Federal Ministry
of Finance

Economic and Financial Reports

German

Stability Programme

October 2000 update

Published by: Federal Ministry of Finance, Press and Information Division
Content and layout: Division I A 1 (Fiscal Policy)

This publication is also available on the Internet:
http://www.bundesfinanzministerium.de/finwiber/index.html

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I. Introduction

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) the EU Member States having adopted the single currency are obliged to submit updated stability programmes each year to the ECOFIN Council. The other EU Member States submit convergence programmes. The ECOFIN Council delivers an opinion on these programmes.

The first stability or convergence programmes governed by the provisions of the Stability and Growth Pact were submitted at the end of 1998 in accordance with an ECOFIN Council statement of 1 May 1998. With reference to the coordination of economic policies, the ECOFIN Council in its report to the European Council in Helsinki is in favour of updated programmes also being submitted no later than the end of the year.

The German stability programme of January 1999 was updated in early December of that year. The update and a supplement dated January 2000 were approved by the ECOFIN Council in February 2000. It is clear from the December 1999 update that the objectives set out in the original programme were circumspectly and realistically defined, especially in view of the fiscal policy measures envisaged in the Future Programme drawn up in the summer of 1999.

The supplement dated January 2000 made allowance for the Tax Reform 2000 which had been introduced by Federal Chancellor Gerhard Schröder and Federal Finance Minister Hans Eichel in December 1999. The comprehensive tax policy measures improve the underlying conditions for growth. Hence for the years 2001 to 2003, GDP growth in nominal and real terms was put at one half of a percentage point higher than before adoption of the Tax Reform 2000.

The present update of the German Stability Programme was approved by the cabinet on 11 Ocotber 2000.

The responsible committees of both houses of the German parliament will be briefed immediately after the programme has been submitted to the Council of the European Union and the European Commission.

In format and content the programme conforms to the guidelines drawn up by the ECOFIN Council in October 1998. In accordance with the ECOFIN Council agreement, a somewhat earlier submission date was chosen this year.

The updated stability programme is based on data available as at mid-September.

The Federal Ministry of Finance publishes the updated stability programme and will also post it on the Internet (www.bundesfinanzministerium.de/finwiber/index.de).

II. Limitation of government spending and promotion of growth and employment

A. Overall fiscal, economic and social policy strategy

To promote growth and employment, lasting reform measures must interact effectively with favourable macroeconomic conditions. This is reflected among others in the Future Programme 2000 adopted by the government in the summer of 1999, which was outlined in the December 1999 update of the stability programme.

The Future Programme puts forward a policy concept spanning several years, aiming to regain the scope for action in tackling crucial future tasks. The impact of this programme is reinforced by the Alliance for Jobs, in that the conclusion of long-term collective wage agreements geared to promoting productivity and employment helps to enhance the underlying economic conditions.

The quality and sustainability of public finances over the longer term are of central significance, serving to strengthen market confidence and thus to stimulate investment and consumption. At the same time, a permanently sustainable financial situation in the euro zone assists the ECB in performing its task of ensuring monetary stability and contributes to an environment favourable to growth and employment. Consequently, the government will continue to pursue its current fiscal policy concept.

The fiscal policy concept rests on two central pillars:

- Consistently following the consolidation course aiming to achieve a balanced federal budget in the year 2006 and pursuing the long-term objective of debt reduction;

- undertaking tax reforms on the basis of sound public finances, substantially lessening the tax burden on corporate and individual taxpayers and creating an internationally competitive tax system.

Since the government adopted its future programme to promote growth and employment, some of the central measures in the programme have been set on foot or have already been put into effect.

Decisive action has been taken in the following areas:

- The consolidation course has been held in the federal budget for 2001 with the aim of regaining scope for fiscal policy action and introducing reform measures;

- the Tax Reform 2000 has been put in place aiming at a sustainable improvement of the conditions for investment and employment in in Germany;

- the ecological tax reform has been established to encourage the efficient use of resources and to reduce non-wage labour costs.

B. Holding the consolidation course

In the Future Programme 2000, the government entered in 1999 on a course of strict expenditure reduction. This course will be held in the coming years. The consistent pursuit of consolidation is set out in the draft budget for 2001 and the financial plan up to the year 2004. This fiscal policy concept further serves to ensure that the medium-term objective of a balanced budget featuring no net borrowing in 2006 can be achieved.

In the draft federal budget for 2001, net borrowing is brought down to DM 46.1 bn as envisaged in the Future Programme 2000. The progressive reduction of net borrowing is also incorporated in the financial plan up to the year 2004.

Table 1: Development of government net borrowing up to 2004 (DM bn)

	2001	2002	2003	2004
Net borrowing	46.1	41.2	30.4	20

Additional charges of some DM 20 bn will need to be absorbed in 2001. These are the result of:

- measures to finance the reform of corporate taxation;
- bringing forward the third stage of the Tax Relief Act 1999/2000/2002 to 1 January 2001;
- charges imposed in connection with mediation to ensure acceptance of the savings package.

These additional charges will be offset by

- continuing application of the general commitment for extra spending to be compensated by redirecting funds elsewhere in the same budget heading;
- relief afforded by additional tax revenue and lower labour market spending in the wake of the favourable development of the economy;
- selective privatisation measures.

In this respect, the government reiterates its intention not to use one-off extra revenue to finance permanently effective tax reductions and spending programmes. This is also reflected in the use of the proceeds from the auction of mobile phone licences (UMTS), which will be used in full for the reduction of debt.

By pursuing its policy of bringing down debt the government reduces in turn its expenditure on interest payments and at the same time creates fresh scope for future-oriented investment. The government will consult with its coalition partners in the course of the autumn on the use to be made of the savings thus realised on interest payments.

C. Tax Reform 2000

The strict consolidation course followed by the government creates the necessary conditions for tax cuts to promote growth and employment. In conjunction with the reform of the pension system, the tax reform measures are an essential part of the German structural reform package.

- In the Tax Relief Act, the government affords aggregate relief to taxpayers of around DM 30 bn in the period from 1999 to 2002.

- The Tax Reform 2000 focuses further relief of a good DM 62 bn up to 2005 on dependent employees, families and small and medium-sized business. Of this, some DM 33 bn goes to private households, DM 23 bn to small business and about DM 7 bn to large-scale enterprises.

- Once all measures are in full effect, the total volume of relief afforded by the tax reform measures will amount in 2005 to more than DM 93 bn as compared with the position in 1998 when the present government came into office.

The main elements of the Tax Reform 2000 are the comprehensive reform of corporate taxation and the restructuring of the tax schedule:

- In reforming the system of corporate taxation, the government is giving targeted stimulus to enhance Germany's status as an internationally competitive investment location.

The reform can be outlined as follows:

- Corporate income tax will be reduced from 40 % (on retentions) and 30 % (on distributions) to a standard rate of 25 %.
- The system of full imputation of corporate income tax will be replaced by the half-income system. This will equalise the tax charge on national and international investors.
- For unincorporated companies, relief will be provided by allowing trade tax to be credited in a standardised form against the income tax liability.
- The post-reform tax charge on corporations in conjunction with trade tax will amount on average to only 38 ½ %. Whereas Germany's tax regime had previously featured one of the highest charges on business by international standards, this will put it in the middle range.
- The project includes reforms of the structure of corporate taxation. For instance, the problem of double charging of corporations (taxation of profits at corporate level and of distributed profits at shareholder level) will be resolved in standardised form as from 2002 with the application of the new half-income system, giving reduced taxation at both levels.
- The outcome of the logical application of this change from full imputation to the half-income system is the exemption from tax of gains realised by corporations on selling their holdings in other corporations. This will substantially facilitate the sale of enterprises and will make for more efficient corporate structures.

- The reform of the tax schedule will help to afford relief to small business, dependent employees and families.

The benchmark data of the tax schedule reform are as follows:

- The basic rate will be reduced in three stages up to 2005 from the present 22.9 % to 15 %.
- The basic personal allowance will be raised also in three stages from the present figure of DM 13,499 to DM 14,989.
- The top rate of income tax will be brought down in three stages up to 2005 from the present 51 % to 42 %.
- Progressive increases in tax will be levelled-off in the mid-income range.

The tax schedule reform will help to increase the resources available to private households for saving and consumption. The reduction of the basic rate also gives greater incentive to take up work in the low-income range and may thus be expected to support the re-integration of lower-qualified persons in the labour market.

The Tax Reform 2000 equally stengthens supply and demand. It is intended to lend lasting support to the economic growth in Germany, not least to enable it to catch up with more vigorous development in some other EU Member States.

D. Continuation of the ecological tax reform

Last year the government completed the phasing-in of an ecological tax reform. As from 1 April 1999, an electricity tax of DM 0.02 per kilowatt-hour was introduced, the mineral oil duty on motor fuels was raised by DM 0.06 and - as a one-off measure - on light heating oil by DM 0.04 per litre, and a charge of DM 0.0032 per kilowatt-hour was imposed on natural gas.

The ecological tax reform is to continue in stages up to the year 2003, retaining the special arrangements for production enterprises. This will incorporate an increase of DM 0.06 a year in the rate of duty on motor fuels, while the tax on electricity will be raised by DM 0.005 per kilowatt-hour each year. This approach will generate incentives to use resources more sparingly and in an economically more appropriate manner.

The funds generated by the ecological tax reform will be used to reduce the pension insurance contribution rate, thus relieving the pressure on labour as a production factor. The success of this approach is indicated by the reduction of the pension insurance contribution rate from 20.3 % to 19.3 % since the end of 1998.

At the same time, structural change in the German economy will be speeded up. For instance, better use will be made of the potential for energy conservation and market access for environmentally-friendly technologies will be improved. In this way, tax policy will help to achieve ecological restructuring of the German economy.

Additionally, the government is directing its endeavours to achieve a Europe-wide solution in the taxation of energy.

III. Enhancing quality and sustainability of public finances

A. Future-oriented policy to enhance budget quality

The draft federal budget for 2001 and the medium-term financial plan reflect both the government's consolidation efforts and in particular its efforts for implementing reforms. Notwithstanding the pressing need for fiscal discipline, future-oriented points of special emphasis will be set with the aim of enhancing budget quality:

- Research, education and science: The greater emphasis placed on this sector is in line with the conclusions of the European Council in Lisbon. This will assist in accelerating Germany's transition to a competitive, dynamic, knowledge-based economy. Annual increasing ressources for this sector are provided since the federal budget for 1999. The federal budget for 2001 makes provision for extra spending in this sector, to be financed from interest savings in connection with the auction of UMTS licences.

  Main areas in which action will be taken are the following:

  - Stepping up the promotion of university construction: In this area, the government will increase its funding by about DM 215 m in the coming year. In all, about DM 2.2 bn is appropriated for this purpose.

  - Implementing the reform of the Federal Law on Grants for Education and Vocational Training: The government will make available additional funds of some DM 400 m in 2001 and about DM 500 m a year as from 2002 for the promotion of education and vocational training.

- Strengthening the promotion of specific projects: The government will make available additional funds of some DM 280 m for this purpose in 2001. Main beneficiaries will be important future-oriented areas like information- and communication-technologies, biotechnology and molecular-medicine.

- Upbringing and housing allowances: Additional funds of DM 300 m will be made available to take account of the amendment to upbringing allowance arrangements. Young families in the middle-income range will benefit especially from this. About DM 500 m will be provided in the budget to cope with the increase in general housing allowances as from 1 January 2001.

- Transport infrastructure: In view of the projected increase of 20 % in passenger traffic and 50 % in goods traffic up to 2015, the aim is to ensure that the necessary infrastructure is in place. Thus the programme for 1999 to 2002 incorporating investment of more than DM 67 bn ensures continuity in planning and construction. A substantial part of the aforementioned interest savings from the auction of UMTS licences will be used to improve transport infrastructure with particular emphasis on the rail network.

- Labour market policy: The successful programme to counter youth unemployment will continue in 2001 as well. The programme to counter long-term unemployment will also be extended. Both programmes are stepping-stones to entry into the primary labour market.

- Reform of tax and social security systems: The continuing consolidation course will establish the basis for lessening the tax charge as provided in Tax Reform 2000. At the same time, measures to reform the social security systems will ensure that these systems retain both their financeability and their effectiveness over the long term. Here, too, the government's policy is in line with the resolutions of the Lisbon European Council.

B. Pension reform helping to establish sound public finances

The government's aim is to put in place a concept of old-age provision taking account both of the demographic challenges and of the need to maintain equity between the generations. The government intends to implement a reform that will stabilise the system of old-age provision in the long term and will offer a worthwhile and reliable arrangement both for contributors and for pensioners.

Among the central elements of the pension reform concept are the following:

- Return to the principles of net-wage-related pension adjustment;
- progressive establishment of a supplementary old-age provision on a voluntary, funded basis with government assistance;
- inclusion of an equalisation factor in the pension calculation formula as from 2011, taking effect progressively and holding the pension level at 64 % also for new pensions from 2030 onwards.

This reform aims to hold the contribution rates below 20 % up to the year 2020. Thereafter, a moderate increase is envisaged up to a maximum figure of 22 % in the year 2030. In this way the pension reform will also make an important contribution towards restricting non-wage labour costs, raising the income and purchasing power of working households and thus promoting growth and employment.

As part of the Future Programme, the pension reform underpins the government's consolidation efforts. In the long run, the reduction of pension contribution rates will afford relief to the government, amounting to DM 16.3 bn in the year 2030, as regards the general grant to the pension insurance funds and the inclusion of child upbringing periods in determining pension levels.

The principles of the pension reform will be applied to the other old-age provision systems regulated by federal statute, in particular the pension arrangements for public service officials.

IV. Other structural reforms to promote growth and employment

In addition to the aforementioned measures, the reform process in Germany is making progress in other areas as well. The government has set on foot a multitude of other structural reforms to promote growth and employment.

These measures are described in detail in the national report on structural reform which the government will put out at the end of November 2000 within the framework of the Cardiff process. Hence only a few examples are cited here:

- Market opening and competition in former monopoly sectors: In telecommunications and electricity supply in particular, market opening and competition have resulted in substantial price reductions and numerous innovations. Hence the government will continue with its consistent application of this policy approach. The regulatory framework for telecommunications is being refined with the aim of lessening the intensity of regulation in those areas in which efficient, structurally secure competition has already evolved. The market for mobile multimedia applications has been opened with the granting of UMTS licences by competitive auction.

  With regard to postal services, the government supports significant steps towards market opening within the European single market as from 2003. The aim of this is to proceed with the opening of the market for postal services in Germany in line with developments at European level in order to guarantee equal competition between all postal service providers within the European single market.

  The electricity and gas markets have now been fully liberalised. In this respect the government is working to ensure that agreements between provider associations give simple network access on transparent terms.

  To avoid distortions of competition and to ensure that liberalisation remains fully effective on a lasting basis, the government endorses the balanced and rapid opening of markets for electricity and gas in the European partner countries. The aim must be to achieve fully open markets in all EU Member States.

- Use of new information technologies: The programme of action on "Innovation and Jobs in the Information Society of the 21st Century" will be more speedily implemented. The aims of this programme are largely in line with the "eEurope Initiative" adopted by the Feira European Council.. In collaboration with trade and industry, the unions and other key groups in society, the government will work in the current parliamentary term to achieve among other things an appreciable rise in the number of Internet users in the total population.

  To promote the rapid spread of efficient use of the Internet, the Directive on electronic commerce will be translated into national law as early as possible. The Directive transfers the principle of free provision of services to electronic trading. To make this possible and to prevent any discrimination of domestic suppliers, measures will include the elimination of restrictive provisions in the law applying to rebates and gifts.

- Improving the underlying conditions for SMEs: Globalisation and the advance of new technologies pose exceptional challenges to small and medium-sized enterprises. The government's economic and fiscal policies thus place special emphasis on creating an environment in which these enterprises are able to adapt successfully to structural change. The tax reforms afford relief of some DM 30 bn to SMEs.

  In addition, the government will continue with its consistent elimination of bureaucratic obstacles, will make it easier for young, technology-oriented companies to gain access to direct-investment capital and will continue to provide a high level of assistance for business start-ups.

V. Outlook for the general development of the economy from 2000 to 2004

A. Global economic environment

The global economy is currently in a phase of vigorous expansion. The world-wide upturn in economic activity has accelerated considerably since mid-1999. Output and demand are on a clear upward trend in virtually all regions. This has also been reflected in a marked expansion of international trade in the course of the past year. In addition to the positive impact on the world economy deriving from continuing recovery in developing and emerging economies, the trend has been reinforced in particular by persistently robust growth in the U.S.A. and by the quickening upswing in western Europe. In Japan, too, there are increasing signs that economic activity is gathering pace.

German exporters in particular have benefited from the global economic upswing. In the first half of 2000, exports of goods and services were 14.3 % up in real terms on the previous year's level, with appreciable increases especially in demand from non-EU third countries. Net exports have thus played a key role in contributing to aggregate economic development.

As against the previous year, at least one percentage point of real GDP growth of 3.3 % in the first half of 2000 was attributable to net exports. During the remainder of this and in the course of the coming year, global economic growth may be expected to show some degree of slackening. Monetary policy in the industrial economies (U.S.A., western Europe) will cease to supply a positive impetus for growth.

Moreover, the increase in output in developing and emerging economies cannot be expected to continue to accelerate. Japan is likely to be the only industrial economy to register significantly higher average economic growth in the course of 2001.

B. Underlying assumptions for the development of the economy in Germany

The projection is based on the following assumptions for the period through 2001:

- World economic output will again pick up more strongly in the current year at about 4 ½ % in real terms as against 1999, declining slightly in 2001 to around 4 %.

- With vigorous growth continuing unchanged in the U.S.A., the upturn in economic activity in Europe has since gathered increasing pace as well. Economic growth in the euro zone is expected to be perceptibly stronger than in 1999 at around 3 ½ % in the current and a good 3 % in the next year.

- World trade in 2000 is also expected to register much stronger growth than in 1999 at 9 to 10 %, while in the coming year it is likely to slacken off again to about 7 ½ %. In the current year, competitive prices and the pattern of goods will again enable German exporters to enlarge their share of world markets.

- Despite the upward pressure exerted by oil, price movements in Germany will remain moderate in the foreseeable future; the stability target of the European Central Bank will not come under threat. A wage policy geared to stability and employment in conjunction with stable or slightly declining unit labour costs will curb domestic price upcreep.

C. Trends in Germany in 2000 and 2001

Germany is currently in the midst of a marked upturn in economic activity which is gaining breadth and progressing without generating inflationary tensions. The government based its spring forecast on growth of 2 ¾ % in real terms for 2000 and 2001. In view of the good results turned in after the first six months of the year, growth for the year 2000 as a whole may be expected to register at 3 % in real terms.

German exports on the one hand have benefited from the favourable global economic environment and from increasingly competitive prices and have made a major contribution to aggregate growth. On the other hand, the positive stimuli have now also fed through to domestic demand, reinforced above all by private consumption spending and by investment in plant and equipment.

The prospects of a sustained upturn in consumption will continue to improve. Factors in favour of this are the tax relief and the lessening of non-wage labour costs resulting from the reduction of pension insurance contribution rates, which in addition to pay increases and rising employment make for favourable income perspectives. In view of the well above-average propensity of private households to purchase consumer durables, private consumption spending may be expected to expand appreciably especially in the coming year.

Investment in plant and equipment may be expected to register a sustained upward trend. Investment was supported in the current year by growing foreign demand, improved prospects in the domestic economy, high capacity utilisation, the continuing demand for replacement capital spending and advance dispositions in expectation of the reform of corporate taxation. As in previous years, construction investment is the weakest link in the aggregate economic structure. There are still substantial excess capacities, particularly in the new Länder.

Only in the coming year may one expect to see signs of a reversal of the trend in construction investment in Germany as a whole, supported by developments in the former federal area.

Foreign trade is expected to make a clearly positive contribution to growth in the current year. The broadly-based global economic upturn, especially in the euro area as well, the most important market for German goods and services, affords favourable sales prospects.

But the effects of the economic upturn are also becoming apparent in central and east European countries and in the Asian region. This favourable trend is reinforced by the growing ability of German exporters to compete on prices at world market level. Hence Germany's share in the aggregate volume of world trade is likely to increase further in the current year.

In all probability the stimulus provided by foreign trade will weaken in the coming year in line with the expected development of the world economy. Over the period covered by the projection as a whole, the pace of economic activity is not expected to accelerate further.

D. Medium-term growth perspectives

In the years following German unification the gross domestic product grew on average by only 1 ½ % a year in real terms. However, the nineties featured substantial fluctuations in growth, caused not least by the after-effects of unification. Hence the growth trend calculated on the basis of the nineties is likely to underrate the potential rate of future increase.

On the other hand, the expected development of economic activity in 2000 and 2001 cannot simply be transferred to the results expected over a longer period of time.

Thus the medium-term perspective focuses rather on the development of the economy's growth potential. By initiating structural reforms and concluding longer-term collective wage agreements geared to stability and employment, the government and the social partners have clearly improved the prospects of achieving a higher growth path. Thus the projection of aggregate economic development up to 2004 is based on the assumption that additional substantial efforts by the parties to the economic process will further improve the underlying conditions.

The growth rate of approximately 2 ½ % in real terms assumed in the medium-term projection up to 2004 is accordingly about one percentage point higher than the average growth of the gross domestic product in the past few years.

The broad application of new information and communications technologies offers further prospects of a stronger expansion of productive capacity in Europe and in Germany.

E. Overview

Table 2: Projection of aggregate economic development for the years 2000 to 2004

	1999	2000	2001	2004/01	2004/99
	Change on the year in %, rounded for the review period				
Use of GDP (at 1995 prices):					
Private consumption*)	2.6	2	3	2 ½	2 ½
Government consumption	- 0.1	½	½	½	½
Gross fixed capital formation	3.3	3 ½	3 ½	3	3 ½
of which: public sector	5.4	½	½	1 ½	1 ½
Exports	5.1	8 ½	6 ½	5	6
Imports	8.1	7 ½	7 ½	5 ½	6
Gross domestic product	1.6	2 ¾	2 ¾	2 ½	2 ½
Movement in prices (1995 = 100):					
Private consumption *)	0.3	1 ½	1	1 ½	1 ½
Gross domestic product	0.9	½	1 ½	1 ½	1 ½
Gainfully employed	1.1	½	1	½	½

*) Including private non-profit organisations

1999: Provisional result of the Federal Statistical Office of September 2000.
2000 and 2001: Results of the Interdepartmental Working Party on Overall Economic Projections, May 2000.
2002 to 2004: Medium-term projection, May 2000, to be reviewed end-October 2000.

VI. Medium-term outlook for the development of public budgets

A. Trends in the financial deficit

Two exceptional sets of circumstances have played some part in shaping the projection for the current year as set out in this stability programme:

- The auction of UMTS licences was finalised in Germany on 18 August 2000. The yield of some DM 99.4 bn is posted in National Accounts as proceeds from the sale of a "non-financial asset" in accordance with a Eurostat decision. Hence the effect of the yield is to reduce the deficit, so that general government will show a clear surplus in the current year.

- In late August 2000 the Federal Statistical Office published revised figures for the preceding years. These show in particular that the deficits of the past two years were less favourable than last reported; the deficit for 1999 at - 1.4 % now stands three tenths above the figure for March. This is attributable on the one hand to adjustments in connection with the transition to the new European system of integrated economic accounts (ESA) in 1995, on the other hand to the inclusion of new basis data of financial and current account statistics. Incidentally, the revision bears out the fact that transition from the former system to ESA in 1995 caused hardly any change in Germany's deficit ratios.

The proceeds from the sale by auction of UMTS licences result in a non-recurrent, abrupt improvement in the deficit/surplus ratio. Whilst official statistics will show the surplus in accordance with ESA rules, a set of data showing this one-off effect is hardly suited to assessing fiscal policy development. A balance excluding the UMTS proceeds is a more suitable instrument for policy assessment.

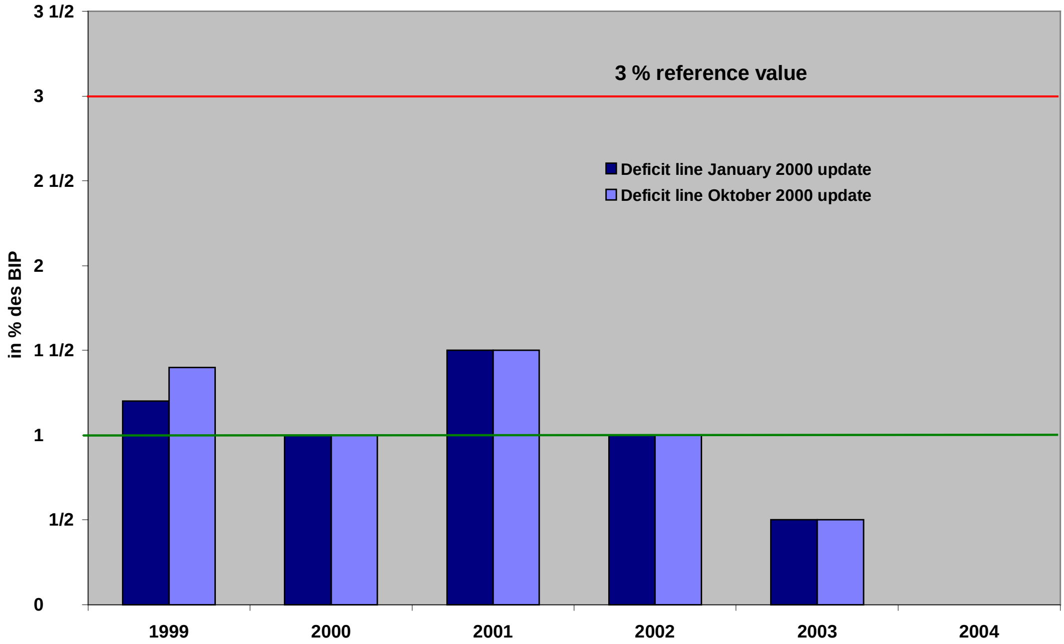
Table 3: Development of deficit/surplus ratio to the year 2004

	1999	2000	2001	2002	2003	2004
Deficit/surplus ratio	- in % of GDP -					
- January 2000	- 1.2	- 1	- 1 ½	- 1	- ½	-
- September 2000						
- excluding UMTS proceeds	- 1.4	- 1	- 1 ½	- 1	- ½	0
- including UMTS proceeds		+ 1 ½				

The January 2000 projection was based on a comparatively favourable development of base values for 1998 and 1999. According to the data then available, it had proved possible in 1998 to reduce the deficit by 0.9 percentage points to - 1.7 % of GDP, whilst initial results for 1999 showed a further deficit reduction by 0.5 percentage points (to - 1.2 % of GDP). Notwithstanding the tax relief taking effect at the beginning of the year, a target figure of - 1 % was set in January for the current year. The balance for 1999 adjusted in March to - 1.1 % confirmed the projection for 2000.

In principle the base deterioration in 1999 should be expected to feed through to the following years. Moreover, allowance must be made for extra charges on the budget in the year 2000 such as the government's contribution to the Foundation "Remembrance, Responsibility and Future" (compensation for slave labourers) and additional expenditure for the postal relief funds. On the other hand, there are indications of a favourable trend in revenue which may be expected to result in receipts in excess of the tax revenue estimation undertaken in May 2000. The improved situation in the labour market is also likely to lead to reduced spending in this area. All in all, therefore, it will be possible for the envisaged balance of - 1 % of GDP to be achieved. Calculations including the proceeds from the sale by auction of UMTS licences show a surplus of 1 ½ % of GDP.

Figure 1: Deficit ratio - development to the year 2004



The decisions now made on tax cuts aim at the promotion of growth and employment in Germany on a long-term basis. Therefore a temporary increase in the deficit to - 1 ½ % of GDP in the coming year is acceptable. But this deficit increase does not imply any departure from the government's consolidation course. On the contrary, the central, regional and local authorities will offset part of their losses on the revenue side by restricting their spending. With the help of strict expenditure discipline, only about half of the total volume of relief amounting to approximately one percentage point of GDP will have an effect on the deficit. The favourable development of the economy will also play a part in this (on the expenditure side). However, additional receipts in the budgets at all levels of government from the sale of shareholdings will have no effect on the "Maastricht" deficit.

The continuing policy of restricting expenditure will enable a deficit of - 1 % to be registered again in the year 2002. The 2003 stage in relief provided by the tax reform fits smoothly into the process of consolidating public budgets. Despite the additional relief this will provide for taxpayers it will be possible to bring the deficit down to - ½ %.

In 2004, the final year of the projection, the government account will be in balance. In this respect Germany will comply with the requirement to establish an additional "safety margin" to the medium-term deficit target.

Table 4: Deficits/surpluses by level of government

(National Accounts definitions; 2000 excluding UMTS proceeds)

	1999	2000	2001	2002	2003	2004
Financial deficit	- DM bn -					
Federation incl. special funds	- 59.9	c. -45	c. -55	c. -40	c. -30	c. -20
Länder and local authorities	- 5.9	c. -5	c. -20	c. -10	c. -5	c. +10
Social insurance	+ 10.8	c. 0	c. +5	c. +5	c. +5	c. +5
General government	- 55.0	-40 to -50	-65 to –75	-40 to –50	-25 to -35	+5 to -5
General govt. deficit in % of GDP	- 1.4	- 1	- 1 ½	- 1	- ½	0

From 2000: Balances rounded to full DM 5 bn

B. Trends in expenditure

The consistent restriction of spending is reflected in a continual decline in the government spending ratio. With government spending growing at an average annual rate of 2 %, the increase stays well below the rise in nominal GDP. As early as this year the government spending ratio will be reduced to 48 % of GDP, not least as a result of the measures incorporated in the government's future programme. It will not be possible in the current year to achieve a further reduction to 47 ½ % as assumed in January in view of the slight base deterioration and the aforementioned extra charges on the budget.

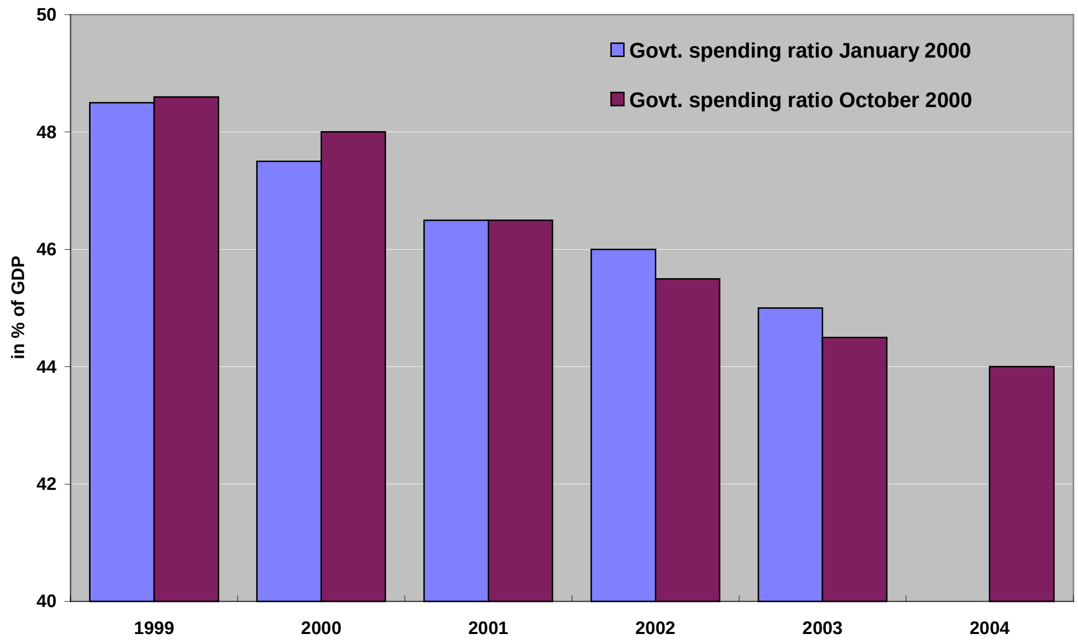
The above calculation does not take into account the fact that the proceeds from the sale of UMTS licences are posted in National Accounts as a negative item on the expenditure side. In statistical terms, this results in a government spending ratio of 45 ½ % for 2000.

Table 5: Government spending ratio – development to the year 2004

	1999	2000	2001	2002	2003	2004
Government spending ratio	- in % of GDP -					
- January 2000	48.5	47 ½	46 ½	46	45	-
- September 2000						
- excl. UMTS proceeds	48.6	48	46 ½	45 ½	44 ½	44
- incl. UMTS proceeds		45 ½				

In the succeeding years, however, the ratio undercuts the figures projected at the start of this year. The progressive reduction continues to a figure of 44 % in the final year 2004. Thus in the period from 1999 to 2004 the government spending rate will have been brought down by about 4 ½ percentage points.

Figure 2: Government spending ratio – development to the year 2004



A binding definition of government revenue and expenditure in ESA terminology has been available since the middle of the year. Improved international comparability of the data now makes it possible to study the development of individual categories of revenue and expenditure in relation to GDP and to aggregate spending.

In general, the expected decline in the government spending ratio will also decrease the share of GDP taken by each expenditure category, whilst looking at trends in expenditure categories in terms of aggregate spending will point up the structural shifts within the general government sector.

Expenditure on intermediate consumption purchases, compensation of employees and social benefits in kind will increase on a yearly average by 1 ½ % in the projection period. In relation to GDP and to aggregate spending this expenditure will become less significant in the coming years: from 40.4 % in 1999 the share in total budget volume will decline by 2004 to less than 40 %. This is among other things a reflection both of the future programme and of the ongoing reduction of public-service personnel.

The social benefits in cash, including both old-age and retirement pensions and payments such as child allowances and unemployment benefits, are expected to register a yearly increase of 2 %. The social benefits paid by social insurance funds will register a more marked increase than those of central, regional and local authorities, the latter being moderated among others by the decline in expenditure on supplementary unemployment benefits. The share in aggregate spending will remain constant at about 39 % up to 2004.

At 7 ½ %, the share of interest payments in aggregate spending at the end of the projection period will be at the 1999 level. Expenditure on interest payments will increase by a yearly average of 2 %. Rising interest charges resulting from the net borrowing still necessary in the coming years will be offset by interest savings derived from applying the UMTS proceeds to debt redemption. Planning is based on the assumption of a balanced federal budget in the year 2006.

The further reduction of statistical deficits will create the conditions needed to reverse the trend in the burden of interest payments on public budgets.

The decline in the investment ratio evident since the mid-nineties will be checked. The share of GDP taken by public-sector investment sank from 2.9 % in 1992 to 1.8 % in the past two years, induced both by the expiry of special effects arising from unification and by budget consolidation measures.

Over the same period, the share of investment in aggregate spending declined from 6.1 % to 3.8 %. This trend will be countered by using the interest savings from debt redemption with UMTS proceeds in the year 2001 for future-oriented spending. Investments will increase by a yearly average of 2 %, and thus in proportion to the aggregate budget. In the year 2004, 4 % of aggregate spending will go on investment.

Other transfers will also rise by a yearly average of 2 % over the projection period and will continue to take about 10 % of spending. Whilst declining subsidies curb the upward movement, owner-occupied homes premiums (which will increase further on account of changes in the system of promoting the ownership of residential property) and investment grants (which will regain significance as from the year 2000) will also be a factor. Reducing tax revenue on a cash accounting basis, these payments are treated in National Accounts as transfer expenditure.

C. Trends in revenue

The growing interconnections between the principal components on the revenue side of the government account, taxes and social contributions, limit the extent to which their development may be reviewed separately. This is shown by the ecological tax reform, the revenue from which is applied to reduce social contributions. Measures of this kind increase the tax ratio while reducing the social contribution ratio. Allowance must be made for these structural shifts when looking at the individual components in isolation.

Technical note:
Owing to differences in methodology, the projection on the basis of National Accounts definitions is not directly comparable with the results of the Working Party on Tax Estimates.

Table 6: Development of tax, social contribution and tax and fiscal charges ratio to 2004

	1999	2000	2001	2002	2003	2004
	- in % of GDP -					
Tax ratio	24.1	24 ½	23	23 ½	23	23 ½
Social contribution ratio	18.9	18 ½	18	17 ½	17 ½	17
Tax and fiscal charges ratio						
- January 2000	43.1	42 ½	41 ½	41 ½	41	-
- September 2000	43.1	43	41	41	40 ½	40 ½

Whilst the tax ratio will increase slightly in the current year, the 2001 stage of the tax reform will result in a marked reduction of the level by 1 ½ percentage points to 23 %. In the following years the effects of tax relief and the growth-induced rise in tax revenue will work in opposite directions. The tax ratio will rise slightly to 23 ½ % in 2004, the final year of the projection, which being between the major stages of 2003 and 2005 will afford no substantial extra relief. But this will be only a temporary rise, as the year 2005 which is not yet included in the projection will afford perceptible relief in the next stage of the tax reform.

The development of the social contribution ratio reflects the aim of the ecological tax reform of bringing down the cost of labour as a production factor. In the current year as a result of the lower contribution to statutory pension insurance the ratio will decline to 18 ½ % in tandem with the slight rise in the tax ratio. In succeeding years it will decline further to 17 % in 2004.

The tax and fiscal charges ratio will remain unchanged in the current year as against 1999 on account of the opposite trends in the tax and social contributions ratios. The development of the tax and fiscal charges ratio in the coming year will be shaped by the tax reform. With the marked reduction from 43 to 41 % the tax and fiscal charges ratio will be brought down to a level last registered in 1993. At the end of the projection period it will stand at 40 ½ %.

D. Accelerated reduction of government debt

The January 2000 update of the stability programme envisaged a reduction of the debt ratio to 58 ½ % of GDP by the end of the projection period (2003). This was based on the assumption of the debt ratio falling below the Maastricht Treaty reference figure of 60 % in the year 2002.

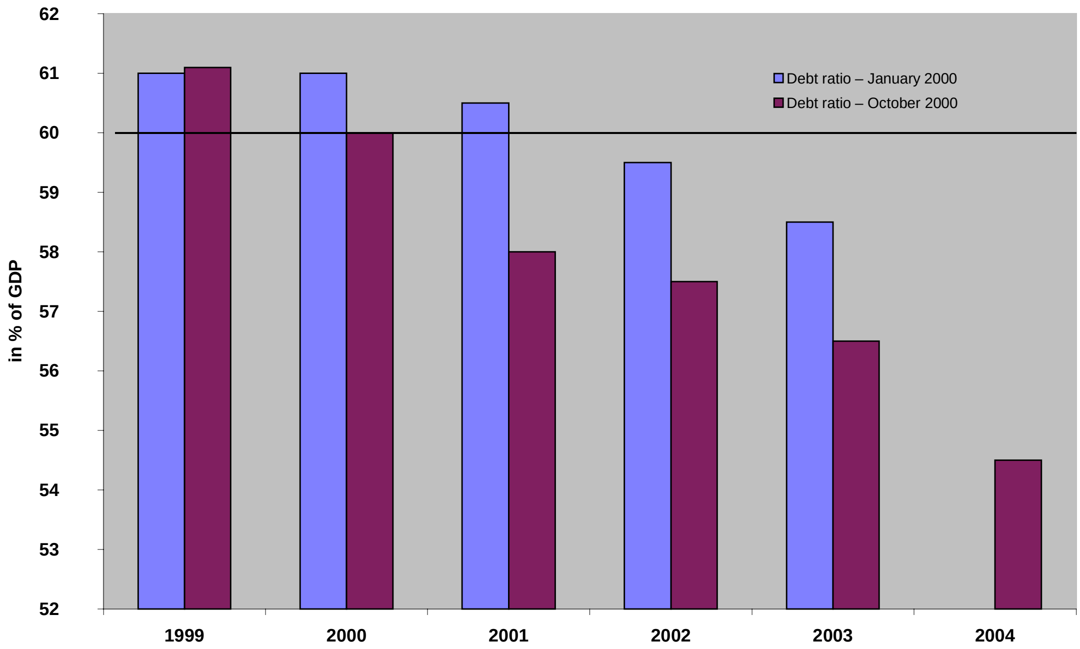
The proceeds from the auction of UMTS licences open up a fresh perspective for reducing the debt ratio. The government announced at an early stage that the proceeds would be used in full for debt redemption. This will enable the debt ratio to be brought down appreciably more quickly than had previously been envisaged.

The use of the UMTS proceeds to reduce government debt will be a two-stage process. Redemption will be shared between the current and the coming year for technical and efficiency-related reasons, so that the full effect on the debt will not be apparent until 2001. As plans now stand, about DM 35 bn is to be applied to debt reduction in the current year, bringing the debt ratio down to 60 % of GDP by year-end. In January 2001 the government will redeem bearer bonds of the "Currency Conversion Equalisation Fund" in the amount of approximately DM 64 1 /2 bn; as a result, the debt ratio will fall to 58 % in the coming year, appreciably undercutting the 60 % reference figure. By the end of the projection period the debt ratio will decrease by a further 3 ½ percentage points to 54 ½ % of GDP.

Table 7: Debt ratio – development to the year 2004

	1999	2000	2001	2002	2003	2004
Debt ratio	- in % of GDP -					
- January 2000	61	61	60 ½	59 ½	58 ½	-
- September 2000	61.1	60	58	57 ½	56 ½	54 ½

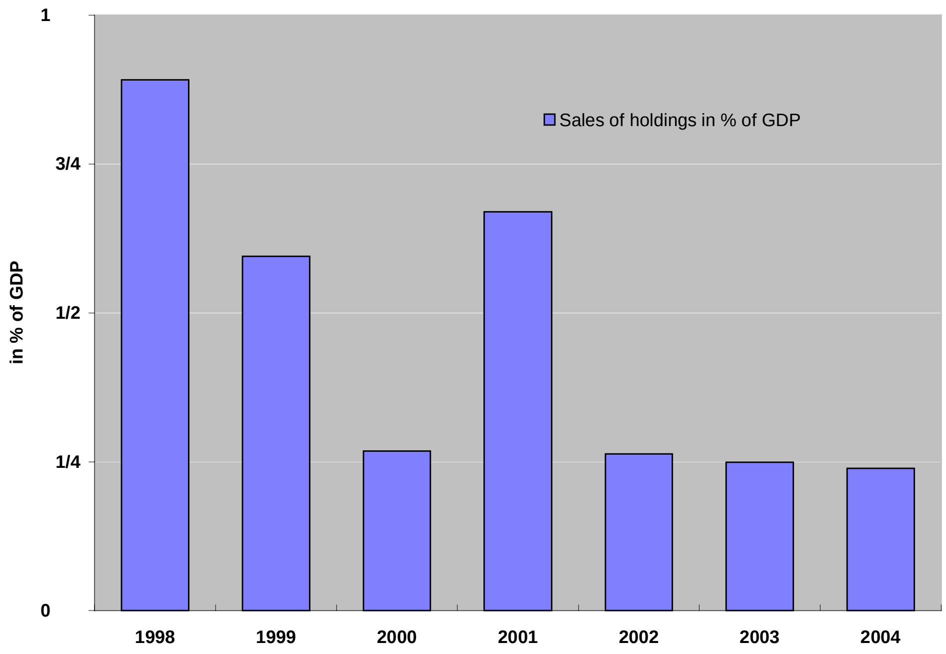
Figure 3: Debt ratio - development to the year 2004



Whilst the UMTS proceeds enable a one-off reduction of the level to be made, it is the bringing down of statistical deficits up to 2004 accompanied by relatively rapid growth that underlies the further continual reduction of the debt ratio. Other than in the calculation of the general government deficit, proceeds from the sale of government holdings are also a factor in this context.

In the year 2001 in particular, in which public budgets have to bear the heaviest burden of the tax reform, central, regional and local governments will again make greater use of privatisation to offset part of their substantial revenue losses. In the succeeding years, sales of government holdings will be stabilised at a lower level.

Figure 4: Sale of government holdings as a percentage of GDP



E. Impact on public finances of changes in underlying economic data

Fiscal policy performs an important function in the stabilisation of the economy. But public budgets exert an automatic stabilising effect even without additional fiscal policy action. In its Economic Outlook of December 1999, the OECD estimates the moderating influence of these effects on cyclical fluctuations in Germany at around one third.

However, there is substantial uncertainty inherent in the estimation of cyclical sensitivities. Inferring the impact of greater or smaller growth on public finances can give reliable results only if there are stable links between the development of specific macroeconomic aggregates and movements in revenue and expenditure which can be estimated with an adequate degree of precision.

Experience shows, however, that stable elasticities cannot be assumed, especially with regard to taxes.

Neither in the short nor in the medium term is there any direct automatic linkage between aggregate economic activity and additional tax receipts. The development of tax revenue reflects the many and varied trends, some operating with a time-lag, in the specific bases of assessment of the individual taxes. Added to this are the financial effects, some offsetting and some reinforcing each other, of numerous changes in tax legislation.

On the expenditure side, the measurement of cyclical sensitivity is largely influenced by the variables to be included. Besides labour market spending, other expenditure categories also respond at least indirectly to cyclical fluctuations. Thus it may be assumed that personnel expenditure in public budgets is also partly influenced by the cyclical situation. This is because income trends in the public service are frequently geared to (cyclically-dependent) private-sector pay agreements. If this expenditure is taken into consideration the effects of a change in growth expectations are appreciably less pronounced. This applies all the more if allowance is also made for the fact that expenditure on investment is typically run down at times of lower economic activity.

A study commissioned by the Federal Ministry of Finance from the Ifo Institute in Munich shows that the cyclical sensitivity of the budget balance tends to be the greater the higher a country's government spending ratio, the more progressive the overall system of taxes and fiscal charges and the more comprehensive the support afforded to the unemployed. The study envisages for Germany a lessening of the cyclical sensitivity of the budget balance in view of the efforts to bring down the government spending ratio and to reduce direct taxes.

A rough estimate can be made of the cyclical impact on the general government budget by means of a simplified calculation involving taxes, social charges and labour market spending, but the quantitative results can have only a limited information yield.

Given an improvement in growth of ¼ % a year as from 2001 in conjunction with a slightly declining government spending ratio, the financial balance in the final year could improve by just under ½ % of GDP, while a deterioration in growth of the same order in conjunction with a rising government spending ratio would result in a deficit of just under ½ % of GDP in the year 2004.

F. Impact of interest changes on public spending

In view of the complex structure of government debt the impact of interest rate changes can be deduced only with simplified assumptions. Accordingly, the results are no more than a rough assessment, which nonetheless points up the trend of such impact.

Raising the interest rates underlying the projection by one percentage point for the duration makes itself felt in interest spending only with a time-lag. For instance, the annual gross borrowing requirement of central government in the period from 2000 to 2004 amounts to about one seventh to one fifth of its total debt. Only after the complete conversion of all liabilities would the average interest payable on public debt increase by one percentage point over the base scenario. The average interest payable on government debt would rise by roughly one half of a percentage point by the end of the projection period.

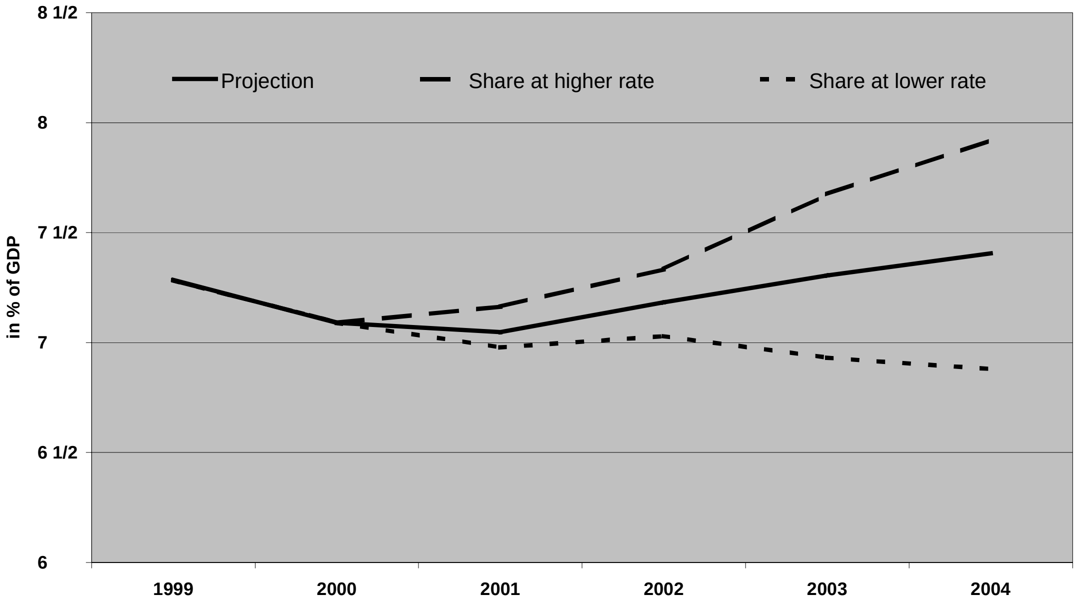
Assuming an interest rate higher by one percentage point, the share of interest payments in total spending could increase to 8 % in 2003 and 2004, whereas the projection is based on a share of 7 ½ %. This is based on the assumption that total spending would be increased by the extra spending on interest payments. If the interest plus were to be offset by savings elsewhere in the budget, the interest share would be slightly greater. However, this increase would still be within the 8 % rounding.

The higher interest payments would not endanger the budget balance in the year 2004.

The above scenario makes no allowance for the countermeasures adopted in government borrowing. According to how interest rates developed, the government's debt management would restructure the follow-up financing in order to minimise the charge on the budget. To this extent the expenditure growth outlined here represents an upper limit which could be undercut by appropriate use of credit policy instruments.

Were the market rate as from 2001 to remain one per cent below the interest rate assumptions made in the projection, it would be possible for the share of interest payments in total spending to be brought down to 7 % and to be held at this figure up to the end of the projection period.

Figure 5: Share of interest payments in total spending



VII. Summary and outlook

Germany is well on the way to achieving the sustained expansion of growth and employment. The government's fiscal and economic policy approach has played a central part in this. At the same time, the measures set out by the government in this update of the German Stability Programme meet the requirements of the Stability and Growth Pact.

- The government will continue to pursue the stability-oriented fiscal policy course adopted last year in the future programme to secure employment, growth and social stability.

- The fiscal policy course ensures a balanced relationship between consolidation and tax relief, since tax relief is and will remain founded on the observance of strict expenditure discipline.

- Extensive tax relief afforded both to small and medium-sized business and large-scale enterprises and special attention to future-oriented sectors such as research and education will sustainably reinforce the innovative capacity and willingness to invest of German trade and industry.

- Consumption and the savings capacity of private households will be stimulated by the appreciable relief afforded to dependent employees and families.

- The reform of statutory pension insurance in particular is necessary not only to cope with the demographic challenges but also to ensure that public finances remain on a permanently sound footing.

- Both in the year 2000 and in the year 2001, the government deficit will keep to the course laid down in the stability programme as updated in January of this year. A deficit of 1 % of GDP is expected for the year 2000. Including the proceeds from the sale of UMTS licences will result in a surplus of 1 ½ % of GDP in the year 2000.

However, this one-off effect is left out of account for the assessment of fiscal policy under the Stability and Growth Pact.

- The government account will be balanced in the year 2004, the final year of the projection. Hence Germany will comply with the requirement of observing an additional "safety margin" in relation to the medium-term stability target. At the same time, this will provide a firm foundation for the 2005 stage of the tax reform.

- Germany's position in reducing the debt ratio will at all events be better than assumed in the last update. From the year 2001 onwards (and thus one year earlier than originally planned), the debt ratio will again be well below the reference figure of 60 % of GDP.

- Germany's fiscal, economic and social policies are characterised by solidity and reliability. They comply with the provisions of the Stability and Growth Pact and thus reinforce market confidence. In their orientation to favourable macroeconomic conditions on the one hand and lasting structural reform on the other, they are also in line with the European broad guidelines of economic policies.