

German

stability programme

December 2002 update

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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 present update of the German stability programme was approved by the Cabinet on 18th December 2002. The responsible committees of both houses of the German parliament will be briefed immediately.

The programme follows the format and content guidelines specified by the ECOFIN Council in October 1998 and last supplemented by the code of conduct on format and content in stability and convergence programmes of 27 June 2001.

It proved impossible to keep to the presentation deadline for this year prescribed in the code of conduct. The Bundestag election on 22nd September 2002 necessitated the introduction of a completely new 2003 federal budget on 3rd December 2002. The corresponding coordination with the Länder took place in the Financial Planning Council on 27 November 2002.

The updated stability programme is based on data available as at end November 2002.

The Federal Ministry of Finance publishes the updated stability programme among others on the Internet at:

www.bundesfinanzministerium.de

I. Summary

- As last year, adverse conditions attend this year's update of the German stability programme. Major contributing factors have been the uncertainty and poor growth affecting the global economy and the associated retarded economic recovery in Europe as well as special factors, such as the century floods of autumn 2002.
- The continuing effect of other special factors, such as the necessary continuation of economic development payments for the new Länder, Germany's substantial net contributions to the EU budget and the high (and still climbing) level of support payments relating to international obligations restrict Germany's room for manoeuvre in fiscal terms.
- The unfavourable underlying economic conditions are having a particularly adverse effect on taxation revenue and are also leading to additional expenditure in relation to the labour market and social security. Against this background, the general government deficit for the years 2002 to 2004 deviates from the forecasts made in the December 2001 update. A deficit of - 3 ¾ % of the gross domestic product (GDP) is predicted for 2002.
- In November 2002, the federal government responded to the deterioration in the fiscal situation by devising a savings programme that prescribes a volume of around 14 billion euros (around 0.7 percentage points of GDP) for all government bodies in 2003 alone. On the expenditure side, the programme requires sustained consolidation and structural reform measures affecting the labour market and social security. On the revenue side, measures dismantle tax benefits and anomalies, which is designed to give both the Länder and local authorities additional revenues. Based on this programme an aggregate deficit of - 2 ¾ % of gross domestic product (GDP) is expected for 2003.
- The reduction in the deficit is supported by the result produced by the Financial Planning Council of 27 November 2002. Accordingly, the federal government, Länder and local authorities have agreed on a common objective of reducing the government deficit to under - 3% of GDP in 2003. In this session, the Financial Planning Council reviewed for the first time adherence to budgetary discipline with reference to the National Stability Pact for national implementation of the European Stability and Growth Pact agreed upon in March 2002. It agreed on a 6-point plan, together with a strategy and a timetable for attaining the objective of a balanced general government budget in the year 2006. In the coming years, every public body will be required to contribute to the achievement of this common objective.
- The entire consolidation course is based on a medium-term growth scenario, which we consider to be both realistic and attainable, when viewed against the background of the

measures introduced as well as those currently in preparation. It provides for real GDP growth of 1 ½ % in 2003 and average growth of 2 ¼ % for the period 2004 to 2006. This assumption corresponds to average growth in GDP for the period 2001 to 2006 of barely 2 % in real terms.

- To ensure long-term sustainability of public finances and greater fairness between the generations, Germany is pursuing a broad strategy, which comprises structural reforms in social security systems and on the labour market, as well as - importantly - long-term reduction of national indebtedness.

II. Outlook for the general development of the economy to 2006

A. *Global economic environment*

Although global economic activity picked up during the first six months of 2002, by the middle of the year this momentum had noticeably slackened. In fact, the USA rapidly overcame last year's recession. Nevertheless, owing to share price drops in international financial markets, the increased uncertainties concerning military intervention in Iraq and consequent higher crude oil prices, consumer and investor confidence were noticeably curbed and economic activity weakened.

The economic slowdown radiated out from the USA to the other major economic regions of Japan in Europe. In these regions, domestic demand was not generally strong enough to be able to compensate for these slackening external economic conditions. In addition, there was increased uncertainty regarding economic trends in South America's crisis countries of Argentina and Brazil.

As a result of this, international organisations have gradually scaled back their growth projections during the year, although they have not fundamentally doubted that global economic activity will pick up again during the coming year. This revival might, however, be softer than forecast at the beginning of the year. Monetary stimuli in the USA and Europe, an overcoming of investor and consumer loss of confidence resulting from drops in share prices and from the current geopolitical uncertainties as well as from declining energy prices are nevertheless assumed to constitute a favourable foundation for an acceleration in world economic growth and also, therefore, in world trade during the period covered by the projection.

B. Assumptions of growth forecasts in 2003

As regards the short-term (up to 2003) period covered by the projection, macroeconomic forecasts are based on the following assumptions:

- At a probable rate of approximately 2 ½ %, the growth of the world economy in 2002 is just as moderate as in 2001 (2.2 %). In 2003, global GDP will grow somewhat more strongly than in previous years, at a rate of approximately 3 ½ %. Global economic momentum in the period covered by the projection gained strength from an upswing in the USA, EU member states and in Central and Eastern Europe.
- World trade will probably grow by around 2 % in 2002 and by around 5 ½ - 6 % in 2003.
- Political developments relating to the Iraq crisis should have no (lasting) negative effects on either international financial markets, oil prices, consumer or investor confidence.
- The situation in South America's crisis countries (Argentina, Brazil) will stabilise. It will not exert any negative effect on international capital movements. In general, it is assumed that capital markets will stabilise (no sustained share price drops, continued low real capital market interest rates).
- Wages policy will hold to its stability-orientated course. Most recent wage agreements have been over 3 %; while the effective increase in wages is likely to amount to a good 2 % this year and 2 ½ % in 2003. Thus, it allows a neutral medium-term distribution between profits and wages.
- Unit labour costs rose around by approx. 1 ½ % in 2002 and will rise by approximately 1 % in 2003.
- In the period covered by the projection, the rise in consumer prices is around 1 ½ % in each case and, therefore, falls within the stability objective of the European Central Bank (ECB). No threats to price level stability can be discerned within the national economy. Oil prices are exerting a generally easing effect.

C. Outlook for general development of the economy in 2003

Following the clear decline in economic activity in 2001, economic development has been slightly more positive since the start of 2002. In the first three quarters, GDP increased after seasonal adjustment against the preceding quarter by around ¼ % in real terms. This offset the slight deterioration in GDP in the second half of 2001, which was caused mainly by the global economy. In general, however, this upward trend is still very restrained. The vigorous increase in economic momentum generally expected for the second half of 2002 did not materialise.

Initially, the economic recovery was supported mainly by foreign demand. Exports rose slightly, whereas imports were generally weak at first. However, the national economy has also been

giving out positive signals and has stabilised, on the whole. In this context, development trends relating to demand components have been moving in opposite directions: Investment, including both plant and equipment and construction investment, has continued to be inclined towards weakness. In contrast, the consumer expenditure of private households has recently increased.

The price environment is favourable. The acceleration of inflation caused at the start of the year in the main by weather-related food price increases noticeably regressed as the year went on - not least, due to base effects from the previous year. In the second half of the year, the intermediate crude oil price increases brought about a slight acceleration of inflation, which was nonetheless curbed by the moderate development of prices occurring in the national economy. The extensive price stability also contributes to further strengthening of the upward trend.

In the labour market, the situation continues to be affected by the restrained level of economic activity. Since the start of 2001, unemployment has risen significantly while paid employment has been declining since mid-2001. The labour market situation can only be expected to improve during the coming year, if the upswing regains its momentum and the labour market reforms currently planned are implemented.

In its autumn projection at the end of October 2002, the federal government forecast economic growth in Germany of $\frac{1}{2}$ % in real terms for 2002. As regards 2003, it assumes that economic activity will be reinforced, with economic growth on average for the year being $1\frac{1}{2}$ % in real terms. These assessments are also shared by most national and international institutions (research institutes, EU commission, IMF, OECD).

Thus, the course of reinvigorated economic activity corresponds to the classic pattern: Global economic momentum in the period covered by the projection gained strength from an upswing in the USA, EU member states and in Central and Eastern Europe. This development should also be reflected in that of world trade. Therefore, German exports will probably regain momentum noticeably and should, in particular, also derive benefit from their regional and sector structure (high proportion of investment goods). They are also favoured by the relatively advantageous unit labour cost trend and business adjustment strategies, both of which aim at securing market share.

Given the improvement in foreign trade conditions, the national economy will increasingly gain momentum, while the upswing will also gain ground. Plant and equipment investment is likely to benefit from both the more favourable export trend and the revitalised national economy. At the start of the coming year in particular, the construction industry could be strengthened by necessary reconstruction works resulting from the flood disaster in the new Länder. On the back of wage increases that are higher when compared with previous years, private consumption is likely to strengthen generally.

The fact that the economic recovery is subdued means that the labour market will revive only gradually. In the course of the coming year, employment looks likely to increase slightly. On average for the year 2003, however, due to the unfavourable development that took place in

2002, the respective unemployment and employment figures will remain largely unchanged. The reforms connected with implementation of the Hartz scheme are expected to afford considerable relief to the labour market, although these effects are only likely to bite later on in the year.

As regards risk, the assumed continuing recovery in the global economy and world trade is clearly dogged by considerable uncertainty. In particular, the sustained improvement in the US economy is by no means certain, despite being generally expected. Further, political developments relating to the Iraq crisis could have negative effects on international financial markets, oil prices, consumer and investor confidence. There are also risks in relation to the ongoing trends in South America.

Against this, however, must be set the prospects for a more rapid recovery than the projection allows; for, during previous periods of weakness, the power behind forces of economic expansion has often been underestimated.

D. Medium-term growth outlook up to 2006

The slowdown in the world economy, the unfulfilled expectation regarding rapid economic recovery in the USA, as well as increasing uncertainty caused by both the Iraq conflict and terrorism, also have a negative impact on Germany's medium-term growth outlook. The prospect of sustained economic expansion continues to be supported, however, in particular by favourable underlying conditions:

- Vigorously expanding world trade in the medium-term,
- Moderate wage trends with barely increasing unit labour costs,
- Highly stable price levels,
- Clearly increasing corporate and asset income with positive effects on corporate investment, and
- Low capital market interest rates.

The annual growth rate of barely 2 % in real terms assumed in the projection of aggregate economic development between 2001 and 2006 presupposes that the current growth risks are rapidly dealt with and the existing positive factors are able to work to the full. Opportunities for greater growth and employment under conditions of price stability flow in particular from the synergy achieved between disparate policy areas. In Germany, fiscal policy is successful in rehabilitating public finances and wage trends remain within permitted tolerances. This makes it easier for the ECB to achieve its objective of ensuring stability in price levels under monetary conditions favourable to growth and employment.

The federal government also expects the following factors to exert a positive effect on growth:

- Implementation of the strategy adopted in Lisbon intended to increase employment and continue structural reforms in the goods, capital and labour markets,
- Continuing integration of the internal market, which will increase in size simultaneously with the entry of ten new member states into the EU.
- Increased efforts in relation to education, research and science, as well as the promotion of groundbreaking technologies,
- The next phases of tax reform in 2004 in 2005.

Further, the rapid, comprehensive implementation of reforms in the labour market will give noticeable additional energy to growth and employment. Moreover, the adjustment processes currently still operating in the new Länder will gradually cease to be burdensome; and will be replaced by strengthening, expansive forces in that part of Germany.

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

- Overcoming the weakness in growth in the major industrial countries, global growth will be similar in size to that of previous years.
- Thus, world trade will probably expand vigorously in the medium-term (5 - 6 % p.a.).
- The structure of exchange rates and interest rates will scarcely change at all. (The applicability of current values is assumed.)
- Sufficient energy and resources will be available at favourable cost; the crude oil price will remain largely stable.

Subject to the initial situation and the conditions and assumptions described here, the following benchmark figures result for the projection of aggregate economic development from 2006 to 2005:

- average GDP growth at constant prices of barely 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.

The strongest impetus in this area is expected to come from exports. A vigorous expansion in both world trade and the German sales markets could lead to an increase in exports of around 5 ½ % p.a. in real terms. In the event of an increase in imports of around 5 % p.a. in real terms, the external balance of goods and services would markedly improved in terms of constant and current prices. At the same time, corporate investment in plant and equipment expanding at + 2 ½ % p.a. in real terms would constitute a major engine of growth. Construction, in contrast, is only likely to provide a positive impetus again in the medium-term, once the structural adjustment processes currently underway are complete.

Despite the relief generated by the next phases of tax reform private consumption will, at around 1 ½ % p.a., probably develop rather more weakly than GDP, not least because of increased private old age pensions activity. The growth in public consumption will be reduced, as a result of the consolidation course (+ ½ % p.a.).

Table 1: Projection of aggregate economic development for the years 2001 to 2006

	ESA Code	2001	2002	2003	2006/01
GDP at constant prices; annual change in %	B1g	0.6	½	1 ½	2
GDP at current market prices; annual change in %	B1g	2.0	2	3 ½	3 ½
GDP deflator		1.4	1 ½	1 ½	1 ½
Gainfully employed persons (Germany)		0.2	- ½	- 0	½
Labour productivity¹		0.1	1	1 ½	1 ½
Use of GDP: Change on the year at constant prices					
1. Private consumption spending²	P3	1.5	- ½	1 ½	1 ½
2. Govt. final consumption	P3	0.8	1	1	½
3. Gross fixed capital formation	P51	- 5.1	- 4 ½	1 ½	1 ½
4. Changes in inventories (GDP growth contribution)³	P52 + P53	- 0.6	0	0	½
5. Exports	P6	5.0	1 ½	5 ½	5 ½
6. Imports	P7	1.0	- 2 ½	5	5
GDP growth contributions³					
7. Domestic demand		- 0.2	- 1	1	1
8. Inventory changes	P52 + P53	- 0.6	0	0	½
9. External balance of goods and services	B11	1.4	1 ½	½	½

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.

2001: Provisional result of the Federal Statistical Office of August 2002.

2001 and 2003: Results of the Interdepartmental Macroeconomic Forecasting Group of October 2002.

- October 2002 projection

2006: Medium-term projection, April 2002, reviewed end-October 2002.

The federal government assumes that Germany's macroeconomic production capacities will grow further and - based on the current situation of spare capacity - will leave room for a further strong expansion of demand in the future. With an average increase in potential production of 1 ½ to 2 % p.a., and in the event of the development assumed here for the (actual) gross domestic product, the macroeconomic production gap would gradually close by the end of the period covered by the projection. In any case, estimates of potential output and any corresponding calculations of production gaps are generally attended by specially uncertain factors.

Both the macroeconomic environment and the behaviour of political players will help to maintain a lower aggregate inflation rate of $1\frac{1}{2}\%$ a year. Hence GDP at current prices is likely to increase by $3\frac{1}{2}\%$ a year.

As regards wages per employed member of the workforce, an increase of $2\frac{1}{2}\%$ p.a. is assumed. This means that gross wages and salaries will increase by 3% p.a. Thus, employee remuneration will also increase by 3% p.a., and corporate and asset income by 4% p.a.

If productivity develops in accordance with the long-term trends currently observed in Germany, it can be expected that employment will start to increase once more. Further, the rapid, comprehensive implementation of reforms in the labour market will give noticeable additional energy to this new growth in employment.

Productivity in energy and resource utilisation has been improved in recent years. This means that economic growth has been disconnected from the environmental impact normally associated with it. This path, which leads to sustain economic development in Germany, will continue to be trodden. This will be accomplished, among other ways, by fulfilling the obligations imposed by the Kyoto Protocol. Thus, the Federal government is pursuing the fundamental principle of sustainability, thereby preserving in the long-term the natural foundations of life for present and future generations.

III. Fiscal policy in Germany

A. Fiscal policy in the European context

Germany regards the Stability and Growth Pact as the suitable anchor for a stability-orientated fiscal policy in Europe, even in times of weak growth. The pact provides a clear, functional body of regulations enabling a corresponding level of flexibility. In the current debate, it is frequently overlooked that the pact has been configured right from the start to cope with economic fluctuations. This is accomplished by means of its medium-term "close to balance or in surplus" objective. This "breathing capacity" of the Pact enables fundamentally flexible reactions to current circumstances. At the same time, it is the responsibility of both the EU Commission and the ECOFIN to refrain from applying the pact in an overly rigid or mechanical way; and it is also incumbent upon them, when making recommendations, to take into consideration the specific economic conditions of individual member states as well as any possible repercussions on other fiscal or economic objectives.

In this sense, the ECOFIN statement of 12 February 2002 in relation to the recommendation of the EU Commission to the Council to send an early warning to Germany in form of a recommendation did not, in fact, weaken the Pact; but rather, it qualitatively improved it. The Council took the Commission's reservations into account by noting the express commitments made by Germany under the 2001 stability programme. These commitments included:

- an aspiration not to exceed the 3 % threshold for the general government deficit and to monitor budget trends at all levels,
- careful implementation of budget plans in the current year,
- confirmation that a budget position "close to balance" will be achieved by 2004,
- adoption of national agreements with all levels of government to ensure implementation of the commitments made.

On 12 February 2002, the federal government clearly stated that the deficit objective could only be achieved at a particular level of economic growth (2003 and 2004: 2 ½ %). In view of both an extremely restrained upward economic trend this year and the changed prospects for 2003, Germany is being forced to alter course on deficit reduction, so that fiscal policy too can contribute to greater growth and employment.

The adoption of a national stability pact means that public budgets at all levels have in effect acknowledged their responsibility for implementation of medium-term consolidation objectives. This regulatory arrangement fulfils the corresponding promise of the Federal Finance Minister made in February 2002. At the same time, Germany is also in compliance with the specific recommendation made in the "broad economic policy guidelines".

In accordance with the requirements of the European "broad economic policy guidelines", the federal government is preparing further structural reforms, mainly in the area of social insurance, but also with the intention of reducing bureaucracy and further liberalising the goods and financial services markets. Important legislative reforms relating to the labour market are also underway, and supplementary reforms will follow. The specifications formulated in the current "broad economic policy guidelines" designed to strengthen "ecological sustainability" constitute another component of Federal government policy.

B. General government fiscal policy

The federal government, Länder and local authorities are pursuing a sustainability-orientated fiscal strategy, which is designed to ensure the ability to take action both today and tomorrow and at the same time to make a fundamental contribution to greater fairness between the generations.

1. National stability pact

On 21st March 2002 in the Financial Planning Council, the federal government and the Länder agreed on a National Stability Pact for national implementation of the European Stability and Growth Pact. The purpose of this agreement was to ensure that budgetary discipline is maintained at all levels of government.

On 20th December 2001, the federal government, Länder and local authorities discussed the reorganisation of the system of federal revenue equalisation and agreed to amend the Budgetary Principles Act for national implementation of the Maastricht criteria. Originally, this amendment was only intended to enter into force on 1st January 2005, simultaneously with the reorganised revenue equalisation. In order to extend the statutory freedom of action of the Financial Planning Council as early as possible, it was decided at the request of the Federal government to have it enter into force on 1st July 2002.

The new regulatory arrangement conforms to the procedure set for budget monitoring of EU member states. It ensures that, in addition to the Federal government, the Länder (including the local authorities falling within their competence) will comply with European provisions. With due consideration being paid to the institutional structures of German federalism, preventive monitoring instruments designed to ensure compliance with the Maastricht criteria have been set up.

The key components of the new regulatory arrangement set up under § 51a HGrG are:

- Federation and Länder to make efforts to reduce net borrowing with the aim of achieving budget balance;
- The Financial Planning Council's coordination function is given stronger legislative underpinning and is made more specific with regard to EU legal requirements.
- The Financial Planning Council will take into consideration economic and fiscal factors and then make recommendations regarding budgetary discipline. In particular, it will recommend a common expenditure course designed to ensure implementation of European requirements. The federal government will reduce its expenditure for 2003 and 2004 by an annual average of ½ percentage point. Both the Länder and local authorities undertake to restrict their expenditure growth to 1 % annual average during this period.
- The Financial Planning Council, to which the Federal Minister of Finances, the Federal Minister for Commerce and Labour, the Finance Ministers of the Länder as well as representatives of local authorities and local authority associations all belong, to discuss compatibility of the budgetary development of territorial authorities with the provisions of the Stability and Growth Pact.
- In addition, the Financial Planning Council to make, if necessary, recommendations for the restoration of budgetary discipline.

“§ 51a Maintenance of budgetary discipline within the framework of European Economic and Monetary Union

(1) The Federal government and the Länder shall comply with their responsibility to adhere to the provisions of Article 104 of the Treaty Establishing the European Community and of the European Stability and Growth Pact and shall strive towards a reduction in net borrowing with the aim of achieving balanced budgets.

The Financial Planning Council shall take into consideration economic and fiscal factors and then make recommendations regarding budgetary discipline. In particular, it shall recommend a common expenditure course within the meaning of § 4 Paragraph 3 of the Standards Act (*§ 4 Absatz 3 des Maßstäbengesetzes*). On this basis, the Financial Planning Council shall discuss the compatibility of budgetary development, in particular that of expenditure and financial balances of the Federal government and the Länder including their local authorities and local authority associations, with the provisions of Article 104 of the Treaty Establishing the European Community and of the European Stability and Growth Pact.

(3) In the event that the budgetary discipline of territorial authority bodies does not comply sufficiently with paragraphs 1 and 2 above as per the relevant requirements, the Financial Planning Council shall discuss the reasons behind this non-compliance and shall make recommendations for the restoration of budgetary discipline.”

The clear reinforcement of the Financial Planning Council's powers demonstrates a greater emphasis on the binding effect of the decisions of equal partners (peer pressure), as and when those decisions come about in the course of co-operation procedures. This is in contrast to the statutory/constitutional restriction of budgetary autonomy, which is inherently problematic.

The insertion of Section 51a Para. 2 HGrG enacts that decisions of the Financial Planning Council on a commonly recognised expenditure course must be used as a guide for the budgets of the Federal government and Länder (including local authorities). The power of the Financial Planning Council established under paragraph 3 to make any necessary recommendations for the restoration of budgetary discipline re-enacts the procedure agreed in the European Stability and Growth Pact in the event of excessive deficits; namely, initially, recommendations must be made for restoration of budgetary discipline at national level and below.

At a special session of the Financial Planning Council on 21st March 2002 and also at another session of the Financial Planning Council on 27 November 2002, the federal government and the Länder adopted decisions to ensure practical implementation of the arrangements contained in § 51 HGrG.

At its autumn session on 27 November 2002, the Financial Planning Council discussed maintenance of budgetary discipline within the context of European economic and monetary union, on the basis of § 51a Haushaltsgrundsätzegesetz (Budgetary Principles Act) for the first time. The Financial Planning Council has set down a list of joint decisions in a six point plan, which is intended to give specific effect to a strategy and timetable agreed between the Federal government and the Länder for timetable for attaining the objective of a balanced general government budget in the year 2006.

- The Federal government and the Länder agree on a common objective of reducing the government deficit to under - 3 % of GDP in 2003. The decisions adopted on 21st March 2002 by the Financial Planning Council for the years 2003 and 2004 regarding the National Stability Pact are reaffirmed.
- In addition, every individual public body has undertaken to contribute in the coming years to the achievement of a balanced general government budget in 2006.
- Specifically:
 - At the next Financial Planning Council session, the Federal government will present a financial plan featuring net borrowing at zero in 2006.
 - At the next Financial Planning Council session also, the Länder will present their contributions to achieve a balanced general government budget in 2006 and their strategies to achieve balanced regional (*Land*) budgets.

Both the proceedings and the actual work of the Financial Planning Council will continue to improve in efficiency in the coming years and, thus, will further the process of budgetary discipline at national level and below.

2. Local authority financial reform

The development of the financial situation at local authority level points to fundamental structural problems. In particular, the trade tax (*Gewerbesteuer*) collected by the local authorities is progressively losing its traditional function as a constant, plentiful revenue source. Dependence on what is frequently a low number of taxpayers increases the likelihood of unforeseen shortfalls - especially in the case of industry-specific developments. In its present version, trade tax is therefore no longer a reliable revenue source capable of ensuring the vital continuation of services, when seen in the context of local authority self-administration.

The federal government, Länder and local authorities all regard comprehensive structural reform of the local authority financing as essential. For this reason, in March 2002, the Federal government created a special commission to investigate reform of local authority finances. Its brief is to tackle the fundamental problems of local authority financing. The commission's objective is to come up with concrete proposals for legislation on the most urgent issues of local authority financing, if possible by mid-2003. A central plank of reform in this context relates to the future of trade tax and, therefore also, to the entire system of local authority tax revenues. Injecting greater consistency into local authority tax revenue inflows and thus also local authority investment capabilities constitutes an important objective of reform efforts.

However, the commission has also been looking at the expenditure site. Here, greater attention has been paid to social welfare as a cost-intensive task of local authorities and, centrally, also the question of creating efficient links between public transfer payments for the work-capable unemployed. This area presents structurally weak cities and local authorities in particular, which in any event often have relatively poor revenue generating capacity, with difficult problems.

At the present time, working groups have been created to deal with both topics. They are taking stock of proposals relating to the future of trade tax and also the financial consequences for local authority bodies that could result from a redesign of unemployment assistance and social welfare. Assuming that the results of the commission's work on reform of local authority finances will become available by the middle of next year, it is intended to institute the corresponding legislative proceedings expeditiously, so that the principal measures can enter into force by 1st January 2004.

C. Fiscal policy of the Federal government in the current legislation period

The economic conditions underlying fiscal policy have deteriorated considerably since the start of growth's noticeable weakening in 2001. This weakness in growth entails a clear reduction in tax income and also leads to substantial additional burdens relating to labour market expenditure. As regards tax revenues, the income-reducing, economic effects of the previous year (base effect) only add to the effects due to lower growth for 2002 and 2003.

All this currently operates as a burden on both the implementation of the federal budget 2002 and the creation of the federal budget 2003. Tax shortfalls and additional expenditure in relation to the labour market, owing to the cyclical decline in employment, create an additional burden of 13.5 billion € in the federal budget 2002. As far as the year 2002 is concerned, these additional burdens must be offset by a corresponding increase in net borrowing in the federal budget. On 20th November 2002, the Federal government adopted a supplementary budget.

In contrast, clear savings that will lead to structural improvements can be introduced at the time of creation of federal budget 2003. Nevertheless, here too, it will be impossible to offset additional financial burdens completely with expenditure cuts and reductions in tax benefits, if the upward economic trend that is beginning to show itself for the coming year is not to be threatened. However, as far as the federal budget is concerned, the policy of strict expenditure caps will be maintained. As against the 2002 budgetary target, expenditure in 2003 will drop by 1.8 %. Thus, the federal government is adhering to the reduction in federal spending agreed on in the National Stability Pact for 2003 and 2004, i.e. an average of ½%.

At the same time, appropriate stimuli to economic growth are provided by further improving the quality of public expenditure. This will be done by reorganising the current structure of expenditure. Future-orientated expenditure will be reinforced, whereas economically dubious and ecologically harmful subsidies and tax benefits will be dismantled. Further, by 1st January 2003, the fifth phase of the Ecological Tax Reform will enter into effect.

One example of this is the budget of the Federal Ministry for Education and Research, which has been increasing for years. In the period 1998 to 2002, this ministry's expenditure increased by 21.5 %. The second government draft budget for 2003 adopted on 20th November 2002 provides for a further significantly disproportionate increase of 3.7 %.

At the same time, the economic situation of families merits special attention. Since the change of government in 1998, the federal government has effected clear improvements in the economic conditions affecting families; and as part of this process, it is increased financial payments to families by a good 13 billion € to 53.2 billion € per annum.

Both family and education remain priority areas. Increased provision of all-day schools is of particular importance, given the severe shortage in this area. By 2007, the Federal government will inject 4 billion € into its "Future, Education and Care" programme. This programme is designed to facilitate the establishment of additional all-day schools.

With 7.1 billion € at its disposal, the Flood Relief Fund gives massive support to reconstruction following the flood disaster. The Federal government has contributed 3.5 billion € to the Fund. This is 500 million € more than the additional revenues it derives from postponing the second phase of tax reform by one year and the one-year increase in corporation tax to 26.5 %. In anticipation of the Fund's resources, the Federal government provided around 500 million € in 2002.

The tax burden will lessen considerably again by 1st January in 2004 and 2005 respectively, due to the entry into effect of the second and third phases of tax reform (volume of relief: 23 billion €). This should improve the conditions underlying additional investment and any revival of domestic economic activity.

IV. The development of public budgets

A. Trends in the budget balance

The weak economic development of both the last and the current year has had far-reaching effects on public budgets. As the result of massive collapses in tax revenues and despite tight management of budgets characterised by budgetary blocks at all levels of government, the **2002 government deficit** will rise above the deficit ceiling prescribed by the Maastricht treaty. The public sector financial balance ("Maastricht deficit") will increase by around one percentage point over 2001 and will constitute – **3 ¾ % of gross domestic product**.

This increase in the deficit above the 3 % mark cannot be ascribed to the development of the current year alone. The 2001 government deficit was affected both by the tax relief that came into effect at the start of 2001 and by economic performance that remained well below expectations and also gave rise to corresponding burdens on the revenue side as well as the expenditure side. In the end, therefore, this deficit was substantially higher than forecast in the stability programme of October 2000. The value of - 2 ½ % of GDP projected for 2001 in the stability programme of December 2001 was confirmed in the figures published by the Federal Office of Statistics in both January 2002 (- 2.6 %) and February 2002 (- 2.7 %). In August 2002, the 2001 deficit was revised to - 2.8 % of GDP, although this was based on a number of unique transactions. Thus, Germany entered 2002, a year with weak growth on average, burdened by a relatively high "base".

Table 2: Development of deficit/surplus ratio¹⁾

	2001	2002	2003	2004	2005	2006
Deficit/surplus ratio	- in % of GDP-					
- December 2002 projection	- 2.8	- 3 ¾	- 2 ¾	- 1 ½	- 1	0
<i>Memo item:</i>						
<i>Increase in real GDP in %</i>	0.6	½	1 ½	2 ¼	2 ¼	2 ¼
- December 2001 projection	- 2 ½	- 2	- 1	0	0	-
- Base scenario -						
<i>Memo item:</i>						
<i>Increase in real GDP in %</i>	¾	1 ¼	2 ½	2 ½	2 ½	-
- December 2001 projection	- 2 ½	- 2 ½	- 1 ½	- 1	- 1	-
- Scenario with lower growth assumptions						
<i>Memo item:</i>	¾	¾	2 ¼	2 ¼	2 ¼	-
<i>Increase in real GDP in %</i>						

1) Deficits are - in the light of the uncertainties affecting estimates made in relation to any projection - rounded to ¼ percentage points of GDP for short -term projections (2002 and 2003), and ½ percentage points of GDP for medium-term projections.

The stability programme of December 2001 provided for a deficit reduction for 2002 in the event of an increase of real GDP by 1 ¼ % (base scenario) and for a scenario involving growth of ¾ %, the deficit "roughly on the same level as in 2001". In fact, public budgets during this year did indeed come under massive pressure, although from several directions, especially in relation to revenue:

- The general economic recovery has occurred later and has proved more timid than expected. The Federal government's autumn projection predicted a growth rate of barely ½ % for the current year. The situation in the labour market is less favourable than had been assumed in the spring. The general economic development is reflected directly in both the revenue and expenditure sides of public budgets. The Federal government is being forced to spend around 5 billion € more than planned on supplementary unemployment benefits and the grant to the Federal Labour office alone.
- The financial burdens are substantially heavier, when viewed in the context of revenue. The tax revenue estimation of May 2002 and even the tax revenue estimation of November 2002 showed significant corrections to tax revenue for the current year. The total estimated deviations for federal government, Länder and local authorities amount to 26 ½ billion € as against the projection of November 2001. Although these figures reflect the reduction in growth assumptions that has occurred during the course of this year (down from 1 ¼ % to barely ½ %), nevertheless this effect is far from being able to account on its own for the total volume of shortfalls.
- 2002 tax revenues are characterised by quite exceptional influences. These can be attributed to the pattern of economic activity in recent years and the system changeover undertaken for taxation of capital corporations. Although in "normal" times with no severe economic fluctuations or any major tax law changes, taxation income and nominal GDP more or less change in harmony with each other, based on the stated exceptional developments, current estimates predict for 2002 a reduction in tax revenues of - 1.5 % in the event of growth of around 2 % in nominal GDP.

Due to technicalities of the tax collection process, corporation tax revenues have reflected the economic development of a single year only partially. This is because two or more years generally elapse between the times of advance payments and final settlement respectively. The income of a single year could include - as in this year - an accumulation of higher repayments for past periods involving small or even no advance payments. In this regard, the special situation obtaining in individual sectors, such as lending or telecommunications, plays an important role in the current year.

Although these effects are cyclical, they cannot be attributed to the economic development of the current year. Therefore, the procedure used to determine the structural deficit cannot capture such effects. It is impossible to take special effects into consideration by using fixed elasticities based on average values of the past, after calculating an "output gap". The result of this is that the structural deficit will be exaggerated this year, while in other years it could well be stated to be too small. The same applies to the effects of tax law changes in the area of assessed taxes, where some of these effects begin to be felt only after a considerable delay. Here too, there are discrepancies between the time of the economic transaction and the time of receipt of the resulting tax revenues.

- Against the expectations contained in the last stability programme, social security will in turn show a clear deficit, which is roughly double that of 2001. Just the financing of expenditure on pensions insurance, accomplished by reducing the contingency reserve, will probably bring about a deficit of around two percentage points of GDP by the Maastricht definition.¹ The fact that health insurance policies are unlikely to succeed in balancing the financial deficit completely is another germane factor.
- Not least, the expenditure incurred in connection with the flood disaster in August in the new Länder and Bavaria also forms part of the burdens of 2002. Although the bulk of the funds provided from the public purse to deal with these losses will only be obtained in the coming year, in 2002 the Federal government also supplied funds for emergency assistance in anticipation of payments coming from the Flood Relief Fund. Although it is currently impossible to estimate all the payments made this year by the Länder and the local authorities, the total burden suffered by the public budget is likely to be of the order of 1 percentage point of GDP.

Now that the 3 % mark has been passed and a requirement exists to bring the deficit back beneath the ceiling set by the Treaty in the short term, fiscal policy is once again facing difficult challenges. In view of the development of the current year, it will not be possible to hold to the objective set by the last stability programme of achieving a public budget position close to balance in 2004. It is clear that in view of the deficit in 2002 of - 3 ¾ % of GDP, such an objective cannot be achieved; or at least, it can only be achieved at the cost of an even more severe expenditure course, which cannot be justified in macroeconomic terms and is also unrealistic from the standpoint of relevant legal obligations.

In view of an expected increase in real GDP of 1 ½ % in 2003, economic conditions for improvement in budget deficits are becoming more favourable, although the pressure on budgets will continue, not least because of the ongoing burden on the labour market. The tax estimation

¹ Drawings from reserves have no effect on the (financial) asset position of the government; and therefore under the national accounts rules, they are not regarded as revenue.

of November 2002 has, for 2003, led to estimated deviations of 22 billion € against the projection of May 2002. When compared with the medium-term estimate undertaken in May 2001, the total amount of these deviations for local authority bodies is almost 40 billion €.

The Federal government has introduced the necessary substantial deficit reduction in its draft Federal budget for 2003, together with certain new measures integrated within it and affecting both the revenue and the expenditure sides (Tax Benefit Reduction Law, continued development of ecological tax reform, savings package). The Federal government's net borrowing will drop in the coming year from 34.6 billion € (2002 target including supplementary budget) to 18.9 billion €; and this is without the insertion of any additional privatisation revenues into the budget. With an expenditure rate of - 1,8 %, the Federal government is going well beyond the reduction allocated in the national stability pact.² This sharper reduction shows that the federal government is paying attention to the deterioration in the deficit situation that has taken place in the meantime. Despite the high burdens imposed by tax shortfalls, both the Länder and local authorities will be able to reduce their deficits. Here, in addition to a moderate increase in expenditure³, the measures launched by the Federal government will also lead to additional revenue for the Länder and local authorities. Social security funds will show another slight deficit in the coming year. On present assumptions, the general government deficit could drop to 2 ¾ % of GDP in the coming year.

In 2004, the government deficit will be further significantly reduced as a result of the interplay of favourable macroeconomic development, a slow expenditure growth rate in accordance with the agreements of the Financial Planning Council and the effects of the Federal government's measures package. The Tax Benefit Reduction Law alone will give rise in 2004 to revenue of a good 7 billion € (i.e. around three tenths of a percentage point of GDP) more than in 2003. In addition, the planned further reduction in the Federal government's 2004 net borrowing will not be supported by any major privatisation projects. By the Maastricht definition, the reduction in the deficit will appear correspondingly greater than in the budget accounting balance. This is because proceeds from privatisation are not taken into consideration when calculating the government deficit. In total, a reduction in the deficit ratio to - 1 ½ % of GDP is assumed.

In view of the effects of the 2005 tax stage, which has already been approved, with its additional relief of barely one percentage points of GDP, it will be impossible to pursue the reduction in deficit in 2005 at the same speed as in both the preceding years. In order to continue the tight expenditure restriction policy, the federal government's measures help to ensure that, des-

² Pursuant to the agreement of the financial planning Council of 21st March 2002, The Federal government will reduce its expenditure for 2003 and 2004 by an annual average of ½ percentage point.

³ In the national stability pact, both the Länder and local authorities undertook to limit expenditure growth in 2003 and 2004 to annual average 1%.

pite the deviation from the projection contained in the last stability programme, a deficit reduction of scarcely one half percentage point of GDP will be achieved.

In the final year of the projection, the revenue side is once again dominated by the effects of macroeconomic development, so that there will be sufficient room for another significant reduction in deficits. This will lead to a balanced budget in the year 2006 (see Table 2). The federal government has always stressed that it will adhere to its plans for balancing the federal budget in the year 2006. The Länder and the local authorities will show a slight deficit, both in the cash account and the National Accounts relevant to Maastricht (see Table 3).

Table 3: Balancing items by levels of government

	2001	2002	2003	2004	2005	2006
	- in billion € -					
Federation including Special funds	-28.6	-37 to -39:	-25 to -27:	-14 to -16	-7 to -9	+1 to -1
Länder and local authorities	-26.4	-35 to -37	-31 to -33	-16 to -18	-13 to -15	-2 to -4
Social insurance	-2.6	-5 to -6	-1 to -2	+2 to +1	+2 to +1	+2 to +1
General government ¹⁾	-57.5	-77 to -82	-57 to -62	-28 to -33	-18 to -23	+1 to -4

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

B. Trends in government expenditure

With growth rates of 1.7 % and 1.9 % in recent years, the increase in public expenditure has lagged behind growth of nominal GDP (2.6 % and 2.0 %). As a result, the government spending ratio, which was over 50 % of GDP in 1996, has been dropping continuously. Last year, it reached a level of 48.3 %, having been 48.8 % in 1999 and 48.4 % in 2000. This development shows clearly that the deficit increase of the past year cannot be attributed or only attributed to a minor extent to expenditure-side causes.

This year, general government expenditure will probably increase by a good 2 ½ %. Once again, at plus 3 %, the increase in expenditure on social insurance is considerably above the surplus enjoyed by local authority bodies (+ 2 ¼ % after adjustment for social insurance grants). At first sight, this increase, which exceeds the projected growth of nominal GDP (2 %), seems to point to a relaxation in spending discipline. Closer observation shows, however, that the increase in the rate of spending itself is overshadowed by a series of exceptional factors:

- In recent years, the weighting given to individual components of European Union financing has progressively altered. While both the share and volume enjoyed by VAT own resources shrinks, GDP own resources are increasing in significance. 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 is increasing progressively. This purely statistical effect, which has no influence on the deficit, will lead in 2001 alone to an increase in expenditure of approximately 2 ½ billion €, which is a good one tenth of a percentage point of GDP.
- Given that the general economy has developed more weakly than expected, this year substantial additional expenditure in relation to the labour market will be incurred. At federal government level, expenditure on supplementary unemployment benefits is 2 billion € higher than the result for the year 2001; while the grant to the Federal Labour Office has turned out to be around 3 billion € higher than it was in 2001. Altogether, this is producing a special effect of a good two tenths of a percentage point of GDP.
- Although, as stated, the financial aid for the consequences of the flood disaster in August that has come on stream during the current year cannot be conclusively analysed in figures, it can nonetheless be assumed to have an effect on expenditure of around one tenth of a percentage point of GDP.
- The increase in child benefits at the start of 2002 is leading to an additional burden on public budgets of a good 3 billion €. In both budgets and financial statistics, child benefit, the main purpose of which is to guarantee a minimum standard of existence for children by means of constitutionally permissible tax relief, is balanced on the revenue side with taxation revenue. The National Accounts, in contrast, prove that child benefit is a monetary social benefit on the expenditure side. The Maastricht accounting system records additional expenditure appearing in the budgets of territorial authorities as a reduction in revenue. This also applies in the case of the owner-occupied homes premium, the total volume of which should grow by around one billion € in the current year.

In total, the unique and/or statistical effects that have to be taken into account when analysing expenditure growth, amount to more than one half of a percentage point of GDP. It is clear that, despite the supposedly high growth rate, which is in turn causing the government spending ratio to climb to 48 ½ %, the causes of the deterioration in the 2002 deficit are not to be found on the expenditure side.

Table 4: Development of the government spending ratio

	2001	2002	2003	2004	2005	2006
Government spending ratio	- in % of GDP-					
December 2002 projection	48.3	48 ½	48	46 ½	45 ½	44 ½
December 2001 projection	48	48	46 ½	45 ½	44 ½	-

The development of expenditure in the coming years will be characterised by continued, concerted efforts in budgets at all levels to reduce deficits. Critically important to the projections are the agreements of the Financial Planning Council on the national stability pact already mentioned elsewhere. In this context it should be borne in mind that the agreement on budget monitoring refers to an expenditure concept from financial statistics, i.e. a cash-orientated concept. The definition of expenditure contained in the National Accounts, which is the one used in the comments below, differs from that of financial statistics.⁴ Despite these differences, development from the standpoint of financial statistics is the principle determining factor for the National Accounts expenditure course.

The projection is based on the assumption of annual average expenditure growth of a good 1 ½ % in the years 2002 to 2006. In this regard, although the momentum in relation to social insurance is less than in the preceding years - in terms of measures that restrain payments, it nonetheless still exceeds the increase in the case of territorial authorities. The measures taken by the federal government to consolidate on the expenditure side, including the implementation of labour market reforms are also helping to weaken the momentum; as do continued the savings efforts by Länder and local authorities. Based on the assumption of a medium-term resurgence in nominal gross domestic product, the government spending ratio will drop to 48 % in the coming year. This is despite the Flood Relief Fund payments required for the areas hit by the flood, which will have a volume of roughly three tenths of a percentage point of GDP. In the subsequent years to 2006, it will then be possible to reduce the public spending ratio in larger steps to 44 ½ %.

⁴ The differences include such things as child benefit and various premiums (the owner-occupied homes premium), which in the national accounts is not balanced with tax revenue - in contrast to the budget accounting balance; instead, it is shown on the expenditure side. VAT own resources could be cited as a "contrary example", as in the National Accounts rules it is deemed to be a direct payment to abroad from the affected sectors and thus not as government expenditure.

Of the individual expenditure categories, expenditure on intermediate consumption (including social benefits in kind) and personnel expenditure will increase in the current year by roughly 2 %, following a surplus of 1.5 % last year. In this context, the above average rise in social benefits in kind (+ 2 ½ %), which principally reflects health insurance expenditure, is having a driving effect, whereas the intermediate consumption and personnel expenditure will increase at very moderate rates of 1 to 1 ½ %. Here the continued reduction in staff numbers in the public service as well as economy drives at all levels should start to produce results. The budgetary blocks imposed over several budgets have probably significantly contributed to restricting intermediate consumption. As regards this expenditure block, in view of the consolidation requirements, no more than continued modest growth of annual average 1 ½ % can be expected in the medium-term. Measured against GDP, the significance of this item will therefore decrease; the ratio decreasing from 19 ½ % this year to 18 % in 2006.

Monetary social benefits are once again posted with above average growth. The increase in child benefit at the beginning of the year, already mentioned, and the substantial increase in expenditure for supplementary employment benefits make a particular contribution to the 2002 expenditure surplus of 4 ½ %. The social benefit expenditure incurred by the Federal Labour Office has also increased disproportionately, due to the current economic trends; and these components alone account for nearly half of the increase. In subsequent years, growth rates of social benefits - not least while labour market reform is being implemented - should markedly decrease, both at territorial authorities and in social insurance funds. In the medium-term, however, an annual average increase of 2 % is assumed.

Interest expenditure in public budgets should decrease slightly in the current year, while in 2001 a reduction of - 0.5 % was achieved. This development can be attributed to comparatively favourable refinancing opportunities in the previous year; and it also partially reflects the use of UMTS proceeds for debt redemption in 2001. In 2002 also, the current situation in the capital market has effectively promoted comparatively favourable refinancing opportunities. Thus, interest expenditure in 2003 will increase only moderately, despite a substantial expansion of net borrowing in 2002 in comparison with last year. As far as subsequent years are concerned, the development of the deficit and the debt level means that a further increase in interest expenditure can be expected. The ratio of interest expenditure to gross domestic product will remain stable in the medium term at around 3 %.

⁵ Intermediate consumption, social benefits in kind and personnel expenditure are looked at in combined form. Insofar as they relate to the "non-market production" of general government, they are the central factors influencing government final consumption expenditure.

The reduction in the investment ratio seen in the last ten years can be attributed to a series of different factors. As stated in greater detail in the last stability programme of December 2001, in this context the effects of reunification, issues of the investment requirements of infrastructure areas, the situation in the individual budgets, and finally also the phenomena of divestments of functions previously carried out by public bodies, all play a role. However, the relative impact of individual factors cannot be estimated with any reliability. It can nevertheless be assumed that the further reduction in investment expenditure by - 1 ½ to - 2 % seen in the current year is partly connected to the additional burdens suffered by public budgets, those burdens being caused by general economic trends. In 2003, the level of public investment activity will be influenced by payments from the Flood Relief Fund. Of the well on 7 billion € available to the Fund to rebuild flood-hit areas, the major share - significantly more than half - will be used for public sector investment. This does not include any financial aid given to other sectors which is being used for investment. Under the narrow definition employed by National Accounts, this expenditure is deemed to consist of "transfers". Over the entire period covered by the projection, expenditure on investment will continue to develop proportionately less in relation to the total budget. At an annual average growth rate of 1 %, the investment ratio will be subject to a further sinking tendency, although it will remain within the rounding of 1 ½ % of GDP.

The other transfers (current and asset transfers as well as subsidies) will increase in the coming year by 3.6 %, mainly influenced by the special effect in relation to GDP own resources described above. Transfers will increase strongly again in the coming year (+ 4 ½ %). The causative factors for this are again the "own resources effect", as well as the increase in expenditure on owner-occupied homes premiums and - for the first time - expenditure on old age pension premiums. Unlike the cash account, National Accounts shows both premiums on the expenditure side. Not least, the financial aid flowing to other sectors as flood disaster assistance is also driving transfer expenditure. In the years 2004 to 2006, the special effects will die away and, supported by declining subsidies, the growth rate of this expenditure category will also subside.

C. Trends in government revenue

Tax revenue for 2002 has been considerably lower than was assumed when the 2002 budgets were devised. As a result of the weaker than expected general economic recovery, it has proved necessary to adjust significantly downward previous tax revenue estimates. This occurred at both the spring meeting and during the November session of the "tax estimates" working group. In contrast to November 2001, there are estimated deviations of 26 ½ billion €.

Despite this, tax revenue will increase slightly compared with 2001 (+ ½ %) in the National Accounts definitions. Tax revenues in cash received by the Federal government, Länder and local authorities are, according to the results of the tax estimates of November 2002, 7 billion € below the actual figure of 2001. However, in the National Accounts the increase in child benefit and the increase in the owner-occupied homes premium do not lead to any reduction in revenue. Even the "own resources effect" has the effect of increasing revenue within the National Accounts. Owing to the slight nature of the increase, the tax ratio⁶ will drop once again in the wake of the reduction in 2001 caused by both tax reform and general economic conditions (from 24.6 % to 23.0 % of GDP).

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

	2001	2002	2003	2004	2005	2006
	- in % of GDP-					
Tax ratio	23,0	22 ½	23	23 ½	23	23 ½
Social contribution ratio	18.5	18 ½	18 ½	18	18	17 ½
Tax/fiscal charges ratio¹⁾						
- December 2002 projection	41,5	41	41 ½	41 ½	41	41
- December 2001 projection	41 ½	42	42	41 ½	41	-

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

Tax revenue will pick up again in the coming year. However, the postponement of the next stage of tax relief from 2003 to 2004, decided on in order to finance the Flood Relief Fund, is another factor behind the rise in the tax ratio to 23 %. In 2004, despite the relief that will come into effect at that time, the more favourable economic situation should make itself felt on the revenue side; and the tax ratio should increase once again, to 23 ½ %. In 2005, the 2005 stage of tax relief in the tax reform programme will slow the development of revenue (see Table 5).

At 18 ½ %, the social contribution ratio (social contributions within the National Accounts definitions in relation to GDP) will remain roughly on the level of 2001 (18.5 %) both this year

⁶ 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, capital 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.

and next year. On the one hand, the ratio is being slowed by the development of the labour market; while on the other, higher average contribution rates in health insurance and the weak development of nominal GDP are subject to rising tendencies. In the medium-term, the ratio-slowness effects of macroeconomic development will probably occur; and this will once again allow room for reduction in contribution rates in individual branches of social insurance. In the medium-term, a reduction in the ratio until 2006 by 1 GDP point is assumed.

When viewed overall, the total amount of taxes and social levies beyond the entire period covered by the projection falls within a relatively narrow band between 41 and 41 ½ % of GDP.

D. Development of structural deficits

Assessments of fiscal policy increasingly evaluate the use of structural instead of nominal deficits. Focusing on structural deficits is intended to filter out cyclical influences on fiscal policy, in order to uncover the "real" fiscal policy and its cyclical impetus.

However, there is no generally accepted calculation method for cyclically adjusted budget balances. In addition, estimates of potential output, which are used as the point of departure for any such calculations, are imbued with considerable uncertainties. This applies to both forecasts and statements of past performance. For potential output amounts to an inherently fictitious variable. Its development cannot be observed in the real world. All methods used to calculate potential output and to illustrate output gaps are dependent on more or less arbitrary assumptions.

Of course, this also applies to methods used to deduce potential output from a given production function. This also applies, however, to the use of the Hodrick-Prescott filter. This filter is employed to separate trends from cycles by means of a special method of creating moving averages. Here, the actual extent of the time series smoothing that is assumed will exert a considerable effect on the estimation of the structural deficit.⁷

Even if the calculation uncertainties are left out of account, one glance at the current estimated results for the structural deficit gives rise to considerable doubts, whether the entire concept of "structural deficits" is even capable of illustrating the cyclical and the non-cyclical parts of the actual deficit (see Table 6). Hence, an isolated look at the deterioration of the structural deficits

⁷ In the case of concepts that focus on a production function - regardless of how it is specified, the differences occurring in the calculation of output gaps are sometimes even larger. This can be illustrated by comparing the estimates of potential output for Germany made by the EU Commission, the IMF and the OECD. Further, the substantial distortions due to German reunification, which are reflected in the statistics, present problems and have implications for the portrayal of potential macroeconomic output.

in the year 2002 as against the year 2001 leads to the conclusion that the rise above the 3 % deficit ceiling cannot be attributed to cyclical factors alone. This would, however, ignore the fact that, due to the use of rigid elasticities derived from past values, no effects lasting longer than the period concerned can be taken into account in any calculations of structural deficits. In principle, the calculation process will allocate taxation shortfalls, based on the weak economic activity of other periods (such as corporation tax refunds to companies in respect of transfers undertaken in past years), to the current period as a structural deterioration. This assumption does not adequately deal with the problem as regards the current development of government revenue in Germany described in section C; this being due to the accumulation effects that can be observed in relation to assessed taxes.

Further, values given for the structural deficit ex post are subject to much greater revision than those given for actual deficits. This problem is inherent to the method itself, due to the repercussions from changes in forecast values. Thus, for example, the 2001 autumn forecast of the European commission for 2002 assumes a structural deficit of - 2.0 %, based on a deficit of - 2.7 % of GDP and assumed growth of + 0.7 %. Against 2001 (- 2.3 %), an improvement in the structural deficit by 0.3 percentage points could have resulted; the cyclical component of the 2001 deficit amounts to - 0.7 %.

In the 2002 autumn forecast, the commission assumes a structural deficit of - 3.3 %, based on actual deficit of - 3.8 % with assumed real growth of 0.4 %. The cyclical component is, therefore, - 0.5 %. This means that despite a reduced growth assumption for 2002, the cyclical component is actually lower than shown in the 2001 autumn projection.

This result may well be correctly calculated in view of the interdependency of past and forecast values. However, it does raise the question of what the implications for fiscal policy might have been in the event of an analysis undertaken ex ante and retrospectively. Seen from the perspective of the 2001 autumn projection, the 2002 fiscal policy was on the right track: whereas seen from the perspective of the 2002 autumn projection - at least, according to the calculated result - the 2002 fiscal policy has led to a deterioration in the structural balance. Since the deterioration in the 2002 deficit is predominantly on the revenue side, the purely mechanically calculated result would indicate that structurally detrimental measures had been taken on the revenue side. However, as against the situation pertaining to the 2001 autumn projection, no major new measures were taken on the revenue side; and this means that the above explanation of the rise in the structural deficit does not hold.

Table 6: Development of potential growth, output gaps and structural deficits

	2001	2002	2003	2004	2005	2006
Real GDP growth	0.6	½	1 ½	2 ¼	2 ¼	2 ¼
General government fiscal balance in % of GDP	-2.8	-3 ¾	-2 ¾	-1 ½	-1	0
Potential growth	1 ¾	1 ¾	1 ¾	1 ¾	1 ¾	1 ¾
Output gap	0	-1 ¼	-1 ¼	-¾	-¼	½
Structural balance in % of GDP	-2 ¾	-3	-2	-1	-1	-½

Calculation is based on a HP filter, smoothing of potential output used Lambda 100. Actual and structural balances for 2004 to 2006 have been rounded to ½ percentage point of GDP.

Against this background, it becomes clear that no mechanistic conclusion in relation to analysis of the appropriateness of fiscal policy can be drawn from the development of structural deficits. All that can be said in this regard is that structural deficits can - at best - supply certain hints that may be helpful for a more thorough causal analysis of a specific fiscal trend.

The figures shown in Table 6 demonstrate a clear, phased reduction in structural deficits lasting beyond the period covered by the projection. Thus, Germany can implement the objective of reducing structural deficits formulated by the Euro Group in October 2002.

E. Development of debt

Last year, a reduction of the debt ratio over the previous year was achieved. This was to 59.5 % of GDP and thus, clearly below 60 % of GDP. In this connection, two-thirds of the proceeds from the auctioning off of UMTS licences totalling 50.8 billion € were used to repay bearer bonds of the "Currency Conversion Equalisation Fund". Well on one-third of the proceeds was used to accelerate the reduction of debt at the end of 2000.

This year, the debt ratio will climb to 61 % of GDP. On the one hand, the forecast for the 2002 nominal gross domestic product had to be reduced by just on one percentage point in the course of this year. This effect on its own is leading to an increase in the debt ratio of one half percentage point. On the other hand, deficits are higher than expected.

Even in 2003, despite clear reduction of deficits and economic recovery, a slight increase in the debt ratio to 61 ½ % of GDP can be expected. In subsequent years, the development of

deficits towards a balanced budget will result in a reduction in the debt ratio to 57 ½ % of GDP in the year 2006 (see Table 7).

Table 7: Debt ratio - development to the year 2006

	2001	2002	2003	2004	2005	2006
Debt ratio	in % of GDP					
December 2002 projection	59.5	61	61 ½	60 ½	59 ½	57 ½
December 2001 projection	60	60	59	57	55 ½	-

The development of government debt according to the Maastricht definition is principally determined by the deficits in terms of the cash account. Privatisation proceeds and loan transactions, which are not taken into consideration when calculating the Maastricht deficit, therefore affect the development of government debt, as does the entire profit of the Bundesbank. Both this and next year, privatisations will still yield revenues of the order of one half percentage point of GDP; while for subsequent years no significant contribution to reduction of the debt ratio is assumed.

F. Sensitivity of the deficit projection to changes of the growth projection

The deficit path laid out in the projection is extremely ambitious. The objective of a balanced government budget in 2006 will be achieved if the restrictive course on the expenditure side is continued, the federal government's planned measures to reduce the deficits are implemented and the assumed, short-term to medium-term macroeconomic revival actually comes about. It is clear that the assumed path does not leave any room for additional burdens on public budgets.

A lower level of medium-term growth would be reflected directly in tax revenue, and indirectly in higher, labour market-caused expenditure. If lower annual average growth of ¼ percentage point is assumed for the years 2004 to 2006, the cumulative burdens in the final year of the projection would run to around four tenths of a percentage point of GDP. A scenario whereby additional burdens of this order of magnitude would be offset by a further tightening of expenditure assumptions seems scarcely realistic; the assumed weakening of growth would have an immediate effect on the government deficit. In this case, the objective of a balanced Maastricht budget for the year 2006 would no longer appear to be achievable.

Table 8: Development of the deficit ratio on deviation from the growth course

	2001	2002	2003	2004	2005	2006
Deficit/surplus ratio	- in % of GDP-					
December 2002 projection	-2,8	-3 ¾	-2 ¾	-1 ½	-1	0
December 2002 projection						
• assuming lower growth for 2004 to 2006	-2,8	-3 ¾	-2 ¾	-1 ½	-1	-½
• assuming higher growth for 2004 to 2006	-2,8	-3 ¾	-2 ¾	-1	-½	½

Deficits are - in the light of the uncertainties affecting estimates made in relation to any projection - rounded to ¼ percentage points of GDP for short-term projections (2002 and 2003), and ½ percentage points of GDP for medium-term projections.

In the event of medium-term growth that is higher by ¼ percentage point - in roughly a mirror image to the above scenario - relief on both revenue and expenditure sides can be expected.

V. The long-term sustainability of public finances

A. 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 both Germany and other EU member states in the coming decades. This is also borne out by model calculations updated in 2000 for planning and decision purposes by the federal government (most recently) and, specifically, the Interdepartmental Working Party on Population Issues.⁸ 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.

An examination of the long-term financial feasibility of old age pensions arrangements in Germany is one of the statutory duties of the Federal government. In the case of statutory pensions insurance (*Gesetzliche Rentenversicherung*), this review takes place annually; whereas in the case of civil servants' pensions (*Beamtenversorgung*), it takes place once per legislative period.

As regards the latest report on the arrangements regarding old age security in the public service, which was published in September 2001, the Federal government very quickly drew specific conclusions. Its proposed amendments to the Civil Servants' Pensions Act, which are aimed at slowing the rise in pensions burdens in future, came into force on 1st January 2002. The same applies to the corresponding amendments of the Military Pension Act. One year previously reductions in the event of early retirement were introduced - as with statutory pensions insurance, in order to reduce costs thereby and to avoid adverse incentives.

Whether these methods will suffice, remains to be seen at the next regular review of long-term financial feasibility of public service pensions costs. The federal government plans to present to the legislatures the results of updated model calculations in a new (i.e. third) report relating to pensions in the public sector towards the middle of the current legislative period.

The 2002 pensions insurance report relating to the statutory pension scheme was adopted by the Federal government on 27th November 2002. It shows both the development of past years and perspectives for statutory pension insurance in the coming years.

⁸ Tab: 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).

The model calculations for all expenditure and revenue of statutory old age insurance regularly refer to development over the next 15 calendar years. In order to reflect longer term patterns and to include the results in the (planned) joint report by the Council and the Commission on adequate and sustainable pensions, the Federal Ministry for Labour (now: Federal Ministry for Health and Social Security) has in the meantime also published projections with a time horizon of 50 years. Particular attention has been paid to ensuring comparability with the data used so far by the Economic Policy Committee. Although calculations of the fiscal burden were performed using the methodology and assumptions agreed on by the Economic Policy Committee, unlike the calculations originally supplied by Germany they also take into account the effects of the 2001 pensions reform.

In order to avoid double counting, as would otherwise occur with any fusion of the corresponding projections for health services, these new calculations did not take into account the contributions to health insurance made for pensioners. Therefore, the data in both the base year and the final year lie below level of the results published to date (in the report of the Economic Policy Committee of November 2001).

The federal government is aware of the risks to which public finances are also exposed in consequence of population ageing in Germany. To supplement the work carried out to date, the Federal government now also has available to it preliminary results of the effects of demographic change on taxation revenue in Germany. The research project commissioned by the Federal Ministry of Finance and undertaken jointly by the DIW (German Institute for Economic Research) and the University of Freiburg has now been completed. This project also included revenue side figures for scenarios based on assumptions that are compatible with the calculations performed to date for the expenditure side (see table). Grossly simplified, it can therefore be assumed, in relation to the trend as a whole, that a slight increase in tax and fiscal charges ratios will take place in the long-term. However, this will not match the demographics-related increases in nominal expenditure that have been projected.

Table 9: Government revenue and expenditure in long-term perspective

in % of GDP	2010	2020	2030	2040	2050
old age pension expenditure ¹⁾	11.1	12.1	13.8	14.4	14.9
Health expenditure ²⁾	6.0	6.4	6.7	7.0	7.1
Tax revenue ³⁾	17.7	17.8	18.0	18.6	19.0

1) Results of modelling calculations undertaken by BMGS (Statutory Pension Insurance and Public Service Workers Pensions)

2) Results of modelling calculations undertaken by the Economic Policy Committee of the EU (Acute Health Care)

3) Results of modelling calculations undertaken by the German Institute for Economic Research (taxation payments of private households)

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 federal government has a broad-based strategy to cope with the risks posed by demographic trends. In the field of fiscal policy in the proper sense, the elements in this strategy include not only the lasting consolidation of public budgets, but also the continued development of the taxation system in step with an increase in the quality of public finances. Reforms in the area of social security (labour market, pensions and health) and a growth and employment-promoting economic policy are the two other major pillars of this strategy. It also includes the targeted promotion of the functioning and efficient capital market in Germany and Europe in general. It serves as the basis for the optimum supply of capital to German business and, therefore, also secures employment. In addition to further developing the real capital stock, tension-free growth in the longer term also requires greater investment in human capital (e.g. in the form of improved performance by the education system).

B. Fiscal policy contribution: Continue consolidation, continue redevelopment of taxation system, reinforce future-orientated expenditure

A fiscal policy orientated towards ensuring the quality and sustainability of public finances can make a major contribution to overcoming the demographic challenge in line with the conclusions of the Lisbon, Stockholm and Göteborg European Councils. The essential areas of activity of a fiscal policy such as this one, which is designed to strengthen future-orientated areas, are:

- continuing on the consolidation course;
- continued development of taxation system, including lessening the burden of taxes and fiscal charges.

1. Continuing on the consolidation course

The successful rehabilitation of public finances is an essential element in a stable economic framework. Fiscal policy can help to maintain stable prices and low 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.

In the field of fiscal policy, the guiding principles of fiscal policy will retain and therefore also preserve their validity in the coming years also. The key components of this comprehensive plan are:

- to reduce debt for permanently sound public finances;

- to promote growth and employment by a sustainable and equitable system of taxes and fiscal charges.

Consolidation efforts are supported in particular by the following measures:

- Continuing stipulation that measures must be fully funded: Additional expenditure must be offset by redirecting other funds in the same budget head.
- Continuation of the linear reduction in central government posts by 1.5 % a year.
- Selective privatisation: Non-recurrent additional revenue from privatisation is not available to finance tax cuts with lasting effect and expenditure programmes.

The federal government would like to pursue this fiscal course in the longer term, which is fundamentally attuned to the goals of consolidation and design. The achievements to date serve as the springboard for further measures to overcome the challenges of the coming years. The long-term objective is to completely eliminate government indebtedness. In this regard, development of the "Guiding Principles Scenario" outlined in the "Guiding Principles of Fiscal Policy" November 2000 should be continued. Modelling calculations show that if a surplus of 1 % in the public sector over the entire economic cycle is achieved, a total reduction in government indebtedness would be possible in around 30 years.

2. Continued development of taxation system / lessening the burden of taxes and fiscal charges

In the context of an overall plan to achieve a sustained fiscal policy, modernisation and simplification clearly serve as the leitmotiv of the federal government's taxation policy. Thus, the reforms initiated in this area during the last legislative period will be consistently continued during the current one. It is intended to dismantle further economically dubious and ecologically harmful subsidies and tax benefits, to broaden the revenue base of public budgets and thereby to provide effective support to the consolidation course. This would enhance transparency and justice in the tax system and reduce enforcement costs. In total, the reduction in taxation-motivated distortions of competition would lead to a strengthening of market forces and thus to greater growth; and, in the longer term, to more jobs.

The next stage of the comprehensive "Tax Reform 2000", postponed by one year under the Flood Disaster Solidarity Act (*Flutopfersolidaritätsgesetz*) designed to remedy unforeseeable flood losses in the summer of 2002, contains significant relief effects with income tax and enters into effect at the start of 2004. After the third stage comes into effect in the year 2005, Germany's income tax system will have the highest basic tax-free amount, the lowest basic rate of tax and the lowest top rate of tax ever in its history. Even on an international comparison, Germany thus has extremely competitive tax levels. Hence, the policy of phased

tax reductions will be continued, so that Tax Reform 2000 can provide citizens and business alike with tax relief of 32 billion Euro per year over 1998 in the final stage in 2005.

Tax Reform 2000 will be supplemented on 1st January 2002 by the entry into force of the Act for continued development of corporation tax law, which further reinforces the emphasis on assisting medium-sized firms. It creates incentives for medium-sized companies to modernise traditional structures and to become more competitive even by international comparison.

The tax benefit reduction bill presented by the federal government provides for a far-reaching, broad-based, socially balanced, ecologically effective reduction of tax benefits and anomalies. Encouragement measures, such as the owner-occupied homes premium, should be continued in future in principle. However, they should be aimed more at target groups requiring encouragement, so as to increase their accuracy and prevent any windfall effects. The following should be undertaken as essential measures:

- Restrictions in the loss offset opportunities for businesses: Over time, this should enable more uniform tax charges, particularly for large companies.
- The cancellation of a whole series of tax benefits in relation to sales taxation, particularly in the area of agricultural inputs.
- Reorganisation of taxation of private sale profits through comprehensive, uniform tax treatment, involving a flat rate of tax of 15 %; the "speculation periods" applicable to date should be abolished. This arrangement is based on customary, international procedures and includes a comparatively low level of taxation, which creates a socially unfair taxation loophole.
- Cancellation of the sales tax exemption for air traffic within Germany and in other EU states.

Even the Act on Further Development of Ecological Tax Reform now adopted by the Bundestag provides for the abolition of tax benefits that are no longer justifiable. This consists in particular of the following measures:

- The reduced ecological tax rates for the production industry and both agricultural forestry in relation to electricity, fuel oil and natural gas will be increased from 20 % to 60 % of the standard ecological tax rates; further, the compensatory transfer will be switched over.
- The reduced electricity tax rate for night storage heaters will be increased from 50 % to 60 % of the standard electricity taxation rate and the tax break terminated on 31st December 2006.
- The standard rate of mineral oil tax for natural gas, liquid gas and heavy fuel oil used for heating will be increased. This will not affect the use in efficient power-heat-coupling

installations or the use of mineral oil for electricity generation (e.g. in gas or steam turbine installations).

- The use of 150 billion € towards an additional programme to make old buildings more energy-efficient and 10 billion € for a conversion programme for night storage heaters, both sums to come from expenditure on further development of ecological tax reform.

In addition, the tax system in Germany is being further developed in ecological terms.

Another central reform project during this legislative period consists in the reorganisation of income tax treatment of old age pension expenditure and old age benefits. Reorganisation was stated to be necessary by the Federal Constitutional Court in its decision of 6th March 2002 on the taxation of pensions. The federal government created a committee of experts to develop a comprehensive solution proposal, and this committee should present the results of its work at the start of 2003.

C. Making social welfare systems future-proof: Contribution of labour market reforms and social security system reforms

Besides the necessary consolidation efforts and the conversion of tax and levy arrangements, structural reforms in the areas of health and the labour market are another focus of the federal government's work. The coalition parties have reached an understanding on a comprehensive health reform in 2003 and created a committee to ensure sustainability in social security financing. The results expected in autumn 2003 are a major contribution to confronting the financial challenges resulting from the demographic trends. The proposals of the „Modern Services in the Labour Market“ Commission (the “Hartz proposals”), with which the unemployed can be assisted more rapidly and efficiently and new employment opportunities located, have already been enacted in legislation in many important respects and have been passed by the Bundestag.

The proposals of the "Modern Services in the Labour Market“ Commission presented in August 2002 are being implemented by the federal government in several stages. Thus, a far-reaching reform of labour market policy is being instituted, operating on three levels.

Firstly, it is necessary to improve the process of job location. This should include:

- setting up comprehensive JobCenter coverage,
- simplification of employment termination law, improvement of advice and a duty to provide early notification on termination,
- extension of childcare opportunities,
- reversal of the burden of proof for the unemployed and the creation of more flexible sanction methods,
- promotion of training and employment for young people and reorganisation of the system of further vocational training,
- encouragement of employment for older persons using a range of new measures, e.g. with time-limited remuneration security (half of remuneration loss in the context of a new employment contract, as opposed to an employment contract pre-existing the period of unemployment, will be borne by the Federal Labour Office) and the release of employers from unemployment insurance contributions in relation to the employment termination of older employers.

Secondly, it is necessary to create customer-friendly, efficient structures in labour market policy, using measures such as

- simplification of job promotion instruments and strengthening of competition,
- fusion of supplementary unemployment benefits and social security welfare, and

- more effective organisation of task processing and controlling at the Federal Labour Office,

and last but not least, the location of additional areas of employment, using measures such as

- creation of „Personal Service Agencies“ in each Labour Office district. These would be entrusted with temporarily placing unemployed persons, so as to enable them to enter permanent employment,
- encouragement of employment in private households,
- introduction of the “Me Inc./Family Inc.” as a new form of self-employment,
- use and development of regional potential in eastern Germany,
- and the introduction of the "capital for work" programme as an the innovative financing instrument for companies.

In the coming year, a structural healthcare reform will be instituted, which aims principally at increasing the quality and economic efficiency of medical services. This includes modernisation of service structures as well as the fee system for employed physicians, liberalisation of the medicinal drugs market, introduction of a patient receipt and voluntary electronic patient card; as well as new initiatives to ensure quality of medical services, increase patient rights and patient safety and, finally, prevention.

In the first step, the federal government will use an enabling act to ensure that sufficient room is made for the major structural reforms and that health insurance contributions remain as stable as possible.

The 2001 pensions reform programme did much to set the course for adaptation of old age insurance to demographic trends. On the one hand, statutory pension insurance with shared financing was adapted to the requirements of an ageing society (modified pension adaptation). On the other, - and this is the fundamental new reform element - support has been provided for the voluntary creation of a supplementary, capital-driven old age pension arrangement, by means of a significant tax incentive, starting this year. At the same time, company pension arrangements have been fundamentally modernised.

From the standpoint of the present, the 2001 pensions reform programme has created some key features for an old age pension system that is sustainable in the long-term; and such a system should also pay due consideration to the objectives of ensuring fairness between the generations, stabilisation of old age security and restriction of incidental wage costs and fiscal burdens.

Nevertheless, the difficult macroeconomic development and the tense situation on the labour market has meant that the actual development of the parameters underlying pensions reform has deviated considerably from these objectives in the meantime. Thus, contribution revenue for pension insurance has increased much more weakly than had been assumed just six months ago.

In order to avoid an increase in the contribution rate from 19.1 % to 19.9 %, which would have been irresponsible from the point of view of the labour market, a Contribution Rate Stabilisation Act has been prepared that will restrict the pensions insurance contribution for the year 2003 to 19.5 %. In this context, no recourse should be had, among other things, to replenishing the contingency reserve depleted during the economic development in 2002. At the same time, the contribution assessment threshold should be raised (from 4,500 € to 5,100 € in the west, from 3,750 € to 4,250 € in the east).

As far as the future is concerned, the objective should be to pursue the road already taken in extending capital-driven supplementary systems; and also to continue to ensure that expenditure in the area of statutory pensions insurance is linked more strongly to revenue.

Against a background of demographic trends, fundamental change in individual employment patterns and income distribution, pensions, health and personal income maintenance insurance will be facing severe problems in the future. In order to render social security arrangements future-proof, the federal government has decided to instruct a committee for the sustainability of financing of social security arrangements to devise proposals for the sustained further development of social security. This committee should present its findings in autumn 2003.

D. Further structural reforms to reinforce momentum of growth

A dynamic general development of the economy is leading to higher government revenues and at the same time provides relief to the expenditure side of the government budget, especially via reductions in income support payments. Thus, improving the conditions for economic growth is critically important, not just for combating unemployment, but also for ensuring the long-term sustainability of fiscal policy. The key to greater growth and employment lies in a convergence between a growth and stability-orientated general economic policy and a comprehensive programme of structural reforms. The federal government is thus continuing its modernisation and reform process, not just in relation to the labour market reforms described above and in the area of social security arrangements, but also in relation to the products and services markets:

- 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 innovations. The federal government therefore intends to press ahead consistently with this policy approach, while simultaneously taking

consumers' interests into account. The regulatory framework for telecommunications is being refined with the aim of ensuring structurally secure competition under market conditions in the telecommunications sector.

Germany is making intensive efforts to open up the national German post monopoly on a Europe-wide scale at the earliest possible date. In order to prevent distorted competition between European mail companies, a purely national approach has, however, been rejected. The European-level compromise on future liberalisation steps aimed at in the Postal Services Directive of 7th May 2002 was implemented into German law by amendment of the German Post Act of 16th August 2002. This statute provides that the weight and price threshold of the monopoly area should be reduced into stages: from 200 g to 100 g on 1st January 2003, and the triple standard tariff, and to 50 g on 1st January 2006 and the 2.5 times standard tariff. It also provides that outgoing, cross-border letter services should be removed early from the monopoly area.

The German electricity and gas markets have been fully liberalised. In this context the federal government is striving to ensure that simplified network access on non-discriminatory and transparent conditions is made possible for private electricity consumers also 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 objective here must be the realisation of complete liberalisation of the energy markets, in accordance with the political consensus in the Council.

- Modernisation of financial and capital markets: A functioning and efficient financial market is of critical importance to the international competitiveness of Germany as a business location. It serves as the basis for the optimum supply of capital to German business and, therefore, also serves to secure growth and employment. The efficiency of our financial market depends to considerable extent on the trust that private and institutional investors have in the integrity, stability and transparency of the market. Targeted promotion of Germany as a financial venue is therefore a central objective of the federal government: In 2002, the Fourth Financial Market Promotion Act in particular considerably expanded the commercial opportunities for market participants and stock exchanges; while at the same time, the Federal Institute for Financial Services Monitoring (BAFin) created an integrated financial monitoring regime, which will make a major contribution to ensuring the stability of the German financial market. Taking due account of the turbulence experienced in the share markets and the balance sheet scandals of recent months, the Federal government will use its 2002 - 2006 financial market promotion plan to further increase investor protection, adjust regulatory conditions and ensure for financing conditions for small and medium-sized enterprises.

A more detailed presentation of the federal government's structural reforms in these areas, as well as in relation to the improvement of conditions for entrepreneurial endeavour, reduction in bureaucracy, development of service industry, strengthening of competition, transition to the knowledge society as well as market-driven instruments of environmental protection can be found in the National Structural Reform Report produced under the auspices of the Cardiff process and published in November 2002.

Annex

Development of public finances⁹

(National Accounts definitions)

	ESA Code	2001	2002	2003	2004	2005	2006
in % of GDP							
Balancing items (B.9) of levels of government							
General government	S.13	-2.8	-3 ¾	-2 ¾	-1 ½	-1	0
Central government	S.1311	-1.4	-1 ¾	-1 ¼	-½	-½	0
State government	S.1312	-1.3	-1 ¾	-1 ½	-½	-½	0
Local government	S.1313	+0.0					
Social security funds	S.1314	-0.1	-¼	-0	0	0	0
General government expenditure (in accordance with the definition in Reg. Intermediate consumption)							
Advance payments Social benefits in kind Compensation of employees ¹⁰	P.2 D.63 D.1	19.5	19 ½	19	18 ½	18	18
Social benefits (other than in kind)	D.62	18.9	19 ½	19	18 ½	18	17 ½
Capital transfers (interest expenditure)	D.4	3.3	3	3	3	3	3
Subsidies	D.3	1.6	1 ½	1 ½	1 ½	1 ½	1 ½
Gross capital formation	P.5	1.7	1 ½	1 ½	1 ½	1 ½	1 ½
Other expenditure		3.3	3 ½	3 ½	3 ½	3 ½	3
Total expenditure		48.3	48 ½	48	46 ½	45 ½	44 ½
General government revenue (in accordance with the definition in Reg. 1500/2000)							
Taxes	D.2 D.5	23.0	22 ½	23	23 ½	23	23 ½
Social contributions	D.61	18.5	18 ½	18 ½	18	18	17 ½
Other revenue		4.0	4	3 ½	3 ½	3 ½	3 ½
Total revenue		45.5	45	45	45 ½	44 ½	44 ½
Financial development of general government							
Total expenditure		48.3	48 ½	48	46 ½	45 ½	44 ½
Total revenue		45.5	45	45	45 ½	44 ½	44 ½
Net lending/borrowing	B.9	-2.8	-3 ¾	-2 ¾	-1 ½	-1	0
Interest expenditure	D.4	3.3	3	3	3	3	3
Primary balance		0.5	-½	½	2	2	3

⁹ Discrepancies in the totals are the result of rounding.

¹⁰ Including other taxes on production (D.29).

Development of government debt

(Maastricht definition)

	ESA Code	2001	2002	2003	2004	2005	2006
in % of GDP							
Government debt		59.5	61	61 ½	60 ½	59 ½	57 ½
Primary balance		0.5	-½	½	2	2	3
Interest expenditure		3.3	3	3	3	3	3
Change in nominal GDP	B.1.g	2.0	2	3 ½	3 ½	3 ½	3 ½

Comparison of projections

and the December 2001 stability programme
and the December 2002 stability programme

	ESA Code	2001	2002	2003	2004	2005	2006
Change in nominal GDP in %							
Stability programme 2002	B.1.g	2.0	2	3 ½	3 ½	3 ½	3 ½
Stability programme 2001	B.1.g	2	3	4 ¼	4 ¼	4 ¼	-
Difference			- 1	- ¾	- ¾	- ¾	-
Balancing item in % of GDP							
Stability programme 2002	B.9	-2.8	-3 ¾	-2 ¾	-1 ½	-1	0
Stability programme 2001	B.9	-2 ½	-2	-1	0	0	-
Difference			-1 ¾	-1 ¾	-1 ½	-1	-
Government debt in % of GDP							
Stability programme 2002		59.5	61	61 ½	60 ½	59 ½	57 ½
Stability programme 2001		60	60	59	57	55 ½	-
Difference			1	2 ½	3 ½	4	-