COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 8.1.2003
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the Updated Stability Programme for Germany, 2002-2006

(presented by the Commission)

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EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, the updated stability programmes, to be presented annually, may be examined by the Council in accordance with these same procedures.

Germany's first stability programme covering the period 1998-2002 was submitted on 4 January 1999 and assessed by the Council on 15 March 1999[2]. The first update of the programme was submitted on 1 December 1999, to which supplementary information was added on 1 February 2000, and assessed by the Council on 28 February 2000[3]. The second update of the stability programme, covering the period 2000-2004, was submitted on 11 October 2000 and assessed by the Council on 27 November 2000[4]. The third update was submitted on 5 December 2001 and assessed by the Council on 12 February 2002[5].

Germany submitted its fourth and most recent update of the stability programme, covering the period 2002-2006, on 18 December 2002. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November 2002 on strengthening the coordination of budgetary policies[6]. This evaluation warrants the following assessment:

> 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"[7]. 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.
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> 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

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1. OJ L209, 2.8.1997
2. OJ C124/03, 5.5.1999
3. OJ C098/01, 6.4.2000
4. OJ C374/01, 28.12. 2000
5. OJ C51/01, 26.2.2002
6. COM (2002) 668 final of 27.11.2002
7. *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.

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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 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 could 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 programme.

The macroeconomic scenario of the updated programme projects GDP growth in 2003 at 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% or 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, for a period of three years the German economy would 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

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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[8], the general government deficit in 2002 turned out to be significantly higher than projected by the December 2001 update of the programme. While the December 2001 programme in its lower growth scenario set a 2002 deficit target of 2 ½ % of GDP, the new stability programme estimates the deficit ratio at 3 ¾ %. This is comparable with the Commission Autumn 2002 forecasts, which led the Commission to initiate on 19 November 2002 the excessive deficit procedure against Germany. The Ecofin Council of 21 January decided on the existence of an excessive deficit and 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 cyclically adjusted deficit by clearly more than half a percentage point of GDP. Given that these measures are of a permanent nature, such an improvement is equivalent to that of the underlying balance, as required by the Commission communication of 27 November 2002[9]. However, there is a non-negligible risk that the nominal government deficit might again exceed the 3% of GDP reference value.

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[8] Current deficit estimate for 2001 of 2.8% of GDP as compared with a projection of 2 ½ % in the updated programme of December 2001.

[9] COM (2002) 668 final of 27.11.2002

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The updated programme expects the nominal general government deficit to decline to some 2 ¾ % 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 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 cyclically adjusted budgetary position of at least 0.5% of GDP on average from 2004 to 2006. Assuming an equivalent improvement in the underlying budgetary position, the German government accounts would come at least close to balance by 2006 also in underlying 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 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 respect of the requirements 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 clearly worse than projected (and hence not be close to balance), not least given the subsequent steps of income tax reform 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.

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The bulk of the budgetary consolidation effort in the programme falls on expenditure reductions. Revenues are expected to remain broadly unchanged. By contrast, the programme expects total government expenditures to fall from 48½ % in 2002 to 44 ½ % 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.

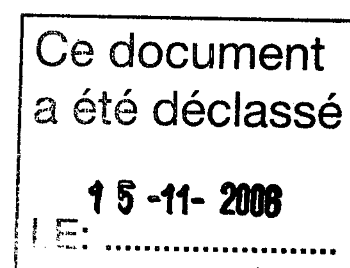
According to the programme update, the ratio of government debt to GDP will again rise above the Treaty's reference value of 60% in 2002, after it had been brought down to 59.5 % by the end of 2001 by the proceeds from the sale of UMTS licences that were used entirely for debt redemption. For 2003, the 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 in terms of emerging budget imbalances cannot be excluded. The planned move to a position of 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. A substantial financing gap will remain 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 ageing population. The German authorities should aim at achieving a large reduction in the debt ratio prior to the budgetary impact of ageing populations taking hold. In addition, there is a need to consider significant reforms of the pension and health care systems that adequately reflect the impending scale of demographic changes underway.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the Stability Programme update of Germany and is forwarding it to the Council.



Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the Updated Stability Programme for Germany, 2002-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5(3) thereof;

Having regard to the recommendation of the Commission;

After consulting the Economic and Financial Committee;

HAS DELIVERED THIS OPINION:

On [21 January 2003] the Council examined the updated stability programme for Germany, which covers the period 2002-2006. The updated programme projects general government finances to improve from a deficit of 3 ¾% of GDP in 2002 to a balanced position in 2006. Government gross debt is expected to decrease from 61% of GDP in 2002 to 57 ½% in 2006.

The Council notes that the new update broadly complies with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[2], although there is still some need for improvement, notably concerning the degree of precision of the quantitative information provided. The Council considers that the updated programme is broadly consistent with the Broad Economic Policy Guidelines (BEPG).

The Council notes that the projected deficit outcome for 2002 (3¾% of GDP) is clearly higher than projected in the lower-growth scenario of the December 2001 update (2½ % of GDP). The Council regrets that the German government has not been able to live up to its commitment of 12 February 2002 not to breach the 3% of GDP reference value for the general government deficit in 2002. While recognising that the rise in the nominal deficit from 2001 to 2002 is partially due to the unexpected slowdown in growth, the Council also notes that there have once more been expenditure overruns in the health sector and that the effects of the 2001corporate tax reform for 2002 had been clearly underestimated. The Council decided on 21 January that an excessive deficit exists in Germany, and issued a

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[1] OJ L209/1, 2.8.1997

[2] *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.

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recommendation to Germany according to Art. 104(7) of the Treaty. According to this recommendation, the German government should *(i)* put an end to the excessive deficit situation as rapidly as possible; *(ii)* implement with resolve its budgetary plans for 2003; *(iii)* ensure that the momentum of budgetary consolidation is maintained throughout the period covered by the updated stability programme, namely through a reduction of the underlying budgetary deficit by at least 0.5% of GDP per year;

The Council notes that in the light of the weakening of economic indicators in recent months, the 1½ % growth rate expected for 2003 appears optimistic, though not impossible to achieve. It requires, nevertheless, an early restoration of economic confidence, not least through implementation of a consistent budgetary adjustment programme. Furthermore, the average growth rates of 2¼ % assumed for the years 2004 to 2006 are above the estimated long-term growth potential of the German economy. This is even the case for the low-growth scenario. Here too, however, it is in the hands of the German government to raise potential growth significantly through coherent reforms, notably of the labour market. The Council strongly urges the German government to undertake the necessary steps for reforms conducive to raising Germanys growth potential.

The Council considers that there is a non-negligible risk that the general government deficit in 2003 may again exceed the 3% of GDP reference value. Therefore, the German authorities should ensure a rigorous budgetary execution and a thorough implementation of the measures announced in the budget for 2003.

The Council acknowledges the projected improvement in the cyclically adjusted balance by at least 0.5% of GDP on average per year up to the new programme's horizon and notes that in cyclically-adjusted terms the government accounts would at least be close to balance by 2006. It is recalled, however that this adjustment path hinges on the full implementation of the announced measures, the respect of agreed expenditure targets for 2003 and 2004 and an agreement on ambitious expenditure targets for 2005 and 2006.

The Council notes that this should lead to a balanced budget by 2006, although this is two years later than planned in last year's update of the stability programme. The Council welcomes the confirmation of the 2006 target by the German *Finanzplanungsrat* (financial planning council) of 27 November 2002.

The Council urges the federal and regional authorities to agree on ambitious expenditure targets for 2005 and 2006 and to ensure strict budgetary implementation at all levels of government. As shown by budgetary developments in the past, this will be crucial in order to attain the projected deficit targets, especially once growth recovers. While the Council welcomes the recent (advanced) implementation of the revised law on budgetary procedures *('Haushaltsgrundsätzegesetz')*, the Council reiterates its view that the mechanism enshrined therein is not yet sufficient to guarantee compliance with mutually agreed objectives by all levels of government.

The Council takes note of the German authorities' intentions to bring the debt level down below the Treaty's reference value by 2005 but notes that these intentions are subject to a number of risks. Therefore the development of the debt ratio remains a source of concern given the need to ensure the sustainability of public finances. On the basis of current policies, the risk of unsustainable public finances in light of ageing populations cannot be excluded. If debt reduction is to make a noticeable contribution towards meeting the budgetary costs of ageing populations, then reaching a balanced budget position by 2006 is a minimum requirement. It will be necessary to run sound public finances over the very long run so as to

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achieve a significant reduction in the debt ratio prior to the budgetary impact of ageing populations taking hold.

The Council considers it to be indispensable that fiscal consolidation, in order to prove sustainable, should be underpinned by far-reaching reforms to raise Germany's very low growth potential. The Council stresses again that the German economy, despite its large size, remains highly vulnerable to external shocks and unable to generate an endogenous and durable growth process. While acknowledging that this still partially reflects the economic consequences of German unification, the Council reiterates the need for urgent reforms not only in the labour market, but also in social security and benefit systems in general, and for a reduction in the regulatory burden of the economy.

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