Bundesministerium der Finanzen

Specialist view

Financial and economic policy

German Stability Programme

December 2001

update

German Stability Programme

December 2001
update

Table of contents

Tables

Figures

Annex

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 coordination of economic policies), the Member States having adopted the single currency are obliged to submit updated stability programmes each year to the ECOFIN Council.
The December 1999 update of the German stability programme focused on the fiscal policy measures incorporated in the Future Programme adopted in the summer of 1999. The January 2000 supplement took account of the Tax Reform 2000. Already in line with the resolutions of the Lisbon European Council (EC), the October 2000 update of the German stability programme concentrated on the issue of improving the quality and sustainability of public finances.

The present update of the German stability programme was approved by the cabinet on 5 December 2001. 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 and most recently supplemented by the code of conduct on the content and format of stability and convergence programmes of 27 June 2001. A somewhat later submission date was chosen this year in order to take account of current economic trends clearly deviating from the original projections.

The updated stability programme is based on data available as at mid-November 2001.

The Federal Ministry of Finance publishes the updated stability programme among others on the Internet at www.bundesfinanzministerium.de.

II. Summary

- Adverse conditions attend this year's update of the German stability programme. In particular, these are decisively influenced by an economic situation marked by global uncertainty and a number of other special factors.

- Against this background the government deficit for the years 2001 to 2003 deviates from the forecasts made in the October 2000 update. A deficit of 2 ½ % of the gross domestic product (GDP) is expected for 2001.

- Germany stands by the objective of submitting a balanced general government budget in the year 2004, thus taking account of the requirement of maintaining an additional "safety margin" in relation to the medium-term stability target.

- To take into account the existing risks, this update incorporates a scenario with appreciably lower growth expectations. Additionally, a sensitivity analysis has been undertaken both for the baseline scenario and for the alternitive scenario. Yet there will be no departure from the consolidation course even in the event of cumulative deviations both in growth expectations and in expenditure projections, which we do not expect to see from our current viewpoint. The consolidation course will be maintained even if such an unfavourable scenario should apply. Deficits will be brought down appreciably in the medium term. The minimal benchmark will be attained at all events.

- In reducing the debt ratio, the reference figure of 60 % will be reached in 2001 and will be undercut as from 2003.

- The German government combines a macroeconomic policy geared to promote growth and stability with lasting structural reform in the product, capital and labour markets. This is also in line with the broad guidelines of European economic policies. Fiscal policy will take account of the present cyclical uncertainties without losing sight of the medium-term consolidation goal.

- The fiscal policy course holds the balance between proactive policy and the need for consolidation. Maintaining strict expenditure discipline is and will remain the basis on which to afford tax relief. The average annual increase in general government spending will continue to be restricted to 2%; for central government, provision is even made in the financial planning period up to 2005 for an average increase in nominal expenditure of only 0.8 %. In tandem with this, the improvement in the quality of the budget will gain increasing significance.

- Appreciable relief given to employees and families will encourage consumption and enhance the ability of private households to save. The continuing relief afforded to enterprises will stimulate investment and thus assist in the creation of jobs.

- Increasing concentration of resources on areas such as research and education and efficient energy use makes it easier to take advantage of the opportunities offered by a knowledge-based society, enhances the ability of the German economy to compete and to meet future challenges and conforms to the objectives of the European sustainability strategy.

- Continuing consolidation and the efforts to raise the number of persons in gainful employment also help to cope with the tasks arising from demographic development. They support and supplement the reform of Germany's pension system of old-age security.

- By putting in place an arrangement to implement at national level the prescriptions of Maastricht and the stability and growth pact, Germany is also complying with the country-specific recommendations of the broad economic policy guidelines.

III. Outlook for the general development of the economy from 2000 to 2005

A. Global economic environment

The global economic environment has deteriorated substantially since mid-2000. The major industrial countries were in a phase of cyclical deceleration even before the terrorist strikes. The momentum of the global economy was already decreasing when it was additionally curbed by the events of 11 September 2001.

It is difficult to judge at present what after-effects these events will have. The substantial clouding-over of economic prospects proceeded from the U.S.A., currently in a recession, affecting the other industrialised countries as well as the developing and emerging economies. It is likely that the recessive tendencies will continue for the course of this year especially in Japan. In western Europe, economic growth will remain heavily curbed in the short term.

In the course of the coming year, however, the forces of global expansion may be expected to regain the upper hand. The perceptible monetary and fiscal stimuli in the U.S.A. will exert a stronger influence. This will give more favourable foreign trade conditions which in conjunction with the growing impact of this year's monetary policy measures are likely to help promote economic recovery in Europe as well.

After the sharp fall this year in the course of marked global economic deceleration, world trade is likely to be revitalised in the coming year in tandem with the development of the global economy, approaching again to its long-term trend towards the end of the year.

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

The projection is based on the following assumptions for the period through 2002:

- There will be no further shocks to global confidence (no more terrorist attacks within or outside the U.S.A.).
- There will be essentially no change in energy and raw materials prices, especially in the price of crude oil (technical assumption).
- The U.S.A. is in recession in the second half of this year, though vigorous monetary and fiscal stimuli will lead to rapid recovery next year. In Japan a recession is imminent. In the euro area, it is assumed that economic recovery will set in early in the course of next year.

  It is assumed that the world economy will register growth of 2 to 2 ½ % in real terms this year which will pick up slightly in 2002 to 2 ½ to 3 % in real terms.

- World trade will grow by 4 to 5 % in real terms in the period covered by the projection. This implies a marked acceleration in the course of the coming year. Germany's sales markets abroad are likely to expand in line with this.
- The increase registered in consumer prices will be largely eliminated again as the after-effects of higher energy costs and rising food prices as a result of animal epidemics cease to apply. There is no threat to the stability target of the European Central Bank.
- Wages policy will hold a course geared to maintaining stability and employment in the period covered by the projection. Unit labour costs will rise only moderately in this and next year.
- Fiscal policy will keep to the consolidation course. Tax relief and child benefit increases will exert a stabilising effect on the economy in this and next year.

C. Trends in Germany in 2001 and 2002

The German economy was already losing momentum as from mid-2000 in consequence of global cyclical deceleration, the rising cost of energy and foodstuffs and the previous tightening of monetary policy. Added to this is a substantial increase in risk to the economy as a whole in the wake of the terrorist strikes in the U.S.A. The German government expects GDP to register average annual growth of around ¾ % in real terms for 2001.

In the coming year, economic activity may be expected to pick up again gradually as the impact of rising prices ceases to have effect and under the assumption of more favourable global economic conditions. In 2002, the German government expects to see GDP rise by around 1 ¼ % in real terms.

The rise in the cost of energy predominantly as a result of increasing oil prices caused substantial real income losses putting a brake on private consumption. This was aggravated in the spring of this year by rising food prices in consequence of the animal epidemics, further restricting the real scope for consumption. After the downturn in the second half of 2000, consumer activity recovered somewhat as a result of the tax relief afforded since the start of this year, though the effect of this relief was in part cancelled out by the loss of purchasing power. Nonetheless, the contribution to economic growth is still too small.

However, the tax reform exerts a stabilising effect on economic activity; it has prevented an even more marked weakening of growth. In the coming year, private consumption is likely to derive increasing gains from the diminishing pressure of energy and food costs, from improved family benefits and from the tax relief measures that have been adopted.

The notably vigorous growth of German exports up to the end of last year has been appreciably curbed by the slowdown in global economic activity. But German exports as well may be expected to regain lost ground when global economic activity picks up as projected in the first half of next year.

Development of the economy in general has also been depressed in particular by the process of contraction in the construction industry which has persisted for years and which accelerated perceptibly again in the first half of this year. This is partly attributable to sustained structural adjustment in the new Länder. Construction investment in Germany as a whole is expected to stabilise in the course of the coming year. But positive impetus is to be expected only from commercial construction in the former federal area; the consolidation process is likely to continue in the new Länder, though easing off slightly.

Investment in plant and equipment has also declined most recently in response to cyclical deceleration. The marked slowdown in investment activity is not least a reflection of the global economic downturn, with the industrial sector as principal investor being particularly susceptible on account of its comparatively heavy foreign trade commitment. Investment activity may also be expected to pick up again in the coming year as foreign trade conditions improve.

The slowdown in economic activity has also had a delayed impact in the labour market. The labour market situation is likely to improve in the course of the coming year with the expected global economic recovery, but given the state of the labour market at the end of 2001 this will not be adequately reflected on average for the year.

D. Medium-term growth perspectives

Notwithstanding the consequences that may still arise in connection with the terrorist strikes, the global economic slowdown and the initially unfulfilled expectations of rapid economic recovery in the U.S.A., medium-term growth perspectives for Germany remain positive.

The prospect of sustained economic expansion is supported in particular by the favourable underlying conditions: vigorously expanding world trade in the medium term, wage trends geared to stability and growth and a highly stable price level. Additionally, the fiscal policy measures already adopted are expected to show positive effects for the entire period covered by the projection.

The annual real increase in the gross domestic product since reunification amounted to only about 1 ½ %. During this period, as at present, there were repeated disruptions which curbed the growth trend. The German government is proceeding on the assumption that negative factors of this kind will not reappear with such frequency and to such an extent in the five-year period now before us.

The annual growth rate of around 2 % in real terms assumed in the projection of aggregate economic development up to 2005 presupposes that the current growth risks are rapidly dealt with and the existing positive factors are able to work to the full in stimulating domestic demand. It is further assumed that all policy areas will work together efficiently to bring about a lasting improvement in the prospects for more growth and employment at stable prices.

In common with most other industrialised countries, Germany will in future face a growing need to cope with the problems posed by demographic change. Population ageing is moving ahead. The number of persons of working age will already be on a clearly downward trend in the period covered by the projection. This makes it all the more important to enhance the productivity of the existing workforce by stepping up investment in human capital and by making it easier above all for women and older workers to enter, re-enter or remain in working life. Bottlenecks are already apparent in the labour market, not only in the areas of information and communications technology. Highest priority must therefore be given to the future-oriented qualification of gainfully-employed persons and to life-long learning.

Achieving tension-free growth in the longer term also requires fixed assets to be developed and their quality to be improved in the course of structural adjustment processes. Substantial investment in the capital stock of the economy and in the infrastructure will therefore continue to be necessary.

The German government assumes that the policy course it has adopted will lead to an appropriate expansion of the production potential with more effective utilisation of macroeconomic capacities.

The following technical assumptions are made for the medium-term projection:

- The volume of world trade will continue to expand vigorously (by 6 to 7 % a year), though this expansion will be somewhat less marked than the average of the past five years, with German sales markets likely to expand in roughly the same order.
- The real external value of the euro will remain largely unchanged.
- Marked price stability and a favourable interest-rate level will be assured in the EMU.
- Sufficient resources will be available at favourable cost; the crude oil price will remain largely stable.

Subject to the conditions and assumptions described above, the following benchmark figures result for the projection of aggregate economic development from 2001 to 2005:

- average GDP growth at constant prices of around 2 % a year;
- rise of 1 ½ % a year in the aggregate price level;
- increase of ½ % a year in the number of gainfully employed persons.

As before, exports will continue to provide the mainstay of growth. Given the assumed expansion of world trade and sales markets, exports could increase by about 6 % a year in real terms. The foreign balance at constant and current prices would improve slightly given an increase in exports of around 6 ½ % a year in real terms. Besides this, corporate investment is also likely to register disproportionately large growth in relation to output. The medium-term projection assumes that plant and equipment spending will expand by around 5 % a year in real terms, whereas construction spending, especially on residential construction, will expand only slightly. Despite tax relief and with a slightly upward savings trend, private consumption is likely to register a somewhat smaller increase than GDP of a good 1 ½ % a year, whilst government final consumption will increase only moderately on account of the consolidation course (+ 1 % a year). The stability-oriented cooperation between policy areas will help to maintain a lower aggregate inflation rate of 1 ½ % a year. Hence GDP at current prices is likely to increase by 3 ½ % a year.

E. Overview

Table 1: Projection of aggregate economic development for the years 2001 to 2005

	ESA Code	2000	2001	2002	2005/00
GDP at constant prices; annual change in % (7+8+9)	B1g	3,0	¾	1 ¼	2
GDP at current market prices; annual change in %	B1g	2,6	2	3	3 ½
GDP deflator		-0,4	1 ½	1 ½	1 ½
Gainfully employed persons		1,6	0	0	½
Labour productivity[1]		1,4	½	1	1 ½
Use of GDP: change on the year at constant prices					
1. Private consumption spending[2]	P3	1.5	1 ½	1	1 ½
2. Govt. final consumption	P3	1.2	1	1	1
3. Gross fixed capital formation	P51	2.3	-2	1 ½	3
4. Changes in inventories (GDP growth contribution)[3]	P52 + P53	0.4	-½	½	.
5. Exports	P6	13.2	5 ½	4	6
6. Imports	P7	10.0	3	5	6 ½
GDP growth contributions[3]					
7. Domestic demand (1+2+3)		2.0	-0	1 ½	2
8. Changes in inventories (=4)	P52 + P53	0.4	-½	½	.
9. External balance of goods and services (5-6)	B11	1.1	1	-0	.

1) GDP at constant prices per gainfully employed person.
2) Including private non-profit organisations.
3) Real change in per cent of pre-year GDP.
2000: Provisional result of the Federal Statistical Office of August 2001.
2001 and 2002: Results of the Interdepartmental Macroeconomic Forecasting Group of October 2001.
2005: Medium-term projection, May 2001, reviewed end-October 2001.

IV. Perspectives for the development of public budgets

A. Trends in the financial deficit

The medium-term reduction of the government deficit has become appreciably more difficult as compared with the last stability programme update of October 2000. Last year a government deficit of - 1 ½ % of GDP was assumed for the year **2001**, based on GDP growth of 2 ¾ % and taking account of the tax relief effective as from the start of the year, whereas the actual result is likely to be roughly **- 2 ½ % of GDP**. This result is attributable to the combined effect of a number of unfavourable developments:

- The projection for the year 2001 was based on the assumption of a deficit of - 1 % of GDP (excluding the proceeds from the auction of UMTS licences (UMTS proceeds)) in the year 2000. However, in August 2001 the Federal Statistical Office revised the deficit for 2000 to 1.3 % of GDP (excluding UMTS proceeds) using more up-to-date financial statistics. In addition to adjustments to the social insurance funds and to interest expenditure, the reasons for the increase in the deficit include a change in the method of posting Bundesbank profits in the accounts[1]. This adjustment to the year 2000 base affects the current and the coming years. This extra charge alone means that the deficit target for 2001 of - 1 ½ % of GDP set in the last stability programme cannot be met.

- It was assumed in the last stability programme that the finances of the social insurance institutions would show positive development. Triggered by a deficit in the statutory health insurance funds, however, the social insurance institutions as a whole will close with a negative result this year, increasing the aggregate deficit by about - 0.1 % of GDP.

1 The profit contribution made by the Bundesbank to the federal government may include capital gains from the sale of foreign exchange or gold, which are treated in the National Accounts as "financial transactions" and thus not as government revenue. The adjustment to the profit contribution to allow for these "financial transactions" was hitherto undertaken on the basis of a Eurostat decision dating from 1997. In August 2001 the Federal Statistical Office applied a new arrangement to the posting of the Bundesbank profit contribution making allowance for all elements of the Bundesbank's profit and loss account, including operating and interest expenditure. This has resulted in appreciably lower federal government revenue in the past years and accordingly in higher deficits. This change alone puts a charge on the result for 2000 and consequently on the deficit for 2001 of a good 0.1 percentage point of GDP.

- Weak economic activity in the current year is the principal factor behind the unexpected increase in the deficit for 2001. In the present situation the German government puts GDP growth at only ¾ % in real terms. The growth rate is thus 2 percentage points below the figure assumed when the last stability programme was drawn up. Flagging growth puts both the revenue and the expenditure side of public budgets under pressure. The tax revenue estimation of May 2001 already registered shortfalls of € 3.5 bn, but it was not until the tax estimation round of 8/9 November 2001 that the impact of the cyclical downturn on the revenue side became fully apparent: as against the spring estimate, this showed that public budgets would have to expect additional revenue shortfalls of € 6.6 bn. Added to this are charges imposed by the labour market situation in the form of declining revenue from social security contributions and extra spending, especially by the Federal Labour Office. The rise in funds required by the Federal Labour Office directly affects the federal budget in that the grant for unemployment insurance will be higher than originally assumed. More funds will also have to be made available for the supplementary unemployment benefits disbursed directly from the federal budget.

The change in growth expectations also has a negative effect on the outlook for the development of the deficit in 2002. As compared with the assumptions made in the last stability programme, based on average growth of 2 ½ % a year in real terms for 2002 to 2004, the current assessment of economic growth for 2002 at + 1 ¼ % is much more subdued. Accordingly, the tax revenue estimation of 8/9 November 2001 forecast additional tax revenue shortfalls for the coming year in excess of the 2001 base effect.

All in all, compared with the estimation of May 2001, public budgets in Germany can expect to receive € 9.8 bn less in tax revenue next year. The problems on the revenue side will make it considerably more difficult to bring down the deficit by around one half of a percentage point in 2002 as envisaged in the last stability programme.

On the other hand, in view of the deficit positions now reached there is an urgent need for public budgets at all levels to keep to the course pursued successfully in past years of reducing deficits and debt ratios. Only in this way will it be possible for budgets to maintain or to regain the scope for action which would otherwise be under threat from rising interest expenditure.

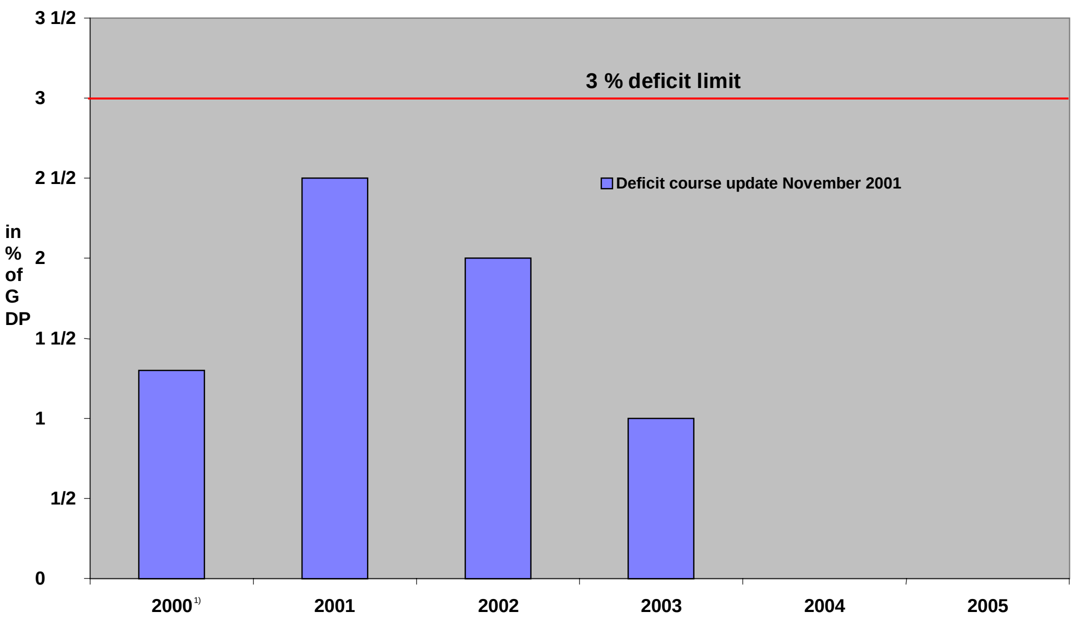
This is all the more necessary if the further risks to the development of public budgets are included in the picture. National and international institutions agree that there are at present greater uncertainties inherent in the projections of global economic development than in earlier forecasts. In view of an expected general government deficit for 2001 of - 2 ½ % of GDP and uncertainty in the outlook for the economy, the reduced "safety margin" in relation to the 3 % ceiling clearly shows that there is no alternative to continuing to follow the consolidation course. Central, regional and local governments will meet the challenges of the coming year by streamlining their budget management and reduce the deficit for **2002** despite declining revenue trends to about **- 2 % of GDP**.

Table 2: Development of the deficit/surplus ratio

	2000[1)]	2001	2002	2003	2004	2005
Deficit/surplus ratio	- in % of GDP -					
Projection November 2001	**-1.3**	**-2 ½**	**-2**	**-1**	**-0**	**-0**
Memo item: Increase in real GDP in %	*3.0*	*¾*	*1 ¼*	*2 ½*	*2 ½*	*2 ½*
Projection October 2000	-1	-1 ½	-1	- ½	0	-
Memo item: Increase in real GDP in %	*2 ¾*	*2 ¾*	*2 ½*	*2 ½*	*2 ½*	*-*

1) Excluding UMTS proceeds. Including UMTS proceeds gives a surplus of 1.2% of GDP.

Figure 1: Deficit ratio - development to the year 2005



1) 2000 excl. UMTS proceeds. Including UMTS proceeds gives a surplus of + 1.2 % of GDP.

Germany stands by the objective of achieving a balanced general government budget in the year 2004. This objective is an extremely ambitious one in view of the cyclically-induced tax revenue shortfalls for 2001 and 2002, perceptible both in the short and medium term, the tax relief already adopted for 2003 and the base level for 2001/2002. The situation will be eased by the social insurance funds, which will register surpluses again as from 2003. But restricting the growth of expenditure by central, regional and local authorities in the years after 2002 as well will remain an essential precondition for balancing the general government budget in 2004 within the meaning of the Maastricht Treaty. Subject to these conditions, the deficit for **2003** can be brought down to about **- 1 %** of GDP in order to reach a figure "close to balance" in 2004.

The final year of the projection is influenced by the further stage in relief provided by the tax reform as already adopted in the summer of 2000. Cuts in the income tax schedule will afford additional relief to individual taxpayers of around one percentage point of GDP in 2005 which will have to be borne by public budgets.

However, if expenditure trends continue on a moderate course, which will already be a necessity at federal level in view of the planned submission of a balanced federal budget in the year 2006, it will be possible for the general government financial balance to be held at approximately **0 % of GDP** in the year **2005** as well.

Table 3: Deficits/surpluses by level of government

	2000[1)]	2001	2002	2003	2004	2005
Deficit/surplus ratio	- in % of GDP-					
Federation including special funds	-1.2	-1 ½	-1 ½	-1	-½	-0
Länder and local authorities	-0.2	-1	-½	-½	-0	-0
Social insurance	+0.0	-0	-0	+0	+0	+0
General government[2)]	-1.3	-2 ½	-2	-1	-0	-0

1) Excluding UMTS proceeds. Including UMTS proceeds gives a balance +1.3 % for central government and +1.2 % for general government.

2) Discrepancies between the total of deficits and the general government deficit are attributable to rounding.

If the consolidation course is consistently held and the economy as a whole develops in line with the current projection, the projection shows that budget balance in 2004 and 2005 is feasible. It does seem appropriate however, to draw up a scenario with appreciably lower growth expectations making adequate allowance for what are at present particularly large macroeconomic uncertainties, especially with regard to real GDP growth in 2002.

Should the growth rate turn out to be substantially lower in the coming year, it would be possible to achieve the envisaged deficit reduction in relation to 2001, given the additional charges on public budgets, only by making more extensive cuts on the expenditure side. But in a cyclically difficult phase this method of "saving the way in" would be counterproductive; hence any further cyclically-induced revenue shortfalls or extra spending would have to be at the expense of increasing the deficit.

Should growth in 2002 be half a percentage point weaker than assumed, the deficit for the coming year would remain roughly at the 2001 level. On account of the base effect, however, the deficits for the following years would also be affected by the weakening in 2002, as it would be virtually impossible to offset this effect by further cuts in an already restrictive expenditure line. An across-the-board increase in deficit levels by about half a percentage point of GDP up to 2005 would have to be expected.

If annual average growth for 2003 to 2005 were weaker by one quarter of a percentage point of GDP it would be possible to achieve full budget balance only by making unrealistic assumptions in terms of expenditure.

A scenario of this kind based on exceptionally cautious assumptions shows that the general government deficit subject to these conditions is likely to register 2 ½ % of GDP in 2001 and 2002, 1 ½ % of GDP in 2003 and about 1 % of GDP in 2004 and 2005. In this scenario, budget balance will be achieved in the year 2006.

In the face of higher general government deficits in this and in the coming year, contrary to statements made in October 2000, discussions on the use of structural deficits both to assess the budget situation and as a target figure for budget management have gained further ground. These discussions are nothing new. With all due caution regarding the extent to which structural balances can provide meaningful information, the German government expressly recognises the contribution that analysis of structural budget balances can make to the assessment of the budget situation. If analysis is restricted exclusively to the cyclical portion of the deficit there is indeed a danger of overstating achievements in bringing down the deficit at times of favourable economic activity.

However, the information yield from structural deficit analysis relates only to trends. The structural deficit is not an observable but a computed figure that can be decisively influenced by the assumptions made and additionally requires the use of questionable and for Germany scarcely reliable past data. Hence a figure of this kind may be consulted as an extra aid in addition to the analysis of actual budget balances. But the latter remain the central element of the stability and growth pact. Structural deficits, on the other hand, are not suitable as instruments of budget management.

In view of the substantial uncertainties involved in their computation, the German government refrains from supplying any quantitative data on the structural deficit. But it does expressly welcome the use of procedures jointly developed at European level as an additional instrument to assess fiscal policy development in the Member States of the European Union and the budget lines set out in the stability and convergence programmes.

The structural deterioration of budget balances induced by the tax reform and the cyclical factors are reflected cumulatively in the increase of the deficit for 2001. Thus as compared with the preceding year both the structural and the cyclical portion of the deficit are at a higher level. The further short and medium-development of the structural balance is directly dependent on whether the consolidation course assumed in the projection can be maintained.

The German government is convinced that it will be possible to reduce the structural portion of the deficit as early as next year and thus to contribute to further reduction towards zero by the end of the period covered by the projection.

B. Trends in government expenditure

The deficit projection is based on the assumption of an average annual rise in general government expenditure of just under 2 %, with central, regional and local authorities registering a lower rate of increase at + 1 ½ % than social insurance(+ 2 ½ %). Holding this expenditure line over the entire period covered by the projection is an ambitious objective but one which is necessary for budget balance in the medium term[2].

After having peaked at 50.3 % in 1996, the government spending ratio (aggregate government spending in relation to the gross domestic product) has been appreciably reduced. Last year the

[2] This applies all the more in view of the fact that the definition of expenditure in National Accounts differs from that in financial statistics, the concept of which applies to the accounting of national budgets. Thus child benefits as well as a number of other allowances (such as the owner-occupied homes premium) are posted "gross" in National Accounts. Whereas budget accounting balances these items with tax revenue and thus shows lower tax receipts, National Accounts leave tax revenue unchanged and post these items on the expenditure side. Measures such as an increase in child benefits which in national budgets influence the revenue side are incorporated as an increase in spending in National Accounts.

government spending ratio amounted to 48.4 % of GDP. If UMTS proceeds are included (which are treated as negative expenditure in National Accounts), the figure is reduced to 45.9 % of GDP.

Current year expenditure will rise by + 1 ½ % to a similarly moderate extent as in the past year. Given the comparatively weak nominal GDP growth of + 2 % the government spending ratio will register only a slight decline to 48 %. Government spending is to register a below-average increase in 2002 as compared with the growth of nominal GDP (+ 2 ¾ %), but the ratio will still remain within the 48 % rounding margin. Among others, this will be the result of additional labour market spending, the package of measures to enhance internal and external security and the rise in child benefits.

From the year 2003 onwards, stronger GDP growth and the restriction of the increase in expenditure to well below 2 % will be reflected in the government spending ratio as well. Whilst this ratio will be generally above the trend forecast in the last stability programme as a result of weaker growth in 2001 and 2002, it will nonetheless register a continuous and marked decline in the last three years of the review period to 44 ½ %.

Table 4: Development of the government spending ratio

	2000[1)]	2001	2002	2003	2004	2005
Government spending ratio	- in % of GDP-					
November 2001 projection	**48.4**	**48**	**48**	**46 ½**	**45 ½**	**44 ½**
October 2000 projection	48	46 ½	45 ½	44 ½	44	-

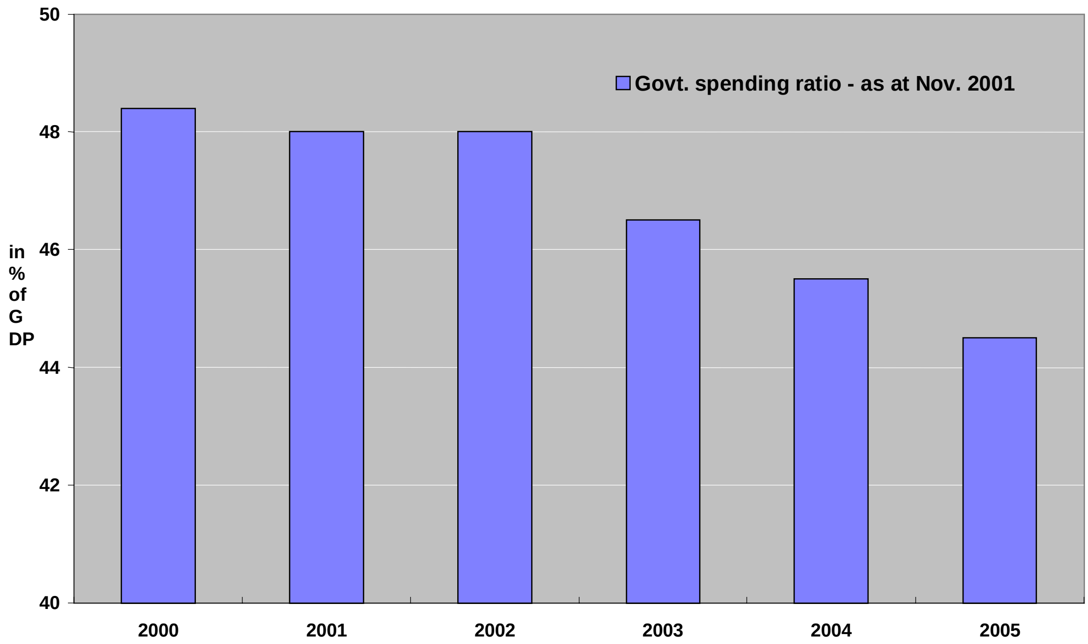
1) Excluding UMTS proceeds. Including UMTS proceeds gives a government spending ratio of 45.9 % of GDP.

Consolidation efforts are not focused on individual expenditure categories but are spread over the entire range of budget spending. Thus the outlay for intermediate consumption (including social benefits in kind) and personnel costs[3], which still accounts for more than 40 % of aggregate expenditure, will decline in terms of GDP from 19 ½ % in 2000 to 18 % in 2005. This trend reflects both the efforts by central, regional and local authorities to cut spending (for instance in response to the government's Future Programme) and the continuing reduction of public service personnel, the effect of which is likely to remain especially apparent in the new Länder.

[3] Intermediate consumption, social benefits in kind and personnel expenditure are looked at in combined form. Insofar as they relate to the "non-market output" of general government, they are the central factors influencing government final consumption expenditure.

The annual reduction of personnel by 1.5 % continues to apply in the area of central government. The generally applicable, restrictive expenditure line at + 1 ½ % on average per year overlays special effects such as the more marked rise in social benefits in kind in the field of social insurance and the additional expenditure on security in 2002.

Figure 2: Government spending ratio - development to the year 2005



In the current and the coming year, monetary social benefits are likely to register an above-average increase on account of unfavourable labour market development as well as the rise in child benefits as from 1 January 2002 and increases in the housing allowance. However, the rising trend in this expenditure category will ease towards the end of the projection period in line with the upturn in economic activity. An average increase of a good 2 % a year is expected. The share in aggregate spending will be just under 40 % in 2005; in relation to GDP this represents a decline from around 19 % to 17 ½ % in the final year of the projection.

Interest payments account for 6 ½ % of aggregate expenditure in public budgets this year as compared with 6.9 % last year. This decrease reflects in particular the use of proceeds from the auctioning of UMTS licences, which has perceptibly eased the interest burden. However, the further rapid reduction of interest charges is made more difficult by the fact that deficits for 2001 and 2002 are appreciably larger than originally planned. Interest payments in relation to GDP may be expected to stand at about 3 %, though with a slightly declining trend, given an average annual increase of 2 % in the projection period.

Induced both by the expiry of special effects arising from reunification and by the pressure of consolidation requirements, the share of public-sector investment in aggregate expenditure has declined since 1992 from 6.1 % to 3.8 % in 1997 and has since then remained virtually constant at that level. Standing at 2.9 % of GDP in 1992, the investment ratio declined up to 1997 to 1.9 % of GDP. The ratio stood at 1.8 % in 2000.

A decline in the investment ratio cannot automatically be taken to indicate a deterioration in the pattern of expenditure. Thus the public investment requirement has decreased in some areas in the past. At the same time, extensive outsourcing of municipal undertakings from public budgets has been noted in the past few years, especially on the part of local authorities. For statistical purposes, the outsourced undertakings do not make up part of general government, so that it may be assumed that at least some portion of the investments formerly attributable to the public sector is now being made by private corporations. Finally, increased sales of government shareholdings also tend to reduce the volume of investment by general government.

However, investments cannot in principle be fully excluded either when a consolidation strategy demands that the increase in government spending is to be curbed and the government spending ratio reduced. Central government also promotes investment by way of tax concessions and credit guarantees which are not reflected on the expenditure side of the federal budget. Encouraging private investment by creating appropriate underlying conditions is also an essential part of a policy aiming to step up investment activity. It must be assumed that in view of the constraints on the budget investment spending will continue to be under pressure, especially (but not solely) at local authority level. In the narrow National Accounts definition, the investment ratio will decline up to 2002 with the impact of consolidation requirements to 1 ½ % of GDP and will remain within this rounding up to 2005.

It is assumed that other transfers will rise by a yearly average of around 1 %. In this respect the decrease in subsidies will be overcompensated by a marked rise in transfers. Among the capital transfers the owner-occupied homes premium will notably register vigorous growth up to 2004, and in the case of current transfers expenditure will be inflated by a statistical effect relating to the own resources contributions to the EU[4].

[4] From 2002 on, GDP own resources will be assigned greater weight than VAT own resources. As GDP own resources are deemed in National Accounts to be a transfer by general government to the EU whereas VAT own resources are seen as a direct payment by private sectors to the EU, the general government expenditure volume increases by more than € 4 bn, although the operation represents only a shift between financing instruments. As the revenue side as well is increased by the same amount, the operation has no effect on the balancing item.

C. Trends in government revenue

The development of tax revenue in the current year reflects the impact of massive tax relief afforded since the start of the year and of cyclically-induced shortfalls. In May, the Working Party on tax revenue estimation had originally assumed a shortfall of around € 3 ½ bn as against the previous estimate, but the subsequent slowdown in economic activity in the second half of the year clearly left its mark on the revenue side. The development of assessed taxes and value-added tax in particular was weaker than expected. According to the most recent estimate, central, regional and local government will have to make do with about € 6.6 bn less in tax revenue in the current year and with € 9.8 bn less next year than assumed in the spring.

Nonetheless, the tax ratio[5] at 23 % (after 24.6 % in 2000) will reach the figure assumed one year ago because tax revenue shortfalls and the weak development of nominal GDP will offset each other. Given a comparatively slight increase in nominal GDP the ratio will rise in 2002 despite the expected revenue shortfalls to 23 ½ % of GDP. In the following year, tax relief and the growth-related increase in tax revenue will work in opposing directions, and the tax ratio is likely, as in 2004, to be around the 2002 level. In the final year of the projection, a trend towards more dynamic growth in tax revenue will come together with the effects of the 2005 stage of the tax reform; as a result, the share of taxes in GDP will amount to 23 %.

Table 5: Development of tax, social contribution and tax and fiscal charges ratio

	2000	2001	2002	2003	2004	2005
	- in % of GDP-					
Tax ratio	**24.6**	**23**	**23 ½**	**23 ½**	**23 ½**	**23**
Social contribution ratio	**18.7**	**18 ½**	**18 ½**	**18 ½**	**18**	**17 ½**
Tax/fiscal charges ratio[1)]						
- November 2001 projection	**43.3**	**41 ½**	**42**	**42**	**41 ½**	**41**
- October 2000 projection	43	41	41	40 ½	40 ½	-

1) Discrepancies between the tax/fiscal charges ratio and the total of tax ratio and social contribution ratio are the result of rounding.

5 Tax ratio as defined in National Accounts. As already mentioned, this differs from the tax ratio in cash terms among others in that certain items, such as owner-occupied homes premiums, investment allowances and child benefits, are posted "gross". On the other hand, in line with the presentation of general government in National Accounts, asset-affecting taxes and VAT own resources (which are regarded as direct payments to the EU by the sectors concerned) are not included. In this definition the tax ratio is applied to the revenue side of central, regional and local authorities and is in particular unsuited to gauging the extent of individual charges.

At 18 ½ % of GDP in the current year, the social contribution ratio will be roughly at the previous year's level. This trend reflects on the one hand the lower contribution rate to statutory pensions insurance in a year-on-year comparison and slightly increasing health insurance contributions in the course of the year. Added to this is the unfavourable development in the labour market, resulting in lower contribution revenue as against earlier estimates. The social contribution ratio will remain unchanged in the coming year despite the assumption of a slight rise in health insurance contributions. The ratio will decline to 17 ½ % at the end of the projection period.

Supported by the trend in the tax ratio the tax/fiscal charges ratio will register a marked decline in the current year from 43.3 to 41 ½ % of GDP. After rising slightly in the coming year, it will decrease to about 41 % in the two last years of the projection.

D. Development of debt

The lower deficits of the year 2000, the favourable GDP trend and the special use made of the UMTS proceeds of € 50.8 bn combined in helping to bring down the debt ratio from 61.3 % to 60.3 % of GDP last year. The UMTS proceeds were applied in full to reduce government debt, with redemption being shared between 2000 and 2001 for technical and efficiency-related reasons. A good third of the proceeds was applied in the second half of last year in order to achieve more rapid reduction of the debt ratio.

The federal government used just under two thirds of the UMTS proceeds at the start of this year to redeem bearer bonds of the "Currency Conversion Equalisation Fund". This redemption was intended to bring down debt to well below 60 % in the current year. Accordingly, the last stability programme designated a figure of 58 % for 2001.

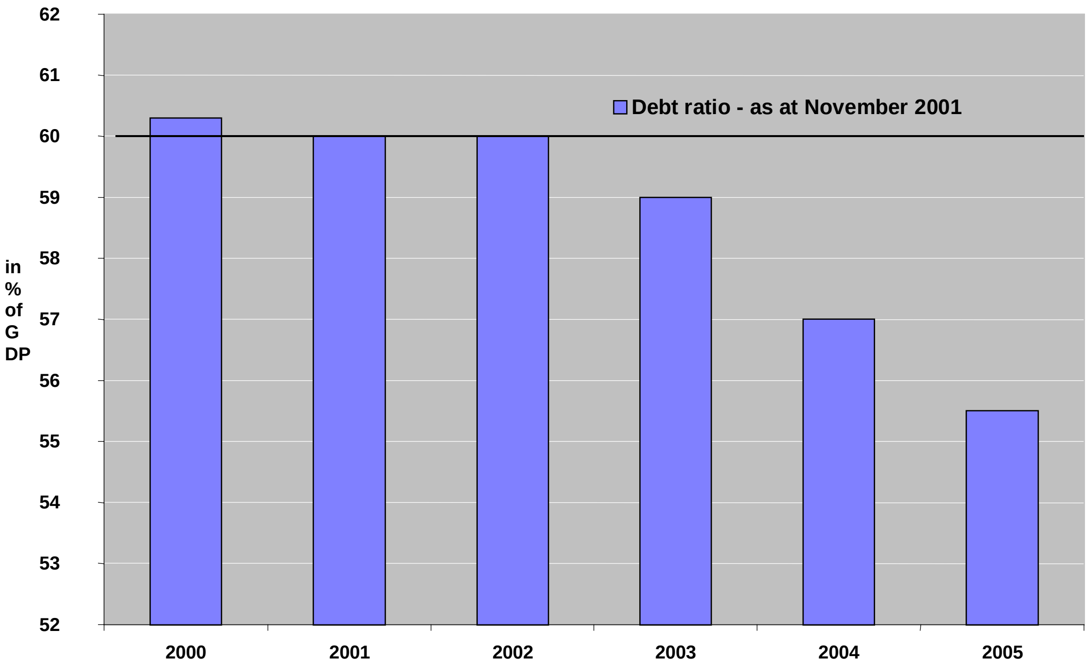
This debt reduction course has come under pressure from two sides. Firstly, the increase in the nominal gross domestic product at only about 2 % is much weaker than expected. Secondly, the projected debt reduction was based on deficit assumptions made against the background of a more favourable economic situation. Given the rise in deficits, the reduction in the debt ratio will be smaller than most recently assumed despite the special effect of the UMTS proceeds. A figure of just under 60 % is likely to result for the current year.

In view of the declining but still cyclically-increased deficits, a significant improvement in the debt ratio is not to be expected in 2002 either, and it is likely to remain unchanged at 60 %. Only in the following years will it register a further decline in line with the reduction of deficits. The debt ratio is posited at 55 ½ % of GDP in 2005.

Table 6: Development of the debt ratio

	2000	2001	2002	2003	2004	2005
Debt ratio	- in % of GDP-					
November 2001 projection	**60.3**	**60**	**60**	**59**	**57**	**55 ½**
October 2000 projection	60	58	57 ½	56 ½	54 ½	-

Figure 3: Debt ratio - development to the year 2005



The development of government debt is largely dependent on the deficits in cash terms. Other than the data in National Accounts, these reflect in revenue and expenditure the "financial transactions" such as privatisation proceeds and loan operations and also the entire central bank profit. Proceeds from the sale of government holdings are of particular importance in calculating government debt according to the Maastricht definition. Greater recourse to such revenue is not unusual especially in years in which the budget is under heavy pressure. In the current year, public budgets will realise proceeds of a good half of a percentage point of GDP from this source; this is double what was realised in the preceding year. In the following years, proceeds are likely to decline and to stabilise at a lower level.

E. Sensitivity of the deficit projection to changes of the expenditure course

German fiscal policy faces a difficult task in adhering to the objective of achieving a balanced general government budget in 2004. Given the larger deficits in 2001 and 2002 as a result of flagging economic activity (-2 ½ and - 2 % of GDP respectively), the starting level for bringing down the deficit to zero within two years is a high one. Moreover, the next stage of tax relief in 2003 will impose additional burdens on public budgets.

The deficit line in this stability programme is an ambitious one. It reflects the federal government's awareness of its fiscal policy responsibility at national and European level alike. The target can be met only by holding consistently to the necessary consolidation course. This will call for responsible fiscal policy at all levels of government. In pursuing this course, the government relies on the support of all other fiscal policy decision-makers in Germany.

The ambitious assumption of moderate expenditure growth of only just under 2 % for the entire projection period involves risks to the deficit line set out in the projection. The sensitivity analysis assumes average annual expenditure growth that is about one quarter of a percentage point higher for all years, including 2001. These figures would be in line with the level of average expenditure growth in the years from 1995 to 2000. This assumption results in changes in the annual deficit reduction steps, both in the projection and in the scenario with appreciably lower growth expectations.

Table 7: Development of the deficit ratio on deviation from the expenditure course

	2000[1)]	2001	2002	2003	2004	2005
Deficit/surplus ratio	- in % of GDP-					
November 2001 projection (Base scenario)	**-1.3**	**-2 ½**	**-2**	**-1**	**-0**	**-0**
Base scenario with increased expenditure line	-1.3	-2 ½	-2 ½	-1 ½	-½	-½
Risk scenario with lower growth assumptions	**-1.3**	**-2 ½**	**-2 ½**	**-1 ½**	**-1**	**-1**
Risk scenario with lower growth assumptions and increased expenditure line	-1.3	-2 ½	-2 ½	-2	-1	-1

1) Excluding UMTS proceeds. Including UMTS proceeds gives a surplus of + 1.2 % of GDP.

As compared with the base scenario, the deficit could in this case be brought down by 2004 to - ½ % of GDP. No further improvement in budget balances could be expected in the following year on account of the tax relief measures taking effect in 2005.

Bearing in mind the still clearly evident progress made in reducing deficits in the medium term there would be no cause to take the slightly higher expenditure line assumed in this less favourable scenario as indicating a departure from the consolidation course or even to talk of relinquishing the stability target. With appromimately 2 % a year, expenditure growth would still be very clearly below the increase in the nominal gross domestic product expected in the medium term.

In contrast to the scenario with lower growth assumptions, that is assuming a constantly lower GDP growth rate, a higher expenditure line would also cause a "stretching" of the deficit line, though the deficits for 2004 and 2005 would still be within the (rounded) figures of the scenario with lower growth assumptions. To this extent a deficit of -1 % for 2004 and 2005 proves to be "robust".

V. Readjust consolidation course - ensure long-term sustainability

A. Guiding principles of fiscal policy: limit spending, promote growth

The present political, economic and social challenges call for a fiscal policy approach that is geared to sustainability. This approach aims to be socially equitable, to ensure solidarity between the generations and to take account of environmental aspects. It must in particular help to promote employment and, in accordance with the resolutions of the Lisbon European Council, the transition to a knowledge-based society. At the same time it must create and maintain scope for an appropriate response to unforeseen occurrences. Special significance attaches to enhancing internal and external security in today's global political environment.

Put forward in November 2000, the guiding principles of fiscal policy make up a broad concept providing a dependable yet flexible orientation framework for fiscal policy decisions by central government reaching well beyond the timescale of the current financial plan. The concept embraces the two guiding principles already forming the basis of two reform packages: the Future Programme to secure employment, growth and social stability and the Tax Reform 2000:

- To reduce debt for permanently sound public finances and greater fairness between the generations.
- To promote growth and employment by a sustainable and equitable system of taxes and fiscal charges.

Quantitative and in part qualitative rules were drawn up for seven central areas and put together in the form of pointers:

1. **Pointer for the performance of government functions:**
   Ensure transparency, enhance productivity
   Objectives include:
   - Regularly review government activity as to efficiency and if necessary restructure it.
   - Consistently implement the linear reduction in central government posts by 1.5 % a year as provided in the Future Programme 2000.

2. **Pointer for the configuration of public budgets:**
   Reduce deficits, redeem debts
   Objectives include:
   - Submit a balanced federal budget in 2006.
   - Start government debt reduction as from 2007.

3. **Pointer for the configuration of public spending:**
   Maintain expenditure discipline, enhance quality
   Objectives include:
   - Give priority to future-oriented spending (e.g. investment in and spending on education, science and research).
   - Reduce interest payment obligations and (making allowance for the extensive tax relief) appreciably bring down the interest-tax ratio in the medium term for central government.

4. **Pointer for the configuration of state aid:**
   Restrict volume, refine targeting
   Objectives include:
   - Press ahead with the selective dismantling of subsidies.
   - Regularly review promotional instruments in the new Länder and focus on effective measures, while maintaining solidarity and the dependability of promotional policy.

5. **Pointer for the configuration of public revenue:**
   Secure funding of government actions, reduce burden on the individual
   Objectives include:
   - Bring down the tax/fiscal charges ratio to below 40 % in the medium to long term.
   - Continue to support an adequate European body of regulations in the field of tax policy (e.g. to counter unfair tax competition, to achieve harmonisation of energy taxation).

6. **Pointer for the configuration of financial relations in a federal state**
   Objectives include:
   - Review and if necessary reduce joint financing arrangements between central and regional government.
   - Support greater commitment by Federation and Länder in observing general government objectives.

7. **Pointer for the coordination of fiscal policy at European level:**
   Work for European unity, learn from Europe
   Objectives include:
   - Consistently fulfil and apply the Stability and Growth Pact.
   - Selectively refine fiscal and economic policy within the European framework.

B. Consolidation course in worsening conditions

The successful rehabilitation of public finances is an essential element in a stable economic framework. Fiscal policy can help to maintain low prices and interest rates by keeping public deficits down and/or dispensing with government borrowing. Broader scope for fiscal policy action can be used in the long term for key future-oriented investment, thus helping to enhance the growth potential of the economy. Furthermore, reducing debt is the most important contribution fiscal policy can make to solidarity between the generations.

The progressive reduction of net borrowing as set out in the Future Programme 2000 will be precisely observed despite flagging growth accompanied by a marked falling off in tax revenue and the extra labour market spending. This holds both for the federal budget for 2002 and for the financial planning period up to 2005. Additional charges on the federal budget will be offset and strict limits on expenditure growth will continue to be imposed. The financial plan up to 2005 puts the average nominal increase in spending at only 0.8 %. This is a token of the government's determination to continue to place strict limits on spending and a further assurance of the medium-term objective of presenting a balanced federal budget in 2006.

Net borrowing in 2002 can be held unchanged at € 21.1 bn. Keeping to this figure will not be at the expense of the pattern of expenditure in the federal budget. Investment spending will not be affected. The nominal decline is based exclusively on redirecting funds under the Investment Promotion Law as special complemental federal grants on the revenue side, as agreed with the Länder.

The relationship between constructive policy and necessary consolidation will remain in balance despite the marked slowdown in economic activity. Central tax policy reforms, such as the promotion of families and the Law to refine corporate taxation, will be carried out. The resulting extra charges can be financed without exceeding the benchmark data in the federal budget for 2002.

Significant underlying conditions must be taken into account in the consolidation of public budgets:

- <u>Pronounced export orientation of the German economy</u>: The economic benchmark data in particular have worsened. As compared with other EU countries, the impact of the present downturn in global economic activity is greater in Germany, both in general and on account of closer links between German and U.S. enterprises.

- Continuing effect of the Tax Reform 2000 and other tax relief measures adopted by the federal government up to 2005: The volume of relief afforded to private households and business undertakings from the measures already implemented in the Tax Reform 2000 makes up about € 23 bn in 2001 alone. As compared with 1998, all federal government tax reform measures will afford relief in a total volume of around € 56 bn in 2005.

- Allowing the automatic stabilisers to take limited effect while observing the requirements of the stability and growth pact: Consistently pursuing the consolidation of public budgets does not rule out allowing the automatic stabiliser to take limited effect; on the contrary, "saving the way in" would be counterproductive in a cyclically difficult phase. In accordance with the broad guidelines of economic policies it is decisive to keep to the expenditure course with the aim of achieving a budget close to balance or in surplus. Temporary slight increases in the deficit as a result of tax revenue shortfalls are acceptable for public budgets against the background of current economic trends.

- Need to continue providing funds for reconstruction in the new Länder: The principal deficit of the new Länder is still the lack of jobs that are competitive both in regional and supraregional terms. The weaker development of employment in German in the nineties as compared with other EU countries is attributable to massive job cutbacks above all in eastern Germany, initially in the industrial sector, from 1995 on in the construction sector and continuously in the public sector. Against this background, disproportionately broad deployment of active labour market policy instruments will continue in the new Länder. The current subsidies report shows that financial assistance given exclusively to the new Länder still accounts for 19 % and thus for a substantial share of aggregate financial assistance afforded by the federal government. The Solidarity Pact II agreed by the Federation and the Länder is a continuation of Solidarity Pact I applicable up to 2004, providing a sound basis for the promotion of economic activity in the new Länder up to 2019.

- German payments to the EU budget: Germany makes a substantial contribution to financing the EU budget. The EU budget for 2000 comprised around € 83 bn. Germany's share in this amounted to about € 21.8 bn or 24.8 %.

- German assistance for countries of central and eastern Europe (CEE) and the new states of the former Soviet Union: Stable development in central and eastern Europe is of crucial significance for the economic and political future of the EU. Germany has a special interest in this, not least on account of its geographical location.

  Considerable amounts have been expended in past years on measures to stabilise the CEE countries and the new states of the former Soviet Union, and this expenditure will continue in the coming years as well. (Between 1990 and 2000, assistance to CEE countries totalled € 45.6 bn and to the new states of the former Soviet Union € 78.5 bn.)

- The consequences of the current global political and security situation cannot yet be fully assessed.

Consolidation efforts are supported in particular by the following measures and trends:

- Continuing stipulation that measures must be fully funded: Additional expenditure must be offset by redirecting other funds in the same budget head.

- Relief provided by extra tax revenue and lower labour market spending in the course of the expected upturn in economic activity in the coming year.

- Increase in tobacco duty and insurance tax to finance measures enhancing internal and external security.

- Selective privatisation: Non-recurrent additional revenue from privatisation is not available to finance tax cuts with lasting effect and expenditure programmes. This principle is reflected for instance in the fact that the UMTS proceeds are applied to debt redemption whereas the permanent savings on interest expenditure are used within the framework of the "future investment programme" for growth-promoting investment in the fields of infrastructure, education and research.

- National arrangements for a procedure to maintain budgetary discipline within the framework of European Economic and Monetary Union:

  An arrangement complying with the requirements of Maastricht and the stability and growth pact at national level is at present going through the legislative process, which is expected to be concluded on 20 December 2001. The arrangement provides for

  - Federation and Länder to make efforts to reduce net borrowing with the aim of achieving budget balance;
  - the Financial Planning Council to recommend a joint expenditure line for Federation and Länder which would ensure compliance with the provisions of the Maastricht Treaty and the stability and growth pact;
  - the Financial Planning Council to assess whether the budget trends of central, regional and local government are in conformity with the provisions of the stability and growth pact;
  - the Financial Planning Council to make recommendations in the event of a need to restore budgetary discipline.

C. *Enhancing quality and sustainability of the budget – promoting future-oriented tasks*

Special significance is attached to the quality and sustainability of public finances in line with the conclusions of the Lisbon, Stockholm and Göteborg European Councils. The aim is to ensure economically productive, socially equitable and ecologically acceptable development. Key areas in which action must be taken to this end are

- continuing on the consolidation course;
- lessening the burden of taxes and fiscal charges;
- concentrating on future-oriented areas of fiscal policy;
- shaping responses to deal with the problems of ageing.

To work out a comprehensive national sustainability strategy making allowance for fiscal policy aspects, the federal government has additionally convened a "Council for Sustainable Development" made up of representatives of different groups in society and has set up a committee at State Secretary level.

The transition to a knowledge-based society is of central importance in enhancing the ability to compete and cope with future challenges. The government is therefore stepping up the deployment of funds in the field of education and research. About € 8.4 bn will be made available for this in 2002, over 2.7 % more than in the current year and 12 % more than in 2000.

The selective use for investment in future-oriented areas of interest savings derived from the application of UMTS proceeds to debt redemption will help to promote productivity, growth and employment. The future investment programme focuses on transport (rail), education, rehabilitation of old building stock and energy research, particularly research into renewable energy sources and fuel cells. The programme runs from 2001 to 2003 and makes provision for additional annual investment of some € 2.1 bn (½ % of GDP).

The federal budget for 2002 includes a fully-financed package of measures in the volume of € 1.5 bn to enhance internal and external security. Elements of police, intelligence service, humanitarian, economic and military activity are effectively combined in an overarching aggregate strategy.

D. Shaping a response to the demographic challenge

Low birth-rates and increasing life expectancy will lead to crucial shifts in the age structure of the population in Germany in the coming decades. This is also borne out by model calculations updated in 2000 for planning and decision analysis purposes by the federal government in the Interdepartmental Working Party on Population Issues. Proceeding from the current population structure and making specific assumptions as to birth frequency, death rate and international migration, the model calculations show what demographic future trends may be expected. Thus even the model variant C as shown below and including comparatively high immigration is expected to lead to double the elderly dependency ratio by the year 2050.

Table 8: Change in the age structure of the population

	Elderly dependency ratio [1)]					
	1999	2010	2020	2030	2040	2050
Model A [2)]	25.4	33.3	36.2	47.5	57.1	57.3
Model B [2)]	25.4	33.1	35.5	45.6	53.6	53.4
Model C [2)]	25.4	33.1	35	44.2	51.2	50.9

1) The ratio of persons of pensionable age (65 years and older) to the number of persons of working age (20 to under 65 years of age).

2) Variants with lower (A), medium (B) and higher (C) immigration balances
Source: Model calculations in 2000 by the Interdepartmental Working Party on Population Issues

The discussion on ways of dealing with the consequences of population ageing has been on the political agenda in Germany for some years now. This has been backed by the work of the Study Commission on "Demographic Change" convened by the Bundestag, which in the course of several parliamentary terms and in constant dialogue with academic institutions has been engaged on a comprehensive review of the economic and social consequences of population ageing.

Recommendations for action in specific policy areas in which shifts in the age structure of the population have a special impact are to be expected in the course of the coming year. The federal government itself also complies with comprehensive reporting obligations in relation to parliament on questions concerning the long-term financeability of the social security systems. These include the pension insurance report, the old-age security report and the social report.

In its most recent public service pensions report, the federal government submitted a presentation of pension charges in the whole of the public service on a timescale extending to the year 2040. This creates a basis for legislative decisions geared to the principle of sustainability.

The federal government is apprised of the risks to which public finances are also exposed in consequence of population ageing in Germany. However, long-term forecasts of demographic, economic and fiscal trends, especially if they incorporate international comparisons, involve considerable problems with regard to the necessary data basis and the comparability of results. It is not least with this in mind that the ECOFIN Council has called for the Community-wide approaches hitherto adopted to present the consequences of population ageing on public finances to be more precisely examined and refined. The demographic and macroeconomic assumptions made in the previous work by the Economic Policy Committee are intended above all to ensure that the results are technically comparable. They do not necessarily have to match the trends which the Member States themselves consider especially probable or plausible.

The federal government intends to adopt a broadly-based strategy to cope with the risks posed by demographic developments. The elements in this strategy include not only reforms in the field of social security but also the lasting consolidation of public budgets and an economic policy that encourages growth and employment.

The objective is to put in place an old-age security concept taking account both of the demographic challenges and the aspect of equity between the generations. The federal government aims to undertake a reform that will stabilise the system of old-age protection over the long term and is attractive and reliable both for contributors and pensioners. In the sector of statutory pensions insurance this has been implemented in the pension reform.

Among the key elements of the pension reform concept are

- modification of the pension adjustment formula - return to the principles of wage-related pension adjustment;
- progressive establishment of additional, voluntary, fully-funded (private or company) old-age provision promoted by the government. This will place old-age security on a broad financial basis and will safeguard the living standards achieved in a working life notwithstanding the expected demographic trends. Whilst the pension level will decline from the present 69 % of average net earnings to not less than 67 % in 2030, this gap will be more than offset by increased pension payments from company and private provision, so that it will be possible in 2030 to achieve a higher standard of living than that now ensured by the statutory pension alone.

Taking account of the currently assumed benchmark data on demographic and economic development, the contribution rate to statutory pensions insurance will remain below 20 % up to 2020 and rise to not higher than 22 % in 2030. In this way the non-wage labour costs arising from statutory pensions insurance will be stabilised as an essential contribution towards safeguarding growth and employment.

The 2001 Law to amend public service pensions, intended to curb the future rise in pensions costs, transposes the measures implemented in the statutory pensions insurance with the same effect to the pensions paid to public service officials.

E. Ecological tax reform: helping to achieve sustainable policy

In 1999 the federal government commenced the phasing-in of the ecological tax reform. An electricity duty of DM 0.02 per kilowatt-hour was introduced on 1 April 1999. The mineral oil duty on motor fuels was increased by DM 0.06 per litre. A one-off rise of DM 0.32 per kilowatt-hour was introduced in the duty on natural gas, and the duty on light heating oil was raised by DM 0.04 per litre (also one-off).

Retaining the special arrangements for the taxation of business enterprises, the ecological tax reform will continue in several stages up to 2003. Rates of duty on motor fuels will be raised each year by DM 0.06 (€ 0.307 as from 2002) per litre. Electricity duty will be increased each year by DM 0.005 (€ 0.026 as from 2002) per kilowatt-hour. This will provide market incentives for the economical use of resources.

The receipts from the ecological tax reform are used virtually in full to reduce and stabilise the rate of contributions to the statutory pensions insurance, thus easing pressure on the cost of labour as a production factor. The success of this approach may be seen from the fact that the rate of contributions to the statutory pensions insurance in 2001 is around 1.3 points lower than it would have been had the receipts from the ecological tax reform not been used. Additionally, over € 200 m will be used to promote renewable energy sources and for tax reductions and exemptions for rail traffic, short-haul public passenger transport and environmentally beneficial combined heat and power (CHP) plant.

This is also helping to speed up structural change in the German economy, for example by making more effective use of the potential for innovation in the field of energy conservation and helping environmentally beneficial technologies to gain a foothold in the market.

In this manner tax policy contributes to the ecological restructuring of the German economy. The first signs of positive effects in the environment are already apparent: petrol consumption has declined and the number of persons using public transport has risen. Traffic-related CO_2 emissions registered a decrease of about 2 % in 2000 for the first time in several years. Besides this, the federal government is supporting efforts to bring about an EU-wide solution in the taxation of energy.

VI. Promote the forces for growth

A. Continuing tax relief

Tax relief measures to promote growth and employment are at the heart of the reform of direct taxation. In conjunction with the pension reform, the tax reforms already set in train by the federal government are at the forefront of Germany's endeavours to implement structural reform. Expenditure discipline and stability orientation form the basis for comprehensive tax relief.

As compared with 1998, these reforms will by 2005 provide individual and corporate taxpayers with direct tax relief of some € 56 bn. The provision of tax relief is concentrated on the years 2001, 2003 and 2005. The tax reform 2000 alone reduced in 2001 the tax charge on consumers and investors by € 23 bn. The measures decided and those already adopted have a lasting confidence-building effect and will help to stimulate economic activity in 2002 as well. They are an asset item to set against the current economic uncertainties. Fiscal policy is thus making allowance for the present unpredictability of the economic situation without losing sight of the objective of medium-term consolidation.

In terms of income distribution, the tax relief measures benefit mainly dependent employees and families as well as small and medium-sized businesses. At the same time, the measures to reform corporate taxation also afford perceptible relief to larger enterprises. In conjunction with changes in the system of corporate taxation, the marked reduction in corporation tax rates to 25 % will serve to permanently reinforce Germany's status as a location for productive investment.

The following key reforms will also take effect as from 1 January 2002:

1. Two central elements of the new concept will be implemented as part of the reform of corporate taxation:

   - In the taxation of dividends, the full imputation system will be replaced by the half-income system, which is much less complex and suited to cross-border investment within Europe. Only half of the distribution received by shareholders from incorporated companies will then be liable to income tax. In turn, the corporation tax already paid by enterprises will no longer be allowed as a credit.

- Gains from the sale of cross-corporation shareholdings will in principle be tax-exempt as from the 2002 assessment period. This will give businesses the flexibility they need to optimise their shareholding structures. Arrangements to improve the tax conditions for restructuring in unincorporated companies as well are currently being deliberated in parliament.

2. Further improvements are being made to the tax laws relating to family benefits. This will afford families additional relief of over € 2.5 bn in 2002.

   Improvements in the family benefits system coupled with the tax reforms as already decided will afford a family with two children and average annual income of € 30,000 total relief of € 2,412 a year (2005 as against 1998). In this context, the improvement include the following taking effect in the coming year.

   - Child benefits for the first and the second child will be increased by € 16 from € 138 to € 154 a month.
   - The tax-free child allowance will be raised from € 3,564 to € 3,648 a year.
   - Instead of the child-minding allowance of € 1,548 a tax-free allowance of € 2,160 a year will be granted in respect of the costs of child-minding, upbringing and education.

3. The process of setting up additional, fully-funded old-age provision is supported by tax arrangements along the lines of the family benefits system, with the payment of a grant being combined with a deduction from the tax base. In principle, a broad range of products involving both company pension schemes and private old-age pensions are eligible for promotion. The additional, fully-funded old-age pension will be taxed at the point of provision. Promotion will increase in stages up to 2008, when a total promotion volume of € 10 bn will have been reached.

The tax cuts already decided for 2003 and 2005 make provision for further improvements in the income tax schedule to promote productive activity. The details are as follows:

- The basic rate of tax will be reduced in two stages from 19.9 % to 17 % and then to 15 %.
- The top rate of tax will be reduced in the same time intervals from 48.5 % to 47 % and then to 42 %.
- Parallel to this, the basic tax-free amount will be raised from € 7,235 (2002) to € 7,426 and then to € 7,664.
- Progressive increases will be levelled off over the whole range of the tax schedule.

B. Encouraging growth and employment by further structural improvements

The federal government shares the conviction held in the EU that the key to increasing growth and employment lies in the interaction of macroeconomic policy oriented to growth and stability with sustainable structural reforms. The tax and pensions reforms will give rise to fundamental improvements. Besides this, reforms in the product, capital and labour markets are especially important.

In the "Job Activation" Law the federal government has put in place a comprehensive package of measures to reform the promotion of employment. In this context (in line with the Employment Guidelines of the European Union) the preventive approach to labour market policy is to be appreciably strengthened. This will focus on a reorientation of the concept of job placement and advisory services. Thus the position of both sides – the assistance offered by the labour office and the obligations and activities of unemployed persons – will be set out in an agreement. Additionally, the "Job Activation" Law provides new opportunities for promoting practical basic and advanced training, facilitates the reintegration of young persons and older workers, extends the scope for the supply of workers by temporary employment and reinforces the evaluation of active labour market policy.

Further necessary structural reforms and the measures resulting from them are described in detail in the national structural reform report submitted by the federal government in mid-November 2001 within the framework of the Cardiff process. Hence only a few examples are cited here:

- Market opening and competition in former monopoly sectors:
  Market opening and competition, especially in the telecommunications and energy fields, have given rise to substantial price cuts and numerous innovative measures. The federal government therefore intends to press ahead consistently with this policy approach. The regulatory framework for telecommunications is being refined with the aim of establishing effective and structurally secure competition under market conditions in the telecommunications sector. The market for mobile multimedia applications was opened when UMTS licences were granted in a competitive tendering procedure.

  The federal government supports free-market structures in the markets for postal services as well. However, it has not been possible to fully liberalise the postal markets at European level. It remains the government's objective to continue to move towards the opening of postal markets in Germany and Europe.

The electricity and gas markets have been fully liberalised. In this context the federal government is striving to ensure that simplified network access on transparent conditions is made possible on the basis of supplier association agreements. To avoid distortions of competition and to ensure that liberalisation remains permanently fully effective, the federal government supports the balanced and speedy opening of the markets for electricity and gas in European partner countries. The aim must be to achieve fully open markets in all EU Member States.

- Improving the underlying conditions for SMEs:
  Small and medium-sized enterprises face special challenges as a result of globalisation and the advance of new technologies. Accordingly, particular emphasis is placed in the government's economic and fiscal policy on shaping underlying conditions that enable small and medium-sized enterprises to adapt successfully to structural change. The tax reforms afford relief of around € 16 bn to SMEs.

  In addition, bureaucratic obstacles are being consistently dismantled, access to investment capital is being made easier for young, technology-oriented companies and the promotion of business start-ups is continuing at a high level.

- Reduction of subsidies: The federal government is making further progress on its course of consistently reducing subsidies and redirecting promotional funds to future-oriented areas. This is reflected in the government's 18th Subsidies Report: disregarding the exceptional arrangements pertaining to the ecological tax reform, subsidies will have been brought down by 16 % from 1999 to 2002. This encourages competition, strengthens the initiative and responsibility of enterprises and creates fresh scope for the government to take further action to lessen the burden of taxes and fiscal charges on the individual. Reduction focuses principally on subsidies preserving obsolescent structures, whilst the main promotional emphasis is sited among others in the field of energy conservation.

DEVELOPMENT OF PUBLIC FINANCES[6]
(National Accounts definitions)

	ESA Code	2000	2001	2002	2003	2004	2005
		in % of GDP					
Balancing items (B.9) of levels of government[7]							
General government	**S.13**	**-1.3**	**-2 ½**	**-2**	**-1**	**-0**	**-0**
Central government	S.1311	-1.2	-1 ½	-1 ½	-1	-½	-0
State government	S.1312	-0.4	-1	-½	-½	-0	-0
Local government	S.1313	+0.2					
Social security funds	S.1314	+0.0	-0	-0	+0	+0	+0
General government expenditure (in accordance with the definition in Reg. 1500/2000)							
Intermediate consumption Social benefits in kind Compensation of employees[8]	P.2 D.63 D.1	19.6	19 ½	19	18 ½	18 ½	18
Social benefits (other than in kind)	D.62	18.8	19	19	18 ½	18	17 ½
Capital transfers (interest expenditure)	D.4	3.4	3	3	3	3	3
Subsidies	D.3	1.7	1 ½	1 ½	1 ½	1 ½	1 ½
Gross capital formation	P.5	1.8	2	1 ½	1 ½	1 ½	1 ½
Other expenditure		3.2	3	3 ½	3	3	3
Total expenditure		**48.4**	**48**	**48**	**46 ½**	**45 ½**	**44 ½**
General government revenue (in accordance with the definition in Reg. 1500/2000)							
Taxes	D.2 D.5	24.6	23	23 ½	23 ½	23 ½	23
Social contributions	D.61	18.7	18 ½	18 ½	18 ½	18	17 ½
Other revenue		3.8	4	3 ½	3 ½	3 ½	3 ½
Total revenue		**47.1**	**45 ½**	**45 ½**	**45 ½**	**45**	**44**
Financial development of general government							
Total expenditure		48.4	48	48	46 ½	45 ½	44 ½
Total revenue		47.1	45 ½	45 ½	45 ½	45	44
Net lending/borrowing	B.9	-1.3	-2 ½	-2	-1	-0	-0
Interest expenditure	D.4	3.4	3	3	3	3	3
Primary balance		2.0	1	1	2	3	3

[6] Discrepancies in the totals are the result of rounding.
[7] Balancing items and expenditure for 2000 excluding UMTS proceeds. Including UMTS proceeds gives a balancing of +1.2 % of GDP for general government and +1.3 % for central government. Including UMTS proceeds givers expenditure of 45.9 % of GDP.
[8] Including other taxes on production (D.29).

DEVELOPMENT OF GOVERNMENT DEBT
(Maastricht definition)

	ESA Code	2000	2001	2002	2003	2004	2005
in % of GDP							
Government debt		**60.3**	**60**	**60**	**59**	**57**	**55 ½**
Primary balance		2.0	1	1	2	3	3
Interest expenditure		3.4	3	3	3	3	3
Change in nominal GDP	B.1.g	2.6	2	3	4 ¼	4 ¼	4 ¼

COMPARISON OF PROJECTIONS
in the October 2000 stability programme
and the December 2001 stability programme

	ESA Code	2000	2001	2002	2003	2004	2005
Change in nominal GDP in %							
Stability programme 2001	B.1.g	2.6	2	3	4 ¼	4 ¼	4 ¼
Stability programme 2000	B.1.g	3	3 ½	4 ¼	4 ¼	4 ¼	-
Difference		- ½	- 1 ½	-1 ¼	0	0	-
Balancing item in % of GDP							
Stability programme 2001	B.9	-1.3	-2 ½	-2	-1	-0	-0
Stability programme 2000	B.9	-1	-1 ½	-1	-½	0	-
Difference			-1	-1	-½	0	-
Government debt in % of GDP							
Stability programme 2001		60.3	60	60	59	57	55 ½
Stability programme 2000		60	58	57 ½	56 ½	54 ½	-
Difference			2	2 ½	2 ½	2 ½	-

Published by:

Federal Ministry of Finance
Press and Information Division
Wilhelmstraße 97
100117 Berlin
http:\\www.bundesfinanzministerium.de

Content:

Federal Ministry of Finance
Division I A 1 (Fiscal Policy)
Berlin, December 2001