Translation

German

Stability Programme

December 2004 update

Tabellenverzeichnis:

Appendix

Introduction

In accordance with the provisions of the Stability and Growth Pact - Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and coordination of economic policies - the Member States having adopted the single currency are obliged to submit updated stability programmes each year to the ECOFIN Council.

The present update of the German stability programme was approved by the cabinet on 1 December 2004. The responsible committees of both houses of the German parliament will be briefed immediately.

In format and content the programme conforms to the guidelines drawn up by the ECOFIN Council in October 1998 and most recently supplemented by the code of conduct on the content and format of stability and convergence programmes of 27 June 2001.

The updated stability programme is based on data available on 11 November 2004.

The Federal Ministry of Finance publishes the updated stability programme among others on the Internet at:

www.bundesfinanzministerium.de

1. Summary

- After three difficult years characterised by little or no economic activity the German economy is on course for recovery. Growth of 1.5 % to 2.0 % in real terms is expected for 2005. (Closely calculated, this equates to a GDP growth rate of 1.7 %).

- On account of weak domestic demand, public budgets have to date been unable to benefit from positive macroeconomic trends. Weak demand at home leads to comparatively low increases in tax revenue. As compared with the last update of the German stability programme, general government has been forced to contend with a tax revenue shortfall of € 14 bn in 2004. The revenue shortfall in 2005 amounts to € 17 bn as against the projection in January 2004.

- Against this background, the federal government continues to follow its tripartite fiscal policy approach of growth-promoting structural reform, budgetary consolidation and measures to stabilise economic activity. Key reforms having a lasting impact were set in train in 2004. The Agenda 2010 is effecting decisive improvements in the medium and long-term conditions for growth and employment.

- Making allowance for the tax relief needed to spur economic activity, the expenditure-side consolidation resulting from the federal government’s reform package will reduce the Maastricht deficit by around 1 percentage point of GDP in 2004 as compared with 2003. Altogether, however, there will be no significant reduction of the general government deficit in 2004 on account of tax revenue shortfalls resulting from weak domestic demand and unforeseen shortfalls in other revenue (HGV motorway tolls, Bundesbank profit). The deficit for 2004 at around 3 ¾ % will again exceed the reference value set out in the Maastricht Treaty.

- Part of the unfavourable development in 2004 will continue to have effect in 2005 on account of weak domestic demand. It was thus necessary in the course of adopting the federal budget for 2005 to take additional measures to ensure that the commitment given to European partners of undercutting the 3 % limit in 2005 can be redeemed. Accordingly, the federal government is incorporating in the budget for 2005 extra measures with a volume of some € 8 bn to afford relief to general government. The reference figure set out in the Maastricht Treaty will thus once more be undercut in 2005 with a deficit of -2.9 %.

- As the domestic economy is not yet stabilised, a discerning approach will be necessary in continuing on the consolidation course. Excessive cuts in specific expenditure or tax rises would be detrimental to economic recovery. The federal government will review the additional adjustment measures that can be taken if this proves necessary to comply with European requirements.

- From 2006 onwards, given current assumptions, the sizeable consolidation input provided by the restrictive expenditure course will no longer be eroded by a weak trend in revenue. Real GDP in the period under review will increase each year on average by some 1 ¾ %. This will result in a further reduction in the general government deficit of around ½ of a percentage point each year which, however, cannot be expected to lead to a balanced general government budget at the end of the projection period (-1 ½ % of GDP) in view of the unfavourable starting conditions.

- Closer attention will have to be given in the next few years to the correct interaction between long-term consolidation and other structural reforms. More thought must be given to enhancing the long-term sustainability of public finances beyond the forecast period. Thus reforms in the social security systems can limit expenditure growth over the long term.

Extra curbs on spending in the health-care sector can help to bring about a significant improvement in the long-term trend of public finances in general. Additionally, measures that improve the quality of public finances within the framework of budget consolidation are also appropriate in addressing the problem of demographic change.

	2003	2004	2005	2006	2007	2008
Deficit ratio	- in % of GDP -					
Projection December 2004	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**- 1 ½**

In view of the uncertainties inherent in any projection, close-to-current deficits are rounded to one quarter of a percentage point of GDP and to one half of a percentage point in other years. **The calculated deficit ratio for 2005 stands at -2.9% of GDP**.

2. General economic situation and outlook up to 2008

2.1 Global economic development

In the autumn of 2004 the world economy is characterised by a sustained, vigorous upturn, though some momentum has been lost since the spring. This is attributable on the one hand to high oil prices that continued to rise up to October and to the increasing cost of other industrial commodities. On the other hand, economic policy is having a less expansionary effect in the centres of action that have to date driven the upturn. Key fiscal and monetary policy stimuli have ceased to operate in the U.S.A., whilst in China the government is taking steps aimed at curbing runaway economic activity.

The global economy is expected to register strong growth next year as well, though growth rates are likely to be slightly lower. This will also be the case in the U.S.A., where vigorous growth is expected to continue despite some loss of economic momentum. The restrictive measures adopted by the government in China are expected to take effect and reduce the hitherto very high rate of growth. However, China is still likely to impart perceptible impetus to the world economy next year as well. Hence vigorous if somewhat declining demand from China will continue to benefit above all the emerging Asian economies and also Japan, which turned in a surprisingly marked economic recovery this year. Russia is currently experiencing a strong expansion of economic activity, which has been given added momentum by high oil prices and is likely to continue next year as well.

A marked upturn in economic activity was evident this year in the European Union. In most countries this was fuelled mainly by foreign trade, whereas domestic economic activity remained subdued. However, domestic demand also played an important part in underpinning activity in Great Britain, France and Spain. In the coming year, growth in Europe as a whole is likely to proceed at a similar rate as in this year. The impetus provided by foreign trade is expected to be less marked, whilst domestic economic activity gradually gains strength.

2.2 Assumptions underlying the growth forecast for 2005

The short-term projection through 2005 is based on the following assumptions:

- The world economy will continue to grow strongly in the projection period, though at a slightly reduced rate in the course of that period. Growth will be curbed by a marked rise in energy and commodity prices. International organisations put the growth of global GDP at some 5 % in real terms for 2004 and at some 4 ¼ % for 2005.
- Accordingly, world trade is likely to decline slightly from 9 to 10 % this year to around 7 to 8 % in 2005.
- For technical purposes the crude oil price is assumed to be around US$ 38 in 2004 and around US$ 44 in 2005.
- No changes in the pattern of interest and exchange rates are assumed.
- Wages policy will not exert inflationary pressure. Unit labour cost trends will be subdued and will support Germany's competitive position.
- In this and the next year, consumer prices will register a somewhat more marked increase than in the preceding years at 1.7 % and 1.6 % respectively on account of rising energy costs and administered prices.

2.3 General economic development in Germany in 2004 and outlook for 2005

The German economy has moved out of a state of persistent stagnation: The economic recovery that was first noted in Germany in mid-2003 has continued and become more marked in the course of this year.

The first two quarters saw growth pick up quite noticeably, with the price- and seasonally-adjusted gross domestic product (GDP) increasing in each case by 0.4 % on the preceding quarter. However, economic activity lost some of its momentum in the third quarter, with GDP increasing by only 0.1 %.

The upturn in economic activity was driven primarily by a pronounced increase in foreign demand. In this, Germany’s export industry benefited both from the buoyant world economy and from being better placed to compete on prices on account of decreasing unit labour costs. The third quarter saw a noticeable decline from the high level of export growth. This slightly depressed industrial output, which had up to then been on a clearly upward trend. The more recent trend may be ascribed above all to the global retarding effect of sharply rising, persistently high oil prices. However, the domestic economy has still to come up to full speed. Although investment in plant and equipment recently registered a notable rise, private consumption spending has continued to idle, principally on account of unfavourable labour market trends and insignificant increases in the income of private households. But all in all the indicators show an economy in which the expansionary forces are predominant. Hence the economic recovery process may be expected to continue, albeit for some time at a lesser pace.

As in the spring projection, the federal government proceeds in its autumn projection from GDP growth in this and in next year within a range of 1.5 % to 2 % in real terms. Closely calculated, this equates to growth rates of + 1.8 % in the current and + 1.7 % in the coming year. However, these figures somewhat underestimate the pace of purely cyclical upward trend on account of the differing number of working days. Making allowance for these effects gives GDP growth of 1.3 % in 2004 and 1.9 % in 2005.

The German economy will continue to derive considerable impetus from the buoyant though somewhat less vigorously expanding world economy. German exports are likely to register substantially stronger growth in 2004 (by around + 11 %) than the sales markets. These gains in market shares reflect the marked ability of German products to compete on price and quality, which will continue to benefit from moderate trends in unit labour costs and the favourable goods pattern of German exports (among others the predominance of capital goods). In 2005, exports may be expected to increase in line with the expansion of world trade (+ 8 % in real terms).

The stimulus afforded by foreign trade will be increasingly supported in the course of next year by growing domestic demand and especially by stronger investment activity. Business profits rose strongly in the current year. In conjunction with the progress on consolidation and structural adjustment, the low rate of interest and declining unit labour costs, this has substantially improved the business financing and profitability environment.

Hence capital expenditure on plant and equipment may be expected to pick up appreciably next year. However, the trend in construction investment will continue to impair the aggregate development of the economy.

Private consumption is also likely to recover in the coming year. There are two arguments in support of this assumption: First, tax relief may be expected to result in a somewhat more marked rise than before in the disposable income of private households. Second, we are likely to see a perceptible improvement in the labour market situation, not least on account of the reforms already under way.

However, various opposing or temporary effects of the labour market reforms make it difficult to state in advance how labour market figures will develop. From a cyclical point of view the number of persons out of work may be expected to decrease slightly in the course of next year. But the effects generated by combining supplementary unemployment and welfare benefits could push up the level on average for the year. In contrast, the upward trend in gainful activity that already set in this year will continue. On average, this could result in a rise in the number of persons in gainful activity of some 55,000 this year and some 200,000 next year.

The recovery of economic activity in both years will continue against a background of very moderate price trends, though the effect of rising energy prices will still be felt. Consumer prices may be expected to increase by 1 ½ % in each year.

Risks and uncertainties must still be taken into account in the federal government’s autumn projection. How the oil price continues to develop in world markets is a special factor in this context. An oil price permanently in excess of US$ 50 per barrel would perceptibly impair economic growth both worldwide and, of course, in Germany as well. The current undiminished global imbalances, particularly as a result of high fiscal and current account deficits in the U.S.A., present a further risk. This might also have an impact on the euro exchange rate. On the other hand, there are still good prospects of the global economy developing more favourably than assumed in the projection. Added to this is the fact that domestic forces for growth, once they have gained the upper hand, generate a substantial internal momentum that is usually underrated by forecasters.

2.4 Medium-term growth perspectives

The federal government's medium-term projection to 2008 expects to see the gross domestic product increasing on average by around 1 ¾ % a year in real terms. Here the federal government is assuming that the gross domestic product in real terms is coming closer to potential. Notwithstanding all the uncertainties inherent in calculating potential output, this means that the present output gap resulting from almost three years of stagnating economic activity is gradually lessening. Thus towards the end of the projection period the utilisation of aggregate productive capacities will be virtually normal. Potential growth, reflecting the development of the productive capacity of a national economy, will remain within the range of 1 ½ to 2 % a year.

The period of weak growth from 2001 to 2003 also impaired potential growth, both by curbing expansion of the capital stock and by the negative impact of long-term unemployment on the qualifications of affected workers. In the course of lasting recovery – set in train by improvements in macroeconomic conditions and structural reform – aggregate productive capacities are likely to be more strongly expanded again. It should be noted, however, that estimates of productive capacity and especially of the output gap are prone to major uncertainties.

The real growth of the gross domestic product expected for the entire medium-term projection period exceeds the rather unfavourable growth figures since 1991, which featured an average rise in GDP of only just under 1 ½ % p.a. In that period, however, the development of GDP in Germany was held back by a number of special factors, among which were, in particular, the ongoing burdens and adjustment processes imposed by reunification. This was aggravated in the later years by flagging global growth, the negative impact of which was more strongly felt in Germany than in other trading partners on account of the German economy's very close ties to international trade and capital flows – especially in comparison with other European countries.

In contrast, the prospects for growth in the medium-term projection period up to 2008 are now appreciably improved. This is backed up both by the more favourable macroeconomic conditions and by the economic and fiscal policy course adopted by the federal government. In particular, structural reforms in product and factor markets within the framework of Agenda 2010 will enhance the scope for growth and employment in the economy over the medium and long term. Added to this are efforts aimed at creating human and real capital and building up the infrastructure as an important basis for innovation and technological progress.

The macroeconomic trend is backed up by the fact that low short and long-term interest rates, moderate wage increases, stable prices and positive sales expectations will encourage enterprises in the formation of real assets. In particular, the wage policies geared to promoting growth and employment pursued by the social partners have clearly enhanced the ability of German trade and industry to compete at international level and have thus increased export opportunities in world markets. If wage trends in all countries in the euro area are to follow a course oriented to productivity and thus to stability, this would be of great importance for future development. This would assist the European Central Bank in meeting its price target and thus create the conditions for a favourable monetary framework which will in turn exert a positive effect on growth and employment. In this way it might also be possible to bring about a decline in real interest rates in Germany, which are relatively high by the standards of other euro zone countries.

In addition, the following assumptions are made for the medium-term projection:

– The volume of world trade is expected to expand by 5 ½ to 6 ½ % p.a. German exports are likely to increase on average by some 6 % p.a..

– The crude oil price will display at least a tendency to return to the upper range of the target corridor of US$ 22 to 28 per barrel.

– Exchange and interest rate patterns will remain largely stable.

– Inflation in the euro zone will remain within the European Central Bank's target range of below but close to 2 % in the medium term. Price movements in Germany will be well below this target range.

– Wage increases are likely to remain moderate.

Subject to the conditions and assumptions described above, the following benchmark figures result for the projection of aggregate economic development from 2003 to 2008:

- Growth of the gross domestic product by 1 ¾ % p.a. in real terms;
- Rise of 1 % p.a. in the aggregate price level;
- Slight increase in the number of gainfully employed persons with a more marked rise in employment in the further course of the projection period.

Table 1: Projection of aggregate economic development for the years 2003 to 2008

- Origin of GDP; change on the year in % -

	ESA Code	2003	2004	2005	2008/03
GDP at constant prices; p.a. in %	B1g	- 0.1	1.8	1.7	1 ¾
GDP at current market prices; p.a. in %	B1g	1.0	2.6	2.7	3
GDP deflator p.a. in %		1.1	0.8	1.0	1
Gainfully employed persons (domestic) p.a. in %		- 1.0	0.1	0.5	½
Labour productivity[1] p.a. in %		0.9	1.7	1.1	1 ¼
Use of GDP: change on the year at constant prices					
1. Private consumption spending[2]	P3	0.0	0.0	0.8	1 ½
2. Govt. final consumption	P3	0.1	-0.1	-0.2	0
3. Gross fixed capital formation	P51	- 2.2	- 0.9	1.8	2 ½
4. Change in stocks (GDP growth contribution)[3]	P52 + P53	0.9	0.1	0.4	0
5. Exports	P6	1.8	11.2	8.0	6
6. Imports	P7	4.0	7.0	7.9	5 ½
GDP growth contributions[3]					
7. Domestic demand (w/o stocks)		- 0.4	- 0.2	0.7	1 ½
8. Change in stocks	P52 + P53	0.9	0.1	0.4	0
9. External balance of goods and services	B11	- 0.6	1.9	0.5	¼

(1) GDP at constant prices per gainfully employed person.
(2) Including private non-profit organisations.
(3) Real change in per cent of pre-year GDP. 2003: Provisional result of the Federal Statistical Office of August 2004; 2004 and 2005: Results of the Interdepartmental Macroeconomic Forecasting Group of October 2004; 2008: Medium-term projection April 2004, reviewed end-October 2004.

The strongest growth stimuli will be provided by exports. Domestic economic activity – especially investment – will also benefit from this. Hence investment in plant and equipment will register a disproportionately large increase of some + 5 ½ % p.a. in real terms. The process of normalisation in the construction sector – given the marked expansion of capacities in the first few post-unification years – is not yet at an end. Hence construction investment is likely to show only a slight increase of some ½ % in real terms and will make a larger contribution to growth only in the further course of the review period. The increase in private consumption at some 1 ½ % p.a. is expected to be somewhat smaller than that of the gross domestic product. In view of the continuing demands of consolidation, final government consumption is likely to show little or no change.

As economic recovery progresses, increasing relief will be afforded to the labour market as well. Thus given the expected growth of the economy, employment is likely to expand appreciably in the course of the medium-term projection period. This will be helped by rapid, comprehensive implementation of labour market reforms lending extra momentum to the growth of employment.

It may be assumed, however, that the supply of labour will continue to rise as a result of growing participation of women in the labour force and a general increase in the duration of the working life. But desirable as they may be in view of demographic change, another outcome of such shifts in behaviour is that the number of persons registered as unemployed is likely to decrease over time at a lesser rate than the rise in employment.

Price movements are likely to remain very subdued at all levels during the whole period covered by the projection. Pressures tending to accelerate upward price movements are foreseeable neither on the supply nor on the demand side. Wage trends are likely to remain moderate. Gross wages and salaries per employed person (effective wages) will probably rise by 2 % a year, which would be below the real productivity trend (+ 1 ½ % a year) making allowance for the ECB inflation target (close to 2 % a year). In these circumstances a very low aggregate annual inflation rate of only some 1 % p.a. may be expected. GDP at current prices would increase on average by 3 % a year.

3. Fiscal policy in Germany: Structural reforms, consolidation policy and fiscal policy impulses

On account of weak domestic demand, public budgets have not to date been able to derive benefit from the positive development of the economy as a whole. Weak demand at home results in a relatively low increase in tax revenue, and labour market expenditure continues high.

Against this backdrop the federal government sees a tripartite fiscal policy approach as appropriate, consisting of growth-promoting structural reform, budgetary consolidation and measures to stabilise economic activity. Important, lasting reforms were set in train in 2004. The Agenda 2010 decisively improves the medium and long-term conditions for growth and employment. Good progress has also been made on consolidation. Subsidies, especially financial aid, have been consistently reduced in the face of difficult political debate. Perceptible cuts have also been made in the public service and in other government final consumption expenditure.

The federal government will continue to pursue its responsible fiscal policy course. In the next few years, closer attention will have to be given to the correct interaction between long-term consolidation and other structural reforms. Against a background of general economic recovery, fiscal policy will be increasingly directed towards limiting the growth of expenditure and pressing ahead with the consolidation of public budgets. As the domestic economy is not yet stabilised, a discerning approach will be necessary in continuing on the consolidation course. Excessive cuts in specific expenditure or tax rises would be detrimental to economic recovery.

3.1 Implementation of structural reforms: Agenda 2010

In the “Agenda 2010” reform package, fundamental structural reforms have been put through in the labour market and set in train in the social security systems by the federal government. This has laid the foundations for the sustainable financing of social security and for promoting growth and employment.

In **labour market policy**, greater emphasis has been placed on the principle of “promote and demand”, thus linking social protection and improved reintegration prospects with the call for efforts on the part of job-seekers. The aim is more rapid and more effective integration in the labour market. The following are among the principal measures in the laws on modern services in the labour market and the Law on labour market reforms:

- More rapid and better-quality placement of young persons and the long-term unemployed
- Refining the proactive approach in labour market policy instruments
- More effective promotion of business start-ups
- Improving the care and integration of the long-term unemployed, in particular by combining tax-funded supplementary unemployment and welfare benefits into a basic allowance for job-seekers as from 1 January 2005
- Limiting the duration of the claim to unemployment benefits for older workers
- Restructuring the Federal Labour Agency into a modern service provider in the labour market
- Making the labour market more flexible by extending arrangements for part-time, low-wage jobs and reforming dismissal protection regulations so as to promote employment

These structural reforms in the labour market will exert a positive impact on growth and employment in the medium term, so that revenue from taxes and contributions will increase and labour market spending will decrease.

The Law to modernise the **statutory health insurance**, in force since January 2004, serves to improve the efficiency and quality of health care. The reform was supported jointly by the governing coalition and the opposition, and comprises among others structural measures to enhance competition and to increase the responsibility of insured persons, as well as new funding arrangements. The aim is to reduce non-wage labour costs and thus pave the way for increasing employment.

All in all, the legislation is expected to afford relief to the statutory health insurance funds in a volume increasing from some € 10 bn in 2004 to € 14 to 15 bn in 2007. Time is needed for some of the improved incentives to be reflected in a shift in behaviour, but substantial positive fiscal effects may be expected to ensue when all measures kick in. As early as the first half of 2004 the health insurance funds were able to realise surpluses of around € 2.5 bn.

In order to reduce non-wage labour costs, the standard contribution rates to statutory health insurance shared by employers and employees will be decreased by 0.9 of a percentage point as from 1 July 2005 in conjunction with the introduction of an extra contribution by the insured of 0.9 of a percentage point to redistribute the funding of dentures and sickness benefits.

There will be a change in the funding of the **statutory old-age care insurance** as from January 2005 when the Law taking account of children comes into force. On completion of the 23rd year of age, insured persons without children will be required to pay an addition of 0.25 of a percentage point to their contribution. The contribution rate for insured persons with children and for employers will remain unchanged. The federal government has thus complied with the Federal Constitutional Court judgment requiring a difference between contributions by persons having to bring up children and those without children.

In the **statutory pensions insurance** the contribution rate for 2004 was held to 19.5 % with the help of short-term stabilisation measures taking effect on 1 January 2004 (2nd and 3rd Laws amending Book VI of the Social Code). The adoption of the Pensions Insurance Sustainability Law in the course of 2004 set the course for assuring the long-term financial basis of statutory pensions insurance. At the same time, the statutory pension is to remain affordable and pension contributions are to be prevented from placing any greater burden on labour as a production factor.

The long-term measures also include a progressive transition to the taxation of old-age provision on disbursement as from 2005, in conjunction with tax relief for contributors, simplified procedure for state-assisted, private fully-funded old-age provision, elimination of barriers to occupational pension schemes and redesigned management of pensions insurance institutions.

The measures adopted in statutory pensions insurance help to stabilise the contribution rate trend. Were it not for these measures, the contribution rate in 2004 would exceed the actual rate by 1 point and in 2005 by 0.6 of a point. By 2030, the measures incorporated in the three aforementioned laws will afford relief to statutory pensions insurance of up to 2.3 contribution rate points. Curbing the rise of the pensions contribution rate also reduces the grants paid by the federal government to the statutory pension insurance.

Economic policy is constantly concerned with improving the conditions for growth, modernising old-established structures and ensuring that the economy is internationally competitive. The federal government is therefore implementing **additional structural reforms to promote growth and employment**. Foremost among these are the following:

- **Deregulation and reducing bureaucracy:**
  A country’s economic potential can be substantially eroded by excessive state regulation and redundant bureaucratic procedures, as they raise the cost of production in the country concerned and hamper the responsive and competitive ability of business undertakings.

  Accordingly, as part of its efforts to modernise the administration, the federal government launched the “Bureaucracy Reduction Initiative” in early 2003 to eliminate superfluous norms and cut back red tape in Germany. The initiative comprises among others a reform of craft regulations, of occupational training and of provisions governing the award of contracts, brings wages tax procedure up to date and simplifies licensing procedures for research, technology and innovation. The aim is to review the need for existing structures, processes and regulations and to adjust them where necessary so as to afford business undertakings greater scope for productive activity.

- **Strengthening innovation:**
  Innovation is a topic of special significance for a country such as Germany which has scarcely any worthwhile natural resources. Hence specific proposals are being worked out under the "Partners for Innovation" initiative, for instance to improve the start-up opportunities for innovative firms and to make progress on reducing bureaucracy.

- **Campaign to promote SMEs:**
  The federal government launched a campaign to promote SMEs in early 2003. The central objective of the campaign is to secure and to extend the scope for SMEs to procure funding, among others by focusing and streamlining aid programmes for SMEs at the KfW SME Bank and by targeting assistance specifically to innovation in SMEs. The range of information and consultancy offered to business start-ups and SMEs has also been extended. To ensure that SMEs remain able to take on trainees, thus ensuring that the demand for skilled workers can be met, the federal government has brought existing occupational designations up to date and created new ones, and has also concluded a pact on training with trade and industry.

- **Further structural reforms in product, services and capital markets:**
  - Refining competition law to make it more efficient, among others by revising the Law against restraints of competition and the Law against unfair competition, with the revised version of the latter already having entered into force. Promoting competition aims to make business more efficient to the benefit of consumers and to encourage investment and innovation.
  - Further liberalisation in the posts and telecommunications sector.

- Implementation of the ten-point programme to enhance corporate integrity and investor protection. Investors' confidence in the capital market is to be improved by affording greater transparency and increasing the quality of capital market data as well as by qualified advisory services.
- Continuation of privatisation policy, among others full privatisation of government holdings in which there is no longer any substantial federal interest.
- Refinement of legislation governing the supply of energy, including revision of the Energy Management Law in 2004.

The national report on structural reforms submitted in 2004 within the framework of the Cardiff process contains a more detailed presentation of the federal government's structural reforms in product, services and capital markets

The federal government's reform policy has brought about a general improvement in underlying economic conditions with the aim of promoting innovation, investment and growth. However, it will take time for many of the measures adopted to exert their full effect.

3.2 Action taken on consolidation since 1 January 2004

3.2.1 Measures incorporated in the 2004 reform package

The structural reforms in Agenda 2010 are backed up by targeted consolidation measures. Social expenditure by the federal government now accounts for almost half of all federal spending. Together with interest and personnel expenditure, this means than more than 70 % of federal spending is not available for investment and key future-oriented categories. Hence the federal government's consolidation policy is aimed above all at curbing the growth of consumption spending, cutting back subsidies and stabilising tax revenue by resolute action to counter abuse.

On the **expenditure side** consistent progress has been made in 2004 on eliminating special tax arrangements and tax concessions:

- The **Budget Support Law 2004** that came into effect on 1 January 2004 makes provision for extensive savings on the *expenditure side* (e.g. reduction of the owner-occupied homes premium, changes in depreciation arrangements for movable assets, reduction of the mileage allowance for commuters, cuts in tax subsidies on the basis of the proposals put forward by Premiers Koch and Steinbrück). From 2005 onwards the tax measures incorporated in the Budget Support Law will, on balance, generate savings for general government of some € 3.6 bn (2005) to € 5.7 bn (2008).

- The consolidation package of tax arrangements is backed up by implementation of further measures provided in the **Law to reduce tax concessions**, in particular restrictions on loss carry-forwards and changes in the provisions on capital borrowed from shareholders. This will generate savings in public budgets in the order of up to € 1.6 bn a year.

Consolidation measures on the **expenditure side** focus on limiting social spending and making larger cuts in financial assistance.

- Payments to the pensions insurance (some € 78 bn in 2004) make up the largest expenditure category in the federal budget. As the increase in federal payments is dependent to a large extent on how contribution rates to the statutory pensions insurance develop, limiting pensions insurance contributions is a matter of key concern in budgetary policy as well. In the **Second and Third Laws amending Book VI of the Social Code**, the provisions of which took effect between 1 January and 1 April 2004, and the **Pensions Insurance Sustainability Law** promulgated on 26 July 2004, the federal government has adopted measures to limit the contribution rate (e.g. increasing the share paid by pensioners towards their old-age care insurance contributions as from 1 April 2004, suspension of the pension adjustment due on 1 July 2004, introducing a sustainability factor in the pension calculation formula giving relief as from 2005). The consolidation measures incorporated in the reform laws afford relief of some € 2.3 bn to the federal budget in 2004.

- In addition to the aforementioned increases in revenue, the **Budget Support Law 2004** provides relief for aggregate public budgets on the *expenditure side* of € 2.8 bn (2004) to some € 3 bn a year as from 2005 through cuts in the public service and in the upbringing allowance.

- To implement the **proposals for subsidy cuts put forward by Premiers Koch and Steinbrück**, expenditure authorisations in a total volume of some € 0.8 bn were blocked in 2004 in the relevant departmental categories of the federal budget.

- The **general reduction in spending** of **€ 2 bn** provided in the budget for 2004 is fully taken up by numerous cuts in the departmental budgets.

3.2.2 Concept for the budget for 2005

The budget for 2005 is held steady on the consolidation course by general savings requirements and by going ahead with the reduction of subsidies (stage 2 of putting the Koch-Steinbrück proposals into effect). Subsidy reduction is carried on in the **Law to support the innovation campaign by abolishing the owner-occupied homes premium** and, focusing on the agricultural sector, in the **Budget Support Law 2005**.

In contrast to the government draft, the federal budget for 2005 has principally to absorb cyclically-induced extra spending or revenue shortfalls of some € 8 bn. The federal government has thus decided to put further measures into effect to relieve pressure on the budget. This applies especially with regard to the commitments made in the last stability programme and on 25 November 2003 to the ECOFIN Council. This will ensure that

- Germany can again undercut the Maastricht Treaty reference figure;
- the federal budget complies with the requirement set out in Article 115 of the Basic Law (net borrowing less than total investment).

The concept for the budget for 2005 comprises the **following elements**:

- The claims of the postal officials' pension fund[1] on the privatised postal successor undertakings will be transformed by means of a financial transaction into a one-off payment. The federal government will thus be relieved in 2005 from transfer payments to the pension fund of the postal successor undertakings. In economic terms the transaction has the effect of transferring to the state in full the pension obligations of the postal successor undertakings as of the point in time at which the liquidity of the postal officials' pension fund, replenished by a one-off payment, is used up. The relief afforded to general government amounts to some € 5 ½ bn in 2005.
- The federal government can absorb € 1 ½ bn with additional privatisation measures that were originally planned for 2004. According to the results of the tax revenue forecast, the proceeds from the privatisation measures planned for this year are not required in full, so that they can be deployed in part next year.
- The **general reduction in spending** provided in the federal budget for 2005 will be increased by **€ 1 bn**. This additional saving must be made by the departments in executing the budget.
- Moreover, the federal government will take the initiative for a **pay freeze in the public service** for 2005. The budgets of the Länder would benefit in particular from this (see 3.4 below).

In all, the package of measures to secure the budget for 2005 will reduce the general government deficit by around one half of a percentage point of GDP.

The federal government will review the additional adjustment measures that can be taken if this proves necessary to comply with European requirements.

[1] In 2000 the three provident funds of the postal successor undertakings Post, Postbank and Deutsche Telekom were merged into a joint postal officials' pension fund. Grants by the state to the pension fund are made to this in accordance with the liquidity of the pension fund and are not predetermined. In National Accounts they are posted as other current transfers to incorporated companies.

3.2.3 Subsidy cuts and campaign for quality in public finances

In the past few years the federal government has made considerable progress on reducing subsidies. The reduction of financial assistance and tax subsidies will be consistently pursued in the federal budget for 2005, in part by across-the-board subsidy cuts and also by selective reduction of specific promotional measures.

The financial assistance provided by the federal government will decline in 2005 on the year by some € 1 bn to around € 6 bn. Thus financial assistance will have been almost halved as compared with 1998. Up to 2008, financial assistance will be further reduced by almost 11 % (to € 5.4 bn). It is also planned to abolish the owner-occupied homes premium. The promotional aim of this subsidy has been achieved, and it is now no longer justified for this reason and also on account of substantial incidental benefits.

The federal government agreed last year on key principles for future subsidies policy to render subsidies more transparent, justifiable and more easily regulated. In particular, new subsidies are in principle to be granted only in the form of financial assistance and no longer as tax concessions. New and existing financial assistance is to be degressive and time-limited by law and is to permit an efficiency check. Existing tax concessions are to be converted, wherever possible, into financial assistance.

Besides quantitative consolidation, reducing subsidies also helps to achieve the "qualitative" consolidation of public budgets. The aim of qualitative consolidation is to shift the focus of public budgets away from past-oriented to future-oriented tasks, while making allowance for current budget constraints. Above all, expenditure is to be stepped up in categories such as education, research and innovation and on measures to help reconcile the demands of family life and work, whereas the provision of public funds to other, less future-oriented sectors is to be reduced. Hence the federal government has made provision in the budget for 2005 to fund its campaign in support of education, innovation and research by cutting back entrenched subsidies, in particular the owner-occupied homes premium.

The process of demographic change, too, calls for government deficits to be brought down and sustainable limits to be placed on public debt (see also 5 below on this topic).

On the other hand, intergenerational equity demands that precedence be given to expenditure promoting innovation and growth. It is now that we must lay the foundations on which our national economy can develop its full potential and which will secure our future prosperity.

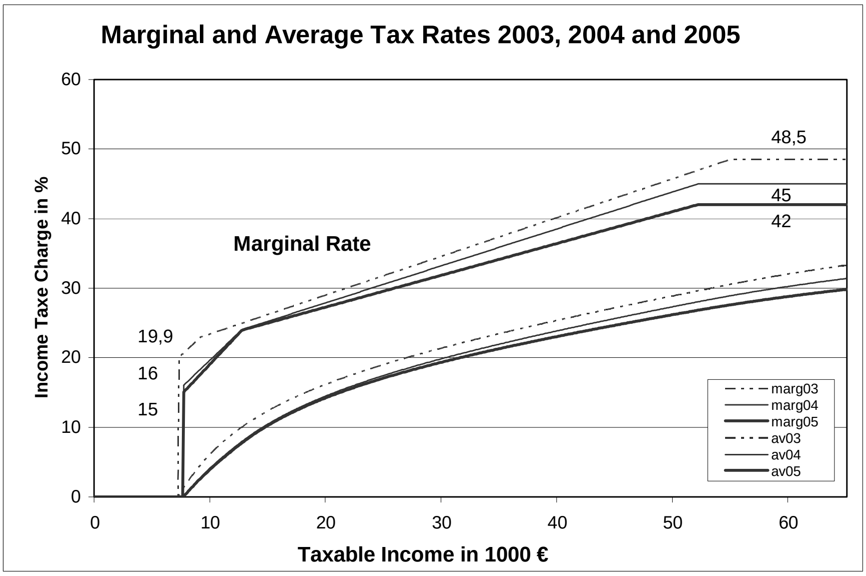
It is thus important for discussions on the refinement of the Stability and Growth Pact to be carried on with the aim of ensuring that the Pact provides clear incentives for promoting growth and employment and for structural reform to achieve sustainable public finances. The current mid-term review of the Lisbon strategy also indicates an urgent need for economic and fiscal policy to be refocused on growth and sustainability and for this to be reflected in public finances as well. It is for these reasons that the federal government – particularly in view of tight budget constraints – attaches major significance to redirecting resources in public budgets to growth-effective spending in the area of real and human capital and to underpinning the knowledge-based society.

This process should be based at EU level on joint analyses of the effect of individual policy measures on growth and employment and should be supported by an intensive exchange of country-specific experience. The questions arising in this context relating to the improvement of the data stock, the efficiency of public spending, the analysis of specific expenditure categories such as infrastructure investment or subsidies as well as institutional issues will need to be examined in greater detail at EU level.

Qualitative consolidation does not run counter to quantitative consolidation. The aim of this "quality campaign" is rather to give the budget a structure enabling it to deal more effectively with the challenges of the future.

3.3 *Fiscal policy stimuli and improvement of incentive patterns: The 2004 and 2005 stages of the tax reform*

With its **tax policy** approach, the federal government has appreciably reduced the tax charge. In 2005 as compared with 1998, the various tax reform measures will afford total relief to private households and businesses of more than € 50 bn.



The final stages of this major income tax reform take effect in 2004 and 2005. In 2004 the top rate of personal income tax is reduced from 48.5 % to 45.0 %. At the same time, the basic rate of tax declines from 19.9 to 16.0% of taxable income. The basic personal allowance rises from € 7,235 to € 7,664. The corporation tax rate that was temporarily raised to 26.5 % for 2003 to fund measures to repair the flood damage is brought down again to 25 %.

The 2004 tax reform stage, originally scheduled for 2005, affords relief of some € 9 bn and thus provides clear fiscal policy stimuli helping both to boost domestic demand and to generate positive incentives for the labour market by way of lower marginal tax rates. This offsets any negative cyclical effects in 2004 resulting from the longer-term application of consolidation measures.

In 2005, when the final stage takes effect, the top rate of tax will be brought down to 42.0 % and the basic rate to 15.0 %. This will afford additional relief of approximately € 6 ½ bn. The final stage of Tax Reform 2000 rounds off in 2005 a historically unprecedented programme of tax relief. As at 1.1.2005 the basic rate of income tax at

15 % will be over 40 % lower than it was in 1998, whilst the top rate of tax at 42 % will at all events be over 20 % below the 1998 figure. The basic personal allowance at € 7,664 will be up by over 20 % on the amount applicable in 1998.

Review of the reform of the income tax schedule

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Basic personal allowance (€)	6,322	6,681	6,902	7,206	7,235	7,235	7,664	7,664
Basic rate of tax (%)	25.9	23.9	22.9	19.9	19.9	19.9	16	15
Top rate of tax (%)	53	53	51	48.5	48.5	48.5	45	42

3.4 National Stability Pact

At a meeting on 21 March 2002, the Financial Planning Council (chaired by the Federal Minister of Finance), comprising representatives of all political subdivisions in Germany, agreed on an amendment of the Law on Budgetary Principles (HGrG) which came into effect on 1 July of that year (see German Stability Programme, December 2003 update).

Under the new arrangement, the Federation and the Länder are enjoined to reduce net borrowing with the aim of achieving budget balance. The Financial Planning Council plays a central part in the procedure to ensure compliance with budgetary discipline by issuing appropriate recommendations especially on a common expenditure line as a yardstick for the budgets of central and regional government (including local authorities).

This appreciable strengthening of the role of the Financial Planning Council places greater weight on the binding effect of decisions reached in a cooperative procedure by equal partners, thus refraining from restricting budget autonomy by way of a law, which would run up against constitutional problems.

At its meeting on 17 November 2004 the Financial Planning Council discussed compliance with budgetary discipline within the framework of European economic and monetary union. The Federation, the Länder and the local authorities acknowledged their responsibility for compliance with the European Stability and Growth Pact and affirmed their intention to bring down the deficit in 2005 to 2.9 % of the gross domestic product. Moreover, the Federation and the Länder confirmed the resolution of 16 June 2004 to limit expenditure growth to 1 %.

As against the 2 % ceiling on expenditure growth agreed before the national stability pact was concluded, the new arrangement reduces the scope for expenditure by the Länder by some 0.2 % of GDP each year. In 2004, the Länder and local authorities complied with the requirements of the national stability pact in particular by cutting personnel expenditure. Non-recurrent payments to officials (Christmas bonus, leave allowance) were either appreciably reduced or cut altogether. The net savings realised in this way amount to around 0.1 % of GDP.

The federal government aims to develop the national stability pact and endorses in this context more clearly-defined rules on the financial responsibility of the Federation as opposed to the Länder. To this end, appropriate negotiations have been taken up in the Commission set up by the Bundestag and the Bundesrat to study the modernisation of the federal system.

3.5 Reform of the federal structure

The federal government is aware of the need to reform Germany's federal structure, not least to facilitate political decision-making and to promote growth and employment. Federation and Länder agree on the objectives of the reform, namely to enhance Germany's capability for taking action on European policy, to render both decision-making processes at national level and the discharge of government functions more efficient and more transparent and to ensure that political responsibilities are more clearly assigned.

The Constitutional Commission set up jointly by the Bundestag and the Bundesrat to look into the modernisation of the federal system has set itself the aim of reaching the necessary consensus on appropriate reform measures before the end of the current parliamentary term. Crucial issues are redefining the assignment of legislative powers to the Federation and the Länder, speeding up legislative procedure by limiting the instances in which the consent of the Bundesrat is required, correcting inappropriate trends in joint financing and reviewing the scope for unbundling the responsibilities of central and regional government in the area of taxation.

3.6 Fiscal policy in the European context

The stability of the single European currency is an essential prerequisite for a properly functioning and developing economic system in Europe. Sound public finances are indispensable for securing the stability of the European Economic and Monetary Union. Hence Europe and above all the monetary union will continue to need the European Stability and Growth Pact (SGP) as an effective means of fiscal policy coordination to ensure permanently high growth and employment, sound and sustainable public finances and stable prices. National consolidation measures must be backed up by action at European level. Bearing this in mind, the federal government calls for EU expenditure for 2007 to 2013 to be limited to no more than 1.0 % of the gross national income of the EU (this is equivalent to a total volume of commitment appropriations of € 815 bn for the period from 2007 to 2013).

Based on the provisions of the EC Treaty and the SGP, the EU Commission instituted on 19 November 2002 an excessive deficit procedure in relation to Germany. On 21 January 2003 the ECOFIN Council confirmed the existence of an “excessive” deficit in Germany and made recommendations pursuant to Article 104 (7) for the reduction of the excessive deficit. On 25 November 2003 the ECOFIN Council declined to follow the recommendations of the Commission on the basis of Article 104 (8) and (9) of the EC Treaty to the effect that Germany and France should be “held in abeyance”, thus entering on a new stage in the excessive deficit procedure. The Commission had previously confirmed that the consolidation package submitted by the federal government conformed to the Council’s recommendations of 21 January 2003. Against the background of the conclusions adopted by the ECOFIN Council on 25 November 2003, the federal government undertook to continue consistently on its consolidation course.

The EU Commission deemed the action by the Council to be in contravention of the EC Treaty and instituted proceedings against the Council on 27 January 2004 before the European Court of Justice (ECJ). In its judgment on 13 July 2004 the ECJ held the conclusions of the ECOFIN Council of 25 November 2003 to be null and void. The Court gave as reason the circumvention of the Commission’s right to make recommendations to the Council to remedy the excessive deficit pursuant to Article 104 (7) of the EC Treaty.

The conclusions by the ECJ make it clear that the Commission alone is both entitled and obliged to be involved in initiatives capable of gaining majority support in the excessive deficit procedure. At the same time, the Commission failed in its application to the Court to find that the Council’s refusal to accept the Commission’s proposal that Germany and France should be held in abeyance constituted a breach of Treaty rules. The judgment confirmed that the submission of recommendations by the Commission for Council decisions did not of itself place the Council under an obligation to take action in the excessive deficit procedure. Hence the ECJ affirmed in its judgment the discretionary powers of the Council and confirmed at the same time that there is no automatism in the excessive deficit procedure.

In the federal government’s view, experience gained from the application of the Stability and Growth Pact in the past few years shows that applying the rules merely to enforce compliance with quantitative prescriptions without precisely examining the individual case in no way makes these rules more credible, but will instead tend to make them less credible. In the past, the “mechanistic” interpretation of the Pact, i.e. excessively rigid, unbalanced concentration on the 3 per cent deficit criterion, has in some instances resulted in measures being recommended in phases of weak growth that had an additionally restrictive effect, delaying the upturn and thus ultimately endangering the lasting positive impact of consolidation.

The ideas put forward by the EU Commission in its Communication of 3 September 2004 entitled “Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact” are an initial basis on which to ensure the economically appropriate, stability- and growth-oriented application of the Pact. Bearing these proposals in mind, the federal government will play a constructive role in discussions on the further development of the Stability and Growth Pact.

Independent of discussions on the refinement of the Stability and Growth Pact, the federal government adheres to its target of once again undercutting the 3 % reference figure next year.

4. The development of public budgets

4.1 Trends in the balancing items

General government deficit 2004: Temporary effects and fiscal policy stimuli

In the current year, the general government deficit shows only a slight change on the preceding year. This trend is shaped by the interaction of four factors having differing effects:

1. Restrictive expenditure course: The structural consolidation measures adopted by the federal government within the framework of Agenda 2010 have been in effect since 1 January 2004. The stagnation of general government expenditure forecast in January 2004 is also borne out by current data. The expenditure policy in conjunction with the associated decrease in the government spending ratio on the year has contributed to consolidation in the amount of 1 ½ % of GDP.
2. Stabilising fiscal stimuli: To avoid short-term contractive effects of consolidation measures designed to have longer-term impact, compensatory fiscal stimuli were applied by bringing forward part of the tax reform stage originally scheduled for 2005. Taken alone, these led in 2004 to a rise in the deficit of around one half of a percentage point of GDP.
3. Cyclically-induced tax revenue shortfalls: As domestic demand is still weak, the upturn in economic activity has not yet led to any significant cyclically-induced additional tax revenue or to a revitalisation of the labour market. The projection underlying the January update of the stability programme was based on the as-

sumption that domestic demand in 2004 would increase by 2.3 % on the year. This projection was downgraded by 1 ½ percentage points, although at the same time an appreciably larger external surplus was indicated. Given equal GDP growth, lower domestic demand leads to appreciably lower tax revenue. The cyclically-induced revenue shortfalls as against the last stability programme update amount to around one quarter of a percentage point of GDP.

4. Temporary effects: Additional deviations from the January projection result from temporary, unforeseeable shifts in specific items of non-cyclical revenue. Thus the shortfall in the Bundesbank profit contribution and the delay in introducing a satellite-assisted system of HGV motorway tolls imposed unexpected charges on public budgets. Nor was it possible to realise proceeds from the taxpayer amnesty arrangements in the volume expected at the start of the year. Taken together, these temporary effects resulted in an unexpected rise in the general government deficit by around one half of a percentage point of GDP.

On account of the above factors and notwithstanding an exceptionally restrictive expenditure course, a general government deficit in the order of € -77 bn to € -82 bn is expected. Hence in the current year the general government deficit will register only a slight decline and at roughly -3 ¾ % of GDP (calculated at: -3.7%) will again exceed the reference figure set out in the Maastricht Treaty.

Projection for 2005 to 2008: Consolidation in conjunction with reform measures and revitalisation of the aggregate economy

Germany's fiscal policy is directed towards bringing down the general government deficit to below the reference figure of 3 % of GDP as soon as possible. Greater scope for fiscal policy action to achieve this objective will be available as the upward trend in aggregate economic activity becomes established in 2005. This is reflected in a corresponding deficit reduction in the projection period.

The projection is based on the data available at the conclusion of the tax revenue estimation on 3 November 2004. It takes account of the fiscal effects of the federal government's package of reform measures set out under 3.2 above and the concept for the budget for 2005.

The assumptions made result in a general government deficit for 2005 of around -3 % (calculated at: -2.9 %) of GDP. Thus the reference figure set out in the Maastricht Treaty will be complied with in the coming year. Compliance with the reference figure in 2005 implies a reduction of the general government deficit by about three quarters of a percentage point as against the current year.

With the decrease in the government spending ratio from around 47 ½ to 46 %, expenditure will contribute in the amount of some 1 ½ % of GDP towards reducing the deficit ratio, whilst the greater part of the reduction in the general government deficit will be achieved by the fiscal effects of structural consolidation measures in the reform package. But apart from the effects of the reform package, a restrictive expenditure course is nonetheless assumed for public budgets at all levels of government in the coming years. However, the consolidation input provided by a restrictive expenditure policy will be offset in the amount of roughly ½ % by the fact that revenue growth is still disproportionately low as compared with aggregate economic development, so that the reduction in the deficit ratio as a whole will amount to between three quarters and one percentage point.

Table 2: Trends in the deficit ratio

	2003	2004	2005	2006	2007	2008
Deficit ratio	- in % of GDP -					
Projection December 2004	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**- 1 ½**
Projection January 2004	-4	-3 ¼	-2 ½	-2	- 1 ½	-

In view of the uncertainties inherent in any projection, close-to-current deficits are rounded to one quarter of a percentage point of GDP and to one half of a percentage point in other years. The calculated deficit ratio for 2005 stands at -2.9% of GDP.

From 2006 onwards, the sizeable consolidation input provided by the restrictive expenditure course will no longer be eroded by disproportionately weak tax revenue growth to the extent currently apparent. As tax revenue gradually increases in proportion to the general trend in economic activity, a further reduction in the general government deficit of around ½ of a percentage point each year will result in the projection period which, however, cannot be expected to lead to a balanced general government budget at the end of the projection period (-1 ½ % of GDP) in view of the unfavourable starting conditions.

Balancing items of levels of government

The federal budget for 2005 provides for an appreciable reduction in net borrowing. Proceeding from a figure of some € 43.7 bn (2004 target plus budget supplement), federal net borrowing is to be brought down to € 22.0 bn. However, a sizeable part of the reduction in net borrowing is attributable to financial transactions (some € 17 bn), so that the impact of the reduction on the general government deficit will be correspondingly less.

The projection period will bring changes in the position of the federal government’s special funds, especially the ERP special fund and the repair fund for flood damage in 2002. The resources in the flood damage repair fund have still not been fully disbursed. Other than originally expected, the disbursement of these resources will extend into the year 2006.

The Länder and local authorities will continue on their consolidation course in the coming year. This rests on a broadly-based restrictive expenditure line, an appreciable increase in trade tax receipts and non-recurrent proceeds from scheduled reimbursements of grants made to regional banks, expected in particular in 2005 as well. But special effects need to be taken into account for 2005 that will ultimately lead to a rise in the deficit of the Länder and local authorities. Thus the one-off payment in 2004 of € 2.7 bn from federal VAT revenue made to compensate the Länder for tax revenue shortfalls resulting from part of the final tax reform stage being brought forward will not apply in 2005. Accordingly, the deficit will be above the pre-year level at around

€ -27 to € -29 bn. In the remainder of the projection period the deficit of the Länder and local authorities will decline to some € -13 to € -15 bn in 2008.

Table 3: Deficits/surpluses by level of government

	2003	2004	2005	2006	2007	2008
	- in € bn -					
Federation including special funds	-39.6	-51 to -53	-38 to -40	-30 to -32	-26 to -28	-22 to -24
Länder and local authorities	-34.8	-25 to -27	-27 to -29	-23 to -25	-19 to -21	-13 to -15
Social insurance	-7.0	-1 to -2	2 to 1	2 to 1	4 to 3	4 to 3
General government[1)]	-81.3	-77 to -82	-63 to -68	-51 to -56	-41 to -46	-31 to -36

(1) Discrepancies between the general government deficit and the total of deficits are attributable to rounding.

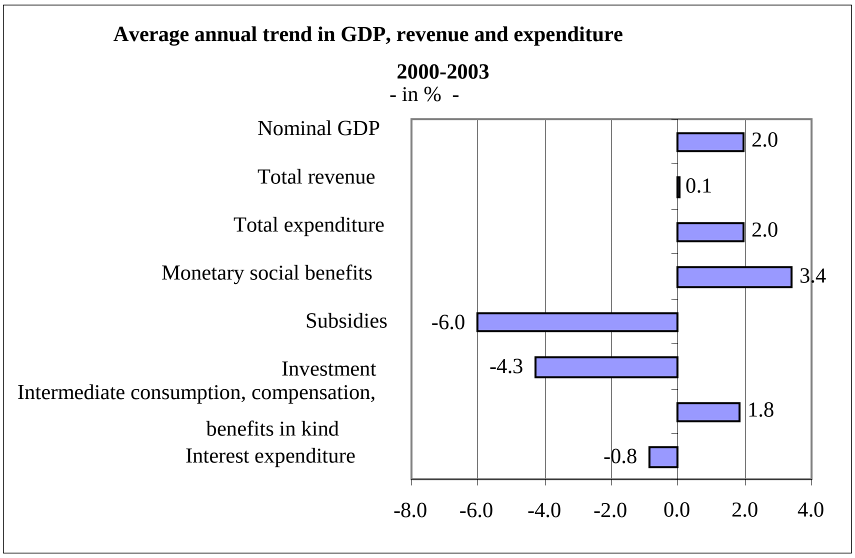
In 2005, social insurance funds will turn in a surplus of € 1 to 2 bn, which is attributable especially to savings on the expenditure side realised as a result of the healthcare reform. Two factors will have particular impact in the medium-term projection:

- Health insurance funds will continue to need surpluses to bring down the high level of short-term borrowings.
- Pensions insurance funds will benefit from the scope afforded by the Pensions Insurance Sustainability Law for setting up a sustainability reserve of 1.5 monthly disbursements by the statutory pensions insurance without having to reduce contributions. Accordingly, surpluses are assumed for statutory pensions insurance over the whole projection period. This will lead to a gradual rise in surpluses in social insurance to some € 3 to 4 bn by the end of the projection period.

4.2 Trends in government expenditure

Decline in general government spending ratio. Expenditure-side consolidation continues

The expenditure trend in Germany has been exceptionally restrictive since the year 2000 when economic stagnation set in. Aggregate general government expenditure rose on average by only +2% p.a. from 2000 to 2003 and was thus in line with the average annual change in nominal GDP in that period. Hence the current fiscal policy problems cannot be ascribed to the trend in expenditure.



In this context, the expenditure trend was determined in particular by monetary social benefits, which registered a marked increase of +3.4% p.a., among others on account of persistently weak economic activity. In contrast, general government consumption (intermediate consumption, social benefits in kind, compensation of employees) registered a less-than-average increase – with the annual average rise in compensation of employees standing at only +0.4%. Subsidies declined on average by -6 % a year in the same period. However, the steady decline in public-sector investment by some 4 % a year, economically undesirable on aspects of quality, does make apparent the economic problems arising from the expenditure constraints imposed by fiscal policy obligations.

The restrictive expenditure course will continue to be followed in the projection period. In the current year the government spending ratio will decrease by over one percentage point. This results principally from the cuts in special payments to public-service employees and savings in social benefits in kind in connection with reform measures in the healthcare sector.

The government spending ratio may be expected to show a further decrease in the same order of magnitude in 2005. This will be attributable mainly to savings in labour market expenditure, which will decline both on account of the social reforms and for cyclical reasons. With an average annual increase of less than 1 % and the resulting decline in the government spending ratio, the consolidation input of general government spending will remain substantially positive in the post-2005 period as well. However, the restrictive consolidation path also goes hand in hand with lower growth in public-sector infrastructure investment.

Apart from this, the following special effects must be taken into account in interpreting the expenditure trend:

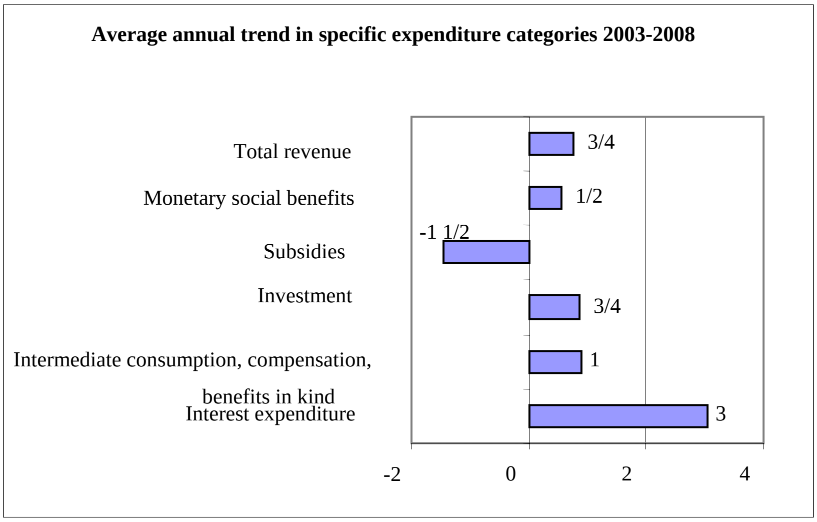
- The weighting of individual components in the funding of the European Union will shift away from VAT own resources towards GNI own resources. As only GNI own resources count as general government spending in National Accounts, whereas VAT own resources are deemed to be direct transfers from the sectors concerned to the EU, the change in the system will lead to an increase in the general government spending ratio. The impact of increased GNI own resources on the deficit in 2005 is around 0.1 of a percentage point of GDP. Contributions to the EU budget in 2005 will amount to some € 23.5 bn, of which on provisional estimates some € 11.2 will flow back to Germany. Net payments to the EU in 2005 will amount to around one half of a percentage point of GDP.
- The federal government’s transfers to the pension fund of the privatised postal successor undertakings in 2005 will be around € 5 ½ bn lower than in 2004 on account of the capitalisation of the undertakings’ pension obligations.
- Considered in isolation, setting up a more efficient job placement system will have the effect of increasing employee compensation in the social insurance funds in 2005 by 0.1 of a percentage point of GDP.

Table 4: Trends in the general government spending ratio

	2003	2004	2005	2006	2007	2008
Gen. govt. spending ratio	- in % of GDP -					
Projection December 2004	**48.8**	**47 ½**	**46**	**45 ½**	**44 ½**	**43 ½**
Projection January 2004	49	48	46 ½	45 ½	44 ½	-

Expenditure trends in detail

As early as 2003 it was apparent that the upward trend in **general government consumption spending** (intermediate consumption. social benefits in kind and employee compensation) was clearly less marked at +0.8 % on the year. In the current year, as a result of savings in healthcare spending, a decline of 1 ¼ % on the year is indicated. This expenditure category may be expected to show disproportionately lower growth for the remainder of the projection period.



With the curb on the upward trend of spending in social insurance, **monetary social benefits** have increased at a greatly subdued rate in the current year (less than +1 % after +2,5 % in 2003). From 2005 onwards the effects of the Agenda 2010 will predominate here, especially the merging of supplementary unemployment and welfare benefits. In conjunction with the upturn in economic activity a slight decrease is to be expected in 2005 and 2006, after which monetary social benefits are likely to register a below-average increase in the projection period, giving an increase of + ½ % p.a. in the projection period as a whole.

Interest expenditure registered only a slight upward trend at +1.1% last year. This is attributable in particular to favourable openings for refinancing expiring credits from previous periods. Interest expenditure is expected to continue to show little or no change in the current year on account of the aforementioned effects, though a clearly increasing upward trend is likely to emerge in the course of the projection period, giving an average annual growth rate of around 3 % p.a. for the period as a whole.

Despite the substantial decreases already registered in the past few years, **subsidies** will again decline in the current year by some -5 % on the year. This reflects in particular the reduction in assistance for the hard coal industry and the progressive reduction of other financial assistance set out in the 2004 reform package. An average annual decrease of -1 ½ % in subsidies is to be expected over the whole of the projection period.

Gross fixed capital formation will decline still further following the double-digit decrease in 2003 (-11.3 %). The rise in public-sector investment originally awaited on account of the need to repair flood damage has failed to materialise. However, the federal government’s initiative to extend facilities for all-day schooling and for the day-care of children under the age of three will exert a stabilising effect on public-sector investment from 2004 to 2007. In all, therefore, gross capital formation may be expected to register a slight average annual increase over the entire projection period.

4.3 Trends in government revenue

<u>Revenue trend 2005: Still no consolidation input with disproportionately low revenue trend</u>

The disproportionately low growth of general government revenue in comparison with the gross domestic product has contributed in every year since the start of economic stagnation in 2001 to the worsening financial situation of public budgets. This trend is set to continue in the projection period as well. As against the share of total revenue in GDP of 45 % in 2003, the ratio will decrease to 42 ½ % of GDP in 2008, the final year of the projection.

Tax revenue: Renewed shortfalls from persistently weak development of domestic demand

According to the November results of the Working Party on Tax Revenue Estimation, **tax revenue** has again fallen short of expectations at the start of the year. Export-driven growth has led to a disproportionately low increase in revenue from the taxes strongly dependent on domestic demand. Added to this are special effects such as the unexpectedly low proceeds from tax amnesty arrangements. Tax revenue shortfalls resulting from the Law on the taxation of old-age income must also be taken into account as against the January projection. Thus in comparison with the last update of the German stability programme, general government budgets have to contend with a shortfall of € 14 bn in tax revenue in 2004. Revenue shortfalls in 2005 as against the January projection amount to € 17 bn. At 22 % of GDP, the aggregate tax ratio will stay at its unprecedentedly low level.

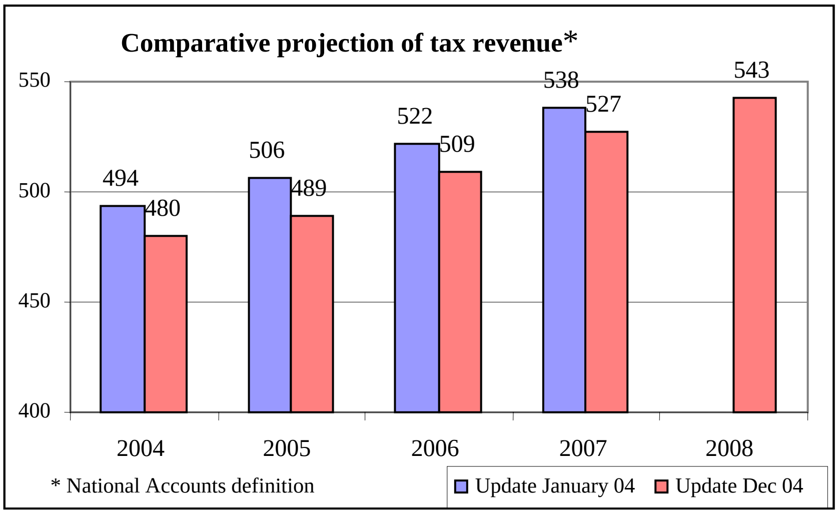


Table 5: Development of tax, social contribution and tax and fiscal charges ratio

	2003	2004	2005	2006	2007	2008
	- in % of GDP-					
Tax ratio	**22.6**	**22**	**22**	**22**	**22**	**22**
Social contribution ratio	**18.6**	**18**	**18**	**17 ½**	**17 ½**	**17**
Tax / fiscal charges ratio[1)]						
Projection December 2004	**41.2**	**40**	**39 ½**	**39 ½**	**39 ½**	**39**
Projection January 2004	41	41	40 ½	40	40	-

(1) Discrepancies between the tax/fiscal charges ratio and the total of tax ratio and social contribution ratio are attributable to rounding.

Tax revenue expectations for the coming years will be shaped not only by the development of economic activity but also decisively by measures to broaden the tax base and additional changes in tax law. Details of the tax law changes taken into account in the projection are as follows:

	Tax revenue additions/shortfalls in € bn				
	2004	2005	2006	2007	2008
Budget Support Law 2004 without tax reform stage 2004 [1)]	+1.5	+3.6	+4.8	+5.5	+5.7
Tax reform stages 2004 and 2005 [2)]	-9.1	-6.2	-0.1	-	-
Law to reduce tax concessions (statement for the minutes) [3)]	+0.7	+1.4	+1.6	+1.6	+1.3
Investment Allowances Law 2005 [4)]	-	-	-0.3	-0.6	-0.2
Old-age Income Law [5)]	-	-1.0	-1.3	-2.6	-3.8

1) Cf. Financial Report 2005, p. 307 – 318; difference nos. 44 and 29;
2) Cf. Financial Report 2005, p. 307 – 318; no. 29 and updated new calculation
3) Cf. Financial Report 2005, p. 303; 4) Cf. Financial Report 2005, p. 322; 5) Cf. Financial Report 2005, p. 327

Social contributions revenue marked by weak economic activity and increased contribution rates

The low level of aggregate economic activity in 2003 and the resulting shortfalls meant that revenue from social contributions could be stabilised only by raising contribution rates to the statutory pensions and health insurance. The average standard contribution rate to statutory health insurance rose last year by 0.3 of a percentage point, whilst pensions insurance contributions were raised by 0.4 of a percentage point in order to stabilise the share of contributions revenue in GDP on the year.

The projection of the trend in social contributions takes account in particular of the effect of reforms in the social insurance sector.

- In health insurance, increased co-payments and cuts in services result in expenditure savings of around € 10 bn. This will lead at the latest in 2005 to reductions in contribution rates that are to be taken into account in the projection of social contributions.
- In pensions insurance, the scope afforded by the Pensions Insurance Sustainability Law for setting up a sustainability reserve of 1.5 monthly disbursements means that pensions insurance surpluses need not automatically lead to reductions in contributions as long as the sustainability reserve is not fully replenished.
- In old-age care insurance, measures to implement a judgment of the Federal Constitutional Court lead to an addition of 0.25 of a percentage point for insured persons who have no children.

Taking the above changes in contribution rates and contribution patterns into account results in an average annual increase of 1 ½ % in social contributions in the projection period. This trend goes hand in hand with a social contribution ratio declining towards the end of the projection period.

Other income: One-off effects in income from sales and property

The following developments should be particularly noted with regard to **other income**:

- Under income from **sales** it had been originally expected that proceeds from a system of satellite-assisted HGV motorway tolls would accrue for the first time in 2004. The system is now to be introduced as from 2005. This will generate a one-off basis effect in income from sales in 2005 of around 0.1% of GDP.
- Under **income from property**, the trend in the euro exchange rate in 2004 caused a virtually complete shortfall in the central bank profit contribution. This one-off effect reduces income in 2004 by around 0.1% of GDP.

4.4 Trends in cyclically-adjusted deficits

The federal government has repeatedly commented on the extreme paucity of the information to be derived from the development of cyclically-adjusted deficits and has in particular expressed doubts as to their suitability for drawing conclusions on budget adjustment measures. Whilst cyclically-adjusted deficits may be a useful source of additional information, they are not seen as a crucial instrument for assessing trends in the general government budget and especially not as a fiscal policy target figure.

The shift now made from the HP filter method used in previous stability programmes to the production function approach has not altered this assessment. The central points of criticism apply equally to the production function approach (susceptibility of the results to revision, mistaken interpretations in current periods from fluctuating elasticities, failure to make allowance for forecast deviations in relation to the GDP deflator, temporary, non-cyclical fluctuations in specific revenue and expenditure items).

The federal government is extremely critical of the interpretation put forward by the European Commission to the effect that the adjustment of deviations in forecasting trend GDP can increase the information yield of the indicator to such an extent that precise conclusions may be drawn from cyclically-adjusted deficit data on the implementation of recommendations for budget adjustment measures (the “conditional approach”).
This longstanding critical assessment of the use of cyclically-adjusted deficits is borne out by the ongoing attempt by the “Output Gaps” Working Group of the ECOFIN Economic Policy Committee to review and refine the methods of calculating cyclically-

adjusted deficits, where it has proved virtually impossible to identify for Germany (and not only for Germany) dependable budget elasticities on the basis of time series analyses.

Notwithstanding these essential criticisms, a reduction in the cyclically-adjusted deficit for 2003 of one half of a percentage point on the year will result on the basis of the aforementioned growth assumptions and the underlying deficit projection. No reduction in the cyclically-adjusted deficit can result in the current year owing to one stage of the tax reform being brought forward for cyclical reasons and to the one-off effects described above. In 2005 and the following years the cyclically-adjusted deficit decreases by around one half of a percentage point a year.

With regard to the figure for 2004 it should be noted in the light of the aforementioned points of criticism that, although part of the unfavourable trend in the nominal deficit is clearly attributable to cyclical factors (change in the composition of GDP), the resulting rise in the nominal deficit is also reflected in a rise in the cyclically-adjusted deficit, as the method employed cannot take account of fluctuations in elasticities. This once again shows that the assessment of fiscal policy cannot be appropriately undertaken on the basis of mechanistic, quantitative cyclical adjustment procedure, but must of necessity always be supplemented by a qualitative approach.

Table 6: Development of cyclically-adjusted deficits

	2003	2004	2005	2006	2007	2008
Real GDP growth	**- 0.1**	**1 ½ to 2**	**1 ½ to 2**	**1 ¾**	**2**	**2**
General government fiscal balance in % of GDP	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
Structural balance in % of GDP	**-3.0**	**-3**	**-2 ½**	**-2**	**-1 ½**	**-1**

4.5 Trends in debt

In the last stability programme update, the development of debt was expected to “peak” in 2005 and 2006. The debt ratio in those years was expected to stand at 65 ½ per cent of GDP. After that, given declining deficits and vigorous growth in the economy as a whole, the debt ratio was expected to take on a downward trend again.

The conditions obtaining at that time have since deteriorated. Less favourable trends have been registered both in borrowing and in the GDP as the reference basis. The increase in debt in absolute terms will be slightly more marked than assumed one year ago, given a deficit which is still high and, though set to decline in future, will do so from a high level. From the current viewpoint, the growth in nominal GDP will be less than in January. The combination of these effects means that debt standing at 66 % in 2005 and 2006 will be one half of a percentage point higher in each year than assumed in the January update.

Table 7: Trends in the debt ratio

	2003	2004	2005	2006	2007	2008
Debt ratio	- in % of GDP-					
Projection December 2004	**64.2**	**65 ½**	**66**	**66**	**65 ½**	**65**
Projection January 2004	64	65	65 ½	65 ½	65	-

On the assumptions made here, therefore, debt is still set to peak in 2005 and 2006. Debt will be reduced in steps of one half of a percentage point in each of the two following years, thus allowing it to be brought down to some 65 % of GDP by 2008.

In view of the discussion about gearing the debt and deficit criteria more closely together it would seem that in particular the discrepancies between net borrowing and general government deficit arising from differing definitions present problems. The differences between net borrowing in cash terms and general government deficit referred to as “stock-flow adjustments” by the European Commission constitute at best a theoretical factor. In terms of content, the definitions of net borrowing and general government deficit employed in the excessive deficit avoidance procedure are in fact two different concepts. A new mechanistic criterion taking account of the amount of debt in deriving deficit targets would thus render the indicators used in budget surveillance procedure more difficult to steer by policy means. This would not resolve but would rather exacerbate the current problems arising from the mechanistic application of the deficit criterion. To this extent it would seem appropriate to take account of the amount of debt in assessing a country's overall fiscal situation – but it should not lead to the definition of new, mechanistic indicators.

4.6 Sensitivity of the deficit projections

The sensitivity analysis depicts the trends resulting from deviations from aggregate economic assumptions. It proceeds from changes of half a percentage point a year in the growth of nominal GDP as against the basis projection. Assumptions and results of the basis projection are unchanged for the current year..

If the growth of nominal GDP fell short of the assumptions by half a percentage point a year in the period from 2005 to 2008, the result would be a slower reduction of the general government deficit leading to a balance of -2 ½ % of GDP in the final year of the projection (see Table 8). It is assumed that the cyclically-induced charges on public budgets are not offset by extra consolidation efforts on the expenditure side. Thus in this respect weaker GDP growth would feed through directly to the deficits; as a result, the reduction of the general government deficit would be stretched. It is calculated that the 3 % reference figure will not be undercut in this scenario until 2006.

Table 8: Sensitivity of the deficit projections

	2003	2004	2005	2006	2007	2008
Deficit ratio[1)]	- in % of GDP-					
Projection December 2004	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
Projection December 2004						
• assuming lower growth of nominal GDP 2005-2008 (- ½ percentage point)	-4	-3 ¾	-3	-3	-2 ½	-2 ½
• assuming higher growth of nominal GDP 2005-2008 (+ ½ percentage point)	-4	-3 ¼	-2 ½	-2	-1	-½

(1) In the light of uncertainties affecting estimates made in relation to any projection. deficits are rounded to ¼ percentage points of GDP for short-term projections (2004) and to ½ percentage points of GDP for medium-term projections.

The more favourable scenario, assuming nominal GDP growth up by one half of a percentage point, results in the deficit ratio declining to -½ % of GDP in the final year of the projection. In line with the ECOFIN Council decisions of 25 November 2003, this projection proceeds from the assumption that additional revenue deriving from stronger-than-expected growth is deployed in full to reduce the deficit.

5. Long-term sustainability of public finances

5.1 Demographic change – a major challenge for fiscal policy

Demographic change is a decisive factor in concerns about the sustainability of public finances. Bearing in mind the issue of equity between the generations and the challenges posed by the demographic trend, the federal government attaches great significance to addressing this problem.
In the same way as other industrial economies, Germany will experience a substantial shift in the ratio of older to younger persons in its population in the coming decades. This is shown by the rise in the elderly dependency ratio, i.e. the ratio of persons of pensionable age to the number of persons of working age. The federal government treated the foreseeable changes in population structure in greater detail in last year's stability programme. According to the calculations by the Federal Statistical Office presented there, the elderly dependency ratio which stood at 27.5 in 2001 is set to double to around 55 by the year 2050. This would mean that there are only two instead of four potential contributors for each person drawing a pension.

Despite all the uncertainties inherent in long-term projections there are at least several economic consequences that can be drawn from so massive a shift in the age structure of the population. Demographic change limits the future growth potential of the economy principally because it appreciably lessens the supply of labour – in the absence of counteracting trends in labour participation. The demand for products and services could be curbed. Changes in population structure also put pressure on the funding of social security systems. Demographic change exerts the greatest direct effect on pensions insurance by causing a continuous deterioration in the ratio of contributors to pensioners, all other things being equal. The federal government already responded some time ago to the demands that demographic change makes specifically on the systems of old-age provision by undertaking reforms in statutory pensions insurance and transposing these reforms to the pension arrangements for public-service officials.

A further step towards securing sustainable funding of pensions has been taken with the introduction of the sustainability factor, which takes account in pension indexation of shifts in the ratio of contributors to persons drawing pensions.

The federal government's reporting on long-term trends in public budgets in the past two years has drawn principally on the results of corresponding studies at Community level. The Member States participated through joint activity in the Economic Policy Committee of the EU in these calculations, which were based on population projections by Eurostat and matching macroeconomic assumptions. However, the results of these studies are now largely obsolete and no longer make sufficient allowance for changes in the legal framework and special features of development in individual Member States. A new Community-wide projection exercise has been initiated but is not likely to be concluded before the middle of next year.

In the meantime, in order to be able to present the consequences of policy decisions on long-term sustainability of public finances, the Federal Ministry of Finance commissioned the ifo Institute for Economic Research to update the relevant calculations for Germany. This shows that the reforms undertaken to date have appreciably reduced, though not eliminated, the rise in the ratio of age-related spending to the gross domestic product (GDP). In the major expenditure categories (spending on old-age security and healthcare spending) the expected increase amounts in total to some 4 percentage points, whereas the last calculations for Germany at Community level (which did not include the effects of recent reforms) showed an increase of around 6 percentage points.

Table 9: Government revenue and expenditure in long-term perspective

	2003	2010	2020	2030	2040	2050
Expenditure in % of GDP						
Old-age provision 1)	11.2	10.8	11.6	12.8	13.3	13.8
Healthcare 2)	6.6	6.0	6.4	6.9	7.5	7.7
Education 3)	4.1	3.9	3.6	3.7	3.6	3.6
Earnings-related unemployment benefits 4)	2.9	2.4	2.0	1.3	1.1	1.1
Revenue in % of GDP						
Total government revenue 5)	45.0	42.2	42.8	43.7	44.6	45.3
Memo item: Reserves 6)	0.5	1.4	0.6	0.2	0.2	0.2
Assumptions in the model calculation						
Productivity gain (p.a.)	0.9	1.5	1.7	1.7	1.8	1.8
GDP growth (p.a.)	- 0.1	1.9	1.7	1.4	1.3	1.1
Labour force participation	77.8	79.2	79.6	81.6	82.5	81.9
Men (20 to 64)	85.1	86.3	86.2	86.9	87.7	87.2
Women (20 to 64)	70.2	71.9	72.9	76.2	77.3	76.6
Unemployment ratio	8.7	7.3	6.3	3.9	3.3	3.3

1) Statutory pensions insurance and public-service officials' pensions
2) Statutory health insurance (acute health care)
3) Including payments for care of pre-school-age children, excluding FLA training expenditure
4) Federal Labour Agency expenditure
5) General government revenue including social contributions
6) Sustainability reserve of statutory pensions insurance and pension reserve for officials

Note:
Results of a model calculation by the ifo Institute. A trend equivalent to GDP growth was assumed for areas (including tax revenue) for which no explicit calculation was made.
Demographic assumptions are in line with the 10th coordinated population forecast of the Federal Statistical Office (mean variant).

The outcome of calculations by the ifo Institute is set out in Table 9. The underlying demographic and macroeconomic assumptions are largely equivalent to those developed by the "Rürup" Commission on the basis of estimates by leading institutions concerned with population and economic research. The effects of the "Pensions Insurance Sustainability Law" of June 2004 and the reforms in the sector of statutory health insurance in reducing the burden of demographic change are taken into account here for the first time. The share of projected expenditure as a percentage of GDP registers even an appreciable decline into the coming decade. The measures adopted in Germany are clearly successful, and only after that time does demographic change cause a renewed rise in expenditure ratios. A model simulation carried out in this context shows that the burden on public budgets has already been appreciably lessened over the whole review period as a result of the reforms. Ultimately, however, even the projected increases in revenue will not be sufficient to fully offset the fiscal impact of population ageing.

5.2 Need for further action

In the recent past the federal government has launched a large number of influential reforms relating to the labour market, to healthcare and pensions (for details see 3.1 above). These have already substantially improved the long-term sustainability of public finances. However, there is still a need for action to secure what has been achieved in this respect. The sustainability goal can best be attained with the aid of a broadly-based strategy comprising action in various policy areas.

It is the task of budgetary policy to ensure that the burden to be borne by future generations is not made heavier by further consolidation of public finances and by bringing down debt; on the contrary, the aim must be to regain scope for future-oriented investment. The course of economic, fiscal and social policy reform on which we have now embarked must be consistently pursued if we are to bring about further improvements in the sustainability of public finances.

Changes in the macroeconomic parameters (demographic trend, labour participation, unemployment, productivity and interest rate trends, healthcare costs) will influence the development of public finances, in some instances substantially, up to the year 2050. The unemployment trend is one of the most significant factors affecting the sustainability of public finances. Both by reducing expenditure and promoting growth, a low unemployment ratio has a markedly positive effect on this sustainability. Progress in medical technology is a further important factor, even though the trend and the cost effects of such progress cannot be determined in advance with any certainty. Positive effects also result from high labour force participation of women and an increase in the labour force participation of older persons. For this reason the federal government has taken action to raise the effective pensionable age by restricting early retirement arrangements and to increase the labour force participation of women, for instance by improving childcare facilities and making provision for all-day schooling.

Further thought must be given in future to means of improving the long-term sustainability of public finances. Reforms in the field of social security systems, for instance, can limit the long-term expenditure trend. Additional curbs on healthcare spending can significantly improve the development of public finances as a whole over the long term. However, these savings may be counteracted by progress in medical technology, which tends to drive up costs. But measures to enhance the "quality of public finances" (see 3.2.3 above), for instance by investing in education, research and innovation and thus raising the growth potential, are an appropriate means of addressing the problem of demographic change. This also involves making use of sustainable approaches to linking ecological and fiscal policy measures.

The Federal Ministry of Finance intends to submit in early 2005 a report on the long-term sustainability of public finances ("Sustainability Report"), presenting the most recent reform measures, setting out the need for further action and identifying starting-points for prompt countermeasures both in fiscal policy (among other continuing consolidation, greater emphasis on future-oriented tasks, subsidy cuts, sustainable tax policy) and in other areas, for example in the social security systems.

Appendix

Table 10: Development of public finances[1)]

(National Accounts definitions)

	ESA Code	2003	2004	2005	2006	2007	2008
		in % of GDP					
Balancing items (B.9) of levels of government							
General government	**S.13**	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
Central government	S.1311	-1.9	-2 ½	-1 ½	-1 ½	-1	-1
State government	S.1312	-1.6	-1 ¼	-1 ½	-1	-1	- ½
Local government	S.1313						
Social insurance funds	S.1314	-0.3	-0	0	0	0	0
General government expenditure (in accordance with the definition in Reg. 1500/2000)							
Intermediate consumption Social benefits in kind Compensation of employees[2)]	P.2 D.63 D.1	19.7	19	18 ½	18 ½	18	17 ½
Monetary social benefits	D.62	19.7	19 ½	19	18	18	17 ½
Capital transfers (interest expenditure)	D.4	3.1	3	3	3	3	3
Subsidies	D.3	1.4	1 ½	1	1	1	1
Gross capital formation	P.5	1.5	1 ½	1 ½	1 ½	1 ½	1 ½
Other expenditure		3.4	3	3	3	3	3
Total expenditure		**48.8**	**47 ½**	**46**	**45 ½**	**44 ½**	**43 ½**
General government revenue (in accordance with the definition in Reg. 1500/2000)							
Taxes	D.2 D.5	22.6	22	22	22	22	22
Social contributions	D.61	18.6	18	18	17 ½	17 ½	17
Other revenue		3.8	3 ½	3 ½	3 ½	3 ½	3
Total revenue		**45.0**	**43 ½**	**43**	**43**	**42 ½**	**42 ½**
Financial development of general government							
Total expenditure		48.8	47 ½	46	45 ½	44 ½	43 ½
Total revenue		45.0	43 ½	43	43	42 ½	42 ½
Net lending/borrowing	B.9	-3.8	-3 ¾	-3	-2 ½	-2	-1 ½
Interest expenditure	D.4	3.1	3	3	3	3	3
Primary balance		-0.7	-½	0	½	1 ½	2

(1) Discrepancies in the totals are the result of rounding.
(2) Including other taxes on production (D.29).

Table 11: Development of government debt

("Maastricht" definition)

	ESA Code	2003	2004	2005	2006	2007	2008
	in % of GDP						
Government debt		**64.2**	**65 ½**	**66**	**66**	**65 ½**	**65**
Primary balance		-0.7	-½	0	½	1 ½	2
Interest expenditure	D.4	3.1	3	3	3	3	3
Change in nominal GDP	B.1.g	1.0	2 ½	2 ½	3	3 ½	3 ½

Table 12: Comparison of projections in the January 2004 and December 2004 stability programmes

	ESA Code	2003	2004	2005	2006	2007	2008
Change in nominal GDP in %							
Stability programme Dec. 2004	B.1.g	1.0	2 ½	2 ½	3	3 ½	3 ½
Stability programme Jan. 2004	B.1.g	1	2 ½	3 ½	3 ½	3 ½	-
Difference		0	0	-1	- ½	0	-
Balancing item in % of GDP							
Stability programme Dec. 2004	B.9	-3.8	-3 ¾	-3	-2 ½	-2	-1 ½
Stability programme Jan. 2004	B.9	-4	-3 ¼	-2 ½	-2	-1 ½	-
Difference		-0.2	½	½	½	½	-
Government debt in % of GDP							
Stability programme Dec. 2004		64.2	65 ½	66	66	65 ½	65
Stability programme Jan. 2004		64	65	65 ½	65 ½	65	-
Difference		0.2	½	½	½	½	