ZEWNEWS

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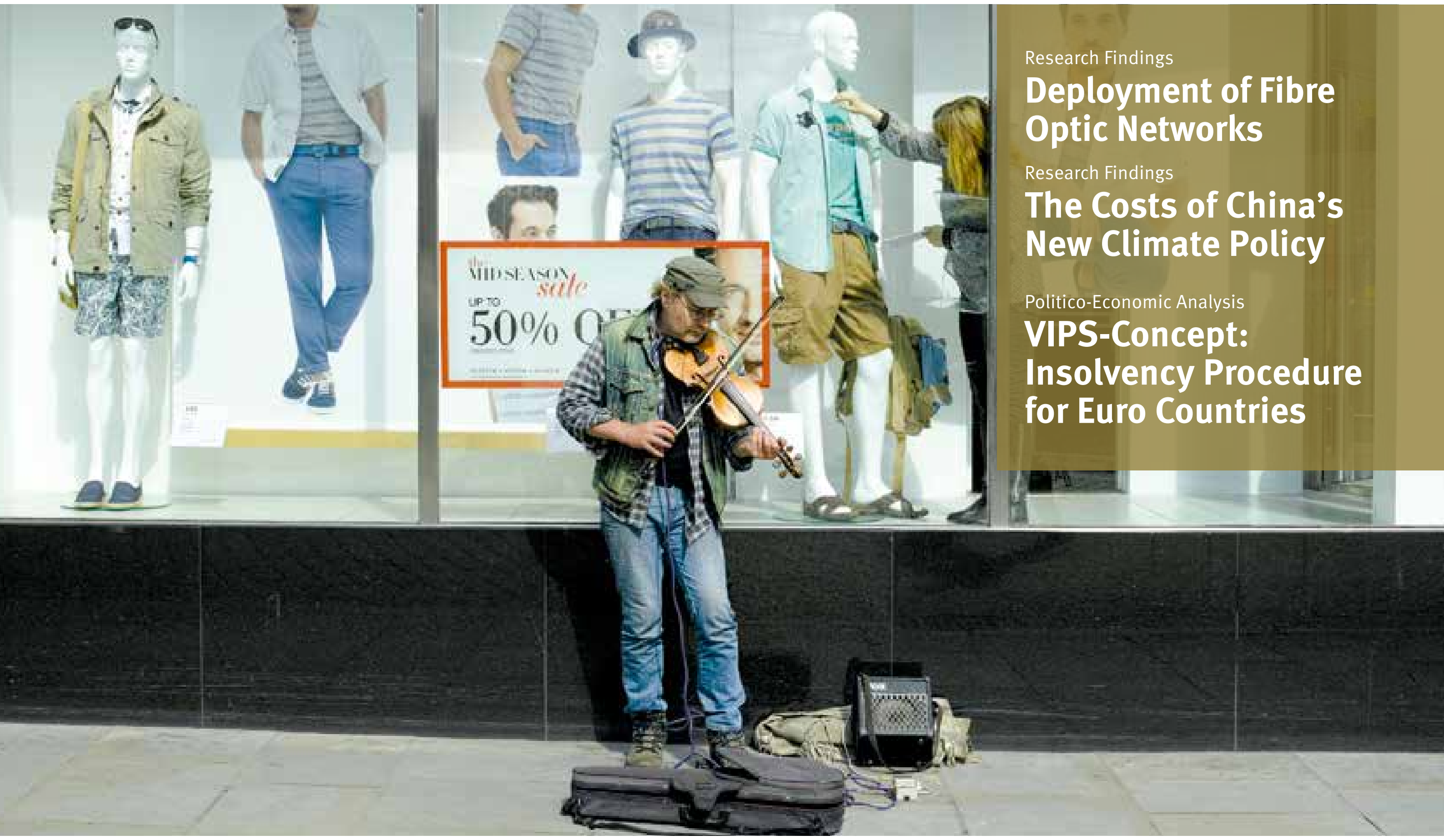
July/August 2014



Some Government Redistribution Measures Shown to Reduce Income Inequality

In the debates about growing income inequality in OECD countries, strong voices are calling for governments to intensify redistribution efforts. A recent ZEW study has found that some redistribution measures create more income equality.

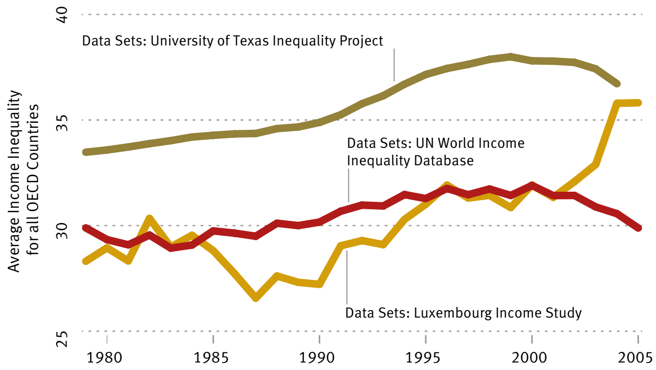
It has been empirically demonstrated that progressive taxation and social spending to benefit the poor mechanically reduce the difference between market incomes and disposable incomes. Nevertheless, the actual reduction depends on whether second-round effects exist that may weaken or offset this meachanical first-round effect. For instance, many redistribution measures reduce incentives to work or invest. High levels of redistribution can also prompt employers to lower workers' wages in the belief that a strong welfare system will compensate the workers for lower earnings. Second-round effects like these make it very difficult to estimate the total impact of government interventions on income inequality, only a few studies identify this specific effect in a causal manner.

Income Inequality in OECD Countries Fell Between 1960 and 1980 – Since the 1980s it's on the Rise Again

In a recent study ZEW economists examined whether specific types of governmental measures can reduce income inequality in the population. For their data, the ZEW researchers looked at tax returns from the years 1981 to 2005 in OECD countries. To approximate the causal effects of public expenditures, social spending policies and progressive taxation on income equality, the study employed several empirical approaches such as fixed effects panel regressions and Instrumental Variables.

To measure inequality, the study's authors use "Gini coefficients", the most common measure of income inequality, based on three datasets: the Luxembourg Income Study (LIS), the UN World Income Inequality Database (WIID), and data from the University of Texas's Inequality Project (UTIP). Since calculation techniques varied – sometimes within a single dataset – the authors examined each data source separately.

INCOME INEQUALITY IN OECD COUNTRIES OVER TIME



Income inequality in Gini points, with values ranging from 0 to 100, 0 being total equality and 100 being extreme inequality.
Source: ZEW

According to the findings of the ZEW study, income inequality fell in OECD states between 1960 and 1980, but has been on the rise again since the early 1980s. For the period after 2000, the WIID and UTIP datasets indicate a slight reduction of income inequality, while the LIS shows a sharp increase. In a first step towards the analysis, the investigators categorized different types of welfare states which with respect to institutions such as the influence of unions on wage negotiations, unemployment benefits, and the taxation system. They find that social-democratic have lower levels of income inequality and lower increases to income inequality, while liberal welfare states show higher levels for both metrics. This suggests that institutional framework can influence income distribution. The upsurge in income inequality in Eastern Europe after the collapse of socialism, in the late 1980s and early 1990s, support these observations.

Higher Social Expenditure and Public Spending Can Effectively Reduce Income Inequality

The ZEW study further found that governmental redistribution policies affect income distribution, despite the second-round effects described above. Specifically, researchers provide evidence indicating that a one per cent increase in public expenditures reduces income inequality by 0.3 per cent; the same increase in social spending lowers income inequality by 0.2 per cent. Increasing rates of progressive taxation, by contrast, were found to have no effect on income inequality, producing mostly insignificant results in the study. This may be due to second-round effects' playing a larger role here than for public spending. Hence, countries that desire to reduce income inequality would be better advised to increase public and social spending than make taxation more progressive. It is important, however, to take into account the empirical problems related to second-round effects when interpreting these results. At the end of the day, more empirical research must be devoted to identifying the causal effect of redistribution policies.

The study (ZEW Discussion Paper No. 14-012) is available for download at: www.zew.de/publikation7331. It has also appeared as "The Impact of Redistributive Policies on Inequality in OECD Countries", Applied Economics 46 (17), 2066–2086.

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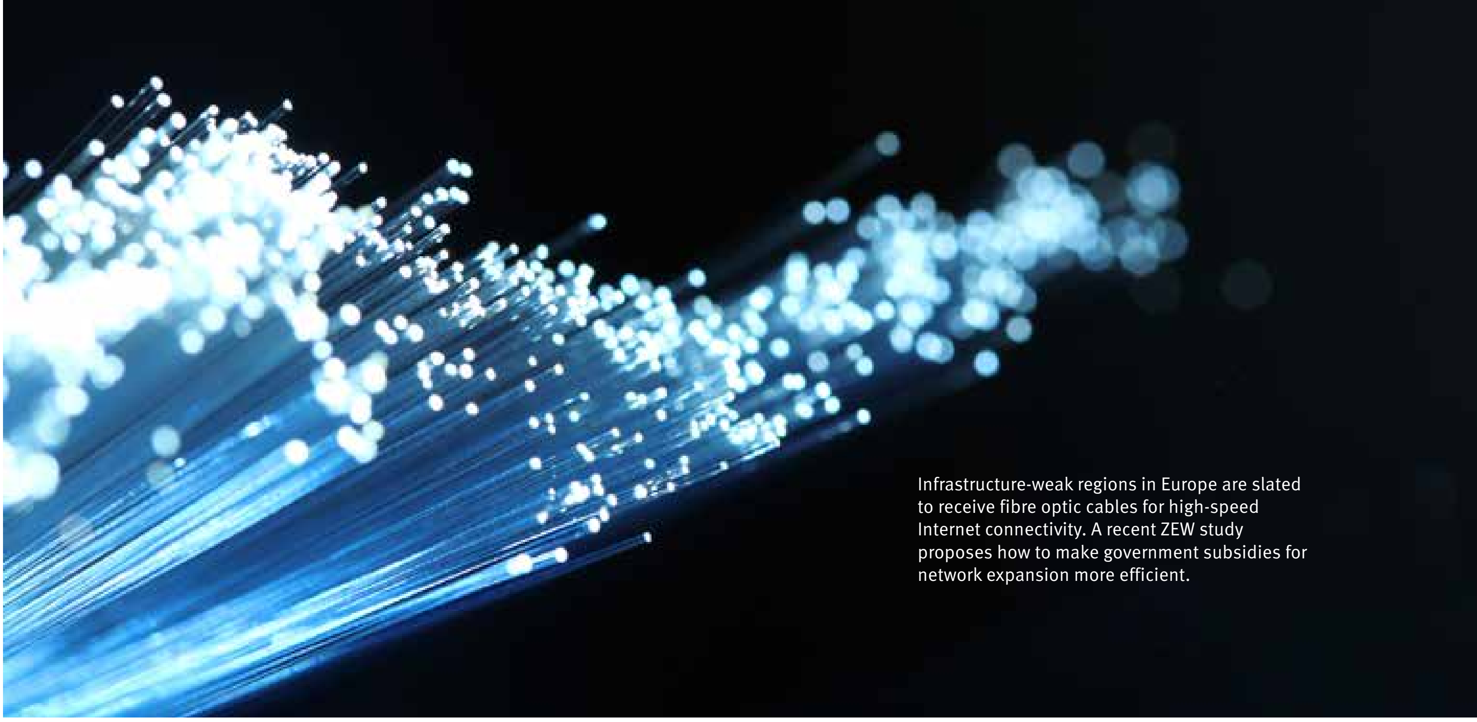
Deployment of Fibre Optic Networks: Making Public Subsidies more Efficient

Fibre optic networks are necessary for high-speed Internet. But the deployment of public subsidies for fibre optic networks is progressing slowly, especially in rural and sparsely populated regions. To speed up the deployment of fibre optic networks, the subsidy contracts between the public authorities and private network operators must become more efficient.

The demand for super-fast Internet connectivity has increased enormously in the past decade and, given the popularity of high bandwidth applications such as file sharing, video streaming, and cloud computing, will continue to grow in the future. And with state and local governments' seeing ultra-high speed broadband as a crucial prerequisite for economic growth, international competitiveness and productivity improvements across all business sectors, there's even more need to replace Europe's predominantly copper-based broadband with fibre optics. Standing in the way, though, are the massive risks and investment costs associated with such a project. These costs are of much greater magnitude than the previous investments required for upgrading first-generation copper networks to faciliate broadband services and add up to billions of euros.

Whereas large parts of East Asia have already deployed nationwide fibre optic networks, Germany and most other European countries still rely on private network operators, who devote their attention to profitable, densely populated areas. As a result, many of Europe's rural areas have fallen behind. It is pre-



Infrastructure-weak regions in Europe are slated to receive fibre optic cables for high-speed Internet connectivity. A recent ZEW study proposes how to make government subsidies for network expansion more efficient.

cisely in these regions, known as “white areas”, that public subsidies can help, eliminating the digital divide by giving everyone equal access to fibre optic broadband. Germany’s Grand Coalition, for instance, intends to outfit the entire country with high-speed Internet by 2018.

Subsidies from the EU have helped expedite the expansion of fibre optic broadband in the member states. From 2003 to 2010, the EU Commission earmarked a total of 3.3 billion euros for this purpose; from 2007 to 2010 it made available an additional 2.3 billion euros from its own funds.

Inefficient Subsidies due to Information Asymmetry

From an economic perspective it is doubtful whether these subsidies are efficient. In most cases, decision-makers – regulators, state and local governments – have limited knowledge about the terms of the subsidies, even though the contracts contain fixed guidelines on a variety of issues, availability and transmission speed in particular.

In a recent study (Discussion Paper No. 14-022) ZEW researchers examined the efficiency of deployment subsidies. The study’s authors began by comparing past and present subsidies around the world for fibre optic networks. They identified the goals set down by subsidy programmes in all the EU states plus ten other countries. For all countries considered, the governments stipulated both the scope of network expansion and the attendant quality standards. But these stipulations, they note, lead to inefficient subsidy contracts because governments are not completely informed about the capital costs of network expansion. Moreover, most of the subsidy contracts contain so-called clawback provisions, which limit operators’ profits without limiting the investment risk. These provisions are hard to enforce because governments must determine ex post whether operators’ profits are disproportionately high – a task that poses its own set of problems.

Subsidy Contracts with Linear Profit Sharing and Risk Spreading – The Efficient Solution

In view of these issues, ZEW investigators recommended an alternative for subsidizing fibre optic networks in white areas: subsidy contracts with linear profit sharing. These contracts delegate decisions about network size to private operators, who tend to be better informed about actual cost and demand. Linear contracts also spread out investment risks and cut operators in on future profits. ZEW researchers argue that this type of arrangement will make it easier for governments to achieve their goals: maximizing the nationwide deployment of fibre optic networks and minimizing subsidy costs and operators’ profits – all without the need to have complete information beforehand.

The proposed linear profit-sharing contracts are good examples of how to put better efficiency incentives into practice but at the same time still limit the burden on public budget. It should be hoped that more innovative contracts will accordingly be implemented. But the efficient amount of government intervention should be determined for each project in response to actual costs and demand and be restricted to white areas only.

The study (ZEW Discussion Paper No. 14-022) is available for download at: www.zew.de/publikation7377

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IN THIS ISSUE

A recent ZEW study identified which German households are more likely to take precautionary measures against flooding. Its findings will help improve incentives and regulations for future flood protection.

Households Insured Against Flooding Take more Precautionary Measures

Private measures to prevent flooding of residential buildings and minimize water damage are an important part of flood risk management. Persons who expect more flooding ahead as a result of climate change are especially likely to take precautionary measures. Curiously, moral hazard was not observed.

When water breaks riverbanks, flooding entire stretches of land, the social, psychological, and economic repercussions can be grave. Germans recall the years 2002 and 2013 for the record floods that struck the Elbe and Danube and some of their tributaries, which took 30 lives and caused billions of euros worth of damage. But even less serious floods – after heavy rains, for example – can exact a heavy toll. And partly owing to climate change, the incidence and severity of flooding is expected to increase in the future.

All the more reason to have insurance. Yet only 33 per cent of German households are insured against flood damage. Though Germany's federal government has in the past offered immediate aid after major floods, state assistance is not guaranteed by law. Flood proofing of private residences – including the use of water-resistant building materials and backflow flaps – is key. Empirical analyses of flood-prone regions have shown that many of these prudential measures are cost efficient, and significantly reduce flood damage.

Flood Risk Management Across Germany

ZEW made the first-ever attempt to assess private precautionary measures against flooding throughout all of Germany. Unlike previous research, this study focused on low-risk areas as well as on traditionally high-risk zones, the rationale being that even elevated regions are routinely affected by heavy rainfall. The data collected can be used to develop new policies – information campaigns, incentives, regulations – that encourage residents to be more prudential.

For the analysis, ZEW collected cross-section data from a standardized survey of more than 6,400 German households conducted in October and November of 2012. The authors specifically examined households that either have a cellar or that are located on the ground floor and hence are potentially at risk for flooding. Some 5,850 households – more than 90 per cent of those surveyed – satisfied one or both of these criteria.

A surprising initial finding of the ZEW study is that many homeowners overestimate the amount of flood protection covered by their insurance. Homeowner's insurance is common in Germany but often it only covers damage caused by storms, hail, and fire; flood damage protection requires a separate policy. In 2012 the market share of home insurance covering flood damage was, as cited above, around 33 per cent. The study's assessment of the representative survey data indicates that almost 60 per cent of homeowners assume that their homeowner's insurance also covers flood damage.

Households with Prior Flood Damage more Likely to Take Precautionary Measures

The study also found that the likelihood of a household's taking private precautionary measures increased by 21 per cent if its members previously suffered financial or physical harm as a result of flooding. Homeowners who expect increased flood damage due to climate change are ten per cent more likely to take such measures. This bump does not apply to renters.

Finally, ZEW researchers investigated whether moral hazard occurs – that is, whether households that are insured against flood damage take fewer precautionary measures in the belief that the insurance money will cover the damage that results. The data do not show this kind of behaviour; on the contrary, households insured against flooding took more precautions than non-insured households. Some of those surveyed took fewer precautionary measures in the expectation of state aid, but they were limited to a small group of renters.

The study (ZEW Discussion Paper No. 14-032) is available for download at: www.zew.de/publikation7451

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The Costs of China's New Climate Policy

The People's Republic of China wants to reduce greenhouse gas emissions while keeping adverse effects on economic growth to a minimum. A recent ZEW study considers the consequences of China's new climate policy.

China aims to achieve a 40 to 45 per cent cut in carbon emissions intensity (megatons of CO_2 per euro) by 2020 compared to 2005 levels. A government-sponsored pilot system for emissions trading is now being tested in several metropolitan areas, including Beijing and Shanghai. The goal is to reduce CO_2 intensity by 17 to 21 per cent compared to 2010 levels within the current Five Year Plan. The emissions reductions are in accordance with China's pledges in the Copenhagen Accord. The European Comission supports Chinese policy makers in designing and implementing an emissions trading scheme considering the experience of the European Emission Trading System.

Slowdown Expected Through 2020

ZEW economists recently published a study illuminating the effects of China's climate targets on economic output. Projecting that China will eventually introduce its pilot system nation-wide, researchers compared various growth scenarios to quantify the influence of climate policy on economic power and sectoral competitiveness. The study also examined the repercussions of a hypothetical network between emissions trading in China and the EU. Assuming moderate economic growth, the study's authors calculated that a 45 per cent reduction in emissions intensity would reduce China's GDP in 2020 by around one per cent below its projected level. If economic growth and/or CO_2 reduction turn out to be greater, a stronger effect on GDP is expected. The calculations of the researchers do not take into account possible technological progress.

According to the study's findings, many sectors of China's economy would be only moderatly affected by a nationwide emissions trading system. Yet some sectors, such as the aluminium industry and electricity generation, are likely to experience serious cost increases. The way emission permits are allocated influences the performance of individual sectors. Permits that are auctioned generate higher costs than those that are allocated for free. This makes the implementation of auctioning more difficult. In all examined cases, the authors found that the introduction of an emissions trading scheme can affect China's economic structure.

Emission Permits Trading with the EU

The ZEW study also considered the effects of linking the emissions trading systems of the EU and the People's Republic. Even with a trade volume capped at 300 million tons of CO_2, China stands to gain in profits and welfare. The price of emission permits would decline in the EU and increase in China, though the trade cap would prevent total price alignment.

The study (ZEW Discussion Paper No. 14-020) is available for download at: www.zew.de/publikation7375

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Increased industrialisation and traffic have created serious smog problems for China's cities. In response, the People's Republic wants to reduce greenhouse gas emissions.

VIPS – Proposal for a Viable Insolvency Procedure for States in the Eurozone

A recent study conducted by ZEW suggests a credible and well-defined debt restructuring mechanism for member states of the eurozone suffering a loss of creditworthiness on the capital market. The following article explains the Viable Insolvency Procedure for Sovereigns (VIPS) in the eurozone.

The government debt crisis unleashed a wave of reforms in 2010 – some of which were implemented in an overly hasty manner – to stabilise the euro and the heavily indebted European countries. Even though the eurozone's institutional framework and its capacity to respond to crises have been improved significantly, the architecture of the euro area remains vulnerable in at least one respect: the absence of a credible and well-defined debt restructuring mechanism in the event of a country's insolvency, i.e. public debt reaches a clearly unsustainable level. The study conducted by ZEW addresses this problem.

The government debt crisis unleashed a wave of reforms in the EU, but there is still no credible and well-defined debt restructuring mechanism in the event of a nation's insolvency.

ZEW's VIPS concept is based on two pillars: first, a contractually binding insolvency regime for the euro area that reestablishes market discipline in the long term; second, credible transitory provisions which construct a bridge into that long-run insolvency regime. VIPS takes a cautious approach and avoids any sudden measures that could destabilise the still fragile situation in the eurozone. Instead, the VIPS proposal opts for a transition period before fully implementing a European debt restructuring mechanism. A credible debt restructuring mechanism would eliminate the expectation on the part of private creditors that eurozone member states would bail out highly indebted countries when required. It would also dispel uncertainty concerning the implementation and the outcomes of a restructuring of government debt.

Clear Rules for Debt Restructuring Negotiations

ZEW proposes a debt restructuring mechanism that becomes effective after a transitional period once the criteria established in advance have been met, or at the latest at a clearly defined point of time in the future. It incorporates ideas put forward in earlier proposals, but with respect to a number of aspects, the VIPS mechanism is more specific and complements the previous proposals. The insolvency procedure proposed by ZEW allows member states facing liquidity constraints a discretionary decision whether to apply for support under a conditional European Stability Mechanism (ESM) programme. Creditors cannot oblige a country to accept liquidity support, let alone force them into debt restructuring. However, if the ESM programme fails to reopen the country's market access within a three-year shelter period, the country must negotiate debt restructuring measures with its creditors, including the ESM. These negotiations require clear-cut and enforceable regulations. During these negotiations, there is a strict debt moratorium that includes a stay on all repayments until the negotiations have ended. Compliance with the debt moratorium is monitored by the ESM and possibly by the ECB/European Commission/IMF troika in order to prevent any payments that would benefit only one group of creditors. For a similar reason, the VIPS concept also includes a eurozone-wide introduction of aggregated "Collective Action Clauses" giving a qualified majority of creditors the option to agree on a debt restructuring scheme that is legally binding for all creditors, including a minority that votes against the scheme and may have a majority for single bond issues.

Problem of Further Economic Destabilization Clearly Addressed

The creditors' maximum loss given default is limited, since a potential haircut must not push a country's debt ratio below the Maastricht limit of 60 per cent of GDP. Earlier proposals have barely touched on the problem that the implementation of a debt restructuring mechanism could result in further destabilisation of the economic situation against the backdrop of high government debt levels and fragile banks. VIPS therefore proposes a lagged implementation, which is the VIPS bridge.

One important pillar of the bridge is that the restructuring mechanism would be defined in detail in the ESM Treaty already today. However, a transition cause would define that the new regime will only enter into force once prespecified quantifiable criteria have been met, including a critical average debt-to-GDP ratio of eurozone member states. If these criteria cannot be met before a predetermined date (for example until 2030), the regime should enter into force at the latest at that very date. This lagged implementation prevents further destabilisation in euro area government bond markets caused by the immediate introduction of the debt restructuring mechanism. At the same time, it takes advantage of the current reform momentum to kick-off an evolution of the system towards a more credible architecture.

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Q&A: The VIPS Proposal from ZEW

VIPS Makes it Easier for Creditors to Estimate Maximum Losses

VIPS – the Viable Insolvency Procedure for Sovereigns – is a well-defined debt restructuring mechanism proposed by ZEW for the case that a country in the eurozone is unable to service its debt any longer. Friedrich Heinemann, one of the co-authors of the proposal and head of the research unit Corporate Taxation and Public Finance at ZEW, explains why it can work. (For more information on the VIPS proposal, see pages 6 and 7.)

What incentives does VIPS offer eurozone member states to accept the debt rescheduling mechanism?

A clearly defined insolvency procedure can help stabilize markets for government bonds in the eurozone. Without such a procedure, investors cannot know how much they stand to lose should the worst case scenario – government bankruptcy – occur. The VIPS we've proposed helps investors reliably estimate the maximum amount they could lose. This expectation anchor can aid in the prevention of panics.

A novelty about VIPS is that it's designed for the long term. There's a transition phase lasting up to 16 years before the mechanism takes effect. Doesn't the proposal run the risk of being abandoned by future governments?

Once the VIPS and its transition regulations become anchored in the ESM Treaty, it will be difficult to roll back. Every subsequent change would require the unanimous decision by the treaty's signatories. A country can exit the ESM Treaty, but then it forfeits its claim to any emergency loans from the ESM.

You devote much energy to studying the ability and willingness of societies to adopt reforms. How do you rate the chances of euro countries' agreeing on VIPS or on a similar debt rescheduling mechanism?

Not bad. The politicians who back VIPS today would be already retired by the time it takes full effect. This makes it easy for them to accept VIPS today.

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Friedrich Heinemann

is head of the research unit Corporate Taxation and Public Finance at the Centre for European Economic Research (ZEW). He also teaches economics at the University of Heidelberg. His research focuses on empirical public finance, fiscal competition, the European Union, federalism in Germany and Europe, and the factors determining whether states and societies can adopt reforms. He studied economics and history at the University of Münster, the London School of Economics and the University of Mannheim.

China: A World Leader in Technology – Wishful Thinking or Reality?

ZEW President Clemens Fuest welcomed about 170 guests from the realms of business, politics and academia at the 2014 ZEW Economic Forum in mid-June. This year's forum was dedicated to the topic "China: A World Leader in Technology – Wishful Thinking or Reality?".

The speakers addressed the challenges German entrepreneurs are facing in China from various perspectives. The forum opened with a lecture by Andrew Tylecote, professor of economics at the University of Sheffield, titled "Openness of the Chinese Innovation and Research System in a Historical Perspective". He first shared his reflections on the factors that drive a national economy's long-term success. Then he reconstructed the starting conditions and development of the Chinese economy since the foundation of the People's Republic.

Georg Licht, Georg Schütte, Andrew Tylecote, Dieter-Heinz Hellmann and Albrecht Heuser engaged in discussion (from left).

Between Cooperation and Technology Competition

Georg Schütte, state secretary at the Federal Ministry of Education and Research, addressed the German-Chinese partnership while focusing on the differences in role perception and the way the partnership is changing due to the globalisation of research and development. Under the given circumstances, Germany needs to reconsider its position between cooperation and technology competition. The government should play a mediating role in this context, and both sides need to be willing to cooperate, Schütte said.

The lectures were followed by a panel discussion on China's role in the global technology race and the resulting challenges for German companies. Georg Licht, head of the ZEW Research Department "Industrial Economics and International Management", chaired the discussion. Dieter-Heinz Hellmann from the KSB Foundation and Albert Heuser from BASF SE joined the two keynote speakers for the discussion. They used the discussion to examplify their salient points again.

According to Dieter-Heinz Hellmann, the key challenge for German companies in China is to understand the nation's culture. German entrepreneurs need to be aware of the specific circumstances in China such as hierarchical party structures and legal loopholes. China also has a couple of domestic problems, e.g. environmental pollution and the shortage of skilled labour, Hellmann added.

Albert Heuser shed light on the need for European companies engaged in China to continue research and development with a focus on cultural factors. This is best achieved by establishing development departments in China, Heuser explained. He further suggested that German companies make use of the growing public pressure to launch green technologies in China.

Ralf Krieger, member of the management board of Freudenberg SE, concluded the 2014 ZEW Economic Forum with his speech on the risks and challenges of business activity in China from the perspective of a German company. In addition to cultural differences, such as the attitude towards intellectual property, there are also several structural challenges like protracted court proceedings and high staff turnover. The greatest risk for German companies, however, would be to miss business opportunities in China, because the country's importance and influence will continue to grow, Krieger concluded.

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New Research Network on Ubiquitous Working Launched

From 6 to 7 May 2014 researchers from the Ubiquitous Working Research Network met for a kick-off meeting at ZEW.

As networks and virtualization have grown and computers have become ubiquitous in the past decades, work is no longer exclusively confined to the workplace. Mobile devices, mobile internet access and remote access to firms' internal networks and data allow for working anywhere at any time. In April 2014 ZEW initiated a project to examine this new phenomenon. Over the next three years an interdisciplinary research network, with funding from the Leibniz Association, will investigate the challenges and opportunities of what is popularly known as "ubiquitous working". Partnering with ZEW on the project are the Knowledge Media Network, the Leibniz Research Centre for Working Environment and Human Factors at TU Dortmund, the Mannheim Institute of Public Health, the University of Mannheim, the University of Amsterdam, and the Free University Amsterdam.
More information can be found at: www.leibniz-education.de/projekt.html?id=64&lang=en

ZEW Presents 2014 Heinz König Young Scholar Award to US Researcher

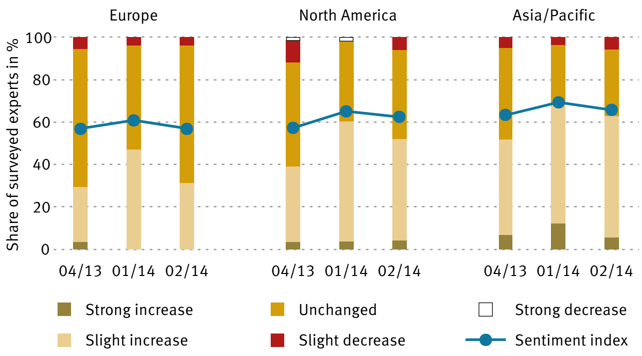
Olga Malkova from the University of Michigan, US, received the 2014 Heinz König Young Scholar Award of the Mannheim Centre for European Economic Research (ZEW). The jury recognised Malkova's excellent research on the effects of parental leave benefits on birth rates. In her analysis she could proof a positive effect of the benefits. Her work is an important contribution to the debate on the effectiveness of family policy measures. The award comes with an endowment of 5,000 euros and includes the opportunity to spend an extended research visit at ZEW. This year's award was sponsored by Freudenberg SE, a member of the ZEW Sponsors' Association for Science and Practice. The Heinz König Young Scholar Award was presented at the 2014 ZEW Summer Workshop in July. This year, 21 papers were selected for presentation out of more than 250 submissions. The selected researchers were invited to the Summer Workshop where they had the opportunity to discuss their work with other up-and-coming researchers and renowned economists such as Gerard J. van den Berg from the University of Mannheim, Ivan Fernandez-Val from Boston University and Ed Vytlacil from New York University. Van den Berg, Fernandez-Val, and Vytlacil also held lectures at the workshop and selected the award winner, Olga Malkova.

From left: Thomas Kohl (ZEW), Volker Christ (Freudenberg), Olga Malkova (University of Michigan) and Gerard J. van den Berg (University of Mannheim).

ZEW Among the Top Five Climate Policy Think Tanks in the World

The Centre for European Economic Research (ZEW) ranks fourth among the approximately 200 institutes evaluated for the recently published "2013 Climate Think Tank Ranking" by the renowned International Center for Climate Governance (ICCG). It is thus among the world's most cutting-edge scientific institutions that work in the field of climate change economics and policy. Compared to 2012, the research institute has moved up two spots in the ICCG ranking, where all the activity outputs of a think tank were standardised by the number of its researchers. The institutes included in the ranking were assessed by ICCG experts according to a set of 15 criteria structured in three pillars: activities, publications, and dissemination. The activity indicator measures the institute's influence on climate policy and its policy involvement. The publications pillar refers to the number and quality of publications. An important factor in this pillar is the number of publications in renowned peer-reviewed academic journals. The dissemination pillar was added as a new criterion in this year's ranking. It evaluates the success of an institute in disseminating its research results at international conferences or via the internet.

Maritime Freight – Stable Growth in Europe and Upward Trend in Asia-Pacific Region



Source: ZEW

Almost two-thirds of the experts queried in the ZEW/Prognos Survey on Transport Markets project stable growth for Europe's short sea shipping industry over the next six months. A third of the experts expect a slight uptick in volume. Just short of half of the ZEW/Prognos survey's participants anticipate moderate growth for the North Atlantic route. For the sea trade with Asia and the Pacific, over 60 per cent see an upward trend in sea trade; six per cent reckon on a sharp increase.

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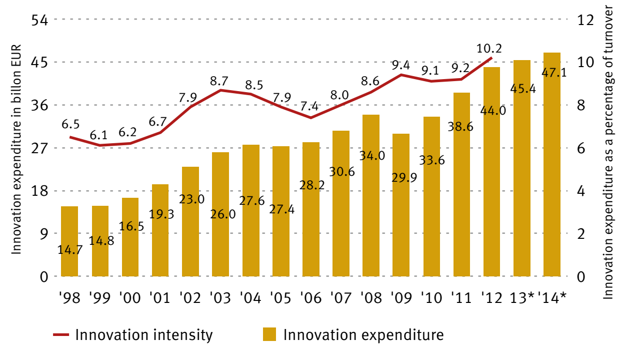
Innovation Expenditures of Automotive Manufacturing Industry Increase at Slower Pace



* Target figures from spring/summer 2013

Source: ZEW, Mannheim Innovation Panel

Over the past 15 years, the German automotive manufacturing industry has tripled its spending on the development and marketing of new products and processes from 14.7 billion euros in 1998 to 44 billion euros in 2012, with an average annual growth rate of 8.2 per cent. The prospective spending on innovation in 2013 amounted to 45.4 billion euros; in 2014, the industry plans to invest 47.1 billion euros. This corresponds to annual growth rates of 3.1 (2013) and 3.8 per cent (2014).

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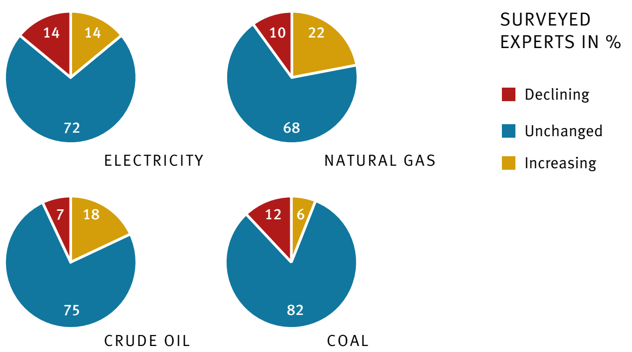
Stable Energy Prices over the Short Term Expected



Source: ZEW

According to the experts surveyed for the ZEW Energy Market Barometer, wholesale energy prices in Germany will remain stable over the short term, e.g. over the next six months. 82 per cent of the experts indicated that coal prices will stay unchanged. With regard to crude oil and electricity about 75 per cent and 72 per cent respectively expect stable prices. 68 per cent of the questioned experts expect that prices for natural gas will keep their current levels over the short term. The ZEW Energy Market Barometer is a biannual survey of some 170 energy market experts.

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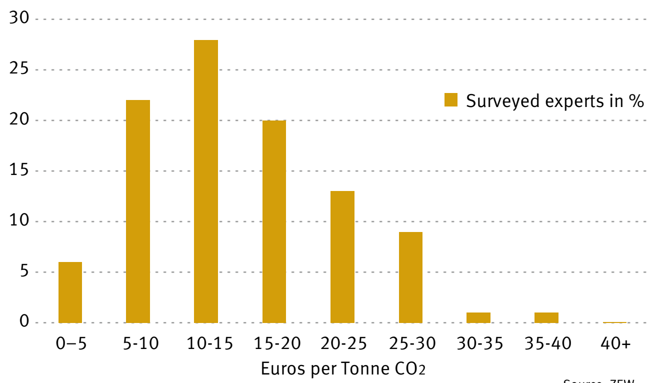
Emission Prices of up to 15 Euros per Tonne CO_2 Anticipated



Source: ZEW

Half of the experts surveyed for the ZEW Energy Market Barometer expect a medium-term (five year-time horizon) price between five and 15 euros per tonne CO_2 on the European emission markets. Prices between 15 and 20 euros are predicted by 20 per cent. 13 per cent of the experts anticipate that the price will range from 20 to 25 euros. Nine per cent are predicting prices of between 25 to 30 euros – only a few experts expect prices of more than 30 euros per tonne CO_2. The ZEW Energy Market Barometer is a biannual survey of some 170 energy experts.

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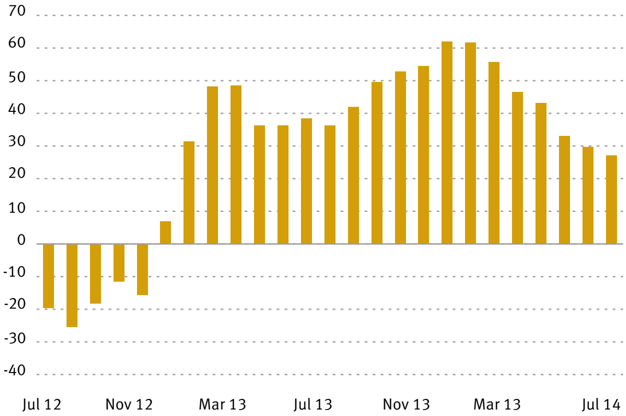
ZEW Financial Market Test July 2014



Balance of positive and negative assessments concerning economic development on a six-months horizon in Germany.
Source: ZEW

Germany: Downward Trend Continues

In July the ZEW indicator of Economic Sentiment for Germany has lost 2.7 points and now stands at 27.1 points (long-term average: 24.7 points). The indicator has declined for the seventh consecutive time. Germany has experienced a slight dent in economic activity recently – retail sales declined and industrial production as well as incoming orders dropped. The current decrease of the ZEW Indicator of Economic Sentiment reflects this sobering development. On a general note, however, the medium-term economic outlook remains favourable. The assessment of Germany's current economic situation declined by 5.9 points to 61.8 points in this month's survey. The ZEW Indicator of Economic Sentiment for the Eurozone has lost 10.3 points compared to the previous month, now standing at 48.1 points.

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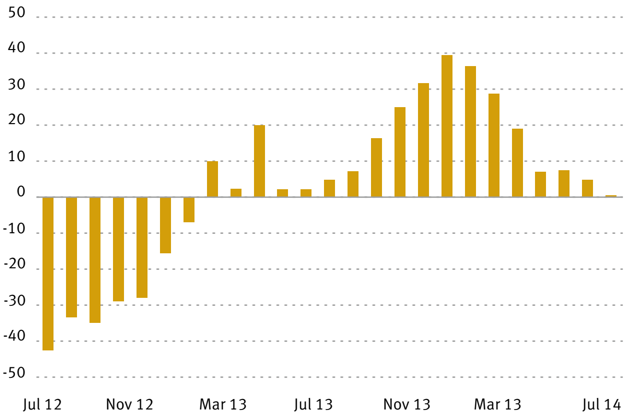

Balance of positive and negative assessments concerning economic development on a six-months horizon in Switzerland.
Source: ZEW, Credit Suisse

Switzerland: Economic Expectations Balanced

In July 2014 economic expectations for Switzerland have declined slightly by 4.7 points. The ZEW-CS Indicator now stands at a nearly balanced level of 0.1 points. This neutral reading of the indicator signals that the current favourable economic conditions in Switzerland are likely to remain until year end. Since April 2014 economic expectations have been shaped by a majority of analysts, who expect the economic situation to remain. In July 70.7 per cent of economic experts share this view. Among the remaining experts optimists and pessimists hold equal shares. The Indicator reflects the expectations of the surveyed financial market experts regarding the economic development in Switzerland on a six-month time horizon. It is calculated monthly by the ZEW in cooperation with Credit Suisse (CS).

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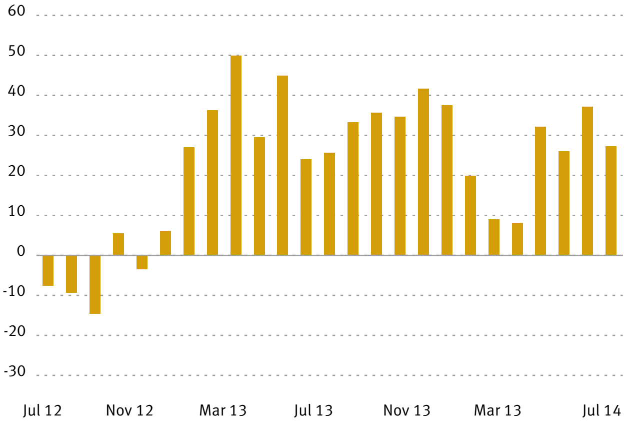

Balance of positive and negative assessments concerning economic development on a six-months horizon in the CEE region.
Source: ZEW

CEE Region: Economic Expectations Decline

In July 2014 economic expectations for Central and Eastern Europe including Turkey (CEE region) have partly reversed their last month's increase. In the current survey the ZEW-Erste Group Bank Economic Sentiment Indicator for the CEE region has lost 9.8 points and now stands at a level of 27.3 points. The experts' assessment of the current economic situation for the CEE region has also dropped by 14.3 points to an almost balanced level of minus 0.1 points. The Indicator reflects the financial market experts' expectations for the CEE region on a six-month time horizon. The indicator has been compiled on a monthly basis together with further financial market data by the Centre for European Economic Research in Mannheim with the support of Erste Group Bank, Vienna. It has been established in 2007.

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Germany's Inheritance Tax Needs Reform

Generating some 4.5 billion euros in revenues each year, Germany's inheritance tax is actually a small source of income for the state – revenues from taxes on tobacco, for example, are more than three times as high. But despite its marginal importance as a source of revenue, the inheritance tax is a hotly debated issue. Proponents of the inheritance tax advocate rate increases, arguing that the taxation of inherited wealth is simply a matter of fairness, as beneficiaries have done nothing to earn the wealth they inherit. By contrast, critics argue that the inheritance tax endangers jobs, as the heirs of family owned companies face large tax bills that can cripple a company's liquidity.

German policymakers have sought to achieve compromise by preserving a tax rate of up to 50 per cent on inheritances and gifts while creating exceptions that ease the burden on entrepreneurs. Company assets, for example, can be transferred tax-free when the heir does not sell the company and when the average wage bill seven years after the transfer is not lower than the average five years prior. This appears to be a reasonable solution at first glance. A closer examination reveals massive weaknesses, however.

First of all, the exceptions create considerable loopholes for tax avoidance. It is difficult to determine whether assets are an essential part of a company, or were merely transferred to a company by heirs to avoid taxation.

Second, the requirement that a company continue to operate as before without a lower wage bill has negative economic effects, as it makes restructuring impossible. However, particularly after the death of an owner, the restructuring or sale of a company is often required in order to save jobs.

Third, the exceptions created for companies raise questions of fairness. Why should gifts and inheritances that are in some cases extremely large be exempted from taxation while other types of wealth are taxed at a 50 per cent rate?

Germany's Federal Tax Court is of the opinion that current inheritance tax rules are incompatible with the principle that all taxpayers should be treated equally. Accordingly, in 2012 the Tax Court asked the Federal Supreme Court to rule on whether the inheritance tax's exemption rules violate the German Constitution. Due to widespread fears that the exemption rules might be abolished, the volume of company assets transferred on an annual basis has increased rapidly in Germany in recent years – from approximately five billion euros in 2010 to 26 billion euros in 2012. Of course, the current exemptions mean there was no associated increase in tax revenues.

As the Federal Supreme Court will soon rule on this issue, policymakers should seize the moment and improve the inheritance tax. Simply abolishing the exemptions for companies would not be a good solution, as it would place excessive burdens on companies, thus endangering jobs and growth. A better solution would be to limit the taxation of inheritances and gifts to between eight and ten per cent, as well as to grant company assets an eight year deferral period, without red tape. This reform would allow companies to pay inheritance taxes with profits from normal business activities while also eliminating the unfairness and economic disadvantages of the current system.

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