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DECEMBER 2004 UPDATE OF THE STABILITY PROGRAMME OF GERMANY (2004-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The German cabinet adopted the update of the German stability programme on 1 December 2004. It covers the period from 2004 to 2008. The programme complies broadly with the data requirements of the "Code of Conduct on the content and format of stability and convergence programmes".[2] Deficiencies relate to (i) the information on external assumptions, (ii) the mixing of incompatible data (policy effects are compared sometimes to a baseline unknown to the reader, and sometimes to 2004 as the reference year); (iii) the presentation of rounded figures for key data. However, improvements are noted in terms of details e.g. in using ESA 95 as a consistent statistical framework in the parts on the macro-economic scenario and the budgetary projections.

The macro-economic scenario underlying the programme projects real GDP growth at 1.7 % for 2005, practically unchanged from an expected rate of 1.8 % in 2004. Adjusted for substantial calendar effects, the figures imply an acceleration of growth by ¾ pp in 2005. In the final three years covered by the programme, growth is expected to remain flat at 2 % p.a. According to Commission services calculations applying the commonly agreed methodology to the figures of the programme, real GDP growth would be somewhat higher than potential, which is estimated to average 1½ % over the period 2004-2008. The output gap would however remain negative until 2008. For the year 2005, the projections of the Commission services are slightly less favourable than those of the programme and downward risks have increased since the Commission services autumn forecast. While real GDP growth projections of the update carry some downward risk for 2005, they appear plausible for the remaining years. However, the GDP deflator underlying the forecast appears to be somewhat high and may imply an overestimation of tax revenues towards the end of the programme period.

As in previous updates, the medium-term budgetary strategy aims at a balance between structural reforms, budgetary consolidation and cyclical stabilisation. The programme aims at reducing the general government deficit to below 3 % of GDP in 2005 and at ensuring a continuous decline in the following years. The deficit is projected to be reduced from 3.7 % of GDP in 2004 to 2.9 % of GDP in 2005, and thereafter to decline steadily by ½ percentage point of GDP per year to 1½ % of GDP in 2008. Compared to the previous programme, the current update follows almost the same path of adjustments, although delayed by one year, on the basis of a slightly weaker growth scenario. The primary balance is projected to swing from a deficit of ½ % of GDP in 2004 to a surplus of 2 % of GDP in 2008. According to Commission services calculations based on the projections of the programme and the commonly agreed methodology, the cyclically-adjusted balance would also improve by 0.6 pp in 2005, but only by 0.3 pp annually in 2007 and 2008 to reach -1.3 % of GDP in 2008. A close-to-balance budgetary position would therefore not be reached by the final year of the programme.

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1 This technical analysis, which is based on information available up to 26 January 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 2 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Stefan Kuhnert (stefan.kuhnert@cec.eu.int), Heinz Jansen (heinz.jansen@cec.eu.int) and Peer Ritter (peer.ritter@cec.eu.int).

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001

As far as it is possible to judge on the basis of current information, the measures announced by the German authorities in November 2004 should be sufficient to reduce the deficit to 2.9% of GDP in 2005, compared with the deficit projected at 3.4% by the Commission services autumn forecast of October 2004. However, this is subject to two main risks: First, growth may be lower than expected. Second, expenditure on social transfers may be higher for reasons other than unexpectedly low growth. Also, the most important one-off measure to reduce the deficit remains subject to a decision by Eurostat. In the years after 2005, the budgetary situation remains vulnerable, although the general government deficit is likely to stay below 3 % of GDP. The budgetary stance laid out in the update seems 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. In view of the improvement in the cyclically-adjusted balance towards the end of the programme period by less than 0.5 pp, the adjustment projected in the update is quite small, despite the implementation of remarkable structural reforms likely to reduce medium-term expenditures. Moreover, the path of budgetary adjustment seems rather optimistic towards the programme horizon, in particular as regards the expected surpluses of the social security system. Furthermore, tax revenues seem to be estimated somewhat favourably from 2006 on. It should also be noted that the one-off measures taken in November 2004 to bring the deficit below 3 % of GDP in 2005 weaken to some extent the budgetary position towards the end of the programme period and beyond. Also in view of this risk assessment, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3 % deficit threshold with normal macroeconomic fluctuations before 2008.

The debt-to-GDP ratio is projected to remain above 60 % of GDP throughout the period covered by the programme. After increasing by 6 pp between 2001 and 2004 to 65½ % of GDP, it is projected to fall to 65 % of GDP by 2008. The projected path for the debt is subject to the same risks as for the deficit ratio: any slippage in the latter would delay the reduction of the debt ratio as from 2007.

The update reviews the important structural reforms implemented in the labour market as part of the "Agenda 2010" package, and in the public pension and health care systems. These reforms are the main reason for the decline of monetary transfers by 2 % of GDP and of government final consumption by 1½ pp between 2004 and 2008. In 2005, a new social benefit scheme is being introduced, which strengthens the incentives for the unemployed to look for jobs while not fully removing the unemployment trap for low-paid work from the tax benefit system. The sustainability of the public pension system was reinforced by linking pensions and the contribution rate to demographic developments. The sustainability of the public pension system was reinforced by linking pensions and the contribution rate to demographic developments. Incentives for later retirement were partially strengthened and the portability of supplementary pension schemes improved. The reforms in the health care sector led to substantial expenditure relief in 2004. However, they will only partly contain future spending pressures.

Germany appears to be in a relatively favourable position with regard to long-term sustainability of the public finances, of which the projected budgetary cost of an ageing population is an important element. However, long-term sustainability hinges crucially on the achievement of the planned budgetary consolidation in the medium-term. The already legislated structural reforms and in particular the pension reform is likely to reduce the budgetary impact of ageing. However, the exonerating budgetary impact of the ongoing reforms is subject to considerable uncertainty, and the update concedes that further measures are needed to contain notably health-related expenditures.

Overall, the economic policies outlined in the 2004 update are partly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, no reduction of the cyclically-adjusted deficit occurred in 2004. The planned medium-term adjustment in the cyclically adjusted balance from 2007 onwards is below ½ pp of GDP and, moreover, subject to risks. It will not lead to a close-to-balance budgetary position over the period covered by the programme. This is despite the fact that Germany has implemented important structural reforms, notably concerning the labour market and pension systems, which put the country in a better position to face the consequences of an ageing population. It remains crucial for Germany to succeed in moving to higher trajectories of actual and potential growth by mobilising its underutilised employment reserves.

In view of the above assessment, it would be appropriate for Germany to (i) do the necessary to ensure the correction of the excessive deficit in 2005; (ii) to implement budgetary adjustments in the years beyond 2005 that will allow a budgetary position of close to balance to be achieved by the end of the programme period; and (iii) continue with structural reforms in order to further improve the long-term sustainability of public finances, in particular as regards the health care system.

Comparison of key macroeconomic and budgetary projections

		2004	**2005**	**2006**	**2007**	**2008**
Real GDP (% change)	**SP Dec 2004**	**1.8**	**1.7**	**1 ¾**	**2**	**2**
	COM Oct 2004	1.9	1.5	1.7	--	--
	SP Jan 2004	*1.7*	*2 ¼*	*2 ¼*	*2 ¼*	--
HICP inflation (%)	**SP Dec 2004**	**--**	**--**	**--**	**--**	**--**
	COM Oct 2004	1.7	1.3	1.1	--	--
	SP Jan 2004	--	--	--	--	--
General government balance (% of GDP)	**SP Dec 2004**	**-3 ¾**	**-2.9**	**-2 ½**	**-2**	**-1 ½**
	COM Oct 2004	-3.9	-2.9	-2.6	--	--
	SP Jan 2004	*-3 ¼*	*-2 ½*	*-2*	*-1 ½*	--
Primary balance (% of GDP)	**SP Dec 2004**	**- ½**	**0**	**½**	**1 ½**	**2**
	COM Oct 2004	-0.8	0.2	0.5	--	--
	SP Jan 2004	*- ¼*	*½*	*1*	*1 ½*	--
Cyclically-adjusted balance (% of GDP)	**SP Dec 2004**[1]	**-3.0**	**-2.4**	**-1.9**	**-1.6**	**-1.3**
	COM Oct 2004	-3.4	-2.4	-2.1	--	--
	SP Jan 2004[1]	*-2.5*	*-2.1*	*-1.6*	*-1.4*	--
Government gross debt (% of GDP)	**SP Dec 2004**	**65 ½**	**66**	**66**	**65 ½**	**65**
	COM Oct 2004	65.9	66.7	67.1	--	--
	SP Jan 2004	*65*	*65 ½*	*65 ½*	*65*	--

Note:
[1]Commission services calculations on the basis of the information in the programme
Sources:
Stability programme (SP); Commission services autumn 2004 economic forecasts (COM) adjusted to include the additional budgetary package presented in November, cf: Communication from the Commission to the Council: "The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice", 14 December 2004, COM(2004) 813; Commission services calculations

1. INTRODUCTION

The German cabinet approved the update of the German stability programme on 1 December 2004 and submitted it on the same day[3]. The programme update has been sent to both houses of the German parliament for information. It covers the period from 2004 to 2008. The update broadly complies with the data requirements of the "code of conduct on the content and format of the stability and convergence programmes". Information on exogenous assumptions does not meet the requirements of Table 7 in Annex 3 of the code of conduct. Moreover, the document suffers from a lack of transparency. This concerns the perennial usage of rounded figures and the mixing of incompatible data (policy effects are sometimes compared to an unspecified baseline and sometimes 2004 is used as a reference year). However, improvements are noted in terms of details, e.g. in using ESA 95 as a consistent statistical framework in the parts on the macro-economic scenario and the budgetary projections.

2. MACROECONOMIC DEVELOPMENTS

The update estimates real GDP growth at 1.8 % in 2004 and 1.7 % in 2005. In calendar-adjusted terms, this implies an acceleration of real GDP growth from 1.3 % in 2004 to 1.9 % in 2005. For the outer years, only trend averages are reported, stating annual real GDP growth rates close to but below 2 %. The update's assessment of the macroeconomic developments in 2004 is in line with the Commission services autumn 2004 forecast. However, in view of the weak growth in 2004Q3, which could be taken into account by the update but not by the Commission services forecast, the update's growth forecast for 2004 may prove somewhat optimistic. Indeed, a preliminary estimate by Destatis arrives at a figure of 1.7% for the year as a whole.

The economy's recent weak performance is posing an additional downward risk to the cyclical recovery in 2005. The German authorities' outlook for real GDP growth in 2005 is already slightly more optimistic than the Commission services autumn forecast. Also expectations about the composition by demand components differ: the German authorities expect stock building and external trade to provide major contributions to real GDP growth, whereas the Commission services are more upbeat on final domestic demand growth, with different implications for government revenues.

Information on the update's basic forecast assumptions is sparse, as no precise figures are reported for several important exogenous variables but only qualitative information. Nevertheless, the update's basic assumptions appear to be largely in line with the Commission services autumn forecast for 2005 and 2006.

3 OJ C68/2,18.2.2004.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007	2008
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**SP**	**SP**
Real GDP (% change)	1.9	1.8	1.5	1.7	1.7	1 ¾	2	2
Contributions:								
- Final domestic demand	-0.2	-0.2	1.0	0.7	1.7	1 ¾	2	2
- Change in inventories	0.3	0.1	0.1	0.4	0.1	¼	¼	¼
- External balance on g&s	1.8	1.9	0.4	0.5	-0.1	- ¼	- ¼	- ¼
Employment (% change)	0.1	0.1	0.8	0.5	0.7	½	½	½
Unemployment rate (%)	9.7	--	10.0	--	9.6	--	--	--
HICP inflation (%)	1.7	--	1.3	--	1.1	--	--	--
GDP deflator (% change)	1.0	0.8	1.0	1.0	0.9	1 ¼	1 ½	1 ½
Current account (% of GDP)	4.2	--	4.4	--	4.4	--	--	--
<u>Sources</u>: *Commission services autumn 2004 economic forecasts (COM); stability programme update (SP)*								

The programme's assessment of the cyclical development beyond 2005 is difficult to evaluate, as point forecasts are only provided for 2005 and 2008 and, with the exception of real GDP growth, time paths are specified as average yearly growth rates. However, with real GDP growth forecasts being close to but below 2 % p.a. from 2006 to 2008, the German authorities are now more cautious than in previous updates regarding the medium-term outlook for *real* growth. On the other hand, compared with the last programme update from January 2004, the forecast for the GDP deflator has been significantly revised upwards, leaving the growth path of *nominal* GDP practically unchanged at 3¼ % p.a. Yet, the update does not substantiate the projected increase in GDP deflator growth. As a further consequence of the rather optimistic nominal GDP growth projection, gross wages and salaries per employee are foreseen to increase by 2 % p.a., which compares with a Commission services autumn forecast of only 1.4 % for 2006.

Based on the programme's macroeconomic scenario and on Commission services calculations according to the commonly agreed methodology, potential output growth is estimated to increase slightly from 1.4 % in 2004 to 1.7 % in 2008. Real GDP growth is thus forecast to outpace its potential in five consecutive years. As a consequence, the negative output gap will be closed in 2008. The adjustment path of the output gap is close to the Commission services' estimate until 2006. In view of Germany's relatively low growth potential, a gradual closure of the output gap within the forecast horizon does not appear unrealistic.[4]

[4] Based on the stability programme data, recent labour market reforms do not lead to higher estimates for potential output growth in 2007 and 2008. This counterintuitive result of the commonly agreed method occurs because labour force potential is determined by working age population growth, (smoothed) labour force participation rates and the NAIRU. All of these determinants display a certain degree of inertia, and may therefore not immediately respond to structural labour market reforms. As a consequence, potential output growth could be underestimated in the final years covered by the programme, and the closure of the output gap thus be postponed until after 2008.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008
	COM	SP[3]	COM	SP[3]	COM	SP[3]	SP[3]	SP[3]
Potential GDP growth[1]	1.4	1.4	1.3	1.4	1.6	1.5	1.6	1.7
Contributions:								
- Labour	0.4	0.3	0.2	0.2	0.4	0.3	0.2	0.2
- Capital accumulation	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.5
- TFP	0.7	0.8	0.8	0.8	0.9	0.9	1.0	1.1
Output gap[1,2]	-1.2	-1.2	-1.0	-0.9	-0.9	-0.7	-0.3	-0.0

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme update

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

The update identifies downside risks to growth, which are related to the external factors, notably to persistent high oil prices and a sudden correction of the imbalances in the US economy. On the other hand, a more favourable outlook for external demand and a stronger recovery of domestic demand would also be conceivable. However, the update neither balances the upside and downside risks nor does it quantify their effects on the German economy. Instead, a mechanical exercise is presented, evaluating the effects on the budgetary position of a permanent ±½ pp shock on nominal GDP growth (see section 4.3).

3. BUDGETARY IMPLEMENTATION IN 2004

Despite consolidation efforts undertaken by the German government, the general government deficit remained almost unchanged from 2003, at 3.9% of GDP in 2004 according to the estimate published by the German Statistical Office on 13 January. This corresponds to the Commission services' autumn forecast and compares with a deficit target of 3.3% of GDP put forth by the 2003 update of the stability programme. As the assumption for real GDP growth remained virtually unchanged between the two updates, the reasons for missing the target are only partly due to cyclical circumstances, namely a tax-unfriendly growth composition, but otherwise result from too optimistic assumptions on particular non-tax revenue items.

In early 2004, income taxes rates were reduced to the amount of 0.7% of GDP as part of the tax relief laws passed in 2000. These reductions were only partly financed by a broadening of the tax base. Although this had been taken into account in last year's update, the revenue outturn, estimated by the update at 43 ½% of GDP, has fallen short by one percentage point of GDP of the target in the 2003 update. About ¼ pp of this shortfall resulted from sluggish domestic demand, which kept consumption tax revenues lower than expected. Tax shortfalls were exacerbated by low mineral oil taxes in the wake of rising oil prices. The increase in the tobacco tax rate in March and December 2004 did not translate into higher revenues, but led to lower consumption of tobacco and to higher illegal tobacco imports. Moreover, the tax amnesty, aiming at repatriating savings deposited undeclared abroad, raised € 0.9bn against expectations of € 5bn. Social contributions at 18% of GDP fell short of target by ½ pp of GDP, as wage growth remained below expectations, and although public health insurers lowered contribution rates less than hoped-for by the government. The 2003 budgetary plan also expected revenues from the introduction of a road toll in 2004, which eventually was postponed to 2005, and dividends from the 2003 Bundesbank profit, which barely materialised.

General government expenditures remained almost unchanged in nominal terms compared with the previous year and, at 47½% of GDP, even turned out ½ pp lower than expected in the previous update. Monetary transfers exceeded the target, in particular since expenditures on transfers such as unemployment and social assistance increased as a result of the weakening labour market. The regular adjustment of retirement benefits was suspended in 2004. The health sector reforms introduced on at the beginning of the year reduced public spending on health care by about 0.2% of GDP compared with 2003.

In 2004, revenue shortfalls mostly affected the federal level (due to the shortfalls in excise duties, the road toll and Bundesbank dividends), thus its deficit was ¾ % of GDP above the target. The lower levels of government were on average able to compensate their tax shortfalls, in particular by reducing public investment and to some extent by continuing to cut bonus payments to employees. The social security system recorded a small deficit of € 1-2bn; the surplus earned by the health service providers was more than offset by larger-than-expected deficit in the nursing care insurance and overshooting monetary transfers.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Evolution of budgetary targets in successive programmes

Figure 1 presents the budgetary adjustment path envisaged by the authorities in the successive updates. The 2000 update aimed at a balanced budget for the general government by 2004, and the 2002 update postponed this target to 2006 (see also Table 3). The 2004 update does not aim for a balanced budget by the programme horizon. The worse-than-expected budgetary outcome in 2004 is not to be compensated by greater consolidation efforts in the future; indeed throughout the programme period, the annual deficits are ½ % of GDP higher than projected in the previous update.

The update expects lower revenues to be the reason for the ratcheting-up of the deficit path. While in 2004 and 2005 revenues fall short of last year's target by 1 % of GDP, the shortfall narrows to ½ % of GDP in each of the outer years. Real GDP growth, however, has been revised downwards compared with the previous update, by a significant ½ pp for 2005 and 2006 and by ¼ pp for 2007.[5]

The expenditure share is projected to fall by ½ pp from 2005 to 2006 and then by a full pp in 2007 and 2008. The cumulative reduction in the expenditure share between 2003 and 2007 remained unchanged from the previous update. Within this period, the expenditure reduction in 2004 and 2005 is greater than planned last year, while in 2006 it is planned to be comparatively less. . This disguises the 2004 update's projection of a stronger expenditure restraint in nominal terms towards the end of the programme period, because the nominal GDP is lower from 2003 on than projected last year.[6]

Table 3: Evolution of budgetary targets in successive programmes

5 For nominal GDP growth – relevant for tax revenues – the downward revision is less substantial: while for 2005 it also amounts to ½ pp, it is marginal for 2006 and 2007.

6 This seems to be related to lower government final consumption compared with the 2003 update, although no new measures were taken in this area compared with the 2003 update. See further below.

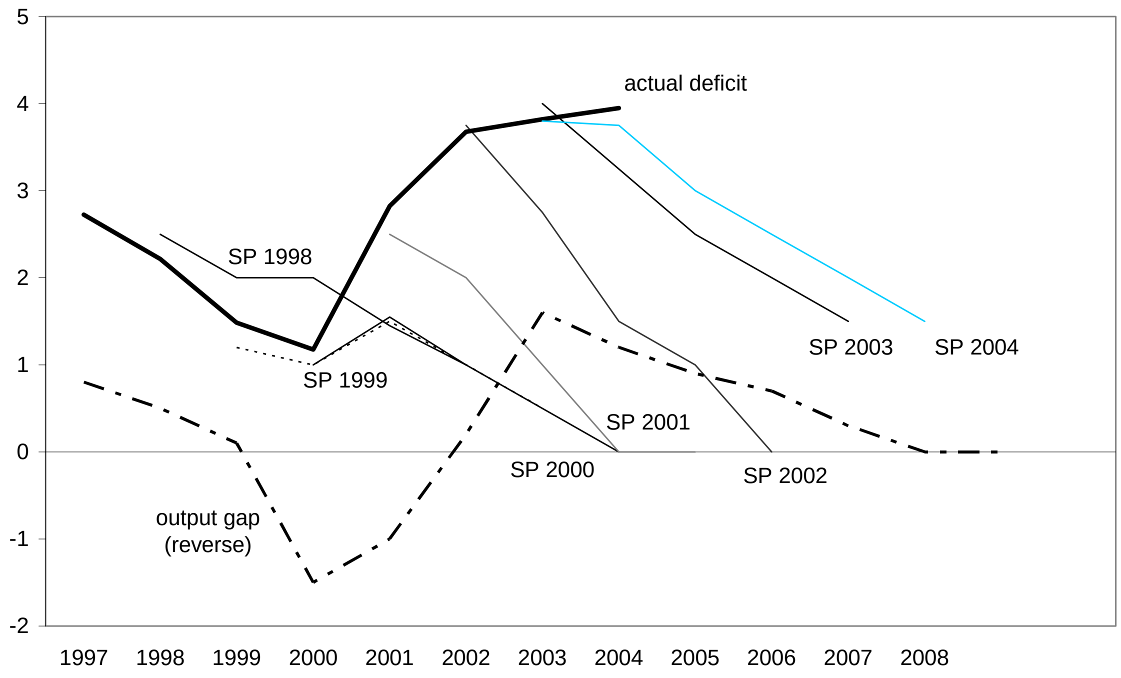
		2003	2004	2005	2006	2007	2008
General government balance (% of GDP)	**SP December 2004**	**-3.8**	**-3 ¾**	**-2.9**	**-2 ½**	**-2**	**-1 ½**
	SP January 2004	-4.0	-3 ¼	-2 ½	-2	-1 ½	--
	SP December 2002	*-2 ¾*	*-1 ½*	*-1*	*0*	--	--
General government expenditure (% of GDP)	**SP December 2004**	**48.8**	**47 ½**	**46**	**45 ½**	**44 ½**	**43 ½**
	SP January 2004	49	48	46 ½	45 ½	44 ½	--
	SP December 2002	*48*	*46 ½*	*45 ½*	*44 ½*	--	--
General government revenues (% of GDP)	**SP December 2004**	**45.0**	**43 ½**	**43**	**43**	**42 ½**	**42 ½**
	SP January 2004	45	44 ½	44	43 ½	43	--
	SP December 2002	*45*	*45 ½*	*44 ½*	*44 ½*	--	--
Real GDP (% change)	**SP December 2004**	**-0.1**	**1.8**	**1.7**	**1 ¾**	**2**	**2**
	SP January 2004	-0.1	1.7	2 ¼	2 ¼	2 ¼	--
	SP December 2002	*1 ½*	*2¼*	2¼	2¼	--	--
Sources: *Stability programmes*							

Box 1: The excessive deficit procedure for Germany

The Commission initiated the Excessive Deficit Procedure for Germany on 19 November 2002 and the Council decided on 21 January 2003 that an excessive deficit exists in Germany. At the same time, the Council recommended to Germany to bring the situation of an excessive deficit to an end in 2004 at the latest. On the basis of information available upon the expiration of the deadline of 21 May, the policies announced by the German authorities satisfied the requirement of budget consolidation measures amounting to 1 % of GDP, and the excessive deficit procedure has been held in abeyance. In November 2003, the Commission considered that the measures taken by Germany in response to the recommendation proved to be inadequate to correct the excessive deficit and adopted a recommendation for the Council to give notice to Germany to take measures to correct the excessive deficit. In this latter recommendation, the Commission proposed to extend the deadline for the correction of the excessive deficit to 2005. On 25 November 2003 the Council did not adopt the recommended decisions but instead adopted conclusions stating that, in light of the commitments by Germany, the excessive deficit procedure was held in abeyance. The Commission brought the case before the Court of Justice and on 13 July 2004 these Conclusions were annulled by the Court.

The Court did not elaborate on the implications stemming from the annulment of the Council conclusions of 25 November for the implementation of the excessive deficit procedure. In its Communication of 14 December 2004 addressed to the Council, the Commission clarified its position in this respect. The Commission considered that a satisfactory resolution of the budgetary problems of Germany within the framework of the Stability and Growth Pact demanded that the assessment of the actions taken to correct the excessive deficit situation should refer to 2005 as the relevant deadline. The Commission also concluded that action taken by Germany appeared to be broadly consistent with a correction of the excessive deficit by 2005 and that no further steps were necessary at that point under the excessive deficit procedure. The Commission noted, however, that if failures in implementing the envisaged correction measures should emerge at a later stage, it would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the Treaty and the Stability and Growth Pact. The Council agreed in its meeting of 18 January 2005 that further steps vis-à-vis Germany under the EDP are not necessary at this stage.

Figure 1: Budgetary adjustment paths in successive programme updates



Source: Stability programme updates

4.2. Budgetary targets in the updated programme

The budgetary strategy remains unchanged from last year's programme, aiming at a balance between structural reforms, budgetary consolidation and cyclical stabilisation. The update does not mention the target of reaching a budgetary position close-to-balance. Need for further structural reform is seen in the area of social security systems, in particular cost containment in the health care system. In the short-term, the update argues that the room for further consolidation would be limited by weak domestic demand.

The 2004 update aims at bringing the general government deficit below the 3%-of-GDP-ceiling in 2005, with the deficit projected at 2.9% of GDP. This is in line with the requirements under the excessive deficit procedure as clarified by the Communication from the Commission to the Council on 'the situation of Germany and France in relation to their obligation under the excessive deficit procedure following the judgement of the Court of Justice'.[7] In subsequent years, the deficit is projected to decline steadily by ½ pp annually to 1½% of GDP in 2008. Based on Commission services calculations according to the commonly agreed method, the cyclically-adjusted balance improves by 0.6 pp in 2005, by 0.5 pp in 2006, but only by 0.3 pp annually in 2007 and 2008, arriving at a

[7] Communication from the Commission to the Council: 'The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice', COM(2004) 813 of 14 December 2004. In October 2004, the Commission services autumn forecast projected the 2005 deficit at 3.4% of GDP. In November, the federal government presented additional expenditure-reducing measures in order to bring the deficit below 3% of GDP in 2005 (see Box 2). The Communication was based on the autumn forecast adjusted for the additional measures.

deficit of 1.3% of potential GDP in 2008. This indicates the need for further structural adjustment in the budget, in particular as the larger steps towards consolidation in 2005 and 2006 result to a considerable extent from the one-off measures included in the 2005 budget (see Box 2). The targets do not allow a close-to-balance budgetary position to be reached by the end of the programme period.

The tax share is projected to remain constant at 22% of GDP throughout the programme period (Table A-2 in the Annex). The update explains that the projected tax revenues were revised downwards compared with the 2003 update for the entire programme period. While the 2004 update's projection is very close to that of the Commission Autumn forecast for the year 2005, it assumes a somewhat optimistic tax revenue growth for 2006-2008. The share of social contributions is projected to fall by 1 pp to 17% of GDP in 2008. The update explains this by the release on expenditure in the public health insurance. Indeed, the health reform introduced in 2004 allows public health insurers to run a surplus in 2004. However, health insurers are required by law to reduce their accumulated debt until 2008. Hence they will be reluctant to lower contribution rates if the exonerating effects diminish in 2005 and thereafter. The possibility of contribution rates falling less than expected in the update must, however, be set against the somewhat favourable assumption for the growth of wages (see Section 2), on which social security contributions are based.[8] All in all, the risks to the projected reduction in the revenue share from 43% of GDP in 2005 to 42½% in 2008 seem balanced..

The expenditure share is projected to fall by 4 percentage points from 47½% of GDP in 2005 to 43½% in 2008. As Table 4 illustrates, government final consumption (- 1½ pp) and monetary transfers (-2 pp) are expected to largely contribute to the expenditure restraint.

The projected decline in government final consumption derives largely from the effects of the health reform introduced in 2004. While the expenditure savings compared with 2003 have indeed been substantial, part of these were the results of cutting the catalogue of refundable medication. In addition, some price caps on medication are being relaxed in 2005. Thus health care expenditure is likely to continue rising, albeit less than before the reform. In its introduction, the update concedes that further expenditure savings in the health sector are needed. General government expenditure on employees' compensation has been restrictive in 2003 and 2004 and is likely to be so in 2005, due to pay cuts and personnel reduction. However, in view of the projected economic recovery, a continuation of this trend into 2006-2008 seems unlikely. In sum, the update's projection of a reduction in government final consumption as a share of GDP seems optimistic, especially for 2007 and 2008.

Monetary transfers are projected to fall from 19½% of GDP in 2004 to 17½% in 2008. Most of this reduction is to occur in 2005 and 2006, namely ½ pp and 1pp, respectively. As pointed out in the update, this is mainly driven by the effects of the labour market reform as part of the "Agenda 2010". Unfortunately, the update does not offer an estimate of the projected expenditure savings. Following the first impressions from the introduction of these laws in January 2005, the savings may turn out to be small, at least for a transitory period. In addition, the 2004 pension reform (*Rentennachhaltigkeitsgesetz*) dampens pension expenditure towards the programme horizon. The update projects age-related expenditure to fall by 0.4 pp of GDP and unemployment insurance by 0.5 pp of GDP from 2003 to 2010. This implies that the

[8] The contribution base is gross wages of jobs liable to social security contributions. These jobs have been declining in 2004, while jobs with reduced contributions rates increased.

remainder of about 1 pp consolidation would derive from substantial reductions in other social benefits. Reductions of such magnitude seem ambitious, if not optimistic, although the labour market and pension reforms will certainly help gaining firmer control over expenditure. The update's optimistic assumptions on social transfers and social contributions can also be questioned from another perspective. The update assumes the surpluses in the social security system to grow from € 1-2bn in 2005 and 2006 to € 3-4bn in 2007 and 2008, allegedly deriving from positive balances in the public health and pension systems. As pointed out, the health sector is unlikely to repeat its remarkable surplus of 2004, though still running surpluses allowing to reduce debt. Furthermore, the government estimates the pension system to be in deficit by almost € 2bn in 2005 and in surplus by about € 1bn in 2006-2008.[9] Overall, the projected contribution of the social security system to reduce the general government deficit until 2008 is not fully explained by the update and likely to be overestimated.

All in all, the path of budgetary adjustment in the update contains elements of optimism, in particular for 2006-2008, relating both to tax and non-tax revenues. It should also be noted that the transaction undertaken by the cash settlement office for pensions of former postal civil servants, one of the one-off measures taken in November 2004 to reduce the deficit below 3% of GDP in 2005 (see Box 2), weakens the budgetary position towards the end of the programme period and beyond. De facto, the federal state will have to cover future pension payments in full once the liquidity from the securitisation is used up. This would result in additional "other expenditure" of 0.3 pp annually from 2007 onwards, on which the update is silent.

Moreover, as pointed out in Part 2 of this assessment, while projected real GDP growth is realistic, the assumed, but unexplained, increase in the GDP deflator towards the end of the programme period raises nominal GDP. While the revenue share is not very responsive to changes in nominal GDP growth, the expenditure share and the general government deficit rise if nominal GDP growth turns out less than expected.

Thus there are substantial risks that the projected reduction in the general government deficit, both in nominal and in cyclically-adjusted terms, may turn out lower than projected in the update.

Based on current information, the measures taken by the German authorities should be sufficient to bring the deficit below 3% of GDP in 2005. It seems also likely that the general government deficit will remain below 3% of GDP from 2006 on. However, the budgetary situation in Germany remains vulnerable. Correction of the excessive deficit requires effective implementation of all the measures envisaged, and of additional measures in case of unforeseen adverse developments. In this regard, the language of the 2004 update is cautious.[10] The consolidation effort is insufficient to restore a close-to-balance budgetary position over the programme period. The update projects an improvement of the cyclically-adjusted balance by only 0.3 pp annually in 2007 and 2008. Even this slow pace carries a downward risk and would in any case be insufficient to meet the country-specific recommendations on public finances in the Broad Economic Policy Guidelines. A sufficient safety margin to avoid breaching in the future the 3% of GDP reference value under normal cyclical conditions would just about be reached by

9 Bericht der Bundesregierung: "Rentenversicherungsbericht 2004", December 2004, Table B-1, available at: http://www.bmgs.bund.de/downloads/RVB04_Kabinett.pdf

10 The update states that "(t)he federal government will review the additional adjustment measures that can be taken if this proves necessary to comply with European requirements." (p. 8)

2007 according to the update, but in view of the above-mentioned risks the safety margin is likely to be reached only by 2008.[11]

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	2008	Change: 2008-2004
Revenues	45.0	43 ½	43	43	42 ½	42 ½	**-1**
of which:							
- Taxes & social security contributions	41.2	40	40	39½	39½	39	**-1**
- Other (residual)	3.8	3 ½	3 ½	3 ½	3 ½	3	**-½**
Expenditure	48.8	47 ½	46	45 ½	44 ½	43 ½	**-4**
of which:							
- Primary expenditure	45.7	44½	43	42½	41½	40½	**-4**
of which:							
Gross fixed capital formation	1.5	1 ½	1 ½	1 ½	1 ½	1 ½	**0**
Collective consumption & social transfers in kind	19.7	19	18½	18½	18	17½	**-1 ½**
Monetary transfers	19.7	19½	19	18	18	17½	**-2**
Subsidies	1.4	1 ½	1	1	1	1	**-½**
Other (residual)	3.4	3	3	3	3	3	**0**
- Interest payments	3.1	3	3	3	3	3	**0**
Budget balance	-3.8	-3 ¾	-3	-2 ½	-2	-1 ½	**2 ¼**
Primary balance	-0.7	- ½	0	½	1 ½	2	**2 ½**

Sources:
Stability programme update; Commission services calculations

11 Reference is made here to the "minimal benchmark". In the case of Germany, the latest estimate for this benchmark is 1.6% of GDP (see 2002 edition of the Public Finance report).

Box 2: The general government budget in 2005

As the main measure in the budget for 2005, the third and last stage of the 2000 tax reform enters into force. The linear-progressive income tax rate falls from 16% to 15% at the bottom, while falling from 45% to 42% at the top. The burden on the budget amounts to 0.3% of GDP. A further change in taxation concerns the tax treatment of pensions. Gradually from 2005 on, pension contributions will be tax-free for all pillars and types of pensions, while pension payments will be fully taxed. Due to the transition, a budgetary burden of 0.05% of GDP arises for 2005, which is rising in the medium-term.

The “Hartz IV” reform of the social benefit system enters into force, involving more strict benefit calculation and better incentives to search for jobs. The update does not offer a budgetary projection, and those presented by the government in the draft law of October 2003 are outdated. However, given the administrative problems in the transition, the budgetary relief for 2005 can be expected small.

In the public pay-as-you-go pension system, a “sustainability factor” is introduced that automatically dampens pension payments (and hence the contribution rate) when the number of recipients rises relative to the number of contributors. A budgetary relief of 0.05% of GDP is expected for 2005. Furthermore, contribution rates to the old-age care insurance rise for pensioners and persons without children.

The road toll for lorries is implemented (revenue of 0.1% of GDP).

In November 2004, the federal government presented an additional savings package in order to bring the deficit to 2.9% of GDP, which contains the following three elements. (i) In 2005, the federal level expects not to incur expenditure of 0.25% of GDP in order to cover a deficit of the cash settlement office that settles the pension payments to the civil servants of the former public post office on behalf of the successor companies to the post office (*Postbeamtenversorgungskasse*). This office will securitise future contributions by the successor companies to the public post office to fully cover its pension obligations for 2005 and 2006. Thereafter, the federal budget will take over the full pension payments of this office, which raises the budgetary burden compared with the status quo. (ii) An additional global expenditure cut is applied to the federal budget (0.05% of GDP). (iii) The federal government will press for no wage increases in the public sector in 2005.

In addition, the general government deficit in 2005 will be lowered by repayments of subsidies by the *Landesbanken* to the respective state budgets, following Commission decisions of 20 October 2004. This is estimated to reduce general government expenditure by 0.2% of GDP, if no offsetting capital injections take place.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)

	2004		2005		2006		2007	2008	Change: 2008-2004
	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Budget balance[2]	-3.9	-3 ¾	-2.9	-2.9	-2.6	-2 ½	-2	-1 ½	2½
Output gap[1,3]	-1.2	-1.2	-1.0	-0.9	-0.9	-0.7	-0.3	-0.0	1.2
CAB[1,2]	-3.4	-3.0	-2.4	-2.4	-2.1	-1.9	-1.6	-1.3	1.7
CAPB[1,2]	-0.3	0.0	0.6	0.6	0.9	1.1	1.5	1.8	1.8

Notes:
[1]Commission services calculations on the basis of the information in the stability programme (SP)
[2]in percent of GDP
[3]in percent of potential GDP
Sources:
Commission services autumn 2004 economic forecasts (COM) adjusted to include the additional budgetary package presented in November, cf: Communication from the Commission to the Council: "The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice", 14 December 2004, COM(2004) 813; Commission services calculations

4.3. Sensitivity analysis

The update does not provide a detailed assessment of the risks related to possible deviations from the central forecast. Instead, a mechanical exercise is presented, evaluating the effects on the general government balance of a permanent ±½ pp shock to nominal GDP growth. In the lower-growth scenario, the deficit will not fall below 3 % of GDP until 2006. In the optimistic scenario, the deficit would narrow to ½ % of GDP by 2008.

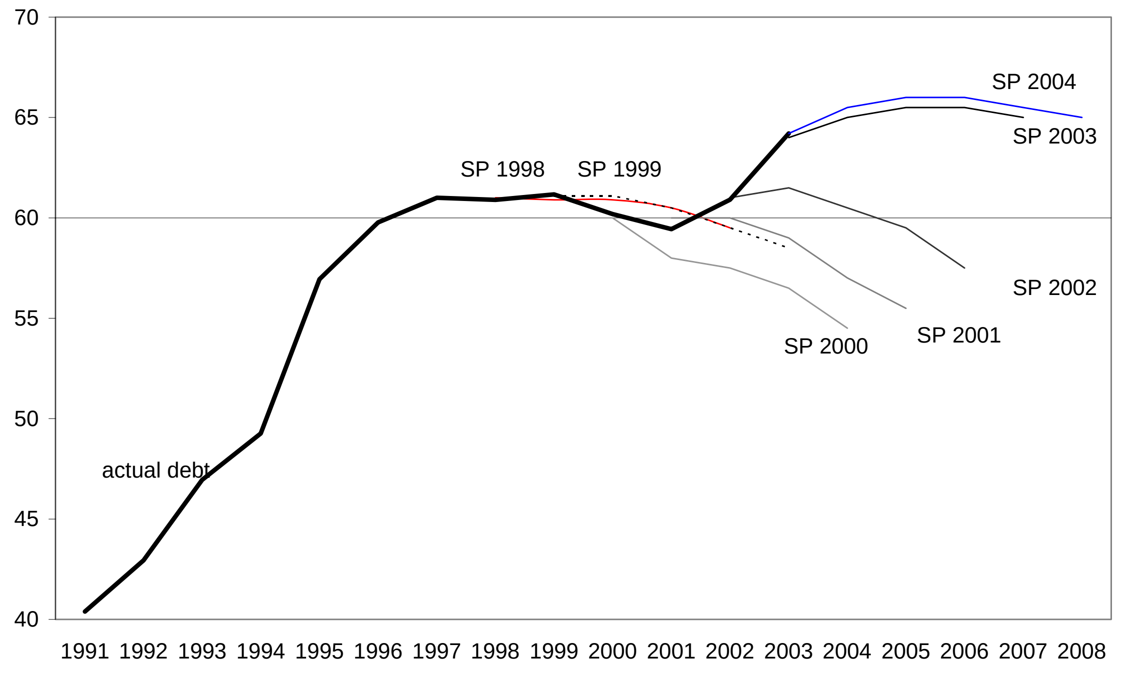
In order to assess the plausibility of these results, Commission services have carried out a similar exercise in evaluating the effects of a sustained ±0.5 pp deviation from the growth targets in the programme baseline over the 2005-2008 period under a no-police-change assumption (i.e. the expenditure level being as in the central scenario). Furthermore, trend output evolves endogenously according to the HP-filter. The outcome regarding the general government balance is quite similar to the update's simulation results, in that deficit ratio is projected not to fall below 3 % until 2006 in the low-growth scenario. Applying the HP-filter, the output gap will only be closed by 2008 in the stronger-growth scenario. In that scenario, the budget will be close-to-balance at the end of the forecast period, as both the general and the cyclically adjusted deficit will reach 0.4 % of GDP in 2008.

5. EVOLUTION OF THE DEBT RATIO

Gross government debt is projected at are expected to rise to 65.5 % of GDP for 2004, implying an increase by 1¼ pp compared with 2003. From the previous programme this amounts to a deterioration by ½ pp caused by the upward revision of the deficit for 2004.

The most recent update of the stability programme expects the debt ratio to rise to 66 % of GDP in 2005, remaining unchanged in 2006 and falling ½ pp in each of the two final years of the programme. With this adjustment path, the 2008 debt-to-GDP ratio will remain nearly one percentage point above the 2003 level, with no progress towards attaining the 60% reference value. What progress there is at the end of the programme period is based on a notable improvement by 2 ½ pp in the primary balance from a 0.7 pp deficit in 2004 to a 1 ¾ pp surplus in the final year. Due to the low and flat growth profile, contributions from interest payments and nominal GDP growth will not change much over the programme period, remaining at slightly above 1 % of GDP (see Table 6).

Figure 2: Debt projections in different vintages of programme updates



Source: Stability programmes; Commission services.

In 2004 and 2005, there are only minor differences between the debt dynamics of the stability programme and the adjusted Commission forecast. The Commission had factored into its projections fewer below-the-line-operations than now incorporated in the programme, largely due to Russian debt repayments and privatisations. For 2006, the Commission predicted a primary deficit about ¼ pp higher than suggested by the update. While government projections for privatisations and stock flow adjustments are plausible, the debt projections suffer from the same risks as the deficit projections.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007	2008
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	61.2	65.9	65.5	66.7	66.0	67.1	66	65½	65
Change in debt ratio (1 = 2+3+4)	0.8	1.7	1.3	1.3	0.5	0.7	¼	- ½	- ¾
Contributions:									
- **Primary deficit** (2)	-1.0	0.8	0.7	-0.2	-0.1	-0.5	- ¾	-1 ¼	-1 ¾
- **"Snow-ball" effect** (3)	2.1	1.3	1.3	1.4	1.3	1.3	1	1	1
- Interest expenditure	3.2	3.1	3.0	3.1	3.0	3.1	3	3	3
- Real GDP growth	-0.5	-1.2	-1.1	-1.0	-1.1	-1.1	-1 ¼	-1 ¼	-1 ¼
- Inflation (GDP deflator)	-0.5	-0.6	-0.5	-0.7	-0.6	-0.6	- ¾	- 1	- 1
- **Stock-flow adjustment** (4)	-0.4	-0.5	-0.8	-0.4	-0.7	-0.4	- ¼	0	¼
- Cash/accruals	0.1								
- Accumulation of financial assets	-0.4								
of which: Privatisation proceeds	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual adj.	-0.1								

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.
Sources:
Stability programme update (SP); Commission services autumn 2004 economic forecasts (COM) adjusted to include the additional budgetary package presented in November, cf: Communication from the Commission to the Council: "The situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice", 14 December 2004, COM(2004) 813; Commission services calculations

The German debt ratio has been exceeding the 60 % of GDP reference value since 2001. A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in Figure 2. It compares the projections for the debt ratio in each year of the programme (starting from the projection for 2004) with the values obtained for the same year by applying an illustrative "rolling debt reduction rule". This rule describes a minimum reduction in the debt ratio over the previous five/four/three-year period; for example, the projection for 2004 is compared with the values obtained for the same year by applying the formula over the periods 1999-2004, 2000-2004 and 2001-2004[12]. If the

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[12] The "rolling debt reduction rule" in the graph is shown for successive five-year periods through a recursive application of the formula:

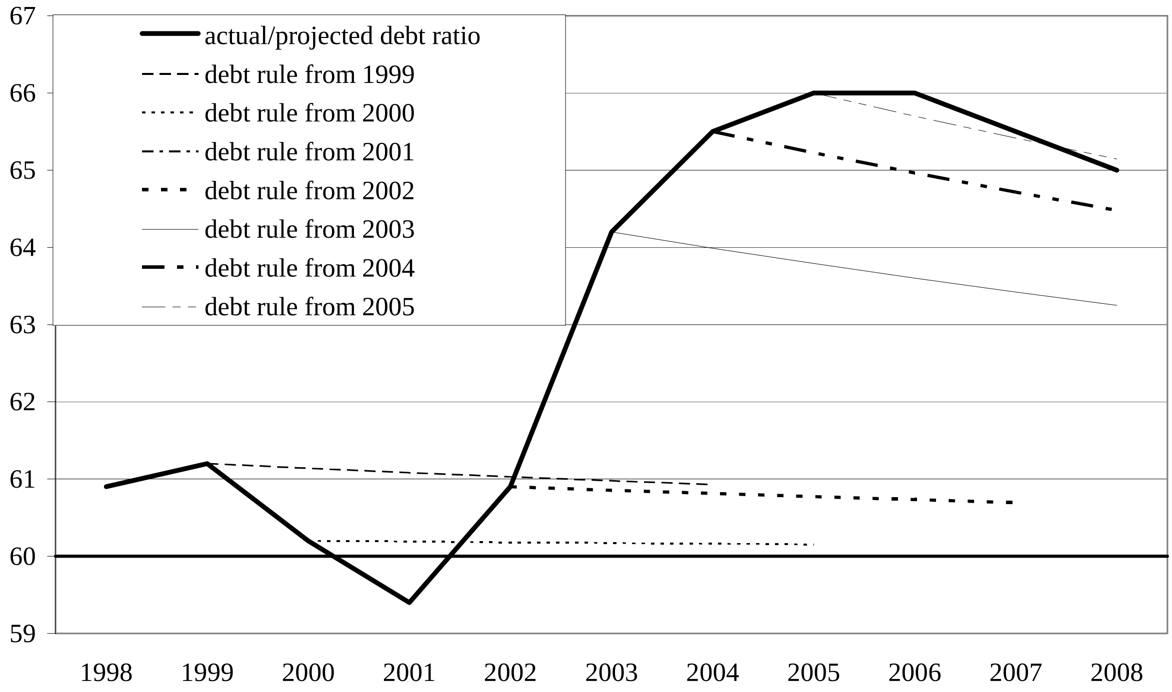
$$\left(\frac{D_t}{Y_t}\right)_{rule} = 0.05 * \left[60 - \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule} \right] + \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule}$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio). The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \left(\frac{y_t}{1 + y_t}\right) * \left(\frac{D_{t-1}}{Y_{t-1}}\right) \cong \frac{DEF_t}{Y_t} - y_t * \left(\frac{D_{t-1}}{Y_{t-1}}\right)$$

debt levels projected in the programme exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in the debt ratio. This is consistent with the idea that the minimum debt reduction should be ensured not year after year but over a medium-term horizon. It can be seen that the debt ratio in the update is planned to diminish by less than what is implied by the rolling debt reduction rule, except for the final year.

Figure 3: Rolling debt rule



Source: Commission services

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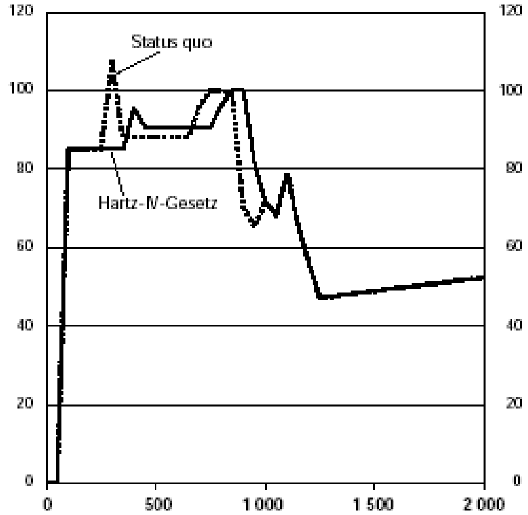
where *DEF* is the government deficit and *y* represents nominal GDP growth. Noting that 0.05*60 = 3, the formula for the "rolling debt reduction rule" describes the path for convergence of the debt ratio towards the 60 % of GDP debt reference value consistent with a deficit equal to the 3 % of GDP reference value. Consistency is achieved for a nominal GDP growth rate of 5 % of GDP. For nominal GDP growth rates higher than 5 %, the minimum debt reduction rule can be respected with deficits in excess of 3 % of GDP; for nominal GDP growth rates lower than 5 %, respect of the minimum debt reduction rule necessitates deficits lower than 3 % of GDP.

6. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The German government plans a significant reduction of the expenditure-to-GDP ratio over the period, namely by 5 pp. between 2003 and 2008. Most of it, i.e. over 4 pp, stems from reduced social transfers, but savings are also expected from lower subsidies, lower investment and other expenditures. While the fall in subsidies and transfers may be taken as indication of a more growth-oriented expenditure structure, this does not hold for the lower investment ratios.

Potential output is likely to benefit, however, from the implementation of the Agenda 2010 package, notably in the context of the Hartz labour market reforms, which increase incentives to take up work. However, contrary to the impression given by the stability programme, disincentives for poorly-qualified unemployed to take up work are only attenuated but not removed (see Figure 3).[13]

Figure 4: Impact of Hartz IV laws on marginal burden (%)



Gross monthly income of single earner (€)

Source: Sachverständigenrat, 2003 Gutachten

Moderate efficiency gains will also result from reforms in other parts of the social security system. Through the introduction of co-payments, the health-care reform should cost awareness on the part of the insured. The introduction of a sustainability factor, leading to lower increases in future pension rights (see Box 2), should strengthen the build-up of private pensions.

Box 3: Health sector reform: cost reduction in 2004, but more effort needed

Legislation to contain the costs in the public health care sector entered into force in January 2004. It involved cuts in the catalogue of goods and services refundable by the system, a better incentive structure to raise cost-awareness with patients and providers, and some steps to strengthen competition in the sector. In the public health system, expenses for medical treatment are usually fully settled between service providers and insurers without involvement of the patients. To mitigate disincentives, a fixed quarterly fee for ambulatory health services was introduced. In addition, patients were offered the choice to switch to a system in which they receive the bill first and get reimbursed by the public insurer. Although the number of medical consultations was falling in 2004, without some financial participation of patients for each ambulatory treatment, incentives do not seem strong enough to scrutinise the doctor's bill.

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[13] Minor changes over the last year do not alter the graph on substance. Due to a higher benefit-withdrawal out, for low-income earners with dependent family members, the marginal burden is generally even higher.

Co-payments to prescribed medication were increased and the price regulation on prescription medication extended. Also, the remuneration of chemists was altered such as to provide incentives to sell lower priced medication of the same class. Yet, despite permitting mail-order and small chains of pharmacies, barriers to entry into the retailing of medication remain. A newly established institute will provide producer-independent benefit analysis of medication and guidelines for treatment. The public health system is still characterised by collective contracting of fees between insurers and service provider organisations. Although a fair amount of competition takes place between public health insurers, it is almost absent between service providers. Individual contracting has now been permitted in limited areas, but this is only a first step in the right direction.

In the first three quarters of 2004, expenditure in the public health sector fell remarkably by about € 3.4 bn y-o-y (about 0.2% of GDP for the same period). A reduction in medication expenditure by over 10% provided the largest contribution, reflecting both cost-cutting measures and reduced demand due to co-payments. Expenditure on ambulatory treatment declined by 5%, reflecting the positive allocation effect of the fixed quarterly fee. The cost-cutting measures reduce the level of expenditure. However, in order to contain the growth rate of expenditure, further efficiency-enhancing measures are necessary in the medium-term, not only for patients but also for health care providers and insurers.

In other areas, structural progress remains limited. Most importantly, attempts to reform the federal governance system in Germany are stuck. In this context, the update overstates the importance of the "national stability pact", which is de facto a non-binding agreement between the federal and the state governments on expenditure paths. It has no enforcement mechanism, nor is it structurally linked to the Stability and Growth Pact. In 2002, the federal and the state governments agreed in the Fiscal Planning Council (*Finanzplanungsrat*) on expenditure paths for the different levels of government for 2003 and 2004. The federal level was to reduce nominal expenditure by on average ½% per year, and the state and local level combined to limit expenditure growth to 1% annually. In 2004, the federal level reduced nominal expenditure by 2% (against an increase of 3% in 2003). The states decreased expenditure by 0.2% (data until November 2004) in 2004 (against an increase of 0.6% in 2003).[14] Although the federal level did not fulfil the requirements of this agreement, this will be without consequences. The 2002 agreement was renewed on 16 June 2004, not without relaxing the expenditure target for the federal level: the federal level should not increase expenditure by more than 1% annually on average in 2005 and 2006.

Moreover, the large-scale intra-German transfers arising from the fiscal equalisation scheme and the social security systems (see Box 3) remain largely untouched. Deregulation has also yielded few tangible results so far.

[14] For the purposes of the *Finanzplanungsrat*, the budgets of the federal level and the state aggregate are taken in cash statistics.

Box 3: East-West Transfers

Since unification, support to the former East Germany has totalled upwards of €1.2 trillion. Specifically earmarked programmes for the East make up a relatively small part of this sum. Most of it resulted from keeping existing West Germany's transfer mechanisms and social security systems essentially unreformed even though the eastern accession changed their foundations. Public and private net payments of over €80 billion annually (some 4% of GDP) are a defining feature of German public finances, creating concern that the massive transfers represent a substantial drag on the West's economy while creating a benefit-dependency trap in the East's labour market that makes its convergence painfully slow. Persistently large transfers have contributed to Germany's difficulties in meeting the Stability and Growth Pact requirements.

Real GNP per inhabitant (Germany in 1991 set at 100)

	Germany	Total West	Berlin	Brandenburg	Mecklenburg Vorpommern	Sachsen	Sachsen-Anhalt	Thüringen	Total East + Berlin	East as % of West
1991	100.0	112.1	91.0	56.8	51.3	50.8	50.6	52.1	59.1	52.7%
1993	99.5	109.5	91.9	61.3	57.0	56.1	55.7	55.6	63.8	58.2%
1995	102.0	110.4	93.7	70.1	67.2	65.7	63.8	63.8	71.4	64.7%
1997	103.7	111.8	93.7	73.7	68.8	69.3	67.0	67.4	74.1	66.2%
1999	107.7	115.8	94.7	77.0	72.7	72.6	71.0	72.6	77.3	66.8%
2001	111.7	119.9	94.3	80.7	75.4	76.7	74.0	77.0	80.3	66.9%
2003	111.9	119.6	92.4	81.8	76.4	80.0	77.2	79.5	81.9	68.4%

Source: Destatis, European Commission

Following unification, it took western Germany until 1998 for the West to regain the real GNP level it had in 1991. After the 1999/2000 boom, stagnation took hold. Apart from Berlin, figures look less bad for the Eastern Länder. Not least as a result of financial transfers, eastern per capita GNP (including Berlin) converged from less than 53% that of the West in 1991 to now over 68% (see Table below). However, while convergence was very impressive until 1996, the nominal convergence of 1½ percentage points since then can be attributed exclusively to demographic developments.

As a result of this convergence East-West transfers are slowly falling in volume, but they still represent 4½% of western GNP. The table below shows, differences among western Länder are quite substantial. When intra-western transfers are included, transfers can reach up to 10% for some Länder to some even being net recipients. For the five New Länder, the transfer shares in 2002 remained in the narrow range of 27 to 32% of GNP. Berlin received some 13% of GNP in net transfers, reflecting the fact that about one third of the city was part of the former GDR.

Most of the transfers are channelled through the social security systems in the form of pensions and unemployment benefits, where they interact with a rigid labour market to increase reservation wages, and hence unemployment. Investments, by contrast, make up only one-fifth of the transfer volume and tend to go to infrastructure and capital-intensive projects. The fact that eastern convergence has slowed to a crawl since the middle of the 1990s attests to the low effectiveness of many of the transfer instruments.

Estimated net transfer of individual German Länder in billion euros

	Baden-Württemberg	Bayern	Bremen	Hamburg	Hessen	Niedersachsen	Nordrhein-Westfalen	Rheinland-Pfalz	Saarland	Schleswig-Holstein	Total West	Berlin	Brandenburg	Mecklenburg-Vorpommern	Sachsen	Sachsen-Anhalt	Thüringen	Total East + Berlin
	in billion €																	
1991	-18.7	-11.2	-0.7	-3.1	-12.5	-0.3	-22.7	-3.8	0.3	-3.1	**-75.8**	8.1	10.5	9.3	22.8	13.0	12.1	**75.8**
1995	-27.2	-22.5	-0.7	-5.5	-17.5	-4.9	-31.3	-3.1	0.6	-2.9	**-115.0**	8.3	16.9	14.3	34.1	22.7	18.6	**115.0**
2000	-29.0	-22.6	0.3	-5.2	-20.6	1.3	-12.9	-1.1	1.4	-1.6	**-89.8**	8.0	14.7	10.3	26.9	16.4	13.6	**89.8**
2002	-27.8	-23.7	0.4	-4.3	-17.8	2.4	-11.3	-0.9	1.1	-1.1	**-83.0**	9.6	13.5	9.9	22.9	14.3	12.8	**83.0**
	as % of GNP																	
1991	-8.3	-4.4	-3.9	-5.6	-9.0	-0.2	-6.3	-5.3	1.3	-6.3	**-5.7**	13.2	54.8	66.6	65.4	65.2	72.5	**45.7**
1995	-10.7	-7.5	-3.5	-8.7	-10.9	-3.1	-7.7	-3.8	2.5	-5.1	**-7.5**	10.7	46.2	54.9	50.9	61.1	54.9	**41.3**
2000	-9.9	-6.4	1.3	-7.2	-11.2	0.8	-2.9	-1.2	5.9	-2.5	**-5.2**	10.5	33.8	35.6	36.9	39.1	34.1	**29.6**
2002	-8.9	-6.5	1.9	-5.6	-9.3	1.3	-2.4	-1.0	4.4	-1.7	**-4.6**	12.4	30.2	33.4	30.4	32.9	31.2	**26.7**

Source: Destatis, European Commission. Net transfers are calculated as the difference between regional GNP and absorption (investment and consumption). In addition, the sum the total intra-German transfers is set to zero. This is done by allocating overall German net exports, stock building and net factor incomes from the rest of the world, for which no regional statistics are available, to each Land in proportion to its GNP.

7. THE SUSTAINABILITY OF PUBLIC FINANCES

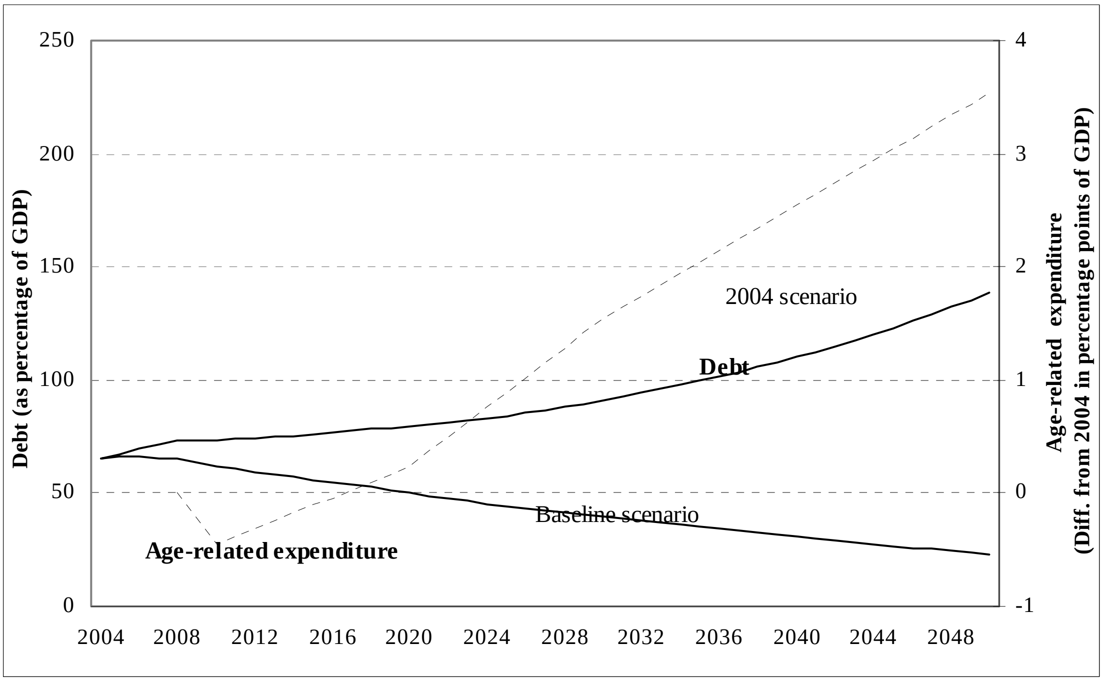
The assessment of the sustainability of German public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by almost 4% of GDP between 2009 and 2050. This includes the effects of the "Pension Insurance Sustainability Law" (*Rentenversicherungsnachhaltigkeitsgesetz*) and the reforms in the statutory health care system[15]. The gross debt ratio is projected to decline steadily over the coming decades. However, if the budgetary consolidation plans in the medium-term do not materialise, a different picture emerges: the debt dynamics would become unfavourable and the debt ratio would rise over the entire projection period and reach 138% of GDP in 2050[16].

[15] In the projections, a rise in the revenue-to-GDP ratio was incorporated, consistent with the assumption of no changes in current legislation. This implies that towards 2050 social security contributions would rise considerably. The laws that govern the social security system imply that *de facto* age-related expenditures drive the contribution rate. The information in the update is based on projections performed by the ifo institute. Moreover, additional information used by the ifo institute was provided by the German authorities and was used in the projections, namely, expenditures on long-term care.

[16] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

Figure 5: Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	-0.8	-0.1	2.0
2004 scenario	1.2	1.6	2.2

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: 26.7%

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and sustainable ones. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050)[17]. S2 shows the gap between the current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, Germany could keep its tax ratio unchanged compared with the projected one at the end

[17] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible imbalances after the end of the projection period.

of the programme period, and considerably more if it fails to consolidate in the medium-term. This would lead to a sustainable debt ratio of around 30% of GDP by the middle of the century[18]. However, if the planned budgetary consolidation up to 2008 does not materialise, there is a gap of 1.5% of GDP compared with the level of the tax ratio needed to satisfy the intertemporal budget constraint. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of around 2% of GDP on average, close to the projection targeted for the last year of the programme period (measured in underlying terms).

In interpreting these results, several factors must be taken into account. First, the sustainability factor should help in keeping pension expenditure under control despite the increase in the old-age dependency ratio. The factor will lower individual pension rights as the dependency ratio increases. Second, labour market reforms should help in raising participation rates and reducing unemployment rates. Labour force participation rates are projected to increase, mainly due to female participation converging towards that of males in the coming decades. Also, the unemployment rate is projected to fall substantially from 8.7% in 2003 to 3.3% from 2030, implying labour market conditions much more flexible than the current ones, which assumes continuing reforms. Third, Germany's long-term strategy is to gradually shift taxation from contributions to the system towards benefits paid out. From a systematic point of view, this is a welcome improvement and, combined with the subsidised so-called Riester-Rente[19], encourages the build-up of private pensions that compensate for the relative loss in income through the sustainability factor. After 2006, however, the attractiveness of the Riester-Rente will be reduced for men when unisex insurance premiums become mandatory for new contracts. As men will start opting for other capital investments that reflect their relatively shorter life expectancy, the financial return of the Riester-Rente would fall for both sexes, which would further erode the attractiveness of the scheme.

* * *

[18] The debt ratio of around 30% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

[19] The build-up of private pension savings up to 4% of income in Government certified investment instruments receives a favourable tax treatment.

ANNEX 1: SUMMARY TABLES DERIVED FROM THE GERMAN STABILITY PROGRAMME UPDATE

Table A- 1: Growth and associated factors

		2003	2004	2005	2006	2007	2008
GDP *growth* at *constant* market prices (7+8+9)	B1g	**- 0.1**	**1.8**	**1.7**	**1 ¾**	**2**	**2**
GDP *growth* at *current* market prices	B1g	**1.0**	**2.6**	**2.7**	**3**	**3 ½**	**3 ½**
GDP deflator		**1.1**	**0.8**	**1.0**	**1 ¼**	**1 ½**	**1 ½**
HICP change		--	--	--	--	--	--
Employment growth		**- 1.0**	**0.1**	**0.5**	**½**	**½**	**½**
Dependent employment*		--	--	--	--	--	--
Labour productivity growth **		0.9	1.7	1.1	1	1	1
Sources of growth: percentage changes at constant prices							
1. Private consumption expenditure	P3	**0.0**	**0.0**	**0.8**	**2**	**2**	**2**
2. Government consumption expenditure	P3	**0.1**	**-0.1**	**-0.2**	**¼**	**¼**	**¼**
3. Gross fixed capital formation	P51	**- 2.2**	**- 0.9**	**1.8**	**3 ¾**	**3 ¾**	**3 ¾**
4. Changes in inventories and net acquisition of valuables as % of GDP	P52 +P53	**0.9**	**0.1**	**0.4**	**¼**	**¼**	**¼**
5. Exports of goods and services	P6	**1.8**	**11.2**	**8.0**	**3 ½**	**3 ½**	**3 ½**
6. Imports of goods and services	P7	**4.0**	**7.0**	**7.9**	**4 ½**	**4 ½**	**4 ½**
Contribution to GDP growth							
7. Final domestic demand (1+2+3)		**- 0.4**	**- 0.2**	**0.7**	**1 ¾**	**2**	**2**
8. Change in inventories and net acquisition of valuables (=4)		**0.9**	**0.1**	**0.4**	**¼**	**¼**	**¼**
9. External balance of goods and services (5-6)		**- 0.6**	**1.9**	**0.5**	**-¼**	**-¼**	**-¼**

* According to social security statistics. i.e. including persons on parental leave

** calculated on basis of effective labour force

Table A- 2. General government budgetary developments

% of GDP		2003	2004	2005	2006	2007	2008
Net lending (B9) by sub-sectors							
1. General government	**S13**	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
2. Central government	**S1311**	**-1.9**	**-2 ½**	**-1 ½**	**-1 ½**	**-1**	**-1**
3. State government	**S1312**	**-1.6**	**-1 ¼**	**-1 ½**	**-1**	**-1**	**- ½**
4. Local government	**S1313**	**--**	**--**	**--**	**--**	**--**	**--**
5. Social security funds	**S1314**	**-0.3**	**-0**	**0**	**0**	**0**	**0**
General government (S13)							
6. Total receipts	**ESA**	**45.0**	**43 ½**	**43**	**43**	**42 ½**	**42 ½**
7. Total expenditures	**ESA**	**48.8**	**47 ½**	**46**	**45 ½**	**44 ½**	**43 ½**
8. Budget balance	**B9**	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
9. Net interest payments		**3.1**	**3**	**3**	**3**	**3**	**3**
10. Primary balance		**-0.7**	**-½**	**0**	**½**	**1 ½**	**2**
Components of revenues							
11. Taxes	D2+D5	22.6	22	22	22	22	22
12. Social contributions	D61	18.6	18	18	17 ½	17 ½	17
13. Interest income	D41	--	--	--	--	--	--
14. Other		3.8	3 ½	3 ½	3 ½	3 ½	3
15. Total receipts	ESA	45.0	43 ½	43	43	42 ½	42 ½
Components of expenditures							
16. Collective consumption	P32	19.7	19	18 ½	18 ½	18	17 ½
17. Social transfers in kind	D63						
18. Social transfers other than in kind	D62	19.7	19 ½	19	18	18	17 ½
19. Interest payments	D41	3.1	3	3	3	3	3
20. Subsidies	D3	1.4	1 ½	1	1	1	1
21. Gross fixed capital formation	P51	1.5	1 ½	1 ½	1 ½	1 ½	1 ½
22. Other		3.4	3	3	3	3	3
23. Total expenditures	ESA	48.8	47 ½	46	45 ½	44 ½	43 ½

Table A- 3. General government debt developments

% of GDP		2003	2004	2005	2006	2007	2008
Gross debt level		**64.2**	**65 ½**	**66**	**66**	**65 ½**	**65**
Change in gross debt			**1 ¼**	**½**	**¼**	**-½**	**- ¾**
Contributions to change in gross debt							
Primary balance		-0.7	-½	0	½	1 ½	2
Interest payments	**D41**	**3.1**	**3**	**3**	**3**	**3**	**3**
Nominal GDP growth	**B1g**	**1.0**	**2 ½**	**2 ½**	**3**	**3 ½**	**3 ½**
Other factors influencing the debt ratio							
Of which: Privatisation receipts		--	--	--	--	--	--
p.m. implicit interest rate on debt		--	--	--	--	--	--

Table A- 4. Cyclical developments

% of GDP		2003	2004	2005	2006	2007	2008
1. GDP growth at constant prices	**B1g**	**- 0.1**	**1.8**	**1.7**	**1 ¾**	**2**	**2**
2. Actual balance	**B9**	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
3. Interest payments	**D41**	**3.1**	**3**	**3**	**3**	**3**	**3**
4. Potential GDP growth		--	--	--	--	--	--
5. Output gap		--	--	--	--	--	--
6. Cyclical budgetary component*		-0.8	-¾	-½	-½	-½	-½
7. Cyclically-adjusted balance (2-6)		-3.0	-3	-2 ½	-2	-1 ½	-1
8. Cyclically-adjusted primary balance (3+7)		0.1	0	½	1	1 ½	2

Table A- 5. Divergence from previous update

% of GDP		2003	2004	2005	2006	2007	2008
previous	**Nominal GDP growth B1g**	**0.9**	**2 ½**	**3 ½**	**3 ½**	**3 ½**	**--**
latest update	**B1g**	**1.0**	**2 ½**	**2 ½**	**3**	**3 ½**	**3 ½**
Difference		**0**	**0**	**-1**	**- ½**	**0**	**--**
previous	**Actual budget balance B9**	**-4**	**-3 ¼**	**-2 ½**	**-2**	**-1 ½**	**--**
latest update	**B9**	**-3.8**	**-3 ¾**	**-3**	**-2 ½**	**-2**	**-1 ½**
Difference*		**0.2**	**-½**	**-½**	**-½**	**-½**	**--**
previous	**Gross debt levels**	**64**	**65**	**65 ½**	**65 ½**	**65**	**--**
latest update		**64.2**	**65 ½**	**66**	**66**	**65 ½**	**65**
Difference**		**0.2**	**½**	**½**	**½**	**½**	**--**

* a positive sign denotes an improvement

** a positive sign denotes a deterioration

Table A- 6. Long-term sustainability of public finances

% of GDP	2005	2010	2020	2030	2050
Total expenditure	--	--	--	--	--
Old age pensions	--	10.8	11.6	12.8	13.8
Health care (including care for the elderly)	--	6.0	6.4	6.9	7.7
Interest payments	--	--	--	--	--
Total revenues	--	42.2	42.8	43.7	45.3
of which: from pensions contributions	--	--	--	--	--
National pension fund assets (if any)	--	--	--	--	--
Assumptions					
Labour productivity growth	--	1.5	1.7	1.7	1.8
Real GDP growth	--	1.9	1.7	1.4	1.1
Participation rate males (aged 20-64)	--	86.3	86.2	86.9	87.2
Participation rates females (aged 20-64)	--	71.9	72.9	76.2	76.6
Total participation rates (aged 20-64)	--	79.2	79.6	81.6	81.9
Unemployment rate (EU-definition)	--	7.3	6.3	3.9	3.3

Table 7. Basic assumptions

	2003	2004	2005	2006	2007	2008
Short-term interest rate (annual average)	--	--	--	--	--	--
Long-term interest rate (annual average)	--	--	--	--	--	--
United States: short-term (three-month money market)	--	--	--	--	--	--
United States: long term (10-year government bonds)	--	--	--	--	--	--
USD/€ exchange rate (annual average)	--	--	--	--	--	--
Nominal effective exchange rate (euro area)	--	--	--	--	--	--
Nominal effective exchange rate (EU)	--	--	--	--	--	--
World GDP growth, excluding EU	--	--	--	--	--	--
United States, GDP growth	--	--	--	--	--	--
Japan, GDP growth	--	--	--	--	--	--
EU-25 GDP growth	--	--	--	--	--	--
Growth of relevant foreign markets	--	--	--	--	--	--
World import volumes, excluding EU	--	--	--	--	--	--
World import prices (goods, in USD)	--	--	--	--	--	--
Oil prices (Brent, USD/barrel)		38	44	--	--	--
Non-oil commodity prices (in USD)	--	--	--	--	--	--

ANNEX 2: LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES IN GERMANY– QUANTITATIVE SCENARIOS

Main assumptions - baseline scenario (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	24.2	24.0	24.7	26.0	27.0	28.0	3.8
Pensions	10.9	10.8	11.6	12.8	13.3	13.8	2.9
Health care*	7.0	6.9	7.5	8.2	9.0	9.5	2.5
Education	3.9	3.9	3.6	3.7	3.6	3.6	-0.3
Unemployment benefits	2.5	2.4	2.0	1.3	1.1	1.1	-1.4
*Total primary non age-related spending***	16.0						
Total revenues	42.1	42.2	42.8	43.7	44.6	45.3	3.2

* including long-term care

** constant

Results (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	63.8	62.2	50.1	39.6	30.9	23.0	-40.7
i + 0.5*	64.1	62.9	53.9	46.8	42.0	39.1	-25.0
2004 scenario							
Gross debt	73.6	73.6	79.6	91.0	110.3	138.7	65.2
i + 0.5*	73.9	74.4	84.5	101.6	129.2	170.2	96.3

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.