German
Stability Programme

December 2003 update

Tables:

Annex:

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 introduced the euro 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 3 December 2003. The responsible committees of both houses of the German parliament will be briefed directly.

In format and content the programme conforms to the guidelines drawn up by the ECOFIN Council in October 1998 and most recently supplemented by the code of conduct on the format and content of stability and convergence programmes of 27 June 2001.

The updated stability programme is based on the data available as at 6 November 2003.

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

1. Summary

- The German economy has been in stagnation for almost three years now with perceptible effects on public budgets. This year's update of the German stability programme is marked by substantial tax revenue shortfalls and cyclically-induced charges on the expenditure side.

- This economic environment places extremely tight restrictions on the scope for fiscal policy action. Special factors such as the continuous support in favour of economic development in the new Länder, Germany's considerable net contributions to the EU budget and the large and mounting payments in discharge of international obligations continue to exert growing pressure on public budgets.

- By far the greatest part of the deficit increase in 2003 as against the assumptions made in the last stability programme is to be ascribed to the unexpectedly weak aggregate economic development.

- The German government revised its fiscal policy targets in 2003 in response to almost three years of persistent stagnation. The objective of attaining balanced federal and general government budgets as soon as possible is, as before, a central guideline of fiscal policy in this respect. In the present cyclical environment, however, a consolidation strategy must be backed up by action to strengthen the forces for growth if it is to be sustainable. Hence the German government's consolidation course is being underpinned on the one hand by an extensive package of structural reforms and on the other hand by fiscal policy action to stimulate economic activity out of its present weakness.

- The combined action of this package of reforms and the recovery of economic growth will bring the deficit down again as from 2004, although at - 3 ½ % of GDP the general government deficit is still expected to exceed the EC Treaty reference figure in the coming year. It would be economically counterproductive to adopt additional austerity measures curbing economic activity in 2004 going beyond the already substantial volume of consolidation incorporated in the reform package. In the present situation, this would tend to generate insecurity among consumers and investors and retard economic recovery not only in Germany but in the euro area as a whole. In 2005 the general government deficit is expected to decline to - 2 ½ % of GDP, thus putting it once again well below the reference value.

- The consolidation line and the envisaged reduction of the general government deficit are based on a medium-term growth scenario adapted to take account of changes in underlying conditions. The government's autumn projection puts real economic growth at 1 ½ to 2 % on average for 2004. This range reflects the prospects of and risks to economic growth in the coming year. Annual real growth of 2 ¼ % is expected for the period from 2005 to 2007, based on an estimated increase of 1 ½ to 2 % in production potential.

- It is essential for the necessary structural reforms to be resolutely put into effect to create the scope for fiscal policy action on key future-oriented tasks. The German government is proceeding on the course of structural renewal and modernisation of the labour and the social security systems in its "Agenda 2010". With the help of comprehensive reforms in the social security systems and the labour and product markets, the aim is to reinvigorate the German economy and boost growth potential, create new jobs and bring down unemployment.

- With this ambitious reform programme the German government is discharging the obligations undertaken in connection with the conclusions of the ECOFIN Council of 25 November 2003.

2. Macroeconomic situation and outlook up to 2007

2.1 Global economic environment

The global economy is on course for recovery: in the U.S.A. in particular there are increasing signs of a vigorous upturn in economic activity which may be expected to lend strong momentum to the development of the global economy. Marked monetary and fiscal stimuli in the U.S.A., low inflation rates, revival of flagging investor and consumer confidence with the end of the Iraq conflict and the recovery on stock markets have established a sound basis for strengthening global expansionary forces. Global economic growth in the coming year is likely to be more pronounced for the year as a whole than was generally expected only six months ago, at the time of the German government's spring projection. International organisations, too, have slightly upgraded their expectations of global economic growth in 2004.

Asian countries may be expected to continue on their path of vigorous economic development. The Chinese economy in particular is clearly on an expansionary course, and the economic upturn in Japan is also expected to continue. The forces for growth in the economies in transition in eastern and central Europe may be expected to remain strong.

In the current year the effect of global economic deceleration was clearly perceptible in the European Union. Indications of recovery were apparent in the second half of the year, though the general effect of this is likely to be weaker than had been expected up to mid-year. With global economic recovery becoming ever more apparent, the upward trend in economic activity in the European Union as a whole is likely to continue and intensify in the coming year.

2.2 Assumptions underlying the growth estimate for 2004

Growth estimates for the short-term projection through 2004 are based on the following assumptions:

- Global economic activity will be perceptibly revitalised in the period covered by the projection. Global GDP is expected to grow by an aggregate of some 4 % in 2004, after increasing by an estimated + 3 ¼ % in the current year and by + 3 % in 2002.

- World trade will expand considerably more strongly next year than in the current year. The volume of world trade is expected to increase in 2004 by some 5 ½ %, after 3 % in each of the preceding years.

- Germany will see a gradual return of consumer and investor confidence in the period covered by the projection– principally though not exclusively on account of diminishing geopolitical uncertainties and risks.

- Wages policy will continue to be geared to stability. The rise in gross wages and salaries per person employed is likely to be just under 2 % in 2003 and 2004. The effective increase in wages will be curbed by cyclical factors and reductions in special payments to employees (e.g. Christmas and holiday bonuses). Thus earnings will remain below the productivity trend of 1 ½ % plus the ECB inflation target of less than but close to 2 %.

- Unit labour costs will rise moderately in this year by around ½ % and will register little or no change next year.

- Consumer prices are likely to rise in Germany by about 1 ½ % in 2004 (2003: around 1 %) and would thus undercut the ECB inflation target. Neither the cost nor the demand side of the domestic economy will give rise to inflationary risks. Among external factors, the strong price-curbing effect of the rising external value of the euro will be perceptible; the US dollar/euro exchange rate relationship is expected to stand at around $1.15/€ (2003: $1.12/€). It is assumed that oil prices will be at the upper edge of the OPEC target range of $22-28 per barrel over the whole period covered by the projection.

2.3 Macroeconomic development in Germany in 2003 and outlook for 2004

An upturn in economic activity was generally expected for 2003 but had failed to materialise by the middle of the year. This was principally attributable to the Iraq conflict which in the first instance served to increase uncertainty among investors and consumers, thus appreciably curbing economic activity both in Germany and world wide. Economic performance in Germany in the first half of 2003 consequently registered little or no change. The gross domestic product (GDP) declined slightly in this period (by - 0.2 % in both the first and the second quarter, adjusted for workday, seasonal and price variations).

Current indicators are now showing increasing prospects of improvement. Business confidence indicators have already been registering a clearly upward trend for several months, and “hard” indicators are now also showing initial signs of recovery, with exports in particular displaying a perceptibly rising tendency. Hence there are good prospects of an upturn in economic activity for the second half of 2003. In the third quarter, the gross domestic product already registered a rise of 0.2 % on the preceding quarter after workday, seasonal and price adjustment. On account of the preceding cyclical weakness, however, the gross domestic product is likely on average to show only little or no change for 2003. A marked recovery is to be expected only in the coming year. The underlying conditions for this are favourable. The generally expected upturn in global economic activity, low short and long-term nominal interest rates, stable prices, improved sales and earnings prospects and stable unit labour costs are factors indicating that the recovery of economic activity in Germany is set to continue and to gather pace. Added to this is a positive working-day effect estimated at a good one half of a percentage point of the gross domestic product.

The government's autumn projection puts real economic growth at 1 ½ to 2 % on average for 2004. This range reflects the prospects of and risks to economic growth in the coming year.

Recovery is expected to assume the pattern typical for Germany over the period covered by the projection: the initial stimuli are provided by foreign trade and feed through gradually to the domestic economy. To aid this, fiscal policy is supporting the development of the domestic economy by bringing forward the third stage of the tax reform. A decisive requirement will be for investors and consumers to relinquish their wait-and-see stance. The fiscal and economic policy measures adopted by the government will play an important part in achieving this.

In terms of foreign trade the conditions for economic recovery are favourable. Positive signs in the U.S.A. are increasing, and many experts now expect to see the economy gain appreciable momentum. This would stimulate the upturn in economic activity in Germany both directly through trade links and indirectly through capital ties (investment in Germany by internationally associated enterprises). German exports are expected to register an appreciable rise – among others, not least because of the regional and sectoral structure of exporting industries (predominance of capital goods). Although the scope for German exporters to compete on price is under pressure from the appreciation of the euro, both exports and foreign orders have most recently once more been registering an upward trend. Investment in Germany will benefit in particular from the expansion of foreign demand, as the goods-producing industry which is highly dependent on exports accounts for a large share of plant and equipment expenditure. In contrast, the weakness in construction activity is likely to persist – with the exception of temporary special factors (making good flood damage and positive effects from the announcement of the decision to abolish the owner-occupied homes premium for new claimants) – , though somewhat less marked than in previous years. Private consumption is likely to register a more pronounced increase in

2004 once consumers have lost their present state of hesitancy. Employment incomes will probably remain under pressure from unfavourable employment trends until well into next year. Economic recovery in Germany is likely to remain free from inflationary pressure. Neither on the cost nor on the demand side are there any signs in the domestic economy of factors exerting upward pressure on prices: unit labour costs will show little or no change next year, and the development of demand is to be regarded as moderate despite the expected recovery. On balance, too, external factors (oil prices, euro appreciation) will ease pressure on price movements over the whole period covered by the projection.

The situation in the labour market will initially continue to give rise to problems despite the positive effects already realised from the reorientation of labour market policy. Employment will be able to benefit from the improvement in economic activity only in the course of 2004. For one thing, there is still a heavy burden from the current year to be coped with, and for another the labour market's response to the expected economic recovery is subject to a time-lag. Accordingly, the government's autumn projection still assumes a slight decline in the number of employed persons (-50,000) on average for 2004 – despite increasing employment in the course of the year. But the effects of the new labour market policy are already clearly to be seen in unemployment trends. The number of persons out of work is set to decline slightly next year on average by 30,000.

There is a broad balance between opportunities and risks in the German government's autumn projection. Given the indications of a favourable global economic environment, growth of up to 2 % in real terms is possible provided that the necessary reform measures which the government envisages are put into effect. On the other hand, if domestic and external conditions turn out less favourable next year, economic growth could be lower. On the domestic side, this would be the case especially if the government's envisaged reforms were to be delayed or substantially modified. There are of course external risks as well. Although the most recent economic data from the U.S.A. are increasingly favourable, there are quite considerable risks in the high current account and general government deficits which could undermine the sustainability of the upward trend in the U.S.A. Yet again, developments may turn out to be even more positive, especially if the global economy expands more rapidly and more strongly than expected.

2.4 Medium-term growth prospects[1]

In the medium term, too, the growth prospects for Germany are favourable. The evaluation of trends and supply-side considerations are afforded first priority in the assessments of medium-term economic development up to 2007. Whilst cyclical factors are taken into account in the initial situation, these tend to take on a smaller role in the projection.

The average annual increase in the gross domestic product in Germany since 1991 stands at only just under 1 ½ % . This growth rate reflects a range of special factors, in particular economic adjustment in consequence of German reunification and the recent weakness of global growth. If a higher growth rate is to be achieved in the medium term it is essential to press ahead with economic renewal in both eastern and western Germany and to create fresh scope for expansion. The lasting improvement in underlying economic conditions is expected to provide positive impetus for the economy as a whole. The medium-term growth process will be supported by stepping up investment in human and physical capital, extending public infrastructure, speeding up technological progress, by the impact of labour market reforms and by further structural reforms going beyond those embodied in the Agenda 2010.

The opportunities to promote growth and employment in development up to 2007 are also seen in the interaction of a macroeconomic policy-mix geared to growth and stability and incorporating far-reaching reforms in all markets.

Positive effects on growth are to be expected in particular from

- implementing the strategy adopted in Lisbon to increase employment and to continue with structural reforms in product, capital and labour markets;
- progressive integration of the single market and from EU enlargement;
- increased efforts to promote education, research and science and to advance future-oriented technologies;
- tax reform;

[1] The government regularly undertakes medium-term estimates of aggregate economic development in the spring of each year. A formal adjustment is made for the stability programme in December, taking account of revised data in National Accounts for the ex post period and revised estimates for the short-term projection period for the current and the following year. In this year's adjustment the assumptions on economic development in the periods for which estimates are not based on cyclical factors ("residual" years) remained unchanged. In some instances this means that the annual average rates of change for the entire period covered by the medium-term estimate deviate from the results projected at the regular medium-term spring estimate.

- proactive labour market and training policies and greater labour market flexibility;
- continuing reforms in the social insurance sector (pensions, healthcare);
- reform of local authority finances to bring about a lasting increase in the financial resources and investment potential available to local authorities.

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

- There will be a global economic upturn in the course of the year. As flagging growth in key industrial economies is overcome, the global economy will expand at rates approaching those of past years; as from 2004, the volume of world trade will return to the medium-term expansionary path (5 - 6 % p.a.).
- There will be no serious turbulence in foreign exchange and financial markets;
- The real external value of the euro will remain largely stable in the medium term.
- The ECB will secure its price target at favourable interest rate levels.
- There will be no constraints in the supply of energy and other resources; the crude oil price will remain largely stable.

Subject to the conditions and assumptions described above, the following benchmark figures result for the projection of macroeconomic development from 2002 to 2007:

- Growth of the gross domestic product by 1 ¾ % p.a. in real terms;
- Rise of 1 % p.a. in the aggregate price level;
- Slight increase in the number of (gainfully) employed persons with a more marked rise in employment in the further course of the projection period.

Table 1: Projection of aggregate economic development for the years 2002 to 2007

	ESA Code	2002	2003	2004	2007/02
GDP at constant prices; annual change in %	B1g	0.2	0	1 ½ - 2	1 ¾
GDP at current market prices; annual change in %	B1g	1.8	1	2 ½	2 ¾
GDP deflator		1.6	1	1	1
Employed persons		- 0.6	- 1 ½	- 0	¼
Labour productivity[1]		0.8	1 ½	2	1 ½
Use of GDP: change on the year at constant prices					
1. Private consumption spending[2]	P3	-1.0	½	1 ½	1 ½
2. Government final consumption	P3	1.7	½	- ½	½
3. Gross fixed capital formation	P51	- 6.7	- 1	2	2
4. Changes in inventories (GDP growth contribution)[3]	P52 + P53	0.1	0	0	0
5. Exports	P6	3.4	1	5	4 ½
6. Imports	P7	- 1.7	2 ½	5	4 ½
GDP growth contribution[3]					
7. Domestic demand (excl. inventories)		- 1.7	½	1 ½	1 ½
8. Changes in inventories	P52 + P53	0.1	0	0	0
9. External balance of goods and services	B11	1.7	- ½	0	¼

(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. 2002: Provisional result of the Federal Statistical Office of August 2003; 2003 and 2004: Results of the Interdepartmental Macroeconomic Forecasting Group of October 2003; 2007: Medium-term projection April 2003, projection reviewed end-October 2003.

As before, the strongest impetus is expected to be provided by exports. The vigorous expansion of world trade and German sales markets could lead to an increase in exports of around 4 ½ % a year in real terms. The foreign balance at constant and current prices would improve appreciably and would contribute to the growth of the economy given an increase in exports of around 4 ½ % a year in real terms. Besides this, corporate investment in plant and equipment at around + 4 % a year will be a key factor in supporting growth, whereas construction is likely to show little or no change and will be able to make a positive contribution to growth only in the further course of the projection period, as the process of structural adjustment is still under way. Private consumption is likely to develop roughly in parallel to the gross domestic product at 1 ½ % a year. The rate of increase of government final consumption is likely to be considerably weaker at around ½ % a year on account of consolidation.

The government expects productive capacity in Germany to continue to increase. However, the recently observed growth weakness may have a retarding effect on the potential production of the national economy, for instance because capital stock expansion is no longer as marked or because workforce qualifications suffer under persistent unemployment. Hence the estimate of productive capacity on which last year's stability programme was based is somewhat uncertain and in this and the coming year may tend towards the lower edge of the range of 1 ½ to 2 % cited at that time. Aggregate productive capacity is likely to register a more marked expansion again only in the course of a lasting recovery – and in response to the reforms initiated by the government. These leave sufficient scope for the development of the gross domestic product assumed in the projection, so that the aggregate output gap can be gradually and smoothly bridged. It should be noted, however, that estimates of productive capacity and especially of the output gap are prone to major uncertainties.

Price movements are likely to remain very subdued at all levels during the whole period covered by the projection. Pressures tending to accelerate upward price movements are foreseeable neither on the supply nor on the demand side. Wage trends are likely to remain moderate. Gross wages and salaries per employed person (effective wages) will probably rise by 2 % a year, which would be below the productivity trend (+ 1 ½ % a year) making allowance for the inflation target of less than but close to 2 % a year. In these circumstances an aggregate annual inflation rate of some 1 % may be expected; GDP at current prices would increase on average by 2 ¾ % a year.

The supply of labour is expected to continue to rise in the coming five years. The foreseeable decline in the number of persons of employable age will be more than offset by growing labour force participation particularly of women. But however desirable they may be in view of demographic change, another outcome of such shifts in behaviour is that the number of persons registered as unemployed is likely to decrease over time at a lesser rate than the rise in employment. Given the assumed development of productivity, which is geared to the longer-term trends observed in Germany, the rate of increase in employment may be expected to pick up only in the course of the medium-term projection period. A further contributory factor is that rapid, comprehensive implementation of labour market reforms will lend additional impetus to employment growth. On average over the entire period covered by the 2007/2002 projection, however, overall employment will register only a slight increase, as before and at the start of the projection period the pressure on the labour market from the phase of marked cyclical weakness will continue to exert a perceptible impact well into the year 2004.

3. Budgetary developments

3.1 Trends in the budget balances

General government deficit 2003: A reflection of underlying economic conditions

The weakness of aggregate economic activity for the third year in succession has again been reflected in an appreciable deterioration of financial benchmark figures in public budgets. Constraints imposed on budget execution have fallen well short of compensating for massive losses on the revenue side and necessary additional spending in the labour market. Financial statistics put the year-end balancing items of political subdivisions at just under € -80 bn as compared with € -57 bn in the previous year. If National Accounts (ESA) definitions are applied and the finances of the social insurance funds are included, a balancing item of the order of € -85 to € -90 bn is indicated. The general government deficit thus increases in the current year to -4 % of the gross domestic product after -3,5 % of GDP in 2002. Hence Germany's deficit exceeds the Maastricht reference value in 2003 as well.

The stability programme of December 2002 cited a deficit range of € -57 to € -62 bn for 2003. The current projection therefore assumes a deficit greater by almost € 30 bn or roughly 1.3 percentage points of GDP than expected one year ago. A comparison of the two projections shows that for 2003 not only the assumption for the rise in GDP in real terms had to be downscaled (from 1 ½ % to 0 %) but that the GDP deflator (from 1 ½ % to 1 %) is also below the assumption then made. Thus the rise in nominal GDP stands only at a good 1 % in contrast to the plus of 3 ½ % calculated last December. In absolute terms this less favourable estimate implies a nominal GDP for 2003 reduced by almost € 50 bn. A difference of somewhat more than one percentage point of GDP in calculating the general government deficit for 2003 may be explained by the deficit's generally assumed GDP elasticity of 0.5. By far the greatest part of the deficit increase on the assumptions made in the previous stability programme may therefore be ascribed to the weak development of nominal GDP; that is, to macroeconomic effects.

In the notification in late February 2003 the German government did not adjust the target figure for the general government deficit for 2003 despite growth expectations having been downscaled from 1 ½ % to 1 % in the 2003 Annual Economic Report. The deficit target figure of -2 ¾ % of GDP was retained principally because additional measures such as the Law to reduce tax concessions and the "bridge towards tax honesty" were included in the draft federal budget and thus also in the projection of the general government deficit. Comparing the assumptions on the development of revenue and expenditure in the 2002 stability programme with the current forecast not only confirms the dependence of the deficit trend on underlying macroeconomic conditions but also enables crucial conclusions to be drawn as to further causes:

- According to the expectations in December 2002, general government expenditure was to increase by 2 % in 2003. From the current standpoint this increase will in fact be just under 2 ½ %. This implies spending of about € 5 bn in excess of the assumption made at that time. It should be noted in this respect that additional spending of € 12 bn on the labour market alone had to be appropriated in the supplement to the federal budget for 2003. Underspends of significant magnitude were thus realised in other categories in the public budgets.[2]
- Revenue from social contributions is lower than projected in the 2002 stability programme. Instead of the expected increase of 3 ½ % this revenue is likely to rise by only 2 ½ %. Yet this shortfall is comparatively moderate in view of the substantial adjustments to the aggregate economic benchmark data. This is the effect of contribution rate increases in health and pensions insurance.[3]
- By far the largest part of the deviations in the general government deficit is attributable to tax revenue shortfalls. Instead of the expected rise of 5 ½ %, tax revenue will register a plus of only about ½ %. For the federal budget alone, the 2003 supplement had to make allowance for revenue shortfalls of € 12 ½ bn, and added to this are the shortfalls in the Länder and local authorities. Over one percentage point of the deficit deviation in 2003 is attributable to this "gap" in tax revenue.[4] But the tax shortfalls cannot be computed in full solely with reference to the lower than expected rise in nominal GDP. It is also to be noted, for instance, that weak development of value-added tax cannot be deduced to the full extent from trends in the relevant economic aggregates. Negative cross-period effects can also result in the change in tax revenue falling short of the volume to be expected when usual elasticities are applied.

---

[2] This may probably be ascribed firstly to an expenditure policy in the political subdivisions that was even tighter than the assumptions – in themselves restrictive. One example of this is the recourse to the clause providing for specific exceptions in public service pay. Secondly, technical aspects must be taken into account. Thus the resources from the flood damage repair fund have not been fully disbursed in the current year. Moreover, payments for the old-age provision grant, which turned out lower than expected, are posted to the revenue side in public budgets but relate to the expenditure side in National Accounts.

[3] The adjustments to the contribution rates in health and pensions insurance were taken into account by the European Commission as measures affecting the deficit against the background of the Council Recommendations of 21 January 2003.

[4] The deviations from the figures of November 2002 calculated in the tax revenue estimates of May and November 2003 total € 18 ½ bn, or just under one per cent of GDP. Added to this are effects evident only in tax revenue in the National Accounts definition on account of differing calculation methods. This includes for instance the posting of grants or the assignment of specific types of tax to the relevant period.

It is evident from these conclusions that exclusively cyclical revenue and expenditure categories may be identified as causes of the unfavourable deficit trend. Tax revenue and labour market spending are among the budget categories which are not susceptible at short notice to the direct influence of fiscal policy. Moreover, the measures contained in the 2002 stability programme or newly incorporated in the projection at the start of the year also affected the tax and labour market areas. It cannot be reliably determined after the event to what extent these measures had the envisaged fiscal impact. The effects of individual measures cannot as a rule be filtered out of the cash results because they are obscured by cyclical effects or by the outcome of other discretionary action. But it is evident that the effect of the measures was impeded or impaired by the difficult macroeconomic environment so that the expected fiscal outcome could not be achieved.

Projection for 2004 to 2007: Deficit reduction in conjunction with reform measures and revitalisation of the aggregate economy

Germany's fiscal policy is directed towards bringing down the general government deficit to below the reference value of 3 % of GDP as soon as possible. In view of the general state of the economy, however, there are limits to the severity of the consolidation course to be adopted – excessively restrictive fiscal policy would impede or weaken the emerging economic recovery. The German government makes allowance for these requirements in its package of measures.

The projection takes account of

- the Budget Support Law 2004[5], which in addition to bringing forward the third stage of the income tax reform from 2005 to 2004 makes provision among others to limit the mileage allowance for commuters, abolish the owner-occupied homes premium for new claimants, realise savings on special public-service payments and introduce further tax measures;
- further measures not contained in the Budget Support Law[6] such as the Law to promote taxpayer compliance, measures to stabilise corporation tax revenue, action to counter illicit employment and tax evasion as well as the reduction of subsidies (among others on the basis of the proposals put forward by Premiers Koch and Steinbrück). Action is also to be taken to ensure that proposals by the "Hartz Commission" continue to be implemented and that general savings continue to be made in budget execution;

[5] The text of the Budget Support Law including a survey of the envisaged fiscal effects is to be found at http://www.bundesfinanzministerium.de/Anlage19878/Entwurf-eines-Haushaltsbegleitgesetzes-2004.pdf

[6] Current draft laws are to be found at http://www.bundesfinanzministerium.de/Steuern-und-Zoelle/Aktuelle-Gesetze-.448.htm

- the measures embodied in the "Agenda 2010", including the combination of supplementary unemployment and welfare benefits, reform of local authority finances, measures in the healthcare and pensions insurance sectors and the amendment of the Tobacco Duty Law;
- further planned tax measures (including the Tax Amendment Law 2003).

The projection is based on the data available at the conclusion of the tax revenue estimation on 6 November 2003. Central elements of the package are currently being deliberated in the political arena. The projection takes account of this package of reform measures and the fiscal effects envisaged by the government. The measures initiated by the government for 2004, including bringing forward the 2005 stage of the tax reform by one year, afford relief to public budgets in the amount of one half of a percentage point of GDP. The relief effect could be expected to amount to a good one percentage point of GDP if the tax rate reductions were not brought forward. From 2005 to 2007 the envisaged volume of relief will increase to around 1 ½ percentage points of GDP. These figures show clearly that the benchmark data in the projection are dominated by the measures now set in train. The implementation of the government's reform package will be a central element in determining the development of public finances in Germany in the coming few years.

Irrespective of the effects of the reform package, the projection assumes a restrictive expenditure line for public budgets at all levels of government in the coming years as well. As against the spring estimate, the tax revenue estimation of November 2003 projects tax revenue shortfalls of more than € 10 bn in 2004 for the political subdivisions. In view of European prescriptions and the limits to net borrowing set by the German constitution there is no alternative for the political subdivisions other than the constant review of appropriations on the expenditure side. One example of this is the recourse to the clause providing for specific exceptions in public service pay, on the basis of which reductions in some special payments have already been made in the current year. Adjustment across a broad front is envisaged for the coming year.

The assumptions made result in a general government deficit of -3 ½ % of GDP for 2004. Thus the reference figure of -3 % will be exceeded in the coming year as well. Reduction to or even below the reference figure of -3 % is not a realistic proposition in view of the deficit of -4 % of GDP registered in 2003. Fully implementing the government's reform package and leaving out of account the bringing forward of the 2005 stage of the tax reform to 2004 would, it is true, result in a general government deficit of slightly below 3 %. But this makes no allowance for the repercussions of even tighter fiscal policy on aggregate economic development. Stepping up the severity of consolidation would tend rather to hinder progress towards attaining the aim of bringing down the deficit ratio to below the reference figure.

Table 2: Development of the deficit ratio[1)]

	2002	2003	2004	2005	2006	2007
Deficit ratio	- in % of GDP -					
Projection November 2003[2)] *Memo item:* *Increase in real GDP in %*	**-3.5** *0.2*	**-4** *0*	**-3 ½** *1 ½ to 2*	**-2 ½** *2 ¼*	**-2** *2 ¼*	**-1 ½** *2 ¼*
Projection December 2002 *Memo item:* *Increase in real GDP in %*	-3 ¾ *½*	-2 ¾ *1 ½*	-1 ½ *2 ¼*	-1 *2 ¼*	0 *2 ¼*	- -

(1) Given the uncertainties in relation to any projection, deficits are rounded to one half of a percentage point of GDP.

(2) The draft of a Pensions Insurance Sustainability Law is still at too early a stage in procedure to be taken into account here. The draft provides for a "sustainability reserve" for pensions insurance to be set up as from 2005 in the event of the bill being adopted. Transfers to reserves have no effect on the (financial) net assets position of general government and are thus not deemed to constitute expenditure under National Accounts rules. Accordingly, a surplus would be realised in pensions insurance with effects on the general government deficit. Setting up the reserve could reduce the general government deficit by up to 0.4 percentage points of GDP each year from 2005 to 2007.

Not least on account of the federal government's reform package the draft federal budget for 2004 provides for an appreciable reduction in net borrowing. Proceeding from a figure of € 43.4 bn (2003 target plus budget supplement), net borrowing is to be brought down to less than € 30 bn. However, the government will use extra privatisation proceeds to bridge part of the gap caused by bringing forward the 2005 stage of the tax reform, so that the reduction in net borrowing will not exert its full impact on the general government deficit. The position of the federal government's special funds will worsen in the coming year as against 2003. This is attributable firstly to the payments from the Flood Relief Fund, which receives no further contributions and will disburse the resources still available through the Länder in the form of transfers or capital expenditure. Secondly, the surplus in the Redemption Fund for Inherited Liabilities will be set at a lower figure on account of a conservative assessment of the Bundesbank profits. The Länder and local authorities will also bring down their deficits in the coming year with the aid of spending restrictions across a broad front. It is assumed that the social insurance funds will still return a deficit in 2004, resulting essentially from the decision to reduce the pensions insurance contingency reserve to 0.2 monthly disbursements in order to stabilise the contribution rate for employment policy considerations.[7]

[7] Withdrawals from reserves have no effect on the (financial) net assets position of general government and are thus not deemed to constitute revenue under National Accounts rules.

Table 3: Deficits/surpluses by level of government

	2002	2003	2004	2005	2006	2007
	- in € bn -					
Federal Government including special funds	-34.2	-41 to -43	-37 to -39	-24 to -26	-19 to -21	-16 to -18
Länder and local authorities	-33.5	-39 to -41	-35 to -37	-29 to -31	-21 to -23	-16 to -18
Social insurance	-6.6	-5 to -6	-2 to -3	0 to -1	0 to -1	2 to 1
General government[1)]	-74.3	-85 to -90	-74 to -79	-53 to -58	-40 to -45	-30 to -35

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

On the current assessment, aggregate economic conditions for a further reduction of the general government deficit will again be more favourable from 2005 onwards. The average increase in GDP of 2 ¼ % a year in real terms – with a GDP deflator of around 1 % – will ensure that the trend in tax revenue takes a more positive turn. Moreover, many of the measures set in train by the government will take effect only in 2005 or will start to exert a greater impact only in that year. This is the case, for instance, with the reduction of subsidies such as the restriction of the mileage allowance for commuters, the abolition of the owner-occupied homes premium for new claimants and also with the healthcare reform. The combination of supplementary unemployment and welfare benefits will exert a significant fiscal effect in 2005. The social insurance funds may be expected to return a virtually balanced result if the envisaged creation of a sustainability reserve as from 2005 is left out of account.[8] Hence the general government deficit will again fall below the 3 % reference figure in 2005, and given the assumptions made here may be expected to stand at around -2 ½ % of GDP.

Tax and contribution revenue will continue to stabilise in 2006 and 2007 as the economic recovery gains pace. Relief will be derived at the same time from diminishing labour market spending. The envisaged volume from the package of measures will register a slight increase, among others as monies payable to former claimants of owner-occupied homes premiums cease to be disbursed. In both years the Federation as well as the Länder and local authorities will continue to reduce their deficits, though budget balance without incurring new debt will not be achieved in the final year of the period covered by the projection despite a slight surplus in the social insurance funds.

[8] See also the note on Table 2 on page 19.

3.2 Trends in government expenditure

Rise in general government spending ratio in 2003 despite consolidation efforts on the expenditure side

Notwithstanding some negative factors, the increase in general government spending in the current year at just under 2 ½ % is roughly in line with the figures in the preceding two years. General government spending rose by 2.3 %[9] in 2001 and by 2.2 % in 2002. On account of the exceptionally weak development of nominal GDP, which will increase this year only by a good 1 %, the government spending ratio will register a rise although spending levels are still moderate. The ratio of general government spending to GDP is likely to stand at 49 % in 2003 after 48.5 % in 2002.

A number of special factors must be taken into account in assessing the trend in expenditure:

- Previous stability programmes have already pointed to changes in the system of European Union funding.[10] A shift is apparent in the weighting of individual components from VAT-based own resources to GDP-based own resources. The change in the system tends to bring about an increase in the general government spending ratio, as in National Accounts only the GDP-based own resources count as general government spending whereas VAT-based own resources qualify as direct transfers from the sectors concerned to the EU. In the current year this effect accounts for over € 2 bn or a good tenth of a percentage point of GDP.
- Resources amounting to around two tenths of a percentage point of GDP were disbursed through the budgets of the Länder in the current year from the special fund to repair flood damage.
- Labour market spending to be funded from the federal budget is € 12 bn higher than the figure originally appropriated in the budget for 2003. This extra expenditure notches up the spending ratio by a good one half of a percentage point of GDP.

Expenditure growth would undercut the two-per-cent mark were it not for these special factors. Hence it is clear that fiscal policy in the current year was still set to achieve consolidation on the expenditure side.

This assessment applies at all levels of government. The political subdivisions return a plus of 2 % after adjustment to allow for grants to the social insurance funds. Expenditure by social in-

[9] The base for 2000 was adjusted to allow for the proceeds from the UMTS licence auction.
[10] See for instance December 2002 stability programme, page 25 f.

surance funds is expected to increase by around 2 ½ %. This would represent an appreciable check on the upward trend as compared with the two preceding years, when increases of 3.4 % (2001) and 3.6 % (2002) were registered.

Further federal government measures to curb expenditure growth

While the expenditure line in public budgets will remain basically restrictive in the coming years, this will be overlapped by the expected effects of the measures now set in train. In all, these measures have the potential to cut or to limit expenditure in an amount of up to one percentage point of GDP. In this context it should be noted that not all measures restricting expenditure are aimed at reducing the general government deficit. The measures affording relief to pensions insurance, for instance, are intended to hold the contribution rate constant at 19.5 %. To this extent the full savings volume of these measures is not reflected in the deficit.

Tight budget management in combination with the additional effects will exert marked restrictive pressure on expenditure in the coming year. The level of general government spending in absolute terms is not likely to change appreciably in comparison with 2003. A significant fall in the general government spending ratio to less than 48 % will result if the government's reform measures are implemented and backed up by the return to more vigorous growth of the nominal gross domestic product. The limitation of expenditure will have a particularly marked effect on the social insurance funds. For 2004, triggered by the reforms in health and pensions insurance, the projection shows a lower expenditure volume than in the current year.

Proceeding from this lower level, social insurance funds are likely to register higher expenditure growth again as from 2005. As a consequence, the plus in general government spending will also be larger than in 2004, despite continuing restraint exercised by political subdivisions in their expenditure policies. These assumptions will result in average expenditure growth of 1 % a year. Another retarding factor is that some of the measures generate a rising volume of relief over time. Among these is the envisaged abolition of the owner-occupied homes premium for new claimants, where the savings effect adds up to two tenths of a percentage point of GDP in the final year covered by the projection. The combination of supplementary unemployment and welfare benefits into "unemployment benefits II" is also intended to realise the planned effect only gradually. The outcome for the general government spending ratio is a steady decline to 44 ½ % in 2007, which will be backed up additionally by the development of aggregate economic activity as it gathers pace.

Table 4: Development of the government spending ratio

	2002	2003	2004	2005	2006	2007
Government spending ratio	- in % of GDP -					
November 2003 projection	**48.5**	**49**	**47 ½**	**46 ½**	**45 ½**	**44 ½**
December 2002 projection	48 ½	48	46 ½	45 ½	44 ½	-

The expenditure trend in detail

Even in the current year the upward trend in intermediate consumption spending (including social benefits in kind) and compensation of employees is appreciably diminished.[11] After an increase of 2.6 % registered in the preceding year, growth in 2003 stands at only just on 1 ½ %. This is attributable both to the weaker upward trend in health insurance spending and in the public service to cuts in special payments and further reductions in personnel. Reforms in the health insurance sector are expected to generate a decline in social benefits in kind in the coming year, whereas intermediate consumption spending will register a more appreciable rise. Compensation of employees is also expected to turn in only a slight rise on account of moderate adjustments and increasing recourse to the clause providing for specific exceptions in public service pay. The expenditure category as a whole is expected to show an increase in the years from 2004 to 2007 roughly parallel to that of aggregate spending.

In response to a limited rise in social insurance spending, monetary social benefits will increase in the current year at a very reduced rate (less than 3 % after 4.9 % in 2002). Here, too, the effects of the reform package will predominate, principally the combination of supplementary unemployment and welfare benefits and measures affecting pensions insurance. Added to this is the adjustment of relevant income thresholds for drawing the upbringing allowance. As a result, monetary social benefits are expected to increase at a less than average rate over the period covered by the projection.

Interest expenditure was down appreciably last year by -3.7 %. This may be attributed both to favourable refinancing opportunities in preceding periods and to effects related to the recording

[11] Intermediate consumption, social benefits in kind and compensation of employees are examined in combined form. Insofar as they relate to „non-market output“, they are the central factors influencing general government final consumption expenditure.

method.[12] Cash expenditure on interest in the current year is not expected to rise on pre-year figures, though an increase is likely to result from the recording method used in National Accounts. An above-average increase in interest expenditure is to be expected in the next few years on account of rising deficit and debt levels.

Investment expenditure will decline again in the current year, though not to the same extent as last year (2002: -4.3 %), despite the additional spending on flood damage repair that ought to be expected. It should be noted, however, that the information to be gained from the data and the extent to which they can be interpreted are influenced by differences in recording methods (the posting of expenditure in National Accounts being geared to incurrence rather than to disbursement). The fluctuating difference between the relevant sets of figures (financial statistics and National Accounts) has in the past repeatedly led to scarcely explicable deviations in the statistical presentation of investment expenditure. Hence the forecast figure for the current year can be no more than an approximate indicator. It must also be noted that resources from the flood relief fund are invested predominantly in sectors other than general government. Accordingly these investments are recorded for statistical purposes in other sectors although financed by general government. A positive rate of change is to be expected for 2004 – again with reference to the payments from the flood relief fund. Investment expenditure is likely to register a more marked increase in the medium term as well, not least because investment (particularly by local authorities) may be expected to pick up with declining deficits. Reinforcing communal investment capacity is an explicit aim of the reform of local authority finances.

Other transfers (current and asset transfers as well as subsidies) will turn in a particularly marked rise of +7 % this year. Increasing GDP-based own resources and above all payments from the flood relief fund are the contributing factors. The opposite trend is shown by subsidies, which have been declining since 2000 and are likely to decrease by 3 % this year.[13] The reduction of subsidies will continue in the next few years. Given these assumptions, the share of GDP taken by subsidies will decline in the medium term from 1.5 % to 1 %. After an interim rise in 2003, asset transfers will decrease appreciably up to 2007, mainly on account of the envisaged abolition of the owner-occupied homes premium for new claimants.

[12] In National Accounts, interest is posted to the relevant period and not recorded at the time it falls due.

[13] It should be noted that the subsidy concept in National Accounts differs from other concepts as regards method. One of the principal features is that investment grants are treated as assets transfers rather than as subsidies.

3.3 Trends in government revenue

Revival of tax revenue in 2004 after massive shortfalls in the current year

Tax revenue in 2003 has lagged well behind expectation. Whilst the most recent tax revenue estimate proceeds from an unchanged level in cash receipts on the preceding year (-0.0 %), a slight increase of one half of one per cent is likely to result in the National Accounts definition.[14] Hence in both sets of figures, taxes show a weaker development than the nominal gross domestic product (+1 %), though the rounded presentation of the tax ratio will remain at 22 ½ %. In the preceding year as well, the rise in tax revenue at +0.3 % fell short of national product growth.

The contrast is even more marked if the expected results for 2003 are compared with the tax revenue estimate made in November 2002: on cash receipts, the forecasts deviate up to the most recent estimate by a total of € 18 ½ bn. The corresponding projection in the National Accounts definition, which formed the basis for the December 2002 stability programme, proceeded from an increase of 5 ½ % in tax revenue for 2003. The rise of only ½ % now expected is equivalent to a deviation of more than one percentage point of GDP.

As set out in 3.1 above, by far the largest part of this shortfall may be attributed to the inadequate growth of aggregate economic activity, though the fact that the rate of growth of tax revenue is below the rise in nominal GDP suggests that special factors (e.g. expansion of the shadow economy) are in play. Hence the revenue from some types of tax, especially value-added tax, is lagging substantially behind the development of the corresponding economic aggregates.

Tax revenue expectations for the coming years depend substantially on the assumptions concerning the effects of the government's reform measures. The assumed fiscal impact of tax measures excluding the bringing forward of the 2005 tax reform stage amounts to around one half of a percentage point of GDP in 2004. This would thus tend to lead to an increase in the tax ratio. However, bringing forward the 2005 tax reform stage affords relief in a volume of ¾ percentage points of GDP and thus counteracts a rise in the tax ratio; hence the ratio of tax revenue to GDP is likely to stand at 22 ½ % in 2004 as well.

[14] The deviation is attributable to variations in recording methods, among others in the period-related allocation of specific revenue and the treatment of allowances.

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

	2002	2003	2004	2005	2006	2007
	- in % of GDP -					
Tax ratio	**22.6**	**22 ½**	**22 ½**	**22 ½**	**23**	**23**
Social contribution ratio	**18.4**	**18 ½**	**18**	**18**	**17 ½**	**17 ½**
Tax and fiscal charges ratio[1)]						
November 2003 projection	**41.1**	**41**	**40 ½**	**40 ½**	**40 ½**	**40 ½**
December 2002 projection	41	41 ½	41 ½	41	41	-

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

The volume of the government's tax measures will increase from 2005 onwards. In conjunction with the upturn in aggregate economic activity and the effects of the progressive arrangement of the tax system, the tax ratio may be expected to rise in small increments up to the end of the projection period and to stand at 23 % in 2007.

Social contribution revenue in 2003 marked by cyclical weakness and higher contribution rates

Despite weak aggregate economic activity and the resulting revenue shortfalls, receipts from social contributions in this year are 2 ½ % up on the previous year's level. This trend may be ascribed both to adjustments in contribution rates to pensions insurance (from 19.1 % to 19.5 %) and health insurance (from 14.0 % to 14.3 % on average for the year) and also to raises in the contribution assessment ceilings. But this has not fully sufficed to make up for the cyclically-related shortfalls in receipts, so that the current-year increase lags behind the estimates made in last year's projection.

The most recent government decisions have set the course for stabilising the pensions insurance contribution rate at 19.5 %. At the same time, the projection assumes reductions in statutory health insurance contribution rates. Measures are envisaged to afford considerable relief to health insurance funds, thus creating the conditions necessary for rate reductions. This includes benefit restrictions to apply as from 2004 or 2005, higher extra charges payable by insured persons and structural relief measures. Making allowance for these changes in the contribution rate, the social contribution ratio is expected to register a declining trend to a figure of 17 ½ % in the final year of the period covered by the projection.

3.4 Trends in the cyclically adjusted deficit

In the last stability programme the German government took a critical view of the information to be derived from the development of cyclically adjusted deficits and in particular expressed doubts as to their suitability for drawing conclusions on the quality of fiscal policy.[15] Whilst cyclically adjusted deficits may be a useful source of additional information, they are not seen as a crucial instrument for assessing trends in public budgets. This remains the German government's view.

Among the points criticised last year is the susceptibility of results to revision. On account of retroactive effects of changes in forecast figures, substantial adjustments – going beyond the revision of actual deficits – may arise in the level of cyclically adjusted which can lead to mistaken interpretations.

Other than the levels of cyclically adjusted deficits, the resulting changes on pre-year figures are relatively immune to changes in growth assumptions. Nonetheless, orientation to year-on-year comparisons does not necessarily produce reliable results. The use of fixed elasticities in calculating the cyclical portion of deficits, for instance, does not make due allowance for the causes of cross-period cyclical effects. Moreover, deficit shifts attributable to changes in the price component of the national product are, not least, "identified" as a structural change in the course of this mechanistic calculation procedure. Hence it is doubtful whether the cyclically adjusted deficit concept can achieve the adequate separation of the general government deficit into a cyclical and a structural part.

The stability programme of December 2002 assumed a reduction in the general government deficit of -3 ¾ % (2002) to -2 ¾ % (2003). Among the short and medium-term growth assumptions made, a reduction in the cyclically adjusted deficit in 2003 of one percentage point resulted on the basis of the HP filter procedure. In contrast, the present projection leads only to a slight improvement in the cyclically adjusted deficit for the current year on the basis of filtered, real growth rates. This outcome shows that no pertinent assessment of the measures adopted by the German government can be undertaken on the basis of the cyclically adjusted deficits.

The weaknesses of the concept, above all its exclusive dependence on past and forecast values of the real gross domestic product, play a central part in this. Separation into cyclical and structural

[15] See German Stability Programme of December 2002, p. 31 ff.

components follows a rigid pattern which does not permit special features in macroeconomic or financial development to be taken into account.
The need to correct the GDP deflator as against the preceding stability programme has already been referred to in 3.1 above. The difference in the deflator alone reduces the rise in nominal GDP by a good half of a percentage point as compared with the assumptions made at that time. It is the nominal rather than the real development of the economic aggregates relevant in each case that is crucial especially for the revenue side of public budgets. The charges on the budgets from the deflator effect are likely to amount to a good quarter of a percentage point of GDP. These effects cannot be filtered out by a procedure focusing on assumptions relating to real growth. The real deficit resulting from weaker-than-expected development of aggregate economic activity is ultimately reflected as an increase in the cyclically adjusted deficit.

Additionally, the calculation of cyclically adjusted deficits proceeds from constant elasticities. This means, for instance, that effects deriving from cyclical trends in previous periods are not identified in the concept as cyclically-induced change. This problem affects above all the revenue from assessed taxes. Equally, tax revenue shortfalls deriving from divergent trends in tax revenue and the relevant economic aggregate. Equally, tax revenue shortfalls deriving from divergent trends in tax revenue and the relevant economic aggregate – i.e. from changed elasticities – increase the structural part of the deficit.

The measures adopted by the German government for the current year are also a factor in ascertaining why structural improvement has been less than expected. The measures implemented, relating essentially to tax and social contributions and to labour market spending, were in line with the Council's recommendations of January 2003. In the spring, the European Commission confirmed the implementation and the volume of the measures. However – as the Commission acknowledges – the extent to which the expected fiscal effects have occurred can not be established ex post. This applies especially to the affected cyclically-sensitive quantities. Overlapping by cyclical influences means that the impact of specific components cannot be singled out.

It is broadly apparent, however, that the measures are not likely as a whole to have achieved their full effect because they were prevented from doing so by the unfavourable trend in aggregate economic activity. And effects such as this, too, are not identified as cyclical in the cyclically adjusted deficit concept but are reflected in that deficit. Hence the lower-than-expected decrease in the cyclically adjusted deficit is likely to be predominantly attributable to the weakness of aggregate economic activity – whether as a result of unfavourable trends in macroeconomic aggregates or retarding influence on the effectiveness of the measures adopted.

Table 6: Development of the cyclically adjusted deficit

	2002	2003	2004	2005	2006	2007
Real GDP growth	**0.2**	**0**	**1½ to 2**	**2 ¼**	**2 ¼**	**2 ¼**
General government fiscal balance in % of GDP	**-3.5**	**-4**	**-3 ½**	**-2 ½**	**-2**	**-1 ½**
cyclically adjusted balance in % of GDP	**-3.3**	**-3**	**-2 ½**	**-2**	**-1 ½**	**-1**

As may be seen from Table 6, the cyclically adjusted deficit will improve by one half of a percentage point of GDP in the wake of the effects of the government's reform package. A "tapered" presentation shows improvement by 0.6 of a percentage point in 2004. This already makes allowance for the negative effects on the balance of bringing forward the 2005 stage of the tax reform to 2004 (-¾ of a percentage point, hence in total a good one percentage point of GDP structural improvement). Structural improvement will also be higher in 2005 as the measures take effect, and may be expected to exceed 0.5 percentage points on the assumptions made. In the final years of the projection the reduction of the cyclically adjusted deficit amounts respectively to ½ of a percentage point.

3.5 Trends in debt

In the December 2002 stability programme, government debt was expected to "peak" in 2003. After that, given declining deficits and vigorous growth in the economy as a whole, the debt ratio was expected to take on a downward trend, bringing it down again to below 60 % in 2005.

Since that time the conditions for reversing the trend have substantially worsened. Both numerator and denominator of the debt ratio have come under pressure. The increase in debt in absolute terms will be perceptibly stronger than assumed one year ago, given a renewed rise in borrowing and a deficit which, though declining, is doing so from a high level. As already described, the reference values will at the same time be lower over the entire projection period on account of downscaled expectations with regard to nominal GDP. The combination of both effects will put government debt higher by 7 ½ percentage points in 2006 than assumed last year.

Table 7: Development of the debt ratio

	2002	2003	2004	2005	2006	2007
Debt ratio	- in % of GDP -					
November 2003 projection	**60.8**	**64**	**65**	**65 ½**	**65**	**64 ½**
December 2002 projection	61	61 ½	60 ½	59 ½	57 ½	-

Subject to the assumptions made, the increase in debt in absolute terms will continue to exceed nominal GDP growth until 2005. With the largest deficit and the lowest rise in GDP, the current year in particular will register a sharp increase in the debt ratio. After that the increase will slow until the trend "peaks" at 65 ½ % of GDP in 2005. Assisted by declining deficits, the ratio will subsequently come down again to 64 ½ % in 2007.

Central, regional and local government realised privatisation proceeds ranging from 0.3 to 0.9 percentage points of GDP over the past few years. Next year – other than originally planned – the federal budget will again have significant recourse to such proceeds in order to offset revenue shortfalls resulting from bringing forward the 2005 stage of the tax reform to 2004. The privatisation volume for all levels of government is likely to amount to half a percentage point of GDP for 2004. Appreciably lower volumes will be registered in the following years.

3.6 Sensitivity of the deficit projection

The sensitivity analysis depicts the trends resulting from deviations from aggregate economic assumptions. It proceeds from changes of half a percentage point a year in the growth of nominal GDP as against the basis projection. Assumptions and results of the basis projection are unchanged for the current year.

If the growth of nominal GDP falls short of the assumptions by half a percentage point a year in the period from 2004 to 2007, the result is a slower reduction of the general government deficit leading to a balance of -2 ½ % of GDP in the final year of the projection (see Table 8). It is assumed that the cyclically-induced charges on public budgets cannot be offset by extra consolidation efforts on the expenditure side. As the assumptions in the basis projection are already restrictive and made even more so by expenditure cuts resulting from the package of reform measures, there is hardly likely to be any scope for further tightening. Thus in this respect weaker

Table 8: Sensitivity of the deficit projections

	2002	2003	2004	2005	2006	2007
Deficit/surplus ratio[1)]	- in % of GDP -					
November 2003 projection	**-3.5**	**-4**	**-3 ½**	**-2 ½**	**-2**	**-1 ½**
November 2003 projection						
• assuming lower growth of nominal GDP 2004-2007 (- ½ percentage point)	-3.5	-4	-3 ¾	-3	-2 ½	-2 ½
• assuming higher growth of nominal GDP 2004-2007 (+ ½ percentage point)	-3.5	-4	-3 ¼	-2	-1	-½

(1) In the light of uncertainties affecting estimates made in relation to any projection. deficits are rounded to ¼ percentage points of GDP for short-term projections (2004) and to ½ percentage points of GDP for medium-term projections.

GDP growth would feed through directly to the deficits; as a result, the reduction of the general government deficit would be stretched. It is calculated that the 3 % reference figure would be reached in this scenario in 2005, albeit under the assumption that all reform measures are implemented unchanged.

The general government deficit will still be above the Maastricht reference figure in 2004 even in the more favourable scenario assuming that growth of nominal GDP is higher by one half of a percentage point. This results in a decline in the deficit ratio to -½ % of GDP by 2007. In line with the ECOFIN Council decisions of 25 November 2003, this projection proceeds from the assumption that additional revenue deriving from stronger-than-expected growth is deployed in full to reduce the deficit.

4. Fiscal policy in Germany

4.1 Federal government fiscal policy

Public budgets are displaying increasingly visible traces of the economic stagnation that has now persisted in Germany for almost three years. The situation is marked by substantial tax revenue shortfalls and cyclically-induced extra burdens on the expenditure side.

Against this backdrop the federal government has reoriented its fiscal policy objectives. As before, one of the guiding principles of this policy is to achieve balanced federal and general government budgets at the earliest possible stage. But in the present economic environment, a consolidation strategy must be backed up by measures to reinvigorate the forces for growth if it is to be sustainable. Hence the federal government's consolidation course is supported on the one hand by a comprehensive package of structural reforms and on the other by fiscal policy stimulus to overcome the weakness in economic activity.

The unexpectedly feeble development of economic activity in 2003 constitutes a substantial impediment to the execution of the federal budget. Tax revenue shortfalls and extra labour market spending have generated an additional burden totalling € 24.5 bn on the budget for 2003. These extra charges are being met in the budget supplement for 2003 by a corresponding increase in federal government net borrowing to € 43.4 bn. Procyclical fiscal policy is avoided by allowing the automatic stabilisers to take effect. Covering the extra expenditure would be possible only by means of massive interventions on the expenditure and revenue sides, especially by cuts in investment projects. Cuts of this kind would be counterproductive, however, as they would further erode domestic demand and investment and impede economic recovery.

In the federal budget for 2004, net borrowing will be brought down by almost one quarter as compared with 2003 to less than € 30 bn. The guiding principle on the expenditure side of the federal budget for 2004 is to limit the growth of consumption spending and to bring down financial assistance. On the revenue side, provision is made for measures to stabilise tax revenue by countering abuse of the tax system and illicit labour as well as by restricting tax concessions and exceptional taxation arrangements. The volume of consolidation initiated by the government in adopting the federal budget for 2004 amounts to some € 14 bn.

The 2004 budget support law that went through the third reading and was passed by the Bundestag on 17 October 2003 is a central element in the federal government's modernisation programme. It incorporates both consolidation measures and components to promote growth:

- The law focuses on a further reduction in tax concessions, especially the abolition of the owner-occupied homes premium, reduction of the flat-rate mileage allowance for commuters, limitation of subsidies for diesel fuel used in farming, abolition of the half-year rule for depreciation allowances and broadening the value-added tax base. These measures are part of the above-mentioned consolidation volume of € 14 bn.

- The law also contains the bringing forward to 1 January 2004 of the tax reform stage scheduled for 2005. Bringing forward this stage affords relief amounting to € 15.6 bn, while total relief afforded by tax rate cuts in 2004 (second and third stage of the tax reform) amounts to € 21.8 bn. The government is thus boosting private consumption and the propensity to invest. At the same time the tax reform will have positive supply-side effects, for instance reducing the basic rate of tax to 15 % will encourage persons in the low-income sector to take up work.

The federal government expects the appreciable net relief afforded to individuals and businesses by bringing forward the third stage of the tax reform to lend perceptible impetus to growth. Additionally, consistent progress in cutting back subsidies in the next few years will lead to extensive savings and extra revenue and thus offset over time the one-off effect of increasing net borrowing. The rise in interest expenditure will be directly counteracted by closing loopholes in the value-added tax regime and by reducing tax concessions in agriculture.

4.2 General government fiscal policy

4.2.1 Reform of local authority finances

On 13 August 2003 the government adopted the draft laws on the reform of trade tax and the merging of supplementary unemployment and welfare benefits. The Bundestag passed the bills with various amendments on 17 October. Subject to the consent of the Bundesrat, this legislation can be adopted as scheduled by the end of the year, so that the initial reform measures can take effect as planned as from 1 January 2004.

Reform of trade tax

The Trade Tax Reform Law tackles the structural deficiencies of the present system of trade tax. It has become apparent that trade tax in its present form fails to function as a steady, productive source of revenue for the municipalities as it has increasingly come to apply to a diminishing number of taxpayers. Trade tax is thus to be developed into a local business tax based on economic capacity and incorporating the right of local authorities to set multipliers.

The reform will serve to stabilise the tax revenue accruing to local authorities. The tax base of the local business tax will be broadened both in respect of taxable persons and circumstances, thus creating an improved foundation for local authority investment. The additional tax revenue generated by these changes will be passed on to the local authorities by reducing the trade tax apportionment taken by central and regional government. The share of VAT revenue assigned to the local authorities will not be increased. In the government draft, any extra burdens imposed by broadening the tax base in respect of taxable persons and circumstances will be largely offset by tax rate reductions for small businesses and self-employed persons provided in the amended version of section 35 of the Income Tax Law. Central and regional government will bear 85 % of this relief. The basic rates of tax on the earnings of incorporated companies will be reduced. Revenue accruing to local authorities will increase by € 2.5 bn in 2004 and by more than € 3 bn a year as from 2005.

Merging supplementary unemployment and welfare benefits

The government's efforts to remedy the structural problems of local authority finances with the draft Trade Tax Reform Law are backed up by a fourth Law on modern services in the labour market ("Hartz IV").

This draft merges supplementary unemployment and social welfare benefits paid to needy jobless who are able to work into a new benefit, the basic provision for jobseekers. The aim is to improve the prospects of placement in regular employment for persons receiving the benefit, especially by providing intensive advisory and support services. The new benefit is to be disbursed by the future Federal Employment Agency and financed by central government.

Over and above the relief afforded by the draft Trade Tax Reform Law, merging supplementary unemployment and welfare benefits will take pressure off local authority finances in the amount of some € 2 bn in 2004 and permanently by some € 2.5 bn a year as from 2005. Structurally weak local authorities with disproportionately large social welfare disbursements will derive greatest benefit from the reform. These measures will also reinforce the investment capacity of local authorities and create additional scope both for budget consolidation and for essential expenditure, not least in order to bring child-care places up to the required number.

4.2.2 National Stability Pact

The Financial Planning Council, chaired by the Federal Minister of Finance and comprising the Federal Minister of Economics and Labour, the finance ministers of the Länder and representatives of the local authorities, decided at a special meeting on 21 March 2002 to bring forward to the year 2002 an amendment of the Law on Budgetary Principles (HGrG) which had already been agreed in the Law to continue the Solidarity Pact but was originally to have effect only from 2005 onwards. The new section 51a HGrG is concerned with a procedure to implement at national level the commitments entered into by Germany at European level in the Maastricht Treaty and the Stability and Growth Pact.

Section 51a HGrG stresses the common responsibility of the Federation and the Länder for complying with budgetary discipline within the framework of European economic and monetary union. Federation and Länder are enjoined to reduce net borrowing with the aim of achieving budget balance. The Financial Planning Council plays a central part in the procedure to ensure compliance with budgetary discipline by issuing appropriate recommendations especially on a common expenditure line as a yardstick for the budgets of central and regional government (including local authorities). The Council also assesses whether trends in the budgets of central, regional and local government are in line with the provisions of Article 104 of the EC Treaty and the European Stability and Growth Pact. If necessary, the Council makes recommendations on measures to be taken to restore compliance with budgetary discipline. The amendment to the law took effect in July 2002 and is referred to as the "National Stability Pact".

This appreciable strengthening of the role of the Financial Planning Council places greater weight on the binding effect of decisions reached in a cooperative procedure by equal partners, thus refraining from restricting budget autonomy by way of a law, which would run up against constitutional problems. At its meeting on 20 November 2003 the Financial Planning Council discussed compliance with budgetary discipline within the framework of European economic and monetary union. The Federation, the Länder and the local authorities acknowledged their responsibility for compliance with the European Stability and Growth Pact.

4.2.3 Reform of the federal structure

The government is aware of the need to reform Germany's federal structure, not least to facilitate political decision-making and to promote growth and employment. Federation and Länder agree on the objectives of the reform, namely to ensure that decision-making processes at national level and the discharge of government functions are generally made more efficient and more transparent and that political responsibilities are more clearly assigned. The Constitutional Commission set up jointly by the Bundestag and the Bundesrat to look into the modernisation of the federal system affords the prospect of reaching the necessary consensus on appropriate reform measures and putting them into effect before the end of the current parliamentary term. Crucial issues are redefining the assignment of legislative powers to the Federation and the Länder, speeding up legislative procedure by limiting the instances in which the consent of the Bundesrat is required, correcting inappropriate trends in joint financing and reviewing the scope for unbundling the responsibilities of central and regional government in the area of taxation.

4.3 Fiscal policy in the European context

The German government unreservedly endorses the European Stability and Growth Pact. It is the central element in the coordination of fiscal policy in Europe. The Pact plays an important part in convergence between Member States and helps to ensure stable underlying conditions in Europe that encourage growth and employment.

In the view of the German government it is neither necessary nor advisable for the Pact to be altered. In its basic configuration the Pact is designed to cope with cyclical fluctuations as well. Proceeding from the medium-term goal of balanced budgets or budget surpluses and making provision for precisely defined exceptions, the Pact affords sufficient leeway for the automatic stabilisers to take effect throughout all phases of the business cycle. It is necessary for the Commission and the Council to make use of the discretionary scope afforded by the Pact to enable the rules to be applied in an economically appropriate manner in each individual case.

Discharging the obligations imposed by the Stability and Growth Pact is and will remain a central objective of Germany's fiscal policy. However, the stagnation of economic activity that has persisted for almost three years coupled with the much weaker than expected development of the economy in the course of 2003 has compelled the German government to relinquish its objective of bringing down the general government deficit to below 3 % of GDP by 2004 at the latest. In particular, under the present circumstances and additionally to secure the progress achieved in consolidating public budgets, the government regards it as necessary to lend perceptible momentum to growth by bringing forward the third stage of the tax reform from 2005 to 2004. This must also be viewed in conjunction with structural reform in the labour market and the social security systems: if disposable incomes are reduced by restricting social benefits, bringing forward tax relief is all the more urgently indicated as the most effective means of countering a negative impact on the economy as a whole.

The German government has adopted an extensive package of structural reforms which is in line with the country-specific recommendations within the framework of the Broad Economic Policy Guidelines for the period from 2003 to 2005. It comprises in particular reforms in the labour market ("Hartz" laws), in the field of social insurance (healthcare reform, decisions on further reform of the pensions system), the reform of local authority finances to secure in the long term the revenue accruing to local authorities as well as a number of deregulation measures focusing on the services sector.

The German government accepts the excessive deficit procedure to which Germany has been subjected pursuant to Article 104 of the EC Treaty. On 21 January 2003 the ECOFIN Council confirmed in accordance with Article 104(6) the existence of an excessive deficit in Germany on the basis of the general government deficit of 3.5 % in 2002 and at the same time made recommendations for the reduction of that deficit. The central element of these recommendations is the implementation of measures having a volume of 1 % of GDP in 2003. The Commission confirmed on 21 May 2003 that the consolidation package submitted by the German government was in conformity with the recommendations made by the Council on 21 January 2003.

On 15 October 2003 the European Commission made recommendations pursuant to Articles 104(8) and (9) of the EC Treaty to the effect that the ECOFIN Council should establish non-compliance with the Council recommendations of January 2003 and give notice to Germany to adopt stricter consolidation measures. At its meeting on 25 November 2003, the ECOFIN Council declined to follow these recommendations. Instead, the Council confirmed once again that Germany had adopted substantial adjustment measures in compliance with the recommendations of January 2003. Additionally, the German government undertook in line with the Council's conclusions to continue consistently on its consolidation course. The central commitments are:

- to reduce the cyclically adjusted deficit in 2004 by 0.6 percentage points;
- to reduce the cyclically adjusted deficit in 2005 by at least 0.5 percentage points or by a correspondingly larger amount to ensure that the general government deficit in 2005 again falls below the reference figure in the EC Treaty;
- to continue to pursue the consolidation course up to 2005 and beyond and in doing so to reduce the cyclically adjusted deficit by at least 0.5 percentage points a year;
- to allocate any additional revenue deriving from stronger-than-expected growth to deficit reduction.

The present update of the stability programme demonstrates how these undertakings are reflected in the measures initiated by the German government and in the projections based on them.

5. Long-term sustainability of public finances

5.1 Impact of an ageing society on public finances

In the coming decades Germany will experience a substantial shift in the ratio of older to younger persons in its population. This is again borne out by the model calculations of the Federal Statistical Office updated in June 2003 and by projections made elsewhere (among others by EUROSTAT).

The ageing of society is already inherent in the present population structure. Thus it is not only in fifty years' time but already in the next two decades that it will become clearly apparent. This is shown by the rapid rise in the elderly dependency ratio, i.e. the ratio of persons of pensionable age to the number of persons of working age (see Table 9). Persons now aged from 35 to 40, from the years with the highest birth-rates, will reach pensionable age between 2020 and 2030. None of the variants put forward by the Federal Statistical Office is devoid of serious changes in the age structure of the population. This applies even in the case where the population figure in absolute terms, not least on account of high immigration, is almost as high in the final year as it is today.

Intensive discussions on the impact of demographic change are in progress both in Germany and in the other Member States of the EU. An initial Community-wide round of projections was concluded in November 2003 by an appropriate report to the ECOFIN Council. Calculations were based in this case on population projections by EUROSTAT and matching macroeconomic assumptions. According to these, the burdens on public budgets in general will increase appreciably as a consequence of population ageing. The increase in the burden of ageing-related expenditure as a proportion of GDP will amount to between 3 to 7 percentage points in most Member States by 2050. The increase for Germany was calculated at 6 percentage points, although the effects of the pensions reform of 2001 and further measures to reduce the burden on public budgets are not taken into account in this calculation.

In terms of the approach adopted, the results of the joint estimates are more readily comparable than those of national calculations made in isolation. But they cannot always make due allowance for special features of individual Member States and for changes in the underlying legal conditions over time. The results of the studies at EU level as adapted and supplemented to bring them into line with current developments (2001 pensions reform) are shown in Table 10, from which it is evident that the expected effects on the revenue side (as well as the decrease in unemployment assumed over the long term) are not sufficient to compensate for the increase in expenditure induced by population change. However, further reform measures planned by the German government in the field of social security will help in the long term to ease the pressure on public budgets (see also 5.2.3 below).

The meaningfulness of data derived from projections in which demographic, macroeconomic and fiscal trends are rolled forward over such lengthy periods is of course limited. The uncertainties inherent in the figures increase the further they are distanced from the base year. Caution is therefore indicated in interpreting the data and deriving recommendations for policy action.

Demographic change is and will remain one of the central challenges. Fundamental policy decisions are now needed to secure lasting growth and employment and to guarantee the sustainability of public finances. The Federal Ministry of Finance will submit its first report on the sustainability of public finances in 2004.

Table 9: Development of the elderly dependency ratio – ratio of persons of pensionable age to the number of persons of working age

	2001	2010	2020	2030	2040	2050
Variant 1	27.5	32.8	36.8	48.5	55.3	56.4
Variant 5	27.5	32.6	36.4	47.3	53.1	54.5
Variant 9	27.5	32.6	36.1	46.5	52.0	53.8

Source: Federal Statistical Office, 10th coordinated population estimate. Variants: low, medium and high population figure, pensionable age 65 years.

Table 10: Government revenue and expenditure in long-term perspective

in % of GDP		2000	2010	2020	2030	2040	2050
Old-age provision [1)]		10.8	11.1	12.1	13.8	14.4	14.9
Health care expenditure[2)]		5.7	6.0	6.4	6.7	7.0	7.1
Education expenditure[2)]		5.4	5.3	5.2	5.5	5.5	5.5
Earnings-related unemployment benefits [2)]		1.1	0.9	0.8	0.7	0.8	0.7
Tax revenue [3)]	(a)	18.7	17.8	18.0	18.6	19.0	18.9
	(b)	18.7	17.5	17.9	18.8	19.5	19.4

Note: All calculations are compatible with assumptions coordinated at Community level.

(1) Results of model calculations by the Federal Ministry of Health and Social Security (BMGS) (statutory pensions insurance, public service pensions).

(2) Results of model calculations by the Economic Policy Committee (EPC) of the EU (acute health care, education expenditure, unemployment benefit spending).

5.2 Central areas for action in fiscal and economic policies geared to long- term sustainability

5.2.1 Continuing on the consolidation course

The development of the economy over the past few years has fallen far short of the government's expectations and of those of national and international experts and institutions. Yet the core elements of the "Guiding Principles of Fiscal Policy" of November 2002 retain their validity in economically difficult periods as well.

For the German government, the following areas for action are foremost in a fiscal policy geared to long-term sustainability:

- Quantitative and qualitative consolidation of the federal budget to achieve sound and sustainable public finances as well as equity between the generations.
- Creation of a sustainable and equitable system of taxes and fiscal charges in order to promote growth and employment.

Even in an uncertain economic environment, fiscal policy must contribute to shaping the underlying conditions which both encourage growth and employment and help to attain other important social objectives, for instance ensuring equity between the generations.

The ambitious aim of achieving a balanced federal budget by 2006 had to be relinquished in 2003 in the face of changes in underlying economic conditions so as not to destabilise the development of the economy with a procyclical fiscal policy approach. Nonetheless, consolidating both the federal and the general government budget remains one of the central objectives of the federal government's fiscal policy. To this end, a responsible fiscal policy must also take account of the following aspects:

- The quality of general government spending must be improved. The current pattern of the federal budget is shaped above all by interest expenditure and spending on social security and the labour market. Hence the aim must be to increase the share of spending on tasks which will enable our society to meet the challenges of the future (such as education and research, reconciling family and career).
- Subsidies – i.e. financial assistance and tax concessions – must be regularly reviewed to ascertain whether they are still justified. The overriding aim is to reduce subsidies to the

greatest possible extent. Granting new subsidies may be envisaged in principle only if they are subject to a time-limit and a clearly-defined efficiency check.

- Making government activity more efficient and more effective also affords scope for further savings. Government must withdraw from economic activity where functions previously performed by the public sector can be performed more efficiently by the private sector.

5.2.2 Refining the tax system

In order to give a clear signal for more investment and employment, the Bundestag has approved the decision to bring forward by one year the third stage of the Tax Reform 2000 (originally scheduled for 2005) and to put it into effect at the same time as the second stage. Once the tax reform has been fully implemented, the basic personal allowance for income tax will stand at € 7,664 – the highest it has been in the history of the Federal Republic of Germany. The basic and top rates of tax will be historically low at 15 % and 42 % respectively. By international standards, too, this will put Germany in an extremely competitive position.

The measures providing tax relief will be supported by structural reform of tax law. The guiding principles of the federal government's tax policy will be modernisation and simplification. Ongoing reduction of tax concessions will be at the forefront. Steps to achieve this are the Law to reduce tax concessions, especially the restrictions it imposes on the scope available to associated companies for arranging taxable transactions and the measures it contains to stabilise corporation tax revenue, as well as the provisions contained in the 2004 Budget Support Law, specifically abolishing the owner-occupied homes premium and restricting the flat-rate commuter mileage allowance. The course adopted to stabilise corporation tax revenue is further pursued in the Law to implement the government's statement to parliament on the Law to reduce tax concessions. Thus bringing the provisions relating to capital borrowed from shareholders into line with European law also serves to close gaps in taxation resulting from the abuse of legal options for arranging taxable transactions. Loss offsetting rules will be changed under this law with the aim of stabilising tax revenue. The two last-named laws still require the consent of the Bundesrat.

Tax simplification and increasing the efficiency of the tax administration feature on the federal government's agenda in addition to the further reduction of subsidies. In this respect appreciable relief has been afforded to numerous small business undertakings in the Law to promote small businesses by raising the threshold of the obligation to keep commercial books of account and standardising the cash receipts and disbursement accounting method. The radical modernisation of wages and income tax procedure pursued in the 2003 Tax Amendment Law, leading in the final stage to fully computerised assessment, will relieve pressure especially on small and medium-sized businesses.

A further key reform project is reorganising the treatment under income tax law of payments in provision for old age and old-age pensions. The draft Law on old-age income provides for progressive transition to the taxation of pensions from statutory pensions insurance funds on disbursement, thus ensuring that taxation conforms to constitutional requirements both during and after the phase of (gainful) employment. Old-age provision will be progressively exempted from tax. This will give persons still in (gainful) employment greater financial scope to make private provision for their old age. The statutory pension will for the most part remain untaxed even after the reorganisation. The introduction of largely standardised taxation in the field of occupational pensions systems, where in the long term there is also to be a general transition to taxation on disbursement, and the elimination of bureaucratic impediments to the preferential tax treatment of private, fully-funded old-age provision ("Riester" pension) are further contributions to greater transparency and simplicity in the tax system.

Finally, the modernisation of tax law also covers the adaptation of general tax conditions to the progressive internationalisation of trade and industry and the increasing mobility of capital. To supplement the EU Interest Directive and the Law to promote taxpayer compliance (still to be approved by the Bundesrat), the German government is planning a future-oriented reform of capital income taxation which is intended to secure Germany's status as an attractive location for capital investors. In this way we can ensure that income from capital makes an adequate contribution to tax revenue. The Law to promote taxpayer compliance is intended to construct a "tax amnesty bridge" for persons having previously acted with intent to evade tax, allowing them to escape criminal and administrative penalties by making a flat-rate payment in lieu of the taxes evaded.

5.2.3 Implementing far-reaching structural reforms

Proactive fiscal policy is dependent upon the resolute implementation of the necessary structural reforms. Carrying out structural reforms in the markets to make them more flexible is a focal point of the German government's economic policy strategy to promote growth and employment. The programme for this is the "Agenda 2010", which the Federal Chancellor outlined on 14 March 2003. It provides for comprehensive structural reforms of the social security systems and the labour and product markets with the aim of reviving economic activity in Germany and boosting the potential for growth, creating new jobs and bringing down unemployment. This includes reshaping the social security systems to correct undesirable trends in social insurance, reduce non-wage labour costs and provide appropriate incentives.

Labour market reforms

The first two Laws on modern services in the labour market, central elements of which already came into effect on 1 January 2003, have implemented key labour market reforms following on from the recommendations of the “Hartz” Commission on “Modern Services in the Labour Market”. The new measures adopted to date are intended principally to improve the quality of and to speed up job placements, to liberalise the hiring of temporary workers in conjunction with promoting placement-oriented temporary employment, to improve the prospects of older workers of finding employment, to encourage people to start up as self-account workers in order to escape unemployment and to reshape the regulations governing low-income employment and the relief of low incomes from social insurance contributions.

Legislation in response to the recommendations of the “Hartz” Commission will be wound up this year in the third and fourth Laws on modern services in the labour market. The third law creates among others the necessary legal conditions for transforming the Federal Labour Office into a modern service provider (Federal Employment Agency). Additionally, the preventive approach in labour market policy will be refined and the laws on benefits as well as the labour market policy instruments will in part be simplified.

The aims of the fourth Law on modern services in the labour market are to merge supplementary unemployment and social welfare benefits for those in need who are able to work into a common public assistance regime and in particular to step up active labour market policy efforts to bring the persons in question – generally long-term jobless – back into employment.

In anticipation of this the federal government has launched two special programmes ("Jump Plus” and “Work for long-term jobless”) intended to help younger or long-term unemployed persons drawing supplementary unemployment and social welfare benefits to enter or re-enter the employment and qualification process. Programme activities are concentrated in structurally weak regions, principally in the new Länder.

Besides this, the “Law on reform in the labour market” reshapes the provisions governing protection against dismissal to make them more conducive to promoting employment. The aim is to reduce obstacles to hiring personnel primarily in small and newly-established businesses and to increase the legal security for employers and employees in the event of dismissals as a result of economic changes in firms. Moreover, the undesirable incentives to take early retirement provided by unemployment insurance are to be lessened by generally limiting the claim on unemployment benefits to twelve months and for workers over the age of 55 to eighteen months. A transitional arrangement (required on constitutional grounds as well) protects the interests of older workers whose claim to unemployment benefits arises not later than 31 January 2006.

Reform of the social security systems

The Law to modernise the statutory health insurance reforms the structures and the funding of the healthcare system. The structural reforms improve quality and efficiency of provision, increase transparency and competition, allow patients greater responsibility and involvement and make the system as a whole more efficient. To this end, among others, patterns of medical care provision are refined and the pharmaceuticals market is reformed with regard to the supply of and trade in medicaments. Placing the responsibility for specific risks on the insured (dentures, sickness benefits), revising the rules on extra payments and exemptions and savings from structural effects enable contributions to be appreciably reduced and create the basis for sustainable funding of the statutory health insurance system.

In order to permanently stabilise the funding of the statutory pensions insurance while guaranteeing equity between the generations, the government has decided to present a comprehensive legislative package incorporating a raft of measures taking effect both in the short and the long term. Two draft laws containing the following provisions have been submitted with the aim of steadying the contribution rate in the short term:

- Reduction of the minimum liquidity reserve to 20 % of monthly disbursement.
- Pension adjustment on 1 July 2004 to be suspended.
- Pensioners to fund the full contribution to old-age care insurance, to be offset by relief afforded to pensioners from immediate transmission of contribution rate changes in statutory health insurance.
- Date of pension disbursement for new entrants to be deferred to the end on the month.
- Contribution rate to be fixed by law at 19.5 %.

The planned measures taking effect in the long term include the progressive transition to taxation of old-age provision on the disbursement of benefits, in conjunction with tax relief for contributors, simplification of procedure in state-assisted, private fully-funded old-age provision, elimination of obstacles in occupational pensions systems and modern management in the pensions insurance institutions. Above all, a sustainability factor is to be introduced in the pensions adjustment formula of the statutory pensions insurance to take account of the ratio of contributors to pensioners.

In adopting this measure the government is following one of the key proposals made by the Commission which it set up to investigate sustainability in the funding of social security systems (the "Rürup Commission"). The government is also scrutinising the further proposals made by the Commission concerning pensions, healthcare and old-age care insurance.

Further structural reforms to strengthen growth and employment

The small business sector in Germany is one of the key factors behind economic growth. Hence the government's small business campaign aims to facilitate business start-ups, eliminate professional barriers to recruitment and enhance the innovative capacity of small and medium-sized enterprises (SMEs):

- Promotion of business start-ups and ultra-small firms (Law to promote small businesses, start-up initiative), for instance by raising the turnover threshold below which businesses are exempted from VAT and improving the social security of self-employed persons.
- Securing the funding of SMEs through a merger of the DtA with the KfW to form a government-held SME Bank and repackaging and streamlining the promotional programmes of relevance to SMEs.
- Training initiative, including the implementation of proposals for mobilising training places as well as modernising the existing and creating new training occupations.
- Reform of the crafts regulations to restrict the requirement of a master craftsman's certificate to crafts where inferior work could present a risk to life and limb.

Eliminating bureaucratic regulations unshackles the forces for innovation and investment, takes pressure off small businesses and promotes growth and employment. The federal government therefore adopted on 19 February 2003 the "Bureaucracy Reduction Master Plan" and on 9 July 2003 the strategic concept of a "Bureaucracy Reduction Initiative". In all, these programmes comprise more than 60 separate measures to afford relief from unnecessary bureaucracy, especially to SMEs. These include pruning the statistical data required from trade and industry, reforming craft regulations and streamlining provisions governing the award of contracts.

Further structural reforms in product, services and capital markets include:

- Developing an efficient regulatory framework for antitrust policies, among others by revising the Law against restraints of competition. Strengthening competition is intended to ensure economic efficiency to the benefit of consumers and to promote investment and innovation.
- Further liberalisation of the telecommunications sector. Thus call-by-call facilities and preselection in local networks have been in place since April 2003 and July 2003 respectively. The Telecommunications Law is to be revised by early 2004, and efforts are under way to ensure that the parliamentary procedure is concluded in the first months of the coming year.
- Setting new points of emphasis in innovation and technology policies with the High-Tech Master Plan and the umbrella fund to promote technology-oriented SMEs.
- Review and refinement of the instruments for consumer protection on the basis of a ten-point programme to enhance investor confidence and to improve the functioning of capital markets by affording greater transparency and increasing the quality of capital market data as well as by qualified advisory services. Moreover, the financial market promotion plan 2002-2006 is in place, focusing on securing the stability and integrity of financial markets and improving their efficiency and competitive ability, improving investor and customer protection and securing the conditions for financing small business.

It is of paramount importance for the upcoming reform measures to be resolutely implemented if the objective of sustainable fiscal policy is to be attained in the medium and long term. The national report on structural reforms submitted in late October 2003 within the framework of the Cardiff process contains a more detailed presentation of the federal government's structural reforms in product, services and capital markets.

Appendix

Table 11: Development of public finances[1)]

(National Accounts definitions)

	ESA Code	2002	2003	2004	2005	2006	2007
		in % of GDP					
Balancing items (B.9) of levels of government							
General government	**S.13**	**-3.5**	**-4**	**-3 ½**	**-2 ½**	**-2**	**-1 ½**
Central government	S.1311	-1.6	-2	-1 ¾	-1	-¾	-¾
State government	S.1312	-1.5	-2	-1 ¾	-1 ½	-1	-¾
Local government	S.1313	-0.1					
Social insurance funds	S.1314	-0.3	-¼	-0	-0	-0	0
General government expenditure (in accordance with the definition in Reg. 1500/2000)							
Intermediate consumption Social benefits in kind Compensation of employees[2)]	P.2 D.63 D.1	19.7	19 ½	19	19	18 ½	18
Social benefits (other than in kind)	D.62	19.4	19 ½	19	18 ½	18	17 ½
Capital transfers (interest expenditure)	D.4	3.1	3	3	3	3	3
Subsidies	D.3	1.5	1 ½	1 ½	1	1	1
Gross capital formation	P.5	1.6	1 ½	1 ½	1 ½	1 ½	1 ½
Other expenditure		3.2	3 ½	3 ½	3 ½	3	3
Total expenditure		**48.5**	**49**	**47 ½**	**46 ½**	**45 ½**	**44 ½**
General government revenue (in accordance with the definition in Reg. 1500/2000)							
Taxes	D.2 D.5	22.6	22 ½	22 ½	22 ½	23	23
Social contributions	D.61	18.4	18 ½	18	18	17 ½	17 ½
Other revenue		3.9	4	3 ½	3 ½	3 ½	3
Total revenue		**45.0**	**45**	**44**	**44**	**43 ½**	**43**
Financial development of general government							
Total expenditure		48.5	49	47 ½	46 ½	45 ½	44 ½
Total revenue		45.0	45	44	44	43 ½	43
Net lending/borrowing	B.9	-3.5	-4	-3 ½	-2 ½	-2	-1 ½
Interest expenditure	D.4	3.1	3	3	3	3	3
Primary balance		-0.4	-1	-½	½	1	1 ½

(1) Discrepancies in the totals are the result of rounding.
(2) Including other taxes on production (D.29).

Table 12: Development of government debt

(Maastricht definition)

	ESA Code	2002	2003	2004	2005	2006	2007
	in % of GDP						
Government debt		**60.8**	**64**	**65**	**65 ½**	**65**	**64 ½**
Primary balance		-0.4	-1	-½	½	1	1 ½
Interest expenditure		3.1	3	3	3	3	3
Change in nominal GDP	B.1.g	1.8	1	2 ½	3 ½	3 ½	3 ½

Table 13: Comparison of projections in the December 2002 and December 2003 stability programmes

	ESA Code	2002	2003	2004	2005	2006	2007
Change in nominal GDP in %							
Stability programme 2003	B.1.g	1.8	1	2 ½	3 ½	3 ½	3 ½
Stability programme 2002	B.1.g	2	3 ½	3 ½	3 ½	3 ½	-
Difference			-2 ½	-1	0	0	-
Balancing item in % of GDP							
Stability programme 2003	B.9	-3.5	-4	-3 ½	-2 ½	-2	-1 ½
Stability programme 2002	B.9	-3 ¾	-2 ¾	-1 ½	-1	0	-
Difference			-1 ¼	-2	-1 ½	-2	-
Government debt in % of GDP							
Stability programme 2003		60.8	64	65	65 ½	65	64 ½
Stability programme 2002		61	61 ½	60 ½	59 ½	57 ½	-
Difference			3 ½	4 ½	6	7 ½	-