Federal Ministry of Finance

Fiscal and Economic Policy

German Stability Programme

December 2008 Update

German

Stability Programme

December 2008 Update

Content

List of Tables

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 the surveillance and coordination of economic policies, as amended by Council Regulation (EC) no. 1055/2005 of 27 June 2005 - the Member States which have adopted the euro are obliged to submit each year an updated stability programme to the ECOFIN Council.

This update of the German Stability Programme was approved by the German Federal Cabinet on 3 December 2008.

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 the competent committees of experts of the German Bundestag and Bundesrat.

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

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

http:// www.bundesfinanzministerium.de

1 Summary

- 2008 saw a substantial cooling-off of the German economy. The decline in macroeconomic activity, which began in spring 2008, is expected to continue for the time being.
- The guiding principle of the federal government’s fiscal policy continues to be a two-pronged strategy consisting of the structural consolidation of public budgets and strengthening Germany’s economic growth potential. The consolidation success achieved in the past years means that the automatic stabilisers can take full effect in the current situation. It also allows the measures contained in the government package “Securing employment by enhancing growth” to provide a strong impetus for public and private investment, to reduce the burden on citizens and companies alike, to spur consumption and to safeguard the progress made with regard to numbers in employment.
- Germany’s objective is to preserve its already almost structurally balanced general government budget over the long-term. The federal government is seeking to have this principle enshrined in the Basic Law within the context of the reform of Germany’s financial constitution, and thus signal its backing for the reformed Stability and Growth Pact.
- Germany will have a balanced general government budget this year. As in last year, the structural general government balance will be almost balanced. Because of the economic slowdown and given the measures adopted, the nominal and the structural general government balance will temporarily deteriorate over the course of the period covered by the Stability Programme. It is likely, however, that the structural budgetary position will be close to balance again from 2011. Factoring out the consequences of the financial market crisis, Germany would also by then have a gross debt ratio which meets to the 60% reference value set out in the Maastricht Treaty.
- In addition to quantitative consolidation, the qualitative improvement of public finances is a core driver of fiscal policy action. As such, the federal government will continue to invest heavily in the future. This includes spending on areas such as research and development, and the family. If the quality of public finances is to be enhanced, it is essential that the effectiveness and efficiency of government spending is improved in all areas. This is one of the objectives being pursued with the planned modernisation of the federal system of budgeting and accounting.

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

One of guiding principles of fiscal policy in Germany is the structural consolidation of public budgets, net of cyclical and temporary effects. Sound public finances ensure that the state has a certain amount of room for manoeuvre, including for future generations. They engender confidence in the state’s ability to act and they are a prerequisite for favourable growth and employment conditions over the long-term. But the reverse is also true: economic growth and increased employment create the best conditions for healthy and sustainable public finances.

In order to ensure the long-term sustainability of public finances, both objectives - growth and consolidation - must remain the permanent focus of fiscal policy. Consequently, next to the quantitative consolidation of public budgets, fiscal policy measures must ensure that these budgets are also designed in a manner conducive to growth over the long-term. There must also thus be a focus on the qualitative aspects of public budgets.

The current level of uncertainty in the financial markets and the real economy underscore how important it is in difficult times to have a state capable of drawing on a full range of budgetary policy measures. Structurally consolidated budgets are crucial if the automatic stabilisers are to be allowed to take effect over the course of the economic cycle without resulting in excessive deficits. Moreover, as a result of consolidation successes of the past, the government is now in a position to take targeted steps towards a growth policy which meets cyclical demands but does not put the confidence in sound finances at risk. To this end, despite, or rather because of, the current developments on the financial markets and the global economic downturn, the federal government remains committed to its goal of structural budget consolidation.

2.1 Package of measures to stabilise the financial markets and to enhance growth

The Act stabilising the financial market, enacted in October 2008, represents a comprehensive approach towards ensuring that the financial market is able to fulfil its functions with regard to the capital supply of German business and the capital investments of German citizens.

The Act comprises various measures which will allow, for a limited period of time, financial institutes to improve their equity capital or ease liquidity squeezes, and lends support to refinancing operations on the capital market by offering the possibility of state guarantees. Thanks to the “financial market stabilisation fund”, targeted measures - to which every financial institute in Germany can take recourse - can be financed. Initially, the fund will not entail any budget expenditure. However, the loans necessary to refinance the funds - which can amount to up to €100 bn. - would provisionally lead to greater national indebtedness. But given the fact that the fund can acquire holdings in financial sector companies and extracts guarantee premiums, the overall burden on the public budgets is expected to be limited.

Against the background of the wide-ranging turbulence on the financial markets, the improvement of financial market regulation, including at the EU and international level, remains a key issue for the federal government. Here, more and more solutions are being found in the global context in cooperation with emerging-market and developing countries.

Along with ensuring stability on the financial markets, the real economy is being made more resistant. In this regard, it is not so much an extensive economic programme which is needed, but rather a programme which bolsters the forces for growth on a sustainable basis by enhancing the willingness to invest, encouraging consumption and safeguarding the progress already made on the employment front without losing sight of the goal of structural budget consolidation.

It was with this in mind that the federal government on 5 November 2008 adopted a set of targeted measures - in addition to the plans detailed under 2.2 below - which not only can be implemented at short notice and have a prompt effect, but which also make economic sense over the long-term. One central focus of the “Securing employment by enhancing growth” programme is to restock and supplement the lending programme of the KfW banking group. To this end, the government has created an additional financing instrument worth up to €15 bn. to boost the lending programmes of the private banking sector, limited until the end of 2009. A second focus of the package of measures is on transport infrastructure: investments which are urgently needed in the transportation sector are being fast-tracked. In addition, an “Innovation and investment programme in transport” worth €1 bn. in each of the years 2009 and 2010 is being put in place.

Furthermore, it was decided to employ 1000 extra specialised staff to improve the placement prospects of employees (job-to-job placement). There are also plans to intensify the Federal Labour Agency’s special programme for less qualified and older employees (WeGebAU). By extending the maximum drawing period for short-term-work unemployment benefit to 18 months for workers whose entitlement to such compensation arises before 31 December 2009, greater planning security is being created for employers who do not hand out redundancies during this period. The use of short-term work to further train employees is also to be made possible.

In the field of taxation, targeted measures have been initiated. These include allowing small and medium-sized enterprises to apply a special depreciation rate for a limited period of two years, and introducing more far-reaching rules on the deductibility of payments made for handicraft services.

In order to increase investment in the energy efficiency of buildings, the funds available for the CO_2-building rehabilitation programme and other measures are being increased by €3 bn. for the period 2009 to 2011. This is contained in the federal government initiative “Old-age as an economic factor” through the KfW support programme to redesign residential spaces to better meet the needs of older residents, as well as the investment pact between federal, regional and local authorities to improve the energy footprint of schools, kindergartens, sport halls and other social infrastructure and large residential areas. The federal government will also introduce measures to promote the development and diffusion of eco-efficient vehicles while easing the adaptation process for the car industry.

Overall between 2009 and 2010, the measures contained in the package will help bolster investments and orders made by companies, private households and communes totalling roughly €50 bn. In addition, measures to ensure companies' financing and liquidity needs are met are financing investments totalling roughly €20 bn.

Already in October 2008, the cabinet adopted measures aimed at easing the strain on both citizens and companies alike to the tune of approximately €6 bn. in 2009 and almost €14 bn. each year in the years thereafter. These measures include increasing children's allowance and reducing the contribution rate to unemployment insurance. In 2009 and 2010 alone, a total of €31 bn. approximately will be made available from all levels of public budgets to bolster the forces for growth.

2.2 Quality of public finances

Improving the quality of public finances is motivated by the desire to increase growth potential. Managing public revenues and expenditure so as to promote growth on a sustainable basis is a fundamental building block towards a permanently higher growth path. Fiscal policy rules and institutions, such as a greater focus on output in the budgeting process, also have an important role to play here. The quantitative and the qualitative aspects of consolidation act as complements to each other: ensuring that the success already achieved in structural consolidation continues to be achieved over the long-term is the most important prerequisite if there is to be more emphasis on policy areas which are focused on the future. It is also against this background that the reform of the constitutional rules on keeping national indebtedness in check continues to be a central objective of the federal government as part of the reform of the federal system in Germany.

Quality of the expenditure side

In its 2009 budget and its financial plan to 2012, the federal government is, in addition to the measures to enhance growth, continuing its two-pronged approach: the foundations for growth are being solidified without losing track of the structural overhaul of the public budgets. For example, as in the previous years, the federal government will once again make additional funds available for research, development and innovation. The 2009 budget provides for additional investment in research and development of roughly €650 m., while the financial plan to 2012 provides for an additional annual €450m for the years thereafter. Moreover, there will be a marked increase in spending on climate protection measures, primarily financed by additional revenues from the auctioning of emission permits. Extra revenue from the the road charges programme will mean more money being invested in transportation. In 2007, an important step was made towards improving work-life balance with the introduction of the parental allowance. The funds for the allowance will be replenished in 2009 by an additional €350 m., as the numbers applying for the allowance has turned out to be greater than originally expected.

A subsidy policy orientated on the quality of public finances means that financial aid (expenditure side) and tax benefits (revenue side) have to be systematically assessed on the basis of a macroeconomic cost-benefit analysis and, where necessary, adjusted or even stopped. Since 1998, federal financial assistance has been roughly halved and, at just over €5.5 bn., has now reached a threshold which cannot be further reduced without running into difficulty. The process of assessing, limiting and rolling-back subsidies has already begun. Three quarters of all current financial subsidies are now under review at the government departments responsible.

Quality of the revenue side

The VAT rise in 2007 was part of an overall concept to overhaul the public budgets and at the same time created a certain amount of leeway for a reduction in the contribution rate to social insurance, namely to unemployment insurance. Since a reduction in social security contributions reduces the difference between gross and net income - the so-called tax wedge - there is more of an incentive to hire staff. In addition, the momentum created as a result of the reduced cost of labour plays an essential part in reducing unemployment. Sustainable financed public budgets are a priority for Germany. A further general reduction in the tax and social security ratio would counteract this objective.

2008 was marked by changes in two areas of tax policy in particular. The reform of business taxation, which came into force at the start of the year, enhanced the basis for economic growth and employment and made Germany more attractive as a place to locate business. In addition, the legislature increasingly turned its attention to the question of old-age provisions. Corresponding legislation was introduced to augment private pension provisions.

2009 will see tax measures introduced to simplify and extend the possibilities open to private households to be seen as clients and employers. Support for employment in the household and services in or around the household, and the favourable tax treatment of care and nursing have been improved. Moreover, family support will be improved from 2009, for example by increasing children’s allowance and raising the tax exemption for dependent children. The tax deductibility of payments made as provisions for health insurance and nursing care insurance will be vastly improved from 2010, providing citizens with around €9 bn. worth of relief. Also planned for 2009 are new rules for inheritance tax. The draft bill to reform the Inheritance Tax Act, which has been adopted by the cabinet, ensures that, when a company is inherited, its continued existence - and thus growth and employment - is not threatened.

Subsidy policy on the revenue side is also focussed on dismantling outdated tax benefits. Many of these have existed unchanged for years or even decades, without much thought being given to whether the original objectives behind the support continue to exist or whether such support is proving at all effective. To redress this situation, the Federal Ministry of Finance has commissioned independent research institutes to evaluate these tax benefits.

Institutional framework conditions

In Germany, the framework conditions for fiscal policy are formed to no small degree by the federal structure of the country. Following the entry into force in 2006 of the first phase of the reform of federalism, which has led, for example, to a more efficient division of responsibilities, a second step is now intended to modify the financial relations between the federation and the Länder. A joint commission comprising members of the upper and lower parliamentary chambers has been constituted, charged with drawing up suitable reform concepts. The constitutional and statutory amendments which arise over the course of the second reform phase are to be adopted before the present legislative period ends.

Limiting national indebtedness and avoiding budgetary risks are seen as two core objectives in the federal state. The institutional conditions for the sustainable development of public budgets, as set out in the constitutional rules governing public finances, must be improved. More stringent rules governing indebtedness and an early-warning system to flag budgetary difficulties before they occur can help the state to regain and permanently retain the financial leeway it needs to fulfil the urgent demands of the future.

A further reform project within the sphere of the fiscal policy institutions is a stronger focus on result-and-resource-based budgeting and accounting. State revenues and expenditures must not only be regularly assessed with regard to their necessity; their effectiveness and efficiency must also be looked at. Moreover, the fiscal effects of budgetary decisions have to be shown in a more transparent manner by including and reporting the resources used. Against this background, the Federal Ministry of Finance is currently working on a reform of the budgeting and accounting system at the federal level. To this end, a project group charged with examining the main reform approaches domestically and abroad was set up and has already submitted its proposals. An extended cash-based accounting system has shown to be a suitable model for a reform of the federal budget.

The intended objectives of this model include:

- to permanently improve how resource use and assets are recorded,
- to manage the budget on the basis of results rather than the deployment of funds,
- to retain the payments level as an important and original control variable,
- to introduce a top-down approach, making the process of drafting the budget more efficient.

The general concept has already been subjected to a rudimentary evaluation. A more detailed concept is currently being drawn up. The aim is to have a specific reform concept for the federal budget on the table by mid-2009. This will be followed by a pilot phase from 2010, during which the detailed concept will be implemented and tested.

Main reforms to boost the momentum for growth

In addition to the measures relating to public finances, other reforms are helping to enhance the growth potential. Open markets, competition and transparency are basic prerequisites for sustainable growth. In the electricity and gas markets, for example, the Ordinance on regulating incentives was implemented and anti-trust supervision stepped up. Germany's postal sector has already been fully open since the end of 2007. In the telecommunications sector, the broadband market is developing at an extraordinarily dynamic pace thanks to the correct regulation and increasing competition in the supply of infrastructure. The railroad sector has also shown positive development, with respect to both increased transportation and competition. Given that over the next 10 to 15 years some €50 bn. to €80 bn. will have to invested in modern telecommunication networks, there is a need for a corresponding policy. The federal government will introduce measures to create incentives for investment.

The federal government will continue to reduce unnecessary bureaucracy. A number of simplifying measures leading to a reduction in bureaucratic burdens amounting to roughly €4.4 bn. each year have already been set in motion. Further measures will follow. For instance, the third SME Relief Act is currently being discussed in parliament. The initiative conceived for the Mittelstand will lead to barriers to entrepreneurial activity being broken down. For example, the reform of the Limited Companies Act will make it easier to set up limited companies. The “Kleiner Mittelstand” initiative (an initiative for smaller-scale SMEs) is improving the financing options open to such companies.

An increasing global demand for energy and ever-scarcer fossil resources mean that Germany and Europe are faced with the challenge of ensuring long-term energy supply while at the same time fighting climate change. With the help of its “Integrated Climate and Energy Programme”, the federal government is introducing measures to increase energy efficiency, reduce energy use and cut CO_2 emissions. The Renewable Energy Act, in particular, has helped Germany build up a leading position in this field.

In markets which are increasingly knowledge-based, quality demands are constantly rising. This is why the federal government has set itself the goal of further improving the framework conditions for education, research and innovation and has initiated a cross-policy hightech strategy. The “Initiative for Excellence” is leading to improved conditions in the field of scientific research. The Pact for Research and Innovation is providing the necessary drive for structural change in the scientific world. For instance, partnerships are being forged between the scientific and the business communities, talented young scientists are being promoted and international competitiveness improved.

The “Initiative on Qualifications”, which was adopted in January 2008, is intended to improve the educational and employment prospects for young people in Germany. By extending the level of day care, the government is aiming to support the development of children at an earlier stage, to ensure that all have the same opportunities in early life, to make it easier to strike a work-life balance and to provide parents with the freedom to choose.

The labour market reforms (Act on modern services in the labour market, Act on labour market reforms, Social Code II Further Development Act) have helped usher in a strong recovery on the labour market. Even those groups faced with particular difficulties on the job market have profited, not only from a more flexible and dynamic environment, but also in the form of special assistance. The structural reforms of recent years and the economic upturn have meant that unemployment has fallen sharply from roughly 5 m. (2005) to just under 3 m. Labour participation - especially among elderly workers - has increased significantly. The sustained reduction in unemployment remains a key task of the federal government.

2.3 The long-term sustainability of public finances

It is already apparent today that the coming years and decades will see marked changes to the population of Germany in terms of structure and size. Here, the fact that society is going to age considerably is going to pose a greater challenge than the possible decline in numbers of inhabitants. By 2050, the old-age dependency ratio, i.e. the ratio between those of retirement age and those of working age, will have roughly doubled. Such a severe change will greatly increase the pressures on public finances.

At both the national and at the EU level, budget forecasts are drawn up at regular intervals covering several years. In each of the last two years, the federal government’s report was largely based on corresponding analysis at Community level. The EU Member States participated in these calculations via the joint work in the Economic Policy Committee. The model forecasts most recently published by the Economic Policy Committee and the Commission were presented in the previous update of the German Stability Programme. These forecasts are tailored to developments at Community level and do not always precisely reflect the specific national circumstances, they tend to lose accuracy over the course of time.

With its Second Report on the Sustainability of Public Finances, the German Federal Ministry of Finance is continuing the national reporting it began in 2005. As with the first publication, this second report is based on model calculations by an independent economic research institute. In order to be better able to address the uncertainties which are part of the nature of long-term forecasting, no specific scenario is chosen as the point of reference. Instead a “central corridor” of equally plausible developments is used as the basis. The limits of this corridor are given by the scenarios T+, which represents favourable developments for sustainability, and T-, which represents unfavourable developments. The results and the underlying assumptions of both scenarios are shown in the following tables:

Table 1: Development of demography-dependent expenditure from a long-term perspective (“T+” scenario)

	2005	2020	2030	2040	2050
	Expenditure as % of GDP				
Old-age provision[1)]	11.4	11.3	12.9	13.7	14.2
Health[2)]	7.1	8.2	8.9	9.9	10.8
Education and family[3)]	6.4	5.3	5.4	5.5	5.4
Unemployed[)]	3.4	2.2	2.1	2.1	2.1
	Assumptions				
Labour productivity[5)] (%)	1.0	1.6	1.6	1.4	1.4
Gross domestic product[5)] (%)	0.9	1.0	0.6	0.9	0.7
Participation rate(%)					
-Women (15-64)	70.8	73.2	74.9	77.0	77.8
-Men (15-64)	82.0	83.1	83.8	85.0	85.3
Unemployment rate[6)] (%)	11.4	7.7	7.7	7.7	7.7
Old-age dependency ratio	28.9	36.7	50.2	59.8	64.4
Population (m.)	82.4	80.5	78.1	74.8	70.7
Population 65+	15.9	19.0	23.0	24.9	24.7

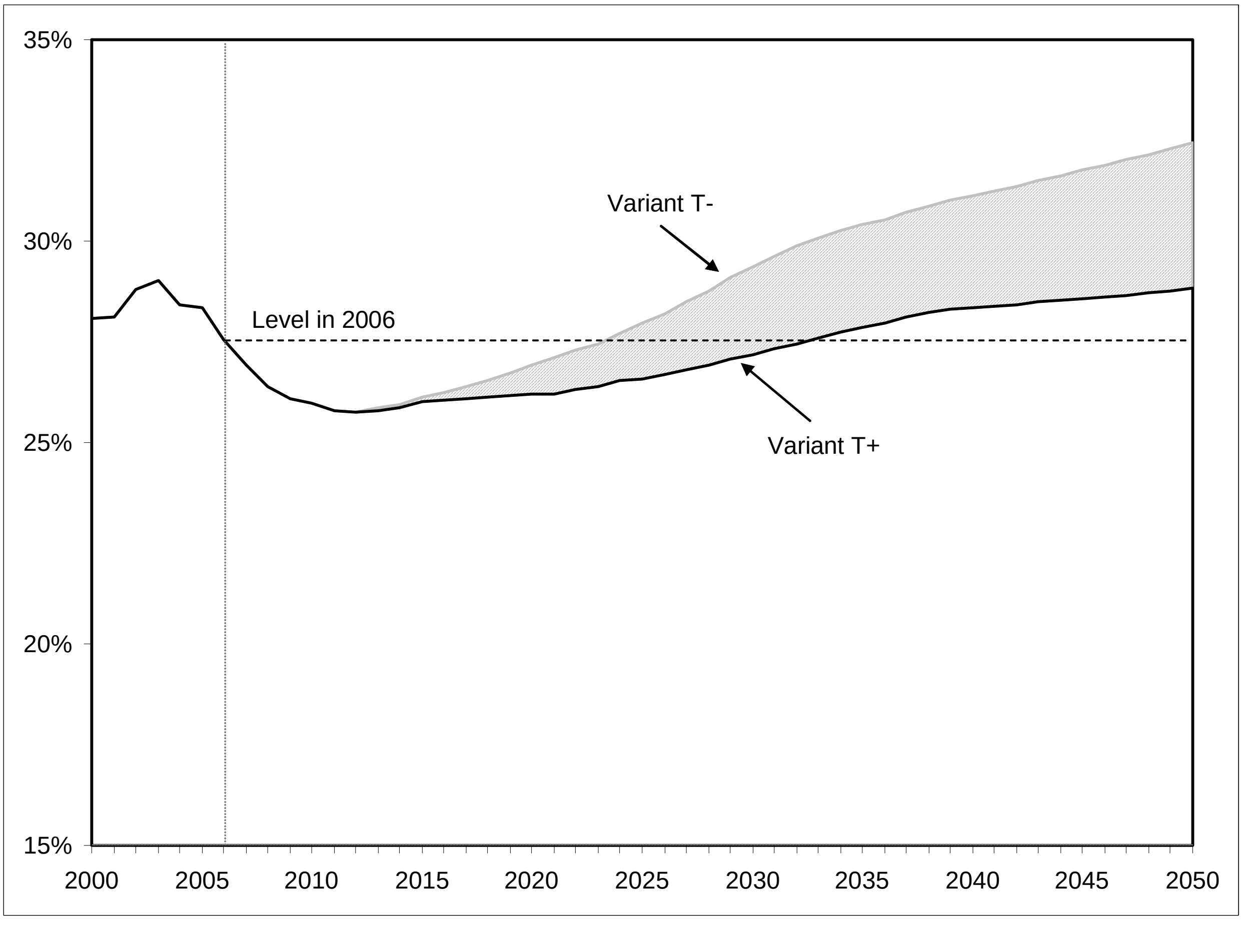
Table 2: Development of demography-dependent expenditure from a long-term perspective ("T-" scenario)

	2005	2020	2030	2040	2050
	Expenditure as % of GDP				
Old-age provision[1)]	11.4	10.9	11.9	12.4	12.5
Health[2)]	7.1	8.0	8.4	9.1	9.5
Education and family[3)]	6.4	5.4	5.6	5.8	5.7
Unemployed[)]	3.4	1.9	1.2	1.1	1.1
	Assumptions				
Labour productivity[5)] (%)	1.0	1.8	1.8	1.7	1.7
Gross domestic product[5)] (%)	0.9	1.7	1.4	1.6	1.4
Participation rate(%)					
-Women (15-64)	70.8	73.7	75.7	77.4	78.1
-Men (15-64)	82.0	83.9	85.0	85.6	86.0
Unemployment rate[6)] (%)	11.4	6.9	4.6	4.0	4.0
Old-age dependency ratio	28.9	35.3	46.4	52.4	53.3
Population (m.)	82.4	81.9	81.2	79.7	77.5
Population 65+	15.9	18.6	22.2	23.8	23.5

1) Statutory pension insurance and civil service pensions
2) Statutory health insurance and social care insurance
3) Education budget, family-related benefits and tax allowances, and parental allowance (2005: child-rearing benefit)
4) Unemployment insurance and basic allowance for job-seekers
5) Change in real terms compared to previous year
6) Registered unemployed (Federal Labour Agency)
Source: Model calculations by the ifo-Institute. Demographic assumptions correspond to the 11th coordinated population forecasts of the Federal Statistical Office.

In a departure from the hitherto method, basic allowance payments for job seekers, which is financed from general budget funds, were taken into consideration in addition to the contribution-related substitute wage payments of national unemployment insurance when assessing spending on unemployment. This results in an increase in the share of this expenditure when compared to the previous year. This same is true for spending on education, which was extended to include payments for family policy measures. The declining proportional trend in spending in this category can be put down to the underlying assumptions on the demographic development, especially with regard to the T- scenario. The following figure shows the overall expected development of the national demography-dependent expenditure looked at in the model calculations:

Figure: Demography-dependent spending (as % of GDP) from a long-term perspective



Source: ifo

As can be seen, in the more favourable variant, T+, spending reaches the 2006 level only after 2030, whereas in the less favourable variant, T-, the level is reached already ten years earlier. Spending pressure increases up to 2050, ranging between 1.3 and 4.9 percentage points in the corridor shown. Taking the mean value, the increase in spending required, at roughly three percentage points, corresponds in the main to the result arrived at for Germany at the EU level, despite slightly different assumptions. Without the pension reform of 2004 (sustainability factor) and that of 2007 (retirement at 67), spending as a percentage of GDP would rise by an additional two percentage points by 2050. This shows that important measures have already been introduced by policy-makers to reach a sustainable long-term state of public finances.

Reforms in the social security systems

The federal government is continuing its course already embarked upon to design both the financing side and the benefits side of the social security systems in such a manner as to meet the challenges of the future. On the one hand, an adequate level of benefit must be ensured for the long-term. On the other hand, the federal government has set itself the goal of keeping the rate of social insurance contributions, which is financed in equal part between employee and employer, permanently below 40 %.

The most significant changes entailed in the 2007 health care reform will come into effect at the start of 2009. This reform creates more incentives for competition for policy-holders between the health insurers. For the first time, the federal government has agreed a uniform contribution rate for statutory health insurance, which it has set at 14.6 % of the income subject to insurance contributions (15.5 % including special contribution from employee). This rate will come into effect from 2009 and will replace the hitherto rates, which varied from insurer to insurer. The contribution rate is 0.5 percentage points higher than the current level and is to be used, among other things, to finance pay increases for doctors with their own practices and for hospital employees, as well as to finance an increase in health care staff in hospitals. As compensation, the contribution rate of unemployment insurance is being reduced.

The contribution revenue will flow for the first time into a newly created health fund. This fund will be paid a federal subsidy increasing by €1.5 bn. each year (€4 bn. in 2009, €14 bn. in the final year 2016) in order to provide general cover for services benefiting society as a whole. From 2009, the health insurers will receive a flat-rate amount from the health fund for each policy holder, adjusted to reflect differences in the risk profile. Morbidity is being taken into account in the financial compensation for the first time. Also from 2009, the insurers will be entitled to demand a limited additional contribution from their policy holders where the allocations from the health fund prove inadequate. Equally, they can pay out a premium where they are running a profit. The federal government is only obliged to modify the uniform contribution rate when the revenue of the health fund drops below 95 % of the expenditure of the health insurers.

In future, mergers between insures providing different forms of coverage will be possible. There will be more competition in the private health sector as it will be easier to transfer ageing-reserves. Every health insurance provider is required to offer a basic rate which does not exclude certain benefits, contains no risk premiums and obliges the insurer to furnish services to all who apply. Finally, also for the first time, every citizen will be obliged to hold a health insurance policy from 2009 on.

The reform of the system of statutory long-term care insurance has been in force since July 2008. Benefit payments, which have remained constant since 1995, are being increased in three steps from 2008 to 2012, with a parallel expansion of out-patient care. Those suffering from dementia will receive more support as well as, for the first time, benefits even where they have not been assigned a nursing care category. The contribution rate to statutory nursing care insurance will increase by 0.25 percentage points in order to redress the financing deficit experienced to date and to finance the expansion of services up to the middle of the coming decade. Here, once more, the effects on the non-wage labour costs have been more than balanced out by a preceding greater reduction of the contribution rate to unemployment insurance. From 2015, the benefit amounts can be retroactively adjusted to reflect price developments of the preceding three calendar years. The gross wage increase in the same period cannot be exceeded, however. The exact rate of adjustment will be set by the federal government.

The contribution rate to unemployment insurance has been, as previously mentioned, substantially reduced, partly from extra revenue as a result of the increase in the rate of VAT. The first reduction was in 2007, where the contribution rate was lowered from 6.5 % to 4.2 %. The second reduction was on 1 January 2008, with the rate falling further to 3.3 %. From 1 January 2009 to 30 June 2010, it will be provisionally reduced to 2.8 %. Thereafter it will be 3.0 %. The cut from 6.5 % to 3.0 % represents an annual reduction in contributions of roughly €28 bn. The provisional cut between 1 January 2009 and 30 June 2010 represents further relief of €2.4 bn. for those paying the contributions. Overall, the contribution rate has been reduced by more than half. This is a direct dividend of the structural reforms of the labour market carried out over the past five years.

The reforms implemented in the last years have laid the foundation for the financial stabilisation of the system of statutory pension insurance. The broad spectrum of support provided for supplementary private and occupational provisions has also helped to ensure a balanced financial basis for old-age insurance. All further decisions in this legislative period will be informed by the statutory targets relating to contribution rates and pension level. The contribution rate is not to exceed 20 % by 2020 and 22 % by 2030. It was decided in 2007 as part of an overall strategy to improve the employment situation of older people to increase the retirement age gradually to 67 in the period from 2012 to 2029.

Several changes have been made since 2001 to modernise the formula used to adjust pensions. This formula is oriented on gross wage developments, but also takes into account the provisions made by employees themselves as part of the introduction of a fully-funded pension system (Riester pension). The formula's sustainability factor reflects the fact that, in future, less contributors will have to pay for more beneficiaries as a result of demographic change. At the same time, the basic rate of statutory pension insurance has been fixed by law. These modifications to the pension adjustment formula were tied to a protective clause which ensures that pensions cannot fall as a result of dampening factors. This protective clause was used in the pension adjustments 2005 and 2006. The dampening effects will be allowed to take retroactive effect from 2011 by halving pension increases until there is no longer a need for compensation.

The increasing private provisions made by the workforce were not included in the calculation of pension adjustments (Riester factor) in 2008 and 2009. The result is higher pension adjustments. Since this involves postponing until 2012 and 2013 the inclusion of this part of the Riester factor in the pension adjustment calculation rather than its abolition, the long-term statutory contribution ceilings can be adhered to.

2.4 German fiscal policy in the European context

The EC Treaty and the Stability and Growth Pact as reformed in spring of 2005 provide the legal basis for budgetary surveillance and the decisions within the context of the current deficit procedures. This legal framework was also the basis on which the ECOFIN Council decided in 2007 to end the excessive deficit procedure against Germany, which had been initiated in 2003.

The fact that Germany was able to reduce its deficit is confirmation of the success of its fiscal policy, which places equal emphasis on structural consolidation and enhancing the potential for growth. Germany continued to push on with the structural consolidation of its budgets in favourable economic times, and this is why it now enjoys the financial leeway for a fiscal policy which stabilises the financial markets and promotes growth.

The national budget is already structurally balanced, and it is Germany’s goal to preserve this balance over the long-term, i.e. to remain within a financing balance of 0 and - 0.5 % of GDP. It is the federal government’s view that, in order to ensure that what has been achieved can also be preserved, rules stipulating that federal and regional budgets should generally be structurally balanced should be anchored in the constitution as part of the second phase of the reform of the federal system in Germany.

The reformed Stability and Growth Pact offers Member States, the Commission and the Council sufficient opportunity to deal with extraordinary circumstances, such as the ongoing financial market crisis, adequately. Where a deficit is being run and the reference value is only marginally exceeded, the causes of the deficit will ultimately have to be assessed. In exceptional cases, the deficit cannot be viewed as excessive according to the Stability and Growth Pact where it is caused by an extraordinary event which is outside of the control of the Member State concerned and which has grave consequences for the national state of finances or which can be traced back to a major economic downturn.

However, the German government believes that, in applying the Stability and Growth Pact, the structural consolidation of public budgets should be put at the heart of fiscal policy even in economically difficult times.

In its National Reform Programme 2008-2010, the federal government outlined the important reforms it is undertaking for more growth and employment. The measures described therein also take into account the general fiscal policy recommendations set out in the “Broad Economic Policy Guidelines” updated in 2008.

3 Macroeconomic situation and outlook to 2012

3.1 Assumptions underlying the macroeconomic forecast for 2008 and 2009 and for the medium-term to 2012

The forecasts are based on the following assumptions:

- Global economic momentum slows down considerably over the course of 2008. At roughly 3 %, the growth rate of the global economy will be markedly lower in real terms than that of the previous year and will further decline to 2½ % in 2009 (as a comparison, the corresponding figure for 2007 was + 5 %). As a result of the slowdown in global economic activity over the period being forecast, the international exchange of goods and services will also decline. World trade will grow at a much slower pace than before, with 4 % and 3 % forecast for 2008 and 2009, respectively. The global economic downturn is unlikely to be long-lasting. It is assumed that world trade will pick up over the course of the period being forecast. Over the medium-term, Germany will be able to assert its market share as a result of its high level of international competitiveness.
- The technical assumptions concerning exchange rates and oil prices are based on the respective averages of the weeks leading up to the forecast. This means an exchange rate of US Dollar 1.50 to the euro in 2008 and US Dollar 1.42 in 2009. The price of a barrel of Brent oil is put at US Dollar 95 for the entire period being forecast. This means an average annual price of crude oil in 2008 of US Dollar 107 per barrel and of US Dollar 95 per barrel in 2009. A further technical assumption is that the ECB’s main refinancing rate will remain at 3.75 % for the entire forecast period.
- With an increase in actual earnings (domestic concept) of 2.4 % in 2008 and 2.8 % in 2009, pay increases will be higher than in the preceding years (1.6 % in 2007). The increase in actual wages is thus closer to the trend of increased labour productivity. Unit labour costs will rise more rapidly than before (+1.6 % in 2008, +2.5 % in 2009), especially as a result of the cyclical downturn of productivity growth in the short-term forecast period. A continued moderate wage development is assumed over the medium-term forecast period, i.e. the growth in actual earnings should be below the growth in nominal trend productivity.
- The macroeconomic framework conditions remain favourable over the medium-term:
  - It is assumed that the international finance systems are soon stabilised and that the negative consequences of the financial market crisis on the real economy can be limited, both in terms of extent and duration.

- The federal government's economic and fiscal policy course make an important contribution towards making Germany a more attractive economic location. By mobilising the macroeconomic factors of production to a greater degree, the structural reforms also play their part in improving medium-term growth and employment prospects within the German economy.

3.2 Macroeconomic situation in Germany in 2008

2008 saw a marked cooling off of the economy in Germany. The slowdown in macroeconomic activity, which set it in spring, is expected to persist for the time being. Industrial manufacturing and both domestic and foreign demand are on a downwards trend and business sentiment has noticeably deteriorated.

So far, the direct effects of the international financial market crisis have been tightly limited in Germany. However, the indirect effects are already being felt via the slowdown in the global economy - in particular in the main trading partner countries in the euro area and in the USA, but also via the worsening framework conditions for trade financing with emerging-market and developing countries. High-end technological investment goods are an important part of Germany's exports. The fact that the demand for these products in particular is declining means that Germany is especially effected by the slowdown in global economic activity.

But the domestic activity in Germany has also weakened over the course of the year. Expenditure on machinery and equipment has slowed down considerably following a strong rise at the start of the year. This is reflected both in the SNA data for the 3rd quarter (decline of 0.5 % in real GDP) and in the downwards trend in manufacturing and receipt of orders for investment goods. Although capacity utilisation is still high, it is expected to decline as a result of falling demand. Following the good results in the first half of the year, the economic indicators also suggest sluggish momentum in the construction industry. The positive trend in orders received for some categories waned somewhat at the current end. Although the trend in building permits for residential and commercial buildings has increased, the deterioration in sales expectations both on the domestic front and abroad could mean that approved projects may be postponed. There has been no evidence so far of a recovery of the most important component of domestic demand, consumption expenditure by private households. This is caused by the decline in purchasing power as a result of the price level increases in energy and comestible goods. There may be a slight recovery over the further course of the year, however. The increase in disposable income - following the expansion in employment, pay increases and the further net reduction in social insurance contribution rates - has a positive effect on private consumption. The rate of inflation, which continues to decline, should also bolster private consumer spending. Nevertheless, the level of consumer prices continues to be significantly higher than before the dramatic price increases for energy and comestible goods in autumn of last year.

The economic downturn has been barely noticeable on the labour market to date. Both the decline in unemployment and the expansion in employment remain strong, albeit with slightly less momentum. The slowdown in the economy is expected to be felt on the labour market with a slight delay - probably only towards the end of the year.

3.3 Short and medium-term outlook for the overall economy

In its autumn forecast, the federal government expects GDP in 2008 to grow by 1.7 % in real terms thanks to the favourable beginning to the year. However, the economy shows a cool down over the course of the year. Flagging stimulus from abroad, declining investment activity and a weaker trend in private consumption are the main reasons for this downturn. The rise in exports is expected to be much less than the previous years, due to the worsened conditions in foreign trade. The trade balance is thus expected to boost growth by just 0.5 percentage points, far less than in 2007. In contrast, domestic demand will be the main contributor to economic growth in this year (+1.2 percentage points). This is mainly the result of the rise in investment in equipment, machinery and construction. On yearly average, investment activity is expected to rise substantially, above all because of the positive 1st quarter. Average spending on private consumption is likely to suffer a setback in 2008 despite the slight recovery expected in the 2nd half of the year. There is expected to be a slight delay before the slowdown in the economy has a negative effect on the labour market - probably towards the end of the year. Taken on average for the year, however, the unemployment figure will register a strong decline (-514 000) while the number of those in work will rise (+532 000).

In light of the worsened situation this year and the less favourable economic framework conditions both domestically and abroad, the federal government has revised its growth forecast for next year to 0.2 % in real terms (given at +1.2 % in the spring forecast). The global economy has cooled down and this is having a noticeable effect on exports. As a result, net exports are not expected to contribute to economic growth in the coming year. Domestic demand is also expected to weaken considerably, due to declining investments in equipment and machinery. Investment in construction is expected to register a slight increase only. Private consumption will more than likely pick up somewhat over the course of the year. A strong increase in individual net wages and salaries is expected. In addition, a further decline in inflation is likely to ease the strain on purchasing power and thus encourage private consumption. The economic slowdown will be apparent on the labour market in 2009. The lower rate of economic growth should lead to a slight reduction in numbers employed (annual average of persons in employment - 42 000). Nevertheless, the number of persons registered as unemployed is expected to remain largely unchanged on yearly average due to a diminishing labour supply, which also reflects demographic trends.

GDP is likely to grow over the entire medium-term forecast period (2008 to 2012) by roughly 1 ½ % per year. The economic slowdown expected over the short-term and its curtailing effect on investment activity and labour market potential will slightly dampen potential growth, i.e. the long-term development of GDP where existing macroeconomic manufacturing capacity is running at normal levels. For this period, potential growth is expected to be just under 1 ½ % per year. Because of the cooling off of the economy, macroeconomic manufacturing capacity is expected to be running at lower-than-normal levels. It is unlikely that this production gap will have been closed by the end of the medium-term forecast period, since it is expected that GDP will only increase at the rate of potential growth in the years following 2009.

Given that world trade is expected to increase over the course of the forecast period, German net exports will make a slight contribution to economic growth. The main driver of growth will be domestic demand, both in terms of consumption and investment. Private consumption will make an increasingly important contribution to economic growth over the course of the medium-term forecast period, and will increase over the entire period at a rate just marginally below that of GDP. Corporate investment is likely to continue to grow at a disproportionately higher rate than macroeconomic production. Employment could rise by approx. 700 000, or ½ %, per year to roughly 40.5 m. persons employed.

One risk for the forecast is that the slowdown in the global economy is more pronounced than expected. Significant uncertainties also exist as to the duration, extent and macroeconomic effects of the financial market crisis. A higher oil price, were it to rise again, would put more pressure on consumers and companies alike. Were the euro to gain again in value against the US dollar, export trade would be hampered, both directly and via third markets.

There is, however, also the possibility that the situation develops more favourably. German companies are in good condition (consolidated balance sheets, sound cash-flows, strongly price competitive). The federal government has embarked upon a course of economic and fiscal policy which is favourable for economic development over the short and medium-term. The package of measures introduced are helping to stabilise both the financial market and the economy. Moreover, Germany has initiated structural reforms (Agenda 2010, Hartz-Reforms) which have contributed to improving the situation on the labour market. There is an opportunity for better economic development if the global economic weaknesses can be overcome more quickly and there is a stronger decline in the inflation rate.

4 Development of the public budgets

4.1 Development of net borrowing/net lending

Balanced general government budget

Germany’s general government budget will be balanced this year for the first time since 1989. While it is also true that a slight surplus of 0.1 % of GDP was originally reported for last year, this had to be revised downwards by 0.3 percentage points following the decision of Eurostat to record in the national accounts the measures undertaken by KfW as part of the risk shield provided to IKB, turning the initial surplus into a deficit (Table 3).

The continued consolidation in the current year 2008 is influenced to a large degree by the – on average – still quite favourable macroeconomic development. This consolidation has led to a noticeable easing of the pressure on public budgets. Real GDP growth in this year is well above its potential path; consequently, there has been additional cyclically-induced revenue from taxes and social contributions, and less needed to be spent on the cyclically sensitive labour market. The economic slowdown which became more apparent as the year wore on has not yet been felt in public revenue and expenditure. This positive development is offset, again this year, by risk shield measures provided to banks with public ownership, which are recordable as notional capital transfers in the general government sector.

Table 3: Development of the general government budget balance

	2007	2008	2009	2010	2011	2012
	- as % of GDP -					
December 2008 forecast	**-0.2**	**0**	**-½**	**-1½**	**-1**	**-½**
December 2007 forecast	0	-½	0	½	½	-

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

The general government budget balance will deteriorate to -½ % of GDP in the coming year. The main reason for the worsened general government budget balance in 2009 is the marked economic slowdown. In addition, the measures described in Chapter 2 aimed at stabilising the German economy and adopted by the cabinet at the beginning of October (package of measures to reduce the tax burden, stabilise social insurance expenditure and invest in families) and at the beginning of November (securing employment by enhancing growth) place a further burden on central, state and local government and the social insurance funds.

The effects of these measures will continue to be felt into 2010. In addition, the decision of the Federal Constitutional Court to review the deductibility from tax of contributions to health insurance, especially private health insurance, will be implemented by making contributions to health insurance and to full nursing care insurance, whether private or statutory, fully tax deductible. Viewed together and taking into account the increase in the contribution rate to statutory health insurance to a uniform 15.5 % from 2009 on, 2009 and 2010 will experience a fiscal stimulus of roughly 1 % of GDP.

The increase in tax revenues will again be higher from 2011 to 2012 – as consequence of a more favourable medium-term GDP growth corresponding to potential growth. At the same time, the expenditure side will be subdued such that from 2011, excluding any further policy changes, the general government deficit can be expected to decline to roughly ½ % of GDP towards the end of the period covered by the Stability Programme.

Net borrowing/net lending by level of government

The Federation (central government), as defined by the System of National Accounts, i.e. including the special accounts belonging to the sphere of the Federation, will register in 2008 a marked decline in its financing deficit to ½ % of GDP, following 1.1 % in 2007 (Table 4). This improvement can be put down to a very moderate increase in expenditure - despite higher negotiated wage agreements - and substantially stronger growth in revenue - despite the reform of business taxation. The modest expenditure development is partly due to a continuation of the restrictive spending policy. It is also partly attributable to a base effect of the preceding year: whereas the increase in expenditure in 2007 was inflated by the support measures provided to IKB by KfW, which were notionally attributable to the Federation, the related capital transfers in 2008, at about €2 bn, were substantially lower. However, there would also have been a lower increase in spending had the expenditure trend been adjusted to reflect these effects in 2007 and 2008.

Despite the tangible success in consolidating the budget, the Federation, as in 2007, remains the only level of government which is running a deficit.

More pressure is expected both on the revenue and on the expenditure side for the Federation in 2009 and 2010 as a result of the subdued economic dynamic and the measures planned. The deficit at the federal level will only be reduced from 2011 onwards, falling to ½ % of GDP.

This forecast is subject to considerable uncertainties in particular as a result of the financial market developments and the related implications for the real economy. However, bookings in the financial market stabilisation fund - set up in October 2008 as a special federal fund to run until the end of 2009 - will have an effect on the deficit may only if guarantees which were granted fail, recapitalisation is not undertaken at market conditions, or the purchase price of assumed risks is higher than the market value of the assets. As such, only a slight increase in the deficit, if at all, is to be expected. Deficits which remain once the fund has been wound down will be divided between Federation and the Länder at a ratio of 65:35. 50 % of the Länder share is apportioned on the basis of inhabitants and 50 % on the basis of 2007 GDP at current prices.

Table 4: Financial balances by level of government

	2007	2008	2009	2010	2011	2012
	In relation to GDP (%)					
Federation and special funds	-1.1	- 1/2	- 1/2	-1	- 1/2	- 1/2
Regional and local government	0.5	1/2	0	- 1/2	- 1/2	0
Social insurance funds	0.4	0	0	0	0	0
Total government	-0.2	0	- 1/2	-1 1/2	-1	- 1/2

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

The situation as regards the public finances of regional and local governments is also positive in 2008: they will again return a surplus of roughly ½ % of GDP. This also includes depreciations of assets amounting to approx. €1 ½ bn in connection with support measures introduced by some of the Länder for their Landesbanken, which have an effect on the deficit. As with the development of public finances at the federal level, the regional and local budgets will suffer under future budgetary strains in subsequent years. They will run a deficit in 2010 and 2011, returning to a balanced budget towards the end of the programme period.

In contrast to the various levels of government, the social security fund will again be running a surplus though a smaller one compared to the preceding year. The main reason for the reduction of the surplus is the cut in the contribution rate to unemployment insurance. The continued positive development on the labour market was unable to compensate for the marked reduction in contributions to unemployment insurance, resulting in a tangible decline in the Federal Employment Agency's financing surplus. The Agency is expected to fall into deficit in 2009 as a result of another reduction in the contribution rate of 0.5 percentage points. Over the course of the programme period, the social insurance fund budget will remain roughly balanced, with the slightly increasing surplus in 2010 and 2011 returning to a "healthy" zero at the end of the programme period.

4.2 Development of government revenue and expenditure

Government revenue

This year's rise in the tax revenue - as defined in the System of National Accounts -, which was an almost exact proportional match to the increase in GDP, means that the tax-to-GDP ratio of 24 % remains at almost the same level as in the previous year (Table 5). In the coming two years, the tax-to-GDP ratio (without social security contributions) will fall by a total of 1 percentage point due to the weaker macroeconomic development and the tax relief measures adopted.

The ratio of social security contributions to GDP for 2008 is just under 16 ½ %. It is expected to remain roughly at this level in the coming years. This is the result of the combination of the slightly higher contribution rate to social insurance overall and the somewhat more modest development in gross wages and salaries. The social contribution ratio is expected to fall to 16 % in 2012 should the contribution rate to the public pension insurance be lowered.

The total tax ratio for 2008 is at 40 % slightly lower than in the preceding year. This is likely to fall by the end of the programme period by a further ½ a percentage point as a result of the expected decline in the tax-to-GDP ratio and in the ratio of the social security contributions.

Table 5: Development of the tax-to-GDP, social contribution, and tax and social security ratios

	2007	2008	2009	2010	2011	2012
	- revenue in % of GDP -					
Tax-to-GDP ratio	**23.8**	**24**	**23 1/2**	**23**	**23**	**23 1/2**
Social security contributions ratio	**16.5**	**16 1/2**	**16 1/2**	**16 1/2**	**16 1/2**	**16**
Total tax ratio						
December 2008 forecast	**40.3**	**40**	**40**	**39**	**39 1/2**	**39 1/2**
December 2007 forecast	40 ½	39 ½	39 ½	39 ½	39	-

Differences between the total tax ratio and the sum of the tax-to-GDP ratio and the social security contributions ratio are due to the figures being rounded off.

Overall, the increase in government revenues this year is 2 ½ % compared to the preceding year. On average over the entire financial planning period, it is 2 % per year.

Government expenditure

Following the negotiated pay agreements in the public sector, the greatly increased social benefits in kind under the statutory health insurance scheme and the renewed strong growth in public gross fixed capital formation, government expenditure this year rose by 2 ½ % compared to 1.7 % last year. Given that this increase is still well below the GDP growth of 3.0 %, the government spending ratio, i.e. government expenditure as % of GDP, in 2008 has declined further to roughly 44 % (Table 6). This is its lowest value since German reunification.

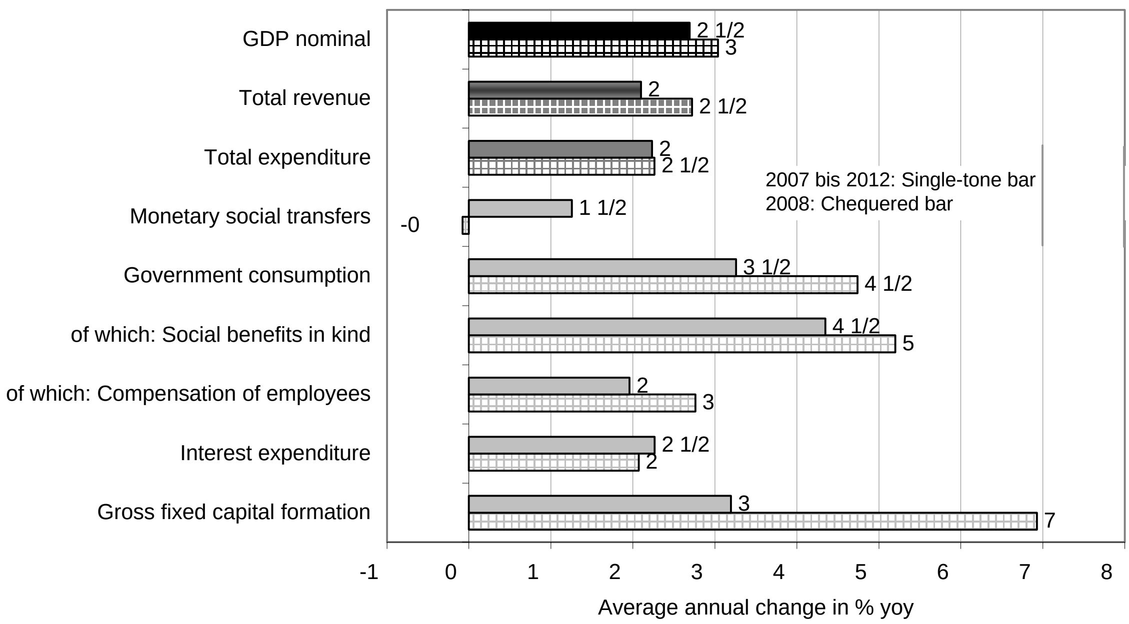
Table 6: Development of government spending ratio

	2007	2008	2009	2010	2011	2012
	- Government expenditure as % of GDP					
Forecast December 2008	**44.2**	**44**	**44 1/2**	**44**	**43 1/2**	**43**
Forecast December 2007	44	43 ½	43	42	41 ½	-

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

The government spending ratio is expected to grow by ½ a percentage point in the coming year. This increase will only be temporary, however, as the years thereafter will see the figure continuing to fall until the end of the programme period. In 2012, the government spending ratio will be 43 %. Viewed over the entire programme period, annual average spending growth will be roughly 2 %. Although it is to be expected that the increase in social benefits in kind remains high and that social payments will, on average, register a higher increase than in 2008, the increase of compensation of employees and gross fixed capital formation will normalise once more over the forecast period.

Figure: Average annual development of public revenue and expenditure and GDP from 2007 to 2012 and in 2008, in % vis-à-vis preceding year



4.3 Development of structural net lending/net borrowing / adjustment path with regard to the medium-term budget objective

2008 general government budget also largely balanced in structural terms

Following a marked reduction of the structural deficit from 2004 to 2007 of almost 3 percentage points in total, the government budget balance for 2008, adjusted for cyclical and temporary effects, was held stable at roughly -½ % of GDP (Table 7). Thus, contrary to last year's forecast of a deterioration in the structural deficit as a result of the entry into force of the reform of business taxation, the increased pay agreements in the public sector and the reduction in the contribution rate to unemployment insurance, the general government budget was once again, for the most part, structurally balanced.

The output gap was again positive, only marginally higher than in the preceding year, amounting to 1 % of potential GDP, therefore GDP growth has been remaining above normal capacity. However, an unchanged output gap also means that cyclical effects had only a small hand in this year's reduction of the structural deficit. The temporary effects to be taken into account this year in calculating the structural government budget balance include the additional burden of €3.5 bn caused by the financial market crisis, federal repayments of €1 bn to Deutsche Post AG following the decision in the state aid case, and roughly €1 bn of overpaid own resources on VAT. The latter is the result of a lower contribution of own resource on VAT from Germany introduced from 2007; however, the reform will first be implemented next year, when overpaid own resources will be refunded.

The deterioration of the fiscal balance in the coming year is caused primarily by cyclical effects, while a successive structural worsening will be registered into 2010, also due to the structural effects of the measures taken to stabilise the economy. It is only in the years thereafter that an improvement to -½ % of GDP will be seen, so that the national budget should be close to structurally balanced towards the end of the programme period.

Table 7: Development of the structural general government budget balance

	2007	2008	2009	2010	2011	2012
Real GDP (% change yoy)	2,5	1,7	0,2	1 1/2	1 1/2	1 1/2
General government net borrowing/net lending (as % of GDP)	-0,2	0	- 1/2	-1 1/2	-1	- 1/2
Structural net borrowing/net lending (as % of GDP)	-0,3	- 1/2	- 1/2	-1	- 1/2	- 1/2

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

However, the forecast of the structural deficit is accompanied by considerable uncertainty which is related to the development of profit-related taxes. The substantial fluctuations observed in past years with regard to profit-related taxes have played a major role in reducing the structural deficit since they are not declared as "cyclical" under the normal methods of adjusting for cyclical factors. However, there is no way that it can be clearly ascertained *a priori* whether, for example, the underlying increase in company profits are ultimately structural in nature - for instance, by companies becoming more competitive - or cyclical - for instance, caused by intertemporal cyclical or other transitory effects. Given that a cooling off of the economy is forecast, there is a danger here that the profit-related taxes are not as buoyant as assumed resulting in an overly-amplified increase of the structural deficit in subsequent years.

Adjustment path with regard to the medium-term budget objective

Germany's objective over the medium-term is to maintain a government budget close to structurally balanced. This will be reached if a medium-term target of between 0 and -½ % of GDP is adhered to. That there has been a slight, short-term deviation from this in the current year is justifiable given the financial market crisis. It is important, however, that the medium-term target remains the focus of a fiscal policy course geared towards long-term sustainability. The consolidation efforts must be taken up anew at all levels of government, especially at the federal level, as soon as the financial market crisis and the related slowdown of macroeconomic activity have abated.

Within the context of the German Commission on Federal Reform, Germany is seeking an amendment to Article 115 of its Basic Law to integrate a new, more-binding debt rule with the goal of running a close-to-balance general government budget on a permanent basis.

4.4 *Development of the level of debt*

Ignoring the effects of the financial market crisis, the 2008 ratio of gross government debt to GDP developed as expected in the December 2007 forecast: as a result of the improved general government budget balance, the ratio would have fallen to 63 % (Table 8).

Whereas up to now the effects of the financial market crisis on the general government deficit were confined mainly to 2007, the rescue and risk-shield measures announced to date will mean an increase this year in the level of government debt by 2 % of GDP. At the level of state governments alone, debt increased through the transfer of the special purpose vehicles attributable to the state sector this year and will increase at the level of the state and the local governments together because of an equity capital injection into a Landesbank next year. In addition, at the federal level, recapitalisation measures are already being taken into account this year in the financial market stabilisation fund. Although recapitalisation and the assumption of risks do not lead to an increase in the deficit as long as they involve an exchange of assets of equal value, they do increase the level of gross debt.

However, these measures have the effect of raising the level of debt on a temporary basis only. The debt level will fall accordingly when the securities mature or are transferred back to the financial institutions. As such, including the effects of the financial market crisis distorts the actual influence of fiscal policy on the ratio of government debt to GDP. Ignoring these effects would mean that the debt ratio would remain unchanged in the coming year given the deterioration of the general government budget balance. The decline predicted in the December 2007 forecast would return from 2010 on, with the 60 % reference value of the Maastricht Treaty being reached at the end of the programme period.

Taking into account the effects of the financial market crisis known to date, and assuming that the induced increase in the level of debt will not be taken back over the course of the programme period, the ratio of gross government debt to GDP, although expected to fall to 61 ½ % in 2012, will still remain above the reference value of the Maastricht Treaty. However, there is a danger, were further institutes to avail themselves of the measures offered within the Financial Market Stabilisation Act, that this development merely represents the lower end.

Table 8: Development of gross government debt

	2007	2008	2009	2010	2011	2012
	- Government debt in % of GDP -					
December 2008 forecast	**65.1**	**65**	**65**	**64**	**63**	**61 1/2**
December 2008 forecast ignoring financial market crisis	65.1	63	63	62	61	60
December 2007 forecast	65	63	61 ½	59 ½	57 ½	-

4.5 *Sensitivity of the government financial balance forecast*

The sensitivity analysis shows the situation where developments deviate from the macroeconomic assumptions. Given the considerable increase in risks since the underlying macroeconomic forecasts for the Stability Programme were made, the sensitivity analysis looks at two risk scenarios which result from a reduction in the annual growth rate of real GDP of ½ percentage point and 1 percentage point, respectively, from 2009 to the rest of the programme period. A constant GDP deflator and a constant GDP composition compared to the basis scenario are assumed.

The sensitivity analysis shows for both scenarios that the general government deficit under otherwise equal conditions would increase already next year by 1 % of GDP, with an even further increase in 2010 (Table 9). Whereas in the "modest" risk scenario of a ½ percentage point lower annual growth rate of GDP from 2010 the deficit falls again to 1 ½ % of GDP by the end of the programme period, the "strong" risk scenario of a sustained 1 percentage point lower average annual growth rate of GDP suggests an increase in the deficit to 2 ½ % of GDP in 2010, remaining at this level until 2012.

It must be borne in mind that standard budget sensitivity is used here to analyse the effects of the business cycle. To the extent that part of the substantial increase in revenue from profit-related taxes in particular might be regarded as transitory, a marked weakening of economic development could cause these taxes in particular to "boomerang". This could lead to an additional deterioration of the general government budget balance.

Table 9: Sensitivity of the government financial balance forecast

	2007	2008	2009	2010	2011	2012
GDP development	- Financial balance in % of GDP -					
Basis scenario	-0.2	0	- 1/2	-1 1/2	-1	- 1/2
Risik scenarios						
• - ½ %-point p.a. vis-à-vis basis			-1	-2	-1 1/2	-1 1/2
• - 1 %-point p.a. vis-à-vis basis			-1	-2 1/2	-2 1/2	-2 1/2

In light of the uncertainty inherent in every forecast, the financial balance is rounded to one half of a percentage point of GDP

Appendix

Table 10: General government budgetary prospects

	ESA Code	2007	2007	2008	2009	2010	2011	2012
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-4,2	-0,2	0	- 1/2	-1 1/2	-1	- 1/2
2. Central government	S.1311	-26,2	-1,1	- 1/2	- 1/2	-1	- 1/2	- 1/2
3. State an local government		11,6	0,5	1/2	0	- 1/2	- 1/2	0
5. Social security funds	S.1314	10,4	0,4	0	0	0	0	0
General government (S13)								
6. Total revenue	TR	1065,9	44,0	44	43 1/2	42 1/2	42 1/2	42 1/2
7. Total expenditure	TE[1]	1070,1	44,2	44	44 1/2	44	43 1/2	43
8. Net lending/borrowing	EDP B.9	-4,2	-0,2	0	- 1/2	-1 1/2	-1	- 1/2
9. Interest expenditure	EDP D.41	67,4	2,8	3	2 1/2	2 1/2	2 1/2	2 1/2
10. Primary balance		63,2	2,6	3	2	1 1/2	2	2 1/2
11. One-off and other temporary measures[1]			-0,3	-0	0	-0	-0	0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		576,3	23,8	24	23 1/2	23	23	23 1/2
12a. Taxes on production and imports	D.2	305,5	12,6	12 1/2	12 1/2	12 1/2	12 1/2	12 1/2
12b. Taxes on income, wealth, etc	D.5	270,8	11,2	11 1/2	11	10 1/2	10 1/2	11
12c. Capital taxes	D.91	0,8	0,0	0	-0	-0	0	0
13. Social contributions	D.61	399,9	16,5	16 1/2	16 1/2	16 1/2	16 1/2	16
15. Other		89,8	3,7	3 1/2	3 1/2	3 1/2	3 1/2	3
16=6. Total revenue	TR	1065,9	44,0	44	43 1/2	42 1/2	42 1/2	42 1/2
p.m.: Tax burden (D.2+D.5+D.61)			40,3	40	40	39	39 1/2	39 1/2
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	448,2	18,5	19	19 1/2	19 1/2	19	19
18b. Social transfers other than in kind	D.62	418,4	17,3	16 1/2	17	16 1/2	16 1/2	16
19=9. Interest expenditure	EDP D.41	67,4	2,8	3	2 1/2	2 1/2	2 1/2	2 1/2
20. Subsidies	D.3	27,1	1,1	1	1	1	1	1
21. Gross fixed capital formation	P.51	35,6	1,5	1 1/2	1 1/2	1 1/2	1 1/2	1 1/2
22. Other		73,4	3,0	3	2 1/2	2 1/2	2 1/2	2 1/2
23=7. Total expenditure	TE[1]	1070,1	44,2	44	44 1/2	44	43 1/2	43
p.m.: Government consumption (nominal)	P.3	435,6	18,0	18 1/2	18 1/2	18 1/2	18 1/2	18 1/2

[1] A positive sign shows a deficit reduction

Table 11: General government debt developments

% of GDP	ESA Code	2007	2008	2009	2010	2011	2012
1. Gross debt		65,1	65	65	64	63	61 1/2
2. Change in gross debt ratio		0,3	2	1	1	1/2	1/2
Contributions to changes in gross debt							
3. Primary balance		-2,6	-3	-2	-1 1/2	-2	-2 1/2
4. Interest expenditure	EDP D.41	2,8	3	2 1/2	2 1/2	2 1/2	2 1/2
5. Stock-flow adjustment		0,2	2	0	- 1/2	-0	0

Table 12: Comparison of the forecasts in the December 2008 and December 2007 Stability Programmes

	ESA Code	2007	2008	2009	2010	2011	2012
Real GDP growth (%)							
Previous update		2,4	2,0	1 1/2	1 1/2	1 1/2	
Current update		2,5	1,7	0,2	1 1/2	1 1/2	1 1/2
Difference		0,1	-0,3	-1 1/2	-0	-0	
General government net lending (% of GDP)	EDP B.9						
Previous update		0	- 1/2	0	1/2	1/2	
Current update		-0,2	0	- 1/2	-1 1/2	-1	- 1/2
Difference		-0,2	1/2	- 1/2	-1 1/2	-1 1/2	
General government gross debt (% of GDP)							
Previous update		64,9	63	61 1/2	59 1/2	57 1/2	
Current update		65,1	65	65	64	63	61 1/2
Difference		-0,2	-2 1/2	-3 1/2	-4 1/2	-5 1/2	

Table 13: Forecast of macroeconomic development from 2008 to 2012[1]

	ESA Code	2007	2007	2008	2009	2010 to 2012[4]
		Index	% change p.a.			
Real GDP, chain index	B1g	108.69	2.5	1.7	0.2	1 ½
Nominal GDP	B1g	2422.90	4.4	3.0	2.0	3
Demand components of real GDP, chain index						
Private consumption expenditure[2]	P.3	102.11	-0.4	-0.3	0.3	1 ½
Govt. final consumption	P.3	104.97	2.2	1.8	1.3	1
Gross fixed capital formation	P.51	102.22	4.3	4.5	-1.4	2
Changes in inventories (GDP growth contribution)[3]	P.52 + P.53	-	0.1	0.2	0.0	0
Exports	P.6	163.52	7.5	4.6	1.2	4
Imports	P.7	141.13	5.0	4.1	1.2	4
Contribution to GDP growth[3]						
Domestic demand (w/o inventories)		-	1.0	1.0	0.1	1 ½
Changes in inventories	P.52 + P.53	-	0.1	0.2	0.0	0
External balance of goods and services	B.11	-	1.4	0.5	0.0	0

(1) 2007: Provisional result from 26 August 2008 of the Federal Statistical Office; 2008 and 2009: Result from 16 October 2008 of the Inter-ministerial Working Group on Macroeconomic Forecasts; 2010 to 2012: Medium-term forecast of 24 April 2008 modified to reflect the result from 16 October 2008 of the Inter-ministerial Working Group on Macroeconomic Forecasts.

(2) Including private non-profit organisations.

(3) Contribution to GDP growth.

(4) GDP rounded to ¼, all other indicators to ½.

Table 14: Price development - deflators[1]

	ESA Code	2007	2007	2008	2009	2010 to 2012[3]
		Index	% change p.a.			
GDP		108.08	1.9	1.3	1.8	1 ½
Private consumption expenditure[2]		110.80	1.7	2.3	2.0	1 ½
Govt. consumption expenditure		105.90	0.2	2.0	2.7	1 ½
Gross fixed-capital formation		103.10	2.9	1.3	0.7	1 ½
Exports		101.03	0.5	1.1	0.7	1
Imports		100.51	-0.1	2.8	0.7	1

(1) 2007: Provisional result from 26 August 2008 of the Federal Statistical Office; 2008 and 2009: Result from 16 October 2008 of the Inter-ministerial Working Group on Macroeconomic Forecasts; 2010 to 2012: Medium-term forecast of 24 April 2008 modified to reflect the result from 16 October 2008 of the Inter-ministerial Working Group on Macroeconomic Forecasts.

(2) Including private non-profit organisations.

(3) GDP rounded to ¼, all other indicators to ½.

Table 15: Labour market development[1]

	ESA Code	2007	2007	2008	2009	2010 to 2012[4]
		Level	% change p.a.			
Employment, persons (domestic) ('000)		39768	1.7	1.3	-0.1	¼
Employment, hours worked (bn. hrs)		57.00	1.8	1.7	-0.1	¼
Unemployment rate (%)		-	8.3	7.3	7.3	7 ½
Labour productivity[2] (2000=100)		106.99	0.7	0.4	0.3	1 ¼
Labour productivity[3] **(2000=100)**		109.94	0.6	0.1	0.3	1 ¼
Compensation of employees (€ bn.)	D.1	1183.47	2.9	3.5	2.7	2 ½
Compensation per employee (€)		33510	1.1	2.0	2.8	-

(1) 2007: Provisional result from 26 August 2008 of the Federal Statistical Office; 2008 and 2009: Result from 16 October 2008 of the Inter-ministerial Working Group on Macroeconomic Forecasts; 2010 to 2012: Medium-term forecast of 24 April 2008 modified to reflect the result from 16 October 2008 of the Inter-ministerial Working Group on Macroeconomic Forecasts.

(2) GDP per person in gainful employment.

(3) GDP per man-hour worked.

(4) GDP and numbers in gainful employment rounded to ¼, all other indicators to ½.

Table 16: Sectoral balances

% of GDP	ESA Code		2007	2008	2009	2010 to 2012
Net borrowing/lending vis-à-vis the rest of the world	B.9		7.6	7.1	7.0	7
of which						
- Balance on goods and services			7.1	6.8	6.7	6 ½
- Balance of primary incomes and transfers			1.7	1.4	1.4	¼
- Capital account			-1.1	-1.1	-1.2	0
Financial balance of private households and private non-profit organisations.	B.9		5.6	5.5	5.4	5 ½
Financial balance of general government	EDP B.9		-0.2	-	-	-