EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 09.06.2006
ECFIN/B1/53562/06-EN

FEBRUARY 2006 UPDATE OF THE STABILITY PROGRAMME OF GERMANY (2005-2009)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The most recent update of the German stability programme was adopted by the German government and submitted to the Council and the Commission on 22 February 2006, i.e. 12 weeks after the deadline of 1 December as specified in the code of conduct. On 22 February 2006, the German government, which had taken office in late 2005, adopted the draft federal budget for 2006 and, notably, also adopted the draft law to raise the central VAT rate from 16% to 19% as from 1 January 2007. The programme covers the period from 2005 to 2009. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct.[2]

On 21 January 2003, the Council decided that an excessive deficit existed in Germany, and recommended, based on Article 104(7), that the excessive deficit be corrected by 2004. In its Communication to the Council of December 2004 on "the situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgement of the Court of Justice", the Commission concluded that 2005 should be considered as the relevant deadline for the correction. In January 2005, the Council concurred with this view. On 1 March 2006, the Commission has recommended to the Council to give notice to Germany in accordance with Article 104 (9) to take measures to correct the excessive deficit by 2007. In its opinion of 17 February 2005 on the December 2004 update of the stability programme, covering the period 2004-2008, the Council invited Germany to do the necessary to ensure the correction of the excessive deficit in 2005; to implement budgetary adjustments in the years beyond 2005 and make the necessary effort in structural terms to achieve a budgetary position of close to balance by the end of the period covered by the programme; and to continue with structural reforms in order to further improve the long-term sustainability of public finances in particular as regards the health care system.

GDP growth in Germany over the last ten years was 1.4% p.a., trailing the euro-area average by more than half a percentage point. The growth potential has been steadily declining throughout this period. Activity, while being driven by buoyant exports, was held back by sluggish domestic demand. From an extended stagnation in the early part of the decade, demand and output picked up in 2004, but weakened again thereafter. With employment creation also subdued, the unemployment rate rose to 9½% of the labour force. The general government deficit breached the 3% of GDP Treaty reference value

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[1] This technical analysis accompanied, in an abridged version, the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 1 March 2006. However, since the update was submitted to the Commission only one week before that date, the editorial process for the technical analysis had to be prolonged beyond the date of the College meeting. The assessment is based on information available up to 10 March. The analysis 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 Peer Ritter and Michael Stierle (e-mail: firstname.lastname@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

[2] As in previous years, the update contains only rounded data and sometimes period averages for the outer years of the programme period. It has gaps in the compulsory and optional data prescribed by the new code of conduct (especially data on unemployment, sectoral balances and a breakdown of tax revenues are missing). See Annexes 1 and 2 for details.

for the fourth consecutive year in 2005. Public debt, having been close to 40% of GDP in 1991, has been exceeding the 60% of GDP Treaty reference value since 2002.

The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 0.9% in 2005 to 1.4% in 2006, with domestic demand gaining momentum. After a slowdown to 1% in 2007, growth is set to resume thereafter, yielding an average growth rate of 1½% for the period from 2005 to 2009. Potential growth is projected to accelerate slightly towards the outer years of the programme, while the output gap would be gradually narrowing but still remain negative in the final year of the programme. This growth profile is influenced by the policy settings agreed by the new coalition government. Judging from currently available information, the macroeconomic scenario appears plausible for 2006. Going forward, however, the scenario appears to be on the high side. The programme's projections for inflation appear realistic for 2006, but may also be on the high side for the remainder of the period.

According to data provided by Eurostat, the general government deficit in Germany amounted to 3.3% of GDP in 2005. These data, pending a further assessment of their quality, are based upon a provisional notification from Germany pursuant to Council Regulation (EC) No 3605/93, which Germany submitted to the Commission on 24 February 2006. The previous update of the stability programme had set a target of 2.9% of GDP for 2005.

The main goal of the medium-term budgetary strategy indicated in the programme is to ensure the long-term sustainability of public finances. To achieve this, the programme proposes to continue budgetary consolidation, while improving the conditions for growth and employment. The programme envisages correcting the excessive deficit by 2007. Specifically, for 2006 and 2007 the projections in the update are for nominal deficits of 3.3% and 2½% of GDP, respectively. Thereafter, the deficit is projected to decline by ½ percentage point of GDP per year to reach a level of 1½% of GDP in 2009. The budgetary adjustment is both revenue- and expenditure-based. From 2006 on, several additional expenditure measures, among them funds for R&D, softer depreciation rules for companies and investment in transport infrastructure, are intended to foster growth. Against this, cutbacks in tax allowances, for example the abolition of the tax subsidy on owner-occupied housing, contribute to consolidation. Most importantly, the programme identifies the restraint in social expenditure as the crucial element of the consolidation strategy. The resulting savings are to be partially used for funding a reduction in the social contribution rate by 2007. The decrease in the share of social contributions, which also results from the subdued growth in the contribution base, is projected to be broadly offset by an increase in the VAT rate in 2007. The share of public investment in GDP is projected to remain constant. Compared with the previous update, the adjustment path has remained broadly the same; however, the deficit ratio is planned to be higher for each year by a rounded ½ percentage point and for 2006 by even more.

The correction of the excessive deficit by 2007 entails, according to the programme, an improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) by more than one percentage point of GDP cumulatively in the years 2006 and 2007. Over the programme period, the structural balance calculated according to the commonly agreed methodology is planned to improve on average by about ½% of GDP per year, although slightly less in 2008 and 2009. The programme sets the medium-term objective (MTO) for the budgetary position as balance in structural terms, which, however, it does not aim to achieve within the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around

1¾% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is slightly more demanding than implied by the debt ratio and average potential output growth in the long term.

Concerning 2006, the risks to the budgetary outcome are considered to be balanced. However, as from 2007, the budgetary outcome could be worse than projected in the programme. The restraint in social spending, which is not laid out in full detail in the programme but is supposed to provide a key contribution to the budgetary adjustment, hinges on the rigorous implementation of the plans. Social expenditure has been one of the main drivers behind the overshooting of the budgetary targets compared with previous programmes. The budgetary targets would be jeopardised if the planned exoneration on social contributions was fully carried out without achieving the corresponding expenditure targets. Moreover, shortfalls in growth might imply shortfalls in revenues, which might prove difficult to compensate by further reduction in expenditure in order to maintain the planned path of the deficit ratio. The programme further announces reforms of the corporate tax system by 2008 and to the health and long-term care insurance, which, while potentially having positive effects on the economy and the budget, may entail a negative impact on the deficit in the short-term.

In view of this risk assessment, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2007. However, it does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations until the penultimate year of the programme period. In the years following the correction of the excessive deficit, the pace of the adjustment towards the programme's MTO implied by the programme is broadly in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times.

The debt ratio is estimated to have reached 67½ % of GDP in 2005, above the 60% of GDP reference value of the Treaty. The programme projects the debt ratio to increase to a rounded 69% of GDP in 2006 and to decline thereafter to reach 67% at the end of the programme period. The evolution of the debt ratio might be less favourable than projected in the programme, given the risks to the budgetary targets mentioned above. In view of this risk assessment, the debt ratio may not be sufficiently diminishing towards the reference value.

With regard to the sustainability of public finances, Germany appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The structural reforms carried out in previous years, and in particular the pension reform, have helped to contain future rises in public expenditure. In addition, the programme mentions the plan to increase the statutory retirement age by two years to 67 years of age, in a stepwise manner between 2012 and 2029. It is also intended to adjust the pension algorithm in force to lower expenditure over time; however no implementation plan is specified. Structural reforms to the health and long-term care systems are announced but not detailed. In view of the current level of government gross debt exceeding the Treaty reference value of 60% of GDP and the currently high structural deficit, implementing rigorously a strong budgetary consolidation over the programme period is necessary so as to reduce the risks to long-term sustainability.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, Germany plans to implement a number of structural reforms in order to improve the sustainability of government finances in the medium to long run. If the expenditure restraint in the social security systems was implemented as planned, the composition of public expenditure would be more favourable towards growth-enhancing categories in line with the Lisbon strategy.

Germany's national reform programme (NRP), submitted on 7 December 2005 within the context of the renewed Lisbon strategy for growth and jobs, identifies six key challenges: the knowledge society; market functioning and competitiveness; business environment; the sustainability of public finances (including sustainable growth and social security); ecological innovation; and the re-orientation of the labour market. Overall, the measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme. The budgetary implications of the actions outlined in the NRP are broadly reflected in the budgetary projections of the stability programme. In addition to the content of the NRP, the stability programme envisages, as part of the reform of the federal system, that potential sanctions, which might arise from the Stability and Growth Pact, would be allocated according to a rule across levels of government. This would be inserted into the German Constitution.

In view of the above assessment, the priority attributed by the government to budgetary consolidation as laid out in the programme is welcome, but there are risks linked to the achievement of the budgetary targets and to long-term sustainability of public finances. Also in the light of the Commission recommendation of 1 March 2006 for a Council decision in accordance with Article 104(9), it would be appropriate for Germany to:

(i) Ensure the planned structural adjustment of cumulatively at least one percentage point in the years 2006 and 2007 to bring the general government deficit below 3% of GDP as rapidly as possible and at the latest by 2007 in a credible and sustainable manner;

(ii) Rapidly achieve the medium-term objective through a reduction in the structural balance of at least 0.5 percentage point per year after the excessive deficit has been corrected, notably by implementing the planned expenditure restraint rigorously so as to be able to provide the planned relief on social contributions, and by ensuring that the announced reform on corporate taxation does not jeopardise the fiscal consolidation;

(iii) Implement the plans to strengthen national budgetary institutions to secure that budgetary targets are achieved at all levels of government.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Feb 2006**	**1.6**	**0.9**	**1 ½**	**1**	**1 ¾**	**1 ¾**
	COM Nov 2005[6]	1.6	0.8	1.2	1.6	--	--
	SP Dec 2004	*1.8*	*1.7*	*1 ¾*	*2*	*2*	--
HICP inflation (%)	**SP Feb 2006**	--	--	--	--	--	--
	COM Nov 2005	1.8	2.0	1.6	1.1	--	--
	SP Dec 2004	--	--	--	--	--	--
Output gap (% of potential GDP)	**SP Feb 2006[1]**	**-0.6**	**-0.9**	**-0.7**	**-1.1**	**-0.7**	**-0.4**
	COM Nov 2005[5]	-0.6	-0.9	-0.8	-0.4	--	--
	SP Dec 2004[1]	*-1.2*	*-0.9*	*-0.7*	*-0.3*	*-0.0*	--
General government balance (% of GDP)	**SP Feb 2006**	**-3.7**	**-3.3**	**-3.3**	**-2 ½**	**-2**	**-1 ½**
	COM Nov 2005	-3.7	-3.9	-3.7	-3.3	--	--
	SP Dec 2004	*-3 ¾*	*-2.9*	*-2 ½*	*-2*	*-1 ½*	--
Primary balance (% of GDP)	**SP Feb 2006**	**-0.8**	**-0.5**	**- ½**	**½**	**1 ¼**	**1 ½**
	COM Nov 2005	-0.8	-0.9	-0.9	-0.4	--	--
	SP Dec 2004	*- ½*	*0*	*½*	*1 ½*	*2*	--
Cyclically-adjusted balance (% of GDP)	**SP Feb 2006[1]**	**-3.4**	**-2.9**	**-2.9**	**-1.8**	**-1.5**	**-1.1**
	COM Nov 2005	-3.3	-3.2	-3.2	-3.0	--	--
	SP Dec 2004[1]	*-3.0*	*-2.4*	*-1.9*	*-1.6*	*-1.3*	--
Structural balance[2] (% of GDP)	**SP Feb 2006[3]**	**-3.4**	**-3.0**	**-2.9**	**-1.8**	**-1.5**	**-1.1**
	COM Nov 2005[4]	-3.3	-3.2	-3.2	-3.0	--	--
	SP Dec 2004	--.	--	--	--	--	--
Government gross debt (% of GDP)	**SP Feb 2006**	**65.5**	**67 ½**	**69**	**68 ½**	**68**	**67**
	COM Nov 2005[7]	66.4	68.6	70.0	71.4	--	--
	SP Dec 2004[7]	*65 ½*	*66*	*66*	*65 ½*	*65*	--

Notes:
[1]Commission services calculations on the basis of the information in the programme
[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures
[3]One-off and other temporary measures taken from the programme (0.1% of GDP in 2005)
[4]One-off and other temporary measures taken from the Commission services' autumn 2005 forecast
[5]Based on estimated potential growth of 1.1%, 1.1%, 1.1% and 1.2% respectively in the period 2004-2007.
[6]According to first estimates, growth was 0.9% in 2005. The Commission services' interim forecast of 21 February 2006 projects growth at 1.5% in 2006.
[7]The ratio was calculated using the GDP series with the old method of allocating FISIM (financial intermediation services indirectly measured) to users, so data are not directly comparable.
Source:
Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM) on the basis of unchanged policies before the new government took office in November 2005; Commission services' calculations

1. INTRODUCTION

The most recent update of the German stability programme was adopted by the German government and submitted to the Council and the Commission as well as to the national Parliament on 22 February 2006, i.e. 12 weeks after the deadline of 1 December as specified in the code of conduct, as the German government had taken office in late 2005. On the date of submission, the German government also adopted the draft federal budget for 2006. The programme covers the period from 2005 to 2009. The programme broadly follows the model structure for stability and convergence programmes specified in the new code of conduct. As in previous years, the update contains only rounded data and sometimes period averages for the outer years of the programme period. It has gaps in the compulsory and optional data prescribed by the new code of conduct (especially data on unemployment, sectoral balances and a breakdown of tax revenues are missing). For details, see Annexes 1 and 2.

2. ECONOMIC OUTLOOK

Average GDP growth in Germany over the last ten years was 1.4% per year, trailing the euro-area average by more than half a percentage point. The estimates of potential growth have been steadily declining from more than 2% in the early 1990s to just above 1% in 2005. Since 2000 economic growth was mainly driven by buoyant exports, while domestic demand remained sluggish. Government consumption remained nearly unchanged in real terms and private consumption only marginally increased, but investment weighed on economic growth. The latter can partly be attributed to a normalisation in the construction sector after building up overcapacities in the aftermath of German reunification. From an extended stagnation in the early part of the decade, demand and output picked up in 2004, but weakened again thereafter. Only recently, growth contribution from external demand was supported by stronger investments, particularly in machinery and equipment. Employment creation was also subdued, particularly concerning full time employment subject to social security contributions. Consequently, structural unemployment remained high with the unemployment rate rising to 9½% of the labour force. As divergence in employment performance between the EU15 and Germany has become more marked the more time has passed since re-unification, the persistently high unemployment rate in Germany can not fully attributed to re-unification. During the last 10 years inflation was on average more than half a percentage point lower in Germany than in the euro area.

The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 0.9% in 2005 to 1.4% in 2006, with domestic demand gaining momentum. After a slowdown to 1% in 2007, growth is set to resume thereafter with 1¾% in 2008 and 2009 yielding an average growth rate of 1½% for the period from 2005 to 2009. This growth profile is influenced by the policy settings agreed by the new coalition government.

Judging from currently available information, the reference scenario appears plausible for 2006. It is mainly in line with the Commission services' interim forecast of 21 February, projecting the real growth rate at 1.5%. Despite minor differences concerning the growth composition, the overall assessment of the main driving forces for growth in 2006 is similar. External demand will remain strong due to a good competitive position and a further decline in unit labour costs combined with a strong world demand.

However, also domestic demand is going to gain momentum with strong investments in machinery and investment. Temporarily, the increase in private consumption will be strong due to the anticipative behaviour of consumers in view of the increase of the standard value added tax rate by 3 percentage points as of 1 January 2007. Private consumption should also be supported by employment growth and declining unemployment. For 2007 and towards the end of the programme period, the stability programme makes favourable growth assumptions. In the first quarters of 2007, both private consumption and housing investment will be negatively affected by the echo-effect from shifting demand forward in light of the VAT increase. This will also temporarily weigh on private investment and employment. Consequently, a growth rate below 1% cannot be ruled out in this exceptional year. Similarly, according to the stability programme, the real growth rate of 1¾% in 2008 and 2009 could be markedly favourable, being approximately half a percentage point above potential growth despite the fact that the forecast for employment creation seems rather cautious. In sum, the forecasts for real growth and the GDP deflator together in the years after 2006 as provided by the update are markedly favourable.

Accordingly, the cyclical conditions are heavily influenced by the temporary swing of GDP growth. According to the programme, the output gap would, after a remarkable improvement in 2006 and a fall back below the 2005 level in 2007, be gradually closing in the remaining two years. However, it still remains negative in the final year of the programme. Hence, apart of the policy induced temporary cooling down in 2007, the cyclical conditions are improving. For 2006 and 2007 the cyclical condition, as measured by the output gap, are plausible. Afterwards, according to the stability programme, the output gap is closing rather quickly in 2008 and 2009. As a result, cyclical conditions are likely to be less favourable towards in these years.

The forecast presented in the Stability programme and the Commission services' interim forecast forecasts are based on similar assumptions and include the measures agreed upon in the coalition agreement and those already decided upon by the new German government. Only the update's (technical) assumption of unchanged short term interest rates seems rather implausible.

Employment growth will remain slow according to the stability programme. While employment is expected not to grow in 2006, it will only increase by ¼% in 2007 and by ½% thereafter while on average GDP growth is relatively strong compared to recent years. Consequently, concerning labour market developments, the forecast of the stability programme is rather cautious, as also highlighted by the programme itself.

The programme’s projections for inflation appear realistic for 2006, but may be on the high side for the remainder of the period. While the increase of the standard VAT rate will lead to a higher deflator for private consumption and hence also for GDP, this effect might be more limited than assumed in the Stability Programme. Current estimations quantify this effect for the Harmonised Consumer Price Index to be around one percentage point. Consequently, even with a deflator for private consumption of nearly 1.5 to 2%, the GDP deflator would rather not reach 1½% in 2007. Also in the following years, a GDP deflator of 1% or slightly more might be on the high side. As regards wages and salaries, the update states that in the medium-term real wage growth should be in line with productivity. In contrast, the Commission services´ autumn 2005 economic forecast projects more subdued wage growth for 2006 and 2007. A (perhaps less pronounced) continuation of this trend might be plausible also for the outer years of the programme, leading to a further decline of real unit labour costs.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008	2009
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.8	0.9	1.2	1.4	1.6	1	1 ¾	1 ¾
Contributions:								
- Final domestic demand	-0.3	-0.1	0.5	0.6	0.8	¼	1	1
- Change in inventories	0.2	0.3	0.0	0.1	0.0	¼	0	0
- External balance on g&s	0.8	0.7	0.8	0.7	0.8	½	½	½
Output gap[1]	-0.9	-0.9	-0.8	-0.7	-0.4	-1.1	-0.7	-0.4
Employment (% change)	0.3	-0.3	0.5	0.0	0.4	¼	½	½
Unemployment rate (%)	9.5	--	9.3	--	9.1	--	--	--
Labour productivity growth (%)	0.5	1.2	0.7	1.4	1.2	1	1 ¼	1 ¼
HICP inflation (%)	2.2	--	2.7	--	2.2	--	--	--
GDP deflator (% change)	2.0	0.5	2.2	0.8	2.5	1 ½	1	1
Compensation of employees (% change)	3.0	--	2.9	--	3.0	--	--	--
Wages and salaries (% change)	0.0	--	0.5	¾	1.8	--	--	--
External balance (% of GDP)	3.9	--	3.9	--	4.4	--	--	--

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

Source:
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)

Commission services' calculations, based on information provided in the programme and according to the commonly agreed methodology, show that the programme projects an acceleration of potential growth towards the outer years of the programme. This increase is slightly above the calculations based on the Commission services´ autumn 2005 economic forecast. As the slightly negative contributions from labour utilisation and the positive contributions stemming from capital accumulation are mainly in line between the two forecasts, the main difference is due to more favourable assumptions on total factor productivity.

Table 2: Sources of potential output growth

	2005		2006		2007		2008	2009
	COM	SP[2]	COM	SP[2]	COM	SP[2]	SP[2]	SP[2]
Potential GDP growth[1]	1.1	1.1	1.1	1.2	1.2	1.3	1.3	1.4
Contributions:								
- Labour	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2
- Capital accumulation	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
- TFP	0.9	1.0	0.9	1.0	0.9	1.1	1.2	1.2

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

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

3. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first discusses budgetary implementation in the year 2005. The second part briefly compares the targets for the general government balance in the new update with those presented in previous stability programmes and describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

3.1. Targets in successive programmes and implementation in 2005

The 2004 update of the stability programme had projected the 2005 deficit at 2.9% of GDP, in order to correct the excessive deficit by 2005 in line with the deadline set in the Council Recommendation under Art. 104(7) of 21 January 2003 in conjunction with the Commission Communication to the Council of 14 December 2004 (for the history of the EDP on Germany, see Box 1). Data provisionally notified by Germany on 24 February 2006 show that the 2005 deficit amounted to 3.3% of GDP, which implies that the excessive deficit was not corrected by the deadline.

As can be seen in Figure 1, the postponement of consolidation has been a recurring pattern across vintages of 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). Since the 2003 update, the aim for a balanced budget by the programme horizon is no longer pursued.

In order to decompose the excess over the deficit target, the fiscal indicators from the previous update are corrected by the impact of the methodological change in the GDP series.[3] Tax revenues as a share of GDP were by about 0.4 percentage point higher than projected, despite the shortfall in growth. The previous programme had projected real growth at 1.7% of GDP in 2005, while it actually was 0.9%. Nominal GDP growth was projected at 2.7% of GDP in the previous update, while it turned out at 1.3% of GDP. However, the growth composition in 2005 was more tax-favourable than expected in autumn 2004. The share of private consumption in GDP was higher than expected, which fed through to indirect tax revenues. Moreover, compared with the official German tax revenue estimation exercise of November 2004, which was underlying the previous update, tax revenue losses in labour income tax were more than compensated for by

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[3] Fiscal indicators from the current update are not directly comparable to those of previous updates. In 2005, the method of allocating financial intermediation service indirectly measured (FISIM) to users was changed in national accounts. Up to now, bank service charges were only partly allocated to users. In the past, FISIM were attributed globally to a notional sector as intermediate input, with no impact on the level of GDP. Now the interest paid or received is split into underlying interest and a service charge. Interest expenditure is lowered by the computed service charge, which is now paid as consumption. Likewise, interest received is higher than the underlying interest rate, in order to enable the lender to pay for the bank service charges. The nominal balance in €-terms is thus unaffected by the new method. However, the level of GDP rises (also retroactively), insofar as FISIM enters final consumption as government (and households) consume such services. Under the old method, the total amount would have been recorded fully as intermediate consumption. In 2005, the amount of FISIM in consumption was € 30.3 bn, which is 1.3% of GDP. In order to compare the current update with previous ones, the change in method applied would thus lower any fiscal indicator from previous updates that is expressed as percent of GDP by about 1½ %.

higher taxes on enterprises, in particular local taxes. The share of social security contributions turned out higher by 0.1 percentage point. At almost unchanged contribution rates, this can be explained by the change in the classification of the pension office for former postal civil servants (PBVK) from the private into the government sector.[4] The share of other revenues was about 0.3 percentage point higher than projected, of which some part was due to higher interest received. In sum, the revenue share was 0.8 percentage point higher than projected.

On the other hand, the expenditure share turned out 1.2 percentage points higher in 2005 than projected. Monetary transfers were by 0.6 percentage points higher than projected. Half of this overspending is due to the classification of the pension office for former postal civil servants (PBVK) into the government sector. The remainder stems to a large extent from overspending on social assistance. Not least in view of the reforms on social benefits implemented on 1.1.2005 ("Hartz IV"), the previous year's programme projected employment to rise by 0.5% in 2005 (the Commission autumn forecast 2004 also projected employment to rise), while it actually decreased by -0.3%. The programme sums intermediate consumption, social benefits in kind and the public wage bill into one category. This category seems to be above target by 0.7 percentage point, of which 0.2 percentage point come from the change in method of allocation of FISIM to users. The remaining 0.5 percentage point are most likely due to higher social benefits in kind, i.e. higher expenditure by the public health insurance. Interest expenditure, corrected for the change in method of allocating FISIM, and public investment were slightly lower than expected in the previous programme, while other expenditure was slightly higher.

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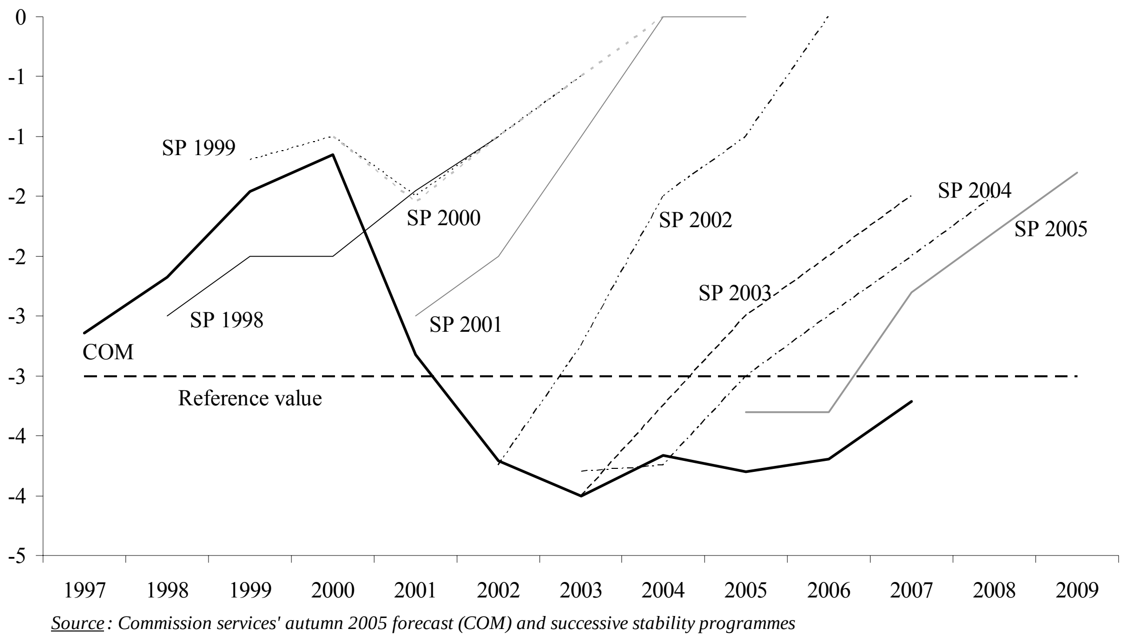
4 The pension office for civil servants of the former public post office (*Postbeamtenversorgungskasse, PBVK*) used to be recorded in national accounts in the private sector. Contributions from the private successor companies of the post office thus used to be transfers within the private sector; contributions by the federal government to the office used to be recorded as transfers to private companies. According to ESA95 rules, the PBVK is recorded now as part of the government sector. The successor companies pay social contributions, and the payments made by the PBVK are recorded as monetary transfers to households. With the revenue from the securitisation of future claims against the successor companies by the PBVK, the government did not make any social contributions in 2005, only the companies did so. In ESA95 terms, this led to a deficit of the PBVK.

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008	2009
General government balance (% of GDP)	**SP Feb 2005**	--	**-3.3**	**-3.3**	**-2 ½**	**-2**	**-1 ½**
	SP Dec 2004	-3.7	-2.9	-2 ½	-2	-1 ½	--
	SP Jan 2004	*-3 ¼*	*-2 ½*	*-2*	*-1 ½*	--	--
	COM Nov 2005	-3.9	-3.9	-3.7	-3.3	--	--
General government expenditure (% of GDP)	**SP Feb 2005**	--	**46.7**	**46 ¼**	**45**	**44 ¼**	**43 ½**
	SP Dec 2004	47 ½	46	45 ½	44 ½	43 ½	--
	SP Jan 2004	*48*	*46 ½*	*45 ½*	*44 ½*	--	--
	COM Nov 2005	47.5	47.6	47.0	46.3	--	--
General government revenues (% of GDP)	**SP Feb 2005**	--	**43.4**	**43**	**43**	**42 ½**	**42 ¼**
	SP Dec 2004	43 ½	43	43	42 ½	42 ½	--
	SP Jan 2004	*44 ½*	*44*	*43 ½*	*43*	--	--
	COM Nov 2005	43.8	43.7	43.2	43.0	--	--
Real GDP (% change)	**SP Feb 2005**	--	**0.9**	**1.4**	**1**	**1 ¾**	**1 ¾**
	SP Dec 2004	1.8	1.7	1 ¾	2	2	--
	SP Jan 2004	*1.7*	*2 ¼*	*2 ¼*	*2 ¼*	--	--
	COM Nov 2005	1.6	0.8	1.2	1.6	--	--

Source:
Stability programmes (SP); Commission services' autumn 2005 economic forecasts (COM) not corrected for the change in method of allocating FISIM in national accounts

Figure 1: General government balance projections in successive stability programmes (% of GDP)



Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

Box 1: The excessive deficit procedure for Germany

On 21 January 2003 the Council decided that Germany was in excessive deficit. On the same date, the Council recommended that Germany bring the situation of an excessive deficit to an end by 2004 at the latest. In October 2003, the Commission considered that the measures taken by Germany had been insufficient to respect this recommendation 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 decided not to endorse the Commission's recommendations but instead adopted conclusions stating that, in light of the commitments by Germany, the excessive deficit procedure (EDP) 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.

Although the Council recommendations under Article 104(7) specified that the excessive deficit needed to be corrected by 2004 at the latest, the Commission Communication of 14 December 2004* concluded that, in view of the unique circumstances created by the Council conclusions of 25 November 2003 and of the ruling of the European Court of Justice of 13 July 2004, the relevant deadline for the correction should be 2005. At the time, based on a growth forecast of 1.5%, the Commission considered that Germany was on track to correct its excessive deficit by 2005 and thus that no further steps under the EDP were necessary, although its budgetary situation remained vulnerable. At the same time, the Communication stated that "should failures in implementing the envisaged correction emerge at a later stage, the Commission 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". In its conclusions of 18 January 2005, the Council concurred with the Commission's conclusions and confirmed that, in cooperation with the Commission, it stood "ready to take steps under the EDP, as appropriate".

The Council Opinion of 17 February 2005 on the 2004 update of the stability programme of Germany confirmed the assessment of the December Commission communication. Specifically, the Council opinion stated that, on the basis of then available information, a budgetary outturn of 2.9% in 2005 should be possible, on condition that the envisaged measures are fully implemented and that additional measures are taken in case of adverse developments. On the other hand, the Council opinion pointed out that as regards 2006, the outturn could be worse than targeted. The Council opinion recommended that Germany do the necessary to ensure the correction of the excessive deficit in 2005 and make sure that budgetary consolidation continues thereafter so as to reach a close-to-balance position by 2008.

Germany did not correct the excessive deficit by the deadline set by the recommendation under Art. 104(7) in conjunction with the Commission Communication of 14 December 2004, i.e. by 2005. On 1 March 2006, the Commission recommended the Council to take a decision in accordance with Article 104(9) and recommend Germany to (i) put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2007, (ii) ensure a cumulative improvement in its cyclically-adjusted balance net of one-off and other temporary measures by at least one percentage point in the years 2006 and 2007, and (iii) take the necessary measures to ensure that budgetary consolidation towards its medium-term objective of a balanced budget in structural terms is sustained through a reduction in the structural deficit by at least 0.5% of GDP per year after the excessive deficit has been corrected.

** "The situation of Germany and France in relation to their obligation under the excessive deficit procedure following the judgement of the Court of Justice", document COM(2004)-813, available at the following website:* http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_com_2004_en.pdf.

3.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

3.2.1. The main goal of the programme's budgetary strategy

The main goal of the medium-term budgetary strategy as stated in the programme is to ensure the long-term sustainability of public finances. To achieve this, the programme proposes to continue budgetary consolidation, while improving the conditions for growth and employment. While phrased somewhat differently, in essence the strategy has remained unchanged from the previous programme. Whereas the previous update argued that the room for further budgetary consolidation would be limited by weak domestic demand, the current update puts forth growth-supporting measures as the core element of the strategy to support the upswing in 2006. Therefore, the programme envisages correcting the excessive deficit by 2007. However, the adjustment path is different compared with the previous update. While the latter envisaged an improvement of ½ percentage point each year, the current update projects no adjustment in 2006, but 1 percentage point in 2007. Specifically, for 2006 and 2007 the projections in the update are for nominal deficits of 3.3% and 2½% of GDP, respectively. Thereafter, the deficit is projected to decline by ½ percentage point of GDP per year. The primary balance follows the same pattern, reaching 1½% of GDP by 2009.

Compared with the update of the previous year, the February 2006 update of the stability programme postpones the budgetary consolidation on average by one year. The headline deficit ratio in 2005 was, at 3.3% of GDP, by 0.4 percentage point higher than projected in the previous update. Accordingly, the current update projects the deficit to reach 1½% of GDP at the end of the programme period, which the previous update projected to be reached already by 2008. In this sense, the worse-than-expected outcome in 2005 is not to be compensated by greater ambition to consolidation in the future.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2005
Revenues *of which:*	--	43.4	43	43	42 ½	42	- 1 ¼
- Taxes	--	21.9	22	22 ½	22 ½	22 ½	½
- Social contributions		17.7	17 ½	16 ½	16 ½	16	- 1 ¾
- Other (residual)	--	3.9	3 ½	3 ½	3 ½	3 ½	- ½
Expenditure *of which:*	--	46.7	46	45	44 ¼	43 ½	-3 ¼
- Primary expenditure *of which:*	--	43.8	43 ½	42	41 ½	40 ½	-3 ½
Intermed. Consum., social benefits, compensation of empl., other taxes on production (no break-down provided)	--	19.1	19	18 ½	18	18	-1 ¼
Social transfers other than in kind	--	19.2	19	18	17 ½	17 ½	-2
Subsidies	--	1.2	1 ½	1 ½	1	1	0
Gross fixed capital formation	--	1.3	1 ½	1 ½	1 ½	1 ½	0
Other (residual)	--	3.0	3	3	3	2 ½	- ½
- Interest expenditure	--	2.8	3	3	3	3	0
General government balance (GGB)	--	-3.3	-3.3	-2 ½	-2	-1 ½	2
Primary balance	--	-0.5	- ½	½	1	1 ½	2
One-off and other temporary measures	--	0.1	0	0	0	0	-0.1
GGB excl. one-off & other temporary measures	--	-3.4	-3.3	-2 ½	-2	-1 ½	2

Source:
Stability programme update; Commission services' calculations, numbers do not add up due to rounding

3.2.2. The composition of the budgetary adjustment in the programme

The planned budgetary adjustment involves increases in revenue and reductions in expenditure. However, at first sight, this is not apparent from Table 4. The revenue ratio is expected to remain roughly constant at 43% of GDP between 2005 and 2007 and to decline to 42% by 2009. In contrast, the expenditure ratio is projected to decline from 46.7% of GDP by over 3 percentage points over the programme period. Projected at 43½% of GDP in 2009, the expenditure ratio would have reached a record low; the government share in GDP was below 44% of GDP for the last time in 1973 (West-Germany). It should be positively noted that, according to the update, the government does not plan to make any recourse to one-off measures. Those measures that are detailed in the update are indeed of a lasting nature.

Table 4 and Table 4a (reproduced here from the update of the programme) provide more detail on the nature of the adjustment. The striking observation on the revenue side is that the increase in tax revenues foreseen for 2007 (1% of GDP) would only be able to compensate for the decrease in social contributions, so as to stabilise the revenue ratio in 2007 but not thereafter. The policy-induced decline in social contributions by lowering the contribution rate to the unemployment insurance accounts for only half of the decline in social contributions in 2007. The update assumes that contribution rates remain constant after 2007. Yet, the share of contributions in GDP is projected to continue declining. This would correspond to the elasticity of contributions to GDP of 0.57 as estimated by the OECD (see Annex 4), but might seem at odds with the statement that wages would increase in line with productivity (see Section 2).

Table 4a: Isolated view of the fiscal impact of the coalition agreements after "Genshagen" (i.e. measures adopted or planned in government meeting on 9/10 January 2006)

	2006	2007	2008	2009
	% of GDP			
Revenue	**-0.1**	**0.5**	**0.6**	**0.7**
Taxes	-0.1	1.0	1.2	1.3
Social contributions	0.0	-0.6	-0.6	-0.6
Expenditure	**0.1**	**-0.4**	**-0.5**	**-0.5**
Monetary transfers	0.0	-0.2	-0.2	-0.2
Capital transfers	0.0	-0.1	-0.1	-0.1
Public consumption	0.0	-0.2	-0.3	-0.3
Gross investment	0.0	0.0	0.0	0.0
Impact on deficit in total	**-0.1**	**0.9**	**1.1**	**1.3**

(- = deficit increase / + = deficit decrease)
Source:
Stability programme update

The planned restraint in expenditure falls to a large extent on social transfers. Indeed, the update states that "*the planned social benefit cuts represent an essential factor in this context. These have an important role to play in consolidating public finances. The medium-term consolidation objectives set out here cannot be reached without reducing the social benefit ratio*."

The update projects intermediate consumption, social benefits in kind and public sector wages in total (it does not provide a break-down) to decline by 1 percentage point over the programme period. The decline until 2007 should, although not explicitly mentioned in the update, be partly due to the wage restraint resulting from the wage agreement of February 2005, which extends until the end of 2007.[5] In addition, cuts in bonus payments for civil servants would contribute to the wage restraint. Table 4a projects a reduction in public consumption by 0.2 percentage points in 2007, resulting from the measures in the 2006 draft federal budget and supplementary laws. For the outer years, however, it is unclear whether the restrictive line on the public sector wage bill could be maintained. Thus, the adjustment in the outer years of the programme in this summary category would be mostly delivered by reduced social benefits from either social assistance or the public health insurance. The update does not detail the adjustment. Even so, health care expenditure has been increasing considerably above the rate of nominal GDP growth over the last decade despite repeated reforms, the last in 2004.[6] Moreover, the increase in

[5] The wage agreement, concluded between the public sector union and the federal and the local levels, foresees zero wage growth between 2005 and 2007 for public sector employees; however wages for employees at the local level in eastern Germany are to be slightly raised. The states, which account for more than half of the public sector employment in Germany, did not join the wage agreement, arguing that the restraint would not go far enough. At the time of writing, the states and the public sector union were negotiating over increasing working hours without wage compensation.

[6] For a description of the 2004 health care reform, see the Commission services' assessment of the December 2004 update of the Stability Programme of Germany, in particular Box 3, which concluded that "in order to contain the growth rate of expenditure, further efficiency-enhancing measures are necessary in the medium-term". Indeed, while health care expenditure declined by 3.1% in 2004, it increased by 3.1% in 2005, which is about the annual average prior to the 2004 reform.

the VAT rate will burden expenditure for medication. Given such a baseline, it adjustment path assumed by the update assumes is not sufficiently backed by measures that would result in a continuing decline in the social benefit in kind-to-GDP ratio.

Social benefits other than in kind are projected to decline by 2 percentage points over the programme period, i.e. by ½ percentage point per year, which the update does not illustrate.

Finally, the update projects other expenditure to be reduced by ½ percentage point in total over the programme period. This might reflect some of the cutbacks in tax allowances, in particular the abolition of the tax subsidy on owner-occupied housing from 2006 on, the effects of which would take time to settle in because of grandfathering. Table 4a seems to reflect this by projecting a reduction in capital transfers.

The projected adjustment path is reflected in the different sectors of government as follows. The deficit of the federal level (in national accounts terms) is projected to remain broadly unchanged in 2006 (see Box 2). It is projected to narrow in 2007 and 2008 by ½ percentage point per year. In 2007, this would be due to the higher tax revenues from raising the standard VAT rate, but also to the cutbacks in tax allowances. The narrowing of the deficit in 2008 would be due to lower transfers to the social security systems. The increase in tax revenues would improve public finances also at the level of the *Länder* by 2007, after which their deficit is projected to remain unchanged. The balance of the social security system is projected to remain in deficit until 2007 and in balance thereafter. At first sight, this may seem a cautious assumption, especially compared with the previous update, which projected a growing surplus between 2005 and 2009. However, the revenue base should weaken because of the reduction in the social contribution rate in 2007 and the reduction in transfers from the federal budget. Both would have to be compensated by expenditure restraint, which, as described above, is not fully backed by trend developments and adopted measures. While the previous update motivated the projected surpluses by the legally required accumulation of a "sustainability fund" (in order to smooth liquidity fluctuations within a year) in the pension system, the current update makes no mention of it. Indeed, the Pension Report by the government does not assume a substantial build-up of this fund until 2009.[7]

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[7] Bericht der Bundesregierung: "Rentenversicherungsbericht 2006", adopted by the government on 8 March 2006, p.36, available at: www.bmas.bund.de

Box 2: The budget for 2006

The draft federal budget for 2006 was presented on 22 February 2006 and is scheduled to be approved by the *Bundestag* by 23 June and by the *Bundesrat* on 7 July 2006. The share of the federal level in total (consolidated) government expenditure is about 31%, the share of the *Länder* weighs about 27%, the local level about 16%, and the social insurance about 45%. Of course, these numbers reflect the substantial flows between levels of government. Figures given below usually apply to general government.

The general government balance is projected to remain unchanged in 2006 compared with 2005. However, there are some structural movements due to policy measures.

On the revenue side, the main measures concern the widening of some and the cutback of other tax allowances on direct taxation. Depreciation rules on non-fixed capital are relaxed, the renovation of buildings and the private use of household repair services receive tax-favourable treatment and higher child and old age care allowances are granted. On the other hand, loopholes on tax-saving investment funds are removed. Regarding indirect taxes, the method of tax collection from small businesses is changed, resulting in tax losses in 2006. For some vehicles, the circulation tax is raised. Overall, the fiscal effects of these measures tend to cancel out, or would cause a slight deterioration of revenues.

On the expenditure side, the allocation for active labour market policies (ALMPs) is increased at the federal level (integration support for unemployed), some further ALMPs are extended beyond their initially foreseen expiry date (e.g. support for older workers), while the means-testing for social benefit recipients is tightened. On the other hand, the Federal Employment Agency plans to reduce its ALMPs, so that discretionary spending in the labour market would rise only slightly.

Subsidies to new technologies and additional spending on road and rail infrastructure add to expenditure. The abolition of the subsidy on owner-occupied housing will make a small contribution to consolidation in 2006 (due to grandfathering), but the effect will grow over time.

The main budgetary effects, however, will derive from action taken well before this budget. As the consequence of the 2005 pension reforms, pension expenditure will rise only slightly. Given the public sector wage agreements, increases in working time and the trend in reducing staffing levels, the public sector wage bill should contribute substantially to consolidation in 2006.

Finally, companies have to carry forward their monthly social contributions from the middle of the following month to the end of the month when the payment is due. This will lead to thirteen instead of twelve cash payments in 2006, but does not affect the budget balance according to ESA95 accounting rules. However, the social security system will be running a cash surplus in 2006, of which some cash will be carried over to 2007, resulting in ESA95 accounting terms in deficits for both 2006 and 2007.

Some of the measures adopted for the 2006 budget will show a larger budgetary impact in 2007. For example, the consolidation effects of the abolition of tax allowances will be larger, but also the tax relief from the softened depreciation rules. This would result in a slight deterioration in revenues also in 2007. Moreover, capital transfers to the government will be lowered by a reduction in the inheritance tax for certain cases. However, in the draft supplementary law to the 2006 draft budget, the government also adopted an increase in the central VAT rate from 16% to 19% of GDP and of the insurance tax rate from 2007 on, which could be expected to raise indirect tax revenues by up to 1% of GDP. The supplementary law further lowers the social contribution rate to the unemployment insurance from 6.5% to 4.5% in 2007 (and beyond), amounting to about 0.6% of GDP. The contribution rate to the pension system is planned to be raised from 19.5% to 19.9% in 2007. In 2007, the expenditure side will be burdened by the introduction of a new support for parents and the prolongation of the investment subsidy for eastern Germany, and also by the impact of the VAT increase on government consumption (in particular health care). On the other hand, the Federal Employment Agency plans further expenditure constraint.

3.2.3. *The programme's medium-term objective (MTO) and the adjustment path in structural terms*

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The programme sets an MTO of a balanced budget in structural terms, which, however, is not achieved within the programme period. The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures), based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, is planned to improve by about ½% of GDP on average per year over the programme period. In the years 2006 and 2007, the correction of the excessive deficit by 2007 entails an improvement in the structural balance by more than one percentage point of GDP cumulatively. From Table 5, it appears that the fiscal consolidation in 2007 occurs in a year, in which the negative output gap widens. The government expects that the adopted reduction in the contribution rate to the unemployment insurance by 2 percentage points in 2007 would be partly financed by expenditure savings delivered by the Federal Employment Agency. Although the draft law for the change in the contribution rate has been adopted, the corresponding savings would have to be detailed not until the Agency's – not yet drafted – 2007 budget. Such savings would to a large extent entail reductions in active labour market policies, which might be difficult to implement. It is unclear, moreover, whether further such restraint could be delivered beyond 2007 in order implement the planned path., the economic effect of the VAT increase, in particular the anticipation of consumption from 2007 to 2006, raise real GDP growth vis-à-vis potential growth in 2006 and depress it in 2007.

After the planned correction of the excessive deficit by 2007, the fiscal effort is envisaged to amount to less than ½ percentage point annually – in years with cyclical conditions projected to be favourable, as the output gap should be closing and approaching zero.

Table 5: Output gaps, cyclically-adjusted and structural balances

	2004		2005		2006		2007		2008	2009	Change: 2009-2005
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-3.7	-3.7	-3.9	-3.3	-3.7	-3.3	-3.3	-2 ½	-2	-1 ½	2 ½
One-offs[2]	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Output gap[3]	-0.6	-0.6	-0.9	-0.9	-0.8	-0.7	-0.4	-1.1	-0.7	-0.4	0.5
CAB[4]	-3.3	-3.4	-3.2	-2.9	-3.2	-2.9	-3.0	-1.8	-1.5	-1.1	1.8
change in CAB	0.0	0.1	0.1	0.5	0.0	0.0	0.2	1.1	0.3	0.7	
CAPB[4]	-0.4	-0.5	-0.2	0.0	-0.3	0.0	-0.1	1.1	1.4	1.9	1.9
Structural balance[5]	-3.3	-3.4	-3.3	-3.0	-3.2	-2.9	-3.0	-1.8	-1.5	-1.1	1.9
change in struct. bal.	0.0	0.1	0.0	0.4	0.0	0.1	0.2	1.3	0.3	0.4	
Struct. prim. bal.[6]	-0.4	-0.5	-0.2	0.0	-0.3	0.0	-0.1	1.1	1.4	1.8	2.1

Notes:
[1]Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures
[3]In percent of potential GDP
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

3.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

3.3.1. Appropriateness of the programme's medium-term objective

As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¾% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit.

The programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is slightly more demanding than implied by the debt ratio and average potential output growth in the long term.

3.3.2. Risks attached to the budgetary targets

The two main risks to the budgetary projections are worse-than-expected macroeconomic developments and a not rigorous enough implementation of the envisaged consolidation. Both risks apply rather to the outer years of the programme.

The macroeconomic outlook provided in the update is plausible for 2006 but may be on the favourable side for 2007. Although the budgetary consolidation package, which is by and large adopted, will unfold to a great extent only by 2007, it will have a substantial economic effect already in 2006. In particular, the reaction of the economy to the most sizeable measure, the increase in the VAT rate, is difficult to predict. Firstly, there is uncertainty about the extent to which producers will be able to pass the additional VAT on to consumers. The less it is passed on, the lower VAT revenues and, because profits will be depressed, enterprise tax revenues. Secondly, the anticipation of taxable consumption from 2007 to 2006 can produce sizeable shifts in revenues and net revenue losses because of the difference in tax rates. Thus, compared with the baseline laid out in the update, a possible deterioration in growth in 2007 could raise growth in 2006, improving the budgetary outcome in 2006 but worsening it in 2007.

Table 6 compares the tax projections by the update with those of the Commission services for the years 2006 and 2007. The Commission services' forecast was finalised in November 2005 before the coalition agreement was published but can still serve as a comparative baseline. For 2006, the update projects a lower tax and social contributions share than the Commission services. According to the analysis in Table 6, the update assumes a less tax-favourable growth composition than the Commission services' autumn forecast. This is mainly due to lower wage growth than projected by the Commission services.[8] However, if a substantial amount of taxable consumption was brought forward from 2007 to 2006, indirect tax revenues should be considerably more dynamic relative to total private consumption in 2006. The update seems to take a cautious stance here. For 2007 also, the update seems to assume a less tax-favourable growth composition than the Commission services. However, this reflects the effect of the decrease in the social contribution rate in 2007, which reduces the compensation of employees for a given rise in net wages, and thus the tax base for personal income taxes and (mechanically) also for social contributions.

For the outer years of the programme, the macroeconomic outlook provided by the programme appears to be favourable. Growth is projected ½ percentage point above potential, which is a substantial margin in view of the low potential growth rate. Lower wage growth than projected would reduce social contributions, but might, on the other hand, dampen pensions and promote employment growth and thus relief to expenditure on transfers. The update assumes that contribution rates remain constant after 2007. Yet, the share of contributions in GDP is projected to continue declining. This would correspond to the elasticity of contributions to GDP of 0.57 as estimated by the OECD (see Annex 4), but might seem at odds with the statement that wages would increase in line with productivity (see Section 2).

The budgetary consolidation projected until 2007 is rooted both in measures that are by and large adopted and also in trend developments on the expenditure side, in particular low pension expenditure growth, public sector wage and salary restraint, reductions in staffing levels, subsidies and in the cost of debt service, and low public investment. On the one hand, the consolidation effect of some adopted measures (in particular the abolition of the subsidy on owner-occupied housing) will grow over time. Also, the assumptions in the programme on pension expenditure seem plausible. On the other

[8] Low wage growth is also the main reason why the Commission services project a lower tax revenue growth than would be implied by the standard OECD ex-ante elasticities (Table 7).

hand, the public sector wage agreement[9] in force will end in 2007. But some trends might not continue into the outer years of the programme. For example, debt servicing costs could rise if the ECB reference rate was raised (assumed constant at the January 2006 rate by the update).

Most importantly, however, there are implementation risks on the expenditure side especially in the area, which the update regards as the core element of the consolidation strategy: social spending. Experience from past vintages of stability programmes shows that the projected path of social spending (more precisely: monetary transfers, thus ignoring health care) was never adhered to.

For recent vintages of stability programme updates, the projections on restraint in social spending are remarkably similar. From the year of submission of the respective update to the final year of the programme period, the 2000 and 2001 updates projected a reduction of the share of monetary transfers in GDP by 1.5 pp cumulatively. From the 2002 update until the most recent one, all projected a reduction of this share even by 2 percentage points cumulatively over the programme period. However, the share of monetary transfers in GDP was 19% of GDP in 2000, and it was about 19% of GDP still in 2005 (even if one controls for the different method of accounting for FISIM in the denominator and nets out the reclassification of the postal pension office in 2005[10]).

One might argue that missing the plans in such a way only reflects growth shortfalls that occurred for every vintage of the update. However, a growth shortfall of about 1 percentage point in one year would increase the share of monetary transfers by about 0.2 percentage point, provided that during this year there is “full inertia” in adjusting monetary transfers in €-terms to lower growth. In the next year, however, one would expect monetary transfers in €-terms to be somewhat adjusted to the growth shortfalls, for example through the formula with which pensions are determined. This might have prevented the ratio from *increasing* over time. However, the *reduction* of the share, as it was always planned, has not been realised over time.

Likewise, for the outer years of the programme period of the current update, about half of the projected adjustment in monetary transfers might require further measures.

In particular, this category comprises pensions, unemployment insurance and social assistance. In the public pension system for employees, expenditure per recipient will be dampened by the weak wage growth and the "sustainability factor" (introduced into the system in July 2005).[11] Total expenditure would thus be mainly driven by the growing number of recipients, but remain below the growth rate of nominal GDP, which might

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9 See footnote 6.

10 The method of calculating FISIM in GDP changed in 2005. Under the old FISIM method, the above-mentioned share would have increased by 0.2 percentage point. The reclassification of the pension office into the government sector increased monetary transfers by 0.3 percentage point in 2005. Thus, from the 2005 result (19.2% of GDP) one would have to subtract 0.3 percentage point but add 0.2 percentage point to make the ratio comparable with previous years.

11 As a result of the weak wage growth in the past years, the pension algorithm in force would have led to declining pensions in 2006. However, the government corrected the statistical base for the calculation by factoring out so-called "one-euro jobs" from the algorithm. This would result in additional expenditure of € 0.5bn in 2006.

explain a decline in the pension expenditure share by 0.2 percentage point annually. This would be limited, however, by pension payments to the rising number of retired civil servants, paid directly by the governments.

Furthermore, a projected reduction in unemployment would contribute to reducing monetary transfers. Unfortunately, the programme does not provide an unemployment projection. However, payments from the unemployment insurance have fallen substantially in 2005 and are projected (by the Federal Employment Agency) to continue so in 2006. This might also be the case in 2007. The reason is not so much a significant improvement in the labour market, but rather the transition of unemployed from the insurance into social assistance (at a lower benefit level), especially as the unemployment insurance period has been shortened for elderly new recipients starting from February 2006 (providing budgetary relief from 2007). The government expects that the adopted reduction in the contribution rate to the unemployment insurance by 2 percentage points in 2007 would be partly financed by expenditure savings delivered by the Federal Employment Agency. Although the draft law for the change in the contribution rate has been adopted, the corresponding savings would have to be detailed not until the Agency's – not yet drafted – 2007 budget. Such savings would to some extent entail reductions in active labour market policies, which might be difficult to implement. It is unclear, moreover, whether further such restraint could be delivered beyond 2007 in order implement the planned path.

Social assistance has been the subject of a major reform at the beginning of 2005 ("Hartz IV").[12] The experience during the first year after the implementation should caution against expecting future cost savings from this reform without further measures. The government adopted measures to correct some disincentives introduced with the reform, resulting in a small adjustment for the general government in 2006. The main driver of expenditure on social assistance is the long-term unemployment in Germany, but the update remains silent on whether to expect long-term unemployment to decline in the medium-term. For the outer years of the programme, improving labour market conditions might be expected to contribute 0.1 percentage point annually to the reduction in the expenditure share. Further information on savings in this category of monetary transfers is provided in Table 4a, which projects the savings arising from the budgetary measures by the new government to amount to 0.2% of GDP in 2007, which should be permanent but not increasing. Again, the update is not explicit on the nature of these measures; however from the coalition agreement of 11 November 2005, it might be inferred that these reflect the savings expected from the Federal Employment Agency in order to fund one percentage point of the adopted decrease in the contribution rate to the unemployment insurance. Overall, economic developments and information provided in the update would explain the adjustment path of monetary transfers as projected in the update fully until 2007. For the outer years of the programme period, about half of the projected adjustment in this category might be explained by current trends and adopted measures.

As regards social benefits in kind, the update assumes consolidation in the health care system by 0.2 percentage point in the outer years of the programme from the health care reform that is planned for summer 2006 – but which is controversial within the government coalition and for which no concrete proposal has yet been made public. It is

[12] Cf. the Commission services' assessment of the December 2004 update of the Stability Programme of Germany.

left open whether the health care reform would concentrate on the revenue or the expenditure side. In fact, much of the current focus in the health care reform debate is on the revenue side, especially on altering the contribution base. However, in order to contain the growth rate of expenditure, further efficiency-enhancing measures would be necessary in the medium-term.

A further risk may arise from the reform of enterprise taxation planned for 2008. Two concepts are advanced in great detail, which would profoundly change the tax code. It cannot be excluded that unexpected tax losses would occur even if the reform was intended to be tax-neutral.[13] Looking at experience, the last corporate tax reform in Germany led to unexpected revenue shortfalls – in the year of implementation (2001), corporate tax revenue dropped to zero.

In sum, the budgetary projections seem plausible for 2006. For 2007, risk remains that those measures that are not yet adopted (in particular in the health care sector and in the unemployment insurance system) are not as rigorously implemented as they are planned, which would worsen the budgetary outlook. For the outer years, both macroeconomic and implementation risks to the planned consolidation path remain.

Table 6: Assessment of tax projections

	2006		**2007**		**2008**	**p.m.:**
	COM	**SP**	**COM[2]**	**SP**	**SP**	**OECD[1]**
Total taxes Change in tax-to-GDP ratio	-0.2	-0.4	-0.2	0.1	-	/
Difference	-0.2		0.3		/	/
of which[3]: - elasticity component	0.3		-[4]		/	/
- composition component	-0.2		-0.4		/	/
p.m. Observed elasticity to GDP	0.7	0.5	0.8	1.1	-	0.97

Notes:
[1]OECD ex-ante elasticity relative to GDP
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4
[4]Not interpretable, since zero growth in tax base would yield infinite elasticity.
Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

3.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Germany did not correct the excessive deficit by the deadline set by the recommendation under Art. 104(7) in conjunction with the Commission Communication of 14 December 2004, i.e. by 2005. On 1 March 2006, the Commission recommended the Council to take a decision in accordance with Article 104(9) and recommend Germany to (i) put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2007,

13 At the presentation of its tax reform concept, the Council of Economic Advisers admitted that its concept, if no other financing measures were found, tax shortfalls of € 22bn (1% of GDP) could arise. (Financial Times Deutschland, 14 February 2006)

(ii) ensure a cumulative improvement in its structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, by at least one percentage point in the years 2006 and 2007, and (iii) take the necessary measures to ensure that budgetary consolidation towards its medium-term objective of a balanced budget in structural terms is sustained through a reduction in the structural deficit by at least 0.5% of GDP per year after the excessive deficit has been corrected.

In view of the above risk assessment, the budgetary stance in the programme seems consistent and with the recommended adjustment path and thus with the correction of the excessive deficit by 2007. The envisaged budgetary strategy seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations as from 2008. In the years following the correction of the excessive deficit, the pace of the adjustment towards the programme's MTO implied by the programme is broadly in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times. Even if the above-mentioned risks for the outer years did not materialise, more fiscal effort would be needed in order to meet the benchmark adjustment in the outer years of the programme, in particular as the output gap is projected to be closing and approaching zero.

Table 7: Assessment of tax elasticities

	2006		2007	
	COM (observed)	**ex-ante[1]**	**COM[2] (observed)**	**ex-ante[1]**
Total taxes Change in tax-to-GDP ratio	-0.2	-0.0	-0.2	0.0
Difference	-0.2		-0.1	
of which[3]: - elasticity component	0.3		-0.1	
- composition component	-0.3		0.0	
p.m.: Elasticity to GDP	0.7	1.0	0.8	1.0

Notes:
[1] Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2] On a no-policy change basis
[3] The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, Germany plans to implement a number of structural reforms in order to improve the sustainability of government finances in the medium to long run. If the expenditure restraint in the social security systems was implemented as planned, the composition of public expenditure would be more favourable towards growth-enhancing categories in line with the Lisbon strategy.

3.4. Sensitivity analysis

The update contains a sensitivity analysis for nominal GDP growth higher/lower by ½ percentage point than in the central scenario. The update plausibly states that a positive growth deviation of roughly ½ a percentage point could lead to the deficit ratio being reduced to the reference value of the Maastricht Treaty in 2006. The update concludes that given that the forecast underlying the programme was at the lower bound of the forecast spectrum, this scenario would certainly be within the scope of possibility. On the other hand, nominal growth at ½ percentage point below the central growth path between 2006 and 2009 would "call into question the possibility of remaining below the reference value in 2007 without implementing further measures."

Against the requirements of the code of conduct, the analysis in the update does not provide an analysis of how revenues and expenditure are projected to react to variations in economic variables, including interest rates.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2009 period; (ii) trend output based on the HP-filter[14] and (iii) no policy response (notably, the expenditure level is as in the central scenario[15]), reveal that, by 2009, the cyclically-adjusted balance would be 0.6 percentage point of GDP above/below the central scenario. Hence, in case of persistently lower real growth, additional measures of similar size would be necessary to keep public finances on the path targeted in the central scenario.[16]

4. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

4.1. Debt developments in the programme

The update does not spell out any objective or strategy as regards public debt. In 2005, debt is projected at 67½% of GDP, which is 1½% higher than projected in the previous update.[17] This is mainly due to the higher-than-expected deficit in 2005 (including the classification of the pension office for former postal workers into the government sector) and to the revision made by Eurostat to the debt series following the September 2005 notification. Privatisations that involved the sale of assets to the *Kreditanstalt für Wiederaufbau* (KfW) would not be considered debt-reducing, pending the actual sale of shares on the market by KfW.

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[14] In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[15] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

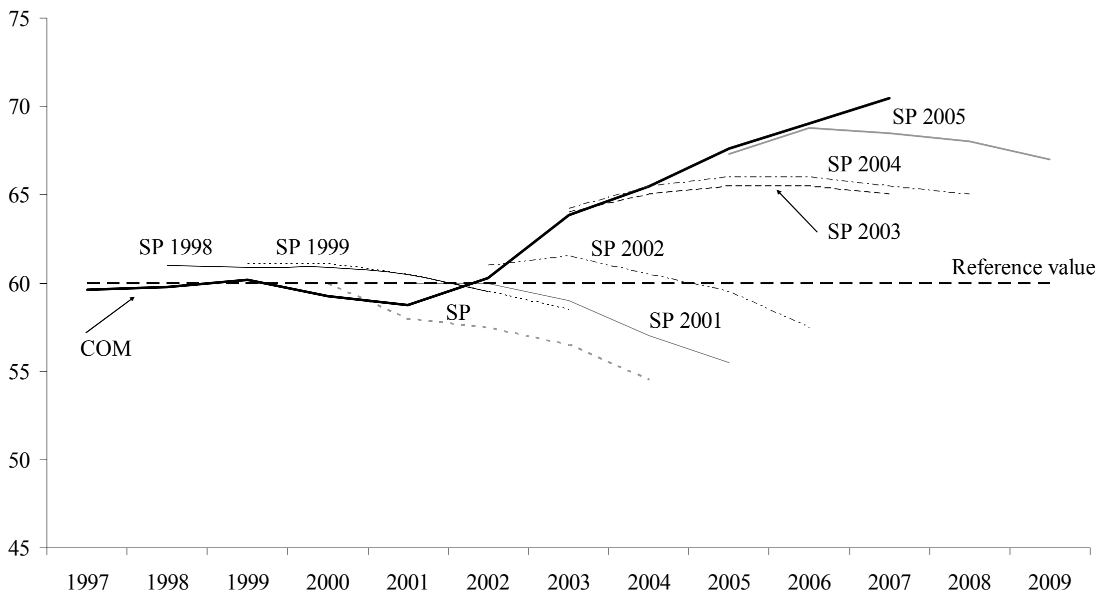
[16] Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

[17] Corrected for the change in the method of allocating FISIM. If the old method were still applied, the debt ratio projected in the current update (and the Commission services' autumn 2005 forecast) would be would increase by about 1½ %. For example, in 2005 the debt ratio was lowered by one percentage point from applying the new method.

From 2006, the update projects the debt ratio about 3 percentage points higher than the previous update (Figure 2). Besides the higher 2005 deficit and the statistical treatment of KfW-holdings of government assets, the postponement of the budgetary consolidation in 2006 to 2007 will further weigh on the debt ratio for the remainder of the programme period. The update does not discuss the reasons for the higher path of the debt ratio.

Table 8 shows that the reduction in the primary deficit contributes to the reduction in the debt ratio from 2007 on. Yet, only in the final year of the programme period, the budgetary consolidation would over-compensate the "snowball effect". The "snowball effect" is the automatic increase in the debt-to-GDP ratio caused by interest expenditure that is not balanced by nominal GDP growth. Throughout the programme period, the update assumes "stock-flow adjustments" to contribute considerably to debt reduction. Such adjustments are primarily sales of assets, for example the KfW's sale of its asset holdings on behalf of the government, initial public offerings of publicly-owned companies and the sales of building companies owned by municipalities. In view of the low potential growth, it is clear that it would not suffice bringing the deficit to just below 3% of GDP for stabilising the debt ratio. Rather, the analysis shows that Germany should aim at achieving its MTO rapidly.

Figure 2: Debt projections in successive stability programmes (% of GDP)



Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

Table 8: Debt dynamics

	average 2000-2004	2005		2006		2007		2008	2009
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	**61.9**	**67.6**	**67 ½**	**69.1**	**69**	**70.5**	**68 ½**	**68**	**67**
Change in debt ratio (1 = 2+3+4)	0.7	2.1	1.8	1.5	1.5	1.4	-0.3	-0.5	-1.0
Contributions:									
- **Primary deficit** (2)	**-0.4**	**1.0**	**0.4**	**0.8**	**0.4**	**0.3**	**-0.6**	**-1.1**	**-1.7**
- **"Snow-ball" effect** (3)	**1.7**	**2.0**	**2.0**	**1.8**	**1.5**	**1.5**	**1.1**	**1.2**	**1.2**
- Interest expenditure	3.1	2.9	2.9	2.9	2.9	2.9	2.9	2.9	3.0
- Real GDP growth	-0.7	-0.5	-0.6	-0.8	-0.9	-1.1	-0.7	-1.1	-1.1
- Inflation (GDP deflator)	-0.7	-0.4	-0.3	-0.3	-0.5	-0.3	-1.1	-0.7	-0.7
- **Stock-flow adjustment** (4)	**-0.4**	**-0.8**	**-0.6**	**-1.1**	**-0.4**	**-0.4**	**-0.8**	**-0.5**	**-0.5**
- Cash/accruals	0.0								
- Accumulation of financial assets	-0.4								
of which: Privatisation proceeds	-0.5								
- 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.

Source:
Stability programme update (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations, including the new method of allocating FISIM to users in GDP, whereas interest expenditure also includes FISIM otherwise recorded as consumption, since it also constitutes cost of debt.

4.2. Assessment

The update projections are more favourable than those of the Commission services' autumn 2005 forecast only for 2007. Since the Commission services' forecast was based on unchanged policies before the current government took office, it does not include the envisaged consolidation in the primary deficit in 2007.

The debt path contained in the update is clearly subject to the same risks as those attached to the budgetary targets. In addition, there is uncertainty regarding the debt-reducing stock-flow adjustments that are implicit in the update. On the one hand, the sale of publicly-owned assets, especially at the local level of government, might even lead to a (slightly) stronger reduction in debt. The city of Dresden privatised its building society in March 2006, which reduced its debt to zero. The impact on general government debt is less than 0.05% of GDP, but more municipalities might follow. In contrast, (far larger) future privatisation proceeds that seem to be underlying the update[18] are still speculative at the present stage.

[18] The update does not dwell on privatisations. However, the privatisation of Deutsche Bahn is mentioned in the "Erläuterungen zum Haushaltsgesetz 2006 und Finanzplan des Bundes 2005 bis 2009 sowie zum Haushaltsbegleitgesetz 2006" as underlying the medium-term fiscal planning. Annex to Pressemitteilung 26/2006, available at: www.bundesfinanzministerium.de.

In view of this risk assessment, the debt ratio may not be sufficiently diminishing towards the Treaty reference value of 60% of GDP.

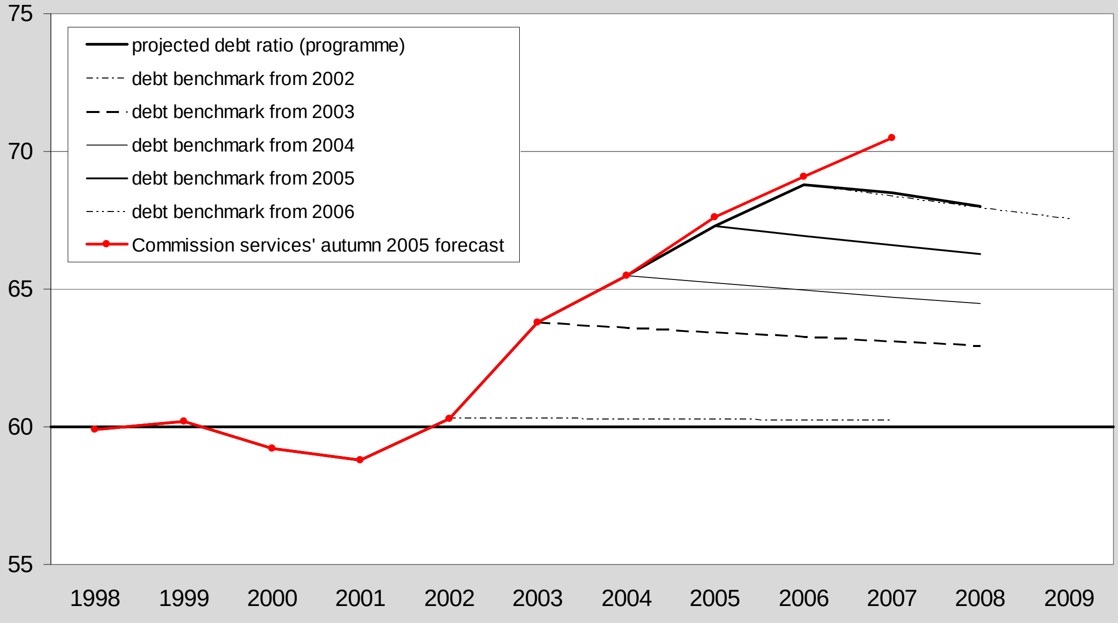
Box 3: The rolling debt reduction benchmark

The debt ratio was close to the Treaty reference value in 1998, when the first stability programme was submitted, and has been exceeding the 60% of GDP reference value since 2002.

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2005 forecasts until 2007 (which are on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (see Annex 5). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2005 is compared with the value obtained for the same year by applying the formula starting in 2000. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph shows that the planned reduction of the debt ratio in the update is about that implied by the five-year rolling debt reduction benchmark.

Germany: rolling five-year debt benchmark



Source: Stability programme and Commission services

5. Structural reform, the quality of public finances and institutional features

The budgetary package adopted by the government on 22 February 2006 (and the measures adopted since the government took office in November 2005) will change the structure of the tax system from 2007. Beyond the immediate macroeconomic impact of consolidation by raising the standard VAT rate, a longer-term assessment could be more favourable, based on the intertemporal shift from direct to indirect taxation. As a consequence of the tax laws 1999/2000, the tax ratio in GDP (incl. social contributions) fell from 43.3% of GDP in 2000 to 39.6% in 2005, i.e. by 3.7 percentage points. Over the same period, the deficit increased from 1.2% of GDP to 3.3% of GDP, i.e. by 2.1 percentage points. The changes in the tax law mainly involved lowering direct income tax rates. In addition, the share of social contributions in GDP decreased because its tax base grew by less than nominal GDP. This is reflected in a decline in the share of direct taxes (incl. social contributions) in total tax revenue[19] from 72.1% in 2000 to 70.2% in 2005, which still remained above the average of the remaining euro area members at 65.6%. With the VAT rise and the reduction in social contributions planned for 2007, the direct tax share in the total tax burden is projected to fall to 67½%. This also reflects the weak tax base for social security contributions, which might even lead to a further slight decline in the tax burden by 2007. A tax burden projected by the update at about 39% of GDP in 2007 would be below its 2000 level in Germany (42.5% of GDP) and that of the euro area average in 2007 (40.8% of GDP). Studies have shown that a change in the tax composition from direct to indirect taxes should have positive effects. First, the real income of transfer recipients is reduced at the benefit of contributors, which may be politically more feasible than cutting nominal benefits. Second, VAT does not burden savings and is thus neutral to intertemporal optimisation, while typically direct taxation (as long as interest and capital gains are taxed) is not. It remains to be seen which changes the corporate tax reform envisaged for 2008 will introduce.

Beyond the reduction in the social contribution rate, several further reforms have been implemented or are planned for the social security systems. In the pension system, it is planned to increase the statutory retirement age stepwise from 2012 until 2029 from 65 to 67 years of age. The budgetary effect of such a measure would arise through prolonging the contribution period without accordingly higher entitlements. A further measure concerns the algorithm, with which annual pensions (in the pay-as-you-go system) are calculated. Pensions are indexed to wage and demographic developments with a lag. With low wage growth, the demographic element (the ratio of contributors to recipients, called "sustainability factor"), which was introduced 2005, would lead to a decline in expenditure per recipient. Current legislation prevents this. It is planned to make up for these non-realised dampening of pension in later years; however, not before 2010. It remains to be seen, though, how this would be calculated and implemented in practice. Moreover, wage growth has been so weak that it by itself would have led to a decrease in pensions in 2006. Thus, the government adopted legislation to keep pensions constant in 2006, and corrected the statistical base for the algorithm by factoring out so-called "one-euro jobs". After the 2004 reform, new measures are planned for the health system. The update does not detail them (as nothing is publicly known), but includes their envisaged budgetary impact into the projections.

Lastly, the update dwells on the reform of the federal system as a contribution to the quality of public finances. Draft laws for changes to the Constitution in this respect are currently being discussed in parliament.[20] The proposed reforms might facilitate political

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19 Defined here as indirect taxes (D.2) plus direct taxes (D.5) plus social contributions (D.61).

20 *Bundestag* and *Bundesrat* created a joint Commission "zur Modernisierung der bundesstaatlichen Ordnung" on 16/17 October 2003, chaired by Edmund Stoiber and Franz Müntefering. The group terminated its work on 17 December 2004 without political agreement. Its final proposals were annexed to the coalition agreement of 11 November 2005. On this basis, the government coalition as well as several Länder presented draft laws to the *Bundestag* and *Bundesrat*. Parliamentary debate began on 10 March 2006 and is scheduled to be terminated in 2006.

decision-making between levels of government. Their impact on public finances is less clear, since the fiscal transfer systems between levels of government and across the *Länder* were explicitly excluded. Nonetheless, the reform package contains a proposal to regulate the responsibility of the federal level on the one hand and that of the *Länder* on the other against the background of the obligations for Germany arising from the Stability and Growth Pact. It is proposed that potential sanctions, which might arise from the Stability and Growth Pact, would be allocated according to a rule across levels of government. This would be inserted into the German Constitution. It is foreseen that 65% of potential sanctions would be allocated to the federal level (which roughly corresponds to the consolidated share of the federal level and social security in total government expenditure in 2005) and the remainder to the state level (implicitly being responsible for the local level, whose finances are supervised by the states). Amongst them, the *Länder* would allocate their share in the order of 35% according to inhabitants and in the order of 65% according to the individual contribution to the total budget deficit of the *Länder*. The idea behind this is to establish a joint liability for sanctions in order to create a common interest in consolidation measures, which, as required by the German Constitution, often have to be decided jointly by majority in both *Bundestag* and *Bundesrat* (the representation of the *Länder* at the federal level).

The proposal to allocate potential sanctions arising from the Stability and Growth Pact to different levels of government is, without doubt, a step in the right direction. Of course, the focus on excesses over the 3%-of-GDP reference value does not improve budgetary coordination with respect to the medium-term objective of budget balance once the excessive deficit has been corrected. Yet, the *Länder* contributions to the budget deficit would be formulated in terms of ESA95 national accounts to be compatible with the Stability and Growth Pact. Currently, budgets are drafted by law in cash accounting in Germany, which is one of the reasons why the consequences of budget drafting at the sub-sector level on the requirements of the Stability and Growth Pact are absent from the public debate in Germany. Thus, even without sanctions being imminent, this proposal could lead to greater awareness about the Stability and Growth Pact at all levels of government. The existing national arrangements for regulating budgetary processes do not seem to have been successful in this respect.

Previous updates[21] elaborated on the "national stability pact", a co-operative approach to implementing the Stability and Growth Pact between levels of government, as a constitutional solution was seen as problematic due to the constitutionally enshrined autonomy of each budgetary authority in the federal state (but limited for the local government and social security system). This approach was enacted in 2002, and is analysed in Box 4. The results are as follows. (i) The agreement was not respected over its first period of implementation (2003 and 2004). (ii) Consequently, it was softened for the next period, 2005 and 2006. However, given the expenditure path for general government projected by the update, the agreement is unlikely to be respected over 2005 and 2006, either. (iii) If not tightened, the agreement would not contribute to achieving the expenditure target for general government for 2009 envisaged by this update.

21 Cf. the 2003 and 2004 updates of the stability programme. The current update makes no mention of it.

Box 4: The "national stability pact"

With full autonomy of the federal and state budgetary authorities enshrined in the Constitution, the coordination of budgetary policy in Germany takes place in the Fiscal Planning Council (*Finanzplanungsrat,* FPLR). It is attached to the federal government and does not have its own office or staff. Chaired by the Federal Minister of Finance, its members are the Federal Minister for the Economy, the finance ministers of the *Länder* and representatives of local government. The FPLR meets behind closed doors. Consensual conclusions are usually published in a tight-lipped press release. In July 2002, an amendment to the Law on Budgetary Principles (*Haushaltsgrundsätzegesetz*, HGrG) entered into force, with a view to implementing at national level the commitments made by Germany in the context of the Stability and Growth Pact. At the time, this meant a general government budget in balance by 2004 (see 2002 update of the stability programme).

The new Article 51a HGrG stresses the common responsibility of the federal level and the *Länder* for complying with budgetary discipline within the framework of European economic and monetary union. Federation and *Länder* are invited to reduce net borrowing with the aim of achieving a balanced budget. The Fiscal Planning Council gives recommendations for budgetary discipline, notably on a common expenditure line for the central and state (including local authorities) governments. The FPLR also assesses whether trends in the budgets of central, regional and local government are in line with the provisions of Article 104 of the EC Treaty and the Stability and Growth Pact. If necessary, the FPLR makes recommendations on measures to be taken to restore compliance with budgetary discipline.

In the FPLR, the levels of government agreed to implement the law as follows. In 2003 and 2004, the federal level was to reduce expenditure by ½% on average per year, the *Länder* were to limit joint expenditure growth to 1% on average per year. [22] The 2002 agreement was renewed on 16 June 2004, relaxing the expenditure target for the federal level: its expenditure growth should not exceed 1% annually on average in 2005 and 2006. The target for the state level remained unchanged.

The agreement is neither detailed as regards data requirements for monitoring, nor are progress reports published. The table below shows compliance with the targets under the following assumptions. The federal level and social security are combined, since the social security systems are controlled by the federal budget through legislation and transfers. Data are in national accounts terms in order to ensure coherence with the SGP, and transfers between government levels are netted out because they are a zero-sum game from the EU perspective.

[22] For a detailed account, see U. Schwarze, M. Snelting (2002), Der nationale Stabilitätspakt, *Wirtschaftsdienst* 5, 272-277.

Agreements on expenditure growth for subsectors of government

	2002 % of total expend.	**2003** (1)	**2004** (2)	**Target** Aver. (1), (2)	**Result** Aver. (1), (2)	**2005** (3)	**2006**[1] (4)	**Target** Aver. (3), (4)
Fed. + Soc. Sec.	63.0	2.2	-1.3	-0.5	0.5	1.6	(0.4)	1
Länder + local	37.0	0.5	-0.1	1	0.2	-0.1	(2.1)	1
General govt.[2]	100	1.6	-0.8	(0.06)	0.35	1.0	(1.0)	(1)

Notes:
[1]Required to comply with the target.
[2]The agreement does not contain a target for general government. Numbers in brackets are implicit.
Source:
Federal Statistical Office, Commission services' calculations.

The table shows that the federal level did not meet its target set for 2003-04, although both the federal budget and the social security systems consolidated strongly in 2004. Yet, the FPLR did not publish a recommendation. The *Länder* exceeded their target in 2003-04. For the target set for 2005-06, the updated programme does not provide enough detail to assess whether the target is planned to be met by 2006. However, compliance with the target would imply that the federal level (including social security) would have to limit expenditure growth in 2006 to 0.4%. Under current budgetary plans, this is unlikely. Being constrained by their constitutional budgetary requirements, the *Länder*, however, are under pressure to restrict expenditure growth by more than what their residual expenditure growth allocation would imply for 2006. (Targets are formulated as two-year averages only.) Thus, for general government, expenditure growth at 1% in 2006 would be consistent with the expenditure projection provided in the update. In the future, however, the FPLR would have to tighten the expenditure ceilings, if it was to conclude a new agreement beyond 2006. Extrapolating the expenditure growth at 1% annually between 2007-09, would result in an expenditure share of 44% of GDP in 2009, which is ½ percentage point higher than that envisaged in the update.

The analysis shows that the agreement on expenditure growth has not performed well. Its targets are not well defined (assumptions are made in Box 4), the monitoring is intransparent, and the sanctioning device (recommendation by the Fiscal Planning Council) not applied. Its relation to other devices for budgetary policy at sub-sectors of government is not clear, either.

For example, "golden rules" apply to the federal and each of the state budgets, anchored in the respective constitutions. These golden rules stipulate that net borrowing should not exceed gross investment (in cash terms), unless special economic circumstances would warrant it. The local level is subject to stricter borrowing constraints and supervision by the *Länder*; the social security systems are subject to rules that ensure balanced budgets (in cash terms and after transfers from the federal budget). In addition, despite the constitutionally enshrined autonomy for the 17 budgets (federal and states), budgetary policy is of course interdependent through the tax revenue sharing system, which is applied to about ⅔ of the tax revenues (in cash terms) prior to setting up individual budgets.

Thus, in order to create greater coherence among the various elements of budgetary coordination in Germany and to strengthen national budgetary institutions, the debate on the reform of the federal system could be widened to encompass the role of the Fiscal Planning Council and its expenditure recommendations as well as the "golden rule" provisions and the tax revenue sharing system. Moreover, stronger budgetary coordination mechanisms should be found for times when the deficit is not excessive but the medium-term objective not reached.

Finally, the measures described above are broadly consistent with the broad economic policy guidelines in the area of public finances (in particular with the integrated guidelines No 2 (second indent) and No 3 - see Annex 3). However, it was decided to prevent pensions from declining in 2006 against the recently reformed established pension algorithm. The budgetary implications of the actions outlined in Germany's national reform programme (NRP), submitted on 7 December 2005 within the context of the renewed Lisbon strategy for growth and jobs, are broadly reflected in the budgetary projections of the stability programme. Overall, the measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Germany's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[23] remains unchanged at the 2005 level throughout the programme period.

On the basis of information in the programme[24], age-related expenditure is foreseen to increase by 2.9 percentage points of GDP between 2009 and 2050, to which pension expenditure contributes most by 2.5 percentage points of GDP (see table A2 in the Annex). The Commission's analysis is based on the set of government expenditure items covered by the common projections carried out by the Economic Policy Committee (EPC)[25]. Tax revenues and non-age related expenditures have been kept constant throughout the projection period. The German update also provides a projection of pension contributions (*Beitragseinnahmen*), which rises by 1.6% of GDP between 2010 and 2050. To ensure full comparability with other countries, this national projection is not taken into account in the leading quantitative indicators; however, its impact on the sustainability indicators is given below.

The gross debt-to-GDP ratio would be on an explosive path in the '2005' scenario. If the budgetary consolidation outlined in the programme was to materialise, gross debt would

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[23] The effects of the cycle and any one-off or other temporary measures have been netted out.

[24] The scenario provided by the update includes all measures implemented until mid-2005. Thus, the structural reforms discussed in section 5 of this assessment (increase in the statutory retirement age, planned health care system reform) are not considered here.

[25] Namely, government expenditure on pension, health-care, education and unemployment benefits. Long-term care is missing from the programme.

decrease below the reference value but would nevertheless reach an explosive path in the 2030s[26] (see Table A4 in the Annex)[27].

Indeed, according to the S1 indicator, a sustainability gap of almost 3% of GDP emerges for Germany in the '2005' scenario, notably due to the low structural primary balance in 2005, which prevents a steady reduction of debt. In the 'programme' scenario, the sustainability gap would be significantly reduced as a result of the planned budgetary consolidation during the programme period. However, S1 only takes into account changes in the primary balance up to 2050, which underestimates the cost of ageing.

A more demanding measure is the government's inter-temporal budget constraint, captured by the S2 indicator, according to which a sustainability gap of about 3½% of GDP emerges in the '2005' scenario. The initial budgetary position is not sufficiently high to fully offset the future budgetary impact of ageing. In the 'programme' scenario, the sustainability gap is reduced by some 2 percentage points of GDP, indicating that a part of the budgetary challenge posed by ageing populations can be dealt with by sticking to the planned budgetary consolidation over the medium-term, as set down in the stability programme. This sustainability gap translates into a required primary balance (RPB) of almost 3½% of GDP, higher than the structural primary balance of almost 2% of GDP of the last year of the programme period.

Moreover, the sustainability gap, as measured by the S2 indicator, would increase by up to ¼% GDP if the (budgetary or structural) adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later (see table A3 in the Annex).

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26 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 should not be seen as a forecast.

27 In the Commission's analysis, a real interest rate of 3% over the long-term (to 2050) is assumed for all Member States, which together with a uniform assumption of a 2% inflation rate yields a nominal interest rate of 5%. These assumptions are also used in the common long-term budgetary projection exercise by the AWG and the EPC (see 'The 2005 EPC projection of age-related expenditure: Agreed underlying assumptions and projection methodologies', ECFIN/CEFCPE(2005)REP/54772, 8 November 2005).

Table 1: Sustainability indicators and the required primary balance

	Sustainability indicators and RPB						
	2005 Scenario				Programme scenario		
	S1	S2		RPB	S1	S2		RPB
Value (of which)	**2.6**	**3.3**		**3.4**	**0.5**	**1.3**		**3.3**
initial budgetary position	*1.2*	*1.2*			*-0.8*	*-0.8*		
debt requirement in 2050	*0.2*	*:*			*0.1*	*:*		
future changes in budgetary position	*1.2*	*2.0*			*1.2*	*2.0*		

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[28]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See the European Commission (2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

The underlying assumptions used when making the long-term projections are those commonly agreed and used by the EPC in the current common projections exercise. Overall, the underlying assumptions in the programme can therefore be considered to be plausible.

The pension reforms introduced in Germany in recent years has contributed to significantly curb future increases in expenditure; however, if the weak structural budgetary position is not corrected, the debt-to-GDP ratio will continue to rise. This underlines the crucial importance of achieving and maintaining a sound fiscal position in view of tackling the budgetary challenge posed by ageing populations.

The German programme provides an increase in pension contributions (*Beitragseinnahmen*). If taken into account, this increase would reduce the S1 indicator by 0.6% of GDP and S2 by 1.1% of GDP. The increase in the contributions is similar to the corresponding table in the 'Ageing report' by the EPC and the Commission[29]. According to this report, the increase pension contributions as a share of GDP is related to a legal constraint that contributions, i.e. the contribution rate, must rise to compensate the projected increase in pension expenditure. It should be noted that this mechanism is implicit in all Pay-As-You-Go (PAYG) pension schemes.

No projections of long-term care are available in the programme, which may overall underestimate the cost of ageing. According to the common EU projections in the

[28] The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

[29] See European Economy, Special Reports No 1 (2006), 'The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)', Economic Policy Committee and the European Commission, Table 3-24.

‘Ageing Report’ by the EPC and the Commission[30], long-term care in the Ageing Working Group (AWG) reference scenario would increase by 1% of GDP between 2010 and 2050. Incorporating this rise in the calculation of the indicators would increase S1 by 0.4% of GDP and S2 by 0.7%. According to existing rules in Germany, long-term care benefits per person are fixed by law without any indexation, total spending on long-term care would therefore fall as a share of GDP when applying strictly current legislation. Nonetheless, current legislation may come under pressure given that benefits will become relatively low in the future compared to the cost of services for long-term care (which being labour-intensive, should grow in line with wages, as assumed in the AWG reference scenario).

* * *

[30] See the report referred to in footnote 28.

Annex 1: Summary tables from the stability programme update

Provision of data on variables in bold characters is a requirement.
Provision of data on other variables is optional but highly desirable.

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g			0.9	1.4	1	1 ¾	1 ¾
2. Nominal GDP	B1*g			1.3	2.2	2 ½	2 ¾	2 ¾
Components of real GDP								
3. Private consumption expenditure	P.3			0.0	0.3	- ¼	½	½
4. Government consumption expenditure	P.3			-0.4	0.3	- ¼	½	½
5. Gross fixed capital formation	P.51			-0.3	2.3	2 ½	2 ¾	2 ¾
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53			0.3	0.1	¼	0	0
7. Exports of goods and services	P.6			6.2	6.5	6	5 ¼	5 ¼
8. Imports of goods and services	P.7			5.0	5.5	5 ¼	4 ¼	4 ¼
Contributions to real GDP growth								
9. Final domestic demand				-0.1	0.6	¼	1	1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53			0.3	0.1	¼	0	0
11. External balance of goods and services	B.11			0.7	0.7	½	½	½

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator				0.4	0.8	1 ½	1	1
2. Private consumption deflator								
3. HICP[31]								
4. Public consumption deflator								
5. Investment deflator								
6. Export price deflator (goods and services)								
7. Import price deflator (goods and services)								

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[32]				-0.3	0.0	¼	½	½
2. Employment, hours worked[33]								
3. Unemployment rate (%)[34]								
4. Labour productivity, persons [35]				1.2	1.4	1	1 ¼	1 ¼
5. Labour productivity, hours worked[36]								
6. Compensation of employees	D.1							

31 Optional for Stability programmes.

32 Occupied population, domestic concept national accounts definition.

33 National accounts definition.

34 Harmonised definition, Eurostat; levels.

35 Real GDP per person employed.

36 Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world	B.9						
of which: - Balance on goods and services							
- Balance of primary incomes and transfers							
- Capital account							
2. Net lending/borrowing of the private sector	B.9/ EDP B.9						
3. Net lending/borrowing of general government	B.9		-3.3	-3.3	-2 ½	-2	-1 ½
4. Statistical discrepancy							

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13			-3.3	-3.3	-2 ½	-2	-1 ½
2. Central government	S.1311			-2.2	-2.1	-1 ½	-1	-1
3. State government*	S.1312			-1.0	-0.9	- ½	- ½	- ½
4. Local government	S.1313							
5. Social security funds	S.1314			-0.1	- 0.3	- ¼	-0	0
General government (S13)								
6. Total revenue	TR			43.4	43	43	42 ½	42 ½
7. Total expenditure	TE[37]			46.7	46	45	44	43 ½
8. Net lending/borrowing	EDP B.9			-3.3	-3.3	-2 ½	-2	-1 ½
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM			2.9	3	3	3	3
pm: 9a. FISIM				0.1	0	0	0	0
10. Primary balance	[38]			-0.5	- ½	½	1	1 ½
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)				21.9	22	22 ½	22 ½	22 ½
11a. Taxes on production and imports	D.2							
11b. Current taxes on income, wealth, etc	D.5							
11c. Capital taxes	D.91							
12. Social contributions	D.61			17.7	17 ½	16 ½	16 ½	16
13. Property income	D.4							
14. Other (14=15-(11+12+13))				3.9	3 ½	3 ½	3 ½	3 ½
15=6. Total revenue	TR			43.4	43	43	42 ½	42
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[39]				39.5	39	39 ½	39	39
Selected components of expenditure								
16. Consumption	P.32			18.6	18 ½	18	18	17 ½
17. Total social transfers	D.62 + D.63							

37 Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

38 The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

39 Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

17a. Social transfers in kind*	P.31 =D.63							
17b. Social transfers other than in kind	D.62			19.2	19	18	17 ½	17 ½
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM			2.9	3	3	3	3
19. Subsidies	D.3			1.2	1 ½	1 ½	1	1
20. Gross fixed capital formation	P.51			1.3	1 ½	1 ½	1 ½	1 ½
21. Other (21=22-(16+17+18+19+20))				3.0	3	3	3	2 ½
22=7. Total expenditure	TE[40]			46.7	46	45	44	43 ½
Pm: compensation of employees	D.1							
* State and local government								

Table 3. General government expenditure by function

% of GDP	COFOG Code	2003	2009
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (= item 7=26 in Table 2)	TE[41]		

40 Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

41 Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		2004	2005	2006	2007	2008	2009
1. Gross debt[42]			67 ½	69	68 ½	68	67
2. Change in gross debt ratio			2	1 ½	- ½	- ½	-1
Contributions to changes in gross debt							
3. Primary balance[43]			-0.5	- ½	½	1	1 ½
4. Interest expenditure (incl. FISIM) [44]			2.9	3	3	3	3
5. Stock-flow adjustment							
of which: - Differences between cash and accruals[45]							
- Net accumulation of financial assets[46] *of which:* *privatisation proceeds*							
- Valuation effects and other[47]							
p.m. implicit interest rate on debt[48]							
Other relevant variables							
6. Liquid financial assets[49]							
7. Net financial debt (7=1-6)							

42 As defined in Regulation 3605/93 (not an ESA concept).

43 Cf. item 10 in Table 2.

44 Cf. item 9 in Table 2.

45 The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

46 Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

47 Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

48 Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

49 AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)			0.9	1.4	1	1 ¾	1 ¾
2. Net lending of general government	EDP B.9		-3.3	-3.3	-2 ½	-2	-1 ½
3. Interest expenditure (incl. FISIM recorded as consumption)	EDP D.41+ FISIM		2.9	3	3	3	3
4. Potential GDP growth (%) (1)							
contributions: - labour - capital - total factor productivity							
5. Output gap							
6. Cyclical budgetary component							
7. Cyclically-adjusted balance (2-6)			-3.1	-3	-2	-1 ½	-1
8. Cyclically-adjusted primary balance (7-3)							

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008	2009
Real GDP growth (%) **Previous update**			1.8	1.7	1 ¾	2	--
Current update			0.9	1.4	1	1 ¾	1 ¾
Difference			0.9	0.3	¾	¼	--
General government net lending (% of GDP) **Previous update**	EDP B.9		-3	-2 ½	-2	-1 ½	--
Current update			-3.3	-3.3	-2 ½	-2	-1 ½
Difference			- ½	- ¾	- ½	-1/2	--
General government gross debt (% of GDP) **Previous update**			66	66	65 ½	65	--
Current update			67 ½	69	68 ½	68	67
Difference			1 ½	3	3	3	--

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure						
Of which: age-related expenditures						
Pension expenditure						
Social security pension						
Old-age and early pensions		10.5	11.0	12.3	12.8	13.1
Other pensions (disability, survivors)						
Occupational pensions (if in general government)						
Health care		6.3	6.7	7.0	7.2	7.3
Long-term care *(this was earlier included in the health care)*						
Education expenditure		3.6	3.3	3.3	3.3	3.3
Other age-related expenditures						
Interest expenditure						
Total revenue						
Of which: property income						
of which: from pensions contributions (or social contributions if appropriate)		7.3	7.3	8.3	8.7	8.9
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Net lending						
Assumptions						
Labour productivity growth		0.8	1.5	1.8	1.7	1.7
Real GDP growth		1.8	1.8	1.0	1.1	1.2
Participation rate males (aged 20-64)*		83.3	85.1	84.5	85.2	85.0
Participation rates females (aged 20-64)*		71.3	72.9	72.5	73.6	72.9
Total participation rates (aged 20-64)*		77.4	79.1	78.6	79.5	79.0
Unemployment rate		8.5	7.0	7.0	7.0	7.0
Population aged 65+ over total population		16.9	18.5	22.0	23.9	23.3

*participation rate (aged 15-64)

Table 8. Basic assumptions

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	2004	2005	2006	2007	2008
Short-term interest rate[50] (annual average)	-	-	-	-	-
Long-term interest rate (annual average)	-	-	-	-	-
USD/€ exchange rate (annual average) (euro area and ERM II countries)	-	-	-	-	-
Nominal effective exchange rate	-	-	-	-	-
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	-	-	-	-	-
World excluding EU, GDP growth	-	-	-	-	-
EU GDP growth	-	-	-	-	-
Growth of relevant foreign markets	-	-	-	-	-
World import volumes, excluding EU	-	-	-	-	-
Oil prices, (Brent, USD/barrel)	-	-	-	-	-

[50] If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].		X	
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.			
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).		X	
The programme provides all compulsory information in these tables.		X	
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.			
Significant divergences between the national and the Commission services' economic forecasts are explained[2].		X	
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and			n.a.

Guidelines in the new code of conduct	Yes	No	Comments
exchange rate stability.			
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.	X		
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		But no quantification of single measures
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.		X	
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			n.a.
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.		X	
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.		X	
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.		X	Sensitivity analysis only in terms of real growth
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			n.a.
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the	X		

Guidelines in the new code of conduct	Yes	No	Comments
sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.			
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].		X	
– Member States should avoid pro-cyclical fiscal policies[2].			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].	X		
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.	X		
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X		
3. To promote a growth- and employment-orientated and efficient allocation of resources			

Integrated guidelines	Yes	No	Not applicable
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[51]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

.

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY}Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax

[51]Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

elasticity[52]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y} .$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon^{'}_{T_i,B_i}\varepsilon^{'}_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon^{'}_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon^{'}_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_iB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

Assessment of tax projections by major tax category

Assessment of tax projections by major tax category

	2006	2007	2008	2009	p.m.:

[52]The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

	COM	SP	COM[2]	SP		SP	
Taxes on production and							
Change in tax-to-GDP ratio	0.0	-0.1	0.0	1.1	-	-	/
Difference	-0.1		1.2		/	/	
of which[3]: - elasticity component	0.0		1.3		/	/	
- composition	0.0		0.0		/	/	
p.m. Observed elasticity					-	-	
- of taxes to tax base[4]	1.0	0.8	1.0	7.7			1.0
- of tax base[4] to GDP	1.0	0.8	0.8	0.6			1.0
Social contributions:							
Change in tax-to-GDP ratio	-0.3	-0.3	-0.2	-0.8			/
Difference	-0.1		-0.6		/	/	/
of which[3]: - elasticity component	0.1		-		/	/	/
- composition	0.0		-0.2		/	/	/
p.m. Observed elasticity					-	-	
- of taxes to tax base[5]	0.6	2.3	0.6	-			0.8
- of tax base[5] to GDP	0.3	0.1	0.8	0.0			0.7
Personal income tax[6]:							
Change in tax-to-GDP ratio	0.1	0.0	0.0	-0.2	-	-	/
Difference	-0.1		-0.2		/	/	
of which[3]: - elasticity component	0.2		-		/	/	
- composition	-0.1		-0.2		/	/	
p.m. Observed elasticity					-	-	
- of taxes to tax base[5]	5.4	11.0	1.6	-			2.3
- of tax base[5] to GDP	0.3	0.1	0.8	0.0			0.7
Corporate income tax[6]:							
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0	-	-	/
Difference	0.0		0.0		/	/	
of which[3]: - elasticity component	0.0		0.0		/	/	
- composition	0.0		0.0		/	/	
p.m. Observed elasticity					-	-	
- of taxes to tax base[7]	0.8	0.5	1.0	0.1			1.0
- of tax base[7] to GDP	1.7	1.9	1.2	2.0			1.5

Notes:
[1]OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4
[4]Elasticity relative to private consumption expenditure
[5]Elasticity relative to compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Elasticity relative to gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	**ex-ante**[1]	**COM**[2] **(observed)**	**ex-ante**[1]
Taxes on production and imports:				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
Difference	0.0		0.0	
of which[3]*: - elasticity component*	0.0		0.0	
- composition component	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[4]	1.0	1.0	1.0	1.0
- of tax base[4] to GDP	1.0	1.0	0.8	1.0
Social contributions:				
Change in tax-to-GDP ratio	-0.3	-0.2	-0.2	-0.2
Difference	-0.1		0.0	
of which[3]*: - elasticity component*	0.0		0.0	
- composition component	-0.1		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	0.6	0.8	0.6	0.8
- of tax base[5] to GDP	0.3	0.7	0.8	0.7
Personal income tax[6]**:**				
Change in tax-to-GDP ratio	0.1	0.1	0.0	0.1
Difference	-0.1		-0.1	
of which[3]*: - elasticity component*	0.3		-0.1	
- composition component	-0.2		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	5.4	2.3	1.6	2.3
- of tax base[5] to GDP	0.3	0.7	0.8	0.7
Corporate income tax[6]**:**				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
Difference	0.0		0.0	
of which[3]*: - elasticity component*	0.0		0.0	
- composition component	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[7]	0.8	1.0	1.0	1.0
- of tax base[7] to GDP	1.7	1.5	1.2	1.5

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Annex 5: The rolling debt reduction benchmark

The rolling debt reduction benchmark discussed in Box 3 is calculated for successive five-year periods through a recursive application of the formula:

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

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):

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

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 benchmark describes the path for convergence of the debt ratio towards 60% of GDP, which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. For nominal GDP growth rates higher than 5%, the benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the benchmark necessitates deficits lower than 3% of GDP.

Annex 6: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	**SCP**	**EPC**	**SCP**	**EPC**	**SCP**	**EPC**	**SCP**
Labour productivity growth*	**1.1**	**0.8**	**1.7**	**1.5**	**1.7**	**1.8**	**1.7**	**1.7**
Real GDP growth*	**2.3**	**1.8**	**1.3**	**1.8**	**0.8**	**1.0**	**1.2**	**1.2**
Participation rate males (aged 15-64)	**83.3**	**83.3**	**85.1**	**85.1**	**84.5**	**84.5**	**85.0**	**85.0**
Participation rates females (aged 15-64)	**71.3**	**71.3**	**72.9**	**72.9**	**72.5**	**72.5**	**72.9**	**72.9**
Total participation rates (aged 15-64)	**77.4**	**77.4**	**79.1**	**79.1**	**78.6**	**78.6**	**79.0**	**79.0**
Unemployment rate	**8.5**	**8.5**	**7.0**	**7.0**	**7.0**	**7.0**	**7.0**	**7.0**
Population aged 65+ over total population	**20.3**	**20.3**	**22.1**	**22.2**	**26.6**	**26.6**	**29.9**	**30.0**

*Figures for Real GDP growth and Labour productivity growth from the SP are estimated as average as follow: 2010 is average of 2004-2010; 2020 is average 2011-2020; 2030 is average 2021-2030 and 2050 is average 2041-2050

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	21.7	21.5	21.9	23.5	24.2	24.6	2.9	2.0
Pensions	10.7	10.5	11.0	12.3	12.8	13.1	2.5	1.8
Health care	6.3	6.3	6.7	7.0	7.2	7.3	1.1	0.8
Long-term care	:	:	:	:	:	:	:	:
Education	3.7	3.6	3.3	3.3	3.3	3.3	-0.4	-0.3
Unemployment benefits	1.1	1.1	0.9	0.9	0.9	0.9	-0.2	-0.2
Total primary non age-related spending	18.8	18.8	18.8	18.8	18.8	18.8	0.0	0.0
Total revenues	42.3	42.3	42.3	42.3	42.3	42.3	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

	S1	S2
2005 scenario	**0.5**	**0.3**
Programme scenario	**0.1**	**0.1**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	67.0	65.3	53.4	55.1	70.3	92.9	25.9
*Gross debt, i + 1**	*67.0*	*66.0*	*60.5*	*70.5*	*97.6*	*137.6*	*70.6*
*Gross debt, i - 1**	*67.0*	*64.7*	*46.9*	*42.7*	*50.3*	*63.2*	*-3.8*
Adjusted gross debt	67.0	65.3	53.4	55.1	70.3	92.9	25.9
2005 Scenario							
Gross debt	72.0	72.3	81.4	109.7	157.7	218.1	146.1
*Gross debt, i + 1**	*72.0*	*73.0*	*90.3*	*131.7*	*201.5*	*295.8*	*223.8*
*Gross debt, i - 1**	*72.0*	*71.6*	*73.3*	*91.5*	*124.3*	*163.4*	*91.3*
Adjusted gross debt	72.0	72.3	81.4	109.7	157.7	218.1	146.1

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.