COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2004
SEC(2004) 193 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

On the updated stability programme of Germany, 2003-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 (formerly 109c) of the Treaty (from 1 January 1999, the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Germany's first stability programme covering the period 1998-2002 was submitted on 4 January 1999 and assessed by the Council on 15 March 1999[2].

Germany submitted its fifth and most recent update of the stability programme, covering the period 2003-2007, on 5 December 2003. Budgetary negotiations in Germany after that date prompted Germany to submit an addendum to this update on 29 January 2004, incorporating the definitive frames for the Federal Budget 2004. The Commission services have carried out a technical evaluation of this revised updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn 2003 forecast as well as subsequent economic developments, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The fifth update of Germany's stability programme largely complies with the Code of Conduct on the Content and Format of Stability and Convergence Programmes. However, two shortcomings make it difficult to provide a thorough assessment. First, the programme makes frequent use of rounding the data to a quarter and even half of a percent. Furthermore, the Code requires providing a break-down of the budgetary developments by levels of government. While this requirement is respected in the update, transparency of the data provided could have been enhanced, had the assumptions underlying these projections been made more explicit, in particular for the level of the Länder.
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> On 21 January 2003, on the basis of a Commission Recommendation, the Council decided in accordance with Article 104 (6) EC that an excessive deficit existed in Germany and issued a recommendation based on Article 104 (7) EC requesting Germany to bring this situation to an end by 2004 at the latest. On 18 November 2003, the Commission adopted two recommendations on the basis of Articles 104 (8)

1 OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C 124, 5.5.1999.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002.

and 104 (9) respectively, for the Council (1) to decide that the measures taken by Germany in response to the recommendation of 21 January 2003 had proved inadequate to bring the excessive deficit to an end, and (2) to give notice to Germany to take the necessary measures to bring the government deficit below 3% of GDP in 2005. On 25 November 2003, the Council did not adopt the two Commission recommendations, but adopted instead a set of conclusions taking note, among other things, of the commitments made by Germany to achieve a reduction of the cyclically-adjusted deficit by 0.6% and at least 0.5% of GDP in 2004 and 2005, respectively, so as to ensure that the general government deficit is brought below 3 % of GDP.

Following the protracted stagnation over the last three years, the 2003 update projects real GDP growth to resume from an estimated minus 0.1% in 2003 to 1.7% in 2004. In the period 2005 to 2007, growth is estimated to average 2¼%. Employment is expected to pick up from zero growth expected in 2004 to an average growth of ¾% from 2005 to 2007. The GDP deflator is forecast at 1% for 2004 and to stay at an average of 1% from 2005 to 2007.

The growth outlook for 2004 appears realistic and is close to the Commission Autumn 2003 projection of 1.6% for 2004. However, the update appears to be rather optimistic regarding the outlook for 2005 and subsequent years, with real growth of 2¼% projected to continue to 2007. The text of the update attributes this to an expected rise in potential output, not explicitly calculated in the programme, the underlying assumption being that the structural reforms – some implemented in 2003 and some forthcoming in 2004 and 2005 – will have an early and substantial positive impact. According to the updated programme, the output gap will not be fully closed by 2007. By contrast, the Commission forecasts real growth of 1.8% in 2005. Moreover, on the basis of the data provided in the addendum to the update, the commonly agreed method results in an estimate for potential growth of 1½% on average between 2005 and 2007. Therefore, even if a cyclical recovery seems to be finally under way, the uncertainties concerning its strength and duration are considerable.

In 2003, despite significant consolidation efforts undertaken by the German government, public finances continued to deteriorate. The general government deficit is estimated by the German authorities to have increased from 3.5% of GDP in 2002 to 4.0% in 2003. As the data are still preliminary, the Commission sees a chance that the 2003 deficit might be slightly lower. Based on the data provided in the programme, the cyclically-adjusted balance improved by 0.2 percentage points in 2003. In its Autumn 2003 forecast the Commission had estimated a deficit ratio of 4.2% and a deterioration in the cyclically-adjusted balance by 0.1 percentage points in 2003.

For 2004, the German authorities project the government deficit at 3 ¼ % of GDP and at 2½% for 2005. At the Ecofin Council of 25 November 2003, Germany committed to reduce the cyclically-adjusted deficit ratio by 0.6 and 0.5 percentage points in 2004 and 2005, respectively. According to the calculations by the German authorities contained in the addendum to the programme update, the budgetary plans for 2004 are consistent with an improvement in the cyclically-adjusted balance by 0.7 and by 0.4 percentage points in 2004 and 2005, respectively. In this way, the envisaged cumulative reduction by 1.1 percentage points would be frontloaded. This effect is due to the political agreement on the budget reached in the mediation committee in Germany in December 2003, which is accounted for in the addendum to the update. Compared with the plans contained in the December update, part of the cuts in subsidies (i.a. to commuters, on owner-occupied housing and from the "Koch-Steinbrück package") have been cancelled. This is partly countered by the introduction of a sustainability fund for the public pension system (from 2005 onwards) and the assumption of offsetting expenditure savings.

However, due to one-time risks in the budget for 2004 the Commission considers likely that the improvement foreseen for 2004 may fall short of 0.7% of GDP. As these risks do not affect the 2005 budget, this shortfall would be reflected as an accordingly greater cyclical adjustment in 2005. In particular, the amnesty on tax evasion may yield less revenue than planned in the government budget for 2004 (while leaving 2005 more or less unchanged). Furthermore, the revenues foreseen from a planned motorway toll system for lorries will not be forthcoming. It is also unclear how the legislated change in the corporate tax regime for health and life insurers will affect tax revenues compared with the official tax estimation of November 2003, on which the 2004 budget is based.

There remains a sizeable risk for the deficit to remain above the 3% of GDP Treaty reference value in 2005 for two reasons. The first is that GDP growth in 2004 and 2005 may well fall short of the central scenario underlying the updated programme. Contrary to previous updates, the sensitivity analysis contained in the new update assumes variations of GDP growth in nominal instead of real terms of ½ percentage point above or below the central scenario for 2004-2007. However, inflation and real growth may impact on the budget in different ways. In the lower (and more realistic) growth scenario the danger for the deficit to exceed 3% of GDP in 2005 is high.

The second risk for the correction of the excessive deficit by 2005 is that the expenditure targets for 2004 or 2005 may not be achieved. In particular, even with growth as expected in the update's central scenario, unemployment-related, pension and health expenditure may be higher than foreseen.

In the update and its addendum Germany confirms its commitment of 25 November 2003 to correct the excessive deficit by 2005 and, if necessary, to take additional measures to that effect.

According to the update, limiting expenditure remains the cornerstone of the budgetary strategy. The expenditure-to-GDP ratio is projected to fall from 49% of GDP in 2003 by about one percentage point annually until 2007. The bulk of the expenditure restraint is envisaged to fall on social benefits, compensation of government employees and subsidy cuts. Comparing the paths of the expenditure-to-GDP ratio contained in the original programme of 1998 and its updates, it appears that for each consecutive programme, the expenditure target was postponed by one year for most of the years covered. Thus, the actual expenditure-to-GDP ratio in 2003 was 49.0%, only slightly lower than in 1997.

The ratio of revenues to GDP is projected to decline gradually from 45% of GDP in 2003 to 43% in 2007. This is supposed to come from reductions in social security contributions, while the tax ratio is projected to remain constant, the income tax cuts being offset by the effect of the cyclical revival.

The budgetary stance in the update is insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position close to balance or in surplus is achieved within the programme period. For 2006 and 2007 the projections, rounded to the nearest half of a percent in the update, are for headline deficits of 2% and 1½% of GDP, respectively. The improvement in the cyclically-adjusted deficit for 2006 and 2007 appears to be rather less than ½ percentage point annually. In addition, a budgetary position providing a sufficient safety margin to avoid in the future breaching the 3% of GDP deficit threshold under normal macroeconomic conditions would not be reached before 2007.

The updated programme states that the German government revised its fiscal policy targets in 2003 in response to almost three years of persistent stagnation. The budgetary strategy adopted in previous updates had been to limit expenditure, flanked by structural measures to improve the functioning of the labour market, strengthen social security finances and broaden tax bases. While these objectives are confirmed, the aim of stimulating business activity by fiscal policy has been added. Fiscal consolidation over and above the proposed measures is regarded as putting the cyclical upturn at risk. The 2000 update aimed at a balanced budget for the general government by 2004, and the 2002 update postponed the target date to 2006. The 2003 update, while reiterating that achieving a balanced budget is remaining central to budgetary policy, no longer contains a target date.

Given the persistent imbalances in Germany's public finances, this revision of fiscal policy targets carries risks. At the end of December 2003 the third stage of tax relief, planned since 1999 and foreseen for implementation in 2005, was partially carried forward to 2004. Although officially in force since 1 January 2004, companies will need time to adjust their administration to the new tax rules. The hoped-for fiscal stimulus to domestic demand from the tax cuts may thus show up only later this year when the recovery may be already underway. Furthermore, the effect of the tax cuts may not be large. The public is aware that under the present tight budgetary conditions net income gains from tax cuts that result in a higher deficit need to be reversed in the future, as witnessed also by the high private savings ratio in Germany.

Although the updated programme specifies the allocation of the deficit to different government levels and insofar follows the requirements of the Code of Conduct, the presentation is vague about which policies the state and local governments are assumed to be pursuing in order to adhere to this path. This lack of information is regrettable since in 2002 the different levels of government agreed in the "Finanzplanungsrat" on expenditure paths for 2003 and 2004. It is not yet decided whether this agreement will be renewed for the time after 2004. Furthermore, the update is silent about the continuing high fiscal transfers to the eastern part of the country, which remains key for Germany's budgetary prospects.

Speeding up the budgetary adjustment would ensure an earlier and larger decline in the debt to GDP ratio, which has risen from 40% of GDP in 1991 to over 60% of GDP in 1997. It is projected to remain above 60% throughout the period covered by the programme and to start declining slightly only in 2007. The development of the debt ratio still risks being less favourable than projected, given the uncertainty about the medium-term growth rate and the actual achievement of the planned deficit reduction.

On the basis of current policies, the risk of future budgetary imbalances cannot be ruled out. Germany made progress in the reform of the public pension system and to a smaller extent in reforming the health sector. Although such reform steps are welcomed, the expected effects may not suffice to offset the long-term demographic impact on pension and health care expenditures. According to Commission quantitative indicators on the basis of current policies, the ageing of the population would result in the debt-to-GDP ratio remaining broadly constant over the next 20 years but increasing substantially thereafter.

The economic policies as reflected in the 2003 update are only partly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. With the "Agenda 2010", presented in 2003, Germany adopted an ambitious reform agenda for pension and health care systems as well as the labour market, overcoming political constraints. Its implementation over the coming years, should raise the growth potential and, hence, mitigate budgetary problems. However, further reform efforts are required.

Although Germany had implemented in 2003 the consolidation measures which were estimated to amount to 1% of GDP, as requested by the Council, they have proven inadequate to put an end to the excessive deficit situation by 2004. Indeed, there are some risks that the budgetary plans for 2004 and 2005 may not ensure the nominal deficit being below 3% of GDP by 2005. In addition, the new update does not foresee the achievement of a budgetary position close to balance or in surplus up to the horizon of the programme.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated stability programme of Germany and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

On the updated stability programme of Germany, 2003-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[5], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [9 March 2004], the Council examined the 2003 update of the stability programme of Germany, which covers the period 2003 to 2007. The update was submitted on 5 December 2003; responding to political developments an addendum was submitted on 29 January 2004. The updated programme largely complies with the requirements of the revised "Code of conduct" on the content and format of stability and convergence programmes, although a greater degree of precision of the data provided would have been desirable. The update also remains vague about the assumptions that underlie its projections of the adjustment path of public finances of different levels of government.

On 21 January 2003, on the basis of a Commission Recommendation, the Council decided in accordance with Article 104 (6) EC that an excessive deficit existed in Germany and issued a recommendation based on Article 104 (7) EC requesting Germany to bring this situation to an end by 2004 at the latest. On 18 November 2003, the Commission adopted two recommendations on the basis of Articles 104 (8) and 104 (9) respectively, for the Council (1) to decide that the measures taken by Germany in response to the recommendation of 21 January 2003 had proven inadequate to bring the excessive deficit to an end, and (2) to give notice to Germany to take the necessary measures to bring the government deficit below 3% of GDP in 2005. On 25 November 2003, the Council did not adopt the two Commission recommendations, but adopted instead a set of conclusions taking note, among other things, of the commitments made by Germany to achieve a reduction of the cyclically-adjusted deficit by 0.6% and at least 0.5% of GDP in 2004 and 2005, respectively, so as to ensure that the general government deficit is brought below 3 % of GDP.

[5] OJ L 209, 2.8.1997.

The 2003 updated programme states that the German government revised its fiscal policy targets in 2003 in response to almost three years of persistent stagnation. The budgetary strategy adopted in previous updates had been to limit expenditure, flanked by structural measures to improve the functioning of the labour market, strengthen social security finances and broaden tax bases. While these objectives are confirmed in the strategy contained in the 2003 update, the aim of stimulating business activity by fiscal policy has been added. Fiscal consolidation over and above the proposed measures is regarded as putting the cyclical upturn at risk. The 2000 update aimed at a balanced budget for the general government by 2004, and the 2002 update postponed the target date to 2006. The 2003 update reiterates that achieving a balanced budget is remaining central to budgetary policy but no longer contains a target date.

Following the protracted stagnation over the last three years, the 2003 update projects real GDP growth to resume from an estimated -0.1% in 2003 to 1.7% in 2004. In the period 2005 to 2007, growth is estimated to average 2¼%. Employment is expected to pick up from zero growth expected in 2004 to an average growth of ¾% from 2005 to 2007. The GDP deflator is forecast at 1% for 2004 and to stay at an average of 1% from 2005 to 2007.

The growth outlook for 2004 appears realistic and is close to the Commission Autumn 2003 projection of 1.6% for 2004. However, the update seems to be too optimistic regarding the outlook for 2005 and subsequent years, with real growth of 2¼%, projected to continue to 2007. This is attributed to an expected rise in potential output, the underlying assumption being that the structural reforms – some implemented in 2003 and some forthcoming in 2004 and 2005 – will have an early and substantial positive impact. By contrast, the Commission forecasts real growth of 1.8% in 2005. Moreover, on the basis of the data provided in the addendum to the update, the commonly agreed method results in an estimate for potential growth of 1½% on average between 2005 and 2007. The scenario for the medium-term improvement in the deficit depicted in the update thus combines the hope of an output gap closure with a notable optimism for an upward shift of potential output. Although not fully implausible, the macroeconomic assumptions appear not consistent with the degree of caution that should underpin a prudent fiscal strategy.

For 2003, the update estimates a deficit of 4.0% of GDP; as these data are still preliminary, the Commission sees a chance that it might be slightly lower. The update targets a general government deficit of 3¼% of GDP in 2004 and of 2½% for 2005. The update thus foresees the excessive deficit to be corrected by 2005 in line with the Council conclusions of 25 November 2003. In cyclically-adjusted terms, based on calculations by the Commission, the budget balance would improve by 0.7 percentage points in 2004 and by 0.4 percentage points in 2005. However, one-time revenue risks in 2004, notably from the amnesty on tax evasion and the motorway toll for lorries, might alter the relative size of the adjustment steps.

In the update and its addendum Germany confirms its commitment of 25 November to correct the excessive deficit by 2005 and, if necessary, to take additional measures to that effect. Indeed, under plausible macro-economic and budgetary assumptions, the adjustment path in the programme may be insufficient to correct the excessive deficit in 2005. The achievement of this objective is surrounded by several risks: (1) GDP growth in 2005 may be below the central scenario of the updated programme. According to the sensitivity analysis performed in the update, under the prudent assumption of a shortfall in nominal growth by half a percentage point in 2004 and in 2005, the headline deficit would lie around 3% of GDP in 2005. (2) The expenditure targets for 2004 or 2005 may not be achieved, even with growth as expected in the update's central scenario. Subject to risk are notably unemployment-related outlays and expenditures on pensions and health, which may turn out higher than foreseen.

The budgetary stance in the update is insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position close to balance or in surplus is achieved within the programme period. For 2006 and 2007 the projections, rounded to the nearest half of a percent in the update, are for headline deficits of 2% and 1½% of GDP, respectively. The improvement in the cyclically-adjusted deficit for 2006 and 2007 appears to be rather less than ½ percentage point annually. In addition, a budgetary position providing a sufficient safety margin to avoid breaching the 3% of GDP deficit threshold under normal macro-economic conditions would only be reached by 2007.

The debt ratio is projected to start declining only in 2007 and to remain above the Treaty 60% of GDP reference value throughout the period covered by the programme. The evolution of the debt ratio risks being less favourable than projected, given the uncertainty about the medium-term growth rate and the actual achievement of the planned deficit reductions.

Germany has recently passed reforms that partly adjust the pension system and, to a lesser extent, in the health sector, to demographic change. While Germany is in a considerably better position than before to meet the budgetary costs of population ageing, risks of imbalances in the long term cannot be ruled out. According to Commission quantitative indicators on the basis of current policies, demographic change would result in the debt-to-GDP ratio remaining broadly constant over the next 20 years but increasing substantially thereafter.

The economic policies as reflected in the 2003 update are only partly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. Although Germany had implemented consolidation measures of the requested size equalling 1% of GDP, they have proved inadequate to put an end to the excessive deficit situation by 2004. Efforts at budgetary consolidation are underpinned by the "Agenda 2010", an ambitious reform programme presented in 2003 with the aim of boosting growth in the medium-term. Implementation began in 2003 and is foreseen to continue over the next years.