COMMISSION OF THE EUROPEAN COMMUNITIES

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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

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1. BACKGROUND

Following evidence of general government deficits above 3% of GDP in 2002, the Council in the first half of 2003 decided on a recommendation from the Commission that an excessive deficit existed in Germany and in France and adopted recommendations with a view to bringing this situation to an end by 2004. In the autumn of 2003 the Commission recommended that the Council should establish that the actions implemented by Germany and France were proving inadequate to correct the deficits and give them notice to take measures to remedy the situation. In the light of the weaker than expected economic situation, the Commission recommended that the deadline for correcting the deficit should be extended to 2005. On 25 November 2003 the Council voted on the recommended decisions but did not achieve the required majority. Instead the Council adopted conclusions addressing recommendations to Germany and France for the correction of the excessive deficit by 2005 and stating that in the light of the commitments by the two Member States the excessive deficit procedure was held in abeyance. The Commission brought a case before the Court of Justice challenging certain elements of the Council conclusions of 25 November 2003. The Court delivered its judgement on 13 July 2004[1]. In its judgement the Court annulled the Council conclusions in so far as they aimed at formally suspending the procedure and modifying the existing recommendations.

In the aftermath of the Court ruling, the Commission stated that "the Commission in cooperation with the Council will consider how to ensure a satisfactory resolution of the budgetary problems of these two Member States within the framework of the Stability and Growth Pact."[2] This Communication serves that purpose.

2. THE IMPLICATIONS OF THE JUDGEMENT OF THE COURT OF JUSTICE FOR THE EXCESSIVE DEFICIT PROCEDURES CONCERNING GERMANY AND FRANCE

The Court did not elaborate on the implications stemming from the annulment of the Council conclusions of 25 November for the implementation of the excessive deficit procedure.

In assessing the current position of Germany and France in relation to their obligations to correct the excessive deficit in accordance with the Treaty and the Stability and Growth Pact, it is appropriate to take into account the consequences of the Council conclusions until their annulment by the Court. These conclusions benefited from the presumption of validity that is attached in principle to every Community instrument. In other words, the two Member States

[1] Case C-27/04, Commission of the European Communities v Council of the European Union.

[2] "Commission statement on the Court of Justice ruling relating to the excessive deficit procedure", IP/04/897 of 13 July 2004.

concerned had the right to assume that measures adopted by Community institutions are valid and thus acted on the basis of the Council conclusions. In substance the Council conclusions went along the same lines of the recommendations of the Commission for remedying the situation, specifically, that the deadline for the correction of the excessive deficit should be extended to 2005. Following the adoption of the conclusions, the actions taken by the Germany and France were geared at meeting the deadline of 2005 set by the Council conclusions for the correction of the excessive deficit. These actions have had a factual effect on the path of adjustment, which cannot be ignored.

In other words, while the Commission maintains its view on the inadequacy of the actions taken by Germany and France to correct the excessive deficit by 2004, in response to the Council recommendations adopted in the first half of 2003, it recognises that the actions of the two Member States concerned, taken in the aftermath of the Council conclusions of 25 November 2003 and up to their annulment by the Court on 13 July 2004 were based on the notion that the deadline for the correction of the deficit had been effectively moved to 2005.

In the light of the unique circumstances created by the Court judgement in relation to the excessive deficit procedure concerning Germany and France, in particular, the consequences of the Council conclusions before their annulment by the Court, the Commission considers that a satisfactory resolution of the budgetary problems of these two Member States within the framework of the Stability and Growth Pact demands that the assessment of the actions taken to correct the excessive deficit situation should refer to 2005 as the relevant deadline.

Accordingly the Commission is called to assess whether the actions taken by each of the two Member States are consistent with a correction of the excessive deficit by 2005.

In the affirmative, the Commission would have to conclude that the Council need not take at this point further steps under the excessive deficit procedure in order to prompt further actions by the Member State concerned.

In the negative the Commission would have to conclude that the Council needs to resume the excessive deficit procedure and enhance the budgetary surveillance of the Member State concerned in order to prompt the necessary corrective action.

The Commission notes that the Council itself in its conclusions of 25 November 2003 expressed its readiness to take a decision under Art. 104(9), on the basis of a Commission recommendation, should the assessment of the situation indicate a failure to meet the 2005 deadline.

The assessment of the situation in the each of the two Member States is presented in sections 3 and 4 of this Communication, respectively. Section 5 draws the conclusions on the action taken by France and Germany and the need for the Council to take further steps under the excessive deficit procedure.

3. ASSESSMENT OF THE SITUATION IN GERMANY

The general government deficit is projected by the German authorities to decline from 3.8% of GDP in 2003 to 3.7% of GDP in 2004. The Commission Autumn forecast projects the 2004 deficit at 3.9%. whereas the 2003 update of the stability programme for Germany projected the 2004 deficit at 3.3% of GDP. In contrast, real GDP growth in 2004 is likely to be higher than expected. In its Autumn forecast the Commission projects real GDP growth at 1.9%

compared with 1.8% by the German government. In the 2003 update of the stability programme (and for the set-up of the 2004 budget), the German authorities had expected growth at 1.7% of GDP. However, GDP growth was driven by external demand, whereas domestic demand remained markedly below expectations.

The absence of improvement in the 2004 government balance relative to plans despite higher-than-expected growth is due to the tax-unfriendly composition of GDP growth. Value added taxes and excise taxes like those for mineral oil and tobacco recorded substantial shortfalls compared with plans. The expected gradual recovery in the labour market failed to materialize, resulting in higher unemployment-related expenditure. Nonetheless, it should be noted that in 2004 total expenditure remained constant in nominal terms compared with the previous year.

Under the assumption of real GDP growth at 1.5%, the Commission Autumn forecast projects the general government deficit at 3.4% of GDP in 2005. This forecast is based upon a no-policy change scenario with the reference date 18 October 2004. On 4 November, the federal government presented an additional savings package. In the Fiscal Planning Council (*Finanzplanungsrat*) meeting of 18 November, the federal, state and local levels of government agreed to reduce the general government deficit to 2.9% of GDP in 2005. This is based on the government's projection of real GDP growth at 1.7% in 2005.

The additional savings package presented by the federal government contains the following three elements. (i) In 2005, the federal level expects not to incur any expenditure in order to cover a deficit of the cash settlement office that settles the pension payments to the civil servants of the former public post office on behalf of the successor companies to the post office (*Postbeamtenversorgungskasse*). (ii) An additional global expenditure cut is applied to the federal budget. (iii) The federal government will press for no wage increases in the public sector in 2005. In addition, (iv) the general government deficit in 2005 will be lowered by a repayment of subsidies by the Landesbanken to the respective state budgets, following Commission decisions of 20 October 2004.

Compared with the baseline 2005 general government deficit of € 76.6bn (3.4% of GDP) in the Commission Autumn forecast, the three measures proposed by the federal government as well as the subsidy repayment by the state banks (*Landesbanken*) are expected to reduce the 2005 deficit to 2.9% of GDP under a GDP growth scenario unchanged from the Commission Autumn forecast. Specifically:

(i) The cash settlement office (classified in the private sector by ESA95) will securitise the expected stream of pension contributions from the post office successor companies, which are laid down in law. In 2003, the fund paid out pensions of about € 6.5bn and received payments from the federal budget of € 5.3bn. The present value of the successor companies' contributions to this settlement office is estimated at about € 13-14bn (German Council of Economic Advisers Annual Report 2005). The proceeds from the securitisation by the cash settlement office are estimated to be sufficient to fully cover its pension payments in 2005 and 2006. The federal state would thus be exonerated from covering the deficit of the cash settlement office in those years, which reduces government expenditure, according to ESA95 rules. This measure is projected to reduce government expenditure by € 5.45bn in 2005 compared with the Commission Autumn forecast. The German authorities have provided Eurostat with detailed information on the nature of the operation.

(ii) Federal ministries are obliged to additional global expenditure savings of € 1bn ("*Globale Minderausgabe*") in 2005. In general, such global savings are included in the budget (i.e. reduce the planned deficit), but are not allocated to the individual budget items (as the individual sub-budgets have already been negotiated between the ministries). For 2005, the federal draft budget presented in June already included a global saving item of € 1.4bn. With this additional global savings, the amount planned as 'global savings' in the budget would now total € 2.4 bn. By way of comparison: the 2004 federal budget included a global saving of € 3.3bn, which was respected. This measure is projected to reduce government expenditure by € 1bn in 2005 compared with the Commission Autumn forecast.

(iii) The federal government aims at granting no pay increases for the public service in 2005 *("Nullrunde").* In general, the federal government negotiates wage contracts with the union for its employees on behalf of all public employers (i.e. also the states). These agreements are then adapted to the civil servants. The last settlement provided for contractual wage increases of 1% on 1.1.2004 and again 1% on 1.5.2004; the current contract ends on 31.1.2005. Given that employees had to take cuts in bonus payments in 2003 and 2004, and the federal civil servants an extension in working time from 38.5 to 40 hours per week from October 2004, a scenario of no pay increases seems unlikely. Given the uncertain outcome produced by this measure, the Commission maintains the assumption of a moderate wage increase as included in the Autumn forecast.

(iv) On 20 October 2004, the Commission decided that some transactions made in the early 1990s by the Länder with (then) seven Landesbanken constitute illegal subsidies. Given the commitment by the Länder in the Fiscal Planning Council, it is assumed that the reimbursement of the subsidies will be booked in the Lander's accounts in 2005 and that no offsetting subsidies will take place. This would result in a € 4.3 bn reduction in general government expenditure in 2005.

In sum, the Commission estimates general government expenditure to be reduced by € 10.75bn (0.5% of GDP) in 2005 compared with the Autumn forecast. Ceteris paribus, the general government deficit is projected to fall to € 65.9bn, equalling 2.9% of GDP. The Autumn forecast projected a reduction in the cyclically-adjusted deficit by 0.5 percentage point in 2005. Including the additional expenditure reduction, the cyclically-adjusted balance would improve by 1 percentage point in 2005. It should be noted that the pension fund transaction is expected to relieve the federal budget of expenditure by 0.25% of GDP also in 2006. Ceteris paribus, this would bring the projected 2006 deficit from 2.9% down to 2.6% of GDP compared with the Autumn forecast. However, none of the above items are structural reforms with long-term benefits. The reduction of expenditure to the cash settlement office shifts an implicit liability to the future, the global savings cut is an *ad hoc* measure and the subsidy repayment a one-time windfall gain. Any unfavourable development on the macroeconomic or on the budgetary side could bring the deficit above 3% in 2005. Should such unfavourable developments occur, the implementation of further additional measures would be necessary to secure the correction of the excessive deficit situation in 2005 at the latest.

The improvement in the macroeconomic and budgetary situation in 2005 would however not be sufficient to bring the debt ratio on a declining path. The Commission projects that the debt ratio will rise to 67.1% of GDP in 2006. Since thereafter implicit liabilities from these measures increase, the Commission does not expect a decline in the debt ratio after 2006. The budgetary situation of Germany remains vulnerable and the need for structural budgetary adjustments all the more pressing.

Germany Commission Autumn 2004 forecast amended by the additional measures

	2003	2004	2005	2006
Real GDP growth (% change)	-0.1	1.9	1.5	1.7
General government balance (as a % of GDP)	-3.8	-3.9	-2.9	-2.6
Cyclically-adjusted balance (as a % of GDP)	-3.0	-3.4	-2.4	-2.1
General government revenues (% of GDP)	45.0	43.5	43.2	43.0
General government expenditure (% of GDP)	48.8	47.5	46.1	45.6
General government gross debt to GDP ratio	64.2	65.9	66.7	67.1

Projections are based on the assumption of an unchanged policy. Figures may not add up due to rounding.

4. ASSESSMENT OF THE SITUATION IN FRANCE

The general government deficit is projected by the French authorities to decline from 4.1% of GDP in 2003 to 3.6% of GDP in 2004. This is in line with the initial target set in the draft Budget for 2004. Respect of the deficit objective in 2004 was facilitated by a clear improvement in the macroeconomic situation relative to Budget projections: the French authorities currently expect real GDP growth at 2.5%, as against 1.7% in the draft Budget for 2004. In its Autumn 2004 forecast, the Commission projected the 2004 deficit at 3.7% of GDP, under the assumption of real GDP increasing by 2.4%.

The absence of improvement in the 2004 deficit relative to plans despite higher-than-expected growth is due to some adverse developments. Notably, in April the 2003 deficit estimate was revised upward, causing a negative base effect (0.1% of GDP). In May, the *Conseil d'Etat* partly cancelled a reform of the unemployment insurance system that foresaw a substantial tightening of eligibility conditions (0.1% of GDP). Finally, health and local expenditure were higher than planned (0.1% of GDP).

Assuming real GDP growth at 2.5%, the draft Budget for 2005 foresees a decline in the deficit from 3.6% of GDP in 2004 to 2.9% of GDP. The deficit reduction is projected to result from expenditure restraint and a significant increase in revenues. Expenditure restraint is planned to stem notably from (i) the stabilisation of State expenditures in real terms for the third year in a row and (ii) a clear slowdown of health expenditure resulting from the first effects of the comprehensive reform of the health insurance system adopted in Summer 2004. The increase in the revenue-to-GDP ratio would reflect (i) the impact of discretionary measures on the fiscal side[3] (0.1% of GDP) and (ii) a one-off payment linked to the transfer of the responsibility for the payment of pensions of the employees in public electricity and gas companies to the social security sector. Since the presentation of the draft Budget in September, this one-off payment has been revised slightly upward (by 0.1% of GDP to 0.5% of GDP).

[3] The tax increases decided in the context of the reform of the health insurance system will more than compensate for the tax cuts announced in the context of the draft Budget for 2005 and for the tax exemptions on interest payments on consumer credits and on inter-generational financial transfers announced in May 2004.

The improvement in the budgetary situation in 2005 would not be sufficient to bring the debt ratio on a declining path. According to the multi-annual projection attached to the Budget, the debt ratio would start declining in 2006. In that year, despite the vanishing of the one-off revenues of 2005, the general government deficit would be brought to 2.2% of GDP.

The Commission services autumn 2004 forecasts show a general government deficit at 3.7% of GDP in 2004 and 3.0% of GDP in 2005. The slight difference between the Commission's and the French authorities' deficit forecasts for 2005 results from two factors: (i) the macroeconomic projection of the Commission is more cautious than that of the French authorities: the Commission projects real GDP growth at 2.2% in 2005 as against 2.5% for the French authorities; and (ii) although considering that the reform of the health insurance system is likely to trigger substantial savings in the medium run, the Commission is more cautious on the impact of the reform in the short term. The cumulated negative effect of these two factors (0.2% of GDP) is only partly compensated by the fact that, based on information provided by the French authorities, the one-off revenues included in the Autumn Commission forecast are slightly larger than those included in the forecast of the draft Budget (by 0.1% of GDP). According to Commission calculations based on its Autumn forecast, the cyclically-adjusted deficit will be reduced by 0.7 percentage point of GDP in 2005, 0.5 percentage point of which reflects the impact of one-off measures.

The budgetary situation of France remains however vulnerable. Given that the deficit is projected to be reduced only marginally below 3% of GDP by the French authorities and to exactly 3% of GDP by the Commission, any unfavourable development on the macroeconomic or on the budgetary side could be sufficient to bring the deficit above 3% and therefore compromise the achievement of the objective of correcting the excessive deficit in 2005 at the latest. In addition, the deficit reduction in 2005 largely relies on the favourable impact on 2005 budgetary statistics of a measure that is broadly neutral for the underlying situation of French government finances. Indeed, while the transfer of the responsibility for the payment of pensions of the employees in public electricity and gas companies to the social security implies a big lump sum payment to the general government in 2005, it also implies additional expenditure in the subsequent years for a comparable cumulated amount since the social security will have to pay the future pension benefits to the employees of the electricity and gas sectors. The temporary nature of this measure is reflected in the Commission deficit forecast for 2006, which, under the assumption of an unchanged economic policy, projects an increase in the deficit to 3.3% of GDP. This means that further consolidation measures will have to be taken in order to avoid another breach of the 3% of GDP ceiling in 2006.

France Commission forecast, Autumn 2004

	2003	2004	2005	2006
Real GDP growth (% change)	0.5	2.4	2.2	2.2
General government balance (in % of GDP)	-4.1	-3.7	-3.0	-3.3
Cyclically-adjusted balance (in % of GDP)	-3.8	-3.5	-2.8	-3.1
General government revenues (% of GDP)	50.5	50.5	50.9	50.4
General government expenditure (in % of GDP)	54.7	54.2	53.9	53.8
General government gross debt (in % of GDP)	63.7	64.9	65.5	66.3

Projections are based on the assumption of an unchanged policy. Figures may not add up due to rounding.

5. CONCLUSIONS

In the light of the unique circumstances created by the Court judgement in relation to the excessive deficit procedure concerning Germany and France, in particular, the effects of the Council conclusions of 25 November 2003 before their annulment by the Court on 13 July 2004, the Commission reaches now the following conclusions on the situation of the two Member States concerned.

As regards Germany, on current information and on the basis of the measures detailed in the 2005 budgetary plans and the additional savings package announced by the Government on 4 November 2004, it appears that actions taken by the German authorities are broadly consistent with a correction of the excessive deficit by 2005. Accordingly, the Commission concludes that no further steps are necessary at this point under the excessive deficit procedure.

As regards France, on current information and on the basis of the measures detailed in the 2005 budget, it appears that actions taken by the French authorities are broadly consistent with a correction of the excessive deficit by 2005. Accordingly, the Commission concludes that no further steps are necessary at this point under the excessive deficit procedure.

The Commission notes that the budgetary situation in each of the two Member States remains vulnerable. Correction of the excessive deficits demands effective implementation of all the measures envisaged. Should failures in implementing the envisaged correction emerge at a later stage, the Commission would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the Treaty and the Stability and Growth Pact.