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ECONOMIC ASSESSMENT OF THE STABILITY PROGRAMME OF GERMANY (UPDATE OF NOVEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Germany's stability programme was submitted on 30 November 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 16 February 2007. Comments should be sent to Peer Ritter (peer.ritter 'at' ec.europa.eu) and Stefan Kuhnert (stefan.kuhnert@ec.europa.eu) in Dir F. The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Germany, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2006-2010, was submitted on 30 November 2006. Under the corrective arm of the Pact, Germany was placed in excessive deficit by the Council in January 2003. The deadline for correcting the excessive deficit is 2007.

Over the past ten years, Germany has gone through a period of adjustment to correct past re-unification imbalances. Wage moderation contributed to a recovery of external price competitiveness, and Germany has significantly gained export market shares, in particular from 2000 onwards. It is noteworthy that the restoration of Germany's external price competitiveness has taken place in a period when other euro area countries enjoyed lower real interest rates than Germany. However, Germany has recently experienced that a strong export performance does not always spill over quickly to higher domestic demand. Germany's growth problem is mostly structural in nature. Economic performance is mainly held back by sluggish growth of total factor productivity and high structural unemployment. Potential growth is not only substantially lower than in the past. It has also fallen behind that of other euro area Member States. Economic policy faces the challenge of improving the conditions for growth, addressing simultaneously the contributions from labour, factor productivity and, to a lesser extent, capital formation. In some areas, the German authorities have initiated reforms, such as on the labour market or in the micro-economic domain on the promotion of research and innovation, which still need time to show their full impact. In others, like corporate taxation, reform steps are being drafted. Yet, further efforts are likely to be necessary, especially on the labour market, to boost potential growth substantially in the longer run.

With a view to the comparatively high level of public debt, any reform measures would need to have a neutral impact on public finances. In this respect, it is still an open question, whether, for instance, the recently enacted labour market reforms will provide sustainable relief to public finances. Against this background, the German economy faces the following challenges with implications for public finances. The first challenge is to ensure sustainability of public finances, although recently adopted measures will substantially dampen future increases in public pension expenditure. Without further reforms in health care and long-term care, demographic developments could put at risk the sustainability of public expenditure. The second challenge is to improve the quality of public spending. The pressure on public budgets from rising social benefits has certainly been at the cost of public investment. Public spending on education has been rather constant over time at about 9½% of primary expenditure, but has been falling somewhat since 2002. Increased efforts in these areas would most likely contribute to raising Germany's growth potential.

The macroeconomic scenario underlying the updated stability programme envisages that real GDP growth will temporarily slow down from 2.3% in 2006 to 1.4% in 2007[2], after

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1 The analysis takes into account (i) the Commission services' autumn 2006 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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

which it is projected at 1¾% on average over the rest of the programme period. Assessed against currently available information (the latest official estimate of GDP growth in 2006 is a figure of 2.7%), this scenario appears to be based on plausible assumptions until 2008 and mildly favourable ones thereafter, in view of Commission projections for potential growth. The programme's projections for inflation appear to be on the high side. Due to the temporary effects of the VAT hike in 2007, the output gap will widen a bit in 2007, but it will move into positive territory in 2008. Germany is thus currently experiencing a period of economic good times.

For 2006, the programme cites a general government deficit of 2.1% of GDP (revised down to 1.9% by latest government announcement), against a target of 3.3% of GDP set in the previous update of the stability programme. The government received unexpectedly high revenues from taxes, which, in line with the Stability and Growth Pact, were not spent in 2006. The overall tax burden is now forecast to increase to around 40% of GDP in 2006, which is about 1% of GDP higher than projected in the previous update. General government expenditure has been kept under control in 2006. The somewhat tighter budgetary execution derives from lower monetary transfers, stemming mainly from the unexpected relief that the improving labour market has provided to the Federal Employment Agency. In addition, interest expenditure and subsidies have been lower than expected.

The main goal of the medium-term budgetary strategy 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. After the envisaged correction of the excessive deficit in 2006, the deficit ratio is projected to decline by ½ percentage point per year (except in 2008) to reach ½ % of GDP in 2010. The improvement in the primary balance follows the same pattern, with the surplus reaching 2% of GDP by 2010. While the budget contains corrective measures on the revenue side, notably the increase in the central VAT rate from 16% to 19%, both revenue and expenditure ratios are set to follow a downward trend in a year-to-year comparison. Indeed, the expenditure ratio would fall by 2½ percentage points to 43% of GDP by 2010, which is planned to be achieved mostly through restraint in social spending. Over the same period, the revenue-to-GDP ratio is projected to decrease by 1½ percentage points to 42% of GDP by 2010; an increase in the tax share (e.g. increase in the central VAT rate in 2007) is broadly offset by a decrease in the share of social contributions (due to the cut in the unemployment insurance rate in 2007 and the downward trend of the contributions share), while non-tax revenues decline. Compared with the previous update, the budgetary targets are higher in each year although no adjustment is planned in 2008. Government gross debt is estimated to have levelled off at 67.9% of GDP in 2006, above the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 3½ percentage points over the programme period.

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures), calculated according to the commonly agreed methodology, is planned to improve from a deficit of around 2% of GDP in 2006 to ½% at the end of the programme period, on average by almost ½% of GDP per year. As in the previous update

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[2] The Annual Economic Report by the German government, published on 31 January 2007, projects growth at 1.7% in 2007. In their interim forecast published on 16 February 2007, the Commission services project growth at 1.8% in 2007.

of the stability programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a balanced position in structural terms, which is in line with the Pact. However, the programme does not aim to achieve the MTO within the programme period.

The risks to the budgetary projections in the programme appear broadly balanced for 2007, but budgetary outcomes thereafter could be worse than projected. In particular, the risk remains that the envisaged decline in the social expenditure ratio would not be achieved without additional measures that are not specified in the programme. Indeed, the update itself states that further reforms are needed on the labour market and in the social security systems. In addition, a significant risk stems from the planned company tax reform in 2008 beyond the budgetary burden estimated in the programme. Thus, it might prove necessary to compensate possible shortfalls in company tax revenues through additional expenditure restraint. Abstracting from that reform, the revenue projections seem prudent. Nevertheless, overall, negative risks to the deficit adjustment remain, in particular from the implementation of the adjustment path in the outer years. In addition, the evolution of the debt ratio may turn out to be less favourable than projected in the programme given the risks to the deficit targets and uncertainty about the debt-reducing stock-flow adjustments assumed in the programme.

In view of this risk assessment, the budgetary stance in the programme is consistent with a correction of the excessive deficit by 2006, one year ahead of the deadline set by the Council. In addition, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations as from 2007, although subject to some risks for 2008. In the years following the correction of the excessive deficit, the pace of the adjustment towards the MTO implied by the programme should be strengthened, especially in 2008, to be in line with the Stability and Growth Pact. In particular, no improvement in the structural balance is planned for 2008, at a time when economic "good times" are expected to prevail. Meeting the required structural adjustment path would actually allow the MTO to be reached by the programme horizon. In view of the risks identified above, the debt ratio may not be sufficiently diminishing towards the reference value over the programme period.

The long-term budgetary impact of ageing in Germany is close to the EU average, though with pension expenditure showing a somewhat smaller increase than in many other countries, as a result of the pension reforms already enacted. A draft law has been adopted to raise the statutory retirement age in steps to 67 years, from 2012 onwards, which will enhance the long-term sustainability of public finances. In addition, developing further private pension arrangements would contribute positively to retirement incomes. Moreover, the current level of gross debt is above the Treaty reference value. Overall, Germany appears to be at medium risk with regard to the sustainability of public finances, which thus remains a policy challenge as mentioned above.

The Implementation Report of the National Reform Programme (NRP) of Germany, provided for in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 18 October 2006. The NRP identifies as key challenges/priorities: the knowledge society; market functioning and competitiveness; business environment; the sustainability of public finances (including sustainable growth and social security); ecological innovation; and reform of the labour market. The Commission's assessment of that programme (adopted as part of its December 2006 Annual Progress Report[3]) showed that Germany is making good progress overall in the implementation, and especially on the macro- and micro-economic key challenges and priority actions. It is moving forward more slowly in the field of employment. Germany was recommended to take action in the areas of long-term sustainability of public finances, competition in goods and services markets, and structural unemployment. As regards the integration of the updated stability programme with the NRP, the company tax reform 2008 and the health care reform are put forward in both programmes. Moreover, the second stage of the reform of the federal system envisages a review of the fiscal relations between levels of government in order to strengthen the accountability of each level. In addition, the stability programme recognises in this context the necessity to develop an institutional framework that would ensure budgetary discipline at all levels of government and foresee measures to pre-empt emerging budgetary crises. The measures in the area of public finances that are mentioned in the stability programme seem consistent with those foreseen in the national reform programme, but both documents do not seem well-integrated.

Overall, the updated stability programme is deemed consistent with a correction of the excessive deficit as of 2006, one year before the deadline set by the Council, and some progress towards the medium term objective will be made in the subsequent years. However, there are risks linked to the achievement of the budgetary targets. Based on the data and despite the policy measures provided in the programme, Germany remains at medium risk as regards the sustainability of public finances. Finally, while the programme addresses the quality of public finances in terms of structure, it does not identify the above-mentioned challenge on educational spending.

[3] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery", 12.12.2006, COM(2006)816.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010
Real GDP (% change)	**SP Nov 2006**	**0.9**	**2.3**	**1.4**	**1 ¾**	**1 ¾**	**1 ¾**
	COM Nov 2006	0.9	2.4	1.4	2.0	--	--
	SP Feb 2006	*0.9*	*1 ½*	*1*	*1 ¾*	*1 ¾*	--
HICP inflation (%)	**SP Nov 2006**	**--**	**--**	**--**	**--**	**--**	**--**
	COM Nov 2006	1.9	1.8	2.2	1.2	--	--
	SP Feb 2006	--	--	--	--	--	--
Output gap (% of potential GDP)	**SP Nov 2006**[1]	**-1.2**	**-0.3**	**-0.3**	**-0.2**	**0.0**	**0.0**
	COM Nov 2006[5]	-1.3	-0.2	-0.4	0.1	--	--
	SP Feb 2006[1]	*-0.9*	*-0.7*	*-1.1*	*-0.7*	*-0.4*	--
General government balance (% of GDP)	**SP Nov 2006**	**-3.2**	**-2.1**	**-1 ½**	**-1 ½**	**-1**	**-½**
	COM Nov 2006	-3.2	-2.3	-1.6	-1.2	--	--
	SP Feb 2006	*-3.3*	*-3.3*	*-2 ½*	*-2*	*-1 ½*	--
Primary balance (% of GDP)	**SP Nov 2006**	**-0.5**	**1/2**	**1**	**1**	**1 ½**	**2**
	COM Nov 2006	-0.5	0.4	1.1	1.5	--	--
	SP Feb 2006	*-0.5*	*- ½*	*½*	*1 ¼*	*1 ½*	--
Cyclically-adjusted balance (% of GDP)	**SP Nov 2006**[1]	**-2.6**	**-2.0**	**-1.5**	**-1.5**	**-1.0**	**-0.6**
	COM Nov 2006	-2.6	-2.2	-1.4	-1.2	--	--
	SP Feb 2006[1]	*-2.9*	*-2.9*	*-1.8*	*-1.5*	*-1.1*	--
Structural balance[2] (% of GDP)	**SP Nov 2006**[3]	**-2.7**	**-2.0**	**-1.5**	**-1.5**	**-1.0**	**-0.6**
	COM Nov 2006[4]	-2.7	-2.2	-1.4	-1.2	--	--
	SP Feb 2006	*-3.0*	*-2.9*	*-1.8*	*-1.5*	*-1.1*	--
Government gross debt (% of GDP)	**SP Nov 2006**	**67.9**	**67.9**	**67**	**66 ½**	**65 ½**	**64 ½**
	COM Nov 2006	67.9	67.8	67.7	67.3	--	--
	SP Feb 2006	*67 ½*	*69*	*68 ½*	*68*	*67*	--

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 (deficit-increasing 0.1% of GDP in 2005).
[4]One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (deficit-increasing 0.1% of GDP in 2005).
[5]Based on estimated potential growth of 1.2%, 1.3%, 1.4% and 1.4% respectively in the period 2005-2008.
Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. Introduction

The most recent update of the German stability programme was adopted by the German government on 29 November 2006 and submitted to the Council and the Commission as well as to the national Parliament on 30 November 2006. The programme covers the period from 2006 to 2010. It includes the federal budget 2007 as adopted by Parliament on 24 November 2006. The programme broadly follows the model structure for stability and convergence programmes specified in the code of conduct. As in previous years, the update contains 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 code of conduct (especially data on unemployment and sectoral balances). Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

2. Economic trends and policy challenges

This section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second part presents the results of a growth accounting exercise and tries to identify the main drivers of the relative growth performance vis-à-vis the euro area. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. The fifth part then identifies major economic challenges with implications for public finances.

2.1. Economic performance[4]

Since the mid 1990s, Germany's economic growth has been lagging behind that of other EU Member States (see Figure 1). At the same time, employment developments in Germany and in other euro area countries also diverged dramatically. While Germany has hardly generated new employment since 1995, the rest of the euro area added almost 15% to its workforce during the past 10 years. As a consequence, Germany's unemployment rate, which had been on average about 2 percentage points below the euro area average until the mid 1990s, rose faster than the euro area aggregate in cyclical downswings, while moderating at a slower pace during upswings. Furthermore, Germany's "non-accelerating inflation rate of unemployment" (NAIRU) increased, against the euro area trend, by nearly 1½ pp since 1995, to reach almost 9% in 2005 (see Annex 4), suggesting that Germany's labour market problems are by and large of a structural nature.

The reasons for the German economy's underperformance in terms of growth and job creation date back to the years immediately following re-unification when wages

[4] For an in-depth analysis of the German economy, see European Commission, Directorate-General for Economic and Financial Affairs: "Raising Germany's Growth Potential", DG ECFIN Occasional Papers No. 28, available at:
http://ec.europa.eu/economy_finance/publications/occasional_papers/2007/occasionalpapers28_en.htm

increased well in excess of productivity. At the same time, Germany' external price competitiveness suffered further, when in 1992 high German interest rates in the aftermath of re-unification led to a crisis within the Exchange Rate Mechanism and a subsequent appreciation of the D-Mark. In spite of the resulting recession in Europe and the currency appreciation, wage increases continued to erode German price competitiveness until 1995, when the real effective exchange rate was some 20% higher than in 1991.[5]

The loss in competitiveness in the early nineties was accompanied by the downright disappearance of eastern Germany's manufacturing sector, rising unemployment, and increases in taxes and social security contributions. In addition, large overcapacities had been built up in the construction sector, in particular in housing, resulting from the boom in the wake of unification.

As can be seen from Figure 2, Germany's external price competitiveness has recovered since the mid 1990s and it stayed more or less flat when price competitiveness worsened in the rest of the euro area after 2000. Consequently, Germany has significantly gained export market shares, in particular from 2000 onwards. Wage moderation contributed substantially to this performance, with increases in nominal compensation per employee on average about 1.5 percentage points below the euro area figure. It is worth mentioning that the restoration of Germany's external price competitiveness has taken place in a period when other euro area countries enjoyed lower real long-term interest rates than Germany. The real interest rate differential, which was still negative in 1995, reached a maximum of two percentage points in 2000. It then fell sharply in 2001 and has since varied from 0.5 to 1 percentage point.

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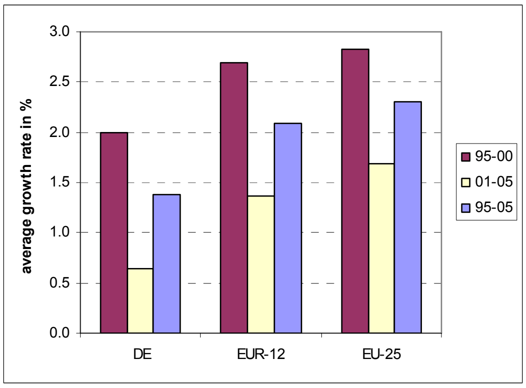
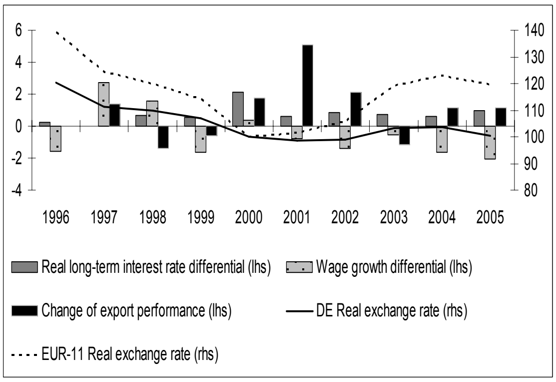
5 For a more detailed analysis, see: H. Jansen (2005), "Domestic gloom and export boom: a look at German competitiveness", European Commission, Directorate-General for Economic and Financial Affairs, Country Focus, vol. 2, issue 6. Estimates of real exchange rates are undertaken in J. Hansen and W. Roeger (2000), "Estimation of Real Equilibrium Exchange Rates", European Commission, European Economy - Economic Paper, no. 144.

Figure 1: Average GDP growth: Germany vs. EU25 and EUR-12	**Figure 2: Indicators of external competitiveness: Germany vs. EUR-11**
	
Source: *Commission Services*	**Note:** Real effective exchange rates based on nominal unit labour costs; 2000=100; *Source:* *Commission Services*

There is reason to believe that Germany has by now completely corrected its original competitiveness problem. While figures for the real effective exchange rate are subject to a margin of error, not least because they omit qualitative factors, it appears that competitiveness is back to where it used to be 15 years ago. In relation to other euro area economies, Germany has even become more competitive than it was in the early 1990s. Competitiveness also benefited from huge foreign direct investments (FDI) by German companies, notably between 1998 and 2000. Although the effects of FDI on the domestic economy are still much debated, it is sure that FDI has promoted Germany's further integration into the world economy, which is also witnessed by an accelerated increase since 2000 in the degree of economic openness: The average of total imports and exports of goods as a share of GDP has increased from 23.7% in 1999 to 31.2% in 2005. This compares with a rather flat profile of this indicator during this period for other larger euro area countries.

While the contribution of the external sector to real GDP growth has risen after 2000, the growth contribution of domestic demand was nil or even turned negative (see Table 1). Capital formation and private consumption have been particularly weak in recent years. The lacklustre performance of private consumption owes much to sluggish growth in household disposable income. This in turn may be largely ascribed to moderate wage developments and particularly a contraction of employment. To some extent Germany has been caught in a vicious circle, with low demand bringing about weak activity and job losses, causing again low demand. Beyond this normal cyclical slump, however, large terms-of-trade losses and increased precautionary savings have constrained consumer spending. This also indicates that Germany should not take too much comfort from competitiveness gains that are largely resulting from wage restraint rather than from structural productivity gains, in particular since there is apparently no automatism which translates improved external price competitiveness quickly into higher domestic activity.

As regards capital formation, the German investment ratio has fallen from 24% in the mid seventies to nowadays 19% of GDP. The secular decline is dominated by construction, where the necessary downsizing from the early-post-war-era levels was interrupted by the post-reunification boom, only to resume at an accelerated pace since the middle of the nineties. Private investment in machinery and equipment, as a share of GDP, has been rather volatile since the late eighties, but with no clear trend. However, the consequences of re-unification, the completion of the EU Internal Market and globalisation, with their implicit needs for corporate restructuring, would have suggested rather an increase in investment, pointing to impediments to capital formation. Temporary factors have probably been at work, such as the need for balance sheet restructuring of companies at the beginning of the present decade, which may explain to some extent the hesitant pick-up in investment at the early stage of the current cyclical recovery.

Although there are signs that domestic demand is finally picking up in Germany, the question remains why it took so long for the external impulse to spill over to domestic demand. Since the full benefits of globalisation can only be reaped within a favourable domestic macroeconomic environment, it appears that deeper-rooted structural problems have prevented a swift spill-over.

The German economy’s apparent structural problems are also reflected in the state of public finances. According to the Commission services' autumn 2006 forecast, the structural budget deficit amounted to 2.6% of GDP in 2005, which is close to the headline deficit of 3.2%. Fiscal institutions already came under intense pressure after re-unification, when the existing tax, social security and transfer system was by and large maintained. The situation was aggravated by the continued decline of the growth potential, which limited the scope for consolidation through higher revenues.

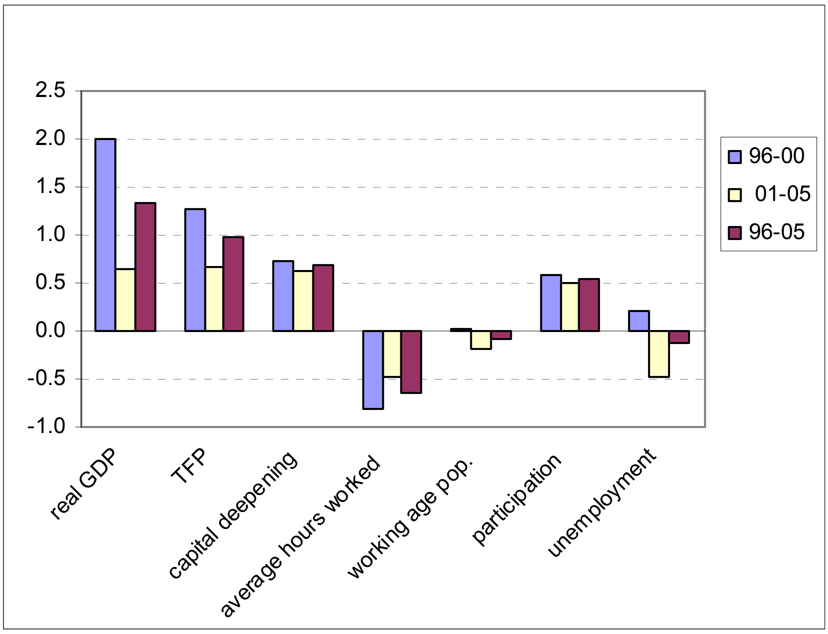
2.2. Anatomy of medium-term growth

Real GDP growth in Germany has declined dramatically over the last 10 years. Figure 3 indicates that the period average of 2% experienced over the 1996-2000 period has been slashed to less than half that rate in recent years. The decline in total factor productivity (TFP) growth, which has traditionally been the major contributor to GDP growth, and the marked increase in unemployment are mainly responsible for the slump in GDP growth. Diverging trends in unemployment also explain to a large part the German economy's growth shortfall with respect to the euro area as a whole. However, as can be seen from Figure 4, at an average of about 0.7 percentage points the growth lag vis-à-vis the euro area has not increased over the past ten years. TFP growth and capital deepening (at least until investment collapsed after 2000) have been stronger growth drivers in Germany than in the euro area as a whole. Hence, less favourable labour market developments appear to be the main cause for the growth shortfall compared with the rest of the euro zone, while only being to a lesser extent accountable for the slowdown of potential growth in Germany.

Germany's unemployment problem relates to the functioning of the labour market and its institutional set-up. From a situation of full employment until the mid-seventies, unemployment has been ratcheting up with each cyclical downturn, moving above the EU average in the current decade. While German re-unification posed an extraordinary challenge for the absorption of labour that became redundant in the transformation process, the problem of weak job creation is rooted more deeply. Thus, the rise in employment since the middle of the 1990s has lagged behind the EU average even in the western part of the country, with the gap widening the more years have passed since the unification shock. Even the moderate wage policy sustained over a long time could not prevent firms from laying off workers on a large scale and did little to stimulate hiring. A number of indicators, such as the increase in the non-accelerating-wages rate of unemployment (NAWRU) which – again deviating from the European trend – has been unabated until now, provides firm evidence that unemployment has largely become structural in nature.

On the other hand, average working time and labour force participation have recently become less of a brake to GDP growth. The growth contribution of workers' participation has been the same in Germany and the rest of the euro area over the past five years, albeit

Figure 3: Real GDP growth and its components



Note:
Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP, L* employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1-ur)$ where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

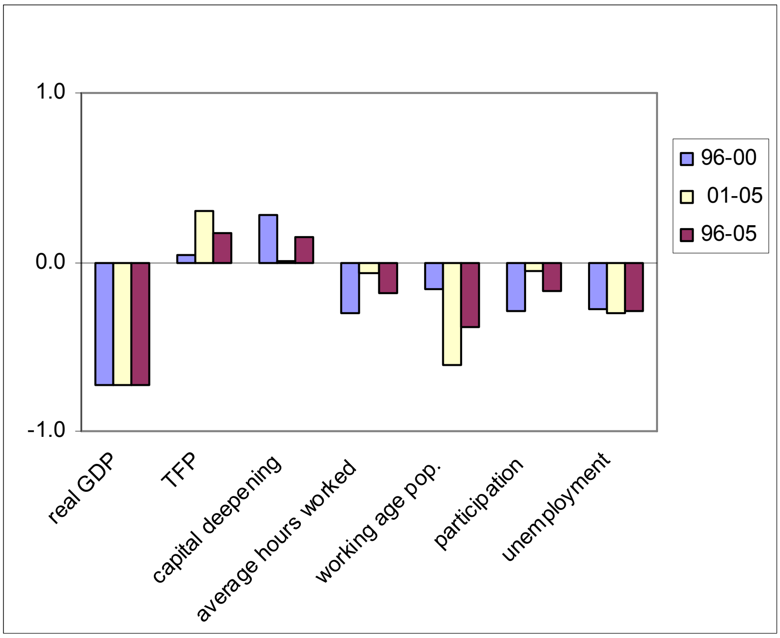
The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source:
Commission services

due to a deterioration in the rest of the euro zone.

While still contributing more than in other euro area economies to GDP growth, declining TFP growth is another cause for the worsening of Germany's long-term growth performance. While Germany scores rather well in terms of many conventional indicators for innovation efforts and spending on research and development is above average, innovation appears to be concentrated on a relatively small number of large companies and, moreover, geared towards rationalisation and cost reduction rather than on developing and introducing new products. Small and medium-sized companies clearly lag behind the industrial leaders and their position has apparently weakened over time. It is them who are most constrained in their access to venture capital, especially since the *Neuer Markt* has been closed. Germany has maintained its strong position in traditional sectors of manufacturing, such as automotive, chemical and machine tools industries, but has been less innovative in frontier technologies and business services, where lags in the adoption and diffusion of innovation may have contributed to the observed slowdown in productivity growth.

Figure 4: Real GDP growth and its components: Difference vis-à-vis euro area



Note:
See note of Figure 3.

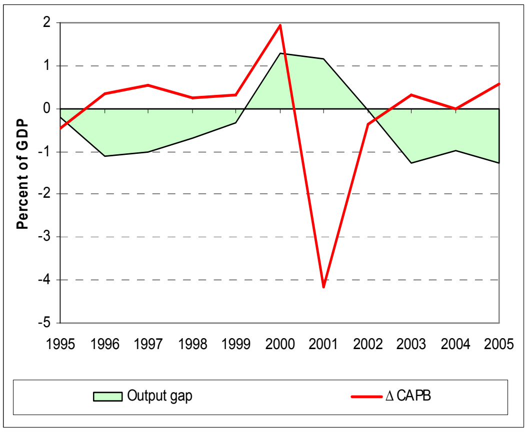
Source:
Commission services

2.3. Macro-policies against the backdrop of the economic cycle

Over the past decade, the German economy passed through a full business cycle. It is now again en route to closing a negative output gap (see Figure 5). A comparison of output gap developments reveals a high degree of business cycle synchronisation between Germany and the rest of the euro zone (see Figure 6). However, taking into account the trend decline in German GDP growth, the volatility of output growth as measured by the standard deviation of output gaps is lower than in the rest of the euro area. Figure 5 does not suggest that fiscal policy has dampened the business cycle over the last ten years. On the contrary, with the cyclically adjusted primary balance (CAPB) increasing in "bad times" and decreasing in "good times", fiscal policy has had a pronounced pro-cyclical stance. In 2001, for instance, when actual GDP was still above its potential, massive tax cuts led to a collapse in the revenue ratio and a corresponding 1.7 percentage point decrease in the CAPB.

Monetary conditions have generally been supportive to growth over the past ten years. Real short-term interest rates, albeit higher than in other euro area member state (see Section 2.1), are still close to their historical low. In addition, continued wage restraint has significantly lowered Germany's real exchange rate.

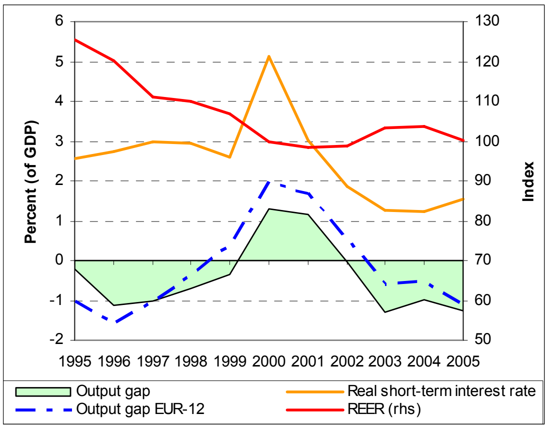
Figure 5: Output gap and fiscal stance



Note: ΔCAPB denotes the change in the cyclically-adjusted primary budget balance.

Source:
Commission services

Figure 6: Output gap and monetary conditions

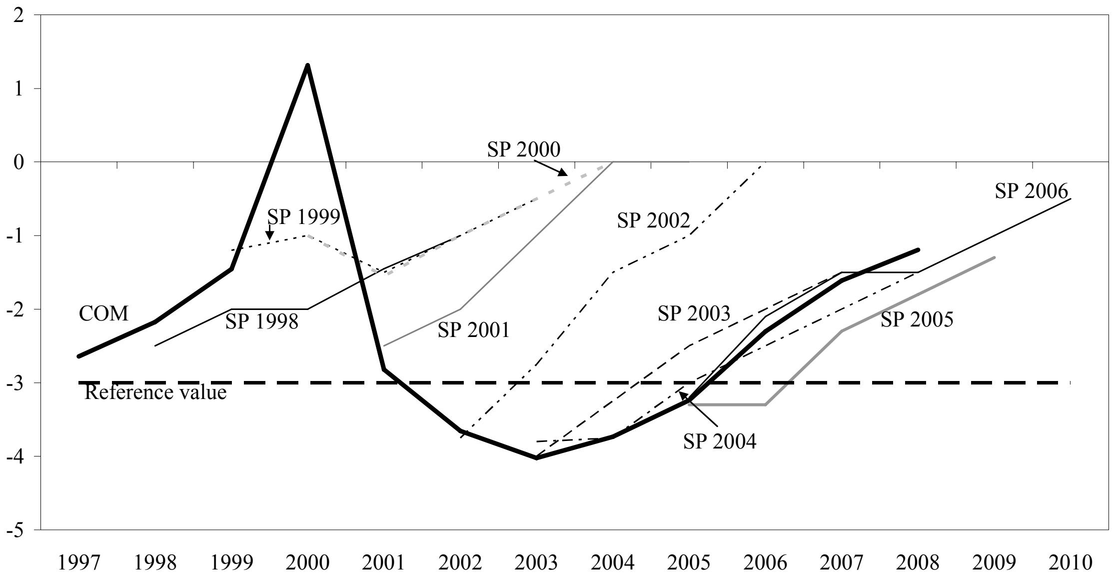


Source:
Commission services

2.4. Public finances

Government revenue as a percentage of GDP dropped from 46.6% in 1999 to 43.5% in 2005. There are two reasons for this. First, tax bases have been growing more slowly than GDP. This applies particularly to revenue-rich tax bases as labour income and private consumption. Second, there have been several significant cuts in direct tax rates between 1999 until 2005. This was only partly balanced by a restraint in primary spending, which has decreased from 44.9% of GDP in 1999 to 44% in 2005. Figure 7 shows that, as a consequence, public finances deteriorated during the last decade. The comparison of several vintages of stability programmes further shows that consolidation was promised for the future but then postponed with almost each vintage. The cyclically adjusted primary budget balance deteriorated by 1.7 percentage points between 1999 and 2005. This indicates that the planned budgetary consolidation as pictured in Figure 7 mostly relied on cyclical upswings, which however, did not materialise to the extent expected during this period. In addition, the expenditure restraint following the tax rate cuts has been insufficient. Germany began exceeding the 3%-of-GDP ceiling in 2002. In an attempt to implement the budgetary targets of the Stability and Growth Pact at the national level, an agreement was set up between levels of government in 2002 that prescribed expenditure growth in 2003 and 2004 (with a renewal until 2006) to the federal and the state level of government. It has been shown that this agreement has only party been respected.[6] The composition of public expenditure has shifted towards social expenditure, also as a result of the weak GDP growth over the recent years. Between 1999 and 2005, social transfers have increased from 61.4% of total expenditure to 64.5%, while public investment fell from 3.9% to 2.9% of total expenditure. However, the decline in public investment is partly also structural with a declining trend since the 1980s, as in many member states. As a consequence, the debt ratio has steadily increased from 60.9% in 1999 to 67.9% in 2005.

Figure 7: General government balance projections in successive stability programmes (% of GDP)



Source:
Commission services and national stability programmes.

2.5. Medium and long-term policy challenges for public finances

Over the past ten years, Germany has gone through a period of competitive adjustment of past re-unification imbalances. Wage moderation contributed to a recovery of external price competitiveness, and Germany has significantly gained export market shares, in particular from 2000 onwards. It is noteworthy that the restoration of Germany's external price competitiveness has taken place in a period when other euro area countries enjoyed lower real long-term interest rates than Germany. However, Germany has recently experienced that rising external trade surpluses do not automatically spill over to higher domestic demand.

6 See European Commission, Directorate-General for Economic and Financial Affairs (2006), February 2006 Update of the stability programme of Germany 2005-2009: an assessment, ECFIN/B1/53562/06-EN. Available from: http://ec.europa.eu/economy_finance/about/activities/sgp/year/year20052006_en.htm.

The preceding analysis has shown that Germany's growth problem is mostly structural in nature. Potential growth is not only substantially lower than in the past. It has also fallen behind that of other euro area member states. Economic policy faces the challenge of improving the conditions for growth, addressing simultaneously the contributions from labour, factor productivity and, to a lesser extent, capital formation. This difficult task has to be accomplished against the background of continuously strained public finances.

In some areas, the German authorities have initiated reforms, such as on the labour market, which still need time to show their full impact. In others, like corporate taxation, reform steps are being drafted. Yet, these efforts by themselves are unlikely to prove sufficient in order to boost potential growth substantially in the longer run. More could be done in the field of innovation policy, where a high regulatory burden and limited access to venture capital may discourage small and innovative firms from market entry.

Given the comparatively high level of public debt, any future reform measures would need to have a more or less neutral impact on public finances. In this respect, it is still an open question, whether, for instance, the recently enacted labour market reforms will provide sustainable relief to public finances. Against this background, the German economy faces the following challenges with implications for public finances:

- To ensure sustainability of public finances: Germany appears to be at medium risk with regard to the long-term sustainability of public finances. Recently adopted measures would substantially dampen future increases in public pension expenditure. However, without further reforms in health care and long-term care, demographic developments would put at risk the sustainability of public expenditure.

- To improve the quality of public spending: The pressure on public budgets from rising social benefits has certainly been at the cost of public investment. Public spending on education has been rather constant over time at about 9½% of primary expenditure, but has been falling somewhat since 2002. Increased efforts in these areas would most likely contribute to raising Germany's growth potential.

Table 1: Key economic indicators

	Federal Republic of Germany						Euro area					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	1.3	2.0	0.6	-0.2	1.2	0.9	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
Domestic demand	0.7	1.7	-0.3	0.6	0.0	0.4	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.6	0.3	0.9	-0.8	1.2	0.5	0.1	0.1	0.1	-0.7	0.2	-0.2
Prices, costs and labour market												
HICP inflation (% change)	1.3	1.1	1.6	1.0	1.8	1.9	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	1.8	2.2	1.5	1.5	1.7	1.6	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.4	-0.1	-0.7	-0.1	-1.1	-1.5	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	0.3	0.8	-0.2	-0.9	0.4	-0.2	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	8.5	8.3	8.7	9.0	9.5	9.5	9.1	9.8	8.5	8.7	8.9	8.6
Competitiveness and external position												
Real effective exchange rate (% change) (1)	-2.0	-4.3	0.3	4.3	0.4	-2.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	0.9	0.2	1.6	-1.2	1.1	1.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	0.8	-0.9	2.4	2.0	3.9	4.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances												
General government balance (% of GDP)	-2.6	-1.7	-3.5	-4.0	-3.7	-3.2	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	61.6	59.8	63.3	63.9	65.7	67.9	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-3.4	-3.3	-2.7	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (4)												
Long term real interest rate (%) (5)	4.1	5.0	3.1	3.0	3.2	2.7	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (6)	70.1	68.9	71.2	71.9	70.6	69.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	59.9	55.3	64.5	66.3	61.5	61.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source :

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3. MACROECONOMIC OUTLOOK

This section has seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

The programme expects strong growth of the world economy in 2006 and a subsequent easing in 2007-2010. As a consequence, world trade, which is foreseen to expand by 8½-9½% in this year, will also grow more moderately in 2007-2010. Exchange rates, oil prices and interest rates are assumed to stay at recently observed levels. These assumptions differ slightly from the common external assumption of the Commission services' autumn 2006 forecast, where for instance oil prices average at 66 US-Dollar rather than 60 US-Dollar per barrel, as assumed in the updated programme.

3.2. Economic activity

According to the programme, economic activity in Germany rebounded over the course of 2006, with the momentum from foreign trade finally spilling over to domestic demand. In particular gross-fixed capital formation is seen as recovering and the protracted decline in construction investment considered as having come to an end. On the other hand, in spite of the significant brightening of the situation on the labour market, there would not yet be any clear upward trend in private consumption. In part due to positive anticipatory effects in the forefront of the VAT hike, real GDP is forecast to increase by 2.3% in 2006, 1.6 percentage points of which are contributed by final domestic demand (see Table 2). On 13 February 2007, the German Statistical Office released its estimate of real GDP growth at 2.7% in 2006.

As a result of budget consolidation, the programme expects a temporary weakening in economic activity in the first half of 2007. In particular private consumption expenditure and construction investment are expected to be negatively affected, while investment and machinery and equipment would remain buoyant. However, during the course of 2007 growth forces are expected to prevail. The programme forecasts real GDP to grow by 1.4% in 2007, to which final demand (0.9 percentage points) and external trade (0.8 percentage points) are projected to contribute almost equally, while less dynamic stockbuilding would weigh on growth.[7] Although the labour market is also expected to slowdown temporarily, it would retain its positive momentum. As a result of a positive carry-over effect, employment is therefore forecast to grow by 0.6% in 2007.

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7 In its Annual Economic Report, published on 31 January 2007, the German government projects real GDP growth at 1.7% in 2007. The upward revision derives from inventories. The rates of growth of private consumption and investment in 2007 have remained unchanged from the SP projection.

An assessment of the programme's projection for the outer forecast years 2008-2010 is difficult, because the programme only provides period averages and numbers in fractions for that time period. Against the backdrop of Germany's low potential growth, which the programme expects to accelerate to about 1½% per annum towards the end of the forecast horizon, real GDP is projected to increase by 1¾% on average between 2008 and 2009, the main contributions stemming from domestic demand. With a quarter of a percentage point, the average growth contribution from external demand is projected to be lower than in 2006 and 2007. The programme assumes only a slight acceleration of compensation per employees to about 1½% on average during 2008 and 2010.[8] This would imply real wage increases below productivity growth during that period.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009	2010
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.4	2.3	1.2	1.4	2.0	1 ¾	1 ¾	1 ¾
Private consumption (% change)	1.0	0.8	-0.1	0.3	1.9	1.0	1.0	1.0
Gross fixed capital formation (% change)	4.5	5.2	0.6	3.4	2.1	3 ½	3 ½	3 ½
Exports of goods and services (% change)	10.1	10.0	6.7	6.7	6.6	4	4	4
Imports of goods and services (% change)	9.8	10.2	5.5	5.5	6.7	4	4	4
Contributions:								
- Final domestic demand	1.6	1.6	0.2	0.9	1.6	1 ½	1 ½	1 ½
- Change in inventories	0.1	0.3	0.1	-0.3	0.0	0	0	0
- External balance on g&s	0.6	0.5	0.8	0.8	0.3	¼	¼	¼
Output gap[1]	-0.2	-0.3	-0.4	-0.3	0.1	-0.2	0.0	0.0
Employment (% change)	0.6	0.6	0.6	0.6	0.6	1/2	1/2	1/2
Unemployment rate (%)	8.9	n.a.	8.4	n.a.	7.8	n.a.	n.a.	n.a.
Labour productivity growth (%)	2.0	1.7	0.7	0.8	1.3	1 1/4	1 1/4	1 1/4
HICP inflation (%)	1.8	n.a.	2.2	n.a.	1.2	n.a.	n.a.	n.a.
GDP deflator (% change)	0.6	0.5	1.2	1.2	0.4	1	1	1
Comp. of employees (% change)	0.8	n.a.	0.9	n.a.	2.0	n.a.	n.a.	n.a.
Real unit labour costs (% change)	-2.1	n.a.	-1.3	n.a.	-0.2	n.a.	n.a.	n.a.
External balance (% of GDP)	4.5	n.a.	5.3	n.a.	5.4	n.a.	n.a.	n.a.

Note:

[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.

Source :

Commission services' autumn 2006 economic forecasts (COM); Stability programme

For the period until 2008, the projection of real GDP growth is broadly in line with the Commission services' autumn forecast (see Table 2).[9] However, for 2007 the programme foresees stronger increases in gross fixed capital formation and private consumption spending, possibly due to differing assumptions regarding the impact of the VAT hike in January 2007. Moreover, in contrast to the Commission services' autumn 2006 forecast, the programme assumes a significant swing in the contribution of inventories to real GDP growth in 2006 and 2007. By contrast, for 2008, the programme's macroeconomic outlook is slightly more pessimistic than the Commission services' and also differs regarding the composition of domestic demand. While the updated programme again expects more dynamic gross fixed capital formation, the Commission services project a much stronger increase in private consumption. The less favourite development of

8 Data on compensation of employees are required by the code of conduct and have been provided by the German authorities upon request.

9 In their interim forecast published on 16 February 2007, the Commission services project real GDP growth at 1.8% in 2007.

private consumption spending, as projected in the updated programme, could be an adjustment of a more optimistic outlook for 2007 or linked to below-productivity wage growth.

In sharp contrast to Germany's growth experience over 2001-2005, when economic growth relied exclusively on external demand, the programme expects a further consolidation of domestic demand. In particular gross fixed capital formation is expected to increase at a solid pace after some years of negative growth. As a consequence, real GDP growth is projected to markedly accelerate over the forecast period, compared with the 2001-2005 average of 0.6%.

Commission services' calculations based on the information in the programme and using the commonly agreed method suggest a gradual closing of the negative output gap until 2009. In 2010, the programme's assumptions would imply real GDP growth broadly in line with its potential rate. The Commission services' autumn 2006 forecast and the programme differ somewhat in their estimates of the output gap in 2008. More precisely, Commission services arrive at a slightly lower potential output and expect a slightly stronger rebound in economic growth for 2008, which would close the negative output gap already in that year.[10] The output gap estimate as inferred from the programme is 0.3 percentage points below Commission services' autumn estimate for 2008. However, the Commission services' projection of a stronger growth rebound in 2008 does not imply a significantly stronger cyclical improvement than projected by the updated programme for the two years between 2006 and 2008. Instead, the stronger rebound in economic growth in 2008 as foreseen by the Commission services may be largely due to more pronounced shifts in the pattern of domestic demand associated with the 2007 VAT rate hike.

More generally, there is an issue of uncertainty regarding real-time estimates of output gaps, and Table 3 suggests that this is of special concern in the case of Germany. Comparing estimates for 2006 across successive Commission services' forecast exercises and across stability programmes, the perception between spring 2005 and November 2006 of Germany's economic conditions in 2006 have strikingly changed. Part of the volatility could be due to the fact that past projections did not take into account the VAT hike, which will most likely have the effect of a less negative output gap in 2006 and more negative in 2007. Moreover, the Commission services' estimates for 2008 seem to be fairly stable.

[10] As the stability programme update does not provide projections for each of the outer forecast years, Commission services' output gap calculations are based on the assumption that annual growth rates for 2008-2010 equal the three-year average growth rates, as provided by the German authorities.

Table 3: Output gap estimates in successive Commission services' forecasts and stability programme updates

	2006		2007		2008	
	COM	SP[1]	COM	SP[1]	COM	SP[1]
SP Nov 2006	--	-0.3	--	-0.3	--	-0.2
Autumn 2006	-0.2	--	-0.4	--	0.1	--
Spring 2006	-0.1	--	-0.3	--	0.0	--
SP Feb 2006	--	-0.7	--	-1.1	--	-0.7
Autumn 2005	-0.8	--	-0.4	--	0.0	--
Spring 2005	-1.0	--	0.0	--	0.0	--
SP Dec 2004	--	-0.7	--	-0.3	--	-0.0

[1] Commission services' calculations according to the commonly agreed method based on the information in the programme.
Source:
Commission services' forecasts and national stability programmes.

3.3. Potential growth and its determinants

Table 4 illustrates that there is no significant difference between the Commission services' autumn 2006 estimate of potential output and the estimates based on the information provided in the programme using the commonly agreed method. Both estimates project only a small contribution of labour to potential growth. Instead, potential growth is expected to mainly rely on capital formation and investment. However, a gradual increase in the investment contribution would slightly accelerate potential output over the forecast horizon.

Table 4: Sources of potential output growth

	2006		2007		2008		2009	2010
	COM	**SP[2]**	**COM**	**SP[2]**	**COM**	**SP[2]**	**SP[2]**	**SP[2]**
Potential GDP growth[1]	1.3	1.3	1.4	1.4	1.4	1.5	1.5	1.6
Contributions:								
- Labour	0.0	0.1	0.0	0.1	0.0	0.1	0.0	0.0
- Capital accumulation	0.3	0.4	0.3	0.4	0.4	0.5	0.5	0.6
- TFP	1.0	0.9	1.0	0.9	1.1	1.0	1.0	1.0

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 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

The programme states that recent reforms are expected to raise labour participation rates, especially of women and older workers and it expects the level of "natural unemployment" to fall. More precisely, employment is projected to increase by roughly ½% p.a., with the reduction in unemployment lagging somewhat behind.

The German labour market has markedly improved in 2006, and the previous downward trend in employment has not only been stopped but even reversed. Employment subject to social contributions is also increasing. This programme's employment outlook thus appears to be reasonable. The forecast of employment growth until 2008 is in line with the Commission services' autumn forecast.

3.5. Costs and price developments

The programme's projection of the increase in the GDP deflator in 2006 and 2007 is much in line with the Commission services' autumn forecast. There is, however, a significant difference in the forecast for 2008, where the programme's expects the increase in the GDP deflator to be 0.6 percentage points higher than in the Commission services' autumn forecast. As the programme does not provide data for any other deflator, this discrepancy is difficult to explain. On the one hand, lower oil prices would raise the GDP deflator, on the other hand, this would likely trigger second-round effects. Furthermore, with wages expected to grow below productivity over the forecast horizon, there would be no significant inflationary pressure from wages. Hence, a forecasted increase in the GDP deflator of about 1% p.a. in 2008-2010 appears to be somewhat on the high side. On the other hand, according to data that has been provided by the German authorities on a confidential basis, real unit labour costs are expected to further decline during the programme period. This is consistent with the assumption of continued net trade surpluses until the end of the programme time horizon.

3.6. Sectoral balances

Apart from the general government balance, the update of the stability programme does not provide any data on sectoral net lending. A meaningful analysis of the update's assumptions regarding the sectoral balances is therefore not possible.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic ‘good’ or ‘bad’ times.

3.7.1. Plausibility of the macroeconomic scenario

The programme expects economic activity in Germany to rebound during the course of the current year, with the momentum from foreign trade finally spilling over to domestic demand. In part due to positive anticipatory effects in the forefront of the VAT hike, real GDP is forecast to increase by 2.3% in 2006, 1.6 percentage points of which will be contributed by final domestic demand. As a result of budget consolidation, the updated programme expects a temporary weakening in economic activity in the first half of 2007. However, during the later course of 2007 growth forces are expected to prevail. The programme forecasts real GDP to grow by 1.4% in 2007. Although the labour market is also expected to slowdown temporarily, it would retain its positive momentum. Real GDP is projected to increase by 1¾% on average between 2008 and 2009, the main contributions stemming from domestic demand. The growth contributions from external demand will be lower than in 2006 and 2007. The programme assumes real wage increases below productivity growth during 2008 and 2010. This corresponds to the wage share declining over the programme period.

For the period up until 2008, the projection of real GDP growth is broadly in line with the Commission services' autumn forecast. Thereafter, Commission services' calculations based on information in the programme and using the commonly agreed method suggest a gradual closing of the negative output gap until 2009, one year later than projected in the Commission services’ autumn forecast. Real GDP growth is expected to grow in line with its potential rate in 2010.

While the programme’s projection for 2008-2010 of wage developments appear to be somewhat on the low side, inflation as measured by the GDP deflator could be on the high side. Otherwise, the programme’s macroeconomic assumptions appear to plausible.

3.7.2. Economic good vs. bad times

According to the Commission services' autumn forecast, in 2006 a significant closing of the negative output gap from -1.2% in 2005 to -0.2% took place. At the same time, employment, which has declined over the past five years, is rising again. The nominal rate of GDP growth in 2006 is the highest since 1995. Germany is thus currently experiencing a period of economic good times. Due to the temporary effects of the VAT hike in 2007, which temporarily counteracts the underlying positive trend, the output gap will widen a bit in 2007, but it will move into positive territory in 2008. There appear to be only minor risks of a relapse into negative territory in 2009 and 2010.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme’s medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country’s position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The February 2006 update of the stability programme had projected the 2006 deficit at 3.3% of GDP, while the current update projects the 2006 deficit at 2.1% of GDP. On 12 January 2007, the German Ministry of Finance announced that the 2006 deficit amounted to 1.9% of GDP. This is better-than-expected by the Commission services' autumn forecast, which projected the 2006 deficit at 2.3% of GDP. The difference stems from revenues. According to the Ministry of Finance, revenues amounted to 43.9% of GDP (Commission services' autumn forecast: 43.5%), expenditures to 45.8% of GDP (Commission services' autumn forecast also 45.8%). The calculations in the remainder of this document, however, will take the projections from the update as the basis for the assessment.

The breakdown of the revision in the headline deficit, according to the programme, is displayed in Table 5. In short, the government received unexpectedly high revenues from taxes and withstood the temptation to spend them in 2006. The tax burden (i.e. revenues from taxes and social contributions) is now forecast to increase to about 40% of GDP in 2006, which is about 1% of GDP higher than projected in February, although there have not been any new discretionary tax measures adopted for 2006 compared to those in the

February update.[11] A small part of the upward revision comes from a base effect from 2005, i.e. a slight upward revision of the 2005 tax revenues. Since the tax base composition in GDP has not changed much compared with the February update, the main reason for the unexpectedly high revenue growth is that taxes are yielding substantially stronger revenues than tax base developments would suggest. Whereas social contributions seem to stay slightly behind tax base growth, the main drivers behind the positive revenue surprise are profit-related taxes.[12] Overall, however, the ratio of total revenues to GDP is projected to increase only moderately compared with the previous year. The first reason is that revenue-rich tax bases continue to develop less dynamically than GDP, and the second is that non-tax revenues decline in 2006 due to a one-off effect in 2005.[13]

According to the updated programme and in line with the Commission services' autumn forecast, general government expenditure has been kept under control in 2006, despite the higher-than-anticipated revenues. Year-on-year expenditure growth is projected at ½% by the current update, whereas the February update had projected expenditure growth at 1%. The somewhat tighter budgetary execution derives from lower monetary transfers, stemming mainly from the unexpected relief that the improving labour market has provided to the Federal Employment Agency. In addition, interest expenditure and subsidies have been lower than expected in February. Yet, a significant part of the revision in the expenditure-to-GDP ratio from 46% as projected in February to 45½% of GDP as projected by the current update is a denominator effect through the unexpectedly high growth in nominal GDP (2.9% versus 2.2%).

This story is mirrored in the cyclically-adjusted deficit, which, according to Commission services' calculations based on the data in the programme, declined by 0.6 percentage points in 2006.[14] In February, the cyclically-adjusted deficit was projected to remain constant compared with the previous year. 0.1 percentage point of this improvement is due to a base effect from 2005 (with nominal deficit at 3.2% of GDP instead of 3.3% as projected in February). Of the remaining unexpected 0.5 percentage points structural improvement, the major part is due to the unexpected increase in revenues beyond that

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11 Note further that revenues recorded in national accounts are unaffected by a one-off measure in cash-terms in 2006: The national authorities required companies to bring their monthly social contributions forward to the end of the month when the payment is due as opposed to the middle of the following month. The resulting thirteen instead of twelve cash payments in 2006 have provided one-off cash relief for the social security system. In national accounts, however, such payments are recorded when they are due, so that the timing when the payment is made is irrelevant.

12 This is not apparent from the simple decomposition of tax revenues into direct and indirect taxes, because corporate taxes (and personal income tax on unincorporated companies) are recorded in national accounts as direct taxes, while local taxes (*Gewerbesteuer*) are recorded as indirect taxes, although both relate to profits.

13 In October 2004, several *Landesbanken* were ordered by the European Commission to return capital injections, which they had received in the early 1990s, to the respective *Länder* budgets. The repayments were made in 2004 and 2005.

14 Because of a deficit-increasing one-off measure in 2005 (the repayment of capital injections by the Landesbanken to the Länder), the structural balance (i..e the cyclically-adjusted balance net of one-off and temporary measures) declined by 0.7 percentage points.

implied by the improved cyclical conditions. A minor part is due to the tighter budgetary execution (net of the lower labour market expenditure due to the cycle).[15]

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009	2010
General government balance (% of GDP)	**SP Nov 2006**	-3.2	-2.1	-1 1/2	-1 1/2	-1	- 1/2
	SP Feb 2006	-3.3	-3.3	-2 ½	-2	-1 ½	n.a.
	SP Dec 2004	-	-	-	-	-	-
	COM Nov 2006	-3.2	-2.3	-1.6	-1.2	n.a.	n.a.
General government expenditure (% of GDP)	**SP Nov 2006**	46.8	45 1/2	45	44 1/2	43 1/2	43
	SP Feb 2006	46.7	46	45	44	43 ½	n.a.
	SP Dec 2004	-	-	-	-	-	-
	COM Nov 2006	46.8	45.8	45.2	44.8	n.a.	n.a.
General government revenues (% of GDP)	**SP Nov 2006**	43.5	43 1/2	43 1/2	42 1/2	42 1/2	42
	SP Feb 2006	43.4	43	43	42 ½	42 ½	n.a.
	SP Dec 2004	-	-	-	-	-	-
	COM Nov 2006	43.5	43.5	43.6	43.6	n.a.	n.a.
Real GDP (% change)	**SP Nov 2006**	0.9	2.3	1.4	1 ¾	1 ¾	1 ¾
	SP Feb 2006	0.9	1.4	1	1 ¾	1 ¾	n.a.
	SP Dec 2004	-	-	-	-	-	-
	COM Nov 2006	0.9	2.4	1.2	2.0	n.a.	n.a.

Note:
Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM)

4.2. 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.

4.2.1. 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. The strategy has remained unchanged from the previous programme. Therefore, the medium-term objective (MTO) for the budgetary position set in the previous update is confirmed (see section 4.2.3 below). The programme credibly envisages correcting the excessive deficit by 2006, one year before the deadline set by the Council (see Box 1 below).

Table 5 allows a comparison of the budgetary adjustment with that envisaged in the February update.[16] The positive surprise in revenues in 2006 is projected to exert a

[15] A small share of the improvement can also be attributed to the slight upward revision in potential growth compared with the February update.

[16] A comparison with the update of December 2004 would have to take into account the host of measures adopted after the change of government in autumn 2005 and is therefore not undertaken here. For reference, see the Technical Assessment of the February 2006 update of the German stability

positive base effect also onto the following years in the programme period. However, part of the positive surprise of 2006 will be undone in 2007. The reason for this is that the current update does not expect the higher-than-expected high tax revenues to continue their trend unabated into 2007. In contrast to the February update, the tax burden is projected to decline slightly in 2007, as can be seen in Table 6 (though the tax burden would still be at a higher level than projected in February). Yet, even taking into account this slight negative swing, the budgetary adjustment over the programme period is less ambitious compared with the previous update. While the latter envisaged the nominal deficit-to-GDP ratio to narrow by about 2 percentage points between 2006 and 2009 (the end-year), the current update foresees an adjustment of about one percentage point over the same time-span. If 2005 is taken as the starting year, the budgetary adjustment planned until 2009 amounts to about 1 percentage point in both updates.[17] In other words, the higher-than-expected high tax revenues in 2006 do not translate into a stronger budgetary adjustment over the medium-term. Some of this result may come from a partial reversal of the 2006 direct-tax intensity.[18] However, for 2008, the current programme projects no budgetary adjustment, whereas the previous programme had projected an adjustment of ½ percentage point, which is partly due to the impact of the company tax reform (see below). The primary balance follows the same pattern, reaching 1½% of GDP by 2009 in the current and the previous update. In the final year of the current programme, the nominal deficit ratio is projected to have reached ½% of GDP.

Box 1: The excessive deficit procedure for Germany

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 21 January 2003 the Council decided that Germany was in excessive deficit. On the same date, the Council recommended in accordance with Art. 104(7) of the Treaty 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.

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programme of 9.6.2006, ECFIN/B1/53562/06-EN, available at http://ec.europa.eu/economy_finance/about/activities/sgp/country/germany_en.htm

17 Note that due to the customary rounding in the updates, the differences between already rounded figures may look sometimes different than the rounded difference between precise values.

18 Revenues from profit-related taxes may out- or underperform compared with the tax base development due to the lead and lag structure of these tax payments. Such time-shifts in the tax liability may be responsible for unforeseen profit-tax revenue swings even in the absence of discretionary measures and may to some extent cancel out over time. Since after all, they originate from the existing tax code, they are neither one-off budgetary gains (or losses) nor "windfall gains".

Although the Council recommendation according to 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 2004 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 were fully implemented and that additional measures were 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 2005. On 14 March 2006, the Council decided to give notice to Germany, in accordance with Article 104(9) of the Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit "as rapidly as possible and at the latest by 2007." Specifically, the Council requested that "in 2006 and 2007, Germany shall ensure a cumulative improvement in its cyclically-adjusted balance net of one-off and temporary measures by at least one percentage point." In addition, Germany was invited to "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." Following the submission of an implementation report by Germany on 5 July, on 19 July 2006 the Commission adopted a Communication to inform the Council that Germany had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council and that no further steps in the excessive deficit procedure were needed at that point. In its meeting of 10 October 2006, the Council shared this view.

(*) "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.

4.2.2. *The composition of the budgetary adjustment*

According to the update, the planned budgetary adjustment involves increases in revenue and reductions in expenditure. However, this is not apparent from the evolution of the revenue and expenditure ratio in Table 6. The revenue ratio is expected to stay roughly constant at 43½% of GDP between 2005 and 2007 and to decline to 42% by 2010. In contrast, the expenditure ratio is projected to decline from 45½% of GDP in 2006 by 2½ percentage points over the programme period. Projected at 43% of GDP in 2010, the expenditure ratio would reach a record low; the government share in GDP was below 44% of GDP for the last time in 1973 (West-Germany). 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 6, Table 6a[19] and Box 2 provide more detail on the nature of the adjustment. The striking observation on the revenue side is that the increase in tax revenues through the measures planned for 2007 (0.97% of GDP) would only slightly over-compensate 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[20] accounts for only half of the decline in social contributions in 2007 (including the rises in the other contribution rates, see Box 2). The update assumes that contribution rates remain constant after 2007. Yet, the share of contributions in GDP is projected to continue declining. As Annex 4 shows for social security contributions, the elasticity of the tax base (compensation of employees) to GDP is estimated by the OECD at 0.7, while the elasticity of the tax base to revenue from contributions is estimated at 0.8, thus implying an elasticity of contributions to GDP of 0.56, i.e. a declining trend in the ratio of social contributions to GDP. As Annex 4 reveals, the elasticities assumed in the update are below or close to that estimated by the OECD for all years in the programme period. Thus, the downward trend in the social contribution ratio is – abstracting from the discretionary reduction in the rate – a reflection of the declining trend in the wage share, which the update projects to continue over the programme period (see Section 3.7.1). As mentioned above, the unexpectedly high increase in profit-related taxes in 2006 is not projected to lead to a corresponding increase in the tax ratio also in the following years, but to abate somewhat already in 2007.

Table 6: Composition of the budgetary adjustment

[19] Equal to Table 2 in: Communication from the Commission to the Council: "Assessment of the action taken by Germany in response to the Council decision of 14 March 2006, in accordance with Article 104(9) of the Treaty, for the deficit reduction judged necessary in order to remedy the situation of excessive deficit", SEC 990(2006) final, 19.7.2006.

[20] The contribution rate is lowered from 6.5% to 4.2%. Table 6a is based on a decline in the rate by only 2 percentage points, as was planned policy at the time, which equals 0.37% of GDP. The additional cut of 0.3 points would amount to an additional budgetary burden of about 0.1% of GDP.

(% GDP)	2005	2006	2007	2008	2009	2010	Change: 2010-2006
Revenues	43.5	43 1/2	43 1/2	42 1/2	42 1/2	42	**-1 1/2**
of which:							
- Taxes	22.0	23	23 1/2	23	23	23 1/2	**1/2**
- Social contributions	17.7	17 1/2	16 1/2	16 1/2	16	16	**-1 1/2**
- Other (residual)	3.8	3 1/2	3 1/2	3 1/2	3	3	**- 1/2**
Expenditure	46.8	45 1/2	45	44 1/2	43 1/2	43	**-2 1/2**
of which:							
- Primary expenditure	43.9	42 1/2	42	41 1/2	40 1/2	40	**-3**
of which:							
Consumption	18.7	18 1/2	18 1/2	18	18	18	**-1**
Transfers other than in kind	19.2	18 1/2	18	17 1/2	17	16 1/2	**-2**
Subsidies	1.2	1	1	1	1	1	**0**
Gross fixed capital formation	1.3	1 1/2	1 1/2	1 1/2	1 1/2	1 1/2	**0**
Other (residual)	3.5	3	3	3 1/2	3	3	**0**
- Interest expenditure	2.9	3	3	3	3	3	**0**
General government balance (GGB)	**-3.2**	**-2.1**	**-1 1/2**	**-1 1/2**	**-1**	**- 1/2**	**1 1/2**
Primary balance	**-0.3**	**0.9**	**1 1/2**	**1 1/2**	**2**	**2 1/2**	**1 1/2**
One-offs[1]	0.1	0	0	0	0	0	0
GGB excl. one-offs	**-3.3**	**-2.1**	**-1 1/2**	**-1 1/2**	**-1**	**- 1/2**	**1 1/2**
Source : *stability programme update; Commission services' calculations, figures may not add up due to rounding*							

In addition to the measures summarised in Table 6a, the current update takes into account the company tax reform planned to take effect in 2008. According to the update, the full permanent annual budgetary burden of that reform would amount to € 5 bn (0.2% of GDP). This is also reflected in the decline of the tax ratio from 2008. Finally, non-tax revenues are projected to decline over the programme period, contributing further to the downward trend in the overall revenue ratio.

Table 6a: Fiscal impact of discretionary measures compared with the baseline

	2006	2007	2008
		% of GDP	
Revenue	**-0.08**	**0.60**	**0.76**
Taxes	-0.08	0.97	1.12
Social contributions	-0.01	-0.37	-0.37
Expenditure	**0.10**	**0.46**	**0.59**
Monetary transfers	0.03	0.31	0.43
Capital transfers	0.01	0.06	0.08
Public consumption	0.07	0.09	0.08
Impact on budget balance in total	**0.0**	**1.1**	**1.4**
(+: balance improving) *Source: Report submitted by Germany on 5.7.2006*			

The planned restraint in expenditure falls to a large extent on social transfers, which is not fully visible from the data provided in the programme, since the Code of Conduct is not precisely followed in the break-down of expenditures. Social transfers in kind (i.e. the public health care system) are contained in the category public consumption (along with public sector wages and intermediate consumption), which is provided in the programme. Social transfers other than in kind (monetary transfers) are also provided in the programme.

The update projects public consumption to decline by a rounded 1 percentage point over the programme period. Until 2007, the wage restraint resulting from the wage agreements of 2005 and 2006 should, although not explicitly mentioned in the update, dampen expenditure growth.[21] In addition, cuts in bonus payments for civil servants would contribute to the wage restraint. Table 6a projects a reduction in public consumption by 0.1 percentage point (with respect to trend) in 2007, resulting from the measures in the 2006 draft federal budget and supplementary laws. In addition, the current update incorporates a health care reform that is planned to enter into force on 1.4.2007. According to the draft law dating from October 2006, social benefits in kind would decrease by € 1.4 bn in 2007 (less than 0.1% of GDP) with respect to trend, mainly due to a change in price regulation for pharmacies. However, a new agreement on this reform, dating from 12 January 2007, abandoned the new price regulation.

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 argues would be in line with projected macroeconomic developments.

Finally, the update projects subsidies, public investment and other expenditure to remain roughly constant over the programme period. Included in the last category are 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.[22] Table 6a 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 forecast to remain broadly unchanged in 2006 and 2007. It is assumed to narrow in 2008 by ½ percentage point and to remain at that level until 2010. In 2007, the counter-balancing effects of the higher tax revenues from raising the standard VAT rate and the decrease in social contributions impact on the federal budget. The narrowing of the deficit in 2008 might be due to lower transfers to the social security systems, which would not be fully mitigated by the lower revenues from the planned company tax reform. Similar revenue effects are also visible in the public finances at the level of the *Länder* due to the revenue sharing system.

The social security system is projected to remain in slight deficit until 2008 and in balance thereafter. The update explains that the reduction in the expenditure from the

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21 The wage agreement concluded between the public sector union and the federal and the local levels of government 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. This agreement lasts until the end of 2007. For the states, which account for more than half of the public sector employment in Germany, a similar agreement was concluded in 2006, which foresees a pay rise in its end-year 2008.

22 Eligibility for the tax subsidy begins from the moment when the application for a building permit is made. In building permit statistics, one can observe an increase in permits every time when a partial abolition of the subsidy was decided or even just discussed but eventually abandoned.

unemployment insurance in 2006 would lead to a surplus in the accounts of the Federal Employment Agency. However, despite a further reduction in unemployment expenditure in 2007, the reduction in the contribution rate would move its accounts into deficit in 2007. Increases in the contribution rates to the pension system and to the public health care system, in addition to low birth-rate-cohorts entering into retirement over the programme period, are projected to move the social systems into slight surplus by the end of the programme period. At first sight, this may seem a cautious assumption. Underlying this development is the above-mentioned assumed expenditure restraint in social transfers. Moreover, the projected slight surplus of the total system by 2010 seems to be due to the pension system only. According to the most recent Pension Report by the government, the surplus is used for a small build-up of a "sustainability fund" (which is legally required in order to smooth liquidity fluctuations within a year) in the pension system.[23]

Box 2: The budget for 2007

The federal budget for 2007 was approved by the *Bundestag* on 24 November and passed the *Bundesrat* on 15 December, so that it entered into force on 1 January 2007. 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 fall from 2.1% of GDP in 2006 to 1½% of GDP in 2007.

As the main measure, the central VAT rate and the insurance tax rate will increase from 16% to 19% as from 1.1.2007, which could be expected to raise indirect tax revenues by up to 1% of GDP compared with the baseline. One percentage point of the increase in the rate will be transferred from the federal budget to the Federal Employment Agency in order to partly fund the reduction in the social contribution rate to the unemployment insurance from 6.5% to 4.2% of the wage as from 2007. The contribution rate to the pension system is set to rise from 19.5% to 19.9% in 2007. In addition, the average contribution rate to the public health care system would rise by 0.5 percentage points in 2007. On 24 October 2006, the federal government adopted a draft law on health care reform. The budgetary relevance in 2007 of the measures foreseen (e.g. a new funding scheme as from 2009) is limited and would have stemmed mostly from the introduction of a new price regulation scheme for pharmacies, which, however, has meanwhile been abandoned. 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, some constraint will be exercised in labour market expenditure, by the Federal Employment Agency on unemployment insurance and by the federal budget on side benefits to long-term unemployed.

The government continues cutting tax allowances, for example on commuting, and some of the cuts in tax allowances undertaken in 2006 will result in additional savings in 2007 (for example on private housing construction). On the other hand, new tax allowances granted in 2006 will remain a burden to the budget. For example, depreciation rules on non-fixed capital were relaxed, the renovation of buildings and the private use of household repair services receive tax-

[23] Bundesministerium für Arbeit und Soziales: "Rentenversicherungsbericht 2006", 29.11.2006, available at www.bmas.bund.de

favourable treatment and higher child and old age care allowances were granted. On 25 October 2006, the federal government adopted a draft law revising the inheritance tax (which accrues to the Länder), so that family-owned companies would be able to defer their tax liability in return for job guarantees. The law (not yet adopted by the *Bundesrat*) is envisaged to enter into force retroactively on 1.1.2007; the budgetary burden in the initial year is likely to be small.

Public finances in 2007 will furthermore benefit from action taken well before this budget. As a consequence of the 2005 pension reforms, pension expenditure will rise only slightly. Given the public sector wage agreements of 2005 and 2006, increases in working time and the trend in reducing staffing levels, the public sector wage bill should contribute substantially to consolidation in 2007.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
o VAT and insurance tax (from 16% to 19%) (up to 1% of GDP) o Social contributions (in total: -0.4% of GDP) - unemployment insurance (6.5% to 4.2%) - pension system (19.5% to 19.9%) - public health care (14.2% to 14.7% on average) - some smaller measures o Reduction of tax allowances (0.1% of GDP)	o Discretionary restraint in labour market expenditure (0.1-0.2% of GDP) o Health care reform 2007 (negligible)

* Estimated impact on general government revenues (+: additional revenues compared with baseline)
** Estimated impact on general government expenditure (+: expenditure savings compared with baseline).
Note: This table contains only new measures, which are implemented in 2007. Measures that were adopted in previous years, which may impact on the 2007 budget, are not listed.
Sources: Commission services and various draft laws.

4.2.3. The medium-term objective (MTO) and the structural adjustment

The current update confirms the MTO of a balanced budget in structural terms, which was set in the February 2006 update. As in the previous update, it is not achieved within the programme period.

As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The "minimum benchmark" is defined as the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value.

The 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 adequately represents the debt ratio and average potential output growth in the long term.

Box 3: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific 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 MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct 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 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

Table 7 shows the budgetary strategy in cyclically-adjusted terms, allowing a comparison with the Commission services' autumn forecast. 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 slightly less than ½% of GDP on average per year between 2006 and 2010. In the years 2006 and 2007, the improvement in the structural balance in cumulative terms as a percentage of GDP amounts to over one percentage point. This is in line with the Commission services' autumn forecast. The swing between 2006 and 2007, however, is slightly different between the two projections. A possible reason for this may be a stronger increase in profit-related taxes in 2006 projected in the update with a larger negative swing in 2007. From Table 7, it appears that the fiscal consolidation in 2007 occurs in a year in which the negative output gap widens. However, the widening of the output gap is caused by the impact of the fiscal measures in that year. The economic effect of the VAT increase, namely the anticipation of consumption from 2007 to 2006, would raise real GDP growth vis-à-vis potential growth in 2006, depress it in 2007 and raise it again in 2008, when consumption patterns will have normalised. In addition, real GDP growth will be fuelled by the relaxed depreciation rules in 2006 and 2007, which will be tightened again with the company tax reform 2008.

In 2008, the company tax reform will weigh on the budget as projected by the current update. This explains the difference in the structural balance between the one implied in the programme and the Commission services' autumn forecast, which did not take the company tax reform into account because not enough detail was known at the cut-off date. Still, the budgetary burden from company tax reform cannot fully explain the lack of structural adjustment in 2008, in view of the structural adjustment as projected in the Commission services' autumn forecast amounting to merely ¼% of GDP – excluding the company tax reform.[24]

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[24] Of course, structural balances should be interpreted with the necessary caution. Indeed, the output gap is projected to be closing somewhat more forcefully by 2008 in the Commission services' autumn forecast than implied in the update. This should, ceteris paribus, lead to a somewhat lower structural adjustment in the Commission forecast than implied by the programme's macroeconomic scenario if the company tax reform were *not* taken into account.

In 2009 and 2010, the structural balance based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, is planned to improve by about ½ percentage point annually.

Overall, the development of the structural balance mirrors the nominal adjustment, which was described in section 4.2.1. A stronger adjustment in 2006/2007 stands in contrast with a projected lack of adjustment effort in 2008. The planned structural balance in 2009 has barely changed between the two most recent updates.[25]

After the planned correction of the excessive deficit by 2006, the average 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 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	2010	Change: 2010-2006
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-3.2	-3.2	-2.3	-2.1	-1.6	-1.5	-1.2	-1.5	-1.0	-0.5	1.6
One-offs[2]	0.1	-	0.0	-	0.0	-	0.0	-	-	-	0.0
Output gap[3]	-1.3	-1.2	-0.2	-0.3	-0.4	-0.3	0.1	-0.2	0.0	0.0	0.3
CAB[4]	-2.6	-2.6	-2.2	-2.0	-1.4	-1.5	-1.2	-1.5	-1.0	-0.6	1.3
change in CAB[6]	0.7	0.7	0.4	0.6	0.8	0.5	0.2	-0.1	0.5	0.4	0.4
CAPB[4]	0.2	0.3	0.5	1.0	1.3	1.5	1.5	1.5	2.0	2.4	1.3
Structural balance[5]	-2.7	-2.7	-2.2	-2.0	-1.4	-1.5	-1.2	-1.5	-1.0	-0.6	1.3
change in struct.bal.[6]	0.6	0.7	0.5	0.7	0.8	0.5	0.2	-0.1	0.5	0.4	0.4
Struct. prim. bal.[5]	0.1	0.2	0.5	1.0	1.3	1.5	1.5	1.5	2.0	2.4	1.3

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. See Table 2 above.

[4]CA(P)B = cyclically-adjusted (primary) balance.

[5]Structural (primary) balance = CA(P)B excluding one-offs and other temporary measures.

[6]Change 2006-2010: annual average change.

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3. Risk assessment

The main risk to the budgetary projections is a not rigorous enough implementation of the envisaged consolidation. To a lesser extent, a further risk might arise from worse-

[25] As Table 7 shows, the output gap as recalculated by the Commission services differ between the updates, not least due to an upward revision of potential growth but also due to changes in the real GDP projections. With a given set of structural measures (i.e. tax rate measures, wage agreements, pension reforms etc.) that have not changed much between the updates, the output gap revisions should have an impact primarily on the nominal balance. Due to the customary rounding of programme data, this effect might not be fully visible in the displayed tables.

than-expected macroeconomic developments. Both risks apply to the years from 2008 onwards.

Table 8 compares the budgetary projection of the update with the Commission services' autumn forecast. Turning to the revenue side, for the years 2006 and 2007, the update's projections are very similar to the Commission services' autumn forecast. Somewhat disguised by the habitual rounding in the update is the fact that the update takes the additional lowering of the unemployment insurance contribution rate (see above) into account, which should lower social contributions by 0.1% of GDP from 2007 on. In addition, the update seems to project a larger negative swing in profit-related taxes in 2007, as has been already mentioned. In general, however, as was shown in section 3.6.1, the projection of real GDP growth is broadly in line with the Commission services' autumn forecast for the period up until 2007. This analysis is mirrored in Table 9, where for 2007 there is no difference between the forecasts in tax base composition, but the difference is due to tax revenue developments deviating from the respective bases. The decomposition of tax revenues between the Commission forecast and what would be implied by simply applying the OECD standard elasticities in the bottom of Table 9 reflects both the budgetary measures, which are discussed at length above, and the continuation of the trend of past years that revenue-rich tax bases, like gross wages, are growing less dynamically than GDP. This has also been discussed at length above.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009	2010
		COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenues	43.5	43.5	43½	43.6	43½	43.6	42½	42½	42
of which:									
- Taxes	22.0	22.5	23	23.3	23½	23.4	23	23	23½
- Social contributions	17.7	17.3	17½	16.7	16½	16.7	16½	16	16
- Other (residual)	3.8	3.7	3 ½	3.6	3 ½	3.5	3 ½	3	3
Expenditure	46.8	45.8	45½	45.2	45	44.8	44½	43½	43
of which:									
- Primary expenditure[3]	44.0	43.1	43	42.5	42	42.1	41½	41	40
of which:									
Consumption	18.7	18.6	18½	18.4	18½	18.4	18	18	18
Transfers other than in kind	19.2	18.7	18½	18.2	18	17.9	17½	17	16½
Subsidies	1.2	1.1	1	1.2	1	1.2	1	1	1
Gross fixed capital formation	1.3	1.3	1½	1.4	1½	1.4	1½	1½	1½
Other (residual)	3.6	3.4	3½	3.3	3	3.2	3	3	3
- Interest expenditure[3]	2.8	2.7	3	2.7	3	2.7	3	3	3
General government balance (GGB)	-3.2	-2.3	-2.1	-1.6	-1½	-1.2	-1½	-1	-½
Primary balance[3]	-0.5	0.4	½	1.1	1	1.5	1	1 ½	2
One-offs[2]	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	-3.3	-2.3	-2.1	-1.6	-1½	-1.2	-1½	-1	-½

Notes:

[1]On a no-policy change basis.

[2]One-off and other temporary measures.

[3]Data on the primary surplus in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable with data in the programme, Commission data on the primary surplus need to be augmented by 0.1% of GDP per year.

Source:

Commission services' autumn 2006 economic forecasts (COM); stability programme update (SP); Commission services' calculations

Table 9: Assessment of tax projections

	2007			2008			2009	2010
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	-0.1	0.2	0.0	-0.6	0.1	0.0	-0.1	-0.3
Difference (SP – COM)	-0.3		/	-0.7		/	/	/
of which [2] *:*								
- discretionary and elasticity component	-0.3		/	-0.4		/	/	/
- composition component	0.0		/	-0.3		/	/	/
Difference (COM - OECD)	/	0.2		/	0.1		/	/
of which [2] *:*								
- discretionary and elasticity component	/	0.5		/	-0.1		/	/
- composition component	/	-0.3		/	0.2		/	/
p.m.: Elasticity to GDP	0.9	1.2	1.0	0.4	1.1	1.0	0.9	0.7

Notes:

[1]On a no-policy change basis.

[2]The decomposition is explained in Annex 5.

[3]OECD ex-ante elasticity relative to GDP.

Source :

Commission services' autumn 2006 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)

In 2008, the update considers revenue shortfalls from the company tax reform, in contrast to the Commission services' autumn forecast as already mentioned. Unfortunately, the update only specifies the full annual budgetary impact of the reform after the base-broadening effects have set in at € 5 bn (0.2% of GDP). Experience has shown, however, that the budgetary effects of company tax reforms have a high projection error. Initially, however, the shortfall from the reform might be larger, perhaps up to 0.5% of GDP (see Section 6 below). Once again, Table 9 shows that there is a difference between the programme's projection and the Commission services' forecast stemming from an apparent deviation of revenues from the tax base developments. On the one hand, this reflects the further lowering of social contribution rates in 2007, which is permanent, and the shortfall from the company tax reform in 2008. In addition, the tax base composition of GDP seems to be more revenue-rich in the Commission services' forecast than in the update. This is however not surprising, since the higher GDP growth in 2008 projected by the Commission services is due to the rebound in domestic demand as a rebound from the VAT-induced slump in 2007. This effect is less pronounced in the update's projection, which might be due to the habitual averaging of the outer years in the programme.

For 2009 and 2010, the macroeconomic outlook provided by the programme appears to be mildly favourable (perhaps also as a result of the update's averaging the period 2008-2010). Growth is projected up to ½ percentage point above potential (as calculated by the Commission services). However, for 2009 and 2010, the update might employ a somewhat cautious stance on wage developments, as was discussed above. With stronger wage dynamics (and no offsetting reaction of employment), the composition of GDP growth in those years might perhaps be more tax-favourable than projected. Taking into account the differences in measures considered in the projections, the update's revenue projection seems plausible up until 2007. For the years between 2008 and 2010, the two risks are of opposite signs. First, there is the negative risk from shortfalls in company taxes. Second, there is the positive risk that wage developments might be more dynamic than assumed and thus growth be more "tax-rich".

The budgetary consolidation projected until 2007 is rooted both in measures that have been adopted in the course of 2006 and also in trend developments on the expenditure side that is based on earlier measures, in particular low pension expenditure growth, public sector wage and salary restraint, and reductions in staffing levels, subsidies and in the cost of debt service, and low public investment. Also, the assumptions in the programme on pension expenditure seem plausible.

As was explained above, the budgetary strategy rests to a large extent on restraint in social spending. In the aggregated expenditure categories provided in the programme, this concerns monetary transfers and public consumption.

The category 'monetary transfers' 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). Total expenditure would thus be mainly driven by the growing number of recipients until the end of the programme. Since currently low birth rate cohorts are entering into retirement and pensions per head will remain constant in nominal terms, total public pension outlays would remain below the growth rate of nominal GDP during the programme period, which might 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 throughout the programme period. Payments from the unemployment insurance have fallen substantially in 2005 and in 2006, which is likely to continue in 2007. The reason is both the surprising improvement in the labour market, and also the transition of some categories of unemployed from unemployment 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). In addition, the Federal Employment Agency has reduced its expenditure on active labour market policy (ALMP) significantly in the past. However, its budget plan for 2007 foresees only a negligible reduction in ALMP spending. So it remains uncertain whether further such restraint could be expected 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").[26] 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. However, given the experience from previous economic cycles, it is not clear whether the current upswing would reduce long-term unemployment.

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, it seems that only part of the projected decline in monetary transfers as a percentage of GDP is backed by implemented measures and current trends. To realise the projected decline, further measures would seem necessary.

As regards public consumption, the main drivers are social benefits in kind, which is the public health care system, and the public sector wage bill. Between 2006 and 2010, the update projects the public consumption share in GDP to decline steadily by one percentage point in total. The update provides some key elements of the draft health care reform, which is planned to enter into force by April 2007. The reform contains elements that may foster efficiency in the health care sector, but the October 2006 draft law reckoned with only rather small budgetary relief (less than 0.1% of GDP annually compared with the baseline). The main expenditure measure has been a change in the price regulation for pharmacies, which has now been abandoned in the political process. From 2009 on, the draft law foresees a change in the financing of the health care insurers by introducing a "health care pool" (*Gesundheitsfonds*), with a centrally administered rate but some limited leeway for insurers to make refunds to their customers. Whether this model will yield significant efficiency gains through increased competition (e.g. in savings on administration) is an open question (see Section 6 below). In broad terms,

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

expenditure in the health care system has been increasing considerably above the rate of nominal GDP growth over the last decade despite repeated reforms, the last in 2004.[27] Moreover, the increase in the VAT rate will burden expenditure for medication.

Over the recent past, public sector wages have stagnated and public employment decreased. However, the public sector wage agreement[28] in force will end in 2007 for the federal and local level (and for the state level it foresees a pay rise in 2008). For the total economy, the update projects moderate wage growth over the full programme period. This might also apply to the public sector beyond 2008, if, in economic good times, the unions were to refrain from aiming at being compensated for the past wage restraint. The remaining components of public consumption might be more or less assumed to grow in line with nominal GDP. Thus, overall, some reduction in the share of public consumption in GDP is not implausible, but the update's projection that it would add up to a full percentage point between 2006 and 2010 might be optimistic in the absence of further measures, especially in the health care sector.

The remaining expenditure categories detailed in the update are less contentious. The projected development on public investment seems plausible, given that at least in the early years of the programme period, many local governments (as the main driver of public investment) are still under tight budgets. The slight decline in the share of other expenditure (residual) is, at least for the initial years of the programme period, due to the consolidation effect of some adopted measures (in particular the abolition of the subsidy on owner-occupied housing construction) increasing over time. On the other hand, debt servicing costs could rise if the ECB reference rate was raised (assumed constant at the November 2006 level by the update).

The implementation risks on the expenditure side in the outer years of the programme are evidenced by the experience from past vintages of stability programmes. Such an analysis 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[29]).

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[27] 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.

[28] See footnote 21.

[29] 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,

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.

Can the current mechanism of expenditure control help? Germany operates a non-binding agreement between levels of government on nominal expenditure growth through the fiscal planning council (*Finanzplanungsrat,* FPLR), a coordination meeting between levels of government.[30] The agreement was established to implement the targets set in the stability programme at sublevels of government, but it is neither detailed as regards data requirements for monitoring, nor are progress reports published. Table 10 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 paid between government levels are subtracted from expenditure because intra-governmental transfers are not relevant from the SGP perspective on general government.

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. The *Länder* outperformed 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 0.7% and the *Länder* to 1.8%. At the time of writing, the results have not yet been published. However, on the basis of the Commission services' autumn 2006 forecast, expenditure growth of general government at 0.8% in 2006 would be consistent with the implicit target for general government over 2005 and 2006. Due to the reorganisation of transfers for social assistance between the federal level and the local level, however, it is at this point not clear that the federal level would not have met the 2005-06 target and the *Länder* level would have outperformed its as in the previous two-year period. Indeed, an expenditure rule for sublevels of government faces difficulties in implementation if intra-governmental transfers change with expenditure obligations.[31] Overall, this expenditure agreement between levels of government is poorly defined and its implementation by the FPLR is intransparent, so that its usefulness for achieving its purpose, implementing the SGP at sublevels of government, is rather limited.

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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.

30 For a detailed description, see Box 4 in the Commission services' Technical Assessment of the February 2006 update of the stability programme.

31 For example, if the local level takes over an expenditure obligation from the federal level and receives a federal transfer for that, in Table 10 the federal level would reduce its expenditure while that of the local level would increase.

In its meeting of 29.6.2006, the FPLR agreed to limit nominal expenditure growth for the federal, state and local level – not clear whether the federal level would also include social security – to 1% on average in the years 2007 to 2010. This would indeed be consistent with the expenditure projection in the current update. Yet, also the FPLR is aware of the risks, stating that "to this end, significant measures have already been taken to limit expenditure, additional ones are necessary".[32]

On 16 December 2006, the *Bundesrat* decided to install a working group to elaborate proposals for the second stage of constitutional reform within this legislative period. The second stage should entail a revision of the fiscal relations between levels of government, which would possibly include the installation of a national stability pact.[33]

Table 10: 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.	63.1	2.2	-1.1	-0.5	0.5	1.3	(n.a.)	1
Länder + local	36.9	0.8	-0.2	1	0.3	0.2	(n.a.)	1
General govt.[2]	100	1.6	-0.8	(0.06)	0.44	0.9	(0.8)	(1)

Notes:
[1]Commission services' autumn 2006 forecast.
[2]The agreement does not contain a target for general government. Numbers in brackets are implicit.
Source: Federal Statistical Office, Commission services' calculations.
Federal Statistical Office, Commission services' calculations.

In sum, the budgetary projections seem plausible for 2006 and 2007. Beyond that, risk remains that measures necessary to underpin the envisaged restraint in social transfers are not adopted, also in view of past experience. Indeed, the update itself states that to achieve the MTO, further reforms were needed on the labour market and in the social security systems. In addition, a considerable budgetary risk arises from the planned company tax reform in 2008. It might become necessary to compensate possible shortfalls in company tax revenues with additional restraint in expenditure. Abstracting from that reform, the revenue projections for the outer years seem to exert a degree of caution. However, overall, negative risks to the budgetary adjustment remain, in particular from the political implementation of the adjustment path in the outer years.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding risk analysis, this assessment is done in two stages: first, a

[32] Bundesministerium der Finanzen, Pressemitteilung 79/2006, 29.6.2006. This was confirmed by the following meeting of the FPLR on 10.11.2006, Pressemitteilung 136/2006.

[33] See Chapter 5 in the Commission services' Technical Assessment of the February 2006 update of the stability programme.

preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 11: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Consistency with correction of excessive deficit by 2007 deadline	yes (from 2006)	yes (from 2006)
b. Safety margin against breaching 3% of GDP deficit limit[1]	from 2007 onwards	from 2007 onwards, but with some risk in 2008
c. Achievement of the MTO	not within programme period	not within programme period
d. Adjustment towards MTO in line with the Pact (after the correction of the excessive deficit)[2]?	should be strengthened (no adjustment in 2008)	should be strengthened

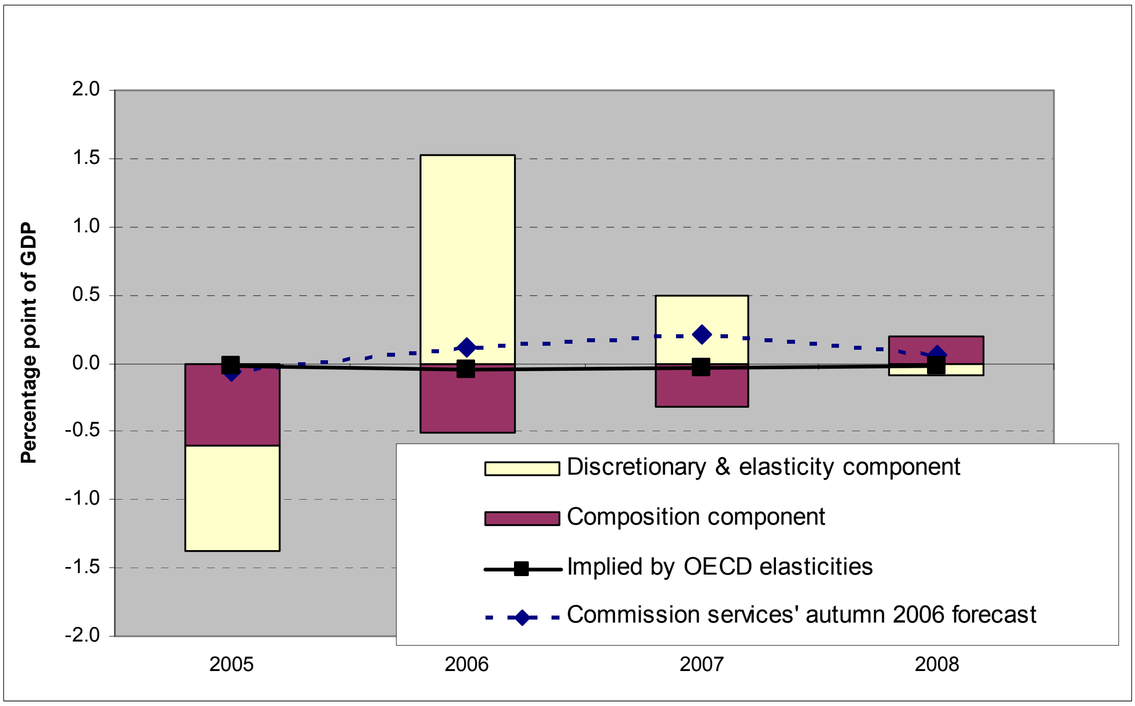
Notes:
[1]The absence of risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1 ½ % of GDP for Germany). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.
Source:
Commission services

Germany seems well on track to correct the excessive deficit one year earlier than the deadline set by the Council. On current projections, the structural adjustment of at least 1 percentage point of GDP in the years 2006 and 2007 requested by the Council will also be met.

The safety margin against breaching the 3%-of-GDP deficit limit would be reached by 2007, according to the programme. However, as detailed above, there might be a risk of violating the safety margin in 2008 in case the revenue shortfalls from the company tax reform prove higher than projected in the programme. Such shortfalls might be mitigated over time, so that it is possible that, with some of the envisaged expenditure restraint being realised, the safety margin would be restored within the programme period.

The medium-term objective (MTO) is not envisaged to be reached within the programme period. Given that the output gap is projected to be closing before the end of the programme period, and that the economy is in 'good times', the adjustment path towards it should be strengthened, especially in the year 2008. This remains particularly valid in view of the risk assessment. While a more revenue-rich growth composition than projected in the update might appear as additional structural adjustment (at face value), slack in the implementation of the envisaged expenditure restraint may result in a lower structural adjustment towards the end of the programme than that underlying the update's projection.

Figure 7: Changes in the tax-to-GDP ratio:
actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.[34] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

[34] On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

5.1. Recent debt developments and medium-term prospects

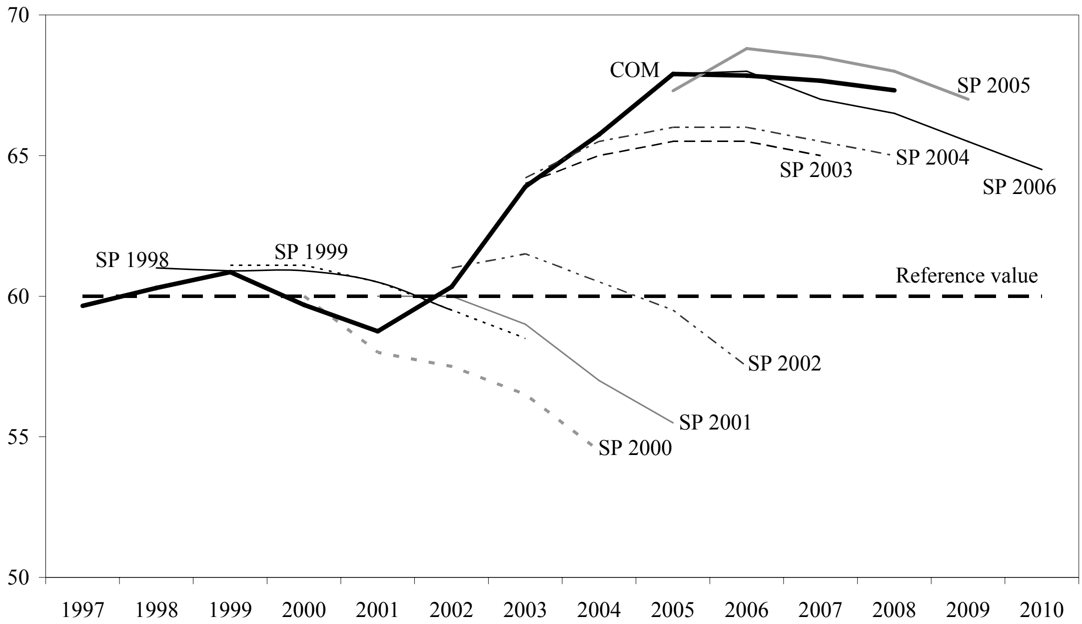
5.1.1. Debt projections in the programme

The programme estimates the government gross debt ratio to reach 68% of GDP at the end of 2006. This is almost the same ratio as in 2005 and 10 percentage points higher than five years earlier. The fast increase in the debt ratio since then can be mainly attributed to an unfavourable 'snow-ball' effect in connection with very low GDP growth rates, as well as to primary deficits, which did not aim at counterbalancing this, from 2002 to 2005.

The current update does not spell out any objective or strategy as regards public debt. From 2006 on, the update projects debt ratios about 1 percentage point lower than the previous update (Figure 9).[35]

Figure 8: Debt projections in successive stability programmes (% of GDP)

[35] Note that debt ratios from updates prior to the February 2006 update are not strictly comparable to the last two updates. This is mainly due to (i) the revision in the GDP series following the sectoral allocation of FISIM (financial intermediation services indirectly measured): If the old method of allocating FISIM were still applied, debt ratios projected in the last two updates would increase by about 1½ %. For example, in 2005 the debt ratio was lowered by one percentage point from applying the new method. See the Commission services' technical assessment of the February 2006 update for more detail; (ii) the revision in the debt series made by Eurostat following the September 2005 notification. Privatisations that involved the sale of assets to the *Kreditanstalt für Wiederaufbau* (KfW) are recorded as borrowing, pending the actual sale of shares on the market by KfW.



Source : Commission services' autumn 2006 forecast (COM) and successive stability programmes

Table 12: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009	2010
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio [1]	**65.7**	**67.9**	**67.8**	**68**	**67.7**	**67**	**67.3**	**66 1/2**	**65 1/2**	**64 1/2**
Change in the ratio	1.0	2.2	-0.1	0	-0.2	-1	-0.3	-1	-1	-1
Contributions [2] :										
Primary balance [3]	-0.4	0.5	-0.4	-0.7	-1.1	-1.2	-1.5	-1.3	-1.8	-2.3
"Snow-ball" effect [3]	1.9	1.8	0.7	0.9	1.1	1.1	1.2	1.1	1.1	1.2
Of which:										
Interest expenditure [3]	3.0	2.8	2.7	2.8	2.7	2.8	2.7	2.9	2.8	2.9
Growth effect (real GDP)	-0.7	-0.6	-1.6	-1.5	-0.8	-0.9	-1.3	-1.1	-1.1	-1.0
Inflation (GDP deflator)	-0.5	-0.4	-0.4	-0.4	-0.8	-0.8	-0.2	-0.7	-0.7	-0.7
Stock-flow adjustment	-0.4	-0.1	-0.4	-0.2	-0.2	-0.7	0.0	-0.6	-0.2	0.0
Of which:										
Cash/accruals diff.	0.0	0.0	-	n.a.	-	n.a.	-	n.a.	n.a.	n.a.
Acc. financial assets	-0.3	0.0	-	n.a.	-	n.a.	-	n.a.	n.a.	n.a.
Privatisation	-0.5	-0.2	-	n.a.	-	n.a.	-	n.a.	n.a.	n.a.
Val. effect & residual	-0.1	0.0	-	n.a.	-	n.a.	-	n.a.	n.a.	n.a.

Notes:

[1]End of period.

[2]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 (in the table, the latter is

[3]Data on the primary balance in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable w

Source :

Stability programme update (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

Table 12 shows that the progressive increase in the primary surplus contributes to the reduction in the debt ratio from 2006 on. From 2007 on (and thus earlier than projected in the previous update), the budgetary consolidation would over-compensate the "snow-ball" effect. This is the automatic increase in the debt-to-GDP ratio because of interest rates above the nominal GDP growth rate.

Throughout the programme period, the update assumes the "stock-flow adjustment" (SFA) to contribute considerably to debt reduction. This is in particular related to sales of financial 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. Forecasting these transactions is fraught with uncertainty because of the decentralised asset holdings and the KfW's sale of assets according to market conditions. Moreover, since budgetary processes in Germany are cast in cash accounting, financial transactions are often adjusted throughout the year to balance the budgets according to the constitutional golden rules (Article 115 of the German Constitution and respective *Länder* constitutions, stating roughly that net borrowing should not exceed gross investment in cash terms).

Comparing the current with the previous update, the amount of negative stock-flow adjustments (i.e. debt-reducing) planned over the period 2005-2009 has been reduced. In the previous update, it amounted to 2.8% of GDP for this period, while in the current update one percentage point less is projected. The updates do not provide specific details on the evolution of the stock-flow adjustment.

5.1.2. Assessment

The Commission services project the debt ratio to fall over the coming years at a slower pace than in the programme, although the projections for the primary surplus and GDP growth are rather similar. The Commission services took a cautious stance and considered a debt-reducing stock-flow adjustment in 2007 only from some expected asset sales by the KfW (and some other financial transactions between 2006 and 2007). For 2008, the Commission services did consider any sale of financial assets (the stock-flow adjustment was set to zero), since not sufficient detail is known.

In contrast, the update seems to consider debt-reducing stock-flow adjustments until 2009, which are, however, not detailed in the update. According to the Statistical Office, the KfW held shares of Deutsche Telekom AG and Deutsche Post AG on behalf of the federal government (so-called *Platzhaltergeschäfte*) worth € 16.9 bn (0.75% of GDP) at the end of 2005.[36] About € 4 bn (0.2% of GDP) were sold in 2006.[37] In addition, the federal government still holds a significant share of Deutsche Telekom AG. Thus, to back its SFA projection at nearly 2% of GDP in 2005-2010, the update seems to take into account further proceeds. These might come from the planned partial privatisation of Deutsche Bahn (although the legal terms of reference for privatisation are not yet fully specified) and securitisation proceeds from the transfer of a government special fund (*ERP-Sondervermögen*) into the federal budget.

On 31.1.2007, the government decided to reorganise the *ERP-Sondervermögen*, which used to be a special fund in general government (but outside the federal budget).[38]

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36 Statistisches Bundesamt, Fachserie 14, Reihe 5.

37 Information from www.kfw.de.

38 ERP: European Recovery Program. This fund originates from the reconstruction programme funded by the US after World War II. It is administered by the federal government and used for subsidised loans to SMEs and development aid projects. See Deutsche Bundesbank, Monthly Report, November 2006.

Outstanding debt and corresponding outstanding loans of about € 14 bn are transferred into the federal budget. This transfer itself has no impact on general government accounts. However, in connection with this transfer, the federal government plans to securitise (part of) the loans granted by the *ERP-Sondervermögen*, in order to meet the golden rule obligation (Article 115 of the Constitution) up to 2010.[39] Such cash receipts do not affect the government deficit in ESA95 terms (as opposed to the cash based accounting used in national budgetary processes), as they correspond to a financial transaction. However, such a securitisation might have an impact on government debt. According to ESA95, a securitisation would be recorded as sale of assets and contribute to reduce debt only if the risk of the asset underlying the securitisation is borne by the acquirer. Details of the securitisation are not yet known.[40]

Box 4 illustrates that – despite the substantial debt-reducing stock-flow adjustments over the programme period – the debt path as projected in the update would meet the debt reduction benchmark only by the end-year of the update. Taking the above-discussed risks on the deficit and the unspecified planned stock-flow adjustments into account, the debt ratio is not sufficiently diminishing over the programme period.

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.

Box 4: The rolling debt reduction benchmark

The German government debt ratio has been exceeding the 60% of GDP reference value in 1999 and then 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 2006 forecasts until 2008 (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" (*). 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 2007 is compared with the value obtained for the same year by applying the formula starting in 2002. 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 less than implied by the five-year rolling debt reduction benchmark, except for the final year of the programme.

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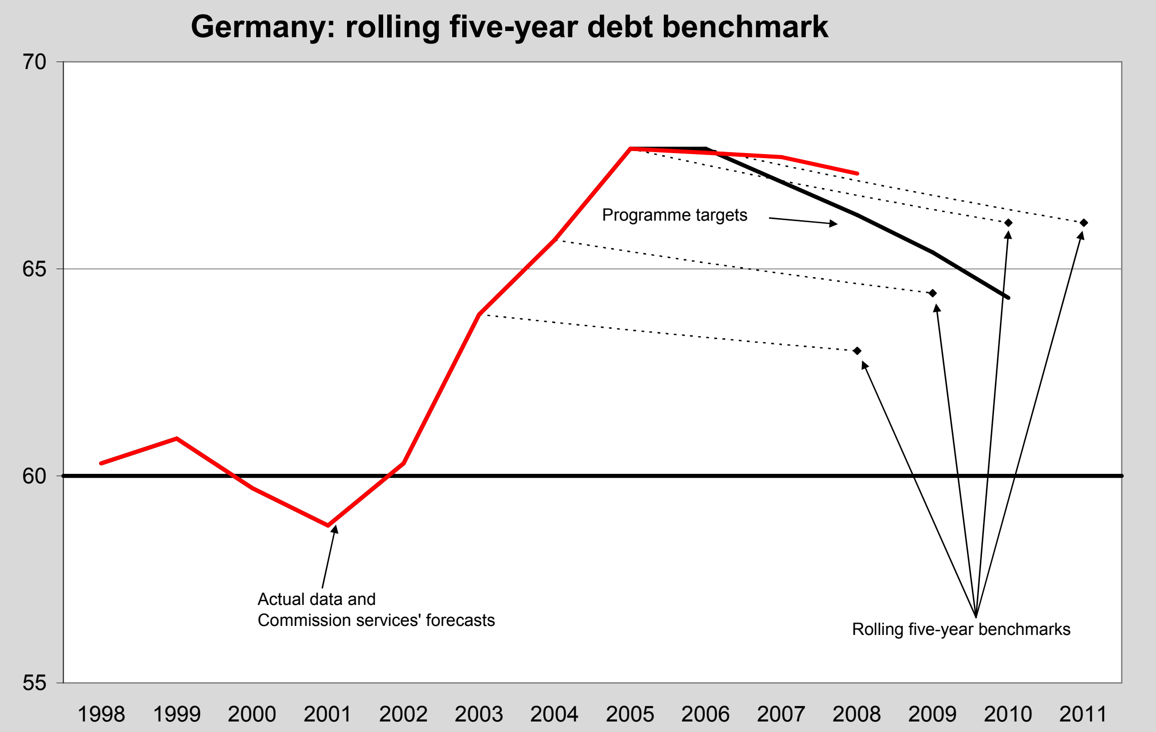
39 See also "Antwort des Parlamentarischen Staatssekretärs Karl Diller vom 30. November 2006", Bundestags-Drucksache 16/3710.

40 In the years to follow, however, one would observe the counter-effect: the debt-increasing effect of loans granted would no longer be countered by loan repayments, since the latter were already anticipated. In as far as loans repayments are used by the ERP-fund to finance loans granted, the securitisation would, if its proceeds were used for other purposes, ceteris paribus reduce the scope for future loans.



Source : Stability programme and Commission services

(*) The rolling debt reduction benchmark for successive five-year periods is defined as a reduction in the difference between the debt ratio and the 60% of GDP reference value of 5 percent per year:
$\left(\frac{D_t}{Y_t}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$, where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively. In the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio. Given the usual approximation of the change in the debt ratio $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \frac{y_t}{1+y_t} \times \frac{D_{t-1}}{Y_{t-1}} \cong \frac{DEF_t}{Y_t} - y_t \times \frac{D_{t-1}}{Y_{t-1}}$ and assuming that the stock-flow adjustment is zero, it is easy to show that 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%. In other words, the 5 percent per year benchmark is the value that makes consistent a continuous respect of the 3% of GDP deficit threshold and an asymptotic respect of the 60% of GDP debt reference value.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[41]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

[41] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereafter: sustainability report).

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (See Box 5), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2010, the final year of the stability programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2010 provided in the stability programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2011. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 13 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections.[42] Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 13: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	changes
Total age-related spending	23.7	22.5	22.9	24.7	25.7	26.4	2.7
Pensions	11.4	10.5	11.0	12.3	12.8	13.1	1.7
Healthcare	6.0	6.3	6.7	6.9	7.1	7.2	1.2
Long-term care	1.0	1.0	1.2	1.4	1.6	2.0	1.0
Education	4.0	3.6	3.2	3.3	3.3	3.2	-0.9
Unemployment benefits	1.3	1.1	0.9	0.9	0.9	0.9	-0.4

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in Germany is slightly below the average of the EU; rising by 2.7 percentage points of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be relatively limited in Germany, rising by 1.7 percentage points due to large reforms enacted since the 1990s. The most recent reform (in 2004) includes the introduction of a 'sustainability factor'. It reflects changes in the ratio of pension contributors and pension recipients, which makes the pension system robust to changes in life expectancy, as pensions are automatically adjusted. The increase in health-care expenditure is projected to be 1.2% points of GDP, lower than on average in the EU. For long-term care, the projected increase of 1% point of GDP up to 2050, is above the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated

Table 1410: Sustainability indicators and the required primary balance

	2006 scenario	Programme scenario

[42] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (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)", European Economy, Special Report No 1, 2006.

	S1	S2	RPB	S1	S2	RPB
Value	2.2	3.3	4.3	0.7	1.8	4.2
of which:						
Initial budgetary position	0.4	0.4	-	-1.1	-1.1	-
Debt requirement in 2050	0.1	-	-	0.1	-	-
Future changes in budgetary position	1.7	2.8	-	1.7	2.8	-
Source: Commission services.						

Box 5 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **Initial Budgetary Position (IBP)**; and, (ii) **Long-Term Change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2011-2015) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, the S1 indicator is additionally decomposed into a third factor, the distance to a debt/GDP ratio of 60% of GDP in 2050 is an additional; the debt requirement in 2050 (DR).

Table 14 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 2.2% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 3.3% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are smaller in the present assessment, by about 1 p.p. of GDP. This is mainly due to a higher estimated structural primary balance in 2006 (at 0.8% of GDP compared with the structural primary balance in 2005 estimated in spring 2006 (at -0.3% of GDP) that was used in the Sustainability Report.

The initial budgetary position is not sufficiently high to offset the impact of the increase in age-related expenditure up to 2050 and there is a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. The programme plans an improvement of the structural balance of 1.4% points of GDP between 2006 and 2010. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances, reducing the S2 sustainability gap by about 1½% of GDP ("programme scenario"). The difference between the initial budgetary position in the 2006 scenario and the programme scenario illustrates how the full respect of the stability programme targets will contribute to tackling the budgetary challenges raised by the demographic developments. According to both sustainability gaps, the long-term budgetary impact of ageing is relatively limited in particular thanks to the pension reform measures enacted in recent years.

The required primary balance (RPB) is about 4¼% of GDP, higher than the structural primary balance of about 2¼% of GDP in the last year of the programme's period.

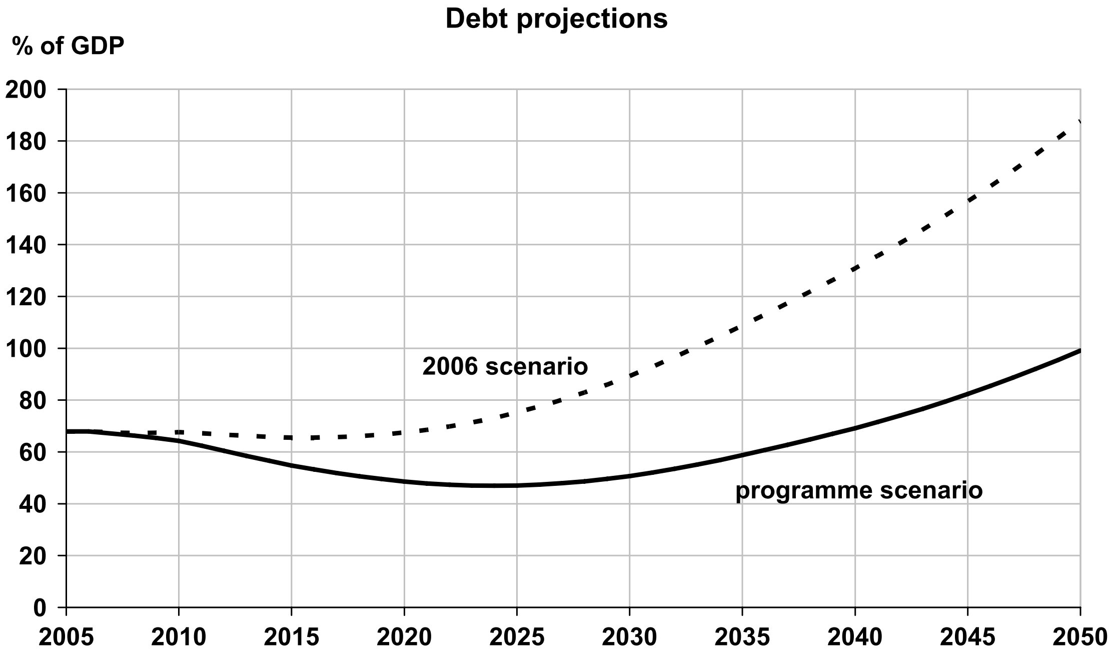
Moreover, the sustainability gap indicators would increase by up to ½% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 10.

The gross debt ratio is currently above the 60% of GDP reference value, estimated in the programme at close to 68% of GDP in 2006. According to the "2006 scenario", the debt ratio is projected to decrease slightly, though remaining above 60%, up to the mid-2010s and thereafter increase throughout the projections period up to 2050. In the "programme scenario", thanks to the stronger budgetary position in 2010, debt would fall below 60% of GDP in the mid-2010s and remain so up to the mid-2030s, when it would be on an upward path and rise above 60%.[43]

[43] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

Figure 10: Long-term projections for the government debt ratio



Source: Commission's services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, the long-term budgetary projections in the programme are the same as those of the EPC and are based on the underlying assumptions commonly agreed and used by the EPC. Yet, the projection for long-term care is not the Ageing Working Group reference scenario.[44] Instead, the German programme includes a scenario which assumes that expenditure on long-term care remains constant as a share of GDP from the current level up to 2050, while the Ageing Working Group reference scenario predicts an increase by 1% point of GDP.[45] Therefore, the long-term projections in the programme may somewhat underestimate the impact of demographic developments on public finances.

Second, Germany's current level of debt is higher than 60% of GDP. After this ratio has been increasing for a number of years, it came to a halt in 2006. A reduction of debt to below the 60% of GDP reference value at a satisfactory pace would strengthen the

44 See the Ageing report (2006).

45 The German authorities consider that the projected increase in expenditure on long-term care in the AWG reference scenario does not reflect current legislation in Germany, where long-term care benefits (i.e. benefits paid out by the public insurance scheme for people receiving formal care at home, care in institutions or cash benefits) are fixed by law without any indexation. A scenario in which long-term care expenditure remains constant as a share of GDP would come closer to the current legislative setting, and would mean that the increase in age-related expenditure would be lower, by 1% point of GDP. However, if the unit costs of supplying long-term care increase more than the general price level of the economy, as is assumed in the Ageing Report in the reference scenario, this could lead to an increasing gap between the needs and provisions of public long-term care.

resilience of the public finances to adverse shocks and to reduce the risks to public finance sustainability.

Third, the benefit ratio (i.e. average pension relative to GDP per worker) in Germany is projected to decrease relatively markedly, by around 20%, in the period to 2050. Employment rates of older workers in Germany (39%) are currently close to the EU average (40%) but are projected to increase by more than on average in the EU. A greater increase in the employment rate of older workers than assumed in the projections would mean that the benefit ratio would decrease less markedly, since it would foster GDP growth and ensure that workers can accumulate more pension rights. A successful implementation of the measures outlined in the programme aimed at increasing employment notably of older workers, including the planned reform to increase the retirement age from 65 to 67, would contribute to more sustainable public finances. Furthermore, the programme highlights that the German authorities promote private pension arrangements to supplement the public pension provision. Indeed, the increase in recent years of contributions to private pension schemes (occupational and individual) in Germany may partly compensate for the projected decrease in the public benefit ratio.

Fourth, the programme projects that pension contributions will rise by 1.6% points of GDP between 2010 and 2050. Such an increase, which was not considered when calculating the sustainability gaps S1 and S2, would fill part of the gap that would emerge in that period between pension expenditure and contributions. Nevertheless, a sustainability gap would remain[46].

5.2.3. Assessment

The long-term budgetary impact of ageing in Germany is close to the EU average, though with pension expenditure showing a somewhat more limited increase than in many other countries, as a result of the pension reforms already enacted. A draft law has been adopted to raise the statutory retirement age in steps to 67 years, from 2012 onwards. Although exemptions to the higher age limit are being granted to a considerable extent, the move will enhance the long-term sustainability of public finances.

The initial budgetary position with a structural deficit in 2006, albeit improved compared with last year, constitutes a risk to sustainable public finances even before the long-term budgetary impact of ageing populations is considered. Moreover, the current level of gross debt is above the Treaty reference value. Consolidating the public finances would contribute to reduce risks to the sustainability of public finances.

Overall, Germany appears to be at medium risk with regard to the sustainability of public finances.

[46] The issue of how to take into account projected changes in the revenue ratio is discussed further in Section IV.3.2 of the Sustainability Report. Changes in contribution rates are not considered to be a risk-reducing factor.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

Germany has undertaken a plethora of reforms in the past years, on the labour market, on social security, on health care and on the pension system. Yet, the update states that to achieve the medium-term objective, further reforms would be needed on the labour market and in the social security systems.

In this chapter, three reform projects that are mentioned in the update are discussed: (i) the company tax reform planned for 2008, (ii) the health care reform 2007, and (iii) the stepwise increase in the statutory retirement age from 65 to 67 as from 2012. All of these reforms have not yet entered into force.

The company tax reform

Four issues are prominent in the discussion on the German corporate tax system: (1) Companies with production facilities in several countries can avoid tax by shifting profits between jurisdictions by, for example optimising the prices for goods and services sold within one group ("transfer-pricing") or by shifting debt between companies of a same group. Huizinga and Laeven (2007)[47] have found that profit shifting activities in Europe are sizeable and mostly at the expense of Germany. They calculate that up to a third of the German corporate tax base is shifted abroad, representing a loss in tax collected of almost € 3 billion. (2) Companies may relocate production facilities to countries with a lower tax burden. In general, econometric evidence seems to support this, but the magnitude of the effect varies across studies.[48] (3) The current system allows the tax deductibility of interest and royalties payments from the corporate tax base but not of equity (whether distributed or retained). While this system is applied in most European countries, it leads the corporate management to preferring debt-financed investment over investment financed by retained earnings or over distributing profits to shareholders. This may have effects on corporate governance and the allocation of capital in the economy. (4) The tax system is an important influence in the choice of the legal form for a company in Germany. Since the legal form of a company implies different means of exercising corporate control, this issue is related to the financing neutrality.

In the current system, the tax burden at the level of the corporation is composed of: 25% corporate income tax on both distributed and retained profits, the solidarity surcharge of 5.5% (earmarked for transfers to Eastern Germany) and the local trade tax (the *Gewerbesteuer*, that varies with location, its base is close to profits and it is deductible from the corporate income tax), at an average rate at 16.18% in 2006. This adds up to the total statutory tax rate at over 38%, the highest in the EU-25.

On 3 November 2006, a working group led by Finance Minister Peer Steinbrück and the Prime Minister of Hesse Roland Koch published key elements of a corporate tax reform (see Box 5) and a table on the fiscal impact. A draft law was published in February 2007, which is scheduled to be adopted by the government in March 2007. The reform is envisaged to enter into force in 2008. The November/February proposal consists in

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[47] Huizinga, H. and Laeven, L. (2007), International Profit Shifting Between European Multinationals. CEPR Discussion Paper 6048. See Table 10.

[48] Nicodème, G. (2006): Corporate Tax Competition and Coordination in the European Union: What Do We Know? Where Do We Stand?, DG ECFIN Economic Papers 250.

introducing a dual income tax, whereby capital income is taxed at different rates than personal income.

BOX 5: The proposed corporate tax reform

Germany collects relatively little corporate income tax revenue (in 2004, the total taxes on incomes from corporations represented 2.2% of GDP, compared with an EU-25 non-weighted average of 3.0%). At present, only about one fifth of all companies are liable to corporate tax (of which over 90% are limited companies, i.e. *GmbH*, the remainder is publicly listed). All other companies, i.e. partnerships (*Personenunternehmen*), fall under personal income tax.

Since 2001, Germany has partially moved to classical double-taxation system of income. Corporate profits are taxed at the level of the corporation with the corporate tax rate (*Körperschaftsteuer*) and with the local trade tax (*Gewerbesteuer*), which is credited against the corporate tax liability. In contrast to the pre-2001 system, the owners of the companies cannot deduct the corporate taxes from their personal income tax. To mitigate this double-taxation, only half of the dividend received is taxed in the hands of individual shareholders (so-called 'half-income system'). Capital gains are taxed only if the asset is held for more than a year or if the stake in the company exceeds 1%. Profits distributed between corporations (both resident and non-resident) are exempt at 95%, and capital gains between corporations are tax-free.

The proposed measures are:

- The corporate tax rate (*Körperschaftsteuer*, KSt) would be lowered from 25% to 15%.
- The local trade tax (*Gewerbesteuer*, GewSt) will be lowered, too. The average GewSt rate currently amounts to roughly 16½%, but is then deducted from the KSt. The proposal foresees the lowering of the rate but would abolish the deductability of the GewSt from the KSt.
- The total impact of these two reforms would be to decrease the statutory corporate tax rate from over 38% to about 29%.
- Moreover, the tax base for the local trade tax (GewSt) would be changed. Currently, it is similar to the KSt base with the exception that only 50% of long-term interest paid can be deducted. The KSt allows a full deduction of interest. It is now proposed that 75% of all interest can be deducted from the GewSt. In turn, also rents, leasing rates and licences enter the local tax base to some extent.
- Companies with very large interest expenditure would able to deduct interest expenditure only up to 30% of gross profits. This "interest barrier" (*Zinsschranke*) applies only for interest expenditure exceeding € 1 bn. This aims at reducing international profit-shifting for very large corporations. According to the proposal, only about "a few hundred" companies would be concerned. In turn, the existing thin capitalization rules to limit profit-shifting through loans between subsidiaries (*Gesellschafterfremdfinanzierung*) would be abolished. Furthermore, the cornerstones contain several other measures to reduce tax-shifting to other jurisdictions by debt shifting between subsidiaries of a corporation.
- Partnerships (*Personenunternehmen*) would be able to credit the GewSt to their personal income tax at a higher rate than currently. They also receive a tax reduction for retained earnings.
- The accelerated depreciation allowance will be lowered. Before 2001, it amounted to 30% of the residual value of the investment, from 2001-2005 it amounted to 20%, in 2006/7 it amounted again to 30%, and is proposed to be lowered from 2008 on to 20% again.
- The reform also considers the introduction of a withholding tax (*Abgeltungssteuer*) at the personal level as from 2009. At present, interest received from savings and half of dividends received are taxed under the personal income tax system. Capital gains are tax-free, provided the asset is held for over a year and the ownership in a corporation does not exceed 1%. In the new system, the withholding tax would now tax fully dividends, savings and realised capital gains at a rate of 25%. The details are not fully worked out, so, for example, it is unclear at present whether capital losses would become tax-deductible or whether the capital gains tax would apply for corporate cross-holdings too. In the current system, capital gains are (rightly) not taxed between corporations.

The stability programme envisages that the revenue loss arising from the new tax amounts to € 5 bn per annum after the measures have taken full effect. By comparison, Germany raised in 2005 an amount of € 16.3 bn on corporate taxes and an additional € 32.1 bn on the local trade tax (including the part levied on personal income revenues). The fiscal overview from the November proposal reveals the following. The reduction of the corporate tax rate (KSt) from 25% to 15% would burden the budget by € 11.6 bn annually (over 0.5% of GDP, but it is not clear what the reference scenario is). From the point of general government revenues, the changes in legislation on the local trade tax (GewSt) are projected by the proposal as budget-neutral. However, the changes are likely that they have an effect on the allocation of tax revenues across levels of government and on the choice of the legal form of the company. The tax credit for retained earnings in partnerships is estimated to burden the budget at about € 5 bn per annum (over 0.2% of GDP).

To finance these reform measures, the proposal lists the reduction in the depreciation allowance at € 3 bn per annum. This is, however, not really a new measure because the reversal of the increase in that allowance for 2006 and 2007 was already decided. Two measures to reduce international profit-shifting are estimated in the proposal to provide budgetary relief of € 3 bn. Finally, the proposal estimates a repatriation of national tax base ("Sicherung des nationalen Steuersubstrats") at € 3.6 bn (somewhat less than 0.2% of GDP).

In general, these figures should be regarded with caution. Profit-related taxes are already difficult to forecast in the absence of system change. In sum, however, the budgetary risk seems larger than € 5 bn (0.25% of GDP) as suggested in the proposal. Under the assumption that profit-shifting activities are almost fully abandoned upon implementation of the reform, the budgetary burden could amount to € 8.6 bn (0.4% of GDP) in the medium term[49], although revenues from the "repatriation of the national tax base" may, in the longer term, indeed be spurred by location decisions in favour of Germany.

The proposed reform would reduce the statutory tax rate at the level of the corporation to slightly below 30%. The statutory tax rate, coupled with the tax-deductibility of debt, is the main determinant for profit shifting across jurisdictions. The planned reduction in the tax rate is therefore a step in the right direction. Whether the other measures to limit profit-shifting will have indeed an impact is not easy to determine.

The statutory tax rate is only an imprecise proxy for comparing physical investment decisions across tax systems because of differences in the tax base, so for example the deductibility of interest expenditure or different depreciation rules. The Average Effective Tax Rate (EATR) measures the tax burden of a hypothetical investment over a range of returns from the view of the company (not from the shareholder). It is a broad indication of the average tax burden on investments. The economic literature shows that it is a determinant of location decisions. The reform seems to reduce the EATR so that

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[49] The proposal estimates € 3 bn + 3.6 bn = € 6.6 bn as reduction in profit-shifting plus, in the long-term, more favourable location decisions. Huizinga/Laeven estimate profit-shifting at € 3 bn. Hence, the proposal assumes that the reform fully abolishes the Huizinga/Laeven estimated effect. Thus, a medium-term risk of € 3.6 bn remains. This would add, at least initially, to the shortfall at € 5 bn as estimated in the proposal.

the reform has the potential to decrease the incentive for companies to move away from Germany.

The integration at the shareholder's level will also be affected by the changes from half-exemption system to the dual income tax system. Under the current system, the dividend is first taxed at the corporate income tax at the level of the company and half of it is then taxed at the shareholder's level. Under the proposal, dividends would be taxed at the full (lower) rate at the company level and then with the withholding tax at the level of the owner. Also from the perspective of the owner of the company, debt financing of investments would be preferred over financing from retained earnings or issuing new equity.

Health care reform

In Germany, two health care systems coexist. Wage earners with a monthly salary below a certain threshold are compulsory members of the public health care system, which is a pay-as-you-go system. Wage earners above this threshold, self-employed and civil servants (and Members of Parliament) are able to decide whether they want to join the public system or take insurance privately, which is organised as a fully-funded system. About 250 public health insurers exist, among which the insured can freely choose, and the insurer is obliged to conclude a contract without discrimination. To adjust for different risk and income profiles of their customers, a revenue and risk-adjustment scheme is in operation among the public insurers. Members of the public system receive full cost coverage and usually are free in their choice of service providers.

Germany has repeatedly implemented reforms to its public health care system, the last in 2004.[50] The 2004 health care reform focused primarily on the reduction in entitlements. The catalogue of refundable prescriptions was cut. An institute for quality control was set up. This institute does not provide a list of all admissible prescription drugs, but makes recommendations in certain cases. There were also elements of strengthening incentives, like the quarterly fee for visits to a doctor's cabinet and a higher lump sum amount for patients to bear on medication. However, according to a recent study, the quarterly fee had no effect on the number of visits.[51] Also, in the public system, unlike private insurance, patients do not receive medical bills but the doctor settles the bill directly with the public insurer. The insured enjoys full cost coverage and thus has no incentive to review the bill. The 2004 reform gave patients the right to ask for the bill and have it reimbursed by the insurer. However, only 0.04% of the patients are using this opportunity.[52]

On 25 October 2006, the government adopted a draft law for further reform, which after much public debate has been adopted (with changes) in the Bundestag on 2.2.2007, by the Bundesrat on 16.2.2007 and will enter into force by 1 April 2007 (*GKV-Wettbewerbsstärkungsgesetz*, GKV-WSG). Entitlements are not cut (but slightly

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[50] For a discussion, see Commission services: Technical Assessment of the December 2004 update of the stability programme of Germany.

[51] Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Discussion Papers 43, RWI Essen 2006. The RWI suspects that only the time-profile of visits to the doctor has changed and thus recommends a per-visit fee.

[52] Frankfurter Allgemeine Zeitung, 4.8.2006

extended).The initial draft law expected the main budgetary savings from a change in price system for medication. The current system of fixed prices for medication (*Festbetragsregelung*) was to be changed to a maximum price system (*Höchstpreise*). Currently, the association of public health insurers determines the price, which the public insurance is prepared to reimburse for groups of comparable medication, so that the difference that remains to the pharmacy retail price is borne by the patient. The draft law expected that with maximum prices, pharmacies or pharmaceutical companies would offer discounts on medication and reduce their margin to the benefit of the patient. The maximum price regulation was dropped from the law that was finally adopted. Moreover, the retail market for medication (pharmacies) is still far from being liberalised. However, by court order in January 2007, the first retail shop of the mail-order pharmacy "DocMorris" in Saarbrücken could be reopened (after lower court instances had ordered to close it down) and around the same time, a pharmacy using "DocMorris" in a franchise manner was opened in Saarland. It is further envisaged to introduce a cost-benefit analysis for new medication, which is, however, not compulsory for the admission of medication.

The fee structure for ambulatory services is to be changed from 1 January 2009. Currently, doctors' fees are determined according to individual services, but only ex post. After each ambulatory treatment, doctors send the list of services provided to the insurers. At the end of the quarter, the total budget for ambulatory services is determined, which is not allowed to rise above the growth rate of gross wages. After the total budget is such determined, individual fees are settled with each doctor according to his number of services provided. In this system, each doctor causes an externality to other doctors: With each additional treatment, the fee for the other doctors is reduced. This current practice is to be replaced by a system, in which doctors' fees are preset according to illness treated (and not by the individual services provided). It is not clear whether this measure would have an expenditure-reducing or –increasing effect.

As from 1 April 2007, individual health insurers will be granted the opportunity to negotiate individual contracts with providers of ambulatory services, which can deviate from the fee structure mentioned above, i.e. the usual collective agreements between the federation of public health insurers and the federation of doctors. In junction with the option for groups of doctors to form ambulatory medical centres, which was introduced by the 2004 reform, this may intensify competition between health service providers. Moreover, the 2007 reform opens up the possibility for public insurers to offer insurance contracts with deductible or reduced choice of service providers to compulsory insured persons. The law foresees that such contracts must not be cross-subsidised from standard contracts with full coverage. This could indeed provide some incentives for the insured not to overuse medical treatment.

The main element of the health reform is, however, on the revenue side. As from 2009, a "health care pool" (*Gesundheitsfonds*) is to be created. The basic idea of the pool was developed in Richter (2005)[53] and propagated by the Economic Advisers to the Finance Ministry in 2005 in a short statement. This basic idea is as follows.

Currently, contributions to the health care system are levied upon gross wage income (at a rate of about 14.2% on average in 2005) by each of the 250 health insurers

[53] Richter, W.: "Gesundheitsprämie oder Bürgerversicherung? Ein Kompromissvorschlag", in: *Wirtschaftsdienst*, 85(11), pp. 693.

autonomously. The reform envisages that one uniform contribution rate is levied on gross wage income as before but accrues to a separate budget. From this budget, each insurer would receive the same amount per insured person. From the perspective of each insurer, this would be a de facto move to a lump-sum fee per head. With a pre-defined catalogue of eligible services, insurers would no longer compete with differences in the contribution rate but with reimbursements or top-ups on the per-head fee received from the pool. If these reimbursements or top-ups are uniform for each insured[54] and would not depend on the individual wage income, they would constitute a lump-sum fee element also from the perspective of the insured. The proponents of the pool-model argue that this would foster competition between insurers because a lump-sum transfer at the end of the month is more transparent that the difference in contribution rate, when contributions are deducted automatically from the wage bill. Moreover, the lump-sum nature would provide more incentives to low-income (and price-sensitive) households to change insurer than a percentage difference in the contribution rate on their low wage income. Richter further suggested that, in a second step, to move the pool into the general tax system.

The law of the health care reform only considers the first step. Moreover, it altered the initial idea in several ways. The possible top-up fee is to be capped at 1% of the wage income of each insured. If the top-up fee remains below € 8, it can be raised without checking for each insured whether the cap is respected or not. Such capping would not render the idea of competition totally ineffective. If the contribution rate was high enough, insurers would not compete by trying to minimise the top-up but by offering the largest rebate (because of the above argument on price-sensitivity) provided the rebates are per head and do not depend on wage income. The 2007 reform law foresees that in the initial year of the pool, the contribution rate should be set in such a way that 100% of expenditure is covered. In the subsequent years, at least 95% of the expenditures should be covered. Contrary to the intentions of the February 2006 update of the stability programme, which foresaw the gradual reduction of the contribution from the federal budget to the public health insurance, the contribution will now be gradually increased. It amounted to € 4.2 bn (0.2% of GDP) in 2006, for 2007 and 2008 it will amount to € 2.5 bn and it then augmented by € 1.5 bn annually up to a total of € 14 bn. Since the federal contribution from the general tax system will flow into the funding pool, it will tend to reduce the pressure on wage-related contributions to rise.

From several *Länder* it has been objected that the reform would constitute a complete equalisation of financial capacity across insurers. This is true by construction. In the current system, financial capacity is fully equalised only for compulsory expenditure, not for administrative cost and additional medical treatment offered by the individual insurer. Compulsory expenditure amounted to 92% of all expenditure in 2005.[55] Full equalisation would indeed be necessary for competition, as insurers have concentrated their business often locally for historical reasons and thus benefit (or not) from local employment and wage differences. In this regard, the 2007 reform simplifies mergers between public insurers. A further objection often made is that the pool would lead to an increase in

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[54] It is not envisaged to differentiate these payments according to individual characteristics, e.g. health risks.

[55] Rürup, B. and Wille, E. (2007): "Finanzielle Effekte des vorgesehenen Gesundheitsfonds auf die Bundesländer, Gutachten im Auftrag des Bundesministeriums für Gesundheit", 3.1.2007, www.bmg.bund.de

bureaucracy. As it stands, the reform might not cause so much additional bureaucracy. Individual contributions continue to be raised by the insurers on the already used contribution base. The only additional element would be the transfer to the pool and the reception of the lump-sum per insured. The introduction of the cap on the top-up might cause further bureaucracy.

Thus the main (if not only) advantage of the pool against the current system is the hoped-for increase in competition among insurers. The question is whether this would lead to a significant reduction in overhead costs. In a comment, the RWI Essen estimates that net savings of 10% in the cost of administration would reduce the contribution rate by 0.08 percentage points.[56]

The October draft law estimated that the health care reform would lead to expenditure savings of € 1.4 bn as of 1.4.2007 when the law is envisaged to enter into force and subsequently of € 1.8 bn annually (compared with the baseline). Since the main expenditure measure, the change in the price regulation described above, has been abandoned, immediate expenditure savings are not to be expected from the law. However, in the medium-term, a higher degree of freedom in contracting between insurers and providers, and also between insurers and customers, might indeed lead to some efficiency gains through competition. While social contributions after the introduction of the funding pool remain primarily related to wage income, the introduction of per-head reimbursements leaves open the possibility of moving to wage-independent contributions at a later stage by reducing the centrally-set contribution rate (and hence increasing the share funded by the per-head contributions).

The draft law does not touch on the choice of high-income earners (and civil servants) to join the alternative private insurance system. Although opting-out from the public system is to be made somewhat more difficult, it is made easier to opt back in. In the initial October draft law, competition among private insurers in the fully-funded private system was to be strengthened by provisions facilitating the portability of retentions for old-age (*Altersrückstellungen*) when switching to another private insurer. Currently, the insured loses his/her retentions upon switching insurers. The law limits such competition with portable retentions to a period of six months after 1 January 2009.

Statutory retirement age

In December 2006, the government adopted a draft law to increase the statutory retirement age from 65 years to 67 years stepwise between 2012 and 2029. The draft law is expected to be finally adopted in March 2007. Under current law, early retirement is possible after 35 years of contributions at the age of 63 at a discount (3.6% per year relative to the age of 65). The draft law foresees that early retirement would remain possible at 63, while the annual discount would now refer to the age of 67. In addition, persons who contributed to the pension system for 45 years would still be entitled to retire at 65 without having to accept a discount at that age.

The reduction in the pension value through the increase of the retirement age is not fully equivalent to the discount that a pensioner would face if he/she retired early at 65 instead of 67. The reason is that the reform would dampen the effect of the demographic factor, which adjusts pensions payments to changes in the dependency ratio.

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[56] RWI-News 4/2006, available at www.rwi-essen.de

In 2007, the contribution rate to the pension system is at 19.9% of wage income. With the increase in the statutory retirement age, the government aims at a contribution rate of 21.9% by 2030.[57] The Advisory Council on Pension Affairs (*Sozialbeirat*) estimates that the increase in the retirement age could dampen the increase in the contribution rate until 2030 by 0.5 percentage points.[58] However, if the exception clause for long-time contributors were not implemented, the *Sozialbeirat* estimates that the increase in the contribution rate could be dampened further by 0.2 percentage points.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The update of the stability programme makes reference to the National Reform Programme (NRP) only in passing, stating that "in its 2006 Implementation and Progress Report on the National Reform Programme 2005-2008, the federal government reported on important reform measures which have been initiated or passed into law since the National Reform Programme was presented". The update further lists some measures that are consistent with the implementation report on the NRP, for example the company tax reform and the health care reform (see chapter 6 above) and also touches on the long-term sustainability of public finances (see section 5.2 above). However, neither the update nor the NRP implementation report provide systematic information on the direct budgetary impact associated with the main reforms envisaged in the NRP. The only exception is the company tax reform, for which at least the annual impact (possibly after the phasing-in period), but no timeline, is provided. The update does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium-term fiscal strategy, either.

Both programmes envisage, as the second stage of the reform of the federal system, a review of the fiscal relations between levels of government in order to strengthen the accountability of each level. In addition, the stability programme recognises in this context the necessity to develop an institutional framework that would ensure budgetary discipline at all levels of government and allow for measures to be taken early against emerging budgetary crises.[59]

Box 6: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of Germany, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 18 October 2006.

[57] Entwurf eines Gesetzes zur Anpassung der Regelaltersgrenze an die demografische Entwicklung und zur Stärkung der Finanzierungsgrundlagen der gesetzlichen Rentenversicherung (RV-Altersgrenzenanpassungsgesetz), Bundestags-Drucksache 16/3794, 12.12.2006

[58] Gutachten des Sozialbeirats zum Rentenversicherungsbericht 2006, 30 November 2006, www.sozialbeirat.de

[59] For a discussion, see Commission services: Technical Assessment of the February 2006 update of the stability programme, chapter 5.

The Commission's assessment of this report, which was adopted on 13 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The 2005-2008 National Reform Programme (NRP) identified 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 reform of the labour market. In its 2006 Annual Progress Report (APR) the Commission pointed out that a stronger response was needed regarding competition in services, integration of less qualified workers, and an increase in childcare facilities.

Overall, Germany is making some good progress in implementing its NRP, especially in the macro- and micro-economic fields. Progress is particularly strong in improving the business environment, where various better regulation measures have been implemented. On the key challenge of employment policies, implementation has moved ahead, but further work remains to be done on tackling high structural unemployment.

Raising the statutory retirement age in steps to 67 years will be a move to long-term sustainability. The NRP foresaw a financial reform and higher efficiency in service provision through more competition in the health care system. Some of the envisaged measures indeed aim at improving efficiency and fostering competition, but further clarification is needed to assess how the proposed "health care pool" (Gesundheitsfonds) would meet these objectives. Measures to adapt the statutory long-term care insurance to demographic changes by introducing elements of a funded scheme, announced in the NRP for summer 2006, are announced for the course of 2007. It is too early, especially as regards the health care system, to assess whether the measures will be sufficient both to ensure long-term fiscal sustainability and to reduce non-wage labour costs. Also, without further measures, progress towards achieving the medium-term objective of a balanced budget is likely to be slow.

There has been good progress on R&D and innovation policies. The federal regulatory office for network services has been given additional powers to address remaining problems such as the high market concentration, lack of transparency and vertical foreclosure in the energy markets. Germany has taken steps to relax the rules governing lawyers and architects, but significant restrictions remain in these and other heavily regulated professional services, as well as in the crafts sector. Given the high level of unemployment among the low-skilled, the report announces more qualification measures for this target group and a review of the tax and benefit system. Major difficulties remain with respect to the effectiveness of the employment services.

The policy areas in the German National Reform Programme where weaknesses need to be tackled with the highest priority are: improving the long-term sustainability of public finances; improving competition, notably in professional services and new broadband markets; and tackling structural unemployment. Against this background, it is recommended that Germany (i) improve long-term sustainability of public finances by continuing fiscal consolidation, leading to debt reduction, and by implementing the health care reform with a view to keeping expenditure growth in check and strengthening efficiency in the health sector; (ii) improve competition in product and services markets, notably by continuing to relax restrictive rules governing many liberal professions and effectively regulating wholesale bitstream access; (iii) tackle structural unemployment including by integrating the low-skilled into the labour market through better access to qualifications, pursuing the proposed tax-benefit reform and by providing more effective employment services for the long-term and young unemployed.

In addition, it will be important for Germany over the period of the National Reform Programme to focus on: ensuring that health care reform makes the health system more efficient; improving public procurement procedures; removing barriers to competition in the rail sector and in gas and electricity networks, where unbundling has been ineffective; speeding up business start-ups and facilitating hiring the first employee; building on existing measures to improve lifelong learning, including by developing adults' vocational training into a fourth pillar of the educational system; increasing the provision of childcare facilities.

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, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the stability programme is broadly consistent with the broad economic policy guidelines.

Table 15: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	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				
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 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 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.

Source:
Commission services

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Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific 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, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a “safety margin” that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics*.

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g		0,9	2,3	1,4	1 ¾	1 ¾	1 ¾
2. Nominal GDP	B1*g		1,5	2,9	2,6	2 ½	2 ½	2 ½
Components of real GDP								
3. Private consumption expenditure	P.3		0,1	0,8	0,3	1	1	1
4. Government consumption expenditure	P.3		0,6	1,2	0,2	½	½	½
5. Gross fixed capital formation	P.51		0,8	5,2	3,4	3 ½	3 ½	3 ½
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		0,2	0,3	-0,3	0	0	0
7. Exports of goods and services	P.6		6,9	10,0	6,7	4	4	4
8. Imports of goods and services	P.7		6,5	10,2	5,5	4	4	4
Contributions to real GDP growth								
9. Final domestic demand			0,3	1,6	0,9	1 ½	1 ½	1 ½
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		0,2	0,3	-0,3	0	0	0
11. External balance of goods and services	B.11		0,4	0,5	0,8	¼	¼	¼

Table 1b. Price developments

	ESA Code	2005 level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator			0,6	0,5	1,2	1	1	1
2. Private consumption deflator								
3. HICP[1]								
4. Public consumption deflator								
5. Investment deflator								
6. Export price deflator (goods and services)								
7. Import price deflator (goods and services)								

[1] Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Employment, persons[1]			-0.1	0.6	0.6	1/2	1/2	1/2
2. Employment, hours worked[2]								
3. Unemployment rate (%)[3]								
4. Labour productivity, persons [4]			1.0	1.7	0.8	1 1/4	1 1/4	1 1/4
5. Labour productivity, hours worked[5]								
6. Compensation of employees	D.1							

[1] Occupied population, domestic concept national accounts definition.
[2] National accounts definition.
[3] Harmonised definition, Eurostat; levels.
[4] Real GDP per person employed.
[5] Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009	2010
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	-3.2	-2.1	-1 1/2	-1 1/2	-1	- 1/2
4. Statistical discrepancy							

Table 2. General government budgetary prospects

	ESA code	2005 Level	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-72.6	-3.2	-2.1	-1.5	-1.5	-1.0	-0.5
2. Central government	S.1311	-47.7	-2	-1 1/2	-1 1/2	-1	-1	-1
3. State government	S.1312	-21.4	-1	- 1/2	-0	- 1/2	-0	0
4. Local government	S.1313							
5. Social security funds	S.1314	-3.4	-0	0	-0	-0	-0	0
General government (S13)								
6. Total revenue	TR	975.9	43.5	43 1/2	43 1/2	42 1/2	42 1/2	42
7. Total expenditure	TE[1]	1048.5	46.8	45 1/2	45	44 1/2	43 1/2	43
8. Net lending/borrowing	EDP B.9	-72.6	-3.2	-2.1	-1 1/2	-1 1/2	-1	- 1/2
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	64.4	2.9	3	3	3	3	3
pm: 9a. FISIM		2.4	0.1	0	0	0	0	0
10. Primary balance	[2]	-10.6	-0.5	1/2	1	1	1 1/2	2
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		493.0	22.0	23	23 1/2	23	23	23 1/2
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	397.0	17.7	17 1/2	16 1/2	16 1/2	16	16
13. Property income	D.4							
14. Other (14=15-(11+12+13))		85.8	3.8	3 1/2	3 1/2	3 1/2	3	3
15=6. Total revenue	TR	975.9	43.5	43 1/2	43 1/2	42 1/2	42 1/2	42
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]			39.7	40	40	39 1/2	39 1/2	39
Selected components of expenditure								
16. Collective consumption	P.32	419.6	18.7	18 1/2	18 1/2	18	18	18
17. Total social transfers	D.62 + D.63							
17a. Social transfers in kind	P.31 = D.63							
17b. Social transfers other than in kind	D.62	430.2	19.2	18 1/2	18	17 1/2	17	16 1/2
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM							
19. Subsidies	D.3							
20. Gross fixed capital formation	P.51							
21. Other (21=22-(16+17+18+19+20))								
22=7. Total expenditure	TE[4]							
Pm: compensation of employees	D.1							

Table 3. General government expenditure by function

% of GDP	COFOG Code	2004	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[1]		

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

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009	2010
1. Gross debt[1]		67,9	68	67	66 ½	65 ½	64 ½
2. Change in gross debt ratio							
Contributions to changes in gross debt							
3. Primary balance[2]		-0.5	1/2	1	1	1 1/2	2
4. Interest expenditure (incl. FISIM) [3]		2.9	3	3	3	3	3
5. Stock-flow adjustment							
- Differences between cash and accruals[4]							
- Net accumulation of financial assets[5]							
of which - privatisation proceeds							
- Valuation effects and other[6]							
p.m. implicit interest rate on debt[7]							
Other relevant variables							
6. Liquid financial assets[8]							
7. Net financial debt (7=1-6)							

[1] As defined in Regulation 3605/93 (not an ESA concept).
[2] Cf. item 10 in Table 2.
[3] Cf. item 9 in Table 2.
[4] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.
[5] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
[6] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.
[7] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.
[8] 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	2005	2006	2007	2008	2009	2010
1. Real GDP growth (%)		0,9	2,3	1,4	1 ¾	1 ¾	1 ¾
2. Net lending of general government	EDP B.9	-3.2	-2.1	-1 1/2	-1 1/2	-1	- 1/2
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 + FISIM	2.9	3	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)							
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	2005	2006	2007	2008	2009	2010
Real GDP growth (%)		0,9	2,3	1,4	1 ¾	1 ¾	1 ¾
Previous update							
Current update							
Difference							
General government net lending (% of GDP)	EDP B.9	-3.2	-2.1	-1 1/2	-1 1/2	-1	- 1/2
Previous update							
Current update							
Difference							
General government gross debt (% of GDP)							
Previous update							
Current update							
Difference							

Table 7. Long-term sustainability of public finances

% of GDP	2000	2004	2010	2020	2030	2040	2050
Total expenditure							
Of which: age-related expenditures							
Pension expenditure							
Social security pension							
Old-age and early pensions		9,5	8,5	7,0	7,0	7,0	7,0
Other pensions (disability, survivors)							
Occupational pensions (if in general government)							
Health care		7,0	7,3	7,7	8,0	8,2	8,3
Long-term care *(this was earlier included in the health care)*							
Education expenditure		4,0	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)		11,4	10,5	11,0	12,3	12,8	13,1
Pension reserve fund assets							
Of which: consolidated public pension fund assets							
(assets other than government liabilities)							
Assumptions							
Labour productivity growth		1,1	0,8	1,5	1,8	1,7	1,7
Real GDP growth		1,5	1,8	1,8	1,0	1,1	1,2
Participation rate males (aged 20-64)							
Participation rates females (aged 20-64)							
Total participation rates (aged 20-64)							
Unemployment rate		9,5	8,5	7,0	7,0	7,0	7,0
Population aged 65+ over total population		14,9	16,9	18,5	22,0	23,9	23,3

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	2009	2010
Short-term interest rate[1] (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)							

[1] If necessary, purely technical assumptions.

Annex 3: 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 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.

Guidelines in the 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.	X		(broadly)
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	Averaging in 2008-10
The programme provides all compulsory information in these tables.		X	Information on HICP, total social transfers and stock-flow adjustments is missing.
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.		X	
Significant divergences between the national and the Commission services’ economic forecasts are explained[2].			not applicable
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 exchange rate stability.			not applicable
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.			not applicable
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	X		

Guidelines in the code of conduct	Yes	No	Comments
measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.			
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.			not applicable
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	
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.		X	
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 sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
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.

Source:

Guidelines in the code of conduct	Yes	No	Comments
Commission services			

Annex 4: Key economic indicators of past economic performance

Germany key economic indicators

	Averages 1996 – 2005	1996 – 2000	2001 - 2005	2003	2004	2005
Economic activity						
Real GDP (% change)	1.3	2.0	0.6	-0.2	1.2	0.9
Private consumption % change	1.0	1.8	0.2	-0.1	0.1	0.1
Government consumption % change	0.9	1.4	0.4	0.4	-1.3	0.6
Investment % change	0.2	2.4	-2.0	-0.8	-0.4	0.8
Exports % change	7.5	9.0	5.9	2.4	9.6	6.9
Imports % change	5.9	8.0	3.7	5.3	6.9	6.5
Contributions to real GDP growth						
Demand						
Domestic demand	0.7	1.7	-0.3	0.6	0.0	0.4
Net exports	0.6	0.3	0.9	-0.8	1.2	0.5
Output gap	-0.4	-0.4	-0.5	-1.3	-1.0	-1.3
Prices and costs						
HICP inflation % change	1.3	1.1	1.6	1.0	1.8	1.9
Unit labour costs % change	0.2	0.1	0.3	1.0	-0.2	-0.9
Labour productivity % change	1.8	2.2	1.5	1.5	1.7	1.6
Real unit labour costs % change	-0.4	-0.1	-0.7	-0.1	-1.1	-1.5
Comparative price levels (EUR25=100)	112.9	115.9	109.8	111.2	109.0	106.0
Labour market						
Employment % change	0.3	0.8	-0.2	-0.9	0.4	-0.2
Employment % of pop work age	69.0	67.9	70.0	69.5	70.1	70.0
Unemployment rate in %	8.5	8.3	8.7	9.0	9.5	9.5
NAIRU in %	8.1	7.9	8.3	8.3	8.4	8.4
Participation rate in %	75.2	73.9	76.4	76.1	77.2	77.0
Working age population % change	-0.1	0.0	-0.2	-0.2	-0.4	0.0
Competitiveness and external position						
Real effective exchange rate % change (1)	-2.0	-4.3	0.3	4.3	0.4	-2.8
Export performance % change (2)	0.9	0.2	1.6	-1.2	1.1	1.0
External balance of g & s	2.5	0.9	4.1	4.0	5.0	5.2
Net borrowing v-à-v RoW	0.8	-0.9	2.4	2.0	3.9	4.2
FDI	2.3	3.4	1.1	1.1	-0.5	1.2
Public finances						
Total expenditure % of GDP	47.7	47.8	47.6	48.5	47.1	46.8
Total revenue % of GDP	45.1	46.1	44.1	44.5	43.4	43.5
General government balance % of GDP	-2.6	-1.7	-3.5	-4.0	-3.7	-3.2
General government debt % of GDP	61.6	59.8	63.3	63.9	65.7	67.9
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-3.4	-3.3	-2.7
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	2.5	3.3	1.8	1.3	1.2	1.6
Long term real interest rate (4)	4.1	5.0	3.1	3.0	3.2	2.7
Household credit % change	n.a.	n.a.	0.7	1.0	0.2	0.0
Corporate sector credit % change (5)	4.4	8.1	0.8	-0.3	-5.3	0.6
Household debt in % of GDP	70.1	68.9	71.2	71.9	70.6	69.5
Corporate sector debt in % of GDP	59.9	55.3	64.5	66.3	61.5	61.0

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Euro area key economic indicators

	Averages 1996 – 2005	Averages 1996 – 2000	Averages 2001 - 2005	2003	2004	2005
Economic activity						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption (% change)	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption (% change)	1.7	1.7	1.8	1.8	1.2	1.4
Investment (% change)	2.6	4.3	1.0	1.0	2.1	2.7
Exports (% change)	5.8	8.1	3.5	1.1	6.8	4.2
Imports (% change)	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth (percentage points)						
Domestic demand	2.0	2.7	1.3	1.4	1.8	1.7
Net exports	0.1	0.0	0.1	-0.7	0.2	-0.3
Output gap	-0.1	-0.2	0.1	-0.5	-0.3	-0.9
Prices and costs						
HICP inflation (% change)	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs (% change)	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity (% change)	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	73.6	73.9	73.2	73.2	72.9	72.7
Labour market						
Employment (% change)	1.2	1.5	0.9	0.7	0.7	0.8
Employment (in % of working age population)	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate (in % of labour force)	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU (in % of labour force)	8.7	9.0	8.5	8.5	8.4	8.3
Participation rate (in % of working age population)	69.9	68.5	71.2	71.4	71.7	71.8
Working age population (% change)	0.3	0.2	0.4	0.5	0.5	0.4
Competitiveness and external position						
Real effective exchange rate (% change) (1)						
Export performance (% change) (2)	:	:	:	:	:	:
External balance of g & s (in % of GDP)	1.9	1.7	2.0	2.1	2.1	1.5
Net borrowing v-à-v RoW (in % of GDP)	:	:	:	:	:	:
FDI inflow (in % of GDP)						
Public finances						
Total expenditure (in % of GDP)	48.1	48.5	47.7	48.2	47.5	47.5
Total revenue (in % of GDP)	45.8	46.4	45.1	45.1	44.7	45.1
General government balance (in % of GDP)	-2.3	-2.1	-2.5	-3.0	-2.8	-2.4
General government debt (in % of GDP)	70.8	72.3	69.3	69.3	69.8	70.8
Structural budget balance (in % of GDP)	:	:	:	-3.2	-2.9	-2.2
Financial indicators (4)						
Short term real interest rate (in %) (5)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (in %) (5)	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% change) (6)						
Corporate sector debt (% change) (7)						
Household debt (in % of GDP) (6)						
Corporate sector debt (in % of GDP) (7)						

Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temprary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source :

Commission Services

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[60].

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 elasticity[61]. 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:

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

[60] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 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.

[61] 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: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

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 $\varepsilon = \sum_i w_i \varepsilon_{T_i B_i} \varepsilon_{B_i Y}$ with w_i the share of the *i-th* tax in the overall tax burden.

Assessment of tax projections by major tax category

	2007			2008			2009	2010
	SP	**COM**	**OECD**[1]	**SP**	**COM**[2]	**OECD**[1]	**SP**	**SP**
Taxes on production and imports:								
Change in tax-to-GDP ratio	0.7	0.9	0.0	-0.1	0.1	0.0	0.0	-0.1
Difference SP – COM	-0.2			-0.2			/	/
of which[3]*:*								
- discretionary & elasticity component	-0.3			-0.1			/	/
- composition component	0.0			-0.1			/	/
Difference COM – OECD	/	0.9		/	0.1		/	/
of which[3]*:*								
- discretionary & elasticity component	/	1.3		/	0.0		/	/
- composition component	/	-0.1		/	0.1		/	/
p.m.: Elasticity								
- of taxes to tax base[4]	4.1	5.4	1.0	0.8	1.0	1.0	1.2	0.8
- of tax base[4] to GDP	0.8	0.8	1.0	0.9	1.2	1.0	0.9	0.9
Social contributions:								
Change in tax-to-GDP ratio	-0.7	-0.6	-0.2	-0.3	0.0	-0.2	-0.2	-0.3
Difference SP – COM	-0.1		/	-0.3		/	/	/
of which[3]*:*								
- discretionary & elasticity component	-0.1		/	-0.1		/	/	/
- composition component	0.0		/	-0.1		/	/	/
Difference COM – OECD	/	-0.4		/	0.2		/	/
of which[3]*:*								
- discretionary & elasticity component	/	-0.5		/	0.1		/	/
- composition component	/	-0.1		/	0.1		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	-1.7	-1.1	0.8	0.6	1.0	0.8	1.1	0.6
- of tax base[5] to GDP	0.3	0.4	0.7	0.5	0.9	0.7	0.5	0.5
Personal income tax[6]**:**								
Change in tax-to-GDP ratio	-0.1	-0.1	0.2	-0.2	0.0	0.2	0.1	0.1
Difference SP – COM	0.0		/	-0.2		/	/	/
of which[3] *:*								
- discretionary & elasticity component	0.1		/	-0.1		/	/	/
- composition component	0.0		/	-0.1		/	/	/
Difference COM – OECD	/	-0.3		/	-0.1		/	/
of which[3] *:*								
- discretionary & elasticity component	/	-0.2		/	-0.2		/	/
- composition component	/	-0.2		/	0.1		/	/
p.m.: Elasticity								
- of taxes to tax base[5]	1.8	1.1	2.3	0.6	1.3	2.3	2.7	2.7
- of tax base[5] to GDP	0.3	0.4	0.7	0.5	0.9	0.7	0.5	0.5
Corporate income tax[6] **:**								
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Difference SP – COM	0.0		/	0.0		/	/	/
of which[3] *:*								
- discretionary & elasticity component	0.0		/	0.0		/	/	/
- composition component	0.0		/	0.0		/	/	/
Difference COM – OECD	/	-0.4		/	0.2		/	/
of which[3] *:*								
- discretionary & elasticity component	/	-0.5		/	0.1		/	/
- composition component	/	-0.1		/	0.1		/	/
p.m.: Elasticity								
-of taxes to tax base[7]	0.4	0.3	0.8	0.2	1.0	0.8	0.9	0.9
-of tax base[7] to GDP	1.6	1.6	0.7	1.5	1.1	0.7	1.5	1.4

Notes:

[1]Based on OECD ex-ante elasticities
[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 2006 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)