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Political Changes in Germany and Europe: A New Environment for Investment?

Both Germany and Europe are currently facing significant challenges in their political environment and legal framework:

- After seven years of a Social Democratic (SPD)/Green coalition government, Germany is likely to witness a change in government—with the new leadership comprising the conservative Christian Democrats (CDU) and the liberal Free Democrats (FDP). German President Horst Koehler has called for early elections, now set to take place on September 18, 2005, after Chancellor Gerhard Schroeder (SPD) lost a “vote of confidence” in the German Parliament. The electorate in Germany is widely expected to vote for a new government and, therefore, also for major political and regulatory changes.
 - This development occurs against the backdrop of major political setbacks for European integration in the last couple of months:
 - The failure of the EU Summit in June on the budgetary framework in the European Union for the years 2007–2013.
 - The unresolved question of full Turkish membership in the EU, which gives rise to political as well as economic conflict between the EU and Turkey.
- Please find below an overview of the expected political changes in Germany and their likely impact on business and investment opportunities.

I. Political Situation in Germany

A. Early elections in mid-September 2005

On July 21, 2005, German President Horst Koehler called for national elections and dissolved Germany's Lower House of the Federal Parliament (Deutscher Bundestag). National elections are now due to take place on September 18, 2005—a year earlier than scheduled. Koehler responded to a Lower House vote on Chancellor Gerhard Schroeder on July 1, 2005, in which a majority of members of parliament voted against Schroeder in a “vote of confidence.” Schroeder had previously asked his own parliamentary groups of Social Democrats and Green Party Members of Parliament to vote against him or abstain, thereby paving the way for early federal elections. Schroeder has argued

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that after the landmark elections in the federal state of North Rhine-Westphalia, where the Social Democrats were voted out of office after 39 consecutive years in state government, the governing coalition of Social Democrats and Green Party would face a devastating legislative stalemate in Germany's Upper House of the Federal Parliament (Bundesrat), which consists of representatives from the governments of the 16 federal states. Consequently, federal elections are set to take place on September 18, 2005, subject to possible legal scrutiny by the Federal Constitutional Court.

B. Expected results of the elections: Conservatives likely to win

Substantial difficulties for the governing coalition. The chances of reelection for Chancellor Schroeder and his coalition of Social Democrats and Green Party are slim.

- *Economic weakness.* Schroeder's political reform agenda has not yet resulted in economic growth, nor has the government succeeded in dealing with the problem of unemployment, which is at a post-war high. Unemployment currently affects more than 11 percent of the work force, or nearly 5 million people, particularly in the territory of the former East Germany. According to public opinion polls, confidence in the Social Democratic Party is at an all-time low regarding their ability to resolve pressing political problems.
- *Increased competition from a new left-wing party.* In addition, the popularity of the Social Democrats is also suffering as a result of the creation of a new left-wing (socialist) party (Die Linkspartei.PDS), an alliance recently formed between the ex-Communist Party (PDS) and disaffected former members of the Social Democrats. Die Linkspartei.PDS is currently expected to gain approximately 8 to 12 percent of the popular vote.

New government likely to be headed by the conservative Christian Democrats. In light of the above, the conservative

Christian Democrats (CDU) are highly likely to emerge from the elections as the strongest party, currently holding a 15 percent lead over Schroeder's SPD in the polls (the CDU is represented in the state of Bavaria by the Christian Social Union, or CSU). Such a result would see Angela Merkel (51), chairperson of the CDU, taking the position as new chancellor, either as leader of :

- a *conservative-liberal coalition* with the Free Democrats (CDU/CSU/FDP coalition), or
- a *grand coalition* of CDU/CSU with a defeated SPD.

Angela Merkel, who grew up in the former communist East Germany, would be the first female chancellor in German history.

Recent polls also leave open the possibility of a so-called "Red-Red-Green coalition," i.e., a government comprised of Social Democrats, the Green Party and the new Linkspartei.PDS. However, both leading Social Democrats as well as Green Party representatives have explicitly denied this option and the leaders of the Linkspartei.PDS have expressly stated that they do not intend to assume posts in government. Consequently, this option may become theoretically possible, but is highly unlikely to become reality.

II. Key New Developments Under a Potential Conservative Government

A new German government headed by the conservatives would bring about significant changes for investors in a number of policy areas: taxation, labor flexibility, healthcare, energy and overall atmosphere for investment.

A. Potential major changes in tax legislation

A new conservative government is expected to restructure complex German tax legislation:

- **Change in corporate taxation for sale of shares.** The CDU plans additional

tax burdens on profits generated through the sale of shareholdings. In December 2001, the governing Red-Green Coalition had restructured the taxation of corporations, and amended Art. 8 b (2) of the so-called Act on Taxation of Corporations (KStG). The result, however, is that a selling corporation now benefits from tax relief on profits generated through the sale of certain shareholdings. This has resulted in an enormous increase in the legitimate claims for tax refunds. As a consequence, the conservatives announced a plan to abolish this tax exemption effective January 1, 2006. It is likely that even a grand coalition of CDU and SPD would amend this provision. Once the revised law comes into force, it will lead to a significant increase in the tax burden on such profits to approximately 22 percent. There is likely to be an increase of transaction activity before the reform takes effect.

- **Reduction of the wage costs for employers.** Other tax-related measures proposed by the CDU are mostly aimed at reducing the financial burden faced by employers in order to encourage the creation of new jobs:
 - *Tax relief for corporations on January 1, 2006.* The CDU plans to give tax breaks to employers by lowering the payroll tax from 6.5 to 4.5 percent and reducing corporate income taxes from 25 to 22 percent commencing on January 1, 2006.
 - *VAT rise to 18 percent on January 1, 2006.* In order to compensate for the aforementioned reductions, the CDU proposes to increase VAT from the current rate of 16 percent to 18 percent effective on January 1, 2006 (products that are currently subject to the lower rate of 7 percent will not be affected by any change). Furthermore, in a move to support families, the Christian Democrats may decide to lower the VAT for certain children's products (e.g., baby food or toys).

The FDP, which is currently opposed to increases in VAT, is nevertheless expected to follow the CDU on this reform, as the former has made it clear that the issue is not a "deal breaker" for entering into coalition with the CDU.

- *Lowering income tax by a reduction in the general rates for large and small incomes on January 1, 2007.* Effective on January 1, 2007, the CDU plans to abolish special tax concessions, which currently benefit employees in respect to work performed on weekends, at night and on public holidays. This is aimed at financing a significant reduction in income tax rates (down to 39 percent for the highest income tax band, 12 percent for low incomes).

B. Move towards greater flexibility on the labor market expected

A new conservative government would seek to make German labor market more flexible:

- **Deviation from collective labor agreements.** Companies and their internal works councils would—upon approval by 2/3 of the employees and the works council—be allowed to deviate from collective labor agreements to the detriment of employees. This could significantly reduce the power of trade unions in Germany and would also be an important signal to foreign institutional investors.
- **Removal of restrictions of statutory protection against dismissal.** The CDU plans to diminish current restrictions for new hires in small businesses (i.e., enterprises with less than 20 employees).
- **Permitting the increased use of temporary employment contracts.** The conclusion of such fixed-term employment contracts is currently subject to considerable restrictions.

All these projects would not be possible with the Social Democrats in government.

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Meanwhile, both major parties are examining specific measures with a view to strengthening the control of international financial investors. Whilst hedge funds are at the center of the discussion, other private equity funds are also likely to be affected.

C. Fundamental health care reforms likely to start in 2007

A conservative government would seek to revise—commencing in 2007—the traditional German health care insurance system, which currently calculates insurance contributions as a percentage of an employee's gross salary. In order to ensure that the amount of such contributions no longer depends on the level of salaries, the CDU plans to restructure the contributions to become one flat-rate charge. The objective is to bring about a long-term reduction in wage costs in Germany, as any future rise in insurance premiums (e.g., due to increasing medical costs or the demographic factor) would no longer automatically result in additional wage costs. To balance out the inequities created by a single flat-rate charge, the government intends to pay the health insurance contributions of low-income groups and children by financing the same from general tax revenue.

D. Significant changes in the energy sector

A conservative-liberal coalition is expected to fundamentally alter the direction of energy policy. For the purpose of reducing energy costs, the new government plans to reassess the existing agreement under which all nuclear power is due to be phased out in Germany by the year 2021. Instead, reactors shall be allowed to operate for as long as it is technically feasible. The phase-out agreement, which was enacted in 2001, was one of the key projects of Schroeder's coalition and represented a fundamental success, particularly for the Green Party and its voters.

E. Overall improvement for foreign investment likely

The overall atmosphere for foreign investment, including the public perception of financial investors, may improve under a new government:

- **The debate on international financial investors ("locusts").** The debate

on international financial investors in Germany has subsided considerably since the topic was first broached in April. The Social Democrats had strongly criticized hedge funds and other foreign investors, branding them as "locusts" (*Heuschrecken*) in a move that was widely regarded as part of the battle against the newly emerging left-wing party. Meanwhile, both major parties are examining specific measures with a view to strengthening the control of international financial investors. Whilst hedge funds are at the center of the discussion, other private equity funds are also likely to be affected. Chancellor Schroeder has called for further international harmonization in this sector. His proposals for national legislation include (with the Christian Democrats being open for discussion):

- *Additional notification thresholds for the purchase of shares in listed companies.* Currently, shareholdings in listed companies must first be notified when they exceed five percent of the voting rights.
- *Notification requirements for share pledges.* These would be brought in line with the applicable legal provisions in the United States and the United Kingdom.

Modifications to shareholders' voting rights are also under discussion. In particular, the Government has considered the introduction of voting limitations on short-term acquisitions and financial incentives for participants in shareholder meetings. However, neither measure is actively being pursued at the moment. Moreover, it is likely that the climate for foreign investors would become more relaxed after the elections.

- **Public subsidies for R&D likely to increase.** In Germany, there is a general desire across the political divide to increase public spending on research and development. Already at the core of Chancellor Schroeder's agenda, the CDU has vowed to

raise the available government funds even further by an additional sum of EUR 1 billion. This increase will also benefit private companies actively pursuing new technologies.

- **Public subsidies for former East Germany to be continued.** The redevelopment program for the former East German territory would be continued by a CDU government without modification; the CDU has explicitly stated that it intends to adhere in full to the investment program over the period from 2006 to 2019. The total sum over this period equates to approximately EUR 156 billion.
- **Corporate Governance Code.** It should also be noted that there is a broad consensus among all parties regarding the new German "Corporate Governance Code," which relates to corporations listed in Germany. There is, for example, an ongoing discussion on the proposal to restrict management stock options. Two recent legislative acts in this area include the mandatory disclosure of the salaries of board members and extended Directors' and Officers' liability. The amendments were agreed upon as recently as June 2005, and we do not expect any changes to be made under a conservative government.
- **Improvement of business atmosphere.** Finally, another significant change could be a change in general mood within trade and industry; opinion polls undertaken amongst Germany's business elite reveal that such a change in government towards a more business-friendly administration is regarded as a positive step for business and investment opportunities in Germany. German leaders draw upon the example of 1983, when the political and economic landscape showed significant similarities to the situation today. Following a change from a Social Democratic to a Conservative government, the economy experienced a significant

boost and Germany achieved high growth rates for several years.

III. More Cautious Reforms with Social Democrats in Government

Most of the above-mentioned reforms would be subject to heated discussion if the election fails to produce a clear majority for either the conservative-liberal coalition or the Social Democrats/Green Party. However, any government in Germany will be required to pursue the reform agenda initiated by Schroeder over the last couple of years. Chancellor Schroeder has vowed that his coalition would adhere to its policy of cautious economic and social reforms.

The SPD has not been very specific in its election program, the so-called "Manifest." It is widely believed that the SPD would generally follow the reform policy initiated during the last couple of years, but with clearer focus on its social agenda. A noteworthy aspect, however, is the approach with regard to new tax laws:

- *Reduction in the rate of Corporate Income Tax.* Both Christian Democrats and Social Democrats would seek to harmonize tax rates for all enterprises, irrespective of their legal entity. The Corporate Income Tax would be reduced to an even greater extent than that proposed by the CDU, namely from the current rate of 25 percent to 19 percent.
- *Special tax for "wealthy" individuals.* We do not expect the SPD to be able to implement its proposal to introduce a special tax for wealthy individuals (annual gross income of more than EUR 250,000, or EUR 500,000 for married couples) in a coalition with the Christian Democrats.

Even the mere existence of the new socialist/left-wing party may force Christian Democrats and Social Democrats in a potential grand coalition to proceed more cautiously with their reform agenda. This would be particularly true if the outcome of the elections theoretically allows the Social Democrats to subsequently

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form a coalition with the left-wing Linkspartei.PDS and the Green Party in the event of political deadlock.

In conclusion, the recent developments in Germany and Europe should encourage all businesses with an interest in this area of the world to follow the political discussion and ensuing regulatory changes carefully to enable them to respond promptly and in the appropriate manner.

IV. Implications of a New Government for International Relations and EU Policy

Fresh start in US-German political relations. Relations between Germany and the United States are expected to improve following Mr. Schroeder's parting from office. New business opportunities may arise for companies on both sides. The personal discord between President Bush and Chancellor Schroeder before and during the war in Iraq has placed a burden on high-level initiatives (despite continuous close cooperation on a working level). President Bush is expected to offer Mrs. Merkel a "fresh start"—and could also seek an opportunity to display his goodwill publicly by encouraging further business cooperation.

Impact of German elections on the European Union. The early elections in Germany and a new government led by Angela Merkel and the CDU will not

change the political agenda in Europe completely. However, a change in government may lead to significant changes in the following areas of EU policy-making:

- **Enlargement.** Angela Merkel and her party are determined to slow down further enlargement of the EU and to avoid a full membership of Turkey. Instead, the Christian Democrats seek to establish a "Privileged Partnership," an option that has been vehemently rejected by Turkey in the past.
- **Budgetary and agriculture reform.** Together with Tony Blair or his successor, a new German government may be inclined to seek a major overhaul of EU finances after the French presidential election in 2007. This reform would most likely include a major reform of the EU agricultural budget, which accounts for most of EU spending.
- **Hope for a new approach in consumer protection and environmental regulation.** Many trade associations and businesses are lobbying for a less prominent role of EU lawmaking in the areas of consumer protection and environmental regulation. The Christian Democrats traditionally have a stricter approach with regard to the necessity of EU lawmaking. They are expected to urge the EU institutions to restrict new legislation in the areas of consumer protection and environmental regulation in order to promote economic growth.

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