Speech by

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at the Federal Ministry of Finance

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Thank you very much, Mr Chairman, Colleagues, Ladies and Gentlemen,

The expression "demographic change" has found its way into everyday language. This is something which is understandable and which is to be welcomed. For there is hardly any area of society which is not affected by the changes in population structure. Becoming aware of these changes, the resulting consequences and, in particular, the correct reaction to them, is not only helpful but is urgently necessary.

Yet I sometimes find the tone of the discussion regrettable. The debates which take place are often over-dramatised, they sow uncertainty and fear of the future amongst people.

The questions to be tackled are undoubtedly urgent. Yet, despondency or panic-mongering are now the last things we need. And I believe at this point that we have no reason for this.

I shall explain why in more detail.

We are all familiar with the starting point, although of course there are some differences in the picture across the European Union. Over the next few decades, the average age of the population will change significantly.

It is of course good news that people are living longer and that this trend will be reinforced over the decades to come.

Higher life expectancy, combined with a low birth rate is, however, bringing about changes in age structure which will have a wide variety of impacts on our societies and economies. Whilst there are currently 4 persons of working age to every person over 65, this ratio will have dropped to 2 to 1 by 2050.

And Germany is not the only country where this is the case. As in Germany, the old-age dependency ratio in the EU as a whole is set to more or less double by 2050. The speed and scale of the expected changes vary from country to country, however.

In Spain, Portugal, Italy, the Czech Republic, Slovakia and Poland - to give some examples - the rise in the old-age dependency ratio will be particularly marked. The corresponding rise in Denmark, Sweden, Luxembourg, the Netherlands and Estonia, on the other hand, will be below average. This demonstrates once again that the question as to where "old Europe" and the relatively "young Europe" are to be found can not simply be answered in terms of geographic location.

Although these differences between the countries should not be ignored, one thing is clear: if no active measures are taken to manage these changes to the population structure, there will be tangible economic consequences – in terms of the availability of labour, economic growth and, not least, public finances.

At the end of last year, the European Commission published a report on the long-term sustainability of public finances for all EU Member States. In the report, the Commission highlights the impacts of demographic change on public budgets. Some of these impacts will be direct, due to age-dependent social transfers and some indirect, as a result of impact on growth potential.

As for Germany, the findings of the Commission report reflect the same trend shown in our own calculations published in our report on sustainability. The political messages are thus essentially the same:

- Firstly – the models show that there will be a severe sustainability gap in public budgets by 2050 if current policy is continued unchanged.

- Secondly – this means that further finance-policy consolidation, teamed with comprehensive reforms in various field of economics, finance and social policy, are vital.

The picture is similar for other EU countries: in most Member States, significant sustainability gaps can be expected if we fail to take action today to combat the impacts of demographic change – through a policy of consolidation and growth.

Yet, as I say, the risks vary widely amongst the different countries. Germany is viewed by the Commission as one of the countries in the medium-risk group. This group also includes Belgium, France, Ireland, Italy, Luxembourg, Spain and the United Kingdom.

In contrast, the Commission sees the situation in Greece, Portugal, Slovenia, the Czech Republic, Hungary and Cyprus as particularly serious. Whilst the Netherlands, Austria, Poland and the Nordic and Baltic countries are seen as having a low risk.

This means that many countries need to take urgent action in the face of the upcoming changes. Yet there is no reason to overly dramatise the risks for public budgets. If comprehensive reforms are continued and an overarching political strategy pursued we will indeed be able to deal with the challenges of demographic change.

Reforms of old-age provision for instance – which have recently taken place in Germany, France and Austria, following those in Italy and Sweden – have significantly contributed to enhancing the sustainability of public finances.

Policymakers have a duty to regain room for manoeuvre, allowing them to proactively shape the future in the interests of today's population, but also of future generations. In order to achieve this, we need a political strategy which

- continues structural consolidation of public budgets

- and links this consolidation with reforms of social-security systems and an improvement of the conditions for growth and employment.

In addition, finance policy needs to create institutional frameworks and structures which help to prevent short-term political measures and enhance the macroeconomic efficiency of public policy.

I am thinking, for instance

- of economically sensible rules to effectively limit state debt,

- of mechanisms which allow the effectiveness and value-for-money of state expenditure to be reviewed on a regular and improved basis,

- or of instruments which would help us to optimise the division of labour between state and private players, thus leading to gains in efficiency.

We must anchor this path in economic and finance policy even more strongly than so far at national and European level. That is why we are placing particular priority on the "quality of public finances" in the context of the Germany EU Presidency.

We want to make it clear that consolidation and the improvement of basic conditions for growth and employment are two sides of the same coin. Together, we want to engage in dialogue over the institutional framework conditions and structures needed to ensure that state action becomes more future-orientated and ensure the sustainability of public budgets in the long term.

Our aim is

- to begin by defining the central criteria for high-quality finance policy

- and then to develop rules and instruments to help us ensure that the idea of future-oriented and sustainable finances becomes firmly anchored in the basic lines of policymaking, as well as in day-to-day decisions.

I shall return later on to the issue of the institutional framework conditions. Let me, first of all, talk about the areas in which action is needed to allow sustainable policymaking:

- structural consolidation of public budgets,

- reforms of the social-security systems and

- the improvement of conditions for growth and employment.

Firstly, I shall begin with the structural consolidation of public budgets:

For us in the area of finance policy it is obvious that rigorous reduction of state debt has to be the number-one priority in most countries – including Germany.

The positive news about the state of the public coffers which we in Germany have heard over the last few weeks is no reason to stray from this course. Quite the opposite in fact: we need to use the opportunity offered by such positive cyclical developments to make determined progress in fiscal consolidation.

Sustainable policymaking requires the additional tax revenue currently being generated to be used to further reduce new debt.

Even at times when the economy is doing well – indeed particularly at such times – we should avoid the temptation of making promises today and leaving future generations to pick up the bill.

The importance of the problematic field of social security is also well known. There is now general recognition of the fact that a new course is needed for social-security systems, in order to

- ensure that the systems can be financed and remain sustainable,

- reduce the burden of debt on future generations and

- create room for manoeuvre for investments in the future which enhance growth and employment.

Only in this way will it be possible to avoid in the long term a vicious circle of ever increasing state debt. And that is why we – like many other countries – have set in motion far-reaching reforms of our social-security systems.

The measures taken to foster private pensions and company pensions have proved a real success story. In 2001, the "Riester Pension" was developed, which is an additional private system of provision, receives state support and is attractive for many people.
Between the introduction of this state support in 2002 and the end of 2006, over eight million private pension plans of this type had been taken out. During 2006, more than 2.4m new pension plans were started – a new record. The number of plans begun in the last quarter was particularly high, at over 1 million.

Developments in the field of company pensions are also very positive. According to surveys, the number of workers paying into a company pension plan rose from 38 per cent in 2002 to 46 per cent in 2004. Taken together with the figures for public sector workers, this meant that almost 16 million workers had a company pension entitlement by 2004, i.e. around 60 per cent of those subject to social insurance.

In the context of tax incentives for old-age provision, I should mention one of the most important reform projects of the recent past: the transition to downstream taxation of retirement income.

This means that contributions are tax free, whilst pensions are taxed when they are paid out later. This transition is taking place over a long transition period in order to substantially cushion the effects.

In the long term, the state will not receive increased revenue from taxation of pensions. Yet this system means that those in employment have greater financial room for manoeuvre to provide for their old age. At the same time, older people will in future make a fair financial contribution to the community.

The introduction of a "sustainability factor" in the calculation of pension levels and the phased raising of the standard retirement age to 67, beginning in 2012, are also important measures to be mentioned in this context.

Structural consolidation of public budgets and reforms of the social security systems are only two elements of a forward-looking and sustainable political approach. Enhancing the conditions for growth and employment is equally important. After all, it is economic growth and employment which play the main role in stabilising public budgets and safeguarding the prosperity of society as a whole.

In Germany, the Federal Government – together with the Länder – has made available an extra 37bn euros during the current electoral term to promote research and development, create momentum for SMEs and the construction industry in particular and increase investments in transport.

Although I do not believe that the economic upswing should essentially be seen as the achievement of policymakers, it is clear that the positive economic data are due, among other things, to the fact that investors and consumers now have greater faith in the future. And this faith is partly due to policymaking, especially the credibility of policymaking.

Our dual strategy of consolidation coupled with pro-growth policies is a credible one

- since it does not promise progress in consolidating our budgets without cutbacks,

- since it does not promise that we will generate increased growth and employment without reforms, some of them far-reaching,

- and since it does not promise that we will be able to make tax cuts or introduce new spending without finding the funding for this.

We are sticking to these principles, including in the context of enhancing the fiscal framework for companies in Germany. The main pillars of the 2008 corporate tax reform are as follows:

- The nominal tax rate for corporate bodies will be lowered by around 9 per cent to under 30 per cent and a further reduction of the burden on SMES introduced.

- Partnerships and corporations will be placed on a more-or-less equal footing in terms of their overall tax liability.

- The funding base of the local authorities will be maintained.

- A flat-rate tax on income from capital will be introduced on 1 January 2009.

Overall, the measures to be introduced amount to a 30bn-euro reduction in taxation. Of this figure, around 25bn euros will be offset by a broadening of the basis of assessment. Although we are too cautious to predict that part of the costs will also be offset through higher growth or to include this assumption in our calculation, nevertheless, it is clear that any shortfall in revenue brought about by the reform will be very limited in its timescale and scope and that it will be of a scale which public budgets can cope with.

Companies will not be the only ones to benefit: if it becomes more attractive to invest in Germany, new additional jobs will be created. And more jobs are obviously the most important contribution to financing the social-security systems. Direct measures will also be implemented to increase labour-force participation rate.

Although trends on the job markets are positive, and earlier reforms are now beginning to take effect, this does not, of course, mean that there is no need for reforms regarding certain groups or special support for certain groups.

Recent figures show that the employment rate for older people in Germany was 48.9 per cent at the end of 2006, compared with 45.5 per cent in 2005 and 37.8 per cent in 1998. This is above the EU average, yet lower than the joint target set by the EU countries of getting at least 50 per cent of older workers into employment by 2010. Incentives and opportunities to remain in employment until standard retirement age need to be enhanced.

We have therefore set in motion the "50plus Initiative" in order to increase the number of older people in work. Firms which employ older unemployed people are entitled to a subsidy to cover part of wage costs. In addition, recipients of "unemployment benefit I' have their wages topped up if they take on a new job which is less well paid than their previous one. The general conditions for vocational training were also improved.

Yet it is not only the participation of older people in the workforce in Germany which is too low – we also have a lot of catching up to do regarding the number of women in work.
The labour-force participation rate for women in Germany, at just under 60 cent, is slightly above the average in the European Union, that is to say the average in the EU of 25, as it was before we celebrated the accession of two new countries this year. Yet there are two notable characteristics to women's employment in Germany:

- a relatively high level of part-time working, at 46 per cent and

- a very low proportion of women in work who have two or more children.

The more children women in Germany have, the less likely they are to go out to work. In Sweden and France, not only is the proportion of women in employment higher than in Germany, it is also almost completely independent from the number of children they have. This suggests that combining work and family is easier in these countries.

In the past, we too often saw family policy as part of social policy, where the focus tended to be on financial transfers to offset financial burdens, in particular by means of child benefit and tax-free child allowance.

Yet, from the sustainability perspective, we need a change of course. Family policy, embedded in a national growth and employment strategy, must also aim to increase the labour-force participation of women, along with the birth rate, by making it possible to combine working with having a family. We need flexible working models on the one hand and childcare options which meet people's needs on the other hand.

Naturally, in the area of family policy, as in other areas, we must spend money responsibly.

The main elements of our new family policy are:

- Firstly, improving infrastructures for families through more day-care places for babies and toddlers and whole-day schooling,

- and, secondly, effective financial support for families through the introduction of parental allowance for all children born on or after 1 January 2007, in line with the Swedish model. Additionally, two thirds of the costs of childcare from birth to the age of 14 can be offset against tax from the beginning of 2006 onwards, up to a maximum of 4000 euros per child.

Finance policy alone will not be able to deal with the challenge of demographic change. What is needed is a comprehensive concept for reform in the areas of finance, economic and social policy, so that all policy areas gear measures to consolidating public budgets and promoting growth and employment.

Only if all policy areas are aware of the overarching responsibility they bear will we be able to make the transition to sustainable budgets. And overarching responsibility means

- clearly defining high and low priority areas and defending this order of priorities steadfastly

- and always taking into account the repercussions and long-term effects of our decisions.

I firmly believe that this type of cross-sectoral political approach will allow us to improve the quality of public finances and achieve sustainable budgets.

In many fields, we are on the right path in Germany, but we have, of course, not yet achieved our goal.

I already mentioned at the beginning of my speech the fact that sustainable policymaking can be strengthened through institutions and rules.

I should like to set out a few possible options for action. New rules on debt, for example. Measures to prevent short-sighted policymaking include rules at both national and EU level to limit state debt.

The work of the Finnish Presidency has shown the importance of underpinning the criteria of the stability and growth pact with sustainable and effective national rules.

I think that Germany's rules on debt require reform, particularly against the background of the goal of achieving sustainable public budgets. What is needed is

1. effective limits on debt

2. a structure able to react to cyclical developments

and

3. consistency with the criteria at European level laid down in the stability and growth pact.

It is therefore logical for reform of our national rules on debt to be a central topic of the second stage of the federalism reform, the reform in which we are aiming, as you know, to adapt our federal structure to the necessary changes.

Ladies and Gentlemen,

ensuring the long-term sustainability of public finances and regaining political room for manoeuvre are the most important tasks which policymakers will have to tackle over the next few years.
And one should neither paint an overly rosy picture, nor an overly grim one. Demographic change confronts policymakers with major challenges, yet these can be tackled if suitable concepts are found.

If it is true to say that we policymakers in the areas of budgetary and finance policy are, as it were, the "advocates of the common good", then the task falls to us to set the right course today in order to anchor long-term perspectives, efficiency and a targeted approach in the day-to-day political process.

Thank you very much.