Economic and Financial Reports

German Stability Programme

January 1999

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I. Introduction

In accordance with the Council decision of 2 May 1998, Germany in common with ten other EU Member States will introduce the euro as from 1 January 1999. A provision of the stability and growth pact agreed in the summer of 1997 is for the Member States introducing the euro to submit annually updated stability programmes. In a statement made on 1 May 1998, ECOFIN ministers undertook to present their stability programmes for 1999 at the latest by the end of 1998.

A change of goverment took place in Germany in October of this year. The new government announced at an early stage that it would adhere to the provisions of the stability and growth pact. Notwithstanding the limited time available since the change of government, Germany now submits its first stability programme within the agreed period. The objectives envisaged and measures planned by the new government have been incorporated in the programme as far as this is at present possible. The programme was approved by the cabinet on 4 January 1999 and will be published by the Federal Ministry of Finance in January 1999.

II. Outlook for the general development of the economy from 1998 to 2002

A. Brief survey of the global economic environment

Against a background of escalating crisis in Asia, deepening depression in Japan and the events in Russia and Latin America, prospects for the world economy were looking increasingly gloomy in the course of 1998, and this process does not yet appear to have been checked. Although Germany's exports to these regions account for only about one tenth of its total export trade, current trends in the global economy will not fail to have consequences for Germany's highly export-oriented industries. German export traders have for some time now been appreciably scaling down their expectations.

B. Trends in Germany in 1998 and 1999

The GDP growth of 2.9 % registered in the first three quarters of 1998, generated mainly by exports, investments in plant and equipment and inventory buildups, was essentially attributable to the quite vigorous upturn at the start of the year. More currently, the impact of global economic slowdown is becoming apparent in Germany as well. The business climate has clouded over, especially on account of the unfavourable export prospects. The strong export upswing has since lost much of its momentum. Trends in the intake of domestic orders are also indicative of a slowdown in plant and equipment investment. There is as yet no sure sign of a turnaround in this process.

The German government forecast is nevertheless based on the assumption that the downturn in economic activity resulting from external factors will be restricted essentially to the winter half-year of 1998/99. This assessment is backed up by the recent improvement in the prospects of upward forces in the domestic economy increasingly gaining the upper hand. Private consumption is likely to benefit from the increase in real disposable incomes, while the current persistently low level of investment in the construction industry may be expected to rise in the coming year.

The projected GDP growth rate of 2 % for 1999 is based on the assumption that once the aforementioned retarding effects of global economic trends have slackened off the further course of the year will see an appreciable increase in the pace of economic activity backed up by stronger domestic forces for growth.

C. Underlying assumptions

The projection is based on the following assumptions for the period through 1999:

- According to the IMF autumn estimate, global economic expansion at 2 % in 1998 will be roughly half of the figure for 1997 and will show only a slight increase to 2 ½ % in 1999. The EU commission expects the upward trend in the euro currency area at 3 % in this and at 2 ½ % in the coming year to be rather stronger than for industrial countries in general.

- After an increase of 9.7 % in 1997, the IMF expects the volume of world trade to show appreciably reduced growth in 1998 at a good 3 ½ %. In 1999, growth is expected to pick up slightly to about 4 ½ %. Expansion in Germany's sales markets abroad, however, may be expected to proceed at a slightly faster pace.

- Despite a perceptible rise in the external value of the D-Mark in the course of 1998 there has been scarcely any change in the 1998 yearly average. Assuming stable exchange rate relations at the current level for 1999 will imply a slight rise in the external value of the euro expressed as the 1999 yearly average.

- Price movements will remain moderate over the entire period under review.

- Following a marked decline in 1998, capital market rates will remain essentially at the present level; in the 1999 yearly average, this implies a lower level than the previous year. Monetary policy will continue to ease in 1999.

- Actual wages are expected to register only a slightly stronger rise than in 1998; wage policy will thus remain on a moderate course.

- In view of the tight financial situation on which the projection is based and the consequent need to keep tax policy measures revenue-neutral, fiscal policy will not in general impart any stimulus to the economy in 1999.

D. Medium-term perspectives

In the medium term, the development of the economy will be shaped rather by the greater stability in trend movements than from within by current cyclical factors and from without by the global economic situation. Hence the government's medium-term projection, assuming a largely stable global economic environment, is geared more to the comparatively continuous development of production capacities (non-monetary capital stock and labour force potential).

The growth of just under 2 ½ % assumed in the medium-term projection through 2002 exceeds the expected growth rate of productive capacity. Given the indentifiable underutilisation in the base year, this will lead to virtually full utilisation of productive capacity by the end of the period under review. It must be pointed out, however, that a high degree of uncertainty is inherent in the calculation of aggregate productive capacity and hence of the extent of utilisation.

For economic development to remain in excess of potential growth over a period of several years will require permanently favourable supply and demand conditions. The government will improve the underlying conditions for sustained economic growth and the creation of new employment by applying a combination of supply and demand policy measures adequate to the problems perceived and by aiming to coordinate the macroeconomic policy approach at national, European and international level.

E. Overview

Table 1: Projection of aggregate economic development for the years 1998 to 2002

(Change on the year in per cent; rounded to half or whole percentage points for the review period)

	1997	1998	1999	2002/99	2002/97
Use of GDP (at 1991 prices):					
Private consumption	0.5	2	2 ½	2	2
Government consumption	- 0.7	1	1	1	1
Gross fixed capital formation	0.1	2	3	3 ½	3
of which: public sector	- 8.6	2	2 ½	1	1 ½
Exports	11.1	7 ½	4 ½	6	6
Imports	8.1	6 ½	5	5 ½	5 ½
Gross domestic product	2.2	3	2	2 ½	2 ½
Movement in prices (1991 = 100)					
Private consumption	1.9	1	1	2	1 ½
Gross domestic product	0.6	1	1 ½	1 ½	1 ½
Gainfully employed	- 1.3	0	½	½	½

1997: Provisional result of the Federal Statistical Office as at 9 September 1998.
1998 and 1999: Results of the Interdepartmental Working Party on Overall Economic Projections, 3 November 1998.
2000 to 2002: Medium-term projection, updated in October 1998.

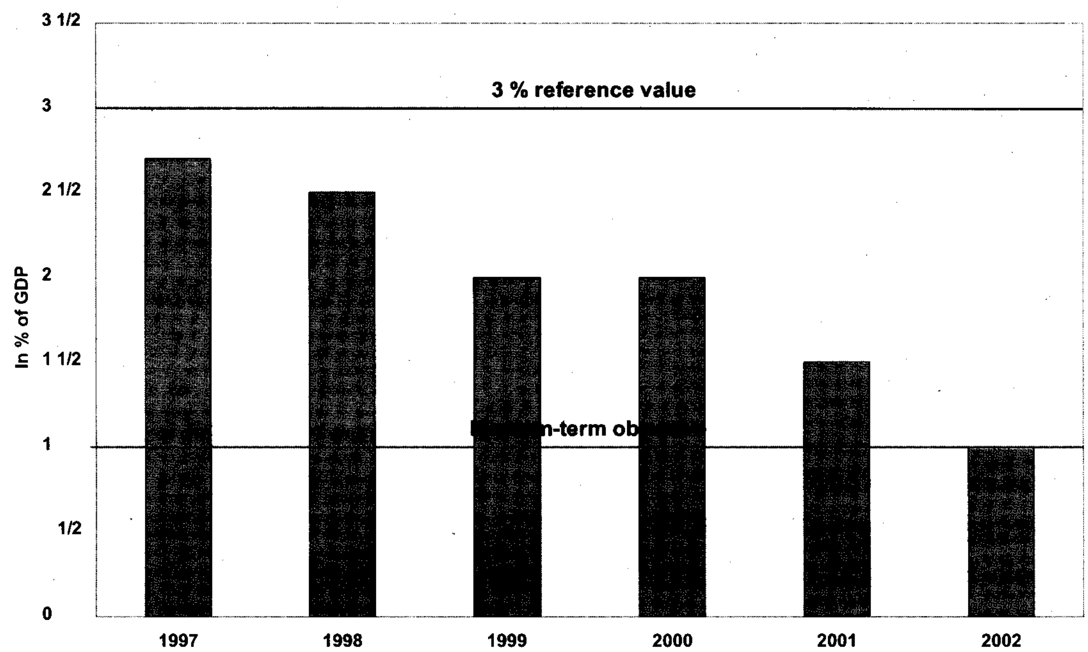
III. Trends in public budgets - the medium-term perspectives

A. Trends in general government deficit

The most recent National Accounts update of September 1998 bears out the deficit ratio for 1997 as published by the Federal Statistical Office in late February of this year. This is put as before at 2.7 % of the gross domestic product (GDP) and thus undercuts both the deficit criterion of 3 % and the target figure of 2.9 % of GDP cited in the last convergence programme submitted in February 1997.

A further appreciable reduction in the general government deficit to about 1 % of GDP is expected for the years up to and including 2002.

Figure 1: Deficit ratio - development to the year 2002



The consolidation of public budgets is based on a restriction of the rise in government spending to an average of 2 % from 1998 to 2002. Government spending will thus be held well below the yearly average increase of nominal GDP at 4 %. The government spending ratio will decline from 49 % in 1997 to below

45 % in 2002. Investment will remain largely constant in relation to GDP, amounting to a good 1 ½ % of GDP in 2002.

The appreciable reduction in government spending by over 4 percentage points will enable the tax cuts envisaged in the Tax Relief Law 1999/2000/2002 to be made, thus affording net relief of about DM 15 bn in 2002, while bringing down the general government deficit to roughly 1 % of GDP.

The tax and social charges ratio, i.e. total taxes and social security contributions as a percentage of GDP, will decline from 42.8 % in 1997 to below 41 % in the final year covered by this stability programme. In a longer-term comparison, this ratio affords a more complete picture of the burden imposed by the state on the population than does a separate review of tax and social security contribution ratios in view of the envisaged structural shift between taxes and social charges resulting from the initiated, ongoing reduction of non-wage labour costs.

Figure 2: Government spending ratio, tax and social charges ratio - development to the year 2002

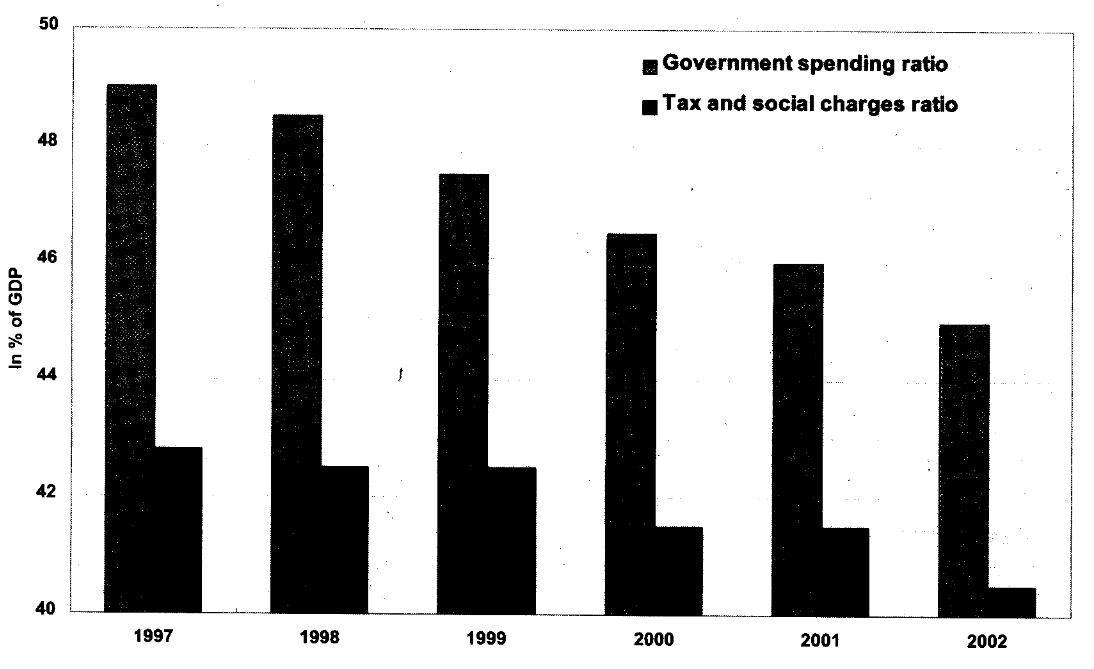


Table 2: Deficit, government spending, tax and social charges ratios - development to the year 2002

	1997	1998	1999	2000	2001	2002
	- in % of GDP -					
Deficit	- 2.7	- 2 ½	- 2	- 2	- 1 ½	- 1
Govt. spending	49.0	48 ½	47 ½	46 ½	46	45
Social charges	42.8	42 ½	42 ½	41 ½	41 ½	40 ½

The reduction of the general government deficit will be borne by the budgets of the Federation, the Länder and the local authorities. As the new draft federal budget for 1999 cannot be presented before the start of 1999, the central government figures must be cited on the basis of provisional data and specific assumptions. In relation to the federal budget it is for instance assumed that the government borrowing ceiling imposed in Article 115 of the constitution, stipulating that the deficit (according to financial statistics) may not exceed expenditure on investment, will not be exceeded.

The social insurance funds registered in 1997 a surplus of DM 6 bn, just under 0.2 % of GDP. This surplus will initially continue to rise, as the claims equalisation reserve of the statutory pensions insurance has to be replenished. The surplus will again decline as from the year 2000.

Table 3: Deficit by levels of government

(Maastricht definition)

	1997	1998	1999	2000	2001	2002
	- DM bn -					
Federation incl. special funds	- 59.1	- 65 to - 70	- 65 to - 70	- 60 to - 65	- 45 to - 50	- 40 to - 45
Länder and local authorities	- 43.0	- 30 to - 35	- 25 to - 30	- 20 to - 25	- 10 to - 15	- 10 to - 15
Social insurance	6.0	appr. + 10	appr. + 15	appr. + 10	appr. + 5	appr. + 5
General government	- 96.2	- 85 to - 95	- 75 to - 85	- 70 to - 80	- 50 to - 60	- 45 to - 55
General government deficit in % of GDP	- 2.7	- 2 ½	- 2	- 2	- 1 ½	- 1

B. *Trends in government debt*

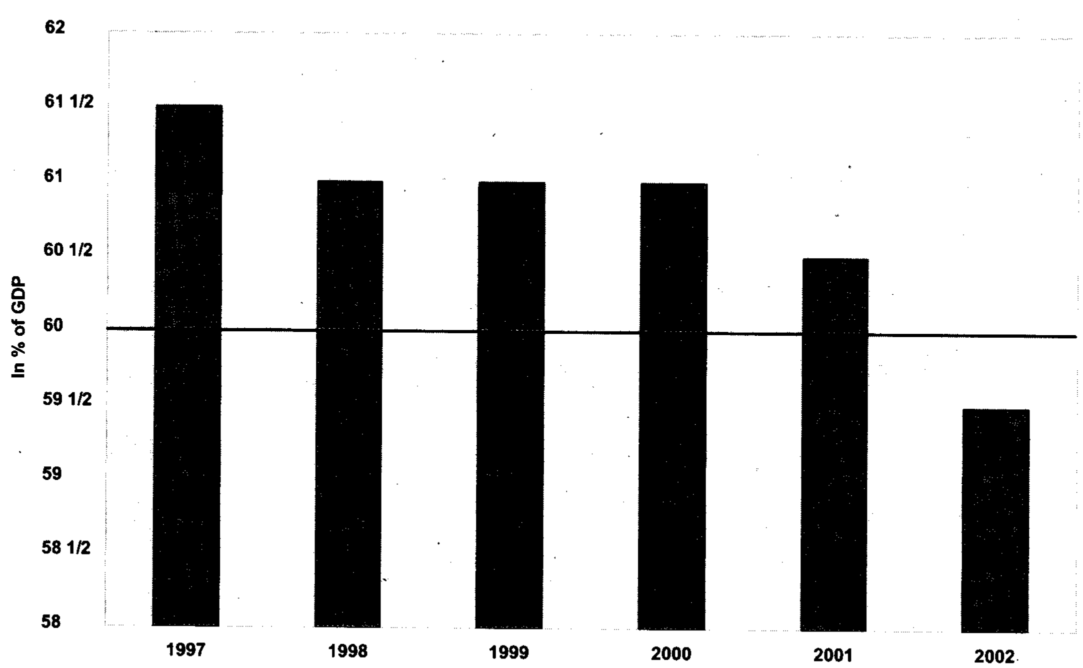
The debt ratio amounted in 1997 to 61.5 % of the gross domestic product (GDP). In 1998 and thereafter it will register a further decline on account of the consolidation of public budgets, falling below 60 % of GDP in the year 2002 for the first time since 1995.

Table 3: Debt ratio - development to the year 2002

	1997	1998	1999	2000	2001	2002
	- in % of GDP -					
Debt ratio	61.5	61	61	61	60 ½	59 ½

It is assumed that the privatisation proceeds of central, regional and local government, which do indeed reduce government debt while not affecting the level of general government deficit, will amount to about 1 % of GDP in 1998 but will subsequently show a marked decline.

Figure 3: Debt ratio - development to the year 2002



C. Effects on general government deficit and government debt of a change in the macroeconomic benchmark data

The general government deficit and government debt would be affected as follows by a change in the macroeconomic benchmark data:

- If average annual growth in the years from 2000 to 2002 were to be one quarter of a percentage point higher than assumed in the projection (price assumptions remaining unchanged), pressure on public budgets would be eased by lower labour market spending, higher social security contributions and larger tax receipts.
- On a purely computational basis, this would reduce the deficit by 0.25 % of GDP in the year 2000.
- The debt ratio would be one half of a percentage point lower in the year 2002.

However, a deficit ratio of 1 % in the year 2002 already meets the medium term objective of the stability and growth pact in Germany. Thus in the event of a downturn in economic activity the automatic stabilisers would be able to work without causing the 3 % deficit ceiling to be exceeded.

Against this background, a reduction of the deficit to less than 1 % of GDP by the year 2000 is not envisaged. In the event of an improvement in the macroeconomic benchmark data, the scope created by additional revenue and underspending should be used principally for further tax cuts to enhance the prospects for growth and employment and to contribute in this way to a lasting stabilisation of government finances.

D. Effects of interest rate movements

Given the complex structure of government debt, the effects on public budgets of a change of 1 percentage point in market rates cannot be precisely quantified. However, the level of government debt, estimated at 59 ½ % of GDP for 2002, gives an indication of the substantial significance of interest rate movements. A change of 1 percentage point in the average rate of interest charged on government debt in the year 2002 would impose burdens on or afford relief to public budgets in the order of ½ % of GDP.

IV. Measures to limit government spending and promote growth and employment

A. Objectives and principles of Germany's economic and fiscal policy

In the coalition agreement of 20 October 1998, the new government set out among others the following objectives and principles of its economic and fiscal policy for the coming parliamentary term.

- Principal objective is **the reduction of high unemployment**. The new government will make use of all possible means to bring about progressive reductions in the number of unemployed in the course of the next four years. This means that all economic and fiscal policy action must be concentrated on achieving this objective.

- Germany's economic and fiscal policy approach is geared to an appropriate **combination of supply- and demand-oriented policies**. This centres on the following measures:

    - a reform of personal and corporate income taxation that will permanently strengthen the domestic economy and enhance the investment potential of trade and industry;
    - the ecologically-based modernisation of the economy in conjunction with an ecological tax reform, aimed at reducing non-wage labour costs and promoting future-oriented products and technologies;
    - modernisation of the state, among others with the aim of dismantling bureaucratic barriers and creating greater transparency and closeness to the citizen;
    - a sound fiscal policy conforming to cyclical needs and ensuring the balanced provision of future-oriented public investment at the highest possible level;
    - a European Employment Pact to complement the Stability and Growth Pact;
    - greater emphasis on European coordination of economic, fiscal and monetary policy.

B. Income tax reform, ecological tax reform and reduction of non-wage labour costs

The first stage of the major **income tax reform** will take effect on 1 January 1999. Besides extending the basic personal allowance, the central feature is an appreciable improvement in child benefits. At the same time, the basic rate of tax will be reduced. As envisaged for the subsequent stages as well, tax-scale adjustments will be combined with a broadening of the tax base. The elimination of special taxation arrangements will restrict the scope for tax subsidies and will at the same time provide for greater objectivity in the determination of corporate profits. Profit determination rules will be brought more closely into line with international standards. Tax law will be simpler and more equitable.

The planned subsequent stages of the tax reform will involve tax rate cuts for all taxpayers. Ultimately, the relief afforded to taxpayers will amount to some DM 15 bn in the year 2002. This relief will benefit above all the families with children and people on smaller incomes and will enhance their purchasing power.

The first measures in the **ecological tax reform** as from 1 April 1999 will increase the cost of energy consumption. The following measures are planned in the first stage (1999):

- Mineral oil duty to be increased by DM 0.06 per litre on motor fuel, by DM 0.04 per litre on heating oil, by DM 0.32 per kWh on gas.

- Introduction of an electricity tax of DM 0.02 per kWh.

The extra revenue that can be generated from ecotaxes will be used for a **reduction of non-wage labour costs**. This will make it possible to combine ecologically meaningful steering effects with a reduction in the cost of labour as a production factor, thus revitalising the labour market and increasing the disposable income of the labour force. The effects on public budgets in 1999 will be as follows:

- The rate of contributions to statutory pensions insurance will be reduced from 20.3 % to 19.5 % as from 1 April 1999. The measures to achieve this will impose a charge of DM 9.0 bn on the federal budget.

- The introduction of the electricity tax and the increase in mineral oil duty rates will generate additional revenue of DM 8.1 bn for the federal budget in 1999.

- Declining expenditure on earnings-related unemployment benefits resulting from the reduction in the rate of contributions to statutory pensions insurance will reduce labour-market spending by the Federal Labour Office and the government by DM 0.5 bn in 1999.

The ecological tax reform to be implemented in several stages will at the same time speed up structural change in German trade and industry. Full use will be made of innovative potential in the field of energy conservation, while environmentally acceptable technologies will be promoted. Germany's position as an international leader in environmental protection products will be further reinforced, enabling the relevant business sector to open up new markets. This too is a contribution towards modernising the German economy.

The government sees the ecological tax reform as a further contribution to attaining the envisaged target of reducing CO_2 emissions by 25 % from 1990 levels by the year 2005.

C. Reforms in the sector of statutory health insurance

The new government intends to bring down statutory non-wage labour costs to below 40 % of the relevant assessment base in order to provide relief both to employers and employed and to fulfil an essential requirement for the creation of new jobs. As a first step towards achieving this, the social insurance contributions are to be reduced by 0.8 percentage points in 1999. This is conditional upon progress being made (in tandem with the reduction of contributions to statutory pensions insurance) in checking the rise of health insurance contributions and holding them steady on a lasting basis. However, it must be done without jeopardising the basic principles of a socially equitable and balanced health care policy.

Against this background, the new government plans to carry out a structural reform of health insurance as from 1 January 2000 which is designed to enhance the quality, economy and efficiency of health care structures. The structural reform makes provision for the following measures:

- Deletion of medically questionable treatments and medicines from the schedules of the health insurance funds;
- introduction of a global budget for health insurance fund expenditures;
- emphasising the provision of treatment by general practitioners, while maintaining the freedom of insured persons to choose their doctor;
- improving cooperation between general practitioners, specialists and hospitals, e.g. by providing for joint use of expensive medical technology;
- reorganisation of the pharmaceuticals market by introducing a positive list and promoting the reimportation of medicaments;
- reorganisation of the system of remuneration for inpatient and outpatient treatment;
- aiming to achieve rehabilitation rather than early retirement and permanent care;
- reform of medical training and review of the specifications of medical professions;
- improvement of patient protection and the reporting of health care issues.

A so-called "preliminary" law is to be put into effect as early as 1 January 1999 to ensure that full preparation is made for the structural reform and to provide for action that must be be taken immediately. This law focuses on the following areas:

- Provisional expenditure ceilings to stabilise contribution rates;
- cutback on surcharges and treatment exclusions;
- removal of features of private-sector insurance provision.

The consequences of the measures incorporated in the law will not impose any extra burden on the finances of statutory health insurance funds, nor does the law involve any additional cost to the territorial authorities.

D. *Modernising public administration in aid of permanently sound public finances*

The government makes use of a broad range of measures to establish a more modern and more effective administration. The effect is not only to improve the quality of government services but also to reduce pressure on public budgets.

Central government **personnel expenditure** will continue in the order of DM 52 ½ bn as a result of linear personnel savings and selective staff reduction in specific administrative areas since 1992, in conjunction with the income increase in 1999. It is expected to rise by about 0.5 % by the year 2002.

Substantial progress has been made in provide finance to cope with the steep rise in **pensions expenditure** by adopting numerous measures relating to pension regulations that will in future afford substantial savings and by setting up pension reserves in the federal budget and the budgets of the Länder.

Thus contributions payable by officials in the coming 15 years will serve to accumulate a pension reserve of approximately DM 60 bn for central and regional governments. Allocations to reserves for the federal government alone are expected to amount to about DM 10 bn. From the year 2014 onwards the accumulated resources can be used for a period of about ten years to offset higher demands on public budgets from pensions expenditure. Additionally, the resulting moderation of income increases will reduce the pay and pension levels by 3 % as against those of salaried employees in the year 2013 and will thus lead to permanent savings in personnel expenditure for officials.

The **introduction of new control and management mechanisms** in public administration is gaining increasing significance within the framework of structural changes and improvements. Against this background, business management techniques such as cost and results accounting or controlling are being tested in pilot projects, while a standard cost and results accounting system is being developed with the aim of rapid introduction throughout the federal administration. The object is to show more clearly the expenditure incurred, including the necessary administrative machinery, in performing specific functions. This may be expected to have a lasting positive effect on the use of available budget resources.

In budgetary procedure, account is taken of the increasing demands made on the administration with a system of **flexible fund management** which encourages efficient and economical administrative action. The introduction of the flexible management of administrative expenditure in the federal budget will generate a yearly efficiency yield of about DM 0.5 bn.

V. Need for a closer economic policy coordination in Europe

In submitting their stability and convergence programmes, EU Member States make a substantial contribution towards the coordination of their budgetary and fiscal policies. Coordination is called for in other policy areas as well with regard to their economic policy implications. The principal objective must be to give added momentum to the creation of employment with the aim of reducing jobless figures throughout Europe.

In the course of its EU presidency, the German government will support the adoption of a European Employment Pact. The initial considerations as to the content are as follows:

- Within the framework of the necessary **macroeconomic coordination**, the aim is to ensure that wage, monetary and fiscal policies contribute to achieving constant, adequate economic growth at a high level of employment and against a background of stability. The implications for specific policy areas are as follows:

  - Stability-oriented fiscal policy under the stability and growth pact must be accompanied by the restructuring of national budgets in favour of investment and provision for the future (environment, education and training, construction, transport).
  - Wage policy that supports the promotion of employment and is geared in the medium term to productivity trends. It is the task of wage and fiscal policy to create dependable conditions for a monetary policy encouraging growth and

employment. This task can be taken on by monetary policy once the stability of price levels is assured over the medium term.

- The coordination of macroeconomic policy must be backed up by **active labour market policy**. The following aspects should be at the forefront.

  - Employment policy guidelines must include agreements on binding and verifiable objectives, especially as far as the reduction of unemployment among young persons and of long-term unemployment is concerned, and also with regard to the discrimination of women in the labour market.
  - National employment action plans must be rolled forward on the basis of the new guidelines.
  - There must be a comparison of national employment strategies using the benchmarking approach (best practice).
  - European employment programmes that affect expenditure and thus run counter to stability-oriented policies should be dispensed with.

- **Structural policy coordination** should focus on the consistent application of the benchmarking approach (aiming to shape structural reforms to achieve the optimum growth and employment effect) in formulating and evaluating the Cardiff structural reform reports. Additionally, joint and binding arrangements to counter tax, social and environmental dumping are of central significance, for instance

  - the effective and timely implementation of the code of conduct to eliminate unfair tax competition in the EU;
  - the establishment of EU-wide minimum standards for the taxation of savings interest;
  - the closer harmonisation of taxes on the use of energy.

VI. Summary and outlook

Germany's economic and fiscal policy is in line with the requirements of the stability and growth pact.

- The new government has already set the course for well-founded growth and increasing employment with the reforms adopted in the field of taxation and social affairs.

- Within the scope of an "Alliance for jobs, training and competitiveness", the government will consult with representatives of business and industry and the unions to agree concrete measures to bring down unemployment, to ensure that training places are available for all young people able and willing to take them and to boost the productivity of the economy. This dialogue with the social partners is also intended to encourage the readiness to conclude employment-promoting wage agreements in Germany that are geared in the medium term to productivity trends.

- Reforms in the field of public administration will help to make the administrative machinery more efficient and to cut costs.

- The government spending ratio will be appreciably reduced by pursuing an economical budgetary policy. At the same time, the budget will be restructured to create scope for future-oriented public investment.

- The general government deficit and government debt will be progressively brought down in the period under review. From the year 2002 onwards, government debt will again be brought down to less than 60 % of GDP. The medium-term objective set out in the stability and growth pact will be met in the year 2002 at a deficit ratio of about 1 %.

- By pursuing stability-oriented fiscal and wage policies, Germany will assist the European Central Bank to make use of the scope available to it without endangering the stability of the euro.

- At European level, Germany will support broader coordination of economic policies. Against a background of progressive European integration, the coordinated assessment of different policy areas is of decisive significance. The stability and growth pact governing the coordination of budgetary and fiscal policy is an essential element in this respect. With stability assured by coordination with the programmes of the other partners and in view of the current decline in overall economic activity, the German government's stability programme will assist the ECB in making timely use of its scope for monetary policy action.