



COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL DECISION

giving notice to Germany, in accordance with Article 104(9) of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

(presented by the Commission)

EXPLANATORY MEMORANDUM

THE EXCESSIVE DEFICIT IN GERMANY

The excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure¹, which is part of the Stability and Growth Pact.

Following evidence of a general government deficit above the Treaty reference value of 3% of GDP in 2002 and based on a recommendation from the Commission, the Council decided on 21 January 2003 that an excessive deficit existed in Germany (Article 104(6) of the Treaty)². In addition, under the terms of the Stability and Growth Pact and based on a Commission recommendation, the Council adopted that same day, a recommendation under Article 104(7) with a view to bringing an end to the situation of an excessive deficit. In this recommendation, the Council called upon *“the German government to put an end to the present excessive deficit situation as rapidly as possible in accordance with Article 3(4) of Council Regulation (EC) No 1467/97”*, meaning that the deficit should be brought below 3% of GDP by 2004. The recommendation was made public. As stated in the Commission Communication of 14 December 2004³, with which the Council concurred on 18 January 2005, in view of the unique circumstances created by the Council conclusions of 25 November 2003 and of the ruling of the European Court of Justice of 13 July 2004, the year 2005 should be considered to be the relevant deadline for the correction of the excessive deficit.

In 2005, the general government deficit in Germany amounted to 3.3% of GDP, according to the data provided by Eurostat based on the report pursuant to Council Regulation (EC) No 3605/93, which Germany submitted to the Commission on 24 February 2006. According to Article 10(3) of Council Regulation (EC) No 1467/97, if *“actual data”* provided by the Commission *“indicate that an excessive deficit has not been corrected by a participating Member State within the time limits specified (...) in recommendations issued under Article 104(7) (...) the Council shall immediately take a decision under Article 104(9)”*, that is, *“give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation”*.

¹ OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

² All documents pertaining to the excessive deficit procedure for Germany can be found on the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/edpde_en.htm.

³ Communication from the Commission to the Council: *The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice* - COM(2004) 813.

THE ECONOMIC AND BUDGETARY SITUATION IN GERMANY

The Commission services' autumn 2005 forecast projected the 2005 deficit at 3.9% of GDP⁴. On a no-policy change basis, the Commission services' forecast projected the deficit at 3.7% and 3.3% of GDP in 2006 and 2007, respectively. Real GDP growth was projected at 0.8% in 2005, 1.2% in 2006 and 1.6% in 2007, with the output gap not fully closing over the forecast period.

Against this background and in view of the still fragile economic situation, the German government, that emerged from the elections of 18 September 2005, devised a strategy to bring the general government deficit below the Treaty reference value by 2007. The government has begun to implement this consolidation strategy already in December 2005, with the adoption of the first measures foreseen therein. On 22 February 2006, the government adopted the draft federal budget for 2006 and, notably, also adopted the draft law to raise the central VAT rate from 16% to 19% as from 1 January 2007.

On 22 February 2006, the Federal Statistical Office released a figure of 0.9% for GDP growth in 2005. According to data provided by Eurostat, the general government deficit in Germany amounted to 3.3% of GDP in 2005. These data, pending a further assessment of their quality, are based upon a provisional notification from Germany pursuant to Council Regulation (EC) No 3605/93, which Germany submitted to the Commission on 24 February 2006. The difference with respect to the Commission services' autumn forecast can be found to a large extent in better-than-expected revenues towards the end of 2005.

The Commission services' interim forecast, published on 21 February 2006, projects real GDP to grow by 1.5% in 2006, which is slightly above the low potential growth rate. It should be noted that this projection is biased upwards by the expected pre-emptive response of domestic demand to the planned increase in the VAT rate. Taking into account the subsequent economic effects, GDP growth in 2007 is currently expected at close to 1%.

Consistent with the above macroeconomic forecast, the nominal deficit is expected to stay slightly above 3% of GDP in 2006, but to drop clearly below the reference value in 2007. The structural deficit (i.e. the deficit in cyclically-adjusted terms, net of one-off and temporary measures) is projected by Commission services to remain broadly unchanged as a percent of GDP between 2005 and 2006 and to narrow by at least 1% of GDP in 2007.

FISCAL POLICY REQUIREMENTS UNTIL 2007 AND BEYOND

Article 5(1) of Council Regulation (EC) No 1467/97 states that "*In the notice, the Council shall request that the Member State achieves a minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically-adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the notice*".

A decisive correction of the excessive deficit in Germany is essential, given the low growth potential and the budgetary challenges from an ageing population. Furthermore, persistent

⁴ This figure was broadly in line with the figure notified by the German authorities on 1 September (3.7% of GDP), the main difference stemming from the securitisation undertaken by the pension office for former post office civil servants, which was not treated as deficit-reducing in the autumn forecast.

budgetary imbalances weigh on confidence and ultimately affect output growth. The budgetary consolidation strategy aiming at securing control of the budgetary imbalances is embedded in the comprehensive work programme devised in November 2005 by the German government. Its implementation is well-advanced. The consolidation strategy aims at a budgetary adjustment in structural terms equalling more than one percentage point to be delivered by 2007. The fact that such strategy will only have limited effects in 2006 partly reflects that some of the measures already implemented will show full effect only with a lag. The envisaged structural budgetary adjustment in the years 2006 and 2007 can be considered consistent with the SGP provisions, including the required annual improvement of the cyclical adjusted balance net of one-off and temporary measures of at least 0.5% of GDP as a benchmark. On the basis of the growth scenario outlined above, the planned adjustment should be sufficient to correct the excessive deficit in a permanent and sustainable manner and would be consistent with the SGP provisions.

In the light of these factors, it appears that the excessive deficit should be corrected by 2007 at the latest. The benchmark of 0.5% of GDP p. a. structural improvement should be respected in cumulative terms in the years 2006 and 2007.

* * *

In view of the above findings, the Commission recommends the Council to give notice to Germany in accordance with Article 104(9) to take measures for the deficit reduction the Council judges necessary in order to remedy the situation of excessive deficit by 2007 at the latest in a permanent and sustainable way. A credible adjustment path with a view to bringing the deficit durably below 3% of GDP by 2007 at the latest would require Germany, on the basis of the Commission services' growth scenario of February 2006, to ensure a cumulative improvement in the cyclically-adjusted balance (net of one-off and temporary measures) by one percentage point of GDP in the years 2006 and 2007. Germany shall take the necessary measures to ensure that budgetary consolidation towards its medium-term objective of a balanced budget in structural terms is sustained through a reduction in the structural deficit by at least 0.5% of GDP per year after the excessive deficit has been corrected. The Commission also recommends that a report be submitted before [14 July] 2006, outlining measures taken to comply with the recommended Council decision. In particular, the report should include a budgetary assessment of the measures with effect on 2006 and 2007 to correct the excessive deficit and possible risks associated to the assumed macroeconomic scenario. The Commission will evaluate this report with a view to assessing progress made towards the correction of the excessive deficit. The Commission also recommends, in accordance with Article 104(9), to request Germany to submit further reports in accordance with a specific calendar.

Recommendation for a

COUNCIL DECISION

giving notice to Germany, in accordance with Article 104(9) of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

THE COUNCIL OF THE EUROPEAN UNION

Having regard to the Treaty establishing the European Community, and in particular Article 104(9) thereof,

Having regard to the recommendation from the Commission under Article 104(9),

Whereas:

- (1) According to Article 104(1) of the Treaty, Member States shall avoid excessive government deficits.
- (2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for sustainable strong growth conducive to employment creation. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure⁵.
- (3) The Resolution of the Amsterdam European Council of 17 June 1997⁶ on the Stability and Growth Pact solemnly invites all parties, namely the Member States, the Council and the Commission, to implement the Treaty and the Stability and Growth Pact in a strict and timely manner.
- (4) By Council Decision 2003/89/EC⁷ of 21 January 2003, it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in Germany.
- (5) In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council addressed a Recommendation to Germany on 21 January 2003, calling on Germany to bring the excessive deficit to an end as rapidly as possible and by 2004 at the latest. The recommendation was made public. As stated in the Commission Communication of 14 December 2004⁸, with which the Council

⁵ OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

⁶ OJ C 236, 2.8.1997, p. 1.

⁷ OJ L 34, 11.2.2003, p. 16.

⁸ Communication from the Commission to the Council: *The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice* - COM(2004) 813.

concluded on 18 January 2005, in view of the unique circumstances created by the Council conclusions of 25 November 2003 and of the ruling of the European Court of Justice of 13 July 2004, the year 2005 should be considered to be the relevant deadline for the correction of the excessive deficit.

- (6) The general government deficit in Germany has been well above the 3%-of-GDP Treaty reference value since 2002. The debt-to-GDP ratio has increased from below the 60% of GDP Treaty reference value in 2001 to a projected 69% of GDP in 2006.
- (7) According to data provided by Eurostat, the general government deficit in Germany amounted to 3.3% of GDP in 2005. These data, pending a further assessment of their quality, are based upon a provisional notification from Germany pursuant to Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community⁹, which Germany submitted to the Commission on 24 February 2006. Additionally, on the basis of currently available information, taking into account the budgetary plans so far adopted by the German government, the general government deficit will remain above the Treaty reference value also in 2006 which confirms that the excessive deficit has not been corrected.
- (8) According to Article 10(3) of Regulation (EC) No 1467/97, if actual data pursuant to Regulation (EC) No 3605/93 indicate that an excessive deficit has not been corrected by a participating Member State within the time limits specified in a recommendation issued under Article 104(7), the Council shall immediately take a decision under Article 104(9) that is, give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.
- (9) The Commission services' autumn 2005 forecast projected the 2005 deficit at 3.9% of GDP¹⁰. On a no-policy change basis, the Commission services' forecast projected the deficit at 3.7% and 3.3% of GDP in 2006 and 2007, respectively. Real GDP growth was projected at 0.8% in 2005, 1.2% in 2006 and 1.6% in 2007, with the output gap not fully closing over the forecast period. Against this background, and in view of the still fragile economic situation, the German government following the 18 September 2005 elections devised a strategy to bring the general government deficit below the Treaty reference value by 2007. The government has begun to implement this consolidation strategy already in December 2005, with the adoption of the first measures foreseen therein. On 22 February 2006, the government adopted the draft federal budget for 2006 and, notably, also adopted the draft law to raise the central VAT rate from 16% to 19% as from 1 January 2007.
- (10) On 22 February 2006, the Federal Statistical Office released figures for GDP growth and the general government deficit in 2005, at 0.9% and 3.3% of GDP, respectively. The difference with respect to the Commission services' autumn forecast can be found to a large extent in better-than-expected revenues towards the end of 2005. The

⁹ OJ L 332, 31.12.1993, p. 7.

¹⁰ This was broadly in line with the figure notified by the German authorities on 1 September (3.7% of GDP), the main difference stemming from the securitisation undertaken by the pension office for former post office civil servants, which was not treated as deficit-reducing in the autumn forecast.

Commission services' interim forecast, published on 21 February 2006, projects real GDP to grow by 1.5% in 2006, which is slightly above the low potential growth rate. It should be noted that this projection is biased upwards by the expected pre-emptive response of domestic demand to the planned increase in the VAT rate. Taking into account the subsequent economic effects, GDP growth in 2007 is currently expected below 1%. Consistent with the above macroeconomic forecast, the nominal deficit is expected to stay slightly above 3% of GDP in 2006, but to drop clearly below the reference value in 2007. The structural deficit (i.e. the deficit in cyclically-adjusted terms, net of one-off and temporary measures) is projected by Commission services to remain broadly unchanged as a percent of GDP between 2005 and 2006 and to narrow by at least 1% of GDP in 2007.

- (11) The following factors should be taken into account in setting the deadline for the correction of the excessive deficit. First, the budgetary adjustment that is being implemented is embedded in a comprehensive strategy with the planned measures already well-advanced in the adoption process, which reduces uncertainty regarding the effectiveness of the consolidation. Second, the limited effects in terms of reduction of the structural deficit expected in 2006 reflect, at least in part, the fact that some of the measures already implemented will produce results only with a lag. Third, a structural adjustment of at least 1% of GDP in the years 2006 and 2007 planned by the government can be considered as consistent with the SGP provisions, including the required annual improvement of the cyclical adjusted balance net of one-off and temporary measures of at least 0.5% of GDP as a benchmark. Based on the overall macroeconomic forecast outlined in (10), such an adjustment would be sufficient to correct the excessive deficit in a permanent and sustainable manner.
- (12) In the light of these factors, it appears that the excessive deficit should be corrected by 2007 at the latest. The benchmark 0.5% of GDP annual improvement in the structural balance should be respected in cumulative terms in the years 2006 and 2007.
- (13) According to the second subparagraph of Article 104(9) of the Treaty, the Council may request Germany to submit reports in accordance with a specific timetable in order to examine the adjustment efforts made in order to comply with this Decision. Germany should submit a report to the Commission by [14 July] 2006 at the latest, outlining the measures that have been taken and are planned to be taken to comply with this Decision. In particular, the report should include a budgetary assessment of the measures quantifying their effects on the budgetary outcome in both 2006 and 2007 to correct the excessive deficit and analyse possible risks associated to the assumed macroeconomic scenario. The Commission will evaluate this report with a view to assessing progress made towards the correction of the excessive deficit. Germany should submit further reports in line with the deadlines for reporting government deficits and debt provided for by Article 4 of Regulation (EC) No 3605/93.

- (14) Adjustment measures should secure a lasting improvement in the general government balance. In order to ensure a sustained budgetary consolidation towards Germany's medium-term objective of a balanced budget in structural terms, a reduction in the structural deficit by at least 0.5% of GDP per year is necessary after the correction of the excessive deficit.

HAS ADOPTED THIS DECISION:

Article 1

1. Germany shall put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2007.
2. In the years 2006 and 2007, Germany shall ensure a cumulative improvement in its cyclically-adjusted balance net of one-off and temporary measures by at least one percentage point.

Article 2

1. Germany shall submit to the Commission, by [14 July] 2006 at the latest, a report outlining the measures taken to comply with this Decision. The Commission will evaluate this report with a view to assessing progress made towards the correction of the excessive deficit.
2. Germany shall submit further reports to the Commission, by [1 October 2006, 1 April 2007, 1 October 2007 and 1 April 2008], examining progress made in complying with this Decision.

Article 3

Germany shall take the necessary measures to ensure that budgetary consolidation towards its medium-term objective of a balanced budget in structural terms is sustained through a reduction in the structural deficit by at least 0.5% of GDP per year after the excessive deficit has been corrected.

Article 4

This Decision is addressed to the Federal Republic of Germany.

Done at Brussels,

For the Council