more flexible under specific circumstances. The French system has already moved in that direction, an evolution we consider fruitful.

The building blocks of a flexicurity system have been gradually introduced with, notably, an increase in the portability of retraining and unemployment benefits rights (*droits rechargeables*) legislated in 2013. At this stage however, they have failed to trigger significant changes in employer and employee behaviour.

We propose:

- To broaden the scope of company-level job preservation agreements by relaxing conditions for the existing *accords défensifs* and by introducing *accords offensifs*.⁴ This would contribute to increasing working time and compensation flexibility in response to changing economic conditions.
- To reduce the dualism of the labour market by making open-ended contracts more attractive to employers and fixed-term contracts less attractive. Employers' reluctance to open-ended hires should be reduced by rendering separation costs and delays more predictable. The goal should be that the majority of hires take the form of open-ended contracts.
- To reduce obstacles to employee mobility across professions and industries by ensuring the full recognition of skills and the full portability of social rights. Rights gained by accumulating on-the-job seniority should be registered in a fully portable individual account.
- To reduce barriers to entry and exit on the product market by strengthening competition, especially in services sectors, and by reforming bankruptcy procedures.

We also suggest laying the ground for action in two other fields:

- The recent reform of vocational training, which introduced portable individual rights that are accumulated while in employment and can be drawn on at will, including while in unemployment, represents a step in the right direction. However, it failed to address problems of training quality and of access, especially for low-skilled workers. The government should set more ambitious goals that would reform the supply-side of training and improve basic skills for all workers. It should consult with social partners and ask them to initiate new negotiations on this basis.

⁴ *Accords défensifs* and *offensifs* are two possible modalities of company-level job preservation agreements. The former, which are the only ones in force, can be introduced only in response to “severe economic difficulties” (in practice, a business downturn that would force the company into collective redundancies) and under strict conditions (for example a company that reduces, but does not avoid, layoffs is not eligible). The latter would make it possible to introduce the same approach but in a preventive way, for example in response to more challenging competition in the marketplace rather than an outright business downturn.

- Unemployment insurance is also an area in which decision belongs not to the government but to social partners. The existing system is unsatisfactory because it: disfavours new entrants (especially the young); does not effectively incentivise (especially for skilled employees and professionals) and support (especially for the least skilled workers) active job search; and because it tends to be managed in a pro-cyclical way. New negotiations are due to commence in 2016. Here again, the government should consult with social partners on the objectives and design of a comprehensive reform.

Task 2: Reform the labour laws framework

In comparison to Germany and many Northern European countries, the balance between legal and contractual labour provisions is significantly biased towards the former. Instead of limiting the application of general laws to a core set of fundamental provisions, while providing social partners considerable leeway in decision-making, French labour laws feature extensive detailed provisions that often include the scope and limit of branch- or company-level derogations by agreement.⁵ Overall, there is limited room for manoeuvre for negotiation among social partners.

Another issue is that implementation of labour laws is fraught with delays, unevenness and unpredictability. Labour jurisdictions, whose members are elected representatives of employers and employees rather than professional judges, are notoriously slow, their conciliatory procedures rarely deliver, their decisions are frequently subject to appeal and there are wide variations in the jurisprudence across tribunals. This results in high levels of uncertainty among individual employers and acts as a deterrent to hiring.

The scope of subsidiarity has been expanded in recent years, as several laws have broadened the reach of derogatory agreements. Representativeness criteria and thresholds have also been introduced for labour unions (2008) and employers' associations (2014), thereby strengthening the legitimacy of collective agreements. A process has started that should lead to a significant reduction of the number of branches, from about 600 (at least half of which are inactive) to one or two hundreds. With regard to settling labour disputes, the government has indicated its intention to introduce a reform bill in the months to come.

Drawing on these changes, scholars have proposed an overhaul of the architecture of labour laws that would introduce derogation by default. This would involve allowing social partners to depart from general provisions unless explicitly prohibited by law (e.g., discrimination). Although this kind of enabling reform bears potentially far-reaching consequences, we are concerned that determining the scope of provisions not open to derogation would be conflictual and require lengthy discussions. We also think that parliament would not be keen on relinquishing its legislative power. Furthermore, the existing scope for derogations is already significant.

⁵ For example, the overtime wage premium is set by law at 25%. It can be lowered (to a minimum threshold of 10%) if employers and employees reach agreement on this. In general, derogations to legal provisions are only possible if beneficial to the employees.

We believe that France should draw from the experience of Germany, which features fewer and better organised branches, where employee representation at the company level, though declining, is still widespread and includes SMEs, and where social partners have more autonomy in negotiating at branch and company levels. We propose the following efforts in order to achieve these objectives:

- Widen the scope of possible derogations to encompass legal provisions in branch-level collective agreements, including agreements featuring some provisions that are not beneficial to employees. Expediting the consolidation of branches is obviously needed to improve effectiveness.
- Foster employee representation in small and medium-size companies. Coupled with the streamlining of existing committee structures in companies with more than 50 employees, empowering employee representation in companies with less than 50 employees would improve conditions for collective agreements.
- Limit the scope of conflict in agreements by making explicit reference to the provisions of collective agreements in individual labour contracts.

Employee representation in smaller companies is controversial among employers. But France cannot regret not being able to develop social dialogue and refrain from better organising employee representation at company level. In Germany, the same threshold starts at five employees.

We do not advocate a dismantling of the legal “extension” procedure that makes agreements reached at the branch level binding for all companies. More generally, we do not consider developments in Germany involving the recent reduction in the coverage of employees by collective negotiation to be positive. Company-level departure from branch-level agreements should be made possible by built-in flexibility, not by a reduction in coverage.

Reform Cluster F2: Lasting and broad-based competitiveness

The French tradable-goods sector as well as its manufacturing sector (which still constitutes the largest share of the sector overall) have weakened significantly over the last 15 years. Employment and value added have fallen markedly, corporate profits have dwindled and the share of French producers in global exports has declined. In comparison to Germany, both French exports and imports are low, which is indicative of the country’s limited insertion in global value chains. Even the number of exporting firms has decreased, from 130,000 in 2000 to 120,000 in 2013.

In a nutshell, there are too few internationally oriented producers and their domestic production is not profitable enough. Consequently, French producers neither innovate nor export enough.

French labour costs in manufacturing are at the same level as in Germany, but French firms suffer from two handicaps. First, German producers can build on a reputation of high-quality products and sell their output at premium prices. Second, the price of other inputs (e.g., land, rents, professional services, transport, other services) is considerably higher in France. Only

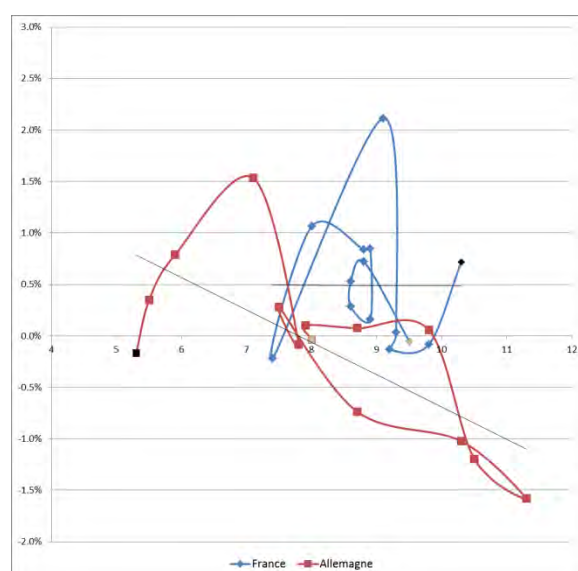
energy remains cheaper but the gap has narrowed as the bulk of higher German energy costs has been passed on to households.

Overall, in France, relative prices have in recent years consistently evolved to favour mostly sheltered sectors over the tradable-goods sectors; the opposite development can be observed in Germany. As a result, tradable-goods sectors in France have become less attractive for both capital and labour. This trend must be reversed.

Measures have been taken in France to strengthen competitiveness, first and foremost through the aforementioned cuts in social security contributions and other tax incentives such as the CIR, a tax credit for research. However, in the context of high taxes, high levels of public spending and a persistent deficit, there are no budget resources available for additional fiscal support to competitiveness

More structural responses are needed in France, especially as real wage growth has remained relatively dynamic in spite of high and increasing unemployment levels. Whereas we might have expected compensation growth in France to slow down in response to worsening labour market conditions (as it has in other European countries), real wages exhibited considerable inertia. This has helped sustain demand in the short term, but in the medium term inertia contributes to prolonging competitiveness problems. There are fears that some of the benefits of the employment and competitiveness tax credit (CICE) introduced in 2013 are being passed on to employees in the form of higher wages.

Figure 1: Unemployment and real wages growth in France and Germany, 2000-2013



Source: annual growth rates of real wages shown on the Y-axis are based for France, on the “salaire mensuel de base”, and for Germany on Destatis “Nominallohnindex”. Nominal wages are deflated using Eurostat harmonised indices of consumer prices. The unemployment rate on the X-axis is AMECO’s total unemployment rate.

Wage growth inertia results from a series of factors. These include mandatory annual wage negotiations at the company level, which derive from a context of high-inflation and create pressure for positive settlements even when there is no income growth to distribute. Relatively tight labour market conditions for intermediate and higher skilled labour is another factor. Generous wage settlements achieved in globally active firms (for which France is no longer a major production base) also account for wage growth. An additional factor is the partial indexing of the minimum wage on average wages, which creates a feedback loop. More generally, the combination of very low inflation and downward nominal wage rigidity contributes to the inertia of real wage growth. (NB: Public-sector wages, which have not increased for more than four years, are not to blame.)

In a situation where tradable-goods firms have watched their profitability decline, a strong signal should be sent that steps are being taken to prevent real wages from growing at a faster pace than labour productivity. When fighting inflation in the 1980s, France was able to take significant and ultimately successful steps to end pervasive indexation. It should follow a similar route now.

We propose the following measures:

- Reduce rents and promote efficiency in the non-tradable sectors. A series of actions should be taken to release land for construction in densely populated areas. Actions considered under cluster 1 targeting improved efficiency and competition in services sectors would contribute to the same goal.
- The law currently requires annual wage negotiations at the company level (though there is no obligation to reach an agreement). However, inflation and productivity are both tepid, leaving little room (if any) for upward wage adjustment. Changing the legal requirements for the frequency of negotiations from an annual to a triennial basis (unless otherwise agreed upon by social partners) would send a strong signal that economic conditions have changed.
- Change the minimum wage indexation formula. The current formula automatically sets an annual increase in line with inflation plus half the average real wage increase. We believe that the real increase of the minimum wage should instead be made dependent on the overall increase of productivity in the economy. Indexation should be a way to ensure that the benefits of growth are shared, not a way to disseminate wage increases over and above productivity gains.

In part 3 in this report, we propose French-German minimum wage convergence as a policy target over a ten-year horizon. Evolutions in both countries in the years to come should be consistent with this goal. For France, this would imply rebalancing the relative roles of the national minimum wage and the branch-level wage minima, which should be given a stronger role in wage-setting.

In the medium term, these actions should be supplemented with more structural initiatives aimed at broadening the export base of the French economy. Tourism is a case in point, as are services such as higher education and health care, which are in high demand in emerging countries.

Reform Cluster F3: A leaner, more effective state

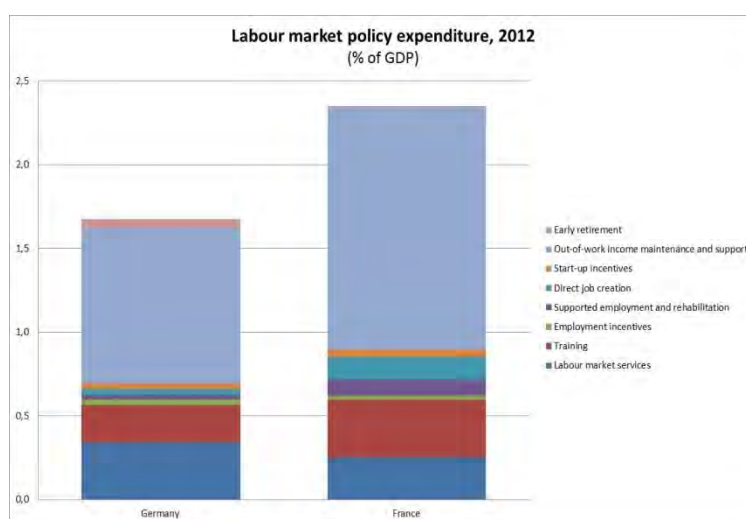
France is still subject to an excessive deficit procedure within the context of the Stability and Growth Pact. Given that discussions are currently underway between the European Commission and the Eurogroup on the measures needed to bring French public finances consistent with EU rules and on the corresponding timetable, elaborating on the French public deficit and debt within the context of this report would have little value added. We do note, however, that within the framework of the Stability and Growth Pact, France has no remaining fiscal space.

Discussions on the pace and pattern of consolidation should take into account the aggregate balance between supply and demand in the euro area and actions taken by partner countries, but there is no room for additional demand support.

The size and effectiveness of government is, however, an issue we need to address. France has the second highest public spending-to-GDP ratio in the EU and one of the highest in the world. In 2014, the primary expenditures-to-GDP ratio (excluding interest payments on public debt) is set to reach 55% of GDP in France against only 42% in Germany. France's high spending ratio in this regard can be explained in part specific institutional features that result from social choices (such as, for example, the nearly exclusively public character of pensions). But, in part, it also results from inefficiencies.

France often relies on palliative public spending as a substitute to a more structural approach to its problems. Housing offers a case in point: corresponding public spending exceeds 2% of GDP, yet housing is certainly no more affordable in France than it is in Germany. Spending on employment (Figure 22) offers another example: in 2012 (i.e., before the introduction of new tax credits) it exceeded German employment spending by about 0.7% of GDP. Differences in spending on unemployment support (resulting in part from higher unemployment) accounted for only half a percentage point. By the same token, public support to private-sector companies in the form of subsidies and tax credits amounts in France to another 4% of GDP. These examples illustrate the broader point that reforms designed to improve the functioning of markets can contribute significantly to reducing public expenditure ratios.

Figure 2: Labour market policy expenditures in 2012 (in percent of GDP)



Source: Eurostat. Expenditures reported here do not include low-wage exemptions from social security contributions

Reforms should also address the organisation of government. As indicated by the OECD, in spite of its much higher public spending, France pays its teachers significantly less than Germany pays its teachers. Sustained wage restraint in lieu of fundamental efficiency-enhancing reforms carries the risk of eroding the quality of public administration and public services at a time when they play a major role in the overall economic and social performance of a nation. The French government suffers from costly overlaps between government levels, insufficiently targeted economic and an insufficient reliance on modern public management methods.

Public spending restructuring takes time. This raises credibility issues for the process. France in this regard suffers from a credibility handicap. As observed by its independent fiscal committee (the *Haut Conseil des Finances Publiques* or HCFP), over the last fifteen years medium-term targets set in the annual Stability Programmes have repeatedly been missed. As a result, policymakers run the risk of being compelled to introduce tax increases and spending cuts that deliver adjustment in the short run but do not improve structural efficiency and effectiveness.

We suggest that France:

- Set itself an overall goal for the primary government spending-to-GDP ratio. Reducing this from 55% in 2013 to below 50% in the years to come could be a sensible target that would provide for effectiveness and allow the government to fulfil the spectrum of responsibilities French citizens expect.
- Carry out a comprehensive medium term-oriented spending review. This should take into account short-term savings as well as the savings brought by efficiency gains, a better selection of policy priorities and the substitution of reforms to palliative public spending.
- Involve an independent fiscal body (presumably the HCFP) in evaluating the impact of expenditure-saving measures. This would help strengthen internal and external credibility.

1.3 Reforms in Germany

Germany faces a paradoxical situation. The success of past reforms, coupled with short-term growth and employment shift attention away from serious long-term structural challenges resulting from demographics and protracted underinvestment.

No other leading economy worldwide has weathered the storm of the crisis as well as Germany. Over the past three years, average growth rates were higher in Germany than in any other major euro area country, unemployment rates dropped to historic lows (7.7%, the lowest level since 1991), the debt-to-GDP ratio fell, and a smart model of industrial innovation – combined with a multi-lateral value chain – generated an unprecedented strength in exports (trade currently accounts for nearly 50% of German GDP). Germany proudly looks back to reforms undertaken a decade ago that changed the rules of the game and are now viewed as explaining its current success.

At the same time, few leading economies worldwide face medium- to longer-term challenges as fundamental as Germany does. The population has started to shrink: absent massive changes, by around 2050, Germany's population will be smaller than that of France or Britain. Today, Germany has around 2.3 workers for every single retired person; by 2060, there will be only about 1.3 workers per retiree. Also, there is a large private and public investment gap. According to the German economic research institute DIW, the public-private investment gap amounts to €75bn (or 3% of GDP) per year and accumulated from 1999 to 2012 to about €1tn (or 40% of GDP). Also, the German financial position is characterised by high savings and large financial outflows to the rest of the world whose returns are low, if not negative. Domestic demand is weak. Education indicators are not strong. Income inequality is rising with clear risks of poverty among elderly people. Our three reform cluster proposals below address these main challenges.

The last time Germany faced such fundamental challenges was from 1995 to 2005. The selection in 1997 of "Reformstau" (reform backlog) as word of the year signaled the widespread awareness of need for structural change at the time. In 1999, the Economist famously called Germany the "sick man of the euro", but it took four more years before Gerhard Schröder launched the Agenda 2010 reforms and two additional years before the reforms entered into effect. The 2005 reform package combined quick-win elements, as well as enabling and catalytic reforms. But 2005 also marked the culmination of several incremental reform steps that had been undertaken since 1995 in a variety of areas, including the financial industry, wage-bargaining, industry structure, taxation and pensions.

We believe Germany needs to initiate yet another wave of reforms. In contrast to France, where reforms are urgent and specific, the German reform needs are more fundamental in nature, require societal transformation and will likely need considerable time for implementation. Our main concern is that procrastination will prevail.

Reform Cluster D1: Demographics and the "open labour market"

Germany's demographics represent its main weakness today. This is not a matter of largely populated economies having advantages over smaller ones. But the transition from a population peak of 82.5mn in 2003 to around 65mn in 2060 requires far-reaching adjustments as it

represents a population decline of around 20%. Depending on productivity rates, a declining working population will generate relatively lower tax income for government. At the same time, infrastructures such as schools and hospitals will need to adjust to lower population levels.

Even with a positive migration flow of 200,000 per year, the German labour force is projected to shrink by 194,000 on annual average from 2014 to 2025 and by 327,000 from 2025 to 2035. Though never fully accurate, such projections underscore considerable problems if no major change takes place. If we accept the baseline scenario, then there are three ways to cope with the resulting challenges:

- (1) Live with the baseline scenario and accept a very sluggish or even stagnating aggregate GDP at normally rising GDP per worker levels. For example, if German GDP per worker rises at the same average rate observed in the past 20 years (1.1%), then German aggregate GDP would increase by only 0.3% per year on average until 2050.
- (2) Expand the German labour force by:
 - a. increasing net migration;
 - b. increasing overall annual working time;
 - c. increasing female participation in the labour market;
 - d. increasing the participation of elderly people in the labour market;
 - e. and continuing efforts to increase fertility rates (an indirect measure).
- (3) Increase total factor productivity along with the productivity of capital and workers to make up for population decline. This approach would still require that adjustments be made in German infrastructure and levels of public spending, but it would facilitate the transition.

We believe (1) is a politically and economically dangerous solution. Therefore, Germany needs to focus on the different elements of (2) and (3). Both elements are part of a shift towards an “open labour market” that lifts all implicit and explicit barriers of entry.

Task 1: Prepare the labour market and society for higher migration levels

Official projections on the net inflow of foreigners into Germany for the next ten years place this figure around 200,000 per year (this is also the average rate witnessed in past decades).⁶ In order to compensate for population decline, German migration inflows need to increase, which could generate further challenges. During the exceptional crisis years of 2012 and 2013, when intra-EU migration rapidly grew, the net inflow was 500,000. In order to fully integrate a large and steady inflow of several hundreds of thousands of people through 2060, Germany would have to open up. At a net migrant rate of 300,000 people per year, a total inflow of 14 million people (or 17% of the current German population) would arrive as migrants to the country by 2060. Is German society ready for this?

⁶ 12. Koordinierte Bevölkerungsvorausberechnung

Current integration data on migrants in Germany points to some troubling concerns. Migrants are twice as likely as non-migrants to end up in poverty. This figure holds across all levels of education: a migrant with an Abitur (or equivalent) has a probability of ending in poverty of 20%, whereas the probability for non-migrants with an Abitur is 9%. Germany clearly needs to improve language training for migrants and make courses more accessible – through subsidies, if necessary. Language training is needed in particular for children joining German schools with no German language skills, but also for migrant workers and their spouses.

We suggest:

- Introducing a point-system for migration to attract those people who are most urgently needed in Germany. Such a system does not have to exclude migration inflows of low-skilled workers.
- Aiming to fully integrate into the labour market foreigners acquiring a German higher education degree by automatically giving them work permits.

Task 2: Remove disincentives for female participation in the labour market

While the employment rate of German women is roughly in line with European or OECD average data (68%) and has risen by ten percentage points from 2002 to 2012, much of this increase took place in part-time employment and was facilitated by the 2001 bill on the right to work part-time. German women are disproportionately represented in part-time employment (at around 50%, compared to 30% in France). Generally, neither the legal nor the tax incentives for women with children to take up full-time jobs are high. Many studies point in fact to direct disincentives for women to join the labour market. The OECD observes that “Germany is the only OECD country where the tax/benefit system does not favour second earners in families with children.”

We suggest:

- Introducing a legal right to return to full-time work after having worked part-time for family reasons. This addition to existing legislation would ensure that many women who want to return to working more hours have a legal right to do so.
- Increasing tax incentives for second earners, particularly second earners in families with children, to join the labour market. We do not believe tax or other monetary incentives for women with children to stay at home are the right way to go. We are aware this is a delicate political issue, but the economic arguments and the comparison with other countries highlight the importance of continuing this debate.
- Enhancing childcare possibilities through increased supply but also by expanding tax deductions for private childcare.

Task 3: Encourage highly qualified men and women to join the labour market earlier in their lives

Highly qualified German women and men join the labour market very late by international comparison. The average German student does not leave university until around the age of 27. This “German exception” poses problems for the overall labour supply in Germany. There are good reasons to believe it could also help explain low fertility rates among highly skilled women in Germany. German women are on average 30 years old when they give birth to their first child (highest level within the OECD). The German fertility rate ranks among the lowest in the OECD world.

Given these circumstances, we recommend that Germany revisit reforms targeting the duration of higher education and course of study at university. The average age of a student in Germany who has acquired his or her first university degree is 26.6. This figure has fallen by almost one year since 2001, but the decrease is largely due to an increase in bachelor degrees (average age 25.5 – nearly 50% of German students obtain such a degree), which are often followed by a masters degree (average age = 29.1). In other cases, the average age is much closer to 28 (*Fachhochschulen* or applied sciences degree = 28.4). There are many explanatory factors underlying these exceptionally long study times, including the relative curricular openness and flexibility found in many German university programmes, the absence of binding time constraints and yearly exams, and the tradition of financing university degrees through part-time jobs.

We suggest:

- Shortening further the length of courses of study in German higher education by (1) strictly applying the Bologna bachelors and masters degree structure to all subjects of study, even if this runs counter to some disciplinary traditions; (2) developing more focused curricula structures with clear time objectives, making it possible for every student to meet these objectives under normal circumstances.
- Significantly increase the availability and accessibility of financial assistance schemes and subsidised student loans, thereby reducing the need to take a job to finance higher education.

Reform Cluster D2: The transition towards a more inclusive growth model

In addition to traditional strengths, the successes of the German economy can be explained by several fundamental changes to German labour and capital market institutions that took place since the late 1990s. This new institutional model is often praised for its increased flexibility, but it has also come under scrutiny for its effects on the redistribution of wealth, equality of chances, and social fairness. Despite positive growth rates and low unemployment, inequality rose in 2011 and 2012 according to OECD data. The poverty rate did not recede and is still around 1 percentage point higher than in France. The unemployment rate has been falling, but the share of long-term unemployment is still too high.

Generally, the German population is not benefiting from relatively solid growth rates as much as it could. This is due to several reasons, including a decade of real-wage restraint, but also the regulatory protection of certain high-income professional services that leads to a skewed income distribution. Finally, Germans save a lot, but they do not get high rates of return, it is therefore necessary to make sure there will be a better transformation of their savings into productive German and European investments.

Task 1: Improve the functioning of the low-wage sector of the labour market

Around 8m Germans work in so-called mini-jobs (paid €450 per month, some of those jobs being second jobs or jobs in addition to other forms of income) and the share of part-time jobs is still high.

While these developments are not cause for immediate concern, they still raise the question of the general orientation of the German growth model. We see a key problem in the low-wage sector, where the incentive structure to exit from mini-jobs with very low social security contributions is problematic, because of a stepwise increase in employer social security contributions, first to 20% in the so-called midi-jobs (€450 to €800 per month) and then to full social security contributions above €800. For those who remain in these entry jobs, the lower social security contributions come at the cost of reduced social security and especially pension benefits.

We suggest that Germany:

- Introduce progressive social security contributions in the low-wage sector (400 € to 1500€), in particular regarding the part of contributions paid by the employees. The French experience with the *allégements de cotisations sociales sur les bas salaires* could be useful to learn from in this respect.

Task 2: Improve the transformation of savings into productive German and European investments

Nearly €2 trillion of savings in Germany are in normal savings accounts. Those savings are channelled via banks towards investments. This set-up has the effect that banks have taken little domestic risks by investing in equity, but instead focused on fixed income investments or asset-backed securities abroad. From 2003 to 2010, it has been calculated that around two-thirds of German net savings left the country, while only approximately one-third remained at home.⁷ During this period, Germany was the largest capital exporter among OECD countries and had the lowest net investment rate in the euro area. The return on this foreign investment has been low, implying losses to the German saver in comparison to the return on domestic investment. Nevertheless, German underinvestment is still considerable and its external surplus has reached new heights. This is not an efficient way to prepare for the ageing of society.

It is thus crucial to build a context in which German savings can be more directly channelled into domestic and foreign equity investments. As said, this reform would also be in line with the

⁷ Hans Werner Sinn 2014, p. 91

broader directions that are appropriate for European financial markets. This will require developing appropriate saving vehicles that mitigate risk to the individual household through diversification and hedging.

We suggest:

- Eliminating regulatory obstacles to investment (see point 2.1 below).
- Facilitating equity holdings through the creation of better vehicles for national and cross-border equity investment.

Task 3: Increase domestic demand

German domestic demand has recently begun to rise; its contribution to German GDP growth is now on par with that of exports. This trend is clearly driven by solid employment figures and low interest rates. However, domestic demand is traditionally rather weak in Germany and measures should be taken in this respect. In our view, such structural strengthening of domestic demand should clearly take place not through fiscal expansion, but through a mixture of regulatory measures and wage policy.

Regulatory measures are needed to distribute some of the profits generated in highly regulated high-income professional services to consumers. This should contribute to lowering savings and increasing domestic demand. At the same time, we believe German wages should be allowed (and even encouraged) to rise further.

We suggest the following measures:

- Regulatory measures are needed to change some of the rules governing highly regulated high-income professional services, where entry control, exclusive rights and scales of fees often lead to a disproportionate distribution of profits (rents) to small groups in society. Such deregulation should contribute to lowering savings and increasing domestic demand.
- German wage levels need to rise further in line with productivity increases, taking also into account the legacy of a near-decade of real wage restraint. Such wage increases will foster German domestic demand and provide a remedy to disproportionately high savings rates in certain areas of the German economy.

2. Investments

2.1 Investments: Why and how?

France and Germany differ in their respective investment position. Whereas public and private investment levels in France have remained relatively high, Germany has been lagging behind the euro-area average for years. In both countries, many questions can be raised as to the allocation of investments and whether the right priorities are set, particularly in public investment. But the challenge goes beyond France and Germany. We believe it would be wrong to look at investments from a purely national perspective.

Current investments in almost every country in Europe are too low. In 2013, gross non-residential capital formation in the euro area was still 16% below the level of 2007 (in volume). In the United States, it was back on its 2007 level, and in China total gross capital formation was 50% above the 2007 level. Europe's low investment is both perpetuating the aggregate demand shortfall and squandering the continent's already shaky competitiveness.

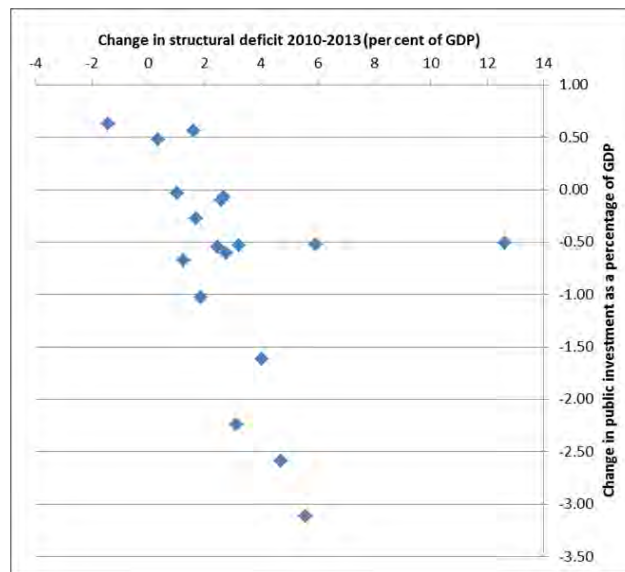
On the private side, the drop in investment is not primarily due to the cost of capital. Except in euro-area countries where financial conditions have not yet normalised, interest rates are at record low levels. The shortfall is mainly due to a lack of macroeconomic demand prospects. Other important factors include persistent regulatory barriers and inadequate regulation; policy uncertainty (especially for regulated sectors where investment has a long-term horizon); and the mismatch between a preference for safety on the part of savers and the risk component of investment. This latter point is significant in a context where public authorities are urging banks and other financial institutions to take less risk on their balance sheet.

On the public side, the drop in investment is largely due to a necessary consolidation of structural spending. Investment is often the first area to subject to cuts when expenditures must be reduced. Some countries initiated fiscal consolidation very early on (mainly Germany from the middle of the 2000s onwards), while others started during the crisis. In Ireland, Greece, Portugal and Spain public investment was cut by 50% to 70% in nominal terms between 2007 and 2013.

We believe that the results of fiscal consolidation should not be squandered and that euro-area member states must continue to reduce structurally high debt levels. But we also believe that cutting public investment can be a dangerously short-sighted move. For this reason, we propose the creation of a public investment booster at the euro-area level to support investments.⁸

⁸ We focus on the members of the euro area because they are the reason why the EU fiscal discipline provision is binding and enforceable.

Figure 3: Fiscal consolidation efforts and public investment



2.2 Getting the questions right

The debate on investments is often dominated by a discussion of specific projects. We do not believe this is the right approach. The investment shortfall (both public and private) is a macroeconomic and structural problem, not a specific problem related to a series of easily identifiable projects or, again, the lack of availability of affordable funding. We also consider the debate over public vs. private investments to be rather artificial and not necessarily constructive. Finding the right mix depends on sectors and the types of projects involved.

Most publicly guaranteed vehicles that focus on private investment projects work through implicitly subsidised rates for investment. In today's near zero interest context, such vehicles are of limited use. They even run the risk of crowding out private investment by undercutting already low rates by only a few additional basis points. Support for investment has to take into account the nature of the problem that Europe is facing. Working on "methods" to increase general conditions, incentives and financing for investment is thus more important than working on specific projects.

Our approach to investment is based on the following five considerations:

First, regulatory uncertainty should be tackled because it acts as a brake to private investment. The reasons are manifold and sector specific, and we cannot enter into those details here. But we want to emphasise that whereas deregulation within the single market has been beneficial in many areas, it has not sufficiently increased regulatory predictability for investors, especially in sectors that have a strong transnational dimension such as energy networks, large areas of the digital economy (e.g., mobile telecoms) or certain elements of the transport sector.

Furthermore, some areas of our economies still have a strong national regulatory bias, thus hampering cross-border initiatives. This was the case in banking before the important step towards banking union. But this is still the case in fields such as energy efficiency, the development of renewable energies, several areas of the services sector and data protection.

Reaching agreement on the right regulatory decision among all EU 28 countries is often a nearly unsurmountable challenge. This is quite natural given differences in political priorities, growth models, investment and regulatory strategies. But the resulting inertia is damaging. Existing differences should not prevent proactive regulatory initiatives among a smaller number of countries sharing political and regulatory priorities. Because it was decided and implemented in response to an acute crisis, banking union has defined a new template for integration: in little more than two years, the euro area has moved from a traditional single-market model that was characterised by significant inertia and left much leeway to national regulators to having put in place a new model that gives extensive responsibility to a single regulator. The model utilised in the field of banking can also be applied to other fields. Naturally, this logic would apply to France and Germany in particular.

Second, Europe should accelerate the transition to a digital, low-carbon economy. As we all know that this transition is indispensable, we should turn the current crisis into an opportunity to make it happen sooner.

By nature, this transition requires substituting on a large scale new, more efficient capital for the existing capital stock. This does not need to involve an ex ante injection of public money. In this respect, the role of government is not primarily to finance, rather to trigger and to facilitate the renewal of the capital stock by setting adequate standards and price signals. Through regulation and taxation, public authorities should incentivise private agents – businesses and households – and foster investment into new equipment.

This is evident in the case of the transition towards a more environmentally friendly economy, which is currently hampered by the low price of carbon on the Emissions Trading System (ETS) market, inconsistencies or unpredictability in the use of taxation for climate preservation purposes, a too lenient attitude towards road haulage in several countries (including France), and a benign attitude vis-à-vis the damages of coal in some others (including Germany). Furthermore, a massive regulatory effort needs to be undertaken to reduce the administrative and legal barriers that slow down infrastructure investments. Similar considerations also apply to the digital sector where private investment decisions depend on public decisions about technical standards, market integration and rules for the handling of data. In these two sectors as well as in other regulated sectors, the return on policy clarity can be very high.

Let us be clear: there is no free lunch in what we are proposing. The transitioning to a new growth regime inevitably involves accelerating the obsolescence of the existing capital stock, which is not without consequences for corporate profits or household wealth. For these reasons there will be resistance to it. It will even have direct and indirect consequences on public finances. But at a time when many companies in Europe lack the will rather than the means to invest, we think that this is the right approach to follow.

Third, the EU (especially continental Europe) should accelerate the transition from a bank-based and credit-based economy to a market-based and equity-based economy. This transformation is necessary, because Europe's credit-based system is not commensurate with its needs in terms of fostering the emergence of a new growth model. In the long term, it should result from financial regulation initiatives already taken in the name of financial stability, such as the requirement that banks post much more capital when taking risk on their balance sheet. Disintermediation and market financing are bound to develop and transform the European

financial landscape. However, public involvement is required in the interim period because households still show a strong preference for bank-based savings and because markets do not yet provide a full substitute to bank lending. This is what justifies temporary public-sector involvement and risk-sharing with the private sector. This risk-sharing should not take the form of subsidised loans, but rather of joint public-private equity investment and of support to long-term investment through the setting up of risk-absorption mechanisms.

Fourth, financial fragmentation in the euro area must be reversed, not only contained. Credit conditions still differ between northern and southern countries. More fundamentally, cross-border credit flows of the sort seen in the 2000s cannot be expected to finance the necessary rebound of investment in southern Europe. Credit excesses have been instrumental in creating the fragilities at the origin of the euro crisis. Had southern Europe been financed by equity flows from the north, it would not have suffered the same boom-and-bust cycle. External debt in several countries is already too high for them to take on further credit, yet to expect them to finance the rebuilding of their economy entirely out of their own savings would be to deny the very purpose of forming a monetary union. Northern European savings should flow again to the south and contribute to a southern revival, but in the form of direct investment and portfolio equity flows rather than debt flows.

Fifth, additional money is needed for public investment. Public capital spending has been severely curtailed. This is particularly the case in Germany, at the euro-area level, and in those countries most affected by the crisis, but clearly not in France.

Against this background we would suggest the following broad directions:

- Improve the overall predictability of regulatory frameworks at the EU level. The new Commission should consider the establishment of forward-looking regulatory frameworks as one of its major priorities. Furthermore, adopt the principle of fast-track national procedures for selected priority investment programmes at the EU level. Major investments are currently hindered by excessively lengthy procedures and disputes. A collective commitment to shortening these delays for programmes of general European interest would help to accelerate an increase in investment.
- Build on the climate agreement reached in October to set an ambitious medium-term corridor for the price of carbon and ensure that national taxes and regulations are consistent with it. This would send a strong signal that carbon-inefficient equipment should be discarded and replaced by more efficient capital.
- Go beyond the single market in selected sectors, following the banking-union template. As discussed in more detail in the third part of this report, we can think of several sectors in which this new model could be implemented, including energy and the digital economy.

We discuss more specific initiatives in the following sections.

2.3 Investments in Germany

The current overall investment gap in Germany is estimated by the DIW Institute at around €75bn (or 3% of GDP) per year, with the accumulated amount between 1999 – 2012 reaching about 1tn EUR (or 40% of GDP). By far the largest part of this gap is due to a lack of private investment, but public investment is also low, especially when compared to other countries: even in 2013, after many other countries had cut spending, the share of public investment in GDP was two-thirds of a percentage point (€16bn) below the EU average.

We consider the lack of investment in Germany to have four primary sources:

- There is a lack of private investment due to regulatory and political barriers as well as policy uncertainty. This is most striking in the energy sector, where nearly all investments are private. The current investment gap in the energy sector is estimated by the DIW Institute at around 30bn EUR per year. Barriers are regulatory and legal: grid investment is blocked by difficult and lengthy procedures. Barriers are also policy-related: uncertainty over the future of the German *Energiewende* and the management by the EU of the ETS and the resulting carbon price makes it difficult for companies to calculate return on investments.
- There is a lack of public investment due to the important and successful fiscal consolidation that led to the “debt brake”, which constitutionally limits federal structural deficits to 0.35% of GDP beginning in 2016.
- There is a lack of public investment due to the coordination failures between the three main layers of governance in Germany: the federal level, the *Länder*-level and the level of municipalities. Around 60% of public investments are carried out at the local level, yet municipalities’ fiscal flexibility has been limited for a number of years by a combination of low local-tax income in the context of the crisis and overall rising social-security expenditures. Germany has had tremendous difficulties constructing its fiscal environment in such a way as to allow investments.
- Finally, Germany still has not identified education as a key investment area. While private investment in research and development has significantly increased in recent years and is now slightly above OECD average, the level of education investment is still among the OECD’s lowest. While this can be attributed at least partly to the high share of vocational training in Germany, under which companies indirectly contribute to education and training expenditure, it is still striking that public and private investment in education has languished.

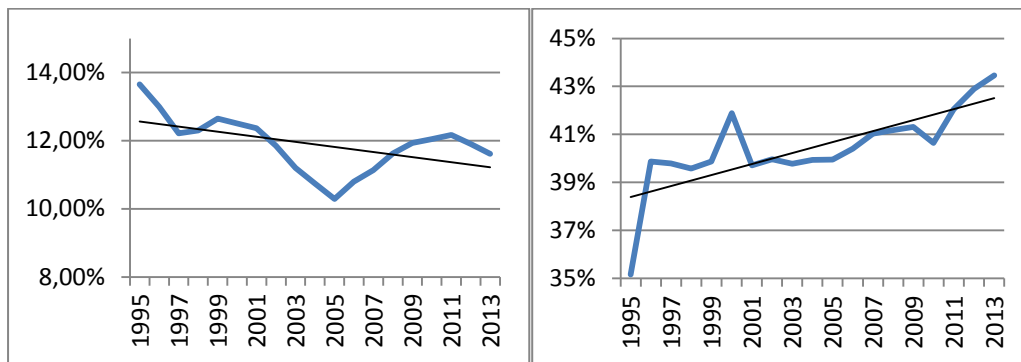
We propose to address the German investment gap through two institutional innovations, one focusing on the level of public investment, the other focusing on how to attract private savings to close the investment gap.

Proposal D1: A minimum threshold for net public investments (“Mindestdrehzahl für Investitionen”)

The current priority list underlying Germany public finances seems to include, in order of decreasing importance: (i) debt reduction, (ii) public consumption and (iii) investments. Given the demographic constraints Germany is facing, debt reduction indeed needs to be given the highest priority, and rightly enjoys constitutionally enshrined status. But in recent years, the focus on deficit reduction with the aim of reducing debt has had a direct impact on investment, and to a much lesser extent on public consumption.

The two following graphs show gross public capital formation as a percentage of general government expenditure and final government consumption as a percentage of general government consumption.

Figure 4: Gross public capital formation (left) and final consumption (right) as percent of general government expenditure



Source: AMECO

We propose a rule that would oblige the German government to adopt a consistent balance-sheet approach to public finances, looking at both the asset and liability sides. Bringing down public debt at the expense of investments is a highly time-inconsistent approach that violates the basic principles of intergenerational justice. Passing on a worn-down house to future generations is not a responsible way of managing wealth. The German public sector (federal level, *Länder*, and municipalities) should at the very least oblige itself to preserve the value of public assets (transport infrastructure, digital infrastructure, public utilities), in this way keeping net public capital formation positive. At the same time, the government should identify key areas of public investment and commit to increased investments in the upcoming three years.

- Our specific proposal is that Germany should introduce a minimum threshold for investments (“*Mindestdrehzahl für Investitionen*”). Such a minimum threshold, which could be set on the basis of net or gross capital formation, should ensure that there will be no further reduction in the value of German public assets. Our proposal would not be in contradiction to or competition with the debt brake. The constitutional debt brake sets a maximum threshold for the aggregate deficit of the German budget, but does not

say anything with regard to spending composition. The “*Mindestdrehzahl für Investitionen*” would focus only on this composition.

- As this minimum threshold would only forestall any further depreciation of assets, and would thus be future oriented, Germany should also identify ways to correct past investment shortfalls. To complement the minimum threshold, there should be numerical targets for a five-year period in areas where additional public investment is most urgently needed, such as infrastructure (“investment accelerators” or “*Investitionsbeschleuniger*”).

These two targets could well be met without coming into conflict with the *Schuldenbremse* (debt brake). According to latest official projections, the structural budget balance for 2014 will be a surplus of about 0.7% of GDP.⁹ The debt-brake deficit ceiling, which will only become binding in 2016, is 0.35% of GDP. Even making room for potentially negative surprises in 2015, there is therefore ample room for manoeuvre within the constitutional limits.

As German public-investment levels derive from federal, *Länder* and local spending choices, there should be a framework agreement between those three levels to ensure that the minimum threshold for investments and the investment accelerators can be implemented.

Proposal D2: A multilevel financing fund to steer German investment to the right targets

Around 60% of all German public investments are carried out at the municipal level. However, municipalities have adapted their investment plans to reflect tightened resource constraints related to sluggish growth and lower local-tax income, as well as increased social expenditure (which is largely channeled through municipal budgets). Today, many German municipalities are highly or even excessively indebted, and do not have the financial flexibility to make investments. In addition, there is little scope for coordinated and cost-effective investment by groups of municipalities in projects that would allow economies of scale.

Against this background, we suggest the following:

- The creation of a five-year multilevel fund for priority projects at the municipal level (“*Zukunftsfond Deutschland*”). This fund would bring together the federal level, the *Länder* and municipalities. The objectives of the fund would be to create institutional capacity that ensures the right projects will be chosen for financing, and to assess whether these projects are suitable for public-private co-financing. In addition, such a fund could contribute to lower transaction costs by assisting with project management, and also by enabling links with similar projects in the tendering process and in the course of implementation.
- We suggest a progressive ramping up, beginning as a largely publicly financed fund during the first years, and an evolution towards a public-private model in the medium to longer term. During the build-up phase, in the years 2015 – 2017, the fund’s financing would mainly be based on direct capital injection from the federal government (and possibly also the *Länder*). This would allow the most important investment projects, many of which have been delayed in recent years, to be swiftly implemented. In parallel, the medium-term

⁹ 0.6% according to the European Commission and 0.8% according to the Ministry of Finance.

function of the fund would be developed through a shift towards a full public-private model, under which public guarantees would be used to attract private financing.

- The medium-term functions of the fund would thus be to:
 - Help public authorities identify and structure good projects for private co-financing.
 - Reduce transaction costs (such as the costs involved in due diligence and in writing a contract) for private-sector finance.
 - Coordinate private-sector co-financing (by banks, insurance companies or infrastructure funds).
 - Develop new, equity-like financial instruments.
 - Through its balance sheet, diversify risk.
 - Attract a pool of public savers (by issuing debt, equity or hybrid securities) that might not ordinarily be attracted to infrastructure. Instruments serving this purpose could include a capital buffer provided upfront by the government, or general public guarantees that could limit the downside risks to savers, in particular small savers.

Together, the two proposals on investment in Germany (the minimum threshold and the multilevel financing fund) should mobilise additional public resources. Indeed, given the current investment-flow shortfall and the gap accumulated over the last decade, Germany should undertake a sustained effort to modernise its public capital stock. We consider that an appropriate target for the next three years would be an additional public investment effort of €8 bn per year, or €24 bn over the 2015 – 2017 period,¹⁰ amounting to half the gap with the rest of the EU. As the budget for 2015 is already being adopted, the sums would have to be proportionally higher in 2016 or 2017 unless a supplementary budget for 2015 became necessary in the context of rapidly declining growth. In the short term, the existing room for manoeuvre within the debt brake would allow the envisaged increase. In the medium term, supplementary investment would need to be financed by a reallocation of public spending or additional taxation.

2.4 Investments in France

In comparison to other European countries, France does not suffer from an acute aggregate investment shortfall. Business non-residential investment has remained at a relatively high level in comparison to other European countries, including Germany. Public capital expenditures amounted in 2013 to 3% of GDP, twice the German level and almost a full percentage point above the EU average. They have not been cut significantly in recent years.

The allocation of investment efforts, however, is an area for improvement.

On the private side, manufacturing and more generally the traded-goods sector suffer from having invested insufficiently in product innovation and the modernisation of production equipment. The relatively low number of robots in use in manufacturing production is a frequently mentioned indicator of a broader phenomenon. As a consequence, many firms that

¹⁰ This sum already takes into account the sum of €10 bn proposed by Germany's minister of finance for the 2016 – 2018 period. As we focus on 2015 – 2017, our overall proposed sum of €24 bn is lowered by €6.6 bn from the newly proposed amounts.

are heavily exposed to international competition struggle to compete in a very demanding environment. A priority for the French economy is to reallocate physical, intangible and human capital towards the traded-goods sector. Tax incentives have been put in place in recent years to favour R&D and equipment investment. What is needed in the next few years is to ensure the stability of the existing schemes.

Housing investment is a cause for concern. In spite of significant public support, construction investment is at a relatively low level. The situation in the sector perfectly illustrates the point made in the previous section about the quality and the predictability of public regulation. Distorted incentives and inadequate regulation have resulted in a curtailment of housing investment.

As regards public investment, the renovation of existing equipment and the extension of infrastructure in densely populated areas have not been given enough priority in comparison to new flagship projects. Public research investment has been criticised for excessive rigidity in the allocation of resources. The *Programme Investissements d'Avenir* has successfully contributed to fostering high-quality central-government investment in education, research and innovation, but overall, public investment is not sufficiently targeted towards projects that yield the largest social returns.

Selectivity in the allocation of investment efforts will increasingly become an issue in the context of the reduction of public expenditures. Central government grants to regional and local governments are to be cut by half a percentage point of GDP in 2015 - 2017 in comparison to past trends, and it is to be expected that investment will bear part of this burden. Systematic project evaluation will need to be given priority to improve the quality and efficiency of public investment.

2.5 Investments in Europe

Investment levels in the euro area have declined in recent years to levels below 20% of GDP. This is not a sustainable level. The pledge by the new president of the European Commission, Jean Claude Juncker, to create a €300 bn investment initiative is based on a similar assessment.

We believe Germany and France should contribute to a European financial initiative to complement the regulatory initiatives at the European level and the national strategies discussed above. Specifically, we suggest the creation of two targeted funds at the European level to (i) attract more private investment and (ii) facilitate better public investment.

Proposal E1: Private investment booster

The aim of the first vehicle would be to address insufficient risk-taking by private capital. We discussed in detail above the reasons underlying that insufficiency and the potentially powerful role of regulatory initiative.

But we also believe that regulatory improvements alone are unlikely to generate private levels of investment sufficient to fill the investment gaps in Europe soon enough. First, because regulatory changes will take time, and because in particularly policy-sensitive sectors such as energy, digital infrastructure, and transportation, regulatory changes alone are unlikely to fully

eliminate the risk of possible future policy reversals affecting future revenue flows. Second, because in the context that we have described, there is an aggregate shortfall both of available equity and risk-taking in Europe, particularly but not only for the financing of cross-border investment.

For this reason, we support the idea of creating a fund that would boost private investment by participating in risk-taking, investing in equity, and helping to cover the risk of policy reversals.

Several proposals for such a fund are already being discussed, and at the time of writing, new input is expected from the European Commission. Instead of adding a new variant of our own, we wish to list the seven requirements that any such initiative should fulfil in order to be useful in the current context.

- First, the fund should be able to acquire genuine equity in companies and projects alongside private investors. As demonstrated by the European Bank for Reconstruction and Development or the Israeli experience with innovation financing, public-private co-financing has proved to be an effective way to incentivise risk-taking, provided incentives are properly aligned and rules for engagement imply that public funds do not end up supporting low- or negative-return investments.
- Second, the fund should be able to participate in the financing of long-term infrastructure investment by taking, depending on the nature and projects, an active or less active risk-bearing financial role. The fund should for example be able to invest in the risk-absorbing tranches of appropriately designed “incentive bonds” (with further tranches being subscribed by EU national development banks and the European Investment Bank, while private tranches with different levels of seniority could be created). This would contribute to align incentives so that the mere participation of relevant public entities in the financing would offer a guarantee against the risk of policy reversals. Alternatively, the fund should be able to participate in risk absorption alongside other investors, for example by subscribing to a mezzanine tranche. This would for example be the case for projects of demonstrated social value but less dependent on public regulation.
- Third, to the extent possible, the fund should aim at decoupling business risk from country risk. The high degree of correlation between these two risks observed in recent years is a significant obstacle to the development of promising companies and is a violation of the single-market concept. The fund should help revive cross-border equity financing and merit-based venture selection irrespective of location.

To fulfil these ends, the fund should have a diversified capital structure, possibly involving EU institutions, individual Member States, national development banks and private investors. EU public capital could be provided through existing budgetary resources, including leftovers from the structural funds and available financing capacity through the EFSM. Participation of all EU members would be desirable but not indispensable. As was done for the EFSF, the structure should be flexible enough to make it possible to start with a subset of member states only.

Member-state capital contributions could draw on the experience of the European Stability Mechanism and the European Financial Stability Facility. Part of the capital would be paid in

directly, and the rest payable upon request. All willing member states could participate, as their capital contribution would affect their debt but not their deficit. States could also jointly guarantee (within preset limits) bonds issued by the Fund, as was done for the EFSF.

This fund should be set up as a new entity, but could be linked to an existing structure, presumably the EIB group. Its corporate governance should be based on the shareholding structure.

The effectiveness of the fund should not be primarily assessed on the basis of its total expected balance sheet and estimated leverage ratios. Leverage should be determined on a project basis, and the fund's contribution should be assessed on the basis of the additional investment that it is able to trigger rather than the total investment it is able to finance.

Calibration of the size of the fund should be done on the basis of cautious leveraging assumptions. We believe that to mobilise sufficient private capital, €20 bn should be brought in by EU institutions, and an additional €30 bn by individual Member States and national development banks.

Proposal E2: Public investment booster

Countries with sufficient financial flexibility can use that flexibility for additional public investment. However, the overall fiscal flexibility in euro-area countries is today strictly limited. Furthermore, some countries have undergone severe public-investment cutbacks, including in high-priority sectors such as education and health care.

With the European Stability Mechanism (ESM), Europe has created a new instrument to assist countries in trouble. But ESM loans provide support to euro-area governments facing market-access difficulties. Neither they nor other forms of loans would be of any help to a government wanting to contain its indebtedness. The EU does provide grants within the framework of the Structural Funds. However they are specifically intended to foster regional convergence. We therefore suggest creating a fund at the European level to provide grants to euro-area Member States. The rationale for limiting it to euro-area members is that they are subject to an enforceable prohibition against excessive deficits.

The fund would be financed in the form of grants from Member States according to the capital key in the form of either (i) paid-in capital, (ii) unused structural funds from the 2007 – 2013 period, or (iii) committed capital in form of earmarked tax revenue to be paid back over a 10-year time period (calculated as net present value for the purpose of the capital key). The type of contribution chosen would presumably depend on the degree of fiscal flexibility in the member state and the existing level of unused structural funds.

The fund would be allowed to borrow, but only to bridge the gap between directly paid-in capital and committed tax revenue. The corresponding debt would be severally guaranteed by each member state up to an agreed ceiling.

The fund could be a private-sector association as a first step (comparable to the European Financial Stability Facility, EFSF). It could later be transformed into a treaty-based institution. Membership would be open to all willing and interested Member States. Voting rights would be based on the capital key. Governance should ensure flexibility and speed in the implementation of agreed programmes.

The fund would give out three types of grants (each accounting for one-third of total distributions):

1) Target grants (grants dedicated to common aims, with *juste retour*)

These grants would be allocated to Member States on the basis of the capital key (*juste retour*), and would therefore not involve any redistribution, but would be dedicated to spending in specific commonly agreed areas (e.g., education, transport infrastructure, etc.) and in support of commonly agreed aims. The purpose of those target grants would be to ensure that certain amounts of public spending are channeled towards investment projects, thereby creating incentives for governments to keep future-oriented spending at the right levels even in times of fiscal consolidation. Access to some of the target-grant programmes could be made conditional on the fulfilment of certain criteria ensuring spending effectiveness. For example, a programme could be dedicated to providing endowments to public universities, but access to it could be made conditional on university governance and autonomy criteria.

2) Solidarity grants (conditional grants for purposes consistent with common aims, no *juste retour*)

Those grants would target high-priority investments in countries where strained public finances jeopardise essential investments in top-priority areas. For example, they could finance the purchase of medical equipment for hospitals in countries under Troika programmes. Access could be made conditional on the implementation of high-priority reforms (for example, with regard to the organisation of hospital services).

3) Excellence grants (unconditional grants, allocated by tender procedure)

Those grants would be devoted to supporting specific projects contributing to the enhancement of the euro area's growth and innovation potential. They would be allocated on the basis of merit only, without a predetermined country key. The evaluation would be carried out by expert groups involving a minimum share of non-EU citizens, and a key assessment criterion would be large positive externalities for the other participating countries. Projects by several countries could also be funded. The scope for different types of projects would be very large.

Public investment in the euro area amounted to €200 bn in 2013, about 15% below its pre-crisis level in volume terms. We suggest calibrating the size of the fund in order to enable it to increase public investment by 5% or €42 bn over three years. About one-fourth of the total could be financed by unused structural funds, and the rest by contributions from the euro-area Member States.

3. An economic Schengen agreement

France and Germany have a leading role within the euro area and the EU, but they should not limit their cooperation to these reimits. They should also strengthen their bilateral relations and launch initiatives that other EU countries may join.

Nearly thirty years ago, the Schengen agreement was signed by five of the then 10 EU Member States. It now has legal EU status and comprises 26 countries, among which 22 are EU members; however, the United Kingdom and Ireland have never joined. The initiative has proved instrumental in fostering cooperation and coalescing efforts in a field where there was and still is no overall EU agreement.

Making use of the flexibilities offered by EU treaties, this concept should serve as a template for initiatives in which France, Germany and other Member States want to go beyond EU integration and policies.

We believe France and Germany should take the initiative on such projects, and we see scope for action at two levels. First, there are sectors where the very concept of national borders looks somewhat outdated. In those sectors, joint regulatory and political efforts should be started today. We call these “borderless sectors”. Second, there are areas where the political and societal choices of two neighbouring countries as closely connected as France and Germany should be under constant mutual scrutiny (“regards croisés”), and should progressively lead to common choices in what we label “convergence areas”.

3.1 Borderless sectors

Economic integration remains one of Europe’s major assets. Market size matters, and no producer worldwide can afford to ignore European preferences. Whenever the EU introduces new technical standards, global suppliers comply. Contrary to popular perception, regulatory competition has often resulted in a “race to the top” (i.e., to Europe’s standards) rather than to the bottom. This is why the EU has been dubbed “the world’s regulator”.¹¹

However, the single market has lost some of its traction. When it was launched three decades ago, the belief was that the removal of non-tariff barriers to trade would create a unified market similar to national ones. Its achievements notwithstanding, this has not happened: legal, regulatory and tax barriers, as well as existing national networks, have prevented the advent of truly pan-European markets. EU directives leave considerable room for discretion at the national level. Fragmentation still prevails, and this is often an obstacle to the emergence of world-class European companies. Furthermore, disagreements between Member States over the direction of reform often result in a considerable status-quo bias, which is severely detrimental in sectors affected by rapid technical change.

The financial crisis highlighted the limits of the single market, as capital flew back behind national borders and regulators discouraged banks from cross-border lending. The event suddenly made clear that what had been deemed a deep integration process was in fact rather

¹¹ Wall Street Journal, 31 March 2006.

shallow and fragile. But in June 2012, the euro-area leaders forged a new concept: banking union. To dismantle the prevailing ring-fencing, they introduced a single supervisor and an integrated resolution mechanism for banks. This is one of the most important examples of “positive integration”, in the sense of political agreement on commonly defined rules and EU-level regulatory objectives (as opposed to “negative integration”, which refers to lowering barriers and defining a lowest common denominator).

We suggest that France and Germany build on this experience and aim for deepened positive integration in a few industries of strategic importance in which regulatory borders severely constrain economic activities and yet large positive effects for all participating countries are likely to result from common regulatory approach. We call those “borderless sectors”, and encourage France and Germany to (i) identify the most important of them, (ii) go so far as to implement common legislation, a common regulatory rulebook and even a common regulator. Consistency with EU law and initiatives would obviously be required, and other EU countries could join, but France and Germany would proceed at their own speed.

Without any pretence to completeness, we suggest three initiatives of this type here, two in the economic field and one in the labour-market field.

3.1.1 Energy

The single market for energy has not fulfilled its promises. Inadequate market design, evolving technologies, new threats, persistent physical constraints and divergent preferences have given rise to a combination of acute fragmentation and deep integration. France and Germany in particular have partially diverged, most visibly in their energy mixes, while at the same time remaining strongly linked by their participation in a common electricity market. However, short-term price signals in the common electricity market no longer provide incentives sufficient to trigger long-term investment. In the absence of capacity mechanisms, intermittent oversupply has driven wholesale electricity prices into low or even negative territory, making some of the most carbon-efficient gas-fired plants unprofitable. Carbon prices are also abnormally low because the 2020 objectives were set at the EU level before the impact of the Great Recession was felt, and were not revised in the light of subsequent economic developments.

Partial integration has produced the worst of both worlds: a common market that does not provide incentives to invest in the development of clean technologies.

A first priority in a joint French-German plan would be to build a new and common vision of a future electricity system that would include a large proportion of renewable energies characterised by intermittency, a high capital expenditure and zero marginal cost. Furthermore, as a significant portion of these new energy-producing technologies are not yet profitable, they must at least temporarily be subsidised without distorting markets.

A promising way to exit this impasse is to create capacity mechanisms to ensure that producers are given the right incentives to invest. But the EU is not the right scale at which to institute these mechanisms, because of its physical fragmentation into regional submarkets. Furthermore, there is no EU-wide agreement on the concept of a capacity market. The right

scale would rather correspond to groupings of neighbouring countries that share a common network.

France and Germany have different perspectives on this issue today. France is more concerned by the need to cover winter peak hours, while Germany's priority is providing a backup for the use of renewable energies. But these differences do not diminish the two countries' interdependence, and are indeed no wider than was the case for banking union. They can be overcome.

The challenge for the future is to devise an EU-wide regulation that sets common ground rules for the security of supply; an EU-wide Emission Trading Scheme (ETS) whose operation sets a credible common price for carbon, thereby ensuring a climate-friendly energy transition; regional capacity mechanisms that provide appropriate long-term investment incentives; and national policies that may differ from one another with regard to energy-mix preferences.

Within the context of a continued effort to enhance the EU-wide common framework, France, Germany and other countries belonging to the same regional grouping (e.g., the Pentalateral Forum that was formed on the initiative of France and Germany together with the Benelux countries) should move forward, and within the next three years (i) agree on a common approach to a joint-capacity mechanism; (ii) agree on a common rulebook regarding the promotion and advancement of renewable energies; (iii) agree on a common rulebook on fostering energy efficiency.

France and Germany should also pool their expertise on the decommissioning of nuclear plants and share research and implementation efforts.

3.1.2 The digital economy

The digital economy is "borderless" almost by definition. While the digital sector is not a sector as such (today, all areas of value creation in the economy have become digitalised in one way or another), regulatory efforts on digital issues need to follow the rules of what we call "borderless sectors".

Joint Franco-German action is of the essence in this field. Of the ten largest internet companies by revenue, six are U.S.-based, three Chinese and one Japanese. In the electronics, hardware, software and semiconductor sectors, the picture is little different, even if exceptions such as SAP and STMicroelectronics do exist. Europe is clearly not as visible as it should be in the global digital revolution. However, this revolution is bringing far-reaching challenges to value creation in Europe. Global industrial leadership today requires totally different priorities than in the past. For example, patents on software are today often more valuable to car companies than are patents on engines. In addition, the European services industries increasingly face the risk of lagging behind global competitors and of being deprived by digital newcomers of the most profitable segments of their business. While consumers benefit from further competition and the introduction of new business model, it is important to ensure that European players take part in this global restructuring

It is also essential that key European public-policy priorities be preserved. Common regulatory approaches are of particular importance in areas such as business-data security, copyright,

privacy protection, the human “right to be forgotten”, consumer protection in digital transactions, taxation issues related to digital transactions, and standards-setting. On these matters, Europe, the United States and other global players do not necessarily share the same values or priorities.

For these tasks, countries like Germany and France individually are simply too small. Scale matters enormously in the digital world, and even a mid-sized national market is too narrow for key national players to reach global relevance fast enough. Even the best innovators with the best projects cannot grow fast enough to compete with rivals whose products have been nurtured on a market five times bigger. It is therefore important to create larger markets with no regulatory borders. Moreover, the European market is large: Europe is the largest market for Google, Facebook, Amazon and Apple. All four companies have higher turnover in Europe than in the United States.

We therefore call for France and Germany to start an initiative focusing on the creation of a common digital strategy based on a common regulatory approach.

In addition, there should be a coordinated approach towards the development of next-generation mobile networks (5G), the further development of positioning systems, and big-data collection and storage.

3.1.3 Professional development, qualification and education

In the European Union, the right of free movement of people is part of the four core freedoms. At the same time, that de jure right is limited de facto by numerous regulatory barriers and/or the absence of joint regulatory rulebooks.

We are aware that moving towards a de facto right of free movement at the level of the EU-28 could be a very difficult political exercise. However, France, Germany and other countries willing to join such an endeavour would gain significantly from the reduction of national barriers in the labour market, education, the recognition of qualifications, and professional development.

For this reason, we suggest that France and Germany move forward with other like-minded countries to create a borderless space in which full mobility is guaranteed in the following areas.

- Qualifications: France and Germany should strike a joint framework agreement on the full de jure and de facto recognition of professional qualifications and degrees across borders. We are aware that legal recognition is already today possible in most areas, but immense limitations in implementation remain.
- Benefits: France and Germany should strike a joint framework agreement on the full transportability across borders of all legal rights and benefits related to labour mobility, in particular (i) health insurance, (ii) pension rights, (iii) unemployment benefits and (iv) vocational training rights. This does not imply that the two countries will have to merge their systems, but a German citizen working in France should automatically (i.e.,

without any cumbersome legal or administrative procedure) be able to move back to Germany and fully keep his or her rights.

- Stipends: France and Germany are still considered to be “foreign countries” in the area of education and research stipends. We recommend changing that status with regard to the portability of stipends and grants. However, this should not imply that the additional benefits from moving to the other country would disappear.
- In view of current labour-market conditions, we propose to commit to making it possible for a French high-school student or a young French job-seeker to obtain enough support to cover the costs of an apprenticeship and a first professional experience in Germany. Interested governments should agree on the principles of a scheme able to foster youth mobility on a massive scale, and agree on appropriate cost-sharing mechanisms.

3.1.4 Other “borderless sectors”

Other possible fields where the “borderless” approach could be applied include:

- The health sector, where the procedures for drug authorisation could be unified and given automatic mutual recognition;
- The fields of biotechnology and the bioeconomy, where joint regulation could provide clarity and pave the way for rapid technical progress while taking into account societal concerns; and
- In a different context, the defence sector, where joint procurement rules and standards-setting for military equipment could lead to significant economies of scale.

We would again like to emphasise that action on “borderless sectors” involves much more than simply agreeing on coordination and joint initiatives. Indeed, we see work on joint regulation as a high priority compared to the vast array of proposals on coordination, dialogue and exchange of views, many of which are important but are clearly not sufficiently followed by effective action.

3.2 Policy-convergence initiatives

In addition to work on “borderless sectors” between France and Germany, we believe that both countries should move more seriously towards convergence in certain economic-policymaking areas over the medium term. Dialogue and joint declarations will not be sufficient to transform the Franco-German region into a true economic union. If France and Germany genuinely want to move even closer together, then they need to converge in key areas.

3.2.1 Convergence towards a common minimum-wage standard

France and Germany have traditionally been far apart with regard to the role of the government in wage formation and wage dynamics.

- In France, wage formation has been heavily influenced by legal provisions and government decisions regarding increases in the nationwide minimum wage. For at least 20 years, sector-level decisions have usually been of limited effectiveness, both because the sectoral structure has been too fragmented and because sectoral minimums essentially followed increases in the overall minimum wage.
- In Germany, sector-level agreements have traditionally played a key role, and there has been significant dispersion in the levels of sector-specific minimum wages. The government refrained from intervening in the wage formation process.

However, a process of convergence between the two countries has started as a consequence of a series of recent developments and decisions on both sides:

- In Germany, the introduction of a minimum wage is a landmark reform with major potential consequences for the country and its partners within the euro area. However, several economic sectors already have minimum wages in place that exceed the €8.50 mark.¹²
- France is seeking a reduction in the number of recognised sectors and a revitalisation of sector-level agreements. In the medium term, a possible quid pro quo could be the strengthening of sector-level wage agreements and a less dynamic evolution of the national minimum wage.¹³

In other words, France is getting closer to the German model at the same time that Germany is evolving towards the French model.

- Building on these developments and on the reforms suggested in this report, we propose that France and Germany set themselves the goal of converging towards a common minimum-wage standard and common minimum-wage evolution principles over a 10-year horizon.

We do not propose complete harmonisation, because tax environments differ and because some degree of flexibility should be retained as long as labour-market integration remains incomplete. Nor do we propose the harmonisation of sector-level minimum standards, because their economic conditions can differ significantly across borders. But we think that a high degree of minimum-wage convergence is achievable.

There would be two main advantages to this:

¹² On 1 October 2014, according to Destatis, sector-specific minimum wages varied between €7.50 and €13.95 per hour.

¹³ This direction has been proposed in the France Stratégie report *Quelle France dans dix ans?* (2014).

- It would set a common standard for what countries of similar development levels and with similar social preferences consider decent minimum hourly earnings for a working person.
- It would help avoid macroeconomic divergence of the sort observed in the euro area during its first decade.
- It would limit excessive downward pressure on low wages.

However, this outlook raises a series of questions that would have to be explored jointly.

- *Levels.* On 1 January 2015, after the German *Mindestlohn* is introduced and new social-security contribution cuts are implemented in France, the hourly cost of minimum-wage labour will likely be lower in Germany than in France. What would the right level or range for convergence be?
- *Link to social-subsistence minimums and in-work benefits:* An important concern in setting the right minimum-wage level is the question of how it compares to social-subsistence minimums, thus providing incentives to work, also taking into account the existence of in-work benefits.
- *Coverage:* Germany's legislation includes more exceptions to the minimum wage (including for employees under 18 years of age) than does France's.
- *Indexation rules:* France has statutory indexation rules in place, but the German *Mindestlohn* does not. How could this issue be reformed in both countries? Should the basis for deciding on wage evolution be euro-area-wide inflation or aggregate inflation in France and Germany?
- *Collective agreements:* Would French and German sector-level negotiation practices converge? If not, what would be the consequences?
- *Other euro-area countries:* France and Germany have similar development levels, but there is wide dispersion of GDP per capita within the euro area. What would be the consequences of convergence between the two main euro-area members?

We propose that the two governments task a binational committee composed of government representatives, independent experts and social partners to explore and report on the feasibility of minimum-wage convergence between France and Germany.

3.2.2 Convergence in labour-market policies

Beyond the specific challenge of the minimum wage, France and Germany need to work towards convergence in several other areas of labour-market policy. We see at least five core areas where common rules and practices could be developed jointly in the medium term.

- *Improvement of the low-wage sector:* Both countries face very similar problems in dealing with the challenges of (i) keeping the tax wedge and social-security contributions associated with low wages as low as possible; (ii) maintaining levels of benefit rights associated with such jobs capable both of preventing poverty at retirement and unemployment, (iii) retaining incentives sufficient to take up low-paid jobs. In Germany, one key problem today is the absence of progressive rates on social-security contributions on lower-paid jobs. In France, reduced-rate employers' social-security contributions are costly, but their employment effects are positive. Finding a converged approach in both countries should be the medium-term objective.
- *Active labour-market policies:* Providing adequate professional training is a key challenge for both the French and the German labour agencies in the context of rapidly changing job profiles. We recommend the development of a common strategy, and ultimately a move towards converging strategies and implementation.
- *Vocational training* is often mentioned as a key component of the current successes of the German economy. While we do not think the German model can be easily exported, we do believe important lessons can be drawn from the way the German model combines schooling and training. At the same time, Germany can certainly draw lessons from France with regard to increasing access to tertiary education for younger people, making its system more permeable ("Durchlässigkeit"). As discussed above, France should implement further reforms improving the quality of and access to training. As a second step, France and Germany should then develop a convergent approach with regard to the transition between schooling, training and first jobs.

3.2.3 Convergence towards comparable retirement provisions

France and Germany have both undergone intense political debates on whether and how to adjust the retirement age to increasing life expectancies while simultaneously honouring past political commitments, accounting for current financial concerns and fully respecting the fundamental principles of intergenerational justice.

Debates in both countries have been similar in the sense that they often focus on headline retirement-age figures and thus tend to oversimplify a complex social reality. In fact, retirement in both countries is based on a complex interplay between minimum retirement age and acquired pension rights. There is also a persistence of sector-specific regimes that present an obstacle to interprofessional mobility.

We believe both countries should strive to simplify their retirement policies significantly over the medium term, and should agree on a common strategy in this respect.

3.2.4 Education

In the words of the late Jan Tinbergen, inequality is a race between education and technology. Against the background of the rise of rapidly changing technologies, robots and the challenges of highly targeted education offensives outside Europe, neither France, Germany nor Europe in general are investing enough in education and lifelong learning. In both countries, about a sixth

of each age cohort struggles at school and enters the labour market without proper training. At the same time, education is on the verge of being transformed by digital technologies. Universal access to high-quality education is the key to building an inclusive society for the future.

We do not recommend a convergence of schooling systems in France and Germany. Existing differences are too large and reflect deeply embedded cultural traditions and societal choices. However, France and Germany need to develop converging strategies on how to train young generations, how to bring the digital revolution into classrooms and how to ensure every young person gets the best training available.

Education is far and away the best engine for driving growth rates up, ensuring equality and thus contributing to social justice. Both countries suffer from a lack of intergenerational justice by putting too little emphasis on providing schooling and training to every single youth in their countries, regardless of social and geographical origin. We therefore would like to conclude our recommendations with a call for both France and Germany to finally take the education challenge more seriously. We do not want to make specific proposals on how the two systems might be improved. But improvements in education might well result in the single biggest effect on the improvement of well-being in the French and German societies of the future.

CONCLUSION

This report has put the focus on priorities. Still, our list of recommendations is long. This shows how much action is required.

Nothing in our proposals is radical. We do not propose a revolution in economic policy. We do not call for a makeover of the social model. We neither suggest the building of a European state nor the dismantling of the EU. The steps that we are proposing are concrete and feasible.

Time is of the essence. France and Germany need to act now. And they need to act together. The biggest danger we see right now is a period of window dressing (*“faux semblant”*) where lip service is paid to grand projects and reforms, but no real steps are taken. In 2017, there will be elections in both countries. This means that 2015 is the crucial year for joint reform and investment.

Europe cannot afford to disappoint again, neither economically nor politically. France and Germany cannot afford not to lead. And they need to lead first and foremost by example. As a new team has taken charge at the European level, the opportunity for action should not be missed.