Federal Ministry
of Finance

Fiscal and Economic Policy

German Stability Programme

December 2007 Update

German

Stability Programme

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Foreword

In accordance with the provisions of the Stability and Growth Pact – Council Regulation (EC) no. 1466/97 dated 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, as amended by Council Regulation no. 1055/2005 dated 27 June 2005 – the Member States that have adopted the euro are obliged to submit updated Stability Programmes each year to the ECOFIN Council.

This update of the German Stability Programme was approved by the German Cabinet on 5 December 2007.

Each update of the German Stability Programme and the corresponding recommendation for a statement by the Council on the updated German Stability Programme are submitted by the federal government to the German Bundestag and discussed there in the competent committees of experts.

The Programme follows the format and content guidelines specified in the Code of Conduct on the form and contents of stability and convergence programmes dated September 2005.

The Federal Ministry of Finance also publishes the updated Stability Programme on the internet at:

www.bundesfinanzministerium.de

1 Summary

- In order to ensure the long-term sustainability of the public budgets, growth and consolidation must both be permanently achieved to an equal extent. The federal government therefore continues to pursue a two-pronged strategy in fiscal and economic policy which is geared to the structural consolidation of the public budgets and the social security systems and to improving the overall conditions that impact on growth and employment.
- It is essential that not only quantitative consolidation, but also improving the quality of public finances is recognised as one of the key tasks of fiscal policy. Improving the quality of public finances requires in particular raising efficiency in all areas of government expenditure. Furthermore, institutional frameworks and rules are necessary to support the long-term sustainability and short-term stabilisation function of the public budgets. For this reason, reforming the constitutional rules that limit government deficits is an important objective for the federal government.
- By reducing the general government deficit to 1.6% of GDP in 2006, Germany succeeded in correcting its excessive deficit a year ahead of the deadline set by the ECOFIN Council in March 2006. The excessive deficit procedure concerning Germany was closed in June 2007. Germany's budget will already be balanced this year – for the first time since 1989. As from 2010, the level of debt will be below the 60% mark, that so Germany will also meet the Maastricht Treaty's second important criterion.
- Both cyclical and structural factors are responsible for Germany's successful consolidation. The structural deficit was reduced by a total of approximately 2 percentage points in 2006 and 2007. This means that the general government budget will almost be balanced in structural terms, too, in 2007. The marked reduction in the structural deficit primarily reflects the consolidation measures adopted by the federal government and the continuation of the previously established restrictive expenditure line.
- Germany's medium-term objective is to observe a structurally balanced budget. This aim will be reached during the 2007-2011 programme period. In their orientations adopted in April 2007, the eurozone finance ministers committed themselves to aim at achieving their medium-term objectives by 2010 at the latest. By implementing this agreement, Germany is also sending an important signal that strengthens the reformed Stability and Growth Pact.
- The successful structural consolidation of the public budgets must not be interpreted as signalling the end of the policy of consolidation. The Federation still has a considerable deficit. Only if the consolidation line laid down in current financial planning is resolutely continued will the Federation also achieve a balanced budget in 2011.

2 Fiscal policy in Germany: quality and sustainability of public finances

The key task of fiscal policy in Germany is the sustainable consolidation of the public budgets. Only sound public finances can give the state the room for manoeuvre it needs – also for coming generations. At the same time they are a necessary prerequisite for conditions that favour long-term growth. Conversely, it is also true that an appropriate level of economic growth and rising employment create the best preconditions for healthy and sustainable public finances – as has been clearly shown by the experience of the last few years in Germany.

The federal government's financial and economic policy is therefore geared equally to the structural consolidation of the public budgets and the social security systems and to improving the overall economic climate affecting growth and employment. The positive development of the last two years confirms the successful interaction between consolidation and growth.

In order to ensure the long-term sustainability of the public budgets, both objectives – growth and consolidation – must be achieved equally and lastingly. Action on fiscal policy must therefore focus not only on quantitative consolidation but also on the need to improve the quality of public finances.

2.1 The quality of public finances

Only if public expenditure and revenue are geared towards the sustainable promotion of growth will it be possible to achieve a permanently higher rate of growth. Quantitative and qualitative consolidation are not contradictory elements in this context; rather, they are mutually complementary. The continuation of structural consolidation and further structural reforms must create the necessary scope for focusing increasingly on future-oriented areas.

Improving the quality of public finances must not, however, be reduced to simply switching government expenditure to tasks that are relevant to growth. Not only must the revenue side of public budgets, too, be geared towards promoting growth and jobs, it is also necessary in particular to improve the efficiency of all areas of government expenditure. The task of fiscal policy is not least to establish mechanisms and structures that make it possible to check the effectiveness and efficiency of the use of public funds. Overall institutional conditions and rules also have a major impact when it comes to permanently establishing the long-term orientation and stabilisation function of public budgets. The ECOFIN Council has emphasised the important role of national institutions and budgetary rules several times, particularly with a view to budget consolidation and avoiding pro-cyclical fiscal policy.[1] In this context, the reform of the constitutional rules limiting government debt is one of the federal government's key objectives in the federalism reform.

Further improving the overall conditions for growth and employment

The federal government is continuing its two-pronged strategy on fiscal policy with the 2008 federal budget and financial planning for the period from now until 2011. In addition to continuing the €25 billion growth-promoting *Impulsprogramm* adopted at the beginning of the legislative period, further priorities are being set in future-oriented policy areas in the financial planning period with a further allocation of almost €10 billion. The focus here is on expenditure in the fields of research and education, internal and external security, and development aid. A supplementary budget for 2007 prepared the way for the Federation to provide a total of €2.15 billion in financial aid from next year for investment by the Länder and local authorities in developing the infrastructure for child care by means of a special fund for the "Expansion of Child Care". As from 2009, the Federation will also share part of the cost of running these additional child-care facilities via a change in the proportion by which value-added tax is distributed between the Federation and the Länder. These are further steps towards improving the work-life balance, following on from the improved tax deductability of child-care costs since 2006 and the introduction of an income-dependent parental allowance in 2007.

As early as the beginning of this year, the overall rate of contribution to social insurance – which is financed in equal parts by employers and employees – was cut by 1.3 percentage points to 39.7%, i.e. below the 40% target set by the federal government. The contribution rate to unemployment insurance will be cut by another 0.9 percentage points to 3.3% on 1 January 2008. Despite the increase of 0.25 percentage points in the contribution rate to public long-term care insurance planned for 1 July 2008, there will thus be a further marked reduction in non-wage labour costs in 2008.

The reform of business taxation, which comes into force on 1 January 2008, strengthens the basis for economic growth and employment and makes Germany more attractive as a business location. The reform improves the tax treatment of equity capital formation by German companies and counteracts the transfer of profits generated in Germany – and hence tax payments – to other countries. The changes in regulations will stabilise the state's revenue base, particularly in the local authorities. The coordinated adjustment of the company tax rates leads to virtual tax neutrality between different legal forms of companies in Germany. The Act's main measures are as follows:

[1] Conclusions of the ECOFIN Council dated 10 October 2006 and 27 September 2007

- The rate of corporation tax is being reduced from currently 25% to 15%. Since the trade-tax base rate is being cut from 5% to 3.5% and the deductibility of trade tax as a business expense is being abolished at the same time, the total tax burden cost is now 29.83% (including the solidarity surcharge), assuming a municipal trade-tax multiplier of 400%.
- Partnerships that prepare balance sheets can pay tax on undistributed profits at an overall rate of 29.8% (including the solidarity surcharge) – in line with the low tax burden of corporations – by taking advantage of preferential treatment for retained income.
- For small and medium-sized enterprises, the provisions of section 7g of the Income Tax Act [EStG] (investment deduction) are being improved, among other things by an increase in the ceiling for business capital to €235,000, an increase in the maximum investment deduction to €200,000, and an extension of the investment period to 3 years.
- A newly introduced "interest barrier" makes taxation-motivated profit transfers abroad more difficult. The interest barrier limits deductible interest to 30% of income before interest paid, depreciation and amortisation are taken into account. Non-deductible interest paid can be carried forward for an unlimited period. In addition to a tax-free amount of €1 million, there is an exception clause for companies with a high level of external financing irrespective of tax motives.
- In the field of trade tax, the former compulsory addition of 50% of interest on permanent debt, which is susceptible to tax structuring, has been abolished. Instead, 25% of all interest and the financed proportions of rents, leases, leasing instalments and licenses are included in the calculation of trade earnings. A tax-free allowance of €100,000 provides relief primarily to small and medium-sized enterprises.

Furthermore, the Act introduces a (flat) 25% final withholding tax plus solidarity surcharge with an option on the assessment of private investment income and capital gains from 1 January 2009. At the same time, the tax-exemption of private capital gains, e.g. from shares outside the one-year holding period, is abolished. The change in the taxation of private income from capital following the introduction of the final withholding tax counteracts the tax-motivated transfer of capital abroad and achieves a modern and internationally competitive taxation of capital income.

The measures taken to reduce the burden on limited companies and partnerships, as well as the final withholding tax, have been designed to avoid putting undue pressure on the budget and take into account the need to consolidate the budgets of the Federation, Länder and local authorities. Overall, the full impact of the reform measures will result in shortfalls in revenue of approximately €5 billion per year.

The federal government intends to revise inheritance tax law with effect from 1 January 2009 in response to a ruling by the Federal Constitutional Court. The coalition parties have already decided key points on this. Inheritances within the immediate family, e.g. the bequeathing of owner-occupied residential property, are to remain largely tax-free as a result of high personal tax-free allowances. The Act also ensures that, when a company is passed on to a successor, the inheritance tax burden does not put the company's survival – and with it growth and jobs – at risk. The reform will not affect the revenue from inheritance tax that goes to the Länder.

Continuing with structural consolidation – improving the quality of the revenue side

In view of the structural gap that still exists in the federal budget in particular, and in order to permanently ensure the amount of room for manoeuvre required by an efficient state, it is absolutely essential that the medium- and long-term consolidation strategy is resolutely continued. A key element in the Federation's fiscal policy, therefore, remains the consolidation concept adopted by the federal government at the beginning of the legislative period, and its core measures which were introduced with the 2006 Budget Supplement Act *(Haushaltsbegleitgesetz)* and are now still having an effect. The most important measures on the expenditure side are those aimed at raising efficiency and effectiveness in implementing the basic income for job seekers and cutting costs in the public administration.

On the revenue side, the three-percentage-point increase in the general value-added tax rate on 1 January 2007 has led to a stabilisation. It has also helped to ease the pressure on the labour factor by financing a reduction in the rate of contribution to unemployment insurance. Shifting the tax burden from direct taxation and fiscal charges to indirect taxation – as practised over the last few years and already decided on for the coming year – are elements of a revenue structure that is both more conducive to growth and more competitive.

The cutback of subsidies[2] makes an essential contribution to the quantitative and qualitative consolidation of the federal budget. The Federation's subsidies will fall by approximately €2.0 billion to €21.5 billion between 2005 and 2008 – the reporting period of the federal government's current 21st subsidy report. The biggest contribution here will come from the abolition of tax expenditures. These will fall by 9% to €15.8 billion. The financial aids, which were already almost halved to €6.1 billion between 1998 and

[2] The remarks on the development of subsidies in chapter 2 relate to subsidies as defined in the federal government's subsidy report. Unlike the National Accounts definition, this also includes tax expenditures.

2005, will decline by another 7% to €5.7 billion by 2008. The financial plan provides for a further cut to €5 billion up to 2011.

Increasing the effectiveness and efficiency of government expenditure

One essential element of a quality-oriented fiscal policy must be a greater orientation towards results. Government expenditure and government tasks must be reviewed regularly, not only to ensure that they are necessary, but also to determine whether they are effective and provide value for money. The Federal Ministry of Finance is currently working on a reform of the Federation's budgetary and accounting system with the aim of improving expenditure efficiency. To this purpose, a project group was set up in October 2006 which has since examined the main proposals for reforming the budgetary and accounting system made in Germany and abroad and submitted proposals for a reform of the budgetary system. According to the knowledge gained in the first project phase up to July 2007, the most suitable reform model for the federal budget seems to be what is known as modern extended cash-based accounting system. This model can provide, at reasonable cost, an improved picture of the Federation's financial and asset position while maintaining a cash-based system by means of an all-inclusive cost accounting comprising a degree of detail that is modified to suit the individual requirements; it can also be combined with a results-oriented budgetary policy. The aims of this reform model are:

- to sustainably improve the recording of assets and the use of resources,
- to make it possible to gear budget control to results instead of to the employment of funds,
- to maintain the payment level as an important and original control variable,
- to introduce the top-down procedure in order to make budget preparation more efficient,
- to limit both the financial and the organisational cost of a new budgetary and accounting system to what is really necessary,
- to optimise the cost-benefit ratio of a system change in a federal budget marked predominantly by transfer expenditure.

The rough draft is currently being evaluated; a concrete concept for the reform of the federal budget will be developed by mid-2009.

The Federal Ministry of Finance has also taken measures to further improve the effectiveness and efficiency of state subsidies. In its policy on subsidies, the federal government follows guidelines that serve to create more transparency, more pressure to justify subsidies, and more ways of controlling them. By adopting these guidelines in

March 2006, the federal government also emphasised the importance of monitoring the success of subsidies. There is particular need for action in the case of tax expenditures. The financial volume of tax subsidies significantly exceeds that of financial aid, and they have hardly been evaluated up to now. The Federal Ministry of Finance has therefore commissioned an international consortium of independent economic research institutes to evaluate the financially most significant tax expenditures. This evaluation will cover more than 90% of the Federation's total volume of tax subsidies. The aim is a systematic assessment of all tax privileges from the overall economic cost-benefit perspective.

Reform of federalism

Germany's federal structure has a considerable impact on the basic conditions of economic and fiscal policy. The first stage of the federalism reform came into force in September 2006. It dismantled excessively complex jurisdictional structures and reorganised the jurisdiction for some areas of legislation. Now, the second stage has the task of adjusting the financial relations between the Federation and the Länder to the changes in the overall system. A joint commission of the Bundestag and the Bundesrat was constituted on 8 March 2007 to develop appropriate reform proposals. The aim is to pass the second stage of the federalism reform within this legislative period.

In the field of fiscal relations, key importance is attached to limiting the government debt and avoiding budget crises in the federally organised state. The institutional prerequisites – as laid down in the constitutional provisions governing public finance – must be improved in such a way as to ensure the sustainable development of the public budgets. More stringent rules on public deficits and an early warning system for budget imbalances could ensure the state's ability to recover – or expand – the financial leeway it needs to tackle the urgent tasks of the future. In addition to financial issues, the talks also cover possible ways of improving the quality and economic efficiency of the public administration, e.g. by restructuring, standardising, automating, concentrating or improving cross-level and inter-organisational cooperation.

2.2 The long-term sustainability of public finances

The structure and, most likely, the size of the German population will change markedly over the coming years and decades. More significant than a possible decline in the population will be the foreseeable ageing of society. The old-age dependency ratio – the relation between the number of people of pensionable and employable age in the population – will approximately double by 2050. These changes in the population structure will increase the pressure on the public budgets, both on the revenue and the expenditure side. On the expenditure side, this applies in particular to those social security systems that mainly serve to cover the risks of retirement: pension and long-term-care insurance, but also health insurance. A relevant aspect on the revenue side is that the fall in the labour supply caused by the change in the age structure will impair economic growth. Against this background, it is important that the reforms carried out in the fields of social security and the labour market are already leading to significant progress towards sustainable public finances.

Long-term budget forecasts are drawn up at both the national and EU level, being repeated every few years. The results of the most recent model calculations published by the EU Economic Policy Committee and the Commission were already mentioned in the December 2006 Update of the German Stability Programme.[3] They form part of the annual risk assessment carried out by the ECOFIN Council in its examination of the stability and convergence programmes with a view to the long-term soundness of government finances. Last year, Germany occupied a mid-table position among the countries appraised.

The federal government has taken further steps since then to counter potential risks to the sustainability of public finances posed by the ageing of the population. The Federal Ministry of Finance will continue national reporting next year with the second sustainability report, which will show how the situation is today on the basis of updated population forecasts. The report, which, like its predecessor, builds on external model calculations by the Munich-based ifo Institute, will also show the extent to which further measures are required to ensure the long-term sustainability of public finances – and point out corresponding action options.

Labour market and employment policy

The policy of reforming the labour market is being continued. Because of their broad scope and complexity, the reforms carried out over the last few years need to be critically re-examined. The "Acts for Modern Services on the Labour market" have been comprehensively scientifically evaluated since their implementation. The recommendations from the evaluation reports published since the summer of 2006 will be taken into account in the discussions on reorienting the instruments of labour-market policy.

The economic upswing – and especially the above-mentioned reforms of the labour market and the Federal Employment Agency (Bundesagentur für Arbeit) – have taken some of the pressure off the Federal Agency's budget. In addition, the Federation's participation in employment promotion was introduced. For example, the contribution rate was cut from 6.5 to 4.2% on 1 January 2007. Despite the lower contribution, the Federal Employment Agency has been able to cover its costs and furthermore increase its

[3] Cf. Table 15 in the Appendix.

labour-market reserve. The cut in the unemployment-insurance contribution to 3.3% on 1 January 2008 will make a further contribution to the sustainable reduction of ancillary wage costs. A decision has been made too to extend the payment period of unemployment benefit for older unemployed people by up to six months. This is to be combined with greater efforts to integrate the people concerned into the labour market. Overall, the Federal Employment Agency's budget position is secured to the extent that it will be able to manage without a federal subsidy up to 2011, build up pension reserves, and carry out all its functions according to its remit.

The labour-market reforms have improved the overall conditions on the labour market. The long-term unemployed and older people – i.e. groups who find it difficult to integrate into the labour market – are also benefiting. The federal government is continuing its policy of target-oriented measures. Hence, in October 2007, the "Fourth Act Amending Book III of the Social Security Code" introduced integration and training subsidies to give poorly educated adolescents and young adults an opportunity to prove their worth in a job and improve their qualifications. Furthermore, the "Second Act Amending Book II of the Social Security Code" provides labour-cost subsidies to improve the chances of the long-term unemployed with multiple procurement obstacles to find a job. As early as 24 April 2007, the "Act Improving Older People's Employment Opportunities" was announced, implementing the measures of the "Initiative 50plus".

Structural reforms in the social security systems

The federal government has implemented the pension insurance reforms stipulated in the coalition agreement. The "Act Adjusting the Minimum Age for Pension Insurance" passed on 20 April 2007 successively raises the minimum age for a standard old-age pension from 65 to 67 years beginning in 2012. It also adjusts the minimum ages of other kinds of pension accordingly and modifies the safeguard clause according to which the attenuations in pension adjustments that have not been realised since 2005 will be subsequently offset, starting in 2011.

These measures are a necessary reaction to rising life expectancy and the correspondingly longer periods of pension receipt. The Act will help meet contribution-rate and pension-level targets; it will also permanently ease the pressure both on the contribution rate in statutory pension insurance and on ancillary wage costs. Raising the minimum age will lead to a reduction in the contribution rate for pension insurance of 0.2 percentage points in 2020 and 0.5 percentage points in 2030. It will thus lead to the long-term stabilization not only of the contribution rate to statutory pension insurance (21.9% in 2030), but also of federal subsidies, whose development will be linked to the development of contribution rates, among other things.

Raising the minimum ages further contributes towards curbing the increase in public expenditure on pensions, which has already been markedly slowed down by the reforms of pension insurance carried out in recent years. Furthermore, the higher minimum ages, together with the reforms of the labour market, have the effect of increasing the size of the potential workforce, thus exerting a positive long-term influence on economic growth.

In the field of private and occupational retirement pension schemes, the federal government is implementing measures aimed at a broader distribution of the additional retirement pension systems. With the "Act for the Promotion of Additional Retirement Pension Schemes and Amending Book III of the Social Security Code," the legislature has decided in favour of permanently extending beyond 31 December 2008 the exemption from contributions of deferred compensation for the purpose of occupational retirement pensions. Furthermore, child benefit for people who have concluded a "Riester contract" will be increased to €300 for all children born after 1 January 2008.

A comprehensive health reform came into force on 1 April 2007. It strengthens competition between health-insurance companies and among service providers.

- Since 1 April 2007, the health-insurance companies have had greater freedom in the tariffs they offer their policyholders and in concluding contracts with service providers. Outpatient and inpatient aspects of care are better integrated. Am independent institute will carry out cost-benefit analyses on new drugs in future. The remuneration system for physicians is being improved.
- Starting in 2009, a uniform contribution rate will be introduced in statutory health insurance which will be fixed by the federal government. From a fund made up of contributions and tax revenues, the health-insurance companies will receive allocations for their policyholders that take differences in age, sex and morbidity into account. If a health-insurance company cannot manage on these funds, it can charge its policyholders a limited additional fee. This strengthens incentives to really compete for premium payers instead of for good risks.
- In order to partially compensate for services that benefit society as a whole, the Federation will pay statutory health insurance an annual subsidy which will rise by €1.5 billion a year from €2.5 billion in 2008 to €14 billion in 2016. Funds are currently available for this expenditure, particularly against the background of the positive and stabilised income development up to 2011. The long-term financing of the statutory health insurance subsidy will be secured during the next legislative period.
- In future, mergers will also be possible between different types of health-insurance companies.

- As from 2009, competition between private health-insurance companies will be intensified by making old-age reserves transferable; it will also be made easier for policyholders to choose and switch companies. In addition, all companies must introduce a basic policy that contains no risk premiums, does not exclude certain benefits, and obliges the insurer to furnish services to all who apply.
- As from 2009, health insurance will be obligatory for all citizens for the first time.

A reform of statutory long-term care insurance will also enter into force in 2008, probably on 1 July. The federal government's bill has been tabled in the Bundestag:

- Benefit payments, which have not changed since 1995, are to be increased in three steps up to 2012; priority will be given to strengthening outpatient care. Dementia patients will receive higher benefits; for the first time they will receive benefits from long-term care insurance, even if they have not been allocated to a specific care level. In future there is also to be dense network of care centres and care consultants to improve the provision of services to those in need of care.
- Further measures aim to improve quality assurance, increase cooperation with healthcare services and reduce red tape.
- The contribution rate to public long-term care insurance is to increase by 0.25 percentage points to finance the (hitherto small) annual financial deficit and the expansion of services up to the end of 2014. Thereafter, a review will be carried out for the first time in 2014 for 2015, and then every three years, to determine whether and to what extent it will be necessary to adjust the benefits paid out by long-term care insurance to the price developments of the previous three calendar years. The extent to which the benefits will be adjusted will be decided by the federal government; the increase is not to exceed the gross development of wages and salaries over the same period.

2.3 German fiscal policy in the European context

Budgetary surveillance and the decisions in the context of the current deficit procedures are legally based on the relevant provisions of the EC Treaty and the Stability and Growth Pact as reformed in the spring of 2005. On this basis, with its decision of 5 June 2007 the ECOFIN Council closed the excessive deficit procedure concerning Germany that had been initiated in 2003. The Council stated that Germany had succeeded in credibly and sustainably reducing its deficit below the ceiling of 3 % of gross domestic product prescribed by the EC Treaty. The Council's decision of 21 January 2003 on the existence of an excessive deficit in Germany was thus abrogated.

By reducing the general government deficit to 1.6% of GDP in 2006, Germany succeeded in correcting its excessive deficit a year ahead of the deadline which the ECOFIN Council had set in March 2006. At the same time, the ECOFIN Council's conditions on reducing the structural deficit were very clearly met. Germany will present a balanced budget in 2007. The successful reduction of the deficit is confirmation of the federal government's economic- and fiscal-policy strategy, which places equal emphasis on structural consolidation and strengthening growth potential.

In their orientations for fiscal policies in euro area Member States adopted in Berlin in April 2007, the finance ministers of the euro area countries stated that they were aiming to reach their respective medium-term budget goals by 2010 at the latest. It is of great importance for the credibility of the reformed Stability and Growth Pact that this agreement is kept by all countries. The federal government will continue resolutely pursuing its policy of sustainable consolidation and improving the quality of public finances. In the federal government view, the aim of reaching on principle structurally balanced budgets on both the central and the states' level of government should also be enshrined in the constitution during the second stage of the federalism reform.

On the the Federation's level the aim of using continuing positive economic development to achieve a balanced budget will not be achieved before 2011, largely due to the (at least initial) fall in tax revenue as a result of the business tax reform. The business tax reform represents a structural improvement in the basic framework for growth and employment. The full economic and fiscal benefits of this reform will primarily be felt in the medium to long term.

Further structural reforms are necessary to ensure the long-term sustainability of public finances. In its 2006 and 2007 implementation and progress reports on the National Reform Programme (NRP) 2005 to 2008, the federal government published information on important projects that have been launched or already implemented by the legislature since the presentation of the NRP. The measures set out in the National Reform Programme and the supplementary implementation reports are simultaneously in line with the general fiscal-policy recommendations relating to the "fundamentals of economic policy" for the period 2005 to 2008.

3 Macroeconomic situation and outlook to 2011

3.1 Assumptions underlying the growth forecast for 2007 and 2008 and over the medium term

The forecasts for the short and medium term (2007 to 2011) are based on the following assumptions:

- The world economy will expand strongly, although the dynamics will weaken slightly. Real global economic growth in 2007 (about +5%) will be only marginally below that of the previous year, but the pace of expansion will slow down somewhat in 2008 (+4½%). World trade of goods and services will benefit from the high level of world economic activity during the forecast period. The volume of world trade is therefore likely to remain dynamic with growth rates of approx. 7% in 2007 and approx. 6% in 2008. Global growth dynamics will weaken slightly in the course of the medium-term forecast period up to 2011. Accordingly, world trade is also likely to expand less strongly. Germany will maintain its market shares in the medium term due to its high level of competitiveness.
- The technical assumptions on exchange rates and oil prices are based on the respective average of the last weeks before the forecast was prepared. This suggests an exchange rate of US$1.35 to the euro for 2007 and $1.40 for 2008. Another technical assumption is that the real external value of the euro will remain largely stable at its current level until the end of the forecast period. The price of Brent oil is put at $70 per barrel in 2007 and $80 in 2008. In the medium term, although there seems little likelihood of supply bottlenecks for raw materials, high prices are nevertheless expected due to high demand for crude oil in particular. Another technical assumption is that the ECB's main refinancing rate will remain unchanged at 4% over the entire forecast period.
- Wage growth will be higher than in the preceding years, with collectively agreed wages and salaries rising in the overall economy by 2.0% in 2007 and 2.1% in 2008. Actual earnings, i. e. wages per employee, are likely to rise by 1.9% (domestic concept) in 2007 and – assuming a slightly positive wage drift – by 2.4% in 2008. Unit labour costs on an hourly basis will only rise moderately (2007: +0.6 %, 2008: +0.9%); as a result, the price competitiveness of German companies will remain high by international comparison. Wage development is expected to remain moderate over the medium-term forecast period; the increase in real actual earnings is likely to be well below the trend in productivity gains.
- The federal government's future-related economic- and fiscal-policy decisions will seek a balance between growth-boosting structural reforms and consolidation of public budgets that takes account of the economic situation. It is assumed that the

full effect of the structural measures will materialize only in a few years. Creating a macroeconomic environment that promotes innovation and investment requires in particular making the markets for goods, finance and services even more flexible, making the most of the existing potential workforce, raising investment and improving quality in the field of education and research – in addition to continuing structural reforms.

3.2 Macroeconomic situation in Germany in 2007

The German economy is currently in a very robust condition – notwithstanding the recent turbulence on the financial markets. In the first six months of 2007, the gross domestic product rose by 1.2% in real terms compared to the second half of the previous year (after adjustment for working-day variations and season). Growth did not slow down to the extent that had been generally expected. Economic activity accelerated again in the third quarter. A lively, strengthening domestic economy is placing the upswing onto a broad foundation. The fact that buoyant domestic forces are becoming stronger is expressed by a big increase in gross fixed capital formation in machinery and equipment expenditure, which – against the background of a high level of capacity utilisation – is benefiting from favourable overall conditions. The most important of these are the positive development of profits and unit labour costs, positive sales prospects both at home and abroad, and long-term nominal interest rates that are still comparatively low. Furthermore, investment this year is especially dynamic because of pull-forward effects related to the phasing out of the temporarily improved conditions for depreciation at the end of 2007. There are contradictory development trends in the construction industry. For example, following the weather-induced boom at the beginning of the year and the special effects caused by the abolition of the owner-occupied homes premium, the expansion of residential construction has slowed down, while commercial building remains dynamic due to the high level of capacity utilisation in the companies. The development of private consumption spending has remained very restrained up to now. This was primarily caused by purchases brought forward last year in the run-up to the increase in the value-added tax rate. On the other hand, private consumption is likely to revive noticeably as a result of expanding incomes – against the background of rising employment, higher wage increases and lower net contribution rates to social insurance. However, the recent increases in prices for energy and food have had a dampening effect, reducing the purchasing power of private households. The continuing upswing is having a growing impact on the labour market. The number of people unemployed is falling steadily, and at the same time employment is rising strongly in all regions and virtually all sectors. The expansion of employment is being boosted mainly by jobs fully liable to social security contributions.

3.3 Short and medium-term outlook for the overall economy

In its autumn forecast, the federal government expects a 2.4% real increase in the gross domestic product in 2007. Net exports of goods and services are expected to boost growth by one percentage point. Domestic buoyant forces will also intensify and account for more than half of total growth (1.4 percentage points). As a result of the continuing upswing, the federal government expects a marked increase in gainful employment of approx. 1.7% and a fall in registered unemployment of about 700,000.

The upswing will continue, with fundamental economic factors remaining favourable. A real GDP growth rate of 2.0% can thus be expected in 2008. Growth is expected to be rather less dynamic than in the previous year, mainly because of slightly lower global economic growth rates (against the background of the real-estate crisis in the USA and the turbulence on the financial markets), the big rise in the oil price and the high value of the euro.

The main source of economic growth in 2008 will be domestic demand, while, in purely arithmetic terms, net exports will hardly contribute at all to GDP growth. Domestic demand will receive a strong boost from fixed capital formation in machinery and equipment. Commercial construction is also likely to contribute to economic growth. Overall, however, the increase in gross fixed capital formation looks likely to be weaker than this year, primarily due to the phasing out of improved conditions for depreciation. On the other hand, private consumption is likely to develop as the main driving force behind the upswing. The further expansion of employment and rising wages are expected to increase the disposable income of the private households and thus encourage private consumption. The annual average level of gainful employment should rise by 300,000. Accordingly, registered unemployment can be expected to continue falling, albeit more slowly than this year (approximately -295,000).

In the subsequent years (2009 to 2011), GDP is expected to grow by approximately 1½% p.a. Annual potential growth is likely to be around ¾% p.a. in this period. Macroeconomic productive capacity will be favoured in this context by another marked expansion in the capital stock and investment in human resources. The improved macroeconomic conditions and the structural reforms will manifest themselves only successively over time – also in a higher long-term growth rate. In the longer term, therefore, there is a good chance that potential growth will continue rising to approximately 2% in the course of the continuing recovery.

On the basis of a resilient world economy, positive stimuli can be expected from foreign trade over the entire forecast period. The strongest growth stimuli during the forecast period will come from domestic demand. Private consumption growth will be much stronger than in the previous years and only slightly slower than the gross domestic product, whereas government final consumption will only increase slightly during the entire forecast period as a result of the consolidation course.

Corporate investment is likely to rise faster than GDP. The development of investment will benefit from the big increase in profits and the moderate development of labour costs. Furthermore, a certain amount of pressure will be taken off companies by the business tax reform and lower social contributions. The high level of capacity utilisation will lead to strong demand for expansion investment. Gainful employment looks likely to increase by about ½% p.a. At the same time, the number of unemployed will probably fall further.

Risks to this forecast are posed by rising prices for raw materials, especially crude oil. The effects of the turbulence on the financial markets and the real-estate crisis in the USA could also burden global economic growth more than is generally expected and thus reduce the external stimuli to the German economy. Similarly, the possibility cannot be ruled out that precisely against the background of the financial-market turbulence – in view of the serious current-account and public deficit in the USA – there might be a major and abrupt devaluation of the US dollar. Within the eurozone, growing differences in inflation rates and wage levels, accompanied by disparities between the current-account balances, could become a burden on economic development. However, there are also chances that the upswing will turn out to be stronger than expected. This could be the case if investment activity is more dynamic and has stronger positive effects on employment and consumption than expected. Moreover, an upswing's own economic momentum is often underestimated. Another possibility is that an even stronger development of demand in the newly industrializing countries of Asia and the transition economies of eastern Europe might counteract a slowdown of growth in the USA to a greater extent.

Table 1: Forecast of macroeconomic development from 2007 to 2011[1]

	ESA Code	2006	2006	2007	2008	2009 to 2011[4]:
		€ bn	% change p.a.			
Real GDP	B1g	2182.95	2.9	2.4	2.0	1 ½
Nominal GDP	B1g	2322.20	3.5	4.4	3.5	3
Demand components of real GDP						
Private consumption expenditure [2]	P.3	1242.09	1.0	-0.2	1.8	1 ½
Govt. final consumption	P.3	400.69	0.9	1.8	1.4	0
Gross fixed-capital formation	P.51	427.21	6.1	6.2	3.7	2[5]
Changes in inventories and net acquisition of valuables (contribution to real GDP growth) [3]	P.52 + P.53	-	-0.1	0.1	-0.1	0
Exports of goods and services	P.6	1038.44	12.5	7.8	6.3	5 ½
Imports of goods and services	P.7	910.96	11.2	6.3	6.8	5 ½
Contribution to GDP growth [3]						
Final domestic demand (w/o inventories)		-	1.9	1.3	1.9	1 ¼ [5]
Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.1	0.1	-0.1	0
External balance of goods and services	B0.11	-	1.1	1.0	0.2	¼ [5]

(1) 2006: Provisional result of the Federal Statistical Office of January 2007;
2007 and 2008: Results of the Interministerial Working Group of Macroeconomic Forecasts from October 2007;
2009 to 2011: Medium-term forecast from April 2007 adjusted to the results of the Interministerial Working Group of Macroeconomic Forecasts from October 2007.
(2) Including private non-profit organisations.
(3) Contribution to GDP growth rate.
(4) GDP, contribution to real GDP growth and working population rounded to within a ¼ of a percentage point, all other figures to ½ of a percentage point
(5) Amended values vis-à-vis the original version due to editorial changes.

4 Development of the public budgets

4.1 Development of net borrowing/lending

Balanced general government budget

This year, Germany will achieve a balanced budget for the first time since 1989. This means that in the course of the consolidation package implemented by the government in 2006, not only was the excessive deficit reduced, but a decisive step was taken towards the sustainability and long-term recovery of the government finances.

In the current year **2007**, general government net borrowing/lending is largely determined by two factors:

- The measures implemented by the federal government, together with the already established, restrictive expenditure line will lead to a continuation of structural budget consolidation. The consolidation effect of these measures alone amounts to about 1% of GDP.[4] Together with the restrictive expenditure line they are making a substantial contribution towards further reducing the general government deficit ratio towards a balanced budget.
- The reduction in the deficit is being reinforced by cyclical factors. As in the previous year, the continuing positive state of macroeconomic growth is noticeably taking the pressure off the public budgets. GDP growth is above its potential path; as a result, the public budgets are experiencing higher cyclically induced revenues in the form of taxes and social insurance contributions and lower expenditures because cyclically sensitive labour-market expenditure is down.

Table 2: Development of the general fiscal balance

	2006	2007	2008	2009	2010	2011
Net borrowing/lending	– as a % of GDP –					
December 2007 forecast	**-1.6**	**0**	**-½**	**- 0**	**+½**	**+½**
December 2006 forecast	-2.1	-1 ½	-1 ½	-1	-½	

In view of the uncertainty inherent in every forecast, net borrowing/lending is rounded to one half of a percentage point of GDP.

[4] The federal government has described in detail the scope and effect of the implemented consolidation measures in its "Report on the Implementation of Measures Required for Budget Consolidation to Reduce the Excessive Deficit". See "Bericht zur Umsetzung von Maßnahmen für den zur Haushaltssanierung erforderlichen Abbau des übermäßigen Defizits nach Artikel 2 Abs. 1 der Entscheidung des ECOFIN-Rates vom 14. März 2006 über die Inverzugsetzung Deutschlands gemäß Art. 104 (9) EG Vertrag", dated 5 July 2006, Internet: http://www.bundesfinanzministerium.de

Next year, net borrowing/lending will worsen to -½% of GDP. The change in net borrowing/lending in **2008** will be influenced in particular by the reform of business taxation described in chapter 2 and by the cut in contributions to unemployment insurance that has been decided on. Furthermore, expenditure will rise, largely due to salary and wage increases for public-service employees. In detail these effects will be as follows:

	(-) = lower revenue and/or higher expenditure compared to financial planning – as a % of GDP –
Reform of business taxation	-0.3
Reduction in the contribution to unemployment insurance from 4.2 to 3.3% and further labour-market measures	-0.3
Higher public-service salaries and wages	-0.1

The measures, which will be effective from 2008, should still be seen against the background of an expenditure line that is moderate compared to economic development. Moreover, the measures already implemented in 2007 are stabilising the tax base and leading to marked savings, particularly in monetary social security benefits. The tax reform and the further reduction in ancillary wage costs will therefore not be fully reflected in general government net borrowing/lending.

In **2009 and 2011**, tax revenue will again generally increase proportionally to macroeconomic development. Expansionary measures of the *Impulsprogramm* implemented in 2006 will be expiring. Following the marked base effect in 2008, expenditure is expected to continue to rise less quickly than the economy as a whole. The temporary worsening of general government net borrowing/lending in 2008 will therefore already be offset in 2009, so that a balanced budget can already again be expected by then. A general government budget surplus amounting to ½% of GDP can be expected towards the end of the programme period if there are no further policy changes.

Net borrowing/lending by level of government

The financial situation of the **Federation** (central government) is easing markedly **in 2007** as a result of the improvement in its revenue basis. The net borrowing envisaged in the supplementary budget for 2007 amounts to €14.4 billion. Looking at the Federation as defined in the National Accounts – i.e. including the special funds that are regarded as being within the sphere of the Federation[5] – net borrowing in 2007 will be about -1% of GDP, compared to -1.5% in 2006. On the revenue side, the adopted fiscal measures will contribute noticeably towards improving the fiscal balance. Expenditure growth will be considerably slower than that of revenue. The expenditure side at the federal level will largely reflect the rising allocations to the social security funds following the cession of one percentage point of value-added tax to the Federal Employment Agency. In 2007, the overall increase in total expenditure by the Federation according to the National Accounts definition will be approximately 2%. Without the additional payments to the social security funds, there would be no increase in the Federation's expenditure – as defined in the National Accounts – in 2007.

Despite the evident success of consolidation, the Federation is the only government level in 2007 that is still a net borrower.

Next year, i.e. in **2008**, both the **Federation's** revenue and its expenditure can be expected to develop largely parallel as a result of the development line for the general government budget outlined above. Not until 2**009** does current financial planning indicate a further marked reduction in net borrowing at the Federation level. After the implementation of financial planning, the Federation will achieve a balanced budget in 2011 according to both the budgetary and the National Accounts definitions.

Table 3: Financial balances by level of government

	2006	2007	2008	2009	2010	2011
	– as a % of GDP –					
Central government including special funds	-1.5	-1	-1	-½	-½	0
State and local government	-0.3	+½	+½	+½	+½	+½
Social security funds	+0.2	+½	+0	+0	+½	+0
General government	-1.6	0	-½	0	+½	+½

Net borrowing/lending has been rounded to within half a percentage point.

The current forecast for the development of budgets in the **Länder and local authorities** shows a very positive picture**.** They will generate a surplus of about ½% of GDP in 2007. Over the entire programme period, no net borrowing is to be expected at the level of Länder and local authorities.

The underlying assumptions on the budget development of the Länder and local authorities were discussed by the Federal Minister of Finance and the Länder finance ministers at the Financial Planning Council meeting held on 14 November 2007. The Länder budgets are making a substantial contribution to reducing the government deficit by continuing structural budget consolidation. Savings in the field of personnel costs deserve special mention here. The personnel costs of the Länder and local authorities fell

[5] ERP special funds, unwelcome legacy repayment funds (Erblastentilgungsfonds), federal railway assets, compensation funds, "Reconstruction Assistance" fund, childcare funds (from 2007), invalidity and survivor's pension plan for post-office civil servants.

by an average of half a percentage point every year from 2002 – the beginning of the deficit procedure concerning Germany – until 2007, due to both collective wage agreements and repeated reductions in the workforce.
Thanks to the relaxed budget situation, a change of trend is emerging in public investment among local authorities: in 2007, the Länder and local authorities will increase their gross investment by more than 20% compared to the previous year.

Not only the central, regional and local authorities, but also the **social security funds** are benefiting from the favourable macroeconomic development. The social security funds can expect a surplus amounting to ½% of GDP this year, despite lower revenue as a result of lower social insurance contributions. The main cause here is savings in the field of Arbeitslosengeld (short-term unemployment benefit). Over 20% less unemployment benefit will be paid out by the Federal Employment Agency this year than in 2006. The fall in unemployment benefit in particular will mean that the Federal Employment Agency will record a substantial surplus this year. In 2008, however, further cuts in the social insurance contributions in particular will lead to a deficit at the Federal Employment Agency, so that taking all the social security funds together a balanced budget looks more likely than a surplus. In the course of the programme period, the social security funds will then gradually accumulate surpluses until the sustainability reserve in old-age pension insurance has reached the level of 1.5 times the monthly expenditure of pension insurance. Once this threshold value is reached, it will be possible to cut the contribution to statutory old-age pension insurance. As a result, from 2011 onwards the expectation is no longer for surpluses but for permanently balanced budgets among the social security funds.

4.2 Development of expenditure and revenue

Revenue trends

An increase of approx. 9% in **tax revenue** according to the National Accounts definition is expected in the current year compared to 2006. Tax revenue is therefore developing much more favourably than was predicted by the last Stability Programme Update (December 2006). The tax level is about 1% of GDP higher than was forecast in December 2006. The tax ratio (without social security contributions) will make up approximately 24% of GDP in 2007. The main causes are the 2007 fiscal-policy measures and the 2006 base effect, as a result of which the tax ratio had already risen by about 1 percentage point to 23% of GDP.

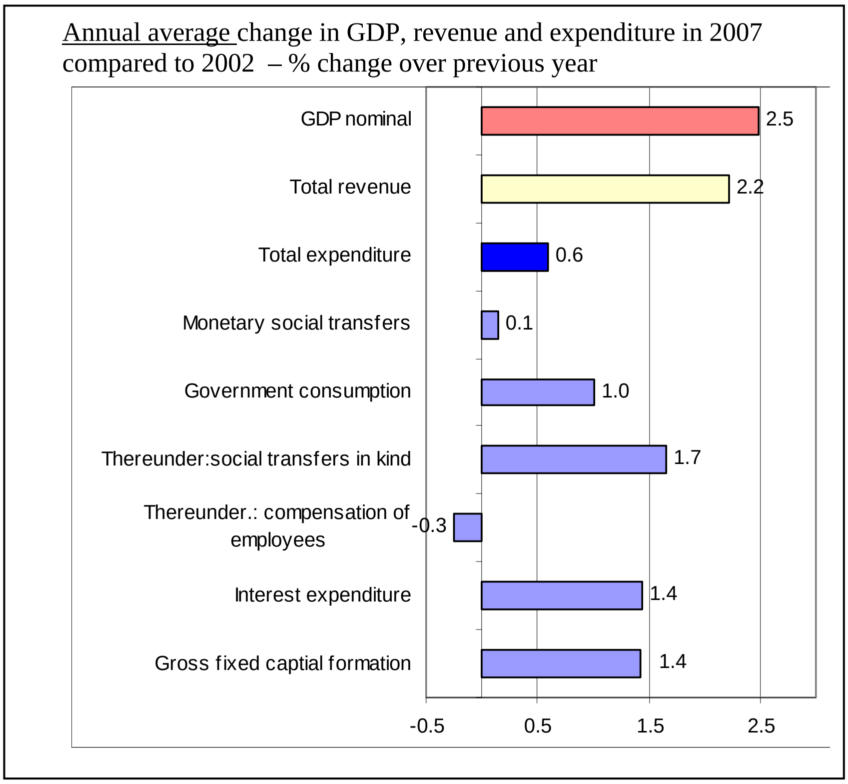
The rising tax ratio (w/o social security contributions) is largely offset by a declining **ratio of social security contributions-to-GDP**. In the current year, revenue from social insurance contributions will fall by about half a percent compared to the previous year as a result of reductions in contributions. The social contribution ratio will fall to 16½% of GDP. Next year, i.e. in 2008, a further lowering of the contribution to unemployment insurance will cause a further drop in the social insurance contributions' share of GDP to about 16%. The (total) tax ratio will subsequently fall to about 39½% of GDP in 2008. At the end of the programme period, the expected reduction in the contribution to pension insurance looks likely to lead to a further fall in the tax ratio.

Table 4: Development of the ratios of taxes and social security contributions to GDP

	2006	2007	2008	2009	2010	2011
	– as a % of GDP –					
Tax ratio (w/o social security contributions)	**22.8**	**24**	**23 ½**	**23 ½**	**23 ½**	**23 ½**
Social-contribution ratio	**17.3**	**16 ½**	**16**	**16**	**16**	**15 ½**
Tax ratio						
December 2007 forecast	**40.1**	**40 ½**	**39 ½**	**39 ½**	**39 ½**	**39**
December 2006 forecast	40	40	39 ½	39 ½	39	-

4.3 Government expenditure: restrictive expenditure line makes a major contribution to balancing the government budget

Although the development of revenue has made a significant contribution to overcoming the excessive deficit over the past two years, a closer look at developments compared to 2006 shows that the expenditure side has made a much bigger contribution towards consolidation. Nominal government expenditure has only risen by an annual average of 0.6% per annum since the deficit first exceeded the 3% ceiling in 2002. The excessive deficit in Germany would not have been reduced without this restrictive expenditure line. About 80% of the cut in the deficit ratio in 2006



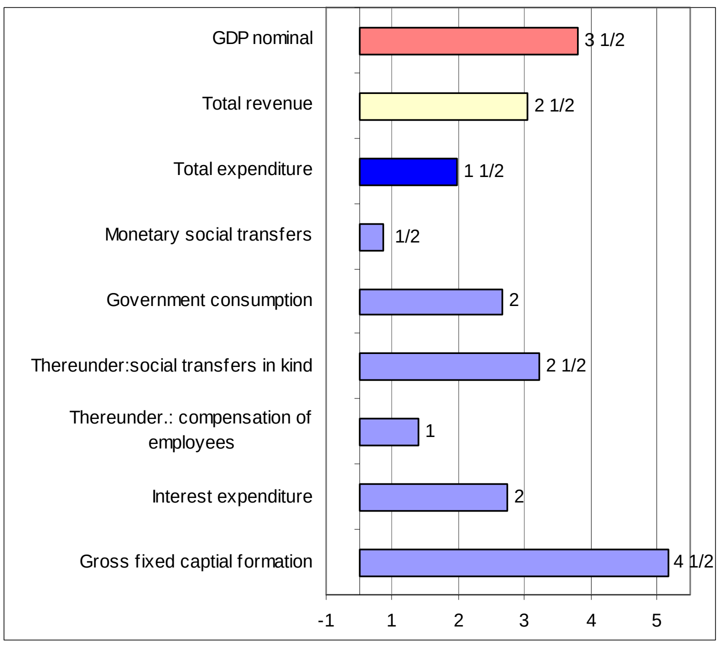
and 2007 came from a reduction in the government spending ratio. In 2002 – the year when the 3% ceiling was breached for the first time – the government spending ratio was 48% of GDP; this year it is expected to be only 44% of GDP. This is the lowest figure since German unification. By comparison, the average government spending ratio in the eurozone was about 46½% of GDP in 2007.

Table 5: Development of the government spending ratio

	2006	2007	2008	2009	2010	2011
Government spending ratio	– as a % of GDP –					
December 2007 forecast	**45.4**	**44**	**43½**	**43**	**42**	**41½**
November 2006 forecast	45½	45	44½	43½	43	-

The restrictive expenditure line will also continue in the course of the programme period. The average annual increase in expenditure during the programme period will be about +1½%. A rise in government expenditure on personnel, running material costs and investment was assumed in the forecast, also against the background of the improved revenue situation. On the other hand, the monetary social transfers (roughly 41% of government expenditure) are only expected to rise slightly during the programme period – also corresponding to development in the economy as a whole.

Annual average development of expenditure, revenue and GDP during the programme period 2007-2011 – % change over previous year



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

2007 budget almost balanced, also in structural terms

When the ECOFIN council gave Germany notice of default because of its excessive deficit on 14 March 2006, it recommended reducing the structural deficit by a total of at least 1 percentage point in 2006 and 2007. The available data show that the structural deficit has in fact been reduced much more than this. By the end of 2007, an almost balanced budget will be achieved, also according to the structural definition; the structural deficit fell by about 2 percentage points in 2006 and 2007.

The structurally almost balanced budget shows that the reduction of the government deficit is primarily based on successes in structural consolidation. In this context, the cyclically induced deficit reduction can be deduced from the change in the production gap in 2006 and 2007. During this period, the output gap has changed from about -2% of potential GDP in 2005 to about +½% of potential GDP in 2007. Macroeconomic activity in 2007 is thus above the average degree of capacity utilization. A cyclically induced deficit reduction of about 1 to 1½ percentage points can be derived from the change in the production gap since 2005. The rest of the deficit reduction leads to a cut in the structural deficit. This primarily reflects all the consolidation effects of the restrictive expenditure line already set up in previous years and the implementation of the consolidation measures adopted by the federal government.

Extensive reduction in the structural deficit does not mean that the policy of consolidation is no longer needed

Despite these evident successes in structural consolidation, **the result of a structurally almost balanced budget in 2007 should be interpreted with caution**. However, it cannot be interpreted as the end of the policy of consolidation:

- On the one hand, the current procedures for adjusting data for cyclical factors do not explain the considerable variations in taxes on profits observed in 2006 as "cyclical". As a result of the economic recovery, in 2006 both taxes on profits and value-added tax rose a lot more than would have been expected by applying the standard budget sensitivity of the cyclical adjustment procedure. The consequence was an increase of about 1 percentage point in the aggregate tax ratio in 2006. However, it cannot be unequivocally clarified a priori whether the reasons behind the underlying rise in corporate profits, for example, are in fact ultimately of a structural or cyclical nature. They could be the result of structural effects, such as an improved competitive situation of the companies; however, there might also be considerable distortions caused, for example, by cyclical or other transitory effects impacting over several accounting periods.
- On the other hand, it must be taken into account that not all levels of government have yet achieved the aim of a structurally balanced budget. Whereas the Länder and

local authorities are posting surpluses, the Federation still has a marked structural deficit. It is crucial, therefore, that the Federation continues the consolidation line laid down in current financial planning.

Adjustment path with regard to the medium-term budget objective

Germany's medium-term objective is to maintain a structurally balanced budget. This aim will be reached during the 2007–2011 programme period. The structural financing deficit will be almost completely overcome as early as 2007. The framework of a structural budgetary postion of close to balance will be maintained during the entire programme period, despite a worsening structural balance in 2008. After a structural deficit of -½% of GDP in 2008, structural equilibrium will be again achieved in 2010 at the latest. A structural surplus of approx. ½% of GDP can be expected at the end of the programme period. The present stability programme thus shows that Germany is implementing the Euro Group's resolution of April 2007, in which the members of the eurozone undertook to aim at reaching their medium-term objectives by 2010 at the latest. Thus an elementary condition for lastingly sustainable government finances is being met with a view to the challenges of an ageing society.

Table 6: Development of structural net borrowing/lending

	2006	2007	2008	2009	2010	2011
Real GDP growth	***2.9***	***2.4***	***2.0***	***1½***	***1½***	***1½***
Net borrowing/lending by the public sector as a % of GDP	**-1.6**	**0**	-½	**-0**	+½	+½
Structural net borrowing/lending as a % of GDP	**-1.5**	**-0**	-½	**-0**	+**0**	+½

In the light of the uncertainty inherent in every forecast, the deficits are rounded to one half of a percentage point of GDP.

4.5 The level of debt: below the 60% reference level by 2010

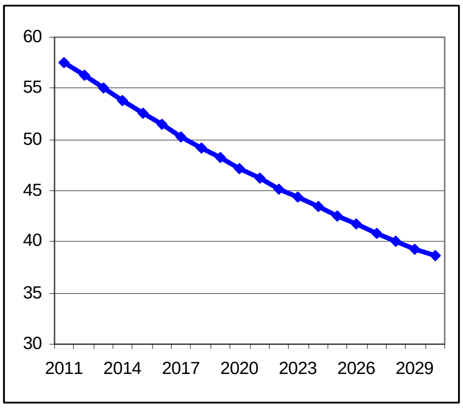
The level of borrowing has developed more favourably than was expected in the last forecast. As a result, the debt ratio will already fall to 65% of GDP this year. It will fall further next year, despite a slight increase in the deficit. Apart from economic development, which will lead to a higher denominator in the debt ratio, another cause lies in the fact that the instrument of cash borrowing will only need to be used partially to finance the deficit in 2008 thanks to high revenue from financial transactions. As a result of the development of net borrowing/lending, the level of debt will fall below the Maastricht Treaty's 60% reference level in 2010. This means that Germany will also meet the Maastricht Treaty's second important criterion after correcting its excessive deficit.

Table 7: Development of the debt ratio

	2006	2007	2008	2009	2010	2011
Government debt	– as a % of GDP –					
December 2007 forecast	**67.5**	**65**	**63**	**61½**	**59½**	**57½**
December 2006 forecast	**68**	**67**	**66½**	**65½**	**64½**	

Against the background of the sustainability problems faced by the public budgets due to the challenges of the ageing society, being below the 60% ceiling is not enough, however. The burdens on the government budget which are to be expected as a result of the ageing society demand a further reduction of debt to a level that is low enough for the government to be prepared for these challenges (cf. on this section 2.2). If the public sector can maintain an almost balanced budget, the level of debt can fall to about 40% of GDP by 2030.

Development of the debt ratio assuming an almost balanced budget – as a % of GDP[1]



[1] Assuming a nominal long-term growth rate of approx. 3½% p.a.

4.6 *Sensitivity of the deficit forecast*

Sensitivity analysis shows the developments that occur where there are deviations from the macroeconomic assumptions. Changes of ½ a percentage point in real GDP growth are assumed for the programme period starting in 2008. A constant GDP deflator and a constant GDP composition compared to the programme scenario are also assumed.

The sensitivity analysis shows that a positive growth deviation of about ½ a percentage point would lead to considerable budget surpluses as from 2010, assuming otherwise identical conditions. If macroeconomic development were to be half a percentage point lower than the growth path forecast assumed here after 2008, the public-sector deficit would remain at -½% of GDP. It must be borne in mind with this analysis that it uses standard budget sensitivity in its analysis of the effects of the economic trend. To the extent that part of the big increase in revenue from taxes on profits in particular might be regarded as transitory, a marked weakening of economic development could lead to a "swing-back", particularly of taxes on profits. In a negative scenario, this could worsen government net borrowing/lending by one additional percentage point.

Table 8: Sensitivity of the deficit forecast

	2006	2007	2008	2009	2010	2011
Net borrowing/lending	– as a % of GDP –					
December 2007 forecast	**-1.6**	**0**	**-½**	**- 0**	**+½**	**+½**
December 2007 forecast						
• assuming a lower increase in nominal GDP from 2008 to 2011 (-½ percentage point)			-½	-½	-½	-½
• assuming a higher increase in GDP from 2008 to 2011 (+½ percentage point)			-0	½	1	+1½

In view of the uncertainty inherent in every forecast, net borrowing/lending is rounded to one half of a percentage point of GDP.

Appendix

Table 9: Development of government finances

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	% of GDP					
Net landing (EDP B.9) by sub-sector								
1. General government	S.13	-37.0	-1.6	0	- 1/2	0	1/2	1/2
2. Central government	S.1311	-34.7	-1.5	-1	-1	- 1/2	- 1/2	0
3. State and local government		-5.8	-0.3	1/2	1/2	1/2	1/2	1/2
5. Social security funds	S.1314	3.5	0.2	1/2	0	0	1/2	0
General government (S13)								
6. Total revenue	TR	1017.2	43.8	44	43	43	42 1/2	42
7. Total expenditure	TE[1]	1054.2	45.4	44	43 1/2	43	42	41 1/2
8. Net landing/borrowing	EDP B.9	-37.0	-1.6	0	- 1/2	0	1/2	1/2
9. Interest expenditure	EDP D.41	64.6	2.8	3	2 1/2	2 1/2	2 1/2	2 1/2
10. Primary balance		27.6	1.2	3	2 1/2	2 1/2	3	3 1/2
11. One-off and other temporary measures [1]					-0	-0		
Selected components of revenue								
12. Total taxes(12=12a+12b+12c)		534.2	23.0	24	23 1/2	24	24	24
12a. Taxes on production and imports	D.2	279.9	12.1	12 1/2	12 1/2			
12b. Taxes on income, wealth, etc.	D.5	250.6	10.8	11	11			
12c. Capital taxes	D.91	3.8	0.2	0	0			
13. Social contributions	D.61	401.1	17.3	16 1/2	16			
15. Other		81.9	3.5	3 1/2	3			
16=6. Total revenue	TR	1017.2	43.8	44	43	43	42 1/2	42
p.m.: Tax burden (D.2+D.5+D.61)			40.1	40 1/2	39 1/2	39 1/2	39 1/2	39
Selected components of expenditure								
17. Intermediate Consumption, Social transfers in kind, Compensation of employees, Other taxes on production	P.2 D.63 D.1 D.29	437.1	18.8	18 1/2	18	18	18	18
18b. Social transfers other than in kind	D.62	428.5	18..	17 1/2	17	16 1/2	16 1/2	16
19=9. Interest expenditure	EDP D.41	64,6	2.8	3	2 1/2	2 1/2	2 1/2	2 1/2
20. Subsidies	D.3	26.8	1.2	1	1	1	1	1
21. Gross fixed capital formation	.51	32.8	1.4	1 1/2	1 1/2	1 1/2	1 1/2	1 1/2
22. Other		64.5	2.8	2 1/2	3	2 1/2	2 1/2	2 1/2
23=7. Total expenditure	TE[1]	1054.2	45.4	44	43 1/2	43	42	41 1/2
p.m.: Government consumption (nominal)	P.3	425.9	18.3	18	18	17 1/2	17 1/2	17 1/2

In the light of the uncertainty inherent in every forecast, the figures are rounded to one half of a percentage point of GDP.

Table 10: Development of the level of government debt ("Maastricht level of debt")

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
1. Gross debt		67.5	*65*	*63*	*61 1/2*	*59 1/2*	*57 1/2*
2. Change in gross debt ratio		0.3	-2 1/2	-2	-1 1/2	-2	-2
Contribution to changes in gross debt							
3. Primary balance		1.2	3	2 1/2	2 1/2	3	3 1/2
4. Interest expenditure	EDP D.41	2.8	3	2 1/2	2 1/2	2 1/2	2 1/2
5. financial transactions		- 0.3	-0	- 1/2	-0	-0	-0

Table 11: Comparison of the forecasts in the December 2007 and December 2006 Stability Programmes

	ESA Code	2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
Previous update		2.3	1 1/2	1 1/2	1 1/2	1 1/2	
Current update		2.9	2.4	2.0	1 1/2	1 1/2	1 1/2
Difference		0.6	1	1/2	-0	-0	
General government net lending (% of GDP)	EDP B.9						
Previous update		-2.1	-1 1/2	-1 1/2	-1	- 1/2	
Current update		-1.6	0	- 1/2	-0	1/2	1/2
Difference		0,5	1 1/2	1	1	1	
General government gross debt (% of GDP)							
Previous update		67.9	67	66 1/2	65 1/2	64 1/2	
Current update		67.5	65	63	61 1/2	59 1/2	57 1/2
Difference		0.4	2	3 1/2	4	5	

Table 12: Price development – deflators [1)]

	ESA Code	2006	2006	2007	2008	2009 to 2011: [3)]
		Index	% change p.a.			
GDP		106.4	0.6	1.9	1.5	1½
Private consumption expenditure 2)		109.3	1.4	1.8	1.6	1½
Govt. consumption expenditure		106.3	0.2	0.6	1.6	1
Gross fixed-capital formation		99.9	1.4	2.6	1.1	1
Exports of goods and services		100.8	1.3	0.4	1.0	1½
Imports of goods and services		101.0	2.8	-0.1	1.0	1½

(1) 2006: provisional result of the Federal Statistical Office of January 2007; 2007 and 2008: results of the Interministerial Working Group of Macroeconomic Forecasts from October 2007; 2009-2011: medium-term forecast from April 2007 adjusted to results of the Interministerial Working Group of Macroeconomic Forecasts from October 2007.
(2) Including private non-profit organisations.
(3) GDP rounded to within a ¼ of a percentage point, all other figures to ½ of a percentage point.

Table 13: Labour market developments [1)]

	ESA Code	2006	2006	2007	2008	2009 to 2011:[4)]
		Level	% change p.a.			
Employment, persons (domestic) ('000)		39,088	0.6	1.7	0.8	¼
Employment, hours worked (bn hrs)		56.0	0.5	1.6	0.9	½
Unemployment rate (%)		-	8.1	7.0	6.6	6
Labour productivity [2)] (2000=100))		105.99	2.2	0.7	1.3	1¼
Labour productivity [3)] (2000=100)		108.98	2.4	0.8	1.1	1¼
Compensation of employees (€ bn)	D.1	1149.99	1.7	3.2	3.0	2
Compensation per employee (€)		33145	1.1	1.4	2.2	-

(1) 2006: provisional result of the Federal Statistical Office of January 2007;
2007 and 2008: results of the Interministerial Working Group of Macroeconomic Forecasts from October 2007;
2009-2011: medium-term forecast from April 2007 adjusted to the results of the Interministerial Working Group of Macroeconomic Forecasts from October 2007.
(2) GDP per person in gainful employment.
(3) GDP per man-hour worked
(4) GDP and working population rounded to within a ¼ of a percentage point, all other figures to ½ of a percentage point.

Table 14: Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009 to 2011
Net borrowing/lending vis-à-vis the rest of the world	B.9	5.2	6.1	6.1	6.3
of which: – Balance on goods and services		5.4	6.4	6.4	6.7
– Balance of primary incomes and transfers		1.0	0.8	0.7	0.7
– Capital account		-1.2	-1.1	-1.0	-1.0
Net borrowing/lending of private households and private non-profit organisations.	B.9	6.0	6.0	5.9	5.7
Net borrowing/lending of general government	EDP B.9	-1.6	-	-	-

Table 15: Long-term development of expenditure sensitive to demographic developments

	2004	2010	2020	2030	2040	2050
	Expenditure as a % of GDP					
Expenditure on pensions [1)]	11.4	10.5	11.0	12.3	12.8	13.1
p.m.: Contribution revenues [2)]	7.7	7.3	7.3	8.3	8.7	8.9
Expenditure on healthcare [3)]	7.0	7.3	7.7	8.0	8.2	8.3
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					
Labour productivity growth (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 rate	73.0	77.4	79.1	78.6	79.5	79.0
males (aged 15-64)	79.8	83.3	85.1	84.5	85.2	85.0
females (aged 15-64)	66.0	71.3	72.9	72.5	73.6	72.9
Unemployment rate	9.5	8.5	7.0	7.0	7.0	7.0
Old-age dependency ratio [6)]	26.8	30.7	34.2	44.0	51.0	51.7
Total population (millions)	82.5	83.1	83.5	82.7	80.7	77.7
Population aged 65+ (millions)	14.9	16.9	18.5	22.0	23.9	23.3

1) Statutory pension insurance and lifetime civil servant pensions
2) Statutory pension insurance
3) Statutory health insurance and statutory long-term care insurance (acute health care and long-term care)
4) Excluding education expenditure by the Bundesagentur für Arbeit (Federal Employment Agency).
5) Substitute wage payments
6) Population 65+ relative to population 15-64

Source:
Results of model calculations by the Economic Policy Committee of the European Union and the European Commission (Ageing Report 2006). Variations due to rounding. Figures relating to productivity gain and GDP growth are based on the respective preceding 10-year period, for 2010 on the period 2004-2010.