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THE COMMUNITY AND GERMAN UNIFICATION :
IMPLICATIONS OF THE STAATSVERTRAG

(Communication from the Commission)

CONFIDENTIAL

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Introduction

1. The draft Treaty on monetary, economic and social union (Staatsvertrag) between the Federal Republic of Germany and the German Democratic Republic represents a decisive step towards German unification. The Staatsvertrag, which is scheduled to come into force on 1 July 1990, involves the immediate introduction of monetary union (with transfer of sovereignty to the Bundesbank) and the gradual integration of the German Democratic Republic in the economic and social system of the Federal Republic of Germany. Under Article 11(3) of the Staatsvertrag, the German Democratic Republic will align its policy on Community objectives. The preamble states that the provisions of the Treaty must ensure that Community law is applied after the achievement of German unity. The Staatsvertrag is thus both the legal framework and the main instrument for the gradual integration of the German Democratic Republic into the legal order of the Community ahead of the formal unification of the two Germanies.
2. In line with the conclusions of the special meeting of the European Council in Dublin, the Federal Government has regularly informed the Community (Council meetings on general affairs or economic and financial affairs) about the progress of the Inter-German negotiations on the Staatsvertrag. The Commission too has had detailed talks with the Ministers and State Secretaries in the Federal Government responsible for the various areas covered by the Staatsvertrag. The Commission has also, on a number of occasions, been able to discuss in detail with the Federal Republic of Germany's main negotiator how the proposed Staatsvertrag will affect the Community's powers. The Commission has thus been able to state its views on certain basic principles and on the substance itself of various provisions.
3. The purpose of this paper is to:
 - give a brief summary of the contents of the Staatsvertrag;
 - assess its compatibility with Community law;

- discuss various macroeconomic implications at Community level;
- comment on the effects ahead of integration;
- highlight certain immediate implications to ensure the success of the interim period;
- set out the timetable for adjusting Community law to integrate the German Democratic Republic into the Community.

STAATSVETRAG: main points

4. The main points of the monetary union part of the preliminary Staatsvertrag concern the conversion rate, the treatment of enterprise debt and restrictions on public finances.

From 1 July 1990, the DM will become the only means of payment in the German Democratic Republic. Sovereignty in the conduct of monetary policy is taken over by the Bundesbank. The prevailing regulations of bank supervision will also apply in the German Democratic Republic. Wages and pensions which prevailed at 1 May will be converted at a rate of 1:1. In general, debt and claims will be converted at a rate of 2:1. However, for residents of the German Democratic Republic, the conversion rate for savings including cash money will be 1:1 within the following limits : children (age group 0-14) - DM 2.000, persons (age group 15-60) - DM 4.000, elderly (age group over 60) - DM 6.000. Remaining money in circulation and savings - with some macroeconomically minor exceptions - will be converted at a rate of 2:1.

Non-residents are allowed to exchange Mark at a rate of 3:1 into DM, however, only to the extent that these have been issued by German Democratic Republic banks after 31 December 1989.

As cash money can be converted at the same conditions as savings accounts, equalization activities first among families but also among the population in general can be expected. Therefore, the theoretical maximum amount of 64 bn DM will probably be converted into DM at 1:1, leading to equalization needs (Ausgleichsforderungen) on the balance sheet of the German Democratic Republic government of about 32 bn DM.

5. Regulations affecting public finances in both the Federal Republic of Germany and the German Democratic Republic budgets concern transfer payments from West to East, budget and borrowing rules for the German Democratic Republic budget, German Democratic Republic public debt after unification, revenue and expenditure structure of the German Democratic Republic budget.

Public transfers in particular consist of support for the old age pension scheme and unemployment insurance (Anschubfinanzierung). These transfers will be limited as they will correspond to budget positions announced in the budget of the Federal Republic of Germany.

As regards budget procedures, the German Democratic Republic is obliged to introduce the West German tax system. Strict borrowing requirements will prevail for different budgets excluding the social security budget. Approval by the Minister of Finance of the Federal Republic of Germany is required for a budget deficit.

Public debt which exists at the time of unification will become public debt of the German Democratic Republic-Länder. This would relieve the Federal budget of any additional debt burden associated with a unified Germany.

While on the revenue side the German Democratic Republic will have to introduce the Federal Republic of Germany tax system, on the expenditure side subsidies for private households and the dwelling sector will have to be reconsidered or abolished. As regards agriculture, CAP regulations will be introduced. Salaries for public servants will have to take account of the general economic and financial conditions in the German Democratic Republic.

A financial fund named "Deutsche Einheit" has been created to provide financial resources to the German Democratic Republic. The overall amount is 115 bn DM, of which 20 bn should be provided by expenditure cuts, while the remaining 95 bn DM will be financed on the capital market. Liabilities are equally shared between the Federal Government and the Länder.

The fund is designed to finance 2/3 of the predicted budget deficit of the German Democratic Republic within the next 4 ½ years. It is not project-linked, i.e. to rebuild the infrastructure of the German Democratic Republic. Moreover, it does not include supplementary contributions to the social security system in the German Democratic Republic. The total amount is spread over a period of 4 ½ years. The contributions of the Federal Republic of Germany to the German Democratic Republic-budget deficit amount to 2/3 of the territorial authorities' deficit in 1990 and 1991. Therefore, fiscal policy in the German Democratic Republic seems to be under a constraint not to exceed the expected deficit.

Any potential financial risks will mainly be borne by the Federal Government, as the existing revenue-sharing mechanisms, i.e. sharing of income tax, value added tax and the horizontal Länder equalization-mechanism (Länderfinanzausgleich) will not be altered until 1994.

6. On economic union, the Staatsvertrag provides for the introduction of the basic rules governing market economies in the German Democratic Republic, e.g. contract freedom between economic agents, abolition of administered prices, wage autonomy on both sides of industry sector of private property rights.

As regards trade, the conditions of German-German trade concerning goods of German origin will be normalized and treated as inter-regional trade. There will be no border and customs control for goods of German origin and exports to the other parts of Germany will not initiate special VAT procedures. Goods of non-German origin, will be treated as normal imports (exports). An inner-German border control will thus still be necessary. Both parties, however, have agreed to prepare the ground for the abolition of inner-German border as soon as possible.

Special quantitative rules can also be introduced in agricultural trade with the Federal Republic of Germany. Nevertheless, the German Democratic Republic is introducing EC regulations including the respective producer price system.

The structural adjustment of enterprises can be supported by the German Democratic Republic government by providing financial resources during a transition period. This support is however dependent upon the financial situation of the German Democratic Republic budget and the consent of the Federal Republic of Germany government must be obtained.

7. According to the social union part, pension, health, accident and unemployment insurance will be administered by self-governing bodies under the legal supervision of the state. They are mainly financed through contributions by employers and employees (normally 50 % each). The German Democratic Republic introduces an unemployment insurance scheme comparable to the Federal Republic of Germany's. A health insurance scheme will be established. In the case of illness, wages are paid by employers according to the regulations in the Federal Republic of Germany. Pensioners have to contribute to the health insurance system. Pensions are fixed at a level that represents 70 % of the average net wages in the German Democratic Republic (after 45 years of paying contribution to the pension system). If the pension would fall below the previous German Democratic Republic pension, the amount of the previous pension will be paid in DM. Pensions will be adjusted according to the development of net wages. If, during a transitional phase, regular contributions to the pension and unemployment schemes do not fully cover expenditures, the Federal Republic of Germany will make a transitory contribution (Anschubfinanzierung).

Compatibility of the Staatsvertrag with Community law

8. During the negotiation of the Staatsvertrag the Federal Government had the job of pursuing the objective of preparing the ground for German unification and at the same time protecting Germany's rights and obligations deriving from Community law.

It was helped by two factors. First, Community law already makes allowance for Germany's special situation, in particular with the Protocol on German Internal trade and connected problems. Second, from the start of the negotiations between the two Germanies, the objective of the Staatsvertrag was to gradually align the law and policy of the German Democratic Republic on Community law.

This objective is reflected in:

- the preamble to the Staatsvertrag, where the contracting parties state their intention that the Staatsvertrag should ensure application of Community law after unification;
- Article 11(3), which provides that the German Democratic Republic should gradually align its economic policy on Community law and the Community's economic objectives, while at the same time respecting the existing economic links with COMECON;

- the first of the principles enshrined in a Protocol annexed to the Staatsvertrag which, as stated in Article 4, is designed to allow the adjustment of German Democratic Republic law to be directed by the requirements of the monetary, economic and social union to be attained by the Staatsvertrag. This fundamental principle is that German Democratic Republic law will be shaped in accordance with the principles of a free, democratic, social and constitutional order and will move towards the legal order of the European Community.
9. The general content of the Staatsvertrag, including its nine annexes, and the institutional arrangements for its application are compatible with Community law, given what has been said above. A number of areas covered by the Staatsvertrag are, however, within the Community's jurisdiction. This is in particular the case with Article 13, which deals with commercial policy, an area where the Community has exclusive powers. The final text of the Staatsvertrag contains provisions which take account of these considerations:
- Article 35 provides that the Staatsvertrag does not affect the international treaties concluded by the Federal Republic of Germany and the German Democratic Republic, which means that from the outset there is no incompatibility between the obligations which the Federal Republic of Germany has contracted with the German Democratic Republic and its obligations towards the Community;
 - Article 13 (3) of the Staatsvertrag, which provides for close cooperation between the contracting parties to defend their external policy interests, stipulates that this cooperation must not infringe the powers of the European Communities.
10. It would have been desirable to stipulate that the arbitration tribunal provided for in Article 7 of the Staatsvertrag should seek preliminary rulings from the Court of Justice in accordance with the Article 177 EEC procedure when it has to settle disputes between the contracting parties on the interpretation of the Staatsvertrag which involve matters of Community law. However, it is not essential that this be stipulated, since it can be argued that it derives automatically from the combined provisions of Article 35 of the Staatsvertrag and Article 177 EEC interpreted in the light of the objectives of aligning the German Democratic Republic's law on Community law as mentioned at point 1. The Federal Government should be able to give an undertaking that it will defend this point of view in any procedure before the arbitration tribunal.

There is, in fact, a certain link between this tribunal and the Community, because if the parties fail to agree, the President of the Court of Justice will have to appoint its President.

11. The objective of aligning the German Democratic Republic's law on Community law is pursued in many areas in the Staatsvertrag. The Commission hoped that in this context, the principle of equal treatment for Community nationals and firms would be clearly asserted. The provisions of the Staatsvertrag on agriculture are wholly satisfactory from this point of view: Article 15 of the Staatsvertrag on the alignment of the German Democratic Republic's system of price stabilization and external protection on the CAP contains a provision that the German Democratic Republic will refrain from introducing levies or refunds in trade with the other eleven Community countries provided that the Community does likewise with the German Democratic Republic (Article 15(1)). The Staatsvertrag can be interpreted to mean that this principle applies to the provisions of the Staatsvertrag concerning the alignment of the German Democratic Republic's customs system on the Community system (Article 30 of the Staatsvertrag on customs law and Article 12(2) on customs surveillance). Similarly it can be argued that the basic principles of a market economy as stated in Article 2 of the Staatsvertrag will be applied with due respect for equal treatment for Community nations and firms in the areas of Community jurisdiction.

When the Staatsvertrag was signed, the German Democratic Republic stated that it will afford nationals and firms from all the Community Member States, on a basis of reciprocity, the same treatment as natural persons and firms in the Federal Republic of Germany if the matter concerned might affect the areas of jurisdiction of the European Communities and there is no express provision to the contrary in the Staatsvertrag.

In view of the objectives of the Staatsvertrag, the statement made by the German Democratic Republic when it was signed and the assurances given by the Federal Government, it can be stated that this equality of treatment will be respected in the application of the Staatsvertrag in the areas of Community jurisdiction.

12. The Staatsvertrag will also affect certain more specific areas of Community law. It will be noted in this respect that the parties are resolved to establish "as soon as possible" the conditions required to completely eliminate controls at the inter-German border (Article 12(3) on inter-German trade) and to remove the tax frontier between them as regards VAT (Article 31(2) on taxation). These provisions must be seen in the context of the Protocol on German internal trade. The Commission has made it quite clear to the Federal authorities that in its view, the existing practice of administrative cooperation with the Commission in the management of German internal trade should make it possible to adapt this management to an increased volume of trade while at the same time continuing to maintain adequate surveillance adapted to the new circumstances. It will be noted that the Staatsvertrag requires the German Democratic Republic to introduce the road tax for lorries planned in the Federal Republic of Germany. The Commission is challenging the compatibility of this tax with Community law.

Macroeconomic implications

13. The prospective economic and monetary unification of the two German states will have a significant positive impact on activity in the Community. It will also contribute to reduce the large external imbalances among some Member States. Providing German Democratic Republic residents with hard currency will probably imply an important shift in the internal demand of the German Democratic Republic towards imports. This will add to the demand effects arising from desired foreign direct investment in the German Democratic Republic and public transfers. All in all, the growth stimulus for the Federal Republic of Germany can be expected to be around 1% of GDP per year in the two years following the introduction of the monetary union, and the effect on the Community as a whole 0.5%.

For the German Democratic Republic a big adjustment process will be required. In the very short run significant imbalances in the form of a current account deficit, a fiscal deficit and unemployment might occur. Provided wages are kept at a realistic level relative to the expected level of productivity, it seems, however, reasonable to expect that substantial investments from both the Federal Republic of Germany and other countries will ensure an accelerated pace of catching-up. To alleviate bottlenecks in infrastructure and ease the adjustment process, transfers from the Federal Republic of Germany are likely to play a considerable role.

14. For the Federal Republic of Germany, the growth dividend referred to above will by the automatic stabilizer effect lead to an increase in the revenue side of the federal budget. This will in some way compensate for the increased transfers to German Democratic Republic. The likely deficit of the total budget for the two German States will also be reduced by revenues from privatization of public property in the German Democratic Republic. The labour market in the Federal Republic of Germany will be affected by integration forces arising from Monetary, Economic and Social Union and leading to new kinds of spill-over effects. Cross-border contracts will become quite attractive to German Democratic Republic residents as they could combine high salaries with low rents.
15. For the Federal Republic of Germany and the rest of the Community the increased demand effect on both consumption and investment might in the short run lead to some inflationary pressure given the already high levels of capacity utilization. It is, however, to be assumed that the monetary authorities in the Federal Republic of Germany will be reasonably successful in sterilizing the excess liquidity that will result from currency conversion and that transitory distortions in the behaviour of monetary aggregates will not unduly affect long-term inflationary expectations. To mitigate any potential inflationary pressure and to avoid any overloading of the monetary policies in the Member States, equal access to the market of the German Democratic Republic will be an important factor. The Federal Republic of Germany might also facilitate the process and reduce the burden of monetary policy by a reduction of subsidies.

Outside the Federal Republic of Germany, the positive growth stimulus would facilitate the task of fiscal adjustment in the countries where public deficits or debt are very high. This would be fully in line with the need for more convergence in the Community and would facilitate the process of creating Economic and Monetary Union.

Effects ahead of integration

16. In its communication to the Dublin European Council on the Community and German unification, the Commission stated that the integration of the German Democratic Republic in the Community will be prepared and assisted by the legislative reform required for the gradual integration of the German Democratic Republic in the Federal order during the interim adjustment phase, i.e. before the unification of the two Germanies. The Commission thus expressed the view that the German Democratic Republic would be integrated into the Community ahead of unification. The Staatsvertrag confirms that the Commission was right. In concluding the Staatsvertrag the German Democratic Republic undertakes to carry out far-reaching legislative reform in a short period of time as support measures for the institution of monetary, economic and social union.

There are two main aspects of this reform:

- Acceptance by the German Democratic Republic of a large number of the Federal Republic of Germany's laws and regulations, which will be introduced without any change when the monetary union is established on 1 July 1990. It is not only monetary legislation and banking and insurance legislation that is involved, but also major sections of the Federal Republic of Germany's civil law (i.e. the civil and commercial codes) and the main company law and worker participation legislation (Mitbestimmungsgesetze, Betriebsverfassungsgesetz);
- A substantial harmonization operation to adjust the German Democratic Republic's legislation to the general principles to be respected in the monetary, economic and social union, as stipulated in the Staatsvertrag and developed in greater detail in an annexed protocol. This harmonization, which is also to be largely completed by 1 July 1990, will first require the repeal or amendment of a number of the German Democratic Republic's laws and regulations listed in Annex III to the Staatsvertrag. Annex IX then specifies the areas in which the German Democratic Republic must introduce new legislation, e.g. competition, price formation and control, taxes and excise duties.

Accomplishment of this legislative reform will have major consequences for the gradual integration of the German Democratic Republic into the Community legal order, ahead of the unification of the two Germanies.

These consequences will be evident in the legal structures required to accommodate a market economy and in the indirect and direct adjustments to Community law.

17. Integrating the German Democratic Republic into the Community will mean abolishing the centralized economy system and introducing principles and structures, from a legal angle too, to allow gradual development towards a market economy with a social dimension. Such measures are essential to enable the German Democratic Republic to fit into the common market. The Staatsvertrag provides for these reception structures to be set up during the interim adjustment phase:
- the monetary reform will involve ipso facto the inclusion of the German Democratic Republic in the European monetary system and prepare for its subsequent inclusion in European monetary union;
 - monetary union, by eliminating all problems of convertibility of currencies and forcing the German Democratic Republic to introduce a banking system in accordance with the principles of a market economy, will clear the ground for the integration of the German Democratic Republic in the Community arrangements for free movement of capital, including freedom of payments under Article 106 EEC and its entrance into the European financial services market;
 - introduction of a system of private property, competition with free price formation (ending of state subsidies), contract freedom and freedom to trade;
 - recognition of the principles of free movement of workers, capital, goods and services (ending of the State monopoly on external trade);
 - introduction of social legislation recognizing the basic principles of a social legal order: freedom of association, free negotiation of wages, right to strike, worker participation both in firms and companies, protection in the event of dismissal;
 - introduction of a social security system (unemployment, sickness and retirement insurance).
18. The reform of the legislation and regulations to which the German Democratic Republic is pledged under the Staatsvertrag will involve indirect adjustments to Community law in certain sectors. First of all, this will concern some of the Federal Republic of Germany's legislation that the German Democratic Republic will be introducing, where such legislation is of Community origin, e.g. as a result of a harmonization requirement. VAT is an example, as is company law and law on the environment. For instance, upon entry into force of the Staatsvertrag, new industrial plant in the German Democratic Republic will have to satisfy the requirements of the Federal Republic of Germany's environmental legislation, which, in part, is harmonized at Community level. As regards existing plant, the German Democratic Republic has undertaken to satisfy these requirements as soon as possible. This automatic adjustment to Community law may occur in other cases with the process of harmonizing the German Democratic Republic's law in accordance with the principles and guidelines set out in the annexes to the Staatsvertrag, in particular in economic law (including banking and insurance) and social law.

19. In some cases the Staatsvertrag calls for direct adjustment to Community law ahead of unification. To begin with, the German Democratic Republic has given a general undertaking to base itself on the Community legal order when carrying out the legislative reform required under the Staatsvertrag (first of the rules set out in the joint protocol annexed to the Staatsvertrag, governing the process for harmonizing the German Democratic Republic's legislation). Other explicit references to Community law concern the following points:

- In adjusting and developing its economic policy the German Democratic Republic will move gradually in the direction of Community law and the Community's economic policy objectives. As regards commercial policy, this principle is in the form of the German Democratic Republic's undertaking to take over, in stages, the customs law of the Community, including the common customs tariff.
- In external economic policy, the German Democratic Republic will have to take into account the GATT arrangements. If this principle is applied it will facilitate the subsequent integration of the German Democratic Republic in the common commercial policy. As regards economic relations with the COMECON countries, and in particular the agreements involved, the Staatsvertrag recommends that the principle of legitimate expectation be respected. It provides for the continuation and development of these relations taking into account the existence of economic and monetary union, the interests of all the parties concerned and application of the principles of a market economy. It is recommended that these international obligations of the German Democratic Republic be adjusted as appropriate, with the agreement of its partners. This adjustment, which will at all events be necessary when the German Democratic Republic is incorporated in the Community, could thus be negotiated during the interim adjustment period. As the Federal Republic of Germany must be directly involved in these negotiations as provided for in the Staatsvertrag and as this is a matter where the Community has exclusive powers, the Community must be associated as well.

The Staatsvertrag makes provision for this with the reference to the need to respect Community jurisdiction in this area.

- The German Democratic Republic will introduce a system of price support and protection in relation to the outside world corresponding to the market organization system of the common agricultural policy, in order to bring the prices of agricultural products within the country to a level that is comparable with that in the Community.

20. The Staatsvertrag thus makes effective preparations for the integration of the German Democratic Republic in the Community and will make it possible to achieve a substantial part of this integration before unification:

- by establishing the essential legal structures to permit the transition to a market economy system;
- by indirectly adjusting the German Democratic Republic's law to Community law in major economic and social sectors;
- by providing explicitly for such adjustments in other sectors.

Finally, it should be noted that the Staatsvertrage can be amended by a simplified procedure, i.e. by simple agreement between Governments, should that be necessary to achieve one of its objectives. If the implementation of the Staatsvertrag is a source of serious difficulties for the impending integration of the German Democratic Republic into the Community, it is quite conceivable that this procedure might be applied, as the objective of preparing for the adjustment of the German Democratic Republic's law to the Community legal order is clearly expressed in the Staatsvertrag.

Management of the interim period

21. The first thing to do is to consider the implications for the management of the Protocol on German internal trade and the consequences of early introduction (before formal unification) of a de facto customs union between the Community and the German Democratic Republic.

As regards management of the Protocol, administrative cooperation with Commission should make it possible - as in the past - to avoid any harmful effects for the economies of the other Member States.

In any case the Protocol would become far less important as selling prices in the German Democratic Republic would be formed by the interplay of supply and demand and trade in most products would be liberalized with the advance introduction of a de facto customs union between the German Democratic Republic and all the Member States.

22. According to the Staatsvertrag as interpreted above (point 11), levies, refunds, customs duties and quantitative restrictions would not apply to the Member States other than the Federal Republic of Germany (principle of equal treatment), provided that the Community offers reciprocity. Legal instruments must therefore be provided to make it possible to adopt a mirror approach on the Community side given that external protection and the CCT would apply and all the Member States would be able to export to the German Democratic Republic with no levies, customs duties and quantitative restrictions. This legislation would have to make possible, in due course, the autonomous suspension of customs duties, levies and quantitative restrictions with the German Democratic Republic.

The legislation should authorize the Commission to suspend customs duties and agricultural levies in the light of the measures applied in the German Democratic Republic (including the price level for agricultural products).

Appropriate proposals will be sent to the Council shortly.

Decisions not to apply refunds can be taken by the Commission.

23. The Commission has agreed with the Federal authorities that they will inform the Commission of any measures they take to develop the economy of the German Democratic Republic. Where such measures constitute or contain state aids the Commission will examine them for their compatibility with Article 92 of the EEC Treaty. One such scheme (the extension of the interest subsidies available under the European Recovery Programme to activities in the German Democratic Republic) has already been approved by the Commission and a further eleven measures are now under examination. This process will allow the Commission to ensure that all aid measures are in conformity with Community objectives and do not unfairly distort competition.

Article 14 of the Staatsvertrag requires coordination between the Governments of the Federal Republic and the German Democratic Republic on the content of certain structural measures proposed by the German Democratic Republic and Article 28 provides for financial grants from the Federal budget to compensate for budget deficits in the German Democratic Republic. Insofar as the application of these articles leads to aid measures in the German Democratic Republic which can only be implemented after the agreement of the Federal authorities and will be directly or indirectly funded from the Federal budget, the Commission considers that these aids must also be assessed under Articles 92, 93 of the EEC Treaty. The Commission is in contact with the Federal authorities to agree on the appropriate practical implementing arrangements to ensure control by the Commission of state aids granted by both German authorities.

24. At its special meeting on 28 April 1990 the European Council concluded that during the interim period the German Democratic Republic will have complete access to European Investment Bank loans and to the loan facilities available under the Euratom and ECSC Treaties.

As regards the EIB, the Council (Ecofin) on 11 June 1990 asked the Bank to provide the German Democratic Republic with loans for investment projects which satisfy the usual conditions governing the operations it finances from its own resources.

The Bank can therefore start up its loan operations in the German Democratic Republic.

The Commission has also just sent to the Council, for its assent, a draft Decision extending to the German Democratic Republic entitlement to all the loan instruments under the ECSC Treaty.

Finally, the Commission has proposed that the Council extend Euratom borrowing operations so that it will be possible to contribute to the financing of investment projects.

These facilities are in addition to Community support as part of the coordinated action of the Group of 24 and participation in EUREKA projects.

