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# 2002 UPDATE OF THE STABILITY PROGRAMME FOR GERMANY (2002-2006)

## AN ASSESSMENT

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## SUMMARY AND CONCLUSIONS

The new update of the German stability programme presents macro-economic and government finance projections for the period 2002-06. The update is broadly in line with the revised “code of conduct on the content and format of stability and convergence programmes”[1]. However, the quantitative information provided in the macro-economic part of the programme leaves some ambiguity due to the frequent use of rounding and period averaging in the projection of variables.

The projections of the updated programme are broadly in line with the Broad Economic Policy Guideline for 2002, although the elaboration of the necessary reform of the health care sector has only been initiated recently.

As repeatedly pointed out in the past, the key problem of the German economy remains its high vulnerability to external developments. Indeed, despite the important size of its domestic market, the German economy, in recent years, has not been able to generate an endogenous and durable growth process. Part of the reasons are the still lasting economic consequences of reunification; the other part is a delay in necessary structural reforms, particularly in the labour market and in the social security systems. High labour costs and relatively generous social benefits provide insufficient incentives for creating jobs and taking up work, especially in the segment of low-skilled jobs. They call for a review of the tax-benefit and wage formation systems, as well as for changes to the regulatory framework in order to encourage labour mobility and flexibility. Rising unemployment currently requires ever higher public transfer payments and social contributions, exacerbating both the budgetary problems and the negative incentives associated with a high fiscal burden. In this way, a vicious circle of slow growth and rising public debt risks being set in motion. Comprehensive structural adjustment in these areas, combined with a dismantling of over-regulation to create a more competitive environment for hitherto sheltered sectors and to facilitate the setting up of new enterprises would go a long way in enhancing the growth potential and the resilience of the German economy.

After contracting in the second half of 2001, activity picked up moderately in the first half of 2002. Nevertheless, economic performance remained disappointing as it failed to set the stage for the expected upturn in the second half of 2002, amidst falling economic confidence indicators. Developments underlined again the weakness of the German economy in generating endogenous self-sustained growth and the dependence on external demand, which remained subdued in 2002. This is reflected most clearly by the decline in real private consumption and the sharp fall in equipment investment in 2002. In addition, construction investment, which – partly as a reaction to the early boom in the new Länder after reunification - has undergone a process of downsizing since the mid-1990s, took a further slump. Overall GDP growth in 2002 is now estimated at below ½ %, falling short even of the lower-growth-scenario projection of ¾ % in the December 2001 stability programme.

The macroeconomic scenario of the updated programme projects GDP growth in 2003 at

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1 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and* converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

close to 1½ %. This already represents a major downward revision from the previous programme's growth projection of 2½ %. Whilst broadly in line with the Commission Autumn 2002 forecast, it now appears somewhat optimistic, as recently the downward risks of the short-term outlook have increased substantially. Most leading indicators have fallen sharply in the last few months, as confidence of both consumers and producers is declining after the unexpected announcements of increases in taxes and social security contributions in 2003. It therefore appears increasingly likely that the economy will stagnate until at least the second quarter of 2003. Growth of 1½ % in 2003, as assumed in the new programme, would, apart from benign external conditions, which the programme expects to provide a positive contribution to growth of some ½ % of GDP, presuppose economic confidence of private agents to be restored soon. The early presentation of a consistent and credible programme for comprehensive economic reform and budgetary consolidation would prove particularly conducive to this end.

For the period 2004-06, the updated programme expects annual output growth to accelerate to an average 2¼ %. The higher momentum is based on the assumption of a strong rebound of domestic demand, accompanied by continuing sizeable growth contributions from the external side. In such a scenario, the German economy would for a period of three years grow distinctly faster than in recent years [average for 1995-2002: 1.4 %]. Growth would also have to be above potential, currently estimated at around 1¾ %. As a consequence, even in the low-growth scenario presented for the purpose of a sensitivity analysis, assuming annual GDP growth of 2 % in those years, the current output gap would be closed by 2006. Apart from the projected pick-up of global economic activity, a faster pace of growth would crucially depend on the implementation of sweeping structural reforms extending to all major areas of the economy. In particular, endogenous growth would benefit from stronger efforts to reform the labour market and from broadening the scope of reforming the tax and social transfer system, leading to the creation of more jobs and a higher employment ratio. Chances for stronger medium-term growth would be further enhanced, if these measures were accompanied by an alleviation of the bureaucratic burden on the business sector, as well as by efforts to raise the efficiency of the education system. However, as there are few indications in the programme for a bold approach towards structural reform, the central scenario for 2004-06 must be considered optimistic. Furthermore, it should be noted that the assumed annual rate of the GDP deflator of 1½ % over the whole forecast period may imply unduly benign prospects for public revenues (and, ceteris paribus, for the government deficit), given that, over the last five years, the deflator averaged only 0.7 %.

Partly as a consequence of weaker growth, but due also to an upward revision of the deficit in 2001[2], the general government deficit in 2002 turned out to be significantly higher than projected by the December 2001 update of the programme. While the later, in its lower growth scenario, set a 2002 deficit target of 2½ % of GDP, the new stability programme estimates the deficit ratio at 3¾ %. This is in line with the Commission Autumn 2002 forecasts, which led the Commission to initiate, on 19 November 2002, the excessive deficit procedure for Germany. On a recommendation from the Commission, the Ecofin Council of 21 January decided on the existence of an excessive deficit and

2 Current deficit estimate for 2001 of 2.8 % of GDP as compared with a projection of 2½ % in the updated programme of December 2001.

addressed recommendations to Germany with a view to bringing the situation to an end (Art 104.6 and 104.7 of the Treaty).

Tax revenues, especially from the business sector, were particularly adversely affected by the sluggish economic activity, although part of the shortfall in business taxes has once again to be attributed to the underestimation of the impact of the 2001 corporate tax reform. More generally, the shortfall in tax revenues compared with the original official projection is also due to overly optimistic assumptions for the development of domestic demand in the previous update of the stability programme. Moreover, the projected rise in VAT receipts on account of the fight against fraud has not materialised. Social security contributions also yielded substantially lower revenues than originally projected, explaining to a large extent the sizeable deficits in all major social security programmes. Nevertheless, expenditure overruns have also occurred, most notably in the health care sector, and in particular owing to a further strong increase in the consumption of prescribed drugs. Other general government expenditure, with some exceptions, remained broadly on target.

For 2003 it seems likely that discretionary measures will reduce the underlying deficit by clearly more than half a percentage point of GDP, as suggested by the Commission communication of 27 November 2002[3]. However, there is a non-negligible risk that the nominal government deficit might again exceed the 3 % of GDP reference value.

The updated programme expects the nominal general government deficit to decline to some 2¾ % of GDP. The fall in the nominal deficit ratio by 1 percentage point from last year is to be brought about by: *(i)* the draft 2003 federal budget (including also the beginning implementation of the proposals of the 'Hartz Commission' for labour market reform); *(ii)* a rise in contribution rates to social security sectors and *(iii)* the respect of the agreed expenditure targets by all levels of government. This deficit projection is subject to considerable risks, as reflected also by the Commission Autumn 2002 forecast, which foresees a deficit of 3.1 % of GDP for 2003. First, many of the revenue-raising measures incorporated in the draft 2003 federal budget have still to be adopted by the *Bundesrat* (parliamentary chamber representing the Länder), where the opposition parties currently hold a majority. Second, the first draft law on the implementation of the proposals made by the 'Hartz Commission' falls in some respects short of the original ideas, casting doubt on the expenditure savings factored into the 2003 federal budget. Third, nominal GDP growth in 2003 may be below the projected 3 %, with important consequences for tax revenues, social security contributions and social transfers. Finally, there are further risks on the expenditure side, notably in the health sector, where the projected (sizeable) savings from the implementation of the 'Vorschaltgesetz' might not come forward.

The present programme aims for a balanced general government budget by 2006, thereby postponing the target set in the previous update (2004). The adjustment path towards the medium-term objective as presented in the updated programme implies an annual improvement in the underlying budgetary position of at least 0.5 % of GDP on average from 2004 to 2006. Thereby, the German government accounts would come at least close

3 COM (2002) 668 final of 27.11.2002.

to balance by 2006 also in cyclically adjusted terms. However, reaching a balanced budget by 2006 hinges critically (again) on the full implementation of the consolidation package presented by the federal government in autumn 2002. Next to the one-year postponement of the tax reform step that was originally foreseen for 2003, the most important elements addressed in the programme are the indirect tax increases mainly for energy products and a reduction in the tax write-offs for businesses. Of critical importance are furthermore a successful reform of the labour market and the adherence to the agreed expenditure line by all levels of government. In this regard, the declaration of the *Finanzplanungsrat* (financial planning council) of 27 November 2002 has to be welcomed, which reconfirmed the overall target to balance the general government budget by 2006 and confirmed the expenditure targets for 2003 and 2004 agreed upon in its meeting of 21 March 2002.

For the compliance with the provisions of the SGP, it is crucial that the announced measures are fully implemented, that agreed expenditure targets for 2003 and 2004 are respected and that ambitious expenditure targets be agreed upon for 2005 and 2006. Failing that, there is a significant risk that Germany's budgetary position in 2005 and 2006 will be worse than projected (and hence not come close to balance), not least given the envisaged subsequent steps of income tax reform due to take effect in 2004 and 2005. Again it should be recalled that reaching the 2006 target is subject to an average rate of GDP growth during the last three years of the programme that lies considerably above the growth record of recent years.

The bulk of the budgetary consolidation effort in the programme falls on expenditure reductions. Revenues are expected to remain broadly unchanged in terms of GDP. By contrast, the programme expects total government expenditures to fall from 48½ % of GDP in 2002 to 44½ % in 2006. Practically all of the adjustment falls on projected reductions in social outlays in the order of 3½ percentage points of GDP at the end of the programme's horizon, which expresses notably a significant and perhaps unrealistic optimism on the effectiveness of the labour market reform.

According to the programme update, the ratio of government debt to GDP will again rise above the Treaty's reference value of 60 % in 2002, after it had been brought down to 59.5 % by the end of 2001 by the proceeds from the sale of UMTS licences that were used entirely for debt redemption. For 2003, the programme, in line with the Commission's Autumn forecast, projects a further rise of that ratio to 61½ % of GDP. Only from 2004 onwards would there be a decline which is projected to bring the debt ratio below the reference value in 2005. Should nominal GDP growth or the reduction of the deficit turn out below projections, there is a clear risk that the reference value for the debt ratio would not be respected throughout the period covered by the updated programme.

The Commission considers that the assessment of the sustainability of public finances in the stability programme is somewhat complacent. On the basis of current policies, the risk of unsustainable public finances cannot be excluded in the long run. The planned move to budget balance by 2006, if achieved, will, however, make a substantial contribution to meeting the projected budgetary costs of ageing populations.

Nevertheless, a position of budget balance in 2006 on its own will not secure the sustainability of public finances. On the basis of long-term Commission projections, a substantial financing gap will open up which has to be closed either through a higher tax ratio (but this could be detrimental to growth and employment creation) or, more preferably, via reforms to limit the growth in age-related public expenditure.

Overall, there is a lack of a comprehensive strategy to prepare for the budgetary impact of the ageing of the population. The German authorities should aim at achieving a large reduction in the debt ratio prior to the budgetary impact of population ageing taking hold. In addition, there is a need to consider fundamental reforms of the pension and health care systems that live up to the prospective demographic challenges.

## 1. INTRODUCTION

The updated German stability programme was adopted by the German Federal Council of Ministers on 18 December 2002 and submitted to the European Commission on the same day. The programme has been sent to the German Parliament for information and is also being made available to the general public[4]. The programme updates the last submission of December 2001 and covers the period up to 2006. The previous update contained a consolidation programme for public finances for the period 2001-2005 and was assessed by the Commission and the Economic and Financial Committee, before the Council gave its opinion in February 2002[5].

In its last opinion, the Council had noted that, regarding the information provided, the German stability programme did not fully comply with the code of conduct[6], especially due to the exaggerated use of rounding. While the section on public finances has made some progress in this regard, there is still a need for improvement particularly in the section presenting the macro-economic outlook where the key aggregates are specified as averages over several years, which is not helpful for the transparency of the analysis. Furthermore, a more elaborate presentation of developments in social security sectors would be highly recommended.

## 2. IMPLEMENTATION OF THE PREVIOUS UPDATE

Following a contraction of demand and output in the second half of 2001, GDP growth in 2002 remained weak without being able to generate the pick-up previously expected. As a consequence, the updated programme estimates GDP growth in 2002 to be significantly below the projections of the December 2001 programme. The programme update expects real GDP growth at ½ % compared with a rate of 1¼ in the baseline scenario of the last

4 The programme has been made available, inter alia, on the internet page of the German Ministry of Finance (*http://www.bundesfinanzministerium.de/Anlage15676/Deutsches-Stabilitaetsprogramm-Aktualisierung-Dezember-2002.pdf*) for the German original; a translation into English should be available early January on the following internet page: (*http://www.bundesfinanzministerium.de/service/translation-/-traduction-.574.htm*)

5 OJ C 51/01, 26.2.2002.

6 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

update. Recent data indicate, however, that even this low figure is unlikely to be attained.

At the heart of the present stagnation is a slump in domestic demand, with receding private consumption and strongly falling investment. Growth was supported exclusively by decelerating inventory depletion and a sizeable external contribution. The latter was not so much the result of rising exports than of falling imports, which reflected the substantial slack in domestic demand.

The current programme – in line with the Commission Autumn 2002 forecast - projects a general government deficit of 3¾ % of GDP for 2002, compared with a projection of 2½ % in the lower-growth-scenario of the preceding update. This considerable nominal divergence is due to a number of factors: First, the 2001 deficit, i.e. the point of departure, is now estimated at 2.8 % of GDP, three tenths of a point higher than the preceding update assumed. Second - and as evidenced also by the current update - growth in 2002 has probably turned out somewhat lower than projected in the lower-growth scenario (¾ %). However, both the current update and the Commission Autumn 2002 forecast imply a deterioration also in the cyclically-adjusted balance[7]. In this regard, the design of the reform of corporate taxation has once more to be critically assessed as corporate and local business taxes (‘Körperschafts- und Gewerbesteuern’) performed clearly worse than projected still in May 2002 by the ‘working group tax revenue estimates’ (‘Arbeitskreis Steuerschätzung’). The May working group had still projected corporate tax revenues of € 7.9 billion, a figure which the November 2002 revision by the working group had to take down to € 850 million[8].

Furthermore the original projections for the rise in domestic demand and in VAT revenues were clearly on the very high side.

Moreover, there were again expenditure overruns in some sectors, especially in the health care system. In particular, a non-negligible part of the high deficit in the health sector (at least € 2.5 billion, i.e. slightly more than 0.1 pp. of GDP) was another sharp rise in the consumption of pharmaceuticals[9]. This was encouraged by the decision to lift the expenditure ceiling on the consumption of pharmaceuticals taken at the beginning of the year 2001. As a consequence, contribution rates to the health care systems, which had already risen by 0.4 pp. on average in 2002, will see another rise by at least 0.3 % in 2003.

Available figures on Länder finances indicate that - in contrast to 2001, when some Länder governments registered expenditure overruns – the probable deterioration in the underlying balance in 2002 was not provoked by the regional level of government[10].

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7 As shown in Table 6 of the update, the deterioration would amount to a (rounded) ¼ % of GDP; the Commission Autumn 2002 forecast implies a deterioration by 0.5 % of GDP, based on a 2002 growth rate of 0.4 % of GDP.

8 To explain the shortfalls in corporate taxes by sluggish growth in 2001 and 2002 is unconvincing. When the working group submitted their May 2002 tax revenue estimate, growth for 2001 was known and the 2002 projection was based on a growth forecast for 2002 of ¾ %, compared with a forecast of ½ % in November 2002.

9 According to the Federal Minister in charge, there has been a rise by 30 % in the last four years.

10 The projections of the November 2002 Finanzplanungsrat actually imply some ‘expenditure overruns’ due to the August 2002 floods.

Following the publication of its Autumn forecast on 13 November 2002, showing a 2002 deficit of 3.8 % of GDP, the Commission on 19 November 2002 initiated the Excessive Deficit Procedure for Germany in accordance with its obligations laid down in Article 104 of the Treaty. With the updated Stability Programme also projecting a deficit of 3¾ % of GDP for 2002, the Commission has on 8 January 2003 recommended to the Council to decide that an excessive deficit existed in Germany.

## 3. THE MACROECONOMIC SCENARIO

### 3.1 External Economic Assumptions

The economic forecast underlying the updated Stability programme is based on a number of technical assumptions on the international environment. Notably, it is assumed that neither the Iraq conflict nor the financial crisis in Latin America will have a major negative effect on international financial markets, oil prices and business confidence. World trade is expected to grow by 5-6 % annually throughout the programme period, based on accelerated growth in the United States, other EU-member states and Eastern and Central European countries. The assumptions on the external economic developments are relatively optimistic. Regarding the years 2003 and 2004, the few figures presented by the current update do not diverge considerably from the assumption underlying the Commission Autumn 2002 forecast. Based on these assumptions, the current update projects Germany to benefit from a positive external contribution to GDP growth in the order of ½ percentage point per year throughout the programme period.

### 3.2 Macroeconomic Developments

Table 1 presents the key macroeconomic figures of the updated programme’s baseline scenario. Two aspects should be noted. First, as already indicated, the customary rounding of important data in the programme constrains a detailed assessment of the macroeconomic assumptions. Second, the macro-economic projections of the programme do not contain information on the years 2004 to 2006, with the exception of real GDP growth, which is shown in Table 2 of the programme. Instead, average figures are given for the period 2001-06, which implicitly contain period averages for the years 2004 to 2006. The figures for the years 2004-06 in Table 1 were calculated such that they (1) match the (rounded) averages for 2001-06 given in the programme and (2) yield consistency between aggregates, on the one hand, and their components, on the other. The presentation of rounded figures only renders the analysis of the medium-term growth outlook unnecessarily complicated.

**Table 1: Macro-economic assumptions of the Stability Programme**

(annual percentage change)

| | 2001 | 2002 | | 2003 | | 2004-6 | 2001-06 |
|---|---|---|---|---|---|---|---|
| | ***Official estimate*** | ***COM*** | **SP** | ***COM*** | **SP** | **(Implicit rates in SP)** | **SP (rounded)** |
| **Real GDP** | 0.6 | *0.4* | ½ | *1.4* | 1½ | 2 ¼ | 2 |
| **Nominal GDP** | 2 | *1.7* | 2 | *2.5* | 3½ | 4 | 3½ |
| **Deflator** | 1.4 | *1.4* | 1½ | *1.1* | 1½ | 1½ | 1½ |
| **Employment** | 0.4 | *-0.5* | -½ | *0.0* | -0 | 1 | ½ |
| **Private Consumption** | 1.5 | *-0.7* | -½ | *1.1* | 1½ | 2 | 1½ |
| **Public Consumption** | 0.8 | *1* | 1 | *1* | 1 | 0 | ½ |
| **Investment** | -5.3 | *-4.8* | -4½ | *1.6* | 1½ | 3½ | 1½ |
| **Exports** | 5 | *2.1* | 1½ | *5* | 5½ | 7 | 5½ |
| **Imports** | 1 | *-2.2* | -2½ | *6.3* | 5 | 7½ | 5 |
| ***Growth contribution*** | | | | | | | |
| *Domestic Demand* | *-0.2* | *-1.2* | *-1* | *1.1* | *1* | *1¾* | *1* |
| *Stocks* | *-0.6* | *0.1* | *0* | *0.5* | *0* | *½* | *½* |
| *External Contribution* | *1.4* | *1.4* | *1½* | *-0.2* | *½* | *¼* | *½* |

*Note: 2001 figures published by Federal Statistical Office.; COM: Commission Autumn forecast; SP: Stability Programme; Growth contributions do not add exactly to total growth due to rounding. The values for 2004-6 are subject to error, because they are not contained in the programme itself. Instead, they are calculated based on the overall (rounded) averages in the last column and the values for 2002-3.*

The short-term growth forecast of the updated programme represents a major downward revision from the previous programme. Thus, GDP growth for 2002 was taken down by ¾ of a percentage point to ½ %, and for 2003 by a full percentage point to 1½ %. The new short-term outlook is fairly close to the one presented by the Commission in its Autumn 2002 forecast. Nevertheless, it now appears somewhat optimistic, as recently the downward risks have substantially increased. Since the Commission forecast was published, growth for the first half of 2002 has been slightly revised downward by Destatis, the German statistical office, and third quarter growth turned out to be slightly weaker than anticipated. Based on this evidence, a growth rate above ¼ % for the whole year 2002 appears now unrealistic.

The current update's growth projections for the years 2003 to 2006 are on the domestic side based on the assumption that wage developments will remain moderate: Wages per employee are projected to rise by 2½ % per year, resulting in unit labour cost increases of 1½ % in 2003, followed by only negligible increases in the following years. Wage developments should therefore be conducive to job creation. Both price increases and interest rates are expected to be very low.

For the 2003 growth rate, the downward revision for 2002 also has implications due to a lower statistical overhang. In addition, most leading indicators have dropped sharply in the last few months, as confidence of both consumers and producers is declining after the unexpected announcements of increases in taxes and social security contributions for 2003. For instance, after falling for seven months in a row, the widely watched Ifo indicator for December is again near its historical low. It therefore appears increasingly likely that the economy will stagnate well into the first half of 2003. This makes it difficult though not impossible to reach GDP growth of 1½ % for 2003, as assumed in the new programme. It would, however, not only require benign external conditions - which the programme expects to provide a positive growth contribution of some ½ % of GDP - but also presuppose economic confidence of private agents to be restored soon.

The updated programme expects annual output growth to accelerate to an average 2¼ % in the period 2004-06. The stronger momentum is based on the assumption of a marked rebound of domestic demand, accompanied by a continuing positive growth contribution from the external side. In such a scenario, the German economy would for a period of three years grow distinctly faster than in recent years. For instance, the average rate of GDP growth for the years from 1995 to 2002 was barely 1.4 %. With growth in the last three years of the programme period above its potential rate (currently estimated at around 1¾ %), the current output gap would be closed by 2006 even in the low-growth scenario, which is presented for the purpose of a sensitivity analysis and assumes an annual GDP growth of 2 % in those years.

Apart from the projected pick-up of global economic activity, a faster pace of growth would crucially depend on the implementation of sweeping structural reforms extending to all major areas of the economy. Growth would also be supported by the presentation and implementation of a credible fiscal adjustment strategy which would raise business and consumer confidence. Endogenous growth in particular would benefit from stronger efforts to improve the functioning of the labour market and from broadening the scope of streamlining the tax and social transfer system, leading to the creation of more jobs and a higher employment ratio. Chances for stronger medium-term growth would be further enhanced, if these measures were accompanied by an alleviation of the bureaucratic burden on the business sector, as well as by efforts to raise the efficiency of the education system. However, as there are few indications in the programme for a bold approach towards structural reform, the central scenario for 2004-06 must be considered optimistic.

While the inclusion of a sensitivity analysis for different growth assumptions is welcome, it appears to be of limited use. First, the variations included are so small (¼ of a percentage point) that their impact is largely hidden by the fact that rounding takes place up to the next ½ percentage figure. Second, there is a probably a greater downward risk to growth in 2003 than for the period 2004-6. For this greater risk, no sensitivity exercise is presented.

It should be further noted that the assumed annual rate of the GDP deflator of 1½ % over the whole forecast period may imply unduly benign prospects for public revenues (and, ceteris paribus, for the government deficit), given that, over the last five years, the deflator averaged only 0.7 %.

# 4. BUDGETARY TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES

## 4.1 Programme overview

In its central scenario, the update projects the general government deficit to decline slightly below 3 % of GDP in 2003 (2¾ %) and to fall further to 1½ % of GDP in 2004, in spite of the next (small) step of income tax reform due to take effect in the later year. For 2005, the updated programme now even projects a small further decline in the nominal deficit, despite the considerable volume of the tax relief planned for that year (more than 1 point of GDP) which had prompted the previous update not to foresee any improvement in the general government balance at all.

With the attainment of a balanced general government budget in 2004 now virtually out of reach, this target has been moved to 2006, requiring an improvement in the nominal balance of 1 percentage point of GDP from 2005 to 2006.

**Table 2: Development of Public Finances:**

**The December 2001 and the December 2002 updates compared**

**(% of GDP)**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| ***Net lending*** | | | | | | |
| **December 2001 (baseline)** | -2½ | -2 | -1 | 0 | 0 | |
| **December 2002** | -2.8 | -3¾ | -2¾ | -1½ | -1 | 0 |
| ***Consolidated gross debt*** | | | | | | |
| **December 2001** | 60 | 60 | 59 | 57 | 55½ | |
| **December 2002** | 59.5 | 61 | 61½ | 60½ | 59½ | 57½ |

## 4.2 Public finances in 2003

Table 2 shows the important changes of the medium-term adjustment path implied by the significantly worse than originally projected outcome in 2002: For 2003, the updated programme still targets a decline in the nominal deficit by1 percentage point of GDP, although the projection for real GDP growth had in the meantime to be taken down considerably (from 2½ % in the baseline scenario of the previous update to 1½ % now). While part of the “stronger” structural consolidation is ‘financed’ by the postponement of the next step of income tax reform from 2003 to 2004, the consolidation package presented by the coalition partners in October 2002 and the new 2003 budget adopted by the federal government on 20 November 2002 provide for considerable expenditure savings and revenue-raising measures, totalling about 0.6 percentage points of GDP. Furthermore, the considerable rise in contribution rates to the pension and health care schemes plus the increase in the income ceiling for pension contributions should ceteris paribus also imply an improvement in the balances of the social security sector.

The projection for the 2003 general government deficit is, however, subject to considerable upside risks: First, many of the revenue-raising measures are subject to approval by the Bundesrat, where the opposition parties hold a majority. The projected expenditure savings depend to an important degree on the implementation of the proposals by the so-called ‘Hartz-Commission’. In at least one important area[12],

12 Regarding the wages of temporary staff (cf. chapter 6).

however, the draft law presented falls clearly short of the original proposals; there are also some legitimate doubts whether even the full implementation would yield the projected savings. Furthermore, recent modifications to the second draft law imply some losses in revenues, not yet incorporated in the update's projections. It also remains to be seen what the overall impact of the recently proposed withholding tax on savings ('Zinsabgeltungssteuer') on tax revenues will be and whether the 'Vorschaltgesetz'[13] will yield the projected savings in the health sector (close to 0.2 % of GDP).

Second, the 2002 point of departure might also be worse than projected by the update: Were December tax revenues and social security contributions to continue the development observed in November[14], the deficit outcome for 2002 might even be higher than the 3.8 % of GDP assumed by the Commission's Autumn 2002 forecast. As was also the case in the past, the first 2002 deficit estimate by the Statistical Office to be published mid-January cannot incorporate actual figures for December tax revenues, nor actual figures for local levels of government nor on the health sector in the fourth quarter.

Finally, the updated programme's projection of a nominal deficit of 2¾ % of GDP in 2003 is based upon a forecast for real output growth of 1½ %. By extension, the absence of a clear acceleration in economic activity in 2003 - a possibility that cannot be excluded in the light of current developments – risks to push the deficit above 3 % of GDP[15].

In underlying terms, however, Germany will probably see a clear improvement in its deficit in 2003. According to the Programme's projections, this improvement would reach one percentage point of GDP in the current year. The Commission's Autumn 2002 forecast, which could only partially incorporate the consolidation package, also projects a decline in the cyclically-adjusted deficit of close to one percentage point of GDP. This marked decline in the structural deficit would also be the result of the rise in the so-called 'ecological tax' ('Ökosteuer') and in tobacco tax, the increase in social security contribution rates and the raising of the income ceilings up to which social security contributions would have to be paid[16], as well as of some savings in the health sector.

### 4.3 Targets and adjustment in 2004 and beyond

As indicated, the updated programme projects for **2004** a decline in the general government deficit by 1 ¼ percentage point of GDP, in spite of the next step of income tax reform (volume around 0.3 % of GDP). In structural terms, this implies that the

13 This law is intended as a transitory solution to limit the ongoing rise in health care expenditure.

14 Unfavourable developments in unemployment and cuts in Christmas bonuses kept wage tax and social security contributions revenues even below the already bad results of November 2001.

15 Given that the 2003 growth deflator projected by the updated programme also appears high, the projected nominal GDP growth is clearly on the very high side. The upper margin of the band for the nominal 2003 general government deficit (€ 62 billion) could - under the assumption of a clearly lower nominal GDP growth rate for 2003 - easily correspond to a deficit ratio of 2.9 % all other assumptions of the updated programme unchanged!

16 This assessment is based on the assumption that wage agreements in the public sector will be moderate or, alternatively, that public employers will strongly reduce personnel in case of generous wage agreements.

consolidation would be clearly more important than projected in the previous update: In its lower growth scenario, the previous update had implied a 2004 growth rate of 2¼ % - i.e. identical with the central scenario of the current update – but a decline in the nominal deficit by half a point of GDP only. Taking into account the tax relief planned for 2004, current projections therefore imply a 'tripling' of consolidation efforts.

According to the update, this clear improvement in the government accounts is to be brought about not only by an acceleration in economic activity, but also by the implementation of the consolidation package decided in late 2002: This package actually projects a consolidation by around € 15 billion for the year 2004, 'financed' equally by a rise in taxes and a reduction in expenditure, especially in 'Arbeitslosenhilfe'[17] (projected savings of around € 5 billion in 2004 alone). Clearly, the attainment of these 'savings' is again subject to the above-mentioned caveats (approval by Bundesrat; full implementation of intended labour market reform…).

While the deficit at the federal level is to decline by around € 11 billion in 2004, the decline at the regional and local level is to reach around € 15 billion, clearly underlining the importance of the 2004 expenditure targets agreed upon in the Finanzplanungsrat of March 2002[18].

The increasing importance of expenditure cuts in 2004 is also highlighted by the revenue and expenditure ratios presented by the update (cf. Table 3): With the tax and social charges ratio projected to remain constant, the decline in the overall deficit in 2004 has to come from the expenditure side.

17 Arbeitslosenhilfe is paid once the claim to regular (and more generous) unemployment benefit ('Arbeitslosengeld') has been exhausted.

18 The update also presents a special chapter on the 'reform of local finances', alluding to the discussions in the Commission of the same name, installed in March 2002 by the federal government. According to the update, this commission will "focus on welfare assistance as a cost-intensive item of expenditure, and the possible financial consequences for central and local government of a reform of unemployment and welfare assistance"; the results of the commission are expected to be presented in mid 2003 and are supposed to be implemented on 1 January 2004.

**Table 3: Revenue and expenditure projections**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| **Tax and social charges** (as % of GDP) | 411/2 | 41 | 41½ | 41½ | 41 | 41 |
| **Total expenditure** (as % of GDP) | 48.3* | 48½ | 48 | 46½ | 45½ | 44½ |

*Source:* Updated German stability programme

*: 45.9 if revenues from UMTS licenses are included

Given that consolidation package 'only' projects expenditure cuts of close to 0.4 % of GDP for 2004, the projection of the expenditure ratio actually implies an additional reduction in expenditure by around one point of GDP (or € 20 billion). The annex might give some hints in this regard: The share of 'social transfers other than in kind' in GDP is projected to decline substantially from 19½ % of GDP in 2002 to 18½ % in 2004 and 18 % in 2005 (and 2006); while part of this decline would be the direct consequence of the implementation of the consolidation package, the rest seems to be expected from the projected growth acceleration.

The identical decline in the share of 'social transfers in kind' seems to be the result of the 'Vorschaltgesetz' in 2003 (cf. above) and of the announced 'structural reform of the health sector' to be implemented in 2004. As the commission on the structural reform of the health sector has only been installed recently**,** it is at this point of time impossible to assess the plausibility of this projection.

The projected developments for the **year 2005** further underline what has been said for 2004: With the revenue ratio decreasing due to the important tax relief of the planned step of tax reform, the overall improvement in the deficit would have to come from the expenditure side, with a decrease in the expenditure ratio by one point of GDP (i.e. around € 20 billion). The consolidation package, however, 'only' projects expenditure cuts of around € 9 billion (slightly more than 0.4 % of GDP) for the year 2005, of which € 4 billion have not been specified yet; the rest has to come from the projected decline in social transfers.

Furthermore the attainment of the ambitious 2005 deficit target is also subject to the next meeting of the Finanzplanungsrat agreeing on ambitious expenditure targets; the current agreement reached on 21 March 2002 only covers expenditure targets for 2003 and 2004.

In the absence of another tax cut, the final year of this update – which by coincidence would also be the final year of the current legislative period - would see an improvement in the nominal deficit by one percentage point, balancing the general government accounts in 2006. As was the case for 2005, a considerable part of the expenditure cuts of the consolidation package – for 2006 slightly more than € 6 billion out of o total of more than € 11 billion – are not specified yet. The remaining expenditure cuts seem once more to result simply from the projected acceleration in growth during the last three years of the current programme and from lower levels of governments adhering to ambitious expenditure targets

All in all, the consolidation strategy presented in the current update is very ambitious. Yet, besides the risks mentioned above, it cannot be excluded that some of the measures presented in the the consolidation package might not yield the projected savings; the update also anticipates considerable savings in social transfers which require a far-reaching reform of the health sector, although serious discussion have only started very recently.

The attainment of the medium-term objectives is moreover not only subject to the risks inherent in the projected strong acceleration in economic activity, but also to the typical uncertainties related to the implementation of tax cuts (not least observed in 2001 and 2002 with the corporate tax reform leading to markedly higher shortfall in taxes than originally anticipated). The medium-term projections also rely on the respect of very ambitious expenditure targets by all levels of government, although the Finanzplanungsrat has not yet reached an agreement for 2005 and 2006.

This analysis is confirmed by the deficit projections presented under the title 'sensitivity analysis'. Assuming an average annual GDP growth of 2¼ % of GDP for the period 2004-06, the general government deficit would reach ½ % of GDP in 2006. Taking into account that the growth average for the years 1995-2002 was 1.4 % only, even the fact that growth in 2004 should benefit from an uncommonly positive calendar effect[19] confirm that the attainment of a balanced position by 2006 will be very difficult .

This conclusion is also reinforced by the fact - already pointed out in the previous assessment - that in Germany a consolidation effort of a cumulated 3.1 % of GDP over two years (as now projected for 2004-2005) has only happened once since the early 1960s[20]. Similarly, the projected decrease in expenditure by 3½ % of GDP in 2003-2006 appears extremely ambitious[21] and dependent on the assumption of very favourable circumstances.

**The analysis in cyclically-adjusted terms** (Table 4) shows that both the current update and the Commission's Autumn 2002 forecast project a clear improvement in the underlying balance in 2003 and 2004. Th update projects a decline in the cyclically-adjusted deficit by 1.1 % of GDP in both 2003 and 2004.For the year 2005, the update only projects a small decline in the structural deficit due to the planned tax reform; by the end of the current update's horizon, the general government finances of Germany would be balanced also in structural terms.

19 Including the fact that 2004 is a leap year.

20 Between 1967 and 1969 the government position improved by 2.5 % of GDP; average output growth amounted to more than 6 % in 1968/69. Between 1975 and 1977 the government position improved by 3.1 % of GDP against average output growth of 4 % in 1976/77.

21 Since 1991 there has been only one year – 1997 – in which the decrease in the expenditure ratio was larger than ½ % of GDP.

**Table 4: Cyclically-adjusted public finances**

| | Stability Programme (CAB as calculated by COM) | | | | Autumn Forecast | | | |
|---|---|---|---|---|---|---|---|---|
| | Budget Balance | GDP Growth | HP Trend growth | CAB | Budget Balance | GDP Growth | HP Trend growth | CAB |
| 2002 | -3 ¾ | 0.5 | 1.7 | -3.1 | -3.8 | 0.4 | 1.6 | -3.3 |
| 2003 | -2 ¾ | 1.5 | 1.8 | -2.0 | -3.1 | 1.4 | 1.6 | -2.4 |
| 2004 | -1 ½ | 2.25 | 1.8 | -0.9 | -2.3 | 2.3 | 1.7 | -1.9 |
| 2005 | -1 | 2.25 | 1.9 | -0.7 | | | | |
| 2006 | 0 | 2.25 | 1.9 | -0.0 | | | | |
| Stability programme December 2002, Commission services Autumn forecast 2002 | | | | | | | | |

In the absence of another tax cut in 2006, the last year of the current update would see a further clear decline in the underlying deficit by 0.7 % of GDP.With an average annual improvement of slightly more than 0.5 % in cyclically-adjusted terms, Germany would thus in be in line with the Commission Communication of 27 November 2002.

### 4.4 Debt ratio

Due primarily to the considerable revenues from the auctioning of UMTS licenses in 2000 (2.5 % of GDP) used for debt redemption in 2000 and 2001, the debt ratio had fallen from a value of 60.2 % of GDP in the year 2000 to a value of 59.5 % by the end of 2001. While the preceding programme update had projected another decline in 2002 – based it is true also on the optimistic growth projection of the baseline scenario – the new update concedes that there will be a considerable rise in the debt ratio. As pointed out in the preceding assessment, this is not only due to the strong rise in the budget deficit, but also to some nominal effects, with the preceding update's GDP deflator for 2002 on the high side.

Not only is the debt ratio projected to exceed the 60 % of GDP reference value of the Treaty in 2002, albeit slightly, but the update also forecasts a furtherrise in the year 2003. Only in the medium-term would there be a decline, depending essentially on the projected strong improvement in the deficit.

In this context, it has to be underlined that in view of the foreseeable ageing of the population, it remains essential that all levels of government contribute to the  decrease in the debt level, in order to guarantee the medium and long-term sustainability of public finances (cf. also the following chapter). In this regard, the important deficit in the public pension system of at least € 4 billion in 2002 – in spite of the huge public transfers[22] already devoted to this sector  - serves as an example of how unforeseen developments

22 Probably exceeding 3.5 % of GDP in 2002.

might easily overthrow projections.

## 5. THE SUSTAINABILITY OF PUBLIC FINANCES

The 2002 updated stability programme contains a section on the sustainability of public finances. It includes the EPC projections for public expenditure on pensions and health care which show an overall increase in age-related spending of some 7 percentage points of GDP between 2005 and 2050.

It is first necessary to consider whether current budgetary polices can ensure that the Stability and Growth Pact will be respected in the light of the future budgetary implications of ageing populations. Based on the projections shown in Annex 2, the Commission considers that on the basis of current policies, the risk of public finances becoming unsustainable in the long run cannot be excluded.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. If achieved, the planned move from a large deficit in 2002 to a position of budget balance in 2006, would make a substantial contribution towards meeting the budgetary costs of ageing population. However, a strategy to meet such budgetary costs will not suffice if based on debt reduction alone. It needs to be accompanied by reforms of the pension and health care systems so as to contain on a lasting basis the upward pressure on public spending on these items. At the same time, reforms are needed to encourage hiring and taking up work, raising employment rates, especially amongst women and older workers.

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. First and foremost, a greater degree of urgency is required about the need to prepare for the budgetary impact of ageing populations. Budgetary objectives need to be more ambitious. As a minimum, a position of underlying budget balance should be attained no later than the deadlines set down in the stability programme. Thereafter it will be necessary to sustain sound budget positions over the long run so that a significant fall in the debt ratio is recorded in the coming decade prior to the budgetary impact of ageing populations taking hold.

## 6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

Germany’s current budgetary problems are not simply the result of the recent economic downturn. They are more deeply rooted in the country’s apparent difficulties of generating endogenous economic growth. As the potential growth rate of the country is the lowest in the EU, there is an urgent need for Germany to address the structural problems that are holding the economy back.

It is encouraging that Germany has now entered into a substantial debate to reform its tax and benefit systems, and, most importantly, the labour market. As this debate has so far resulted in relatively little concrete action, it is too early at this stage to reflect upon its potential outcome.

Some progress will certainly come from reform initiatives for the labour market, inspired by the proposals of the Hartz Commission. If fully implemented, they would not only lead to efficiency gains in the job placement agencies, but also allow jobs to be created in the low-income bracket. The latter has so far been virtually non-existent in Germany because of the negative incentives inherent in the tax/benefit system. By raising tax thresholds and simplifying taxation for income levels up to € 800 per month, it should be possible that more jobs in the low-skill bracket will be created and that part of the (fast growing) shadow economy will re-enter the official economy. Along with some bureaucratic simplifications for self-employed, structural unemployment should fall somewhat. Unfortunately, however, this is counteracted by an increase in the stringency of temporary work regulations, which after a short time span of 6 weeks mandate the payment of wages equivalent to those of the permanent staff. In this way, an opportunity of introducing more flexibility into the labour market is being missed.

The current reform debate for the health care and pensions sector is focused more on raising revenues than on reducing expenditures. The burden of health and pensions contributions will therefore increase further in the near-term. More ambitious efforts are therefore urgently needed to keep rising health care costs under control, especially in the light of population ageing. To this end, the government has installed a new Committee under the chairmanship of Professor Rürup, which is expected to deliver its reform proposals on the health and pension system in the second half of 2003.In the field of taxation, the most notable recent event is the intended replacement of the present tax by a 25 % withholding tax (Zinsabgeltungssteuer) on all interests payments received above € 1601 for a single person (respectively € 3202 for a married couple). This compares with a potential tax rate of 48.5 % for high income earners in the current system. In order to increase incentives to repatriate capital that in the past had fled Germany, current proposals also foresee that 'black' capital declared in 2003 will be subject to a tax rate of 25 %, while any black interest income declared later would be taxed at 35 %.

## 7. OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP

Following the marked deterioration in nominal balances in 2001, the 2002 general government deficit has clearly breached the reference value of the Treaty. Furthermore, the debt level has exceeded the respective reference value. Given that the risks to the updated programme's scenario for 2003 are clearly biased upwards, it appears likely on the basis of current assumptions that Germany will not respect the Treaty's reference value in the current year either.

The attainment of the ambitious medium-term deficit targets is subject to the successful reform of the labour market and of social security systems. Otherwise, there is a clear danger that any external disturbance will immediately translate into rapidly deteriorating public finances. In underlying terms, the strategy presented would imply that Germany, in line with the recent Commission communication of 27 November 2002[23] would reduce its deficit by slightly more than 0.5 % on average per year. The debt level which by end 2002 has risen above the Treaty's reference value of 60 % of GDP, will continue its rise

23 COM (2002) 668 final of 27.11.2002.

in the current year. The decline below the reference value in 2005 forecast by the update is subject to the projected clear and ongoing improvement in the deficit.

Assuming that the projected growth scenario and the consolidation materialises, Germany would be in line with the requirements of the Stability and Growth Pact at the end of the current update's horizon.

## ANNEX 1: SUMMARY TABLES DERIVED FROM THE 2002 UPDATED STABILITY PROGRAMME

### Table 1: Growth and associated factors

| | | 2001 | 2002 | 2003 | 2004-6 | 2006* |
|---|---|---|---|---|---|---|
| GDP *growth* at *constant* market prices (7+8+9) | | 0,6 | ½ | 1 ½ | 2.25 | 2 |
| GDP level at current market prices | | 2,0 | 2 | 3 ½ | 3 ½ | 3 ½ |
| GDP deflator | | 1,4 | 1 ½ | 1 ½ | | 1 ½ |
| HICP change | | -- | -- | -- | | -- |
| Employment growth | | 0,2 | - ½ | - 0 | 1 | ½ |
| Labour productivity growth | | 0,1 | 1 | 1 ½ | | 1 ½ |
| **Sources of growth: percentage changes at constant prices** | | | | | | |
| 1. Private consumption expenditure | | 1,5 | - ½ | 1 ½ | 2 | 1 ½ |
| 2. Government consumption expenditure | | 0,8 | 1 | 1 | ½ | ½ |
| 3. Gross fixed capital formation | | - 5,1 | - 4 ½ | 1 ½ | 1 ½ | 1 ½ |
| 4. Changes in inventories and net acquisition of valuables as a % of GDP | | - 0,6 | 0 | 0 | | ½ |
| 5. Exports of goods and services | | 5,0 | 1 ½ | 5 ½ | 7 | 5 ½ |
| 6. Imports of goods and services | | 1,0 | - 2 ½ | 5 | 7½ | 5 |
| **Contribution to GDP growth** | | | | | | |
| 7. Final domestic demand (1+2+3) | | -0,2 | - 1 | 1 | | 1 |
| 8. Change in inventories and net acquisition of valuables (=4) | | - 0,6 | 0 | 0 | | ½ |
| 9. External balance of goods and services (5-6) | | 1,4 | 1 ½ | ½ | | ½ |
| **Basic assumptions** | | | | | | |
| Short-term interest rate (annual average) | | -- | -- | -- | -- | -- |
| Long-term interest rat (annual average) | | -- | -- | -- | -- | -- |
| USD/€ exchange rate (annual average) | | -- | -- | -- | -- | -- |
| (for non-euro countries) exchange rate vis-à-vis the € (annual average) | | -- | -- | -- | -- | -- |
| World excluding EU,GDP growth | | -- | 2½ | 3½ | -- | -- |
| EU-15 GDP growth | | -- | -- | -- | -- | -- |
| Growth of relevant foreign markets | | -- | -- | -- | -- | -- |
| World import volumes, excluding EU | | -- | 2 | 5½-6 | -- | 5-6 |
| Oil prices | | -- | -- | -- | -- | -- |

*2006/01

## Table 2: General government budgetary developments

| % of GDP | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| **Net lending by sub-sectors** | | | | | | |
| 1. General government | -2,8 | -3 ¾ | -2 ¾ | -1 ½ | -1 | 0 |
| 2. Central government | -1,4 | -1 ¾ | -1 ¼ | -½ | -½ | 0 |
| 3. State government | -1.3 | -1 ¾ | -1 ½ | -½ | -½ | 0 |
| 4. Local government | +0.0 | | | | | |
| 5. Social security funds | -0,1 | -¼ | -0 | 0 | 0 | 0 |
| **General government** | | | | | | |
| 6. Total receipts | 45,5 | 45 | 45 | 45 ½ | 44 ½ | 44 ½ |
| 7. Total expenditures | 48,3 | 48 ½ | 48 | 46 ½ | 45 ½ | 44 ½ |
| 8. Budget balance | -2,8 | -3 ¾ | -2 ¾ | -1 ½ | -1 | 0 |
| 9. Net interest payments | 3,3 | 3 | 3 | 3 | 3 | 3 |
| 10. Primary balance | 0,5 | -½ | ½ | 2 | 2 | 3 |
| **Components of revenues** | | | | | | |
| 11. Taxes | 23,0 | 22 ½ | 23 | 23 ½ | 23 | 23 ½ |
| 12. Social contributions | 18,5 | 18 ½ | 18 ½ | 18 | 18 | 17 ½ |
| 13. Interest income | | -- | -- | -- | -- | -- |
| 14. Other | 4,0 | 4 | 3 ½ | 3 ½ | 3 ½ | 3 ½ |
| 15. Total receipts | 45,5 | 45 | 45 | 45 ½ | 44 ½ | 44 ½ |
| **Components of expenditures** | | | | | | |
| 16. Collective consumption | | -- | -- | -- | -- | -- |
| 17. Social transfers in kind | | -- | -- | -- | -- | -- |
| 18. Social transfers other than in kind | | 18.8 | 19 | 19 | 18 ½ | 18 |
| 19. Interest payments | | 3.4 | 3 | 3 | 3 | 3 |
| 20. Subsidies | | 1.7 | 1 ½ | 1 ½ | 1 ½ | 1 ½ |
| 21. Gross fixed capital formation | | 1.8 | 2 | 1 ½ | 1 ½ | 1 ½ |
| 22. Other | | 3.2 | 3 | 3 ½ | 3 | 3 |
| 23. Total expenditures | 48,3 | 48 ½ | 48 | 46 ½ | 45 ½ | 44 ½ |

## Table 3: General government debt developments

| % of GDP | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Gross debt level | 59½ | 61 | 61½ | 60½ | 59½ | 57½ |
| Change in gross debt | | -2½ | 1- | -1½- | -1½- | -3½-- |
| **Contributions to change in gross debt** | | | | | | |
| Primary balance | | | | | | |
| Interest payments | | | | | | |
| Nominal GDP growth | | | | | | |
| *Other factors influencing the debt ratio* | | | | | | |
| *Of which:* Privatisation receipts | | -- | -- | -- | -- | -- |
| *p.m.* implicit interest rate on debt | | -- | -- | -- | -- | -- |

**Table 4: Cyclical developments***

| % of GDP | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| 1. GDP growth at constant prices | 0.6 | 0.5 | 1.5 | 2.25 | 2.25 | 2.25 |
| 2. Actual balance | -2.8 | -3.75 | -2.75 | -1.5 | -1 | -0 |
| 3. Interest payments | 3.3 | 3 | 3 | 3 | 3 | 3 |
| 4. Potential GDP growth | | -- | -- | -- | -- | -- |
| 5. Output gap | 0 | -1.2 | -1.5 | -1 | -0.4 | 0.1 |
| 6. Cyclical budgetary component | 0 | -0.6 | -0.7 | -0.5 | -0.2 | 0.1 |
| 7. Cyclically-adjusted balance (2-6) | -2.75 | -3.1 | -2.1 | -1 | -0.8 | -0.2 |
| 8. Cyclically-adjusted primary balance (7-3) | 0.5 | 0.1 | 0.9 | 2 | 2.2 | 2.8 |

*Commission calculation. Numbers are very close to figures given in SGP

**Table 5: Divergence from previous update**

| % of GDP | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| GDP growth | | | | | | |
| Previous update | 2 | 3 | 4¼ | 4¼ | 4¼ | - |
| Latest update | 2. | 2 | 3½ | 3½ | 3½ | 3½ |
| Difference | | - 1 | - ¾ | - ¾ | - ¾ | - |
| Actual budget balance | | | | | | |
| Previous update (baseline) | -2½ | -2 | -1 | 0 | 0 | - |
| Latest update | -2,8 | -3 ¾ | -2 ¾ | -1 ½ | -1 | 0 |
| Difference | | -1 ¾ | -1 ¾ | -1 ½ | -1 | - |
| Gross debt levels | | | | | | |
| Previous update | 60 | 60 | 59 | 57 | 55½ | |
| Latest update | 591/2 | 61 | 61½ | 60½ | 59½ | 57½ |
| Difference | | 1 | 2½ | 3½ | 4 | |

## Table 6: Long-term sustainability of public finances

| % of GDP | 2001 | 2006 | 2010 | 2030 | 2050 |
|---|---|---|---|---|---|
| Total expenditure | 48.3 | 44 ½ | -- | -- | -- |
| Old age pensions | -- | -- | -- | -- | -- |
| Health care | -- | -- | -- | -- | -- |
| Interest payments | 3.3 | 3 | -- | -- | -- |
| Total revenues | 41½ | 41 | -- | -- | -- |
| *of which*: from pensions contributions | -- | -- | -- | -- | -- |
| National pension fund assets (if any) | -- | -- | -- | -- | -- |
| **Assumptions** | | | | | |
| Labour productivity growth | | -- | -- | -- | -- |
| Real GDP growth | 0.6 | 2 | -- | -- | -- |
| Participation rate males (aged 20-64) | -- | -- | -- | -- | -- |
| Participation rates females (aged 20-64) | -- | -- | -- | -- | -- |
| Total participation rates (aged 20-64) | -- | -- | -- | -- | -- |
| Unemployment rate | -- | -- | -- | -- | -- |

## Table 7: Basic assumptions from the Commission's 2002 autumn forecast

| | | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| **Basic assumptions** | | | | | |
| Short-term interest rate<br>(annual average) | | 4.4 | 3.4 | 3 | 3.4 |
| Long-term interest rate<br>(annual average) | | 5 | 4.9 | 4½ | 4.8 |
| USD/€ exchange rate<br>(annual average) | | 1.12 | 1.07 | 1.02 | 1.02 |
| (for non-euro countries) exchange rate | | -- | -- | -- | -- |
| World excluding EU,GDP growth | | 2.3 | 2.9 | 3.8 | 4.2 |
| EU-15 GDP growth | | 1½ | 1 | 2 | 2.6 |
| Growth of relevant foreign markets | | 0.7 | 1.8 | 6 | 6.8 |
| World import volumes, excluding EU | | -1.7 | 3.1 | 6.6 | 7.3 |
| Oil prices | | -- | 25½ | 24.1 | 22½ |

## ANNEX 2: QUANTITATIVE ASSESSMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES

This is the second assessment of the sustainability of German public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC.[24]

The German stability programme refers to the EPC budgetary projections for public expenditures on pensions, health care, and long term care. The Table below presents the debt and budget balance development according to two different scenarios, a "programme scenario" and a "2002 situation scenario". The "programme scenario" is calculated on the following basis:

- the projections for age-related expenditures come from the stability programme;
- government revenues are held constant at the ratio projected for 2006;
- the starting point for gross debt and the primary surplus are the 2006 levels reported in the programme.

The "2002 situation scenario" is based on the budgetary data for 2002 in the programme. It is assumed that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allows one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.

The risk of unsustainable public finances, measured in terms of continued compliance with SGP requirements, is apparent under both scenarios as debt levels rise to levels well above the 60 % of GDP reference value.

It is evident that the budgetary consolidation planned over the time horizon of the stability programme will help improve the sustainability of public finances. However, a position of budget balance in 2006 on its own will not secure the sustainability of public finances. A substantial financing gap remains (see positive tax gaps) which needs to be closed either through a higher tax ratio (but this could be detrimental to growth and employment creation) or more preferably via reductions in public expenditure levels.

24 'How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years', Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

# Quantitative indicators on the sustainability of public finances

| Main assumptions - baseline scenario (as % GDP) | 2006 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Total age-related spending* | 17,2 | 17,2 | 19,0 | 22,2 | 23,6 | 23,9 | 6,7 |
| Pensions | 11,4 | 11,2 | 12,6 | 15,5 | 16,6 | 16,8 | 5,4 |
| Health care | 5,8 | 6,0 | 6,4 | 6,7 | 7,0 | 7,1 | 1,3 |
| Other age related expenditures | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| *Total non age-related spending** | 24,3 | | | | | | |
| *Total revenues** | 44,5 | | | | | | |

* constant

| Results (as % GDP) | 2006 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Programme scenario* | | | | | | | |
| Debt | 57,5 | 49,2 | 40,0 | 56,2 | 101,5 | 166,8 | 109,3 |
| Net lending | 0,0 | 0,2 | -0,9 | -4,9 | -8,7 | -12,5 | -12,5 |
| *2002 situation scenario* | | | | | | | |
| Debt | 67,9 | 74,7 | 112,1 | 186,3 | 304,6 | 460,5 | 392,6 |
| Net lending | -4,0 | -4,5 | -8,0 | -15,0 | -22,9 | -31,6 | -27,6 |

| Tax gaps | T1* | T2** | T3*** |
|---|---|---|---|
| Programme scenario | 2,0 | 1,7 | 3,2 |
| 2002 situation scenario | 5,9 | 5,5 | 6,9 |

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 14.2

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.


| Main assumptions - baseline scenario (as % GDP) | 2006 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Total age-related spending* | 17,2 | 17,2 | 19,0 | 22,2 | 23,6 | 23,9 | 6,7 |
| Pensions | 11,4 | 11,2 | 12,6 | 15,5 | 16,6 | 16,8 | 5,4 |
| Health care | 5,8 | 6,0 | 6,4 | 6,7 | 7,0 | 7,1 | 1,3 |
| Other age related expenditures | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| *Total non age-related spending** | 24,3 | | | | | | |
| *Total revenues** | 44,5 | | | | | | |

* constant

| Results (as % GDP) | 2006 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Programme scenario* | | | | | | | |
| Debt | 57,5 | 49,2 | 40,0 | 56,2 | 101,5 | 166,8 | 109,3 |
| Net lending | 0,0 | 0,2 | -0,9 | -4,9 | -8,7 | -12,5 | -12,5 |
| *2002 situation scenario* | | | | | | | |
| Debt | 67,9 | 74,7 | 112,1 | 186,3 | 304,6 | 460,5 | 392,6 |
| Net lending | -4,0 | -4,5 | -8,0 | -15,0 | -22,9 | -31,6 | -27,6 |

| Tax gaps | T1* | T2** | T3*** |
|---|---|---|---|
| Programme scenario | 2,0 | 1,7 | 3,2 |
| 2002 situation scenario | 5,9 | 5,5 | 6,9 |

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 14.2

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

| Main assumptions - baseline scenario (as % GDP) | 2006 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Total age-related spending* | 17,2 | 17,2 | 19,0 | 22,2 | 23,6 | 23,9 | 6,7 |
| Pensions | 11,4 | 11,2 | 12,6 | 15,5 | 16,6 | 16,8 | 5,4 |
| Health care | 5,8 | 6,0 | 6,4 | 6,7 | 7,0 | 7,1 | 1,3 |
| Other age related expenditures | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| *Total non age-related spending** | 24,3 | | | | | | |
| *Total revenues** | 44,5 | | | | | | |

* constant

| Results (as % GDP) | 2006 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Programme scenario* | | | | | | | |
| Debt | 57,5 | 49,2 | 40,0 | 56,2 | 101,5 | 166,8 | 109,3 |
| Net lending | 0,0 | 0,2 | -0,9 | -4,9 | -8,7 | -12,5 | -12,5 |
| *2002 situation scenario* | | | | | | | |
| Debt | 67,9 | 74,7 | 112,1 | 186,3 | 304,6 | 460,5 | 392,6 |
| Net lending | -4,0 | -4,5 | -8,0 | -15,0 | -22,9 | -31,6 | -27,6 |

| Tax gaps | T1* | T2** | T3*** |
|---|---|---|---|
| Programme scenario | 2,0 | 1,7 | 3,2 |
| 2002 situation scenario | 5,9 | 5,5 | 6,9 |

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 14.2

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

**Source:** EPC, and 2002 Updated stability programme of Germany. Commission calculations