

A differing opinion

124. Two members of the Council, Isabel Schnabel and Achim Truger, cannot fully endorse the majority position of the German Council of Economic Experts on the fiscal policy implications of the diagnosis of the current economic state. The **dissenting view** concerns the assessment of the possible **design of a discretionary countercyclical fiscal policy** in the event the economy were to further slow its pace. The question of the debt brake as a potential limitation of automatic stabilisers is discussed elsewhere. ↘ ITEM 574
125. Although no economy-wide recession can yet be diagnosed, the **risk of such a recession has noticeably increased** – to around 36 % according to the estimates of the German Council of Economic Experts. It is even considerably higher by other estimates. ↘ ITEM 87 First signs of the slowdown spilling over to services and the labour market are already visible. It would therefore make sense for fiscal policymakers at federal, state and local level to jointly **identify the existing scope for countercyclical measures** within the framework of the debt brake so that these can be implemented in time if necessary.
126. While the problems of discretionary countercyclical fiscal policy described by the majority are certainly significant, the **problems** of such measures should be **weighed against their benefits** in the event of a sharper economic downturn. First and foremost, temporary measures that could be swiftly implemented and thus have a targeted, markedly stabilising effect – as was the case with individual measures in the 2009 economic stimulus packages – could make sense.

Accelerated depreciation could be temporarily reintroduced as a means of sparking corporate investment to be pulled-forward. Companies could use this method of depreciation to take advantage of the opportunities afforded by Industry 4.0 or for more energy-efficient production, for instance. As there is already a marked slowdown in **corporate investment**, activating such a measure early on could make sense, in order to **achieve** the desired **pull-forward effects** and avoid a procyclical impact. Possible income transfers such as a **child bonus** would not be counted towards the basic minimum income support and could thus stimulate private consumption if current economic weakness were to affect it. **Bringing forward** the **partial abolishment of the solidarity surcharge** scheduled for 2021 or offering temporary income tax reductions would also be conceivable measures. Finally, specific measures such as premiums for low-emission cars could be considered.

127. Despite its particularly high multiplier, **public investment is less suitable as an instrument of business cycle policy** because of the long lead time in implementation. This is true at least as long as the Federal Government and the Länder do not have a ready stock of investment projects the implementation of which can be pulled forward. Nevertheless, a **longer-term investment strategy** could be launched in a timely manner, which could at best boost the economy as a side effect. ↘ ITEMS 575 FF.

128. **Permanent tax cuts** may make sense under some conditions. This is true regardless of the economic state, as is the case with a long-term public investment strategy. In contrast, employing permanent tax cuts **as a discretionary countercyclical policy instrument** ^{↘ ITEMS 121 F.} is **questionable** at least. It is doubtful that structural measures, including the creation of an appropriate general framework, can replace discretionary countercyclical fiscal policy.
129. **Timely** implementation of such measures would also be difficult. For example, lowering corporate tax would require supplementary corporate tax measures in order to avoid “distortions in the corporate taxation system” (Advisory Board to the Federal Ministry of Finance, 2019), thus rendering it a technically and politically complex task. If the solidarity surcharge were to be completely abolished, account would need to be taken of the fact that only a limited impact on consumption in high income classes could be expected. Bearing this in mind, one could ask how **targeted** such a measure would be. The structural fiscal pressure resulting from permanent tax cuts also entails **risks to public finances**. Fiscal policy could be forced to raise taxes considerably elsewhere or cut spending in order to comply with the debt brake. This could be **at the expense of urgently needed investments**. ^{↘ ITEMS 575 FF.}

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229. One member of the Council, Achim Truger, does not agree with the majority position of the GCEE on the subject of ‘Productivity: improving the conditions for growth’. His differing opinion relates to the statements on current account imbalances, some of the economic policy implications for productivity growth and the approach of looking at productivity growth almost exclusively through the lens of increasing (potential) GDP growth.
230. The majority of Council members do not regard Germany’s current account surplus as a major problem that needs to be addressed through economic policy, and consequently do not believe that a **specific value for the current account balance** is a useful target for economic and fiscal policy. They state that experience from recent crises, not least in the euro area, showed that excessive current account deficits could be accompanied by the **risk of sharp corrections**, but that this is not true to the same extent for current account surpluses. In addition, the current account balance is said to be dependent on a number of factors and is hard to influence through economic policy.
231. However, Hünnekes et al. (2019a, 2019b) argue that the **German proclivity for current account surpluses** is an **anomaly** when set in a long-term historical context. They point out that the high level of capital export that has been a virtually permanent feature of Germany’s economy since 1950 has not been good for Germany. Firstly, the **returns on German foreign capital** are considerably **lower** than the returns achieved by other economies on their exported capital. Secondly, **returns generated abroad are lower than those in Germany**, so greater capital expenditure domestically would make more sense. Thirdly, the foreign investments do not provide **effective hedging against risk**. In their summary, they say: “[...It] is [...] not about questioning German industry’s focus on exports or about curbing export volumes. It is about exploring new ways of investing the substantial German savings to produce higher private and social returns at home, instead of continually accepting substantial write-downs on foreign assets” (Hünnekes et al., 2019b).
232. But the German current account surpluses are not just a problem from an isolated national perspective. They also have a **major destabilising effect on the euro area** and the global economy. Current account surpluses and deficits need to be looked at symmetrically. As the French National Productivity Board argues, a combination of permanently relatively slow domestic economic growth and relatively low growth in unit labour costs creates **permanent pressure on partner countries**, particularly within the euro area where there is no longer an exchange rate mechanism that can be used to adjust real effective exchange rates. The resulting tendency towards substantial current account surpluses throughout the entire euro area will have two negative external effects on the member states: firstly, it will cause the euro to appreciate and create disinflationary pressure that is increasingly hard for the ECB to counter as interest rates approach or reach zero. Secondly, the current account surpluses in individual

member states within the eurozone could lead to trade policy conflicts – particularly during the administration of US president Donald Trump (Conseil National de Productivité, 2019, pages 109 ff.).

233. The IMF (2019) also concludes in its **external balance assessment**, which calculates internationally compatible current account balances in medium-term equilibrium, that in 2018, Germany had an equilibrium current account surplus of 2.5 % of GDP, while the actual surplus was 7.3 % of GDP. Accordingly, the real effective exchange rate was found to be undervalued by 13 %. The calculated equilibrium balance also includes a demographic component that the Council majority discusses as an explanatory factor for the high German surplus. However, according to the IMF, the demographic component only accounts for a surplus of less than 1 % of GDP. The majority of the Council themselves come to the conclusion that the real effective exchange rate can explain an additional two percentage points or so of the German economy's current account surplus.
234. Both the IMF and the French National Productivity Board draw the conclusion that an overly restrictive fiscal policy has contributed to the surpluses. Accordingly, a **more expansionary fiscal policy in countries that run a current account surplus** could play an important role in **countering current account imbalances**. According to the IMF (2019, pages 17 f.), within the euro area where accommodative monetary conditions remain necessary to support the return of area-wide inflation to its target, fiscal policy in key creditor economies (Germany and the Netherlands) could be used to boost potential growth through **infrastructure investments** and greater support for innovation. And in Germany, where the current account surplus is associated with rising top income inequality, further **tax relief for low-income households** could boost their disposable income and support domestic demand, while **property and inheritance tax reform** could help reduce excess saving and wealth concentration.
235. The Council majority is proposing some very specific measures to **increase productivity growth**. In some cases it is not clear how the above diagnosis and analysis has led the Council to propose these particular measures, and why and to what extent they would be capable of increasing productivity in Germany. As frequently mentioned in the text, the **productivity slowdown** is part of a **long-term global trend** affecting all developed economies. Moreover, the growth in labour productivity and total factor productivity (TFP) in **Germany** was **not particularly remarkable by international comparison**. Almost none of the rolling five-year averages are at the bottom end of the EU range; since the financial crisis (in the case of TFP) and since 2012 (labour productivity) they have even tended to be at the upper end. ↘ CHART 31
236. The causal analysis discusses a wide range of approaches, which is a very instructive exercise. However, because of the large number of views represented in the literature, including some fairly controversial ones, there is **no persuasive explanation** for the productivity paradox or the differences in the productivity growth of different economies. Such an uncertain basis is hardly appropriate for drawing **clear economic policy implications** for structural reforms in Ger-

many promising a perceptible productivity boost. If structural reforms could easily unleash productivity growth, then why does no developed economy appear to have succeeded in decoupling itself from the international downward trend in productivity growth with any of a wide variety of structural factors.

237. The majority view of the Council is that the slowdown in the rate of new business start-ups in Germany could be due to **product and labour market regulation**. Although this is decreasing, it is still said to be high by international comparison. The Council therefore believes a further reduction of market access barriers is called for, especially in the service sector. Aside from general doubts with regard to the assumed mechanisms by which this would work, many of the usual OECD indicators for **labour market regulation** (protection against dismissal, amount and duration of earnings replacement benefits, trade union density, collective pay bargaining coverage), place **Germany in the middle of the EU rankings**. The same applied in 2013 for the overall indicator for **product market regulation**, which shows a **low level of regulation** (GCEE Annual Report 2015 Chart 94). Only in the area of business services was the indicator significantly higher; here it was **at the top end of the middle of the table**. According to the OECD, the indicator for administrative hurdles to business start-ups is significantly below the OECD average.
238. The Council majority argues that deficits in the provision of private venture capital for companies in the start-up and growth phase need to be overcome. One reason for this relates to the privileged tax treatment of debt capital. The Council therefore repeats its call for its previously developed concept of **interest-rate-based tax exemption for share capital** in connection with corporation taxation. However, that would further promote the dualisation of income tax and would **violate the principle of horizontal equity**, i.e. equal tax treatment of all types of income, even more severely than the flat rate withholding tax.
239. **The interest-rate-based tax exemption for share capital** would reduce **government revenues** in the short term by between €2.8 and 5.6 billion and in the long term by between €3.5 and 7 billion, depending on the underlying imputed interest rate (GCEE Annual Report 2018 table 25). Ninety per cent of such tax relief on company profits would benefit the **top 10 % of taxpayers** (Bach and Buslei, 2017, table 3, 4). The redistribution of the tax burden from top to bottom, which has been going on since the start of the new millennium, if not before, ^{↘ ITEM 719} would thus continue. In the coalition agreement, the parties of government however agreed to **scrap flat-rate withholding tax on interest income** with the aim of creating taxation that is neutral in terms of investment decisions. If interest rates were to rise in future, this could lead to a slight rise in tax revenues. Around 60 % of the additional tax burden is likely to fall on the top 20 % of taxpayers, and would therefore be progressive (Bach and Buslei, 2017, table 3, 4).
240. The Council majority believes that an internationally competitive tax system is very important for private-sector investment activity. The **increase in international tax competition** and decreasing rates of tax on profit means that fiscal policymakers face the challenge of creating an attractive business and regula-

tory environment for private-sector investment in Germany while at the same time providing a functioning public infrastructure. The first thing to say here is that Germany does not have to simply accept international tax competition, as **Peter Bofinger** argued in his **differing opinion last year** on the fiscal policy position of the Council majority (GCEE Annual Report 2018 items 645 ff.): “Rather, Germany should do everything it can at European level to prevent **tax competition and its draining effect**.”

241. When emphasising the importance of an internationally competitive tax system for private investment activity, however, it must be borne in mind that **high quality public infrastructure** is also a key factor for private-sector capital investment. **Cuts to corporate tax rates** on the scale under discussion are **fiscally expensive**: the Advisory Board to the Federal Ministry of Finance (2019) calculates that its proposal to reduce corporation tax from 15 % to 10 % would reduce tax revenues by just under €14 billion, before taking into account any adjustments in reaction to the cuts. Unquantifiable negative effects arising from tax relief for individuals trading as a company have to be added to this sum. The complete abolition of the solidarity surcharge and introduction of the interest-rate-based tax exemption proposed by the Council majority would cost €13 to €17 billion (GCEE Annual Report 2018 items 639 ff.). This type of structural burden on the government budget poses **major risks to public finances** in view of the debt brake and the reduced tax revenues expected as a result of cyclical effects combined with a procyclical economic correction. This would make it more difficult to fund a high quality infrastructure programme.
242. The Council majority opinion does not systematically pursue explanations that try to account for the growth of TFP in part via the **long-term effects of short-term shocks** (total factor productivity hysteresis). Ball (2014), for example, examines the long-term effect of the great recession in OECD countries. Adler et al. (2017) see expansionary macroeconomic policy, in particular in the form of **public infrastructure investment**, as a means of increasing productivity growth primarily in the European countries badly affected by the financial crisis.
243. Ultimately, the approach of the majority of Council members – which examines the increase in macroeconomic productivity almost exclusively through the lens of the rise in the trend growth rate – is by no means the only possible viewpoint. **Productivity growth** does not necessarily only have to be used to increase growth – it can also be used to **reduce working hours** and thus increase **intangible prosperity** in the form of more leisure time. This is why it is problematic to use the USA’s very high per capita income as a benchmark for other economies and thus implicitly hold it up as a model. The high per capita income of the United States – particularly in comparison to Germany and France – is based not on being significantly better in terms of productivity per person hour, but first and foremost on longer working hours per worker.
244. Accordingly, the use of high productivity per person hour to enable shorter working hours for each worker in Germany can – as the Council majority also mentions – be regarded as an expression of a **greater preference for leisure ti-**

me (Blanchard, 2004). A greater **degree of labour market regulation and trade union organisation** is an important factor in this regard (Alesina et al., 2006). Furthermore, the lower income inequality in comparison to the US may mean that individuals are less exposed to social consumption norms that are associated with **inequality** (Bowles and Park, 2005; Oh et al., 2012). The conclusion that an ageing population makes a longer working life inevitable is therefore far from compelling.

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562. Two Council members, Isabel Schnabel and Achim Truger, do not agree with the majority position of the GCEE in Chapter 5 entitled ‘The debt brake: sustainable, stabilising, flexible’. The majority of the members currently see **no need to reform the debt brake**. They believe the debt brake already offers sufficient fiscal leeway for stabilising the economy and for accommodating any potential public-sector **investment** needs. The latter could be **covered by means of** appropriate **prioritisation** of public spending. However, these investment needs were hard to quantify. In addition, **hurdles** to public-sector investment were **not lack of financial resources**, but a high level of capacity utilisation in the building industry and public administration, increasing regulation, and lack of acceptance among the general population.
563. Our criticism relates to three aspects. Firstly, we see **conceptual problems with the debt brake** that suggest a reform will be needed in the longer term. Secondly, we believe it would be advisable to **use existing leeway pragmatically** in order to maintain flexibility within the economic cycle and to meet the substantial need for investment that is essential for the future viability of the German economy and for the transition to a new climate policy. Thirdly, unlike the majority of the members, we do not believe that solving the serious **problems related to a high municipal debt burden** in some of the Länder should be the sole responsibility of those federal states. We believe the federal government could also play its part.
564. We do not advocate the abolishment of the debt brake, let alone of the European fiscal rules, as we fully recognise that high levels of public debt can be problematic. The ‘deficit bias’ may lead to a **tendency towards excessive levels of debt** and too much debt results in issues with sustainability. Nor do we see increasing debt as an end in itself. In the long-term, our focus is on conceptual improvements in the application of the debt brake, while our short-term goal is to ensure that it is applied sensibly within the existing legal framework.

Slightly higher levels of debt can be **useful** for the purpose of public-sector (net) investment, and for stabilising the business cycle. Less debt is not always unambiguously preferable to more debt (Expertise 2007 Item 33). Rather, the target debt level should be the result of a decision based on a context-dependent cost-benefit analysis (Hüther and Südekum, 2019).

565. The fiscal and welfare costs of higher debt are offset by potential **welfare gains** arising from stabilisation of the business cycle and from public-sector investment that could strengthen the growth potential of the economy. Concerns about private investment being crowded out by public-sector spending are likely to be unwarranted, especially if public-sector investment makes private investment more profitable. As Blanchard (2019) has recently argued, in a situation in which the risk-free interest rate is lower than economic growth and the return on capital is low, the **costs of additional government debt** should be **low**. In this

context, the very low interest rates – which are likely to prevail in the foreseeable future – are likely to considerably lower the cost side of the equation and thereby strengthen the arguments for a moderate increase in government debt for worthwhile purposes.

This argument is not based on interest rates remaining low for a very long time. Forecasting future interest rate trends over long periods of time is inherently difficult. However, where financing needs already exist, it may make sense to **take advantage of the low interest rate phase** and to lock in the current low interest rates by issuing long-term bonds. It would even be conceivable to stipulate specific repayment schedules and thus eliminate the risks associated with follow-on financing (Hüther and Südekum, 2019).

Conceptual problems with the debt brake

566. Compliance with the debt brake would **permanently lower the debt-to-GDP ratio**. \searrow CHART 74 Utilisation of the permitted structural deficit of 0.35 % of GDP for the federal government and 0 % of GDP for the Länder would, given average nominal GDP growth of 3 %, imply that the debt-to-GDP ratio converges towards 12 %, although the convergence value would not be reached for many years. If one were to incorporate a structural deficit at the municipal level of 0.15 % of GDP, which would be high by historical standards, the convergence level would be 17 % of GDP. \searrow ITEM 453
567. There is no compelling argument for such low debt-to-GDP ratios, which are implicitly imposed by the restrictive and inflexible deficit targets of the debt brake. In the medium term, they could in fact lead to a **shortage of safe assets** with destabilising effects for the financial markets, particularly at the effective lower bound (Caballero et al., 2016, 2017). US Treasury bonds are only an imperfect substitute for low-risk securities in the euro area, not least because of the exchange rate risk.
568. In this respect, the **European fiscal framework** enshrined in the Stability and Growth Pact is more flexible than the German debt brake. The medium-term target for the structural budget deficit in the preventive arm of the Stability and Growth Pact (medium term objective, MTO) is set every three years on the basis of several criteria, including some relating to sustainability. Overall, a general government structural deficit of **up to 1 % of GDP** will be permitted. Under the fiscal compact, the general government structural deficit is permitted to increase from 0.5 % of GDP to 1 % of GDP.

Even if the federal government were to utilise its maximum structural deficit of 0.35 % of GDP and the municipalities were to incur a structural deficit of 0.15 %, there would still be **fiscal leeway** up to the 1 % ceiling. According to Rietzler and Truger (2019), the social insurance funds have had structural surpluses since 2003, and it is unlikely that the existing fiscal leeway will be used up by structural deficits in the social insurance funds. According to the GCEE's calculations, even in the past these averaged only 0.3 % of GDP in years with deficits.

\searrow ITEM 445

569. The majority of the members concedes that an easing of the debt brake for the federal government and the Länder within the limits of the European fiscal rules can be justified in principle if there is a **sufficiently large safety margin to the 60 % limit** for the debt-to GDP ratio stipulated in the Maastricht Treaty.
 ▴ ITEM 446 It would be logical to focus attention on this argument as an aspect of the debt brake where a need for longer-term reform has been identified.

570. There is a further conceptual problem with the German debt brake. It ignores the **golden rule for public investment**, a widely accepted, decades-old principle of public finance for dealing with budget deficits. The aim of the golden rule is to ensure the intertemporal application of the pay-as-you-use principle, meaning that net investment should be financed through net borrowing to ensure intergenerational fairness. The underlying assumption is that net investment increases the capital stock and thus generates benefits for future generations. Consequently, it is fair for future generations to help pay for the investment by servicing the debt. Future generations inherit public debt, but gain additional capital stock in return.

From this perspective, a refusal to borrow to finance investment leads to an excessive burden for the current generation who have to pay higher taxes or suffer from lower government spending. This creates an incentive for **insufficient public investment** – to the detriment of future generations. This fundamental incentive problem is likely to be exacerbated during times of budget consolidation, because cuts in public-sector investment often appear to be the simplest way of reducing the budget deficit. This was strikingly confirmed during the crisis in the eurozone when public-sector investment was slashed as a result of austerity measures, particularly in the member states that were hit hardest by the crisis (Barbiero and Darvas, 2014).

571. The golden rule of public investment has many **supporters in the academic world**, starting with Richard A. Musgrave, one of the founding fathers of modern public finance (Musgrave, 1939, 1959, pages 556–575). In the context of the fiscal policy debate in the EU, many economists have proposed the introduction of the golden rule for the Stability and Growth Pact (e.g., Fitoussi and Creel, 2002, pages 63–65; Blanchard and Giavazzi, 2004; Barbiero and Darvas, 2014; Truger, 2015). In its 2007 Occasional Report, the GCEE proposed removing public-sector net investment from the constitutional debt ceiling (GCEE Expertise 2007), although this was never adopted as policy.

572. The **majority of members** explicitly **opposes the golden rule** for a number of reasons, including the problem of defining investment in a meaningful way, statistical classification problems, and doubts regarding its positive macroeconomic effects. These problems must be taken seriously. Overall, we believe the evidence of the positive short- and long-term macroeconomic effects of public-sector investment – even only following the classification in the national accounts – to be sufficient to justify granting privileged status to this category of public spending. We thus fundamentally concur with the assessment of the GCEE in 2007, which regards the failure to grant privileged status to net investment as ultimately more problematic than any risk of errors that could occur in applying the rule (GCEE Expertise 2007 items 119 ff.). If, in addition, an **upper**

limit for the maximum permissible net borrowing under the golden rule were to be set, this would address any concerns about fiscal sustainability. It would also stimulate competition within the democratic process about which investment projects should be prioritised.

Pragmatic use of the existing leeway

573. The conceptual problems of the debt brake outlined above indicate the need for fundamental reform, although this would be a slow and lengthy process because it requires constitutional change and harmonisation with the European legal framework. Such a process would leave enough time to resolve some of the complex classification and implementation issues. In the short term, the current legal framework provides some **leeway within the debt brake**, which can be **used pragmatically** to improve stabilisation of the business cycle and strengthen public-sector investment.

Using legally independent public-sector funds, institutions and enterprises (FEU) to exploit the judicial leeway creates a lack of transparency and potentially reduces democratic oversight. If appropriately structured, this would probably **not constitute an unlawful circumvention of the debt brake** (Hermes and Schmidt, 2016). However, these side effects illustrate why it is necessary to reform the debt brake. **Action is required** in two problem areas: the cyclical adjustment of the government's budget balance and the financing of public-sector investment.

574. The fundamental problem of **cyclical adjustment** is that structural and cyclical factors can **never** be disentangled **with certainty** in real time. Even improving the processes cannot solve this fundamental problem. The usual statistical methods therefore result in an adjustment of the estimated potential GDP, even in the event of a temporary cyclical shock. In an economic slowdown, the downward revision of the potential GDP very quickly results in part of the slowdown being recorded as structural, which, in the context of the debt brake, creates a need for structural consolidation and thus **limits the effect** of the **automatic stabilisers**. This can have a negative effect on production and employment and amplify the economic slowdown. Conversely, the positive adjustment of potential GDP in an economic upturn would create structural flexibility and would make the public finances appear healthier than they really are.

In the case of a sharper economic slowdown, there is currently **no guarantee** that the debt brake will provide **sufficient fiscal leeway**. Nor is there any guarantee that the consolidation that would be appropriate in an economic upturn would in fact materialise. For this reason, a reform of the cyclical adjustment procedure should be undertaken as a matter of urgency. This would probably only require an amendment of the legislative decree to the Implementation Act of Article 115 of the German Basic Law (GG) or possibly of the Implementation Act itself. One option might be to switch to the **method** proposed by Jarociński and Lenza (2018) which is **less prone to revisions**. The possibility of a **symmetrical use of the control account** should also be examined, so that surpluses would allow an extension of the maximum permissible net borrowing

when preparing the budget. Such use could be restricted to periods of economic slowdown.

575. There is also the question of whether the debt brake will allow the **necessary scope for public investment** in future. The years since the introduction of the debt brake do not provide much of a clue, given that the economy and the fiscal situation have been exceptionally strong during this period. It is hard to put a precise figure on public-sector investment needs. ↘ ITEM 524 In addition, the statistical measurement of net investment is in itself problematic. This could have led to an exaggeration of the decline, particularly at the municipal level. However, it is unlikely that such distortions are so sizeable that measured correctly there would have been no noticeable decline in investment and no negative net investment at the municipal level.
576. The GCEE highlights **a need for public investment in many areas**, such as in basic research, digital and physical infrastructure (roads, rail, local public transport), battery charging stations for electric cars and regional clusters. In order to assess whether the available fiscal leeway is actually sufficient, it would be helpful to put a specific figure on these needs. Even if the public-sector investment need in each of the areas mentioned by the Council were small, additional investment needs could quickly add up to a figure in the mid two-digit billion range per year. Hüther and Kolev (2019) arrive at an **estimated public-sector investment need** of €450 billion over the next ten years, i.e. €45 billion per year. Calculations of this kind are of course fraught with uncertainty. In addition, it is important to remember that the Council's **tax policy proposals** would lead to a further increase in the fiscal burden in the low double-digit billion range. ↘ ITEM 241
577. Funding through **prioritisation** via reallocations within the budget may be a **sensible** approach in principle. However, reallocation on such a scale within the public budget without increased net borrowing or tax increases is unlikely to be politically feasible. Moreover, as explained above, it would not make sense because the golden rule implies that it is entirely reasonable to require future generations to share in the costs of long-term public investment.
578. Alternatively, an **independent special fund** could be set up to **finance selected future investments** (Hüther and Kolev, 2019; Hüther and Südekum, 2019). This fund could either be provided with resources via 'financial transactions' excluded from the debt brake, or it could borrow itself as a legally independent special fund with borrowing authorisation. Narrowly defined objectives could mitigate classification problems. The local public authority using the funds would continue to be responsible for assessing the usefulness of the investments. Consideration could be given to making access to the special fund dependent on minimum spending for repairs and maintenance.
579. This kind of special fund would serve more to **increase long-term public-sector investment and make it permanent** than to manage the business cycle. With funding security, the long-term horizon of the investment plans could have a positive effect on the development of capacity. However, there could still be **non-financial barriers to investment**, particularly in the

construction sector. The **removal** of such barriers should also be given **high priority**. This may well require additional (current or capital) government spending, for example for the creation of new positions in public administration. The question of whether this spending can also be funded from the special fund would need to be discussed. One possibility would be to make the use of resources from the special fund conditional upon funding these positions from the budget.

Problems of municipal debt

580. There is a strong correlation between low levels of public-sector investment and the underfunding of municipalities, with the latter manifesting itself particularly in high levels of short-term liquidity loans. The problem is strongly concentrated in a handful of Länder (Saarland, North Rhine-Westphalia, Rhineland-Palatinate, Hessen before its debt was taken over by a special fund outside the debt brake, and Lower Saxony). The majority of members attributes these financial problems primarily to **failures of municipal or state policy**. It also emphasises the support provided by federal government by taking over the cost of providing basic income support for elderly people and those with reduced earning capacity, plus a greater proportion of the cost of housing and heating in past years, as well as the restructuring of the financial relations between federal and state governments to take greater account of the municipal authorities' financial situation. For these reasons, the majority argues that it is **not appropriate** to expect the **federal government** or all the Länder to **make further contributions** in order to ease the burden on municipalities.
581. The majority of members recognises the need to find a solution to municipal funding problems. It is right that any potential solution should not result in **negative incentives** for the municipalities or Länder concerned. However, the answer to the question of whether the federal government or the Länder as a whole should have to contribute to a solution depends to some extent on the **cause of the financial problems**. If the municipal funding problems were due solely to failures at the municipal or state level, the federal government's involvement would be unnecessary and could result in adverse incentives.
582. The **federal government** can be held **partly responsible** for the regionally concentrated problems of the municipalities. The greater contribution of the federal government to the costs of municipal social welfare payments can be regarded as closer adherence to the – previously violated – **principle of connexity**, which states that costs must be borne by those who cause them. As the social welfare payments of the municipalities implement federal government laws, the question is why the federal government is reluctant to provide the necessary funding and has done so only gradually, even though it has accepted its responsibility in principle. The **lack of support from federal government over many years** may well be a key factor in explaining many regionally concentrated funding problems and short-term liquidity loans in municipalities with high levels of social expenditure, which now require a solution.

583. In addition, the **financial problems** of the municipalities are **frequently** concentrated **in structurally weak regions** that are negatively affected by structural change arising generally or as a result of globalisation. Based on the analysis by Dauth and Südekum (2016) and Dauth et al. (2017), Truger (2018) points out that the Länder that have the greatest problems with municipal finances (North Rhine-Westphalia, Saarland, Rhineland-Palatinate, Hessen and Lower Saxony) also have an unfavourable economic structure with a relatively large number of municipalities that have been hit particularly hard by globalisation. As individual municipalities and the Länder cannot overcome the challenges of structural change and globalisation alone, and the principle of **equal living conditions** throughout the federal territory is enshrined in Germany's constitution, it can be argued that the federal government should assume at least some responsibility and that a valid case can be made for its participation in finding a solution for municipal finance problems.
584. Steps should be taken to ensure that the principle of connexity is respected in the future. If the federal government or the Länder define (new) responsibilities for the **municipalities**, they must make the corresponding funds available to pay for them. Problems must be **tackled structurally**; solving the problems associated with legacy debt in isolation is not sufficient.

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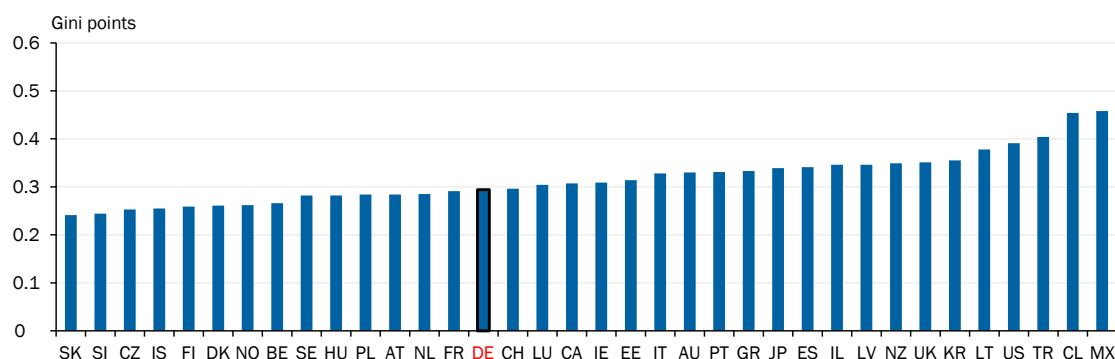
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A differing opinion

709. One Council member, Achim Truger, does not agree with the majority view expressed by the German Council of Economic Experts in chapter 6 “Securing upward mobility, strengthening work incentives”. His dissenting view relates to the Council’s majority assessment that the **development of the distribution of net incomes over time** is unexceptional and unproblematic. It also concerns the resultant **distributional and fiscal policy conclusions** in general as well as the reforms of the tax-transfer system for the low-wage sector in particular.
710. The **majority view of the Council** is that the **income distribution** has remained **largely stable** since 2005 and that the inequality of net wealth is currently lower than it was back in 2007. Reference is also made to the German welfare state’s high intensity of redistribution compared with other countries, which is said to drastically reduce the inequality of net incomes relative to market incomes despite the fairly significant low-wage sector. Consequently, measures aimed at taxing high incomes and wealth more heavily are said to need more justification than the rising inequality of incomes and wealth. The majority of the Council therefore argues that **no additional direct income redistribution measures** should be taken and, instead, it concentrates entirely on measures aimed at maintaining equality of opportunity. According to the majority’s view high inequality is less problematic if every individual has the opportunity to move upward.
711. For several reasons, however, these two factors – **inequality and upward mobility – cannot be separated**, which is why it is problematic to compare policies on equal opportunities with those on redistribution. Firstly, international comparisons across countries reveal that income inequality is negatively correlated with income mobility (Corak, 2013). Secondly, Atkinson (2015, page 11) argues that – from an intergenerational perspective at least – distributional outcomes are a key determinant of equal opportunities. And, thirdly, even a mobility-focused education policy – which is typically regarded as an equal-opportunities policy and an alternative to redistribution policies – relies on an accompanying **improvement in socioeconomic conditions** if it is actually to increase individuals’ chances of enjoying the fruits of a good education (Goldthorpe, 2016).
712. Aside from these fundamental comments it is important to point out that the statements and distributional policy conclusions presented by the majority on the Council are, critically, based on their selection of 2005 as the baseline year for their analysis. However, it is indisputable that the **inequality of net incomes grew massively** between the late 1990s and 2005 while the welfare state’s intensity of redistribution declined sharply at the same time. Consequently, if one were to take the net-income distribution in the late 1990s as a baseline, one could – given the appropriate distributional policy preferences – certainly conclude on this basis that there was a **need for ‘real’ redistribution**.

713. Even after 2005 one does not necessarily have to share the Council majority's view that net-income distribution trends have remained as stable and unproblematic as the majority claims. Both the Gini coefficient and the 90/10-percentile ratio reveal a continuing – albeit much slower – rising trend, which only becomes virtually insignificant in 2016. The **rise in the at-risk-of-poverty rate** from 14 % to 16 %, on the other hand, is statistically significant. If, as Grabka et al. (2019) and Spannagel and Molitor (2019) have done, we were to take 2009 – the year of the financial crisis – as the baseline for our analysis, then even the increases in the Gini coefficient and the 90/10-percentile ratio would be significant and – according to Grabka et al. (2019, page 349) – would justify the statement: “Since the financial crisis the **inequality** of disposable household incomes has started to **rise again**.” It would be legitimate to select 2009 as the year in which income inequality hit a temporary low, as this would be similar to the Council majority's procedure when analysing the wealth distribution. Although wealth inequality remained high on the whole from 2002 to 2017, the Council majority used a temporary increase in 2007 as a justification for claiming that wealth inequality had declined significantly between 2007 and 2017.
714. Even when **compared with other countries**, Germany's ranking in terms of income distribution is not as positive as has been presented by the Council majority. ↘ ITEM 599 ↘ CHART 91 Although an OECD comparison ranks Germany seventh out of 35 countries in terms of its intensity of redistribution, **Germany is ranked only 15th** in terms of distributional outcomes, i.e. the resultant Gini coefficient for equivalised net income. ↘ CHART 106 The fact that Germany has only achieved a mediocre performance in terms of net-income distribution is really remarkable because, since 2005, it has seen a continually sharp rise in employment, which has been accompanied by a modest decline in the inequality of gross wages. ↘ ITEM 596
715. Further problems are posed by the Council majority's interpretation of **lifecycle income development** analysis. It is true that for the analysed birth cohorts up to 1956 – and purely in relation to gross wage incomes – the intra-generational income mobility between cohorts has not decreased over time, which can be interpreted as proof that equality of opportunity has remained unchanged. Moreover, inequality within cohorts is, as expected, lower than for the distribution from a cross-sectional perspective. However, Bönke et al. (2015) – who were the first to conduct a comparable analysis using a substantial sample of data from Germany's statutory pension insurance scheme, which also included younger cohorts in some cases – have pointed out that the Gini coefficient from a lifecycle perspective still amounts to two-thirds of the Gini coefficient for the distribution from a snapshot perspective.
716. Bönke et al. (2015) also conclude that **inequality has increased massively** from the older **cohorts** to the younger ones; the Gini coefficient within a cohort born in the early 1960s is 85 % higher than the Gini coefficient for the 1935 cohort. They conclude as follows: “The potential implications of this fact are far-reaching. By itself, such an increased heterogeneity in terms of labour market outcomes might have a significant impact on cultural and political attitudes by weakening people's feeling of sharing a common fate. Through its effect on the

↘ CHART 106

Gini coefficient of equivalised net household income¹
2016²

1 – SK-Slovak Republic, SI-Slovenia, CZ-Czech Republic, IS-Iceland, FI-Finland, DK-Denmark, NO-Norway, BE-Belgium, SE-Sweden, HU-Hungary, PL-Poland, AT-Austria, NL-Netherlands, FR-France, DE-Germany, CH-Switzerland, LU-Luxembourg, CA-Canada, IE-Ireland, EE-Estonia, IT-Italy, AU-Australia, PT-Portugal, GR-Greece, JP-Japan, ES-Spain, IL-Israel, LV-Latvia, NZ-New Zealand, UK-United Kingdom, KR-Korea, LT-Lithuania, US-United States, TR-Turkey, CL-Chile, MX-Mexico. 2 – 2015: CH, CL, IS, JP, TR; 2014: NZ.

Sources: OECD, own calculations

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distribution of lifetime consumption, the increase in lifetime earnings inequality might substantially affect the social welfare of generations.” (Bönke et al., 2015, page 197). The cohort analysis also suggests that in the future the gradual passing of the older, much more equal cohorts could further exacerbate the inequality of the income distribution. Overall, therefore, the **distributional situation and development** both currently and, potentially, for the future could be deemed to be much **more problematic** than has been presented by the Council majority.

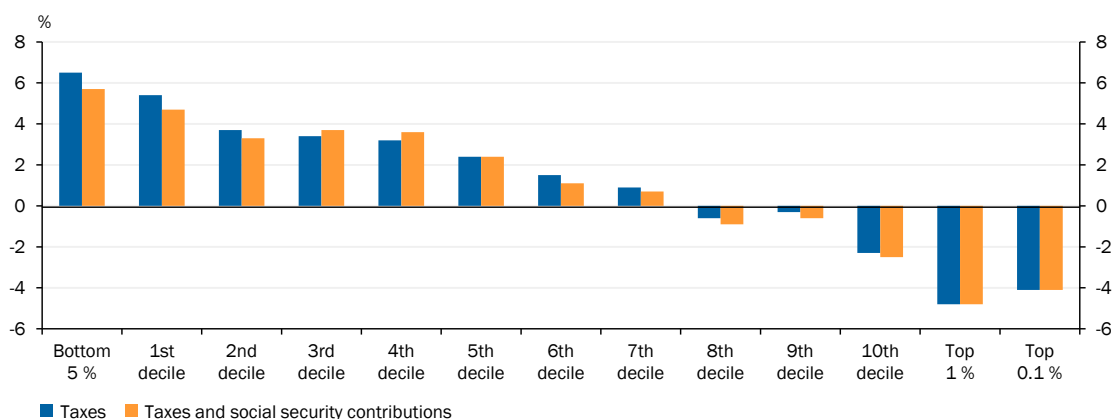
717. Aside from the statistical analysis, it is also the case that (growing) economic inequality might not just be a normative problem but could also have serious consequences for Germany’s democratic political system. Schäfer (2015) shows, for example, that social inequality lowers voter turnout at elections over the long term. Elsässer (2018) comes to the conclusion that German politicians are much more responsive to the preferences of higher professional and income groups than they are to those of lower incomes. One could therefore conclude that the recent and ongoing rise in income inequality has the potential to cause **social and political unrest** and that this might well justify some income redistribution, e.g. through appropriate tax policy measures.
718. **Fiscal policy** between the late 1990s and 2005 had a **particularly noticeable impact on the growth in inequality** as a result of significant tax cuts (Biewen and Juhasz, 2012). Moreover, the distribution of the tax burden shifted massively between 1998 and 2015 to the benefit of higher income groups and to the detriment of lower ones (Bach et al., 2016). ↘ CHART 107 The distribution of the tax burden includes factors that are not contained in the Gini coefficient based on household incomes. These include business taxes and – usually clearly regressive – indirect taxes, which are factored into the analysis through assumptions on how taxes are passed on. The simulation for 2015 shows, e.g., that the Gini coefficient for equivalised net household income rises by

3 percentage points if indirect taxes are included in the analysis (Bach et al., 2016, page 40).

719. The changing levels of tax burdens and reliefs in relation to equivalised gross income are presented for the period from 1998 to 2015. ^{↘ CHART 107} Whereas lower incomes had to bear a much higher tax burden in 2015 than they had in 1998, **high-income households benefited from substantial tax reliefs**. On balance only the top 30 % of households received any tax relief. While the tax burden on the lowest decile in relation to gross income rose by 5.4 % between 1998 and 2015, the top decile received tax relief of 2.3 % over the same period. The tax burden for the richest 1 % of the population was reduced by as much as almost 5 %. If social security contributions are included, the picture is very similar; only the increase in the tax burden on the lower income segments is slightly smaller because these segments pay relatively low social security contributions.
720. Not least such shifts in the distribution of the tax burden in the past could certainly provide the additional justification demanded by the Council majority for measures aimed at taxing high incomes more heavily. In this context it is worth mentioning that a number of **tax policy measures proposed by the Council majority** would further **polarise** the measured **net-income distribution** or the distribution of the tax burden.
721. Simulations by Bach and Harnisch (2017) show that the aforementioned complete **abolition of the solidarity surcharge** ^{↘ ITEM 658} would provide substantial additional tax relief for those with very high incomes. The solidarity surcharge is only payable on income tax liabilities above 972 Euro and starts with a sliding scale where the full surcharge is not yet payable. This means that it has an even more progressive effect than the income tax, which is already highly progressive. The lower half of the income distribution pays virtually no solidarity surcharge, whereas almost 80 % of this tax is paid by the richest fifth of the income distribution, 62 % is paid by the top tenth and 28 % by the top hundredth. ^{↘ CHART 108} It is therefore evident that the tax relief resulting from the complete

^{↘ CHART 107}

Change in the total burden of taxes and social security contributions in 2015 compared with 1998 as a percentage of equivalised gross household income



Source: Bach et al. (2016)

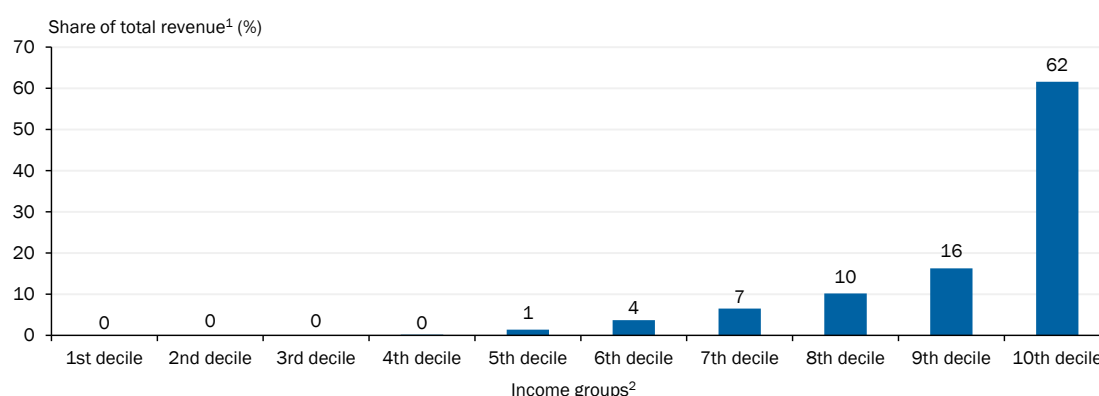
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abolition of the solidarity surcharge would be concentrated at the top end of the income distribution. The complete abolition of the solidarity surcharge would therefore **shift the tax burden from top to bottom** and widen the disparity in the net-income distribution.

722. The Council majority points out that there is a **conflict between the distributional and efficiency goals** of taxation. It therefore claims that although cutting taxes in the top income segments could increase the inequality of net incomes, by boosting investment activity it might also raise the level of incomes overall. The Council majority points out that this also applies to the solidarity surcharge, with roughly 40 % of its revenue coming from corporate earnings.
- ITEM 658 However, the potential **incentive effects** of abolishing the solidarity surcharge as far as firms are concerned **should not be overestimated**. As the Advisory Board to the Federal Ministry of Finance (2019, page 15) points out, this would only reduce the corporate tax burden by a modest 0.83 percentage points. Following Hermle and Peichl (2013), the optimal top rate of income tax – whose calculation factors in negative incentive effects – might well lie way above the current rate including the solidarity surcharge.
723. Despite all of the problems and questions still to be clarified, the findings of the **analysis conducted by Blömer et al. (2019b)** might well provide **justification for drawing more positive economic policy conclusions**. They show that an overhaul of transfer withdrawal rates in low-income segments combined with an increase in the basic level of social welfare might be able to achieve noticeably positive labour supply effects and a significant reduction in the at-risk-of-poverty rate – which has risen recently – without placing a burden on the public finances. Including additional further scenarios that ruled out the option of imposing any further tax burdens – especially on single parents and families with children – and aimed to introduce automatic disbursement of transfer payments in order to overcome the stigma effect, this could certainly be achieved at a reasonable fiscal cost and would genuinely improve the effectiveness of the welfare state, significantly reduce the at-risk-of-poverty rate and ac-

➤ CHART 108

Distribution of revenue from the solidarity surcharge in 2018



1 – Excluding revenue from legal entities, foreigners and domestic non-taxpayers. 2 – Deciles show equivalised total revenue.

Source: Bach and Harnisch (2017)

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tually strengthen work incentives (Blömer and Peichl, 2018). The more modest interventions proposed by the Council majority are hardly likely to achieve the last two points in particular.

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