German

Stability Programme

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0. Foreword **4**

1. Summary **5**

2. Macroeconomic situation and outlook to 2009 **6**

2.1. Assumptions underlying the growth forecast for 2006 and over the medium-term 6

2.2 Macroeconomic situation in Germany in 2005 6

2.3 Short and medium-term outlook for the overall economy 7

3. Fiscal policy in Germany **10**

3.1 Fiscal policy strategy and package of measures by the Federal Government 10

3.2 Reform of federalism 13

3.3 German fiscal policy in the European context 14

4. Development of the public budgets **15**

4.1 Package of measures 2006 to 2009 15

4.2 Development of net borrowing/lending 15

4.3 Development of expenditure and revenue 19

4.4 Development of the structural deficit / adjustment path with regard to the medium-term budgetary objective 20

4.5 Development of the level of debt 21

4.6 Sensitivity of the deficit forecasts 22

5. The long-term sustainability of public finances **23**

5.1 Shaping a response to the demographic challenge 23

5.2 Updated long-term model calculations at Community level 24

5.3 Structural reform in the area of social insurance systems 26

Appendix **28**

Tables

Table 1: Forecast of macroeconomic development for the years 2005 to 2009 8

Table 2: Fiscal effects of the coalition agreements 16

Table 3: Development of the deficit 17

Table 4: Financial balances according to level 18

Table 5: Development of the general government expenditure 19

Table 6: Development of tax, social contribution, and tax and fiscal charges 20

Table 7: Development of structural borrowing/lending 21

Table 8: Development of the debt ratio 22

Table 9: Sensitivity of the deficit forecasts 22

Table 10: Government expenditure from a long-term perspective 25

Appendix:

Table 11: Development of public finances 28

Table 12: Development of general government debt 29

Table 13: Forecasts compared 29

Foreword

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, and as amended by Council Regulation No 1055/2005 of 27 June 2005 - the Member States which have adopted the euro are obliged to submit updated stability programmes each year to the ECOFIN Council. The Member States which have not adopted the common currency submit corresponding convergence programmes.

The present update of the German stability programme was approved by the Federal Government on 22 February 2006.

In both format and content, the Programme conforms to the guidelines set out in the Regulations on the format and content of the stability and convergence programmes ("code of conduct") of September 2005.

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

www.bundesfinanzministerium.de

1. Summary

- One of the central tasks of fiscal and economic policy in Germany is to secure the sustainability of public finances. Developments over the past few years have shown that a course of very moderate spending is not enough in itself to close the structural gaps existing in the public budgets caused, in particular, by an erosion of the tax base and an enduring period of weak economic activity.

- In order to continue the structural consolidation of the federal budget, contributions are required from both the expenditure and the revenue side. In addition, the framework conditions for growth and employment are being improved by way of a programme designed to add economic momentum. This is aimed at solidifying the basis for a self-supporting upswing in the current year and strengthening the potential for growth over the long-term.

- The general government deficit ratio will thus remain in 2006 roughly at the pre-year level. While economic recovery coupled with a continued restrictive course of spending will lead to considerable relief, the forecast assumes that revenues will still rise at a considerably lower proportionate rate than nominal GDP.

- From 2007 on, the development of the deficit ratio will be determined in particular by the Federal Government’s package of measures. Overall, 2007 will see a reduction in the deficit ratio to -2 ½ % of GDP, thereby ensuring that the deficit reference value set out in the Maastricht Treaty is not exceeded. The deficit ratio will continue to fall by half a percentage point annually in the following years.

- In 2007, the structural deficit will be reduced by roughly one percentage point. The change to the structural deficit is the result primarily of the effects of the Federal Government’s package of measures, but it also reflects the restrictive spending policy arising from measures implemented in recent years.

- The Federal Government expects real GDP growth in 2006 of around 1 ½ % (2.2% in nominal terms). Real economic growth in 2007 is expected to be roughly 1% (2 ½ % nominally); in 2008 and 2009, real GDP growth on current estimations should average 1 ¾ % p.a. (2 ½ % p.a. in nominal terms).

2. Macroeconomic situation and outlook to 2009

2.1. Assumptions underlying the growth forecast for 2006 and over the medium-term

Forecasts for the short and medium-term (2005 to 2009) are based on the following assumptions:

- World economic momentum in 2006 will be roughly the same as in the previous year (price-adjusted growth of 4¼ %). World trade is even expected to expand at a slightly greater rate - 7 ½ to 8 % compared with 7 to 7 ½ % in the previous year – with volume growing by 5% to 6% a year over the entire period from 2005 to 2009.
- The technical assumptions regarding exchange rate, oil price and interest rates are taken from the respective averages of the final weeks leading up to the forecast within the Federal Government’s Annual Economic Report at the end of January 2006. This implies an exchange rate of 1.20 US dollars to the euro, a price for Brent oil of 60 US dollars per barrel, and unchanged ECB key interest rates.
- Wage increase, as in the preceding years, will remain very moderate this year with an overall plus in negotiated wages and salaries of roughly 1½ %. With continued negative wage drift, effective wages will increase by just under ¾ % on yearly average. This will lead to a further decline in unit labour costs (by roughly -1%). It is expected over the medium-term that growth in real wages will generally reflect developments in productivity.
- The forecast also takes into account to a large degree the decisions reached at the Federal Government’s gathering in Genshagen on the implementation of the Coalition Agreement.

2.2 Macroeconomic situation in Germany in 2005

In mid-January, the German Federal Statistical Office published first, tentative details of the macroeconomic development in 2005. According to these figures, gross domestic product rose in real terms by 0.9%. Adjusted for working days, the growth rate was 1.1%, the same as in the previous year. When one considers the negative statistical overhang from 2004 with which the Germany economy began the past year, macroeconomic development has even accelerated in 2005.

Nevertheless, the heterogeneous trend between strong external and weak domestic performance, which has characterised recent periods, was once again evident last year. Thus, the export surplus compared to imports contributed 0.7 percentage points to GDP growth while national uses remained weak (growth contribution of +0.2 percentage points). Although there were signs of recovery in investment in machinery and equipment, private consumption stagnated.

2.3 Short and medium-term outlook for the overall economy

In its annual forecast, the German government expects real GDP growth for this year of around 1 ½ %, or 1.4% in exact terms. This is buoyed by the expectation that cyclical momentum could be felt more strongly this year than in 2005. Over the medium term, i.e. from 2005 to 2009, real average GDP growth is expected to be roughly 1½ % p.a..

Given the lively world economy and the further improved competitiveness of German companies on the global market, it is expected that growth will continue to be stimulated primarily by foreign demand. Nevertheless, there is a good chance that the positive stimulus from abroad will make its influence increasingly felt on the domestic economy. This will probably first be strongly felt in investments in machinery and equipment. However, increased private consumption can also be expected in 2006. This is likely, however, to be the result of one-off factors (such as the football World Cup and anticipatory effects in the run up to the increase in VAT on 1 January 2007). The decline in registered unemployment is expected to continue in 2006. Although employment should recover again, a stagnating yearly average can be expected.

Economic recovery will continue to unfold in an environment of price increases that are conducive to stability, even though the effects of increased energy prices will still be felt. Budget consolidation measures can be expected to induce a temporary decline in economic momentum in the coming year. As a result, real economic growth in 2007 should be around 1%. The labour market will also be affected by the temporary weakening of economic momentum, with the result that employment will increase only slightly. However, the increase in employment during the course of the year could be higher than assumed in the forecast, since it has not yet been possible to take into account in the forecast the latest upward revision in the statistics on gainfully-employed persons.

In the subsequent years, 2008 and 2009, GDP is currently expected to grow at an average of approximately 1 ¾ % p.a. The most important basis of the macroeconomic forecast over the medium-term is the considerations relating to the supply side determinants of economic development.

Table 1: Forecast of macroeconomic development for the years 2005 to 2009(1)

	ESA Code	2005	2006	2007	2009/05
GDP price adjusted, chain index; annual change in %	B1g	0.9	1.4	1	1 ½
GDP at current market prices; annual change in %	B1g	1.3	2.2	2 ½	2 ½
GDP deflator p.a. in %		0.4	0.8	1 ½	1
Gainfully employed persons (domestic) p.a. in %		- 0.3	0.0	¼	¼
Labour productivity (2) p.a. in %		1.2	1.4	1	1 ¼
Use of GDP price-adjusted, chain index: Change p.a.					
1. Private consumption spending(3)	P3	0.0	0.3	- ¼	¼
2. Govt. final consumption	P3	-0.4	0.3	- ¼	¼
3. Gross fixed capital formation	P51	-0.3	2.3	2 ½	2 ½
4. Changes in inventories (GDP growth contribution)(4)	P52 + P53	0.3	0.1	¼	0
5. Exports	P6	6.2	6.5	6	5 ¾
6. Imports	P7	5.0	5.5	5 ¼	4 ¾
GDP growth contributions(4)					
7. Domestic demand (w/o stocks)		-0.1	0.6	¼	¾
8. Changes in inventories	P52 + P53	0.3	0.1	¼	0
9. External balance of goods and services	B11	0.7	0.7	½	¾

(1) 2005: Provisional result of the Federal Statistical Office of January 2006;
2006: Yearly forecast of the Federal Government, Annual Economic Report 2006;
2007 to 2009: Medium-term forecast.
(2) GDP per person in gainful employment.
(3) Including private non-profit organisations.
(4) Contribution to GDP growth rate.

The enduring phase of weak economic activity which has been accompanied by a marked reluctance to invest has impaired macroeconomic production capacities. Increased investment in capital assets and human capital should allow the annual potential GDP growth to approach 1 ½ % towards the end of the medium-term. A rate of potential GDP growth ranging from 1 ½ to 2 % once again can be expected in the long-run only.

Exports will deliver the greatest momentum for growth over the entire forecast period, whereas the contribution to economic growth provided by domestic demand will gain in strength only gradually. The upward trend of investor activity expected over the medium-term will most likely go hand in hand with increased private consumption expenditure. Each of these developments would serve to reinforce the other. For, on the one hand, more investment means more employment and hence greater demand from private households, while on the other hand, increased private spending increases turnover for companies, which in turn drives investment activity. These mutually-reinforcing processes would strengthen domestic demand in Germany on a sustainable basis, while government final consumption would increase only slightly over the entire forecast period due to the consolidation course being pursued.

Real medium-term GDP growth of 1 ½ % p.a. and an average annual inflation rate (GDP deflator) of roughly 1% would allow GDP to rise on average by 2 ½ % p.a. in current prices. As a consequence of the reforms, the number of those gainfully employed should increase (increase in number of women and older workers employed) and the level of structural unemployment fall, i.e. the potential labour force should be better exploited as a result of the structural reforms. Gainful employment should rise by roughly ¼ % p.a., with the reduction in unemployment lagging somewhat behind.

The risks contained in this forecast are the development of oil prices on the world market and the undiminished global imbalances which still persist. However, there is also the chance that the global economy will develop more favourably, that crude oil prices will be lower, and that the economic policy measures of the Federal Government will encourage confidence, with a greater impact than assumed on the recovery of the domestic economy.

3. Fiscal policy in Germany

3.1 Fiscal policy strategy and package of measures by the Federal Government

A central task of fiscal and economic policy in Germany is to secure the sustainability of public finances. The challenges posed by demographic change and globalisation can only be mastered if public finances are sustainable.

In order to reach this objective, the structural consolidation of public budgets and the social security systems must be rigorously continued on the one hand, while the framework conditions for growth and employment must be improved, on the other. Developments of recent years have shown that a course of very moderate spending is not enough in itself to close the structural gap in the federal budget, caused in particular by an erosion of the tax base and an enduring period of weak economic activity. With this in mind, the Federal Government intends to fully exploit its leeway for structural reforms in its budgetary and fiscal policy. The promotion of economic growth and the consolidation of public finances cannot be separated.

Against this background, the Federal Government is initiating a programme to bolster the framework conditions for investment and employment, thus solidifying the fundament for a self-supporting upswing. The measures are designed in such a way as to strengthen in particular the incentives for entrepreneurial activity and private demand, thus boosting the economic momentum in Germany on a long-term and tangible basis.

In order to correct the under-financing of the public budgets, simultaneous contributions to consolidation must come from both the expenditure and the revenue side. In this manner, consumer and investor confidence in stable framework conditions for dynamic economic activity, and thus an increase in employment, can be secured. In addition, the measures ensure that the deficit criterion set out in the Treaty of Maastricht will be adhered to from 2007 on.

With a view to implementing such a two-pronged strategy, the Coalition Agreement envisaged a balanced and – especially in relation to the temporal distribution of the burdens borne by private households and companies – well-synchronised package of measures, a package which is now being implemented by the Federal Government on a step-by-step basis. One core element of this strategy is to support the upswing in 2006 through the support programme and by waiting until 2007 before introducing many of the planned structural consolidation measures, especially those which affect the revenue side of the federal budget.

Support of growth

In order to bolster the forces for growth in Germany on a long-term basis, the Federal Government will implement targeted, growth-supporting measures totalling roughly €25 billion up to 2009. The principle elements of these measures are (volume for the federal budget up to 2009):

- **The promotion of research and development.** Supplemented by efforts of the individual federal states, not to mention industry, the goal is to increase spending on research and development to 3% of GDP by 2010. The Federation's contribution towards this target will amount to an additional €6 billion.
- **Impetus for SMEs and industry** A package of measures worth €9.3 billion is intended to improve the conditions for depreciation for a limited time period, to promote to a markedly greater extent than before investment in energy-related building renovation, and to improve the liquidity of smaller companies, in particular, by way of value added taxation.
- **Raising the level of investment in transport infrastructure.** A total of €4.3 billion more than previously planned.
- **Supporting families.** The Federal Government will help to improve the work-life balance by introducing from 2007 an income-dependent parental allowance worth €3 billion in total.
- **Household as employer.** Drawing on support measures worth €2.5 billion, the opportunity to create employment in private households will be enhanced by making it easier to deduct costs for maintenance and modernisation in private residences, household services and childcare.

The reduction of contributions to unemployment insurance by two percentage points is intended to allow the contributions to social insurance to be brought under 40 %. In addition, reforms to corporate taxation will ensure from 2008 internationally competitive corporate tax legislation which, not least because of the attractive tax rates, will strengthen the position of German companies in international competition and make investing in Germany are more attractive prospect.

Consolidation of the public budgets

On the expenditure side, the range of savings envisaged includes (each up to 2009): approx. €3.5 billion from individual subsidies, €4 billion in the public administration, €12 billion in the basic allowance for job seekers, and roughly €11 billion from federal transfers to statutory health insurance schemes.

However, the capacity to create leeway for immediate savings is limited, due also to the spending discipline of the previous years. Total government expenditure rose on average by a mere 1.7% per year between 2000 and 2005, the government spending ratio fell in 2005 to 46.8 %, its lowest stand since 1991. The continued, determined dismantling of subsidies is a further central element for sustainable consolidation. As the government has been able to cut the level of financial aid already by almost half since 1999, the measures now agreed are focused on tax subsidies.

Thus, for example, the possibility of offsetting losses offered by tax deferral models was abolished on 11 November 2005. The owner-occupied homes premium was stopped for new owners from 1 January 2006, and the savers' allowance for unmarried persons will be reduced from 1 January 2007 from €1,370 to €750 (and double the amount for married persons). A further example of the planned tax measures are cuts from 1 January 2007 in the kilometre allowance for employees as well as the noticeable restrictions on further tax planning opportunities.

At only 21.9 % of GDP, the tax ratio in the Federal Republic of Germany is at a historically-low level. Hence, the revenue side can also make a substantial contribution towards correcting the structural under-financing of the public budgets. In view of this, the government will, with effect from 2007, raise the standard rate of VAT and insurance tax by 3 percentage points. In the interests of safeguarding social symmetry, the reduced VAT rate shall remain unaffected and those earning very high incomes will also contribute by way of an increase in the top rate of income tax.

The increase in the rates of VAT and insurance tax will lead to additional tax revenues for aggregate government of approximately €24.5 billion when applied over the entire year. Of this, just under €17 billion (almost €15.3 billion from VAT and almost €1.6 billion from insurance tax) will be available to consolidate the public budgets, since the one percentage point's worth of revenue is to be used to help reduce contributions to unemployment insurance.

The increase in the rates of VAT and insurance tax is a very important element of the consolidation strategy as it makes a considerable contribution towards stabilising the revenue side of the budget on a durable basis and allows the contribution to unemployment insurance, and thus the non-wage labour costs – which slow down economic activity – to be lowered.

3.2 The reform of federalism

The institutional framework conditions represent one factor which exerts considerable influence over the economic dynamic of a national economy. They form the specific constellation in which private economic activity takes place and (fiscal) policy can perform. In connection with the discussion of the “quality of public finances”, the ECOFIN Council at its meeting in January 2006 underlined that the institutional framework and the national fiscal rules are crucial, with regard to the solidity of public finances in particular. The institutional framework for policy in Germany is characterised above all by federalism. Despite the fact that the federal structure played a key role in the economic success of Germany over recent decades, reform in certain areas is long overdue.

Specific steps towards the reform of federalism were agreed in the Coalition Agreement. These are based on the proposals of the Constitutional Commission to Modernise the Federal System (*Verfassungskommission zur Modernisierung der bundesstaatlichen Ordnung*) appointed jointly by the Bundestag and the Bundesrat. Work has already begun on drafting the legislation necessary. It is hoped that the reform package can be adopted in mid-2006.

The agreed reform should reduce the overlap of Federation and Länder, and hence make the allocation of responsibilities between these two more transparent. To this end, it is envisaged that the legislative competence of the Federation be strengthened in areas of supra-regional importance while those of the Länder be strengthened in legislative areas of a regional nature. Further envisaged is the abolishment of framework legislating, a reduction in the number of laws requiring mutual consensus, and the dismantling of joint financing arrangements. Other important reform measures are the improvement in tax administration efficiency and a regional autonomy for the Länder in setting rates for real property transfer tax. The responsibility of the Federation and the Länder for financial obligations of the Federal Republic of Germany arising from breaches of Community or international law under the respective jurisdictions of the Federation and the Länder shall be clarified in the constitution.

The Federal Government has also made significant progress with regard to the domestic implementation of the provisions of the European Stability and Growth Pact. As part of the reform of federalism, Federation and Länder are to share the burden of any possible sanction payments. The Federation would bear 65 per cent of the costs, the Länder 35 per cent. 35 per cent of the Länder share would be borne in solidarity by all the Länder according to their population, the remaining 65 per cent by the Länder which have caused the burden, with individual shares based on the respective Land's part in inducing the burden. A corresponding provision shall be entered into the constitution. This greatly increase the incentive to adhere to the European provision across all levels of government, as all public budgets in future will have a vested interest in preventing sanction payments.

3.3 German fiscal policy in the European context

The basis for the monitoring of budgetary policy and the decisions taken during the course of the current deficit procedure is provided on the one hand by the relevant provisions of the Treaty of Maastricht, and on the other hand by the Stability and Growth Pact revised last year. The federal government expressly welcomes the new provisions, as they allow for appropriate fiscal policy in the European Monetary Union based on comprehensive economic analysis of the individual situation in the respective Member States. The central benchmark for the application of the Stability and Growth Pact – in particular with regard to the discretionary judgement provided for therein - is the question of whether a Member State pursues a correct fiscal and economic policy geared towards the sustainable consolidation of public budgets.

The point of reference for any analysis of the implementation of effective consolidation measures within the context of the deficit procedure against Germany is given by the fiscal policy package of measures set out in the Stability Programme of 2004. The German government has completely implemented these measures. In 2005, the structural deficit was reduced by ½ a percentage point of GDP.

The package of measures planned by the Federal Government will ensure that the deficit reference value in the Maastricht Treaty will not be exceeded in 2007. In addition, one of the central objectives of the Federal Government is the long-term structural consolidation of the public budgets, combined with an improvement in the quality of public spending. In order to reach this goal, further structural reforms on the labour market and in the social insurance systems are planned. The Federal Government presented its package of carefully-coordinated measures drawn up against this background in its National Reform Programme (NRP) (more detail of which can be found in Section 5). At the same time, the package of measures is compatible with the general fiscal policy recommendations of the "Broad Economic Policy Guidelines" for 2005 to 2008.

In order not to threaten economic momentum in 2006, no consolidation measures additional to those contained in the agreed package are planned for the current year. Nevertheless, the possibility cannot be excluded – for instance, where economic development is more favourable than expected – that the reference value is already adhered to or even undercut in 2006 (see sensitivity analysis on page 22).

4. Development of the public budgets

4.1 Package of measures 2006 to 2009

The effects of the Federal Government's measures of fiscal relevance have been set out in 3.1 above. The effect of these measures on the forecasted development of public budgets as defined in the National Accounts (ESA 95) is made clear in Table 2.

- Viewed in isolation, the measures will slightly increase the deficit over the current year. However, this merely represents a reinforcement of the restrictive line already laid down in the public budgets as a result of measures of previous years.
- In 2007, the effects of the measures on the revenue and expenditure side are generally balanced. Roughly one half of the additional tax revenues will be offset by shortfalls in revenue from social contributions. On the expenditure side, in particular the planned cuts regarding the basic allowance for jobseekers and the abolishment of the owner-occupied homes premium lead to savings. Overall, the measures agreed by the grand coalition will serve to reduce the deficit ratio by approximately 1 % of GDP.
- The consolidation effects of the entire package will increase towards the end of the programme period, in particular due to the expiration of measures to support growth, the growing effect of the measures to reduce tax privileges, and the full potency being felt of the structural changes to how the social security systems are financed.

4.2 Development of net borrowing/lending

The following forecast of the development of general government deficit is based on:

- the publication of 22 February 2006 of the Federal Statistical Office on government revenue and expenditure,
- the 2005 outturn for tax revenue from Federation and Länder of 13 January 2006,
- the stand at closing on 13 January 2006 of the federal budget, and
- an estimation of revenue from local taxes for 2005.

Table 2: Isolated view of the fiscal effects of the coalition agreements in Genshagen (definitions according to ESA 95)

	2006	2007	2008	2009
	% of GDP			
Revenue	-0.1	0.5	0.6	0.7
Taxes	-0.1	1.0	1.2	1.3
Social contributions	0.0	-0.6	-0.6	-0.6
Expenditure	0.1	-0.4	-0.5	-0.5
Social transfers	0.0	-0.2	-0.2	-0.2
Capital transfers	0.0	-0.1	-0.1	-0.1
Government consumption	0.0	-0.2	-0.3	-0.3
Gross investment	0.0	0.0	0.0	0.0
Overall impact on deficit **%** of GDP (- =deficit increase, + = deficit reduction)	-0.1	0.9	1.1	1.3

Differences through rounding.

The development in the general government deficit is largely influenced by the assumptions set out above, including the economic development and the effects of the Coalition's package of measures. By itself, the package of measures of the coalition agreements would have led to an increase in the structural deficit. In addition to the isolated view of the effects of the measures, it must be taken into account when looking at the overall effect of fiscal policy that a restrictive course is being followed in the public budgets as a result of the packages of measures of previous years and a restrictive calculation with regard to the 2006 federal budget. For instance, a further reduction in net borrowing to roughly €38 billion was implemented in preparing the 2006 federal budget. Hence, the overall effect of fiscal policy in the years 2006 to 2009 is as follows:

	2006	2007	2008	2009
Overall fiscal effect of fiscal policy Change in structural deficit, as percentage point of GDP (+= reduction, - = increase in structural deficit)	0	1	½	½

As a result of the fiscal policy conception, the government deficit will remain in the current year at last year's level. Although clear relief will be afforded by the economic recovery and a continued restrictive spending policy, revenue still rises at a proportionately much lower rate than nominal GDP. One reason for this is that revenue in 2005 was inflated by 0.1% of GDP as a result of one-off repayments by the *Landesbanken* (state banks). In addition, the rate at which social insurance contributions grows is proportionately well below that of nominal GDP. Hence, despite the assumed restrictive development in spending, on balance there is hardly any reduction of the deficit ratio.

From 2007 on, the development of the deficit ratio will be determined in particular by the Federal Government's package of measures. Added to this is the continued restrictive basic line on the expenditure side as a result of the structural consolidation measures of previous years. Taken together, this means a reduction in the deficit ratio to -2 ½ % of GDP. The deficit ratio will continue to fall by half a percentage point annually in the following years. However, given the unfavourable starting point, it will not be possible to reach the objective of a balanced government budget by the end of the planning period.

Table 3: Development of the deficit

	2005	2006	2007	2008	2009
Deficit ratio(1)	- in % of GDP -				
Forecast February 2006	**-3,3**	**-3,3**	**-2 ½**	**-2**	**- 1 ½**
Forecast December 2004	-3	-2 ½	-2	- 1 ½	-

(1) In view of the uncertainty inherent on every forecast, close-to-current deficits are rounded by a half a percentage point in 2007-2009.

Net borrowing/lending at the levels of government

The deficit of the federal budget (central government) in the National Accounts definition will be roughly -2¼ % of GDP in 2006. On the one hand there will be rising tax revenues and additional savings in personnel expenditure, on the other hand there are additional burdens, in particular from the increase in GNI own resources to finance the expenditure of the European Union (roughly €1 ½ billion), as well as additional spending on measures to encourage labour market entry arising from the labour market reform (roughly €3 billion).

The Federation can then profit in 2007 from the improved revenue base and reduce its deficit in comparison with the previous year by some €15 ½ billion or ¾ percentage points of GDP. Here, improved revenue will be accompanied by additional consolidation measures on the expenditure side. As a result, both intermediate consumption and social transfers other than in kind can be reduced considerably. The deficit ratio of central government will fall to -1½ % of GDP and by the end of the programme period to approximately 1% of GDP.

The deficit of the state and local government will amount to roughly -1% of GDP in 2006. Local government will be afforded some relief via increased revenue from trade tax and the state government will also profit from the growing tax revenue dynamic. However, the positive trend in state government revenue will not yet be able to reduce the deficit ratio in 2006, since the deficit ratio in 2005 was roughly 0.1% of GDP more favourable than, expected due to a one-off effect (subsidy repayments by the *Landesbanken*). Only from 2007 will the low increase in spending coupled with the measures towards the structural improvement of the revenue side lead to a clear reduction in the deficit. At the end of the programming period, the deficit ratio of the state and local government will be a mere -½ % of GDP.

Table 4: Financial balances according to level

	2005	2006	2007	2008	2009
	- in % of GDP -				
Central government incl. special funds	-2.2	-2,1	-1 ½	-1	-1
State and local government	-1.0	-0,9	-½	-½	-½
Social security funds	-0.1	-0,3	-¼	0	0
General government(1)	-3.3	-3,3	-2 ½	-2	-1 ½

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

<u>The development of the social security funds deficit</u> will initially be marked in the current year by the cash effects of changing the deadlines for paying social contributions. As this measure only affects net borrowing/lending in cash terms, the current social security deficit of approximately -¼ % of GDP shall remain this year. From 2007, the development in social insurance funds must be viewed against the background of extensive changes to how the social security systems are financed:

- Contributions to statutory pension insurance will be raised by 0.4 contribution points (roughly 0.1% of GDP).
- Contributions to unemployment insurance will be lowered by 2 contribution points (roughly 0.6% of GDP).
- One percentage point from the planned VAT increase (roughly 0.3% of GDP) will be shifted to unemployment insurance.
- Federal transfers to statutory health insurance will be progressively reduced. The revenue shortfall of 0.1% of GDP in 2007 and 0.2% of GDP in the years thereafter will be compensated for by way of the health reforms planned for the summer.

Together with the overall economic recovery, the measures lead to a structural stabilisation of the development of social insurance, so that the net borrowing/lending will be balanced by the end of the programming period.

Table 5: Development of the general government expenditure

	2005	2006	2007	2008	2009
	- in % of GDP -				
Forecast February 2006	**46.7**	**46**	**45**	**44**	**43 ½**
Forecast December 2004	46	45 ½	44 ½	43 ½	

4.3 Development of expenditure and revenue

Consolidation course on expenditure side remains restrictive

Trends in spending have remained extremely restrictive in Germany since economic stagnation began in 2000. Overall government spending rose on yearly average by a mere +1.1% p.a. from 2000 to 2005. The rate of growth was thus below the average growth of nominal GDP of +1.5% p.a. Worth particular mention in this regard is the fact that, as a result of economic stagnation, the high rise in spending on social benefits was compensated by restrictive counter-measures in other spending categories. Of further help were also the savings which could be made as a result of the low interest levels on debt service payments.

The policy of restrictive spending has resulted in a continual decline of the general government expenditure ratio, which is now at its lowest level since German reunification. This trend will also continue over the forecast period. The government expenditure ratio will sink by roughly ½ a percentage point in the current year. The share of spending in GDP will be reduced by ¾ of a percentage point of GDP each year until the end of the programme period. The planned social benefit cuts represent an essential factor in this context. These have an important role to play in consolidating public finances. The medium-term consolidation objectives set out here cannot be reached without reducing the social benefit ratio.

Revenue trends

In addition to increased social expenditure, the proportionately lower growth of government revenue when compared to GDP represents the core problem in public budget trends in Germany. In the past, consolidation success on the expenditure side was repeatedly overshadowed by slumps on the revenue side. At 21.9%, the tax ratio has fallen to a historically low level in 2005.

Table 6: Development of tax, social contribution, and tax and fiscal charges

	2005	2006	2007	2008	2009
	- in % of GDP -				
Taxes	**21.9**	**22**	**22 ½**	**22 ½**	**22 ½**
Social contributions	**17.7**	**17 ½**	**16 ½**	**16 ½**	**16**
Tax and fiscal charges(1)					
Forecast February 2006	**39.5**	**39**	**39 ½**	**39**	**39**
Forecast December 2004	39 ½	39 ½	39 ½	39	

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

The planned tax measures in 2007 will, on the one hand, lead to a marked structural improvement in the tax base and, on the other hand, will shift the revenue structure from social insurance contributions to tax revenues. The overall fiscal burden will increase slightly in the following years, but the level will not rise significantly in comparison with the previous year. As a result of a proportionately lower increase in social contributions compared to GDP development, the tax and fiscal charges ratio will then decline slightly until the end of the programme period.

4.4 Development of the structural deficit - adjustment path with regard to the medium-term budget objective

The medium-term budget objective within the meaning of the reformed Stability and Growth Pact pursues the goal of a structurally-balanced government budget in Germany[1]. Thus, deficits should only be caused by cyclical factors and be compensated for by surpluses during an economic cycle. On the way to achieving a balanced government budget, the structural deficit is to be reduced by an average of one half of a percentage point each year.

In 2005, it was possible to reduce the structural deficit by roughly one half of a percentage point. It must be noted in the calculation that the imputed steps towards reduction of the structural deficit must be corrected by the effects of the deviations to the forecast in relation to the trend GDP and the GDP deflator.

For the current year, the consolidation policy put forward here seeks, in the interests of managing the economic cycle, to pursue a balanced strategy. Hence the structural deficit in

[1] See article 2a of Council Regulation (EC) No 1466/97 of 7 July 1997, as amended by Council Regulation (EC) No 1055/2005 of 27 June 2005.

the current year will remain at the pre-year level. The structural consolidation measures will be concentrated on 2007, leading to a decline in this year in the structural deficit ratio of roughly one percentage point. In this connection, it should be noted that the reduction of the structural deficit is not the result of the measures of the coalition agreements alone. Even without these measures, the restrictive spending policy resulting from measures of previous years was constructed with a reduction of the structural deficit in mind.

Table 7: Development of structural borrowing/lending

	2005	2006	2007	2008	2009
Real GDP growth	0.9	1½	1	1¾	1¾
General government net borrowing/lending - in % of GDP -	-3.3	-3.3	-2 ½	-2	-1 ½
Cyclically-adjusted net borrowing/lending - in % of GDP-	-3.0	-3	-2	-1 ½	-1
One-off measures- in % of GDP -	-0.1	-	-	-	-
Structural net borrowing/lending - in % of GDP-	**-3.1**	**-3**	**-2**	**-1 ½**	**-1**

4.5 Development of the level of debt

In comparison with the previous update, the level of borrowing has developed less favourably than anticipated. The inclusion of the so-called *Platzhaltergeschäfte* (holding arrangements) and the sectoral reclassification of the postal officials' pension fund also helped increase general government debt. These effects combined raise the level of debt in 2005 to 67½ %. This is 1 ½ percentage points higher than expected in December 2004.

It will not be possible to stabilise the level of debt in 2006. Under the given assumptions, the level of debt will rise to 69% in 2006. As a result of further consolidation, the level of debt can be reduced to 67% of GDP by the end of the programme period.

Table 8: Development of the debt ratio

	2005	2006	2007	2008	2009
Debt ratio	- in % of GDP -				
Forecast February 2006	**67 ½**	**69**	**68 ½**	**68**	**67**
Forecast December 2004	66	66	65 ½	65	

4.6 Sensitivity of the deficit forecasts

The sensitivity analysis presents the developments which occur if there are deviations to the macroeconomic assumptions. Changes in the growth of nominal GDP of ½ a percentage point per year compared with the base forecast are considered.

The sensitivity analysis shows that a positive growth deviation of roughly ½ a percentage point could lead to the deficit ratio being reduced to the reference value of the Maastricht Treaty in the current year. Given that the forecast underlying the programme is at the lower bound of the forecast spectrum, this scenario is certainly within the scope of possibility. On the other hand, a macroeconomic development resulting from a growth rate of ½ a percentage point below the growth path underlying this forecast in 2006 would call into question the possibility of remaining below the reference value without implementing further measures.

Table 9: Sensitivity of the deficit forecasts

	2005	2006	2007	2008	2009
Deficit ration	- in % of GDP -				
Forecast February 2006	**-3.3**	**-3.3**	**-2 ½**	**-2**	**-1 ½**
Forecast February 2006					
• assuming lower increase in nominal GDP from 2006 to 2009 (- ½ a percentage point)		-3 ½	-3	-2 ½	-2 ½
• assuming higher increase in nominal GDP from 2006 to 2009 (+½ a percentage point)		-3	-2	-1	-½

(1) In view of the uncertainty inherent on every forecast, close-to-current deficits are rounded by a half a percentage point.

5. The long-term sustainability of public finances

5.1 Shaping a response to the demographic challenge

One of the central objectives of the Federal Government is to ensure the long-term sustainability of public finances. The challenge for policy-makers is formidable – enduring low birth rates and continued increases in life expectancy will lead to severe changes in the composition of the population over the coming decades. This applies both to Germany and most of the other Member States of the EU.

Whereas today, for every 100 people of working age there are not even 30 inhabitants aged 65 or over, by 2050 this figure could be more than 50. According to calculations by the Federal Statistical Office, this trend would continue to apply even if the total population of Germany were not to reduce significantly in the coming years. The general view of the anticipated demographic change is confirmed by the latest agreed population forecasts at Community level.[2]

There is hardly any area of society that will remain unaffected by such massive changes in the population structure. This is also true for the public budgets. Last year, the Federal Ministry of Finance submitted its first comprehensive "Report on the sustainability of public finances".[3] This report not only contains the anticipated fiscal consequences of population aging under (otherwise) unchanged conditions and the progress made to date with regard to the sustainability of public finances, it also shapes possible approaches for policy to counter these effects. The results of the model calculations show that sustainability gaps still existing can be closed by policy measures.

With this report, which the Federal Ministry of Finance will now submit once every legislature period, the Federal Government is expanding the range of tools which have long been available in Germany to monitor long-term trends in important spending areas.

The FMF's sustainability report makes clear that the reforms provided for by Agenda 2010 allowed a first, substantial step to be taken towards reducing the sustainability gap. Nevertheless, there is still a need for action. Policy-makers have to use additional measures to meet the challenges. To this end, an overall strategy which combines measures in particular in the areas of fiscal, economic and social policy is necessary.

Essentially, all reforms must aim at making the social security systems resilient to demographic change and allowing future growth and employment possibilities to develop their full potential. Higher growth and lower unemployment play a crucial role in reducing government debt and in placing the social security systems on a firm financial footing.

[2] The results are shown in rows 12 to 14 of Table 10 on page 25.
[3] The report may be accessed in German and English on the website of the Federal Ministry of Finance (www.bundesfinanzministerium.de).

5.2 Updated long-term model calculations at Community level

As part of the work conducted in the Economic Policy Committee (EPC) of the EU, the Federal Ministry of Finance is involved in preparing new long-term calculations for the Member States of the EU. Results already exist for some crucial budget components, especially with regard to spending on old-age provisions (see Table 10, rows 1-5). It is likely that, in the areas particularly influenced by ageing populations, spending will rise in the long-term relative to gross domestic product.

In comparison to earlier calculations at the Community level in which the effects of reforms implemented in Germany (such as the introduction of the sustainability factor in calculating pensions) and the changes in the patterns of behaviour already observed (such as the increased labour market participation of older workers) were not taken into account, the rise is now significantly lower. In the case of the biggest spending blocks, health and old-age security, the burden increase expected fell from more than 6 percentage points originally to approximately 3 percentage points now. The attempts to project the costs for old-age care using methods which can be compared community-wide are currently still proving problematic. Therefore, they are not yet contained in the following overview.

At any rate, the informative value of apparently precise figures given by model calculations which extend over a period of 50 years should not be overestimated. Uncertainties in determining the assumptions (see Table 10, rows 6 to 14) and the need to simplify complex relationships mean that the results can present above all from a qualitative perspective, i.e. in relation to the general direction of effects - a correct and clear picture.

Repercussions of projected changes in public expenditure and revenue on economic development are generally not taken into account in the calculations. This also applies in this case to expenditure on education. The possible effects of an increase in the level of participation in education and the related positive effects on productivity development, and thus growth, were ignored for the time being. The results of the calculations to date alone, therefore, do not constitute the complete picture, neither in this context nor with regard to the other spending categories.

In addition, the Community-wide coordinated calculations assume that the structural unemployment ratio will remain at a relatively high level over the long-term. Under the assumptions as developed for example by the so-called Rürup Commission on the basis of estimates by leading population and economic research institutions for projections at the national level, the number of unemployed would register a significantly more marked decline over the long-run.

In this case, not only could lower transfers and lesser pressure on the public budgets be expected, overall economic growth would also be more promising as a result of the subsequent higher employment. The Federal Government is convinced that it will be possible to further reduce structural unemployment in Germany on a long-term basis. It is already working towards this today with corresponding measures.

Table 10: Government expenditure from a long-term perspective: Results of model calculations at the Community level

	2004	2010	2020	2030	2040	2050
Expenditure as % of GDP						
Expenditure on old-age security [(1)]	11,4	10,5	11,0	12,3	12,8	13,1
p.m: Contribution revenue[(2)]	7,7	7,3	7,3	8,3	8,7	8,9
Healthcare expenditure [(3)]	6,0	6,3	6,7	7,0	7,2	7,3
Expenditure on education [(4)]	4,0	3,6	3,3	3,3	3,3	3,3
Unemployment insurance [(5)]	1,3	1,1	0,9	0,9	0,9	0,9
Assumptions						
Productivity gain (p.a.)	1,1	0,8	1,5	1,8	1,7	1,7
GDP growth (p.a.)	1,5	1,8	1,8	1,0	1,1	1,2
Labour force participation	73,0	77,4	79,1	78,6	79,5	79,0
Men (15 to 64)	79,8	83,3	85,1	84,5	85,2	85,0
Women (15 to 64)	66,0	71,3	72,9	72,5	73,6	72,9
Unemployment ratio[(6)]	9,5	8,5	7,0	7,0	7,0	7,0
Elderly dependency ratio[(7)]	26,8	30,7	34,2	44,0	51,0	51,7
Total population (m.)	82,5	83,1	83,5	82,7	80,7	77,7
Population 65+ (m.)	14,9	16,9	18,5	22,0	23,9	23,3

Results of model calculations for the Economic Policy Committee of the EU (WG Ageing). Included in the reference scenario were all measures implemented to March 2005; in the case of employment it was assumed that the structural unemployment ratio converges towards the current EU 15 average. Figures relating to productivity gain and GDP growth are based on the respective preceding 10-year period, for 2010 on the period 2004 to 2010.

(1) Statutory pensions insurance and public-service officials’ pensions
(2) Statutory pensions insurance
(3) Statutory health insurance (acute health care).
(4) Excluding education expenditure by the Bundesanstalt für Arbeit.
(5) Substitute wage payments.
(6) Harmonised definition.
(7) Population 65+ relative to population 15-64.

5.3 Structural reform in the area of social insurance systems

Structural reforms on the labour market and in the social security systems represent an important element in the fiscal policy strategy to ensure the sustainability of public finances. The Federal Government has also presented its package of carefully-coordinated fiscal, economic and structural policy measures in its National Reform Programme (NRP). With this Programme, the Federal Government is concentrating on two central problem areas which arise with respect to growth and employment from the conditions imposed by globalisation and the changing age-structure of society. In doing so, it makes a significant contribution towards revitalizing the Lisbon Strategy.

a) Labour market and employment policy

In recent years, the focus of labour market reform was on the so-called Hartz laws, in which numerous measures were implemented, such as the merging of unemployment assistance and social assistance, the promotion of start-ups, and the possibilities of better integrating the unemployed from problem groups (long-term unemployed, low-skilled, young and old employees). These measures are currently being evaluated. The findings of the evaluation will be fed into newly designed labour market policies in the future.

The Federal Government is acutely aware of the high rates of unemployment among the older generations and those less qualified. With its "50 plus Initiative", the government has a range of measures at its disposal which can help it to tap the employment potential of this group more effectively. In order to improve the labour market opportunities for those less qualified, existing programmes and measures relating to wage supplements are to be bundled and combined into a successful support package.

In addition, the Federal Government will further develop protection against dismissal. Both employers and employees are to be given the opportunity to agree, upon commencement of employment, on a waiting period of up to two years before making the position permanent, instead of the statutory standard waiting period of six months. During this period, the employer may terminate the contract without having to provide the reasons otherwise demanded. At the same time, the possibility of restricting employment contracts without substantive reason to two years is to be abolished, thus sending a clear signal for more unrestricted recruitment.

b) Structural reform in the social security systems

In order to provide relief to the factor labour, the Federal Government plans to permanently reduce contributions to social insurance to under 40% of the portion of gross wage subject to contributions. To this end, the contribution to unemployment insurance will fall as of 1 January 2007 from 6.5% to 4.5%. At the same time, the contribution to statutory health insurance will increase from 19.5% to 19.9%. Comprehensive, future-oriented concepts are being developed with regard to health and long-term care insurance. This includes designing the system of statutory health insurance more competitively, and thus more efficiently, in order to keep the contribution rates stable and, where possible, to even reduce them.

In addition to the measures already introduced, a gradual increase in the legal retirement age for old-age pensions is intended to ensure the long-term financial stabilisation of the statutory pension insurance schemes. Beginning in 2012, the legal retirement age is to be increased to 67 on a gradual basis by 2029. In addition, attenuations in pension adjustments which were not realised in the past are only to be postponed, but not omitted indefinitely.. The Federal Government is focused on adhering to contribution rate stability as well as the legally-prescribed framework for developments in contribution rates, the legally-prescribed pension level and the objective of the statutory social security level. The trend of ever-rising transfers from the federal budget to the statutory pension insurance schemes will be stopped. It is also the goal of the Federal Government to secure in the long-run the pension scheme for civil servants. Thus, the measures taken with regard to statutory pension insurance are to be extended to the retirement scheme for civil servants in such a way as to obtain the same effect whilst respecting the systemic differences.

A broad range of instruments comprising tax elements and allowances are available to promote occupational and private pension schemes. It is planned to assess in 2007 the degree to which occupational and private pension provisions have been taken up, and how this might further develop.

Appendix

Table 11: Development of public finances[1]

(National Accounts definitions)

	ESA code	2005	2005	2006	2007	2008	2009
		Level	% of GDP				
Net lending (B.9) by sub-sector							
General government	S.13	-74,5	-3,3	-3,3	-2,3	-1,8	-1,3
Central government	S.1311	-49,6	-2,2	-2,1	-1,5	-1,2	-1,0
State and local government		-21,5	-1,0	-0,9	-0,5	-0,4	-0,3
Social security funds	S.1314	-3,4	-0,1	-0,3	-0,3	-0,1	0,0
General government							
Total revenue	TR	974,8	43,4	43	43	42 1/2	42
Total expenditure	TE 18	1049,3	46,7	46	45	44	43 1/2
Net lending/borrowing	EDP B.9	-74,5	-3,3	-3,3	-2 1/2	-2	-1 1/2
Interest expenditure (incl. FISIM)	EDP D.41 inkl. FISIM	65,3	2,9	3	3	3	3
pm: FISIM		1,9	0,1	0	0	0	0
Primary balance		-11,1	-0,5	- 1/2	1/2	1	1 1/2
Selected components of revenue							
Total taxes		491,1	21,9	21,8	22,7	22,7	22,7
Social contributions	D.61	397,0	17,7	17,4	16,6	16,4	16,2
Other		86,7	3,9	3,7	3,4	3,4	3,3
Total revenue	TR	974,8	43,4	42,9	42,8	42,5	42,2
p.m.: Tax burden			39,5	39,2	39,3	39,1	38,9
Selected components of expenditure							
Intermediate Consumption Social transfers in kind Compensation of employees Other taxes on production	P.2 D.63 D.1 D.29	429,2	19,1	19	18 1/2	18	18
Social transfers other than in kind	D.62	430,6	19,2	19	18	17 1/2	17 1/2
interest expenditure (incl. FISIM)	EDP D.41 inkl. FISIM	65,3	2,9	3	3	3	3
Subisidies	D.3	27,2	1,2	1 1/2	1 1/2	1	1
Gross fixed capital formation	P.51	29,2	1,3	1 1/2	1 1/2	1 1/2	1 1/2
Other expenditures		67,8	3,0	3	3	3	2 1/2
Total expenditure	TE 21	1049,3	46,7	46	45	44	43 1/2
p.m.: Government final consumption	P.32	417,2	18,6	18 1/2	18	18	17 1/2

(1) Discrepancies in the totals are the result of rounding

Table 12: Development of general government debt (Maastricht definition)

	ESA code	2005	2006	2007	2008	2009
		% of GDP				
Gross debt		**67 1/2**	**69**	**68 1/2**	**68**	**67**
Change in gross debt ratio		1,8	1 1/2	- 1/2	- 1/2	-1
Contribution to changes in gross debt						
Primary balance		-0,5	- 1/2	1/2	1	1 1/2
Interest expenditure (incl. FISIM)		2,9	3	3	3	3

Table 13: Comparison of projections in the February 2006 stability programme and the December 2004 stability programme

	ESA code	2005	2006	2007	2008	2009
Nominal GDP growth (%)						
Current update		1,3	2 1/4	2 1/2	2 1/2	2 1/2
Previous update		2 1/2	3	3 1/2	3 1/2	
Difference		-1	-1	-1	-1	
General government net lending (% of GDP)	EDP.9					
Current update		-3,3	-3,3	-2 1/2	-2	-1 1/2
Previous update		-3	-2 1/2	-2	-1 1/2	
Difference		- 1/2	- 3/4	- 1/2	- 1/2	
General government gross debt (% of GDP)						
Current update		67 1/2	69	68 1/2	68	67
Previous update		66	66	65 1/2	65	
Difference		1 1/2	3	3	3	