COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Germany, 2006-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Germany was submitted in January 1999. In accordance with the Regulation, the Council delivered an opinion on it on 15 March 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Germany, submitted on 30 November 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the new stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country’s position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country’s position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme) and

(4) the Commission’s assessment of the October 2006 national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.1. Recent economic and budgetary performance

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 long-term 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. This difficult task has to be accomplished against the background of strained public finances, despite recent improvements.

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 under consideration. Yet, further efforts are likely to be necessary, especially on the labour market, to boost potential growth substantially in the longer run.

2.2. The excessive deficit procedure for Germany

In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council addressed a Recommendation to Germany on 21 January 2003, calling on Germany to bring the excessive deficit to an end as rapidly as possible and by 2004 at the latest. The Recommendation was made public. As stated in the Commission Communication of 14 December 2004, with which the Council concurred on 18 January 2005, 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 year 2005 should be considered to be the relevant deadline for the correction of the excessive deficit.

As the general government deficit for 2005 exceeded the ceiling of 3% of GDP, the Council decided, on 14 March 2006, to give notice to Germany, in accordance with Article 104(9), 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.

2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the updated stability programme covering the period 2005-2009. The Council welcomed "the priority attributed by the government to budgetary consolidation as laid out in the programme", but noted "that there are risks linked to the achievement of the budgetary targets and to long-term sustainability of public finances." Also in the light of the Council decision of 14 March in accordance with Article 104(9) of the Treaty, the Council invited "Germany to

- ensure the planned cumulative structural adjustment of at least one percentage point in the years 2006 and 2007 which would bring the general government deficit below 3% of GDP at the latest by 2007 in a credible and sustainable manner;

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

- implement the plans to reform the federal system in order to improve the budgetary framework and thus contribute to ensuring that budgetary targets are achieved at all levels of government."

2.4. The Commission assessment of the October 2006 national reform programme

The Implementation Report of the National Reform Programme of Germany, provided for in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 18 October 2006. Germany's National Reform Programme 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[2]) showed that Germany is making good progress overall in the implementation of its National Reform Programme, and especially on the macro- and micro-economic key challenges and priority actions. It is moving forward more slowly in the field of employment. Against the background of strengths and weaknesses identified, 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.

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

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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3 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

4 "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.

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On the updated stability programme of Germany, 2006-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated stability programme of Germany, which covers the period 2006 to 2010.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will temporarily slow down from 2.3% in 2006 to 1.4% in 2007, after which it is projected at 1¾% on average over the rest of the programme period. Assessed against currently available information (the first official estimate of GDP growth in 2006 is a figure of 2.5%), this scenario appears to be based on plausible assumptions until 2008 and mildly favourable ones thereafter, compared with Commission projections for potential growth. The programme's projections for inflation appear to be on the high side.

(3) 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 tax burden (i.e. revenues from taxes and social contributions) is now forecast to increase to around 40% of GDP in 2006, which is

[5] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

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.

(4) 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 point 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.

(5) 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 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 the programme does not aim to achieve within the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. 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 reflects the debt ratio and average potential output growth in the long term.

(6) 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 budgetary

adjustment remain, in particular from the implementation of the adjustment path in the outer years.

(7) 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, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in "good" economic times and could be lower in "bad" economic times. 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.

(8) 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 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 debt ratio may not be sufficiently diminishing towards the reference value over the programme period.

(9) 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. Although exemptions to the higher age limit are being granted, the move will enhance the long-term sustainability of public finances. In addition, developing further private pension arrangements would contribute positively to retirement incomes. The initial budgetary position 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. Overall, Germany appears to be at medium risk with regard to the sustainability of public finances.

(10) The stability programme does not contain a qualitative assessment of the overall impact of the October 2006 implementation report of the National Reform Programme within the medium-term fiscal strategy. In addition, it provides no systematic information on the direct budgetary costs or savings of the main reforms envisaged in the National Reform Programme and its budgetary projections do not explicitly take into account the public finance implications of the actions outlined in the National Reform Programme. 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. In particular, the company tax reform 2008 and the health care reform are put forward in both programmes. Moreover, 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 foresee measures to pre-empt emerging budgetary crises.

(11) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[6].

Overall, the updated 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.

In view of the above assessment, Germany is invited to:

(i) benefiting from economic "good times", strengthen the structural adjustment towards the medium-term objective in 2008 and thereafter: by maintaining tight control over expenditures, while ensuring that the announced reform of the corporate tax system does not jeopardise the fiscal consolidation;

(ii) in view of the level of debt and the projected increase in age-related spending, improve long-term sustainability of public finances by achieving the MTO and by implementing reforms, particularly in the health care system;

(iii) improve the budgetary framework so as to strengthen fiscal discipline at all levels of government, notably by implementing the plans for the second stage of the reform of the federal system.

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[6] In particular, data on HICP inflation, total social transfers and the stock-flow adjustment are not provided in the programme, as well as compensation of employees and the break-down of tax revenues, which were provided separately to the Commission.

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