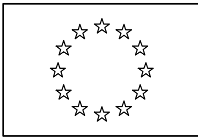

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 06 February 2008
ECFIN D(2008) REP 50191-EN

GERMANY: MACRO FISCAL ASSESSMENT
AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE STABILITY PROGRAMME

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 5 December 2007.

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 (DG ECFIN) of the European Commission, was finalised on 11 January 2008. Comments should be sent to C. Eppendorfer, P. Ritter and M. Stierle (firstname.lastname@ec.europa.eu). The main aim of the 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.

The analysis takes into account (i) the Commission services' autumn 2007 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. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2008. The ECOFIN Council adopted its opinion on the programme on 12 February 2008.

* * *

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

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 2007-2011, was submitted on 5 December 2007.

Economic growth in Germany was significantly stronger in 2006 and 2007 compared with the first half of the decade. Sustained wage restraint as well as structural reforms helped to regain competitiveness and stimulate employment growth. The marked improvement on the labour market supports the projection of a steady recovery of domestic demand, helping to balance an expected lower growth contribution from net external demand. The speed of budgetary consolidation has been remarkable. The general government balance swung from a deficit of almost 3½% of GDP in 2005 to a small surplus in 2007. Similarly, the structural deficit was reduced by 2½ percentage points of GDP between 2005 and 2007. The control of government expenditure was key in the consolidation, with a reduction from almost 47% of GDP in 2005 to below 44% in 2007. This owes to consolidation measures, but also to the fact that unexpectedly high tax revenues were not spent, but used for deficit reduction.

The macroeconomic scenario underlying the programme envisages that real GDP growth will slow down from 2.4% in 2007 to 2% in 2008 and 1½% on average over the rest of the programme period. Judging from currently available information,[1] this growth scenario appears plausible until 2008 and cautious thereafter. According to the programme, GDP growth would remain below potential in 2009–2011, yet employment is projected to be continuously increasing. Wage increases are forecast to remain moderate and would thus not lead to inflationary pressure. The trend improvement in price competitiveness observed over the last decade would, however, come to an end. Until 2009, economic "good times" would prevail.

For 2007, the updated programme foresees the budget in balance, confirmed by the flash estimate of 15 January 2008 by the German statistical office, against a target of a deficit at 1½% of GDP set in the previous update of the stability programme. The marked budgetary improvement over the target resulted from a base effect due to a lower-than-projected 2006 deficit, a stronger cyclical effect and a tighter fiscal stance. Budgetary implementation in 2007 was in line with the policy advice from the Council in its opinion of 27 February 2007 on the previous update of the stability programme. Since unexpected tax revenues were fully used for deficit reduction, budgetary implementation was also in line with the April 2007 Eurogroup orientations for budgetary policies.

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. The medium-term objective (MTO), which is a balanced position in structural terms (i.e. the cyclically-adjusted balance net of one-off and other temporary measures), was broadly reached in 2007. The programme projects the structural balance to weaken somewhat in 2008 and then to improve subsequently, eventually achieving the MTO again in 2010 and a structural surplus by 2011 (calculated according to the commonly agreed methodology). The previous programme did not foresee achieving the MTO

[1] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the Autumn 2007 implementation report of the national reform programme. Recent indicators would, however, point to somewhat lower growth.

within the programme period. Moreover, economic conditions are assumed to support the move of the general government accounts into small surplus. The improvement in the primary balance follows the same pattern, with the surplus reaching 3½% of GDP by 2011. The envisaged consolidation is entirely expenditure-based. This would more than offset the drop in revenue due mainly to the company tax reform and the cut of unemployment insurance contribution rate in 2008. Indeed, the expenditure ratio would fall by 2½ percentage points to 41½% of GDP by 2011, which is planned to be achieved mostly through restraint in social spending. Government gross debt, estimated to decline to 65% of GDP in 2007, still above the 60% of GDP Treaty reference value, is projected to decline further by 7½ percentage points over the programme period.

The risks to the budgetary projections in the programme appear balanced. Whereas current indicators point to somewhat slower growth in 2008 than projected by the programme and the Commission services' autumn forecast, the macroeconomic outlook appears cautious thereafter. Also, over the last two years, the actual budgetary situation turned out better than targeted. The programme seems to assume structural improvements from labour market reforms to be continuing over the programme period. Since no further reforms are planned, the envisaged budgetary outcome requires continued commitment to maintain firm control over expenditure. Likewise, the risks to the projected evolution of the debt ratio appear to be balanced.

In view of this risk assessment, the budgetary stance in the programme seems sufficient to return to the MTO by 2010, as envisaged in the programme. A sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations would be provided throughout the programme period. However, with the planned deterioration of the structural balance by around ½% of GDP in 2008, the fiscal policy stance implied by the programme may turn out not fully in line with the Stability and Growth Pact. Finally, taking into account the risks to the debt projections mentioned above, the debt ratio seems to be sufficiently diminishing towards the reference value over the programme period.

Germany appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is close to the EU average, with pension expenditure showing a somewhat more limited increase than in many other countries, as a result of the pension reforms already enacted. The recent pension reform (2007) will gradually increase the statutory retirement age to 67 years, from 2012 onwards, which should further reduce the expected increase in age-related expenditure. The budgetary position in 2007 as estimated in the programme, which is better than the starting position of the previous programme, contributes to offsetting the projected long-term budgetary impact of population ageing. However, this is not sufficient to fully cover future spending pressures. Maintaining high primary surpluses over the medium term and bringing the debt ratio below the Treaty reference value would contribute to reducing risks to the sustainability of public finances.

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the autumn 2007 implementation report of Germany's national reform programme[2]. The national reform programme 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

[2] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

market. The Commission's assessment is that Germany has made good progress in implementing its national reform programme over 2005-2007. While the stability programme does not specify the direct budgetary impact of the implementation report of the national reform programme, the budgetary strategies outlined in both documents seem consistent. Principal measures with a direct budgetary impact put forth in the NRP implementation report are mentioned in the stability programme, for example the company tax reform, the increase in the statutory retirement age, the social contribution rate cut, childcare facilities and the second stage of the reform of the federal system with a review of the fiscal relations between levels of government in order to ensure budgetary discipline. The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy.

The overall conclusion is that, benefiting from continued strong growth, Germany has used unexpected revenues for deficit reduction and therefore broadly achieved its medium-term objective in 2007, much earlier than envisaged in the previous programme, a result to be commended. In 2008, however, public finances could relapse into a structural deficit. The budgetary strategy foresees a gradual return to the medium-term objective thereafter, based on sustained expenditure restraint. The risks attached to the budgetary projections are neutral; while the underlying macro-economic scenario after 2008 is prudent, the envisaged budgetary outcome requires continued commitment to maintain firm control over expenditure. Germany is at medium risk as regards the sustainability of public finances.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Dec 2007**	**2.9**	**2.4**	**2.0**	**1½**	**1½**	**1½**
	COM Nov 2007	2.9	2.5	2.1	2.2	n.a.	n.a.
	SP Nov 2006	*2.3*	*1.4*	*1¾*	*1¾*	*1¾*	*n.a.*
HICP inflation (%)	**SP Dec 2007**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
	COM Nov 2007	1.8	2.2	2.0	1.8	n.a.	n.a.
	SP Nov 2006	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Dec 2007**	**-0.2**	**0.7**	**1.1**	**0.8**	**0.5**	**-0.1**
	COM Nov 2007[2]	-0.5	0.3	0.6	0.9	n.a.	n.a.
	SP Nov 2006	*-0.3*	*-0.3*	*-0.2*	*0.0*	*0.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Dec 2007**	**5.2**	**6.1**	**6.1**	**6.3**	**6.3**	**6.3**
	COM Nov 2007	5.2	5.8	5.8	6.1	n.a.	n.a.
	SP Nov 2006	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Dec 2007**	**-1.6**	**0**	**-½**	**0**	**½**	**½**
	COM Nov 2007	-1.6	0.1	-0.1	0.2	n.a.	n.a.
	SP Nov 2006	*-2.1*	*-1½*	*-1½*	*-1*	*-½*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2007**	**1.2**	**3**	**2½**	**2½**	**3**	**3½**
	COM Nov 2007	1.2	2.8	2.6	2.8	n.a.	n.a.
	SP Nov 2006	*½*	*1*	*1*	*1½*	*2*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Dec 2007**	**-1.5**	**-0.3**	**-0.8**	**-0.4**	**0.0**	**0.7**
	COM Nov 2007	-1.3	-0.1	-0.4	-0.2	n.a.	n.a.
	SP Nov 2006	*-2.0*	*-1.5*	*-1.5*	*-1.0*	*-0.6*	*n.a.*
Structural balance[3] (% of GDP)	**SP Dec 2007**	**-1.5**	**-0.3**	**-0.7**	**-0.3**	**0.0**	**0.7**
	COM Nov 2007	-1.3	0.0	-0.4	-0.2	n.a.	n.a.
	SP Nov 2006	*-2*	*-1.5*	*-1.5*	*-1*	*-0.6*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2007**	**67.5**	**65**	**63**	**61 1/2**	**59.5**	**57 1/2**
	COM Nov 2007	67.5	64.7	62.6	60.3	n.a.	n.a.
	SP Nov 2006	*68*	*67*	*66½*	*65½*	*64½*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 1.2%, 1.6%, 1.8% and 1.9% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2008 and 2009; all deficit-increasing, according to the most recent programme; and 0.1% of GDP in 2007and 2009; all deficit-increasing, according to the Commission services' autumn forecast.

Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The most recent update of the German stability programme was adopted by the German government on 5 December 2007 and submitted to the Commission and the Council as well as to the national Parliament on the same day. The programme covers the period from 2007 to 2011. It includes the federal budget 2008 as adopted by Parliament on 30 November 2007.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Germany, with a particular focus on cyclical effects on tax revenues. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 0 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key economic indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON TAX REVENUES AND MEDIUM-TERM FISCAL PLANNING

2.1. Introduction

Economic growth in Germany was significantly stronger in 2006 and 2007 compared with the first half of the decade. Sustained wage restraint as well as structural reforms helped to regain external price competitiveness and stimulate employment growth. The marked improvement on the labour market supports the projection of a steady recovery of domestic demand, helping to balance an expected lower growth contribution from net external demand. Last year's Commission services' technical assessment of the updated stability programme traced the growth performance up to 2005 to a decline in total factor productivity (TFP) growth, which has traditionally been the major contributor to GDP growth, and the marked increase in unemployment.

The analysis of the growth performance came to the conclusion that public policy should address the structural weaknesses in the economy. 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. It was argued that Germany should therefore improve the quality of public finances, while securing their sustainability.

Following four years of excessive deficit (2002-2005), the speed of budgetary consolidation has been remarkable. The general government balance swung from a deficit of almost 3½% of GDP in 2005 to a small surplus in 2007. Similarly, the

structural deficit was reduced by 2½ percentage points of GDP between 2005 and 2007. The control of government expenditure was key in the consolidation, with a reduction from almost 47% of GDP in 2005 to below 44% in 2007. This certainly owes to the consolidation measures adopted. However, the size of the structural adjustment turned out to be larger than expected by previous updates of the stability programme (and also larger than expected by the Commission services' forecasts). In Section 4 below, which provides a comparison with the previous update, it is argued that buoyant tax revenues, which the government did not spend but used for deficit reduction, were also responsible for this consolidation.

For budgetary planning it is important to know whether tax revenues will continue to be buoyant in the medium-term or whether budgetary policy should take a prudent stance, being prepared for a possible slowdown in revenue buoyancy.

The following analysis attempts to separate two effects on overall tax revenues over the last ten years. The first stems from the composition of GDP growth. Tax bases for different taxes, which are not equally "revenue-rich", have not developed in parallel. The second effect arises from policy measures, such as changes in tax rates and in the tax base. However, it is also shown that a large portion of the variation in tax revenues cannot be systematically explained.

This introductory analysis concludes that the recent buoyancy of tax revenues, exceeding what could have been expected judging from past developments, might not last forever. On the other hand, GDP growth may become more "tax-rich", i.e. GDP growth would be driven by those components which provide for a revenue-rich tax base. Such uncertainty would call for prudent revenue forecasts in medium-term fiscal planning. Further, fiscal policies should rely more on automatic stabilisers than on discretionary tax policy. Finally, maintaining firm control over expenditure restraint in order to lock in the achievement of a balanced budget should be the appropriate policy conclusion.

2.2. Long-term trends

Figure 1 shows the evolution of the tax burden (tax share as a percentage of GDP), broken down into three main categories, indirect taxes, direct taxes and social contributions. Indirect taxes consist mainly of value added and excise taxes but also of other taxes on production, such as the local trade tax (*Gewerbesteuer*) in Germany. Direct taxes on households consist mainly of the wage tax and also of assessed income tax, which includes tax allowances for employees but also income of self-employed in partnerships, and non-assessed income tax on capital income. Direct taxes on corporations consist of corporate tax and capital taxes. Social contributions are levied on gross wages for the unemployment insurance, the pension system, the health and long-term care systems.

Figure 1: Tax burden

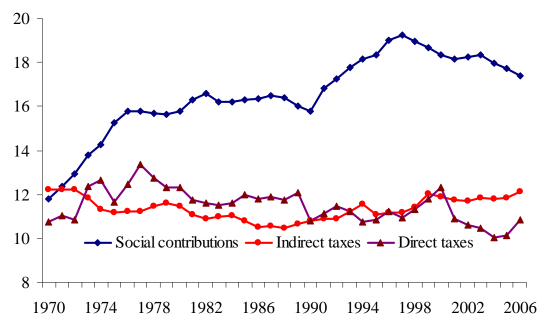
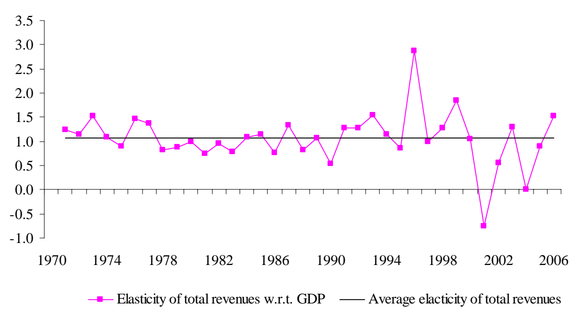


Figure 2: Elasticity of total revenues w.r.t. GDP



Note: National accounts. Data prior to 1991 refer to West-Germany.

Source: Commission services.

Since the 1970s, the welfare state expanded considerably, funded mainly by burdening labour with social contributions. The share of direct taxes in GDP has fallen somewhat in the 1980s after the increase in the 1970s, partly caused by the oil crisis, but increased again after re-unification. Especially since 2000, the share of direct taxes in GDP declined due to cuts in wage and corporate tax rates but also due to changes in the composition of growth, as will be argued below. Indirect tax revenues began increasing since the mid-1990s.

Figure 2 shows the elasticity of tax revenues with respect to GDP. It fluctuates around its average long-term elasticity of unity. These fluctuations have considerably increased since unification. There are two main reasons for such fluctuations. The first is the tax composition. The different tax bases might not develop in parallel. The composition of GDP growth, and with it the tax bases, may not develop in parallel during different phases of the business cycle. Tax bases may further diverge because of long-term trends, such as the decline in the labour share in GDP (and the corresponding rise in capital income), as recalled in the introduction. The second reason is discretionary measures, like adjustments in tax rates and the definition of the tax base. Such policy changes may be undertaken in response to those long-term trends, to a rosy or less-rosy budgetary outlook in the short-term, and also for distributional and efficiency reasons. As will be seen later, those two reasons cannot fully explain the fluctuations. There may be more subtle changes in taxes within broadly defined categories, discretionary measures may not be estimated with good precision ex ante, tax subjects may change their behaviour, perhaps by tax evasion through moving taxable income abroad or by using sophisticated financial instruments.

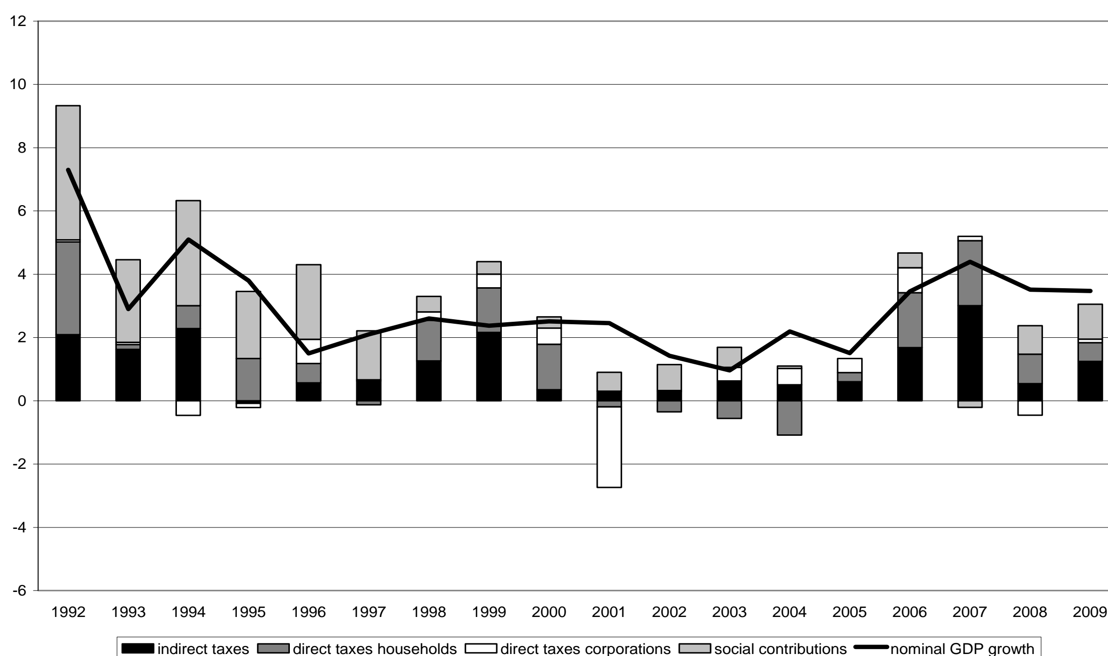
2.3. Developments since the 1990s

Figure 3 displays the revenue developments of four broad tax categories in terms of their contributions to total tax revenues against nominal GDP growth since 1991.[3] These four categories are social contributions (about 43% of total tax revenues in 2006), direct taxes on households (about 23%), direct taxes on corporations (about 3%) and indirect taxes

[3] Data for 2007-2009 are taken from the Commission services' autumn 2007 forecast. The differences between the Commission services autumn forecast and most recent tax measures, as included in the stability programme, are discussed in Section 4 below.

(about 30%).[4] The tax-to-GDP ratio increased in the years, in which the net bar (total tax revenue growth) exceeds the growth rate of nominal GDP. This is the case for most of the 1990s (except 1995 and 1997), whereas in 2001/2002 and 2004/2005 the tax share fell. Box 1 at the end of the section provides an overview over discretionary measures during this period. The starting period is certainly special because of the initial short boom immediately following German unification in 1990 and the ensuing, then temporary, introduction of the solidarity surcharge in mid-1991. In the following growth slowdown, tax revenues would have decreased much more pronouncedly without rising social contributions, which financed the economic transformation in East-Germany to a considerable extent,[5] also in view of high unemployment (Figure 4). In 1995, the solidarity surcharge (a direct tax) was re-introduced, this time permanently. Direct taxes on households made a decreasing contribution to total tax revenue growth. During the cyclical upturn of the late-1990s until its end in 2001, indirect taxes increased (increase in the VAT rate in 1998 and growth supported by private consumption), as did direct taxes on households as well as on corporations.

Figure 3: Growth in tax revenue and nominal GDP since 1991 (in %)



Note: National accounts. 2007-2009: Commission services' autumn 2007 forecast.

Source: Commission services.

In 2001, a reform of corporate taxation was enacted, which is explained in detail below, as well as personal income tax rates cut. In the following years, until 2005, further

[4] The categories follow N. Girouard and C. André (2005), Measuring Cyclically-adjusted Budget Balances for OECD Countries, *OECD Economics Department Working Papers 434*.

[5] See Chapter 2 in: European Commission (2007), Raising Germany's growth potential, DG ECFIN Occasional Papers No. 28, available at: http://ec.europa.eu/economy_finance/publications/publication7528_en.pdf

personal income tax cuts were implemented, while corporate taxes made a positive contribution to overall revenue growth. In 2006, the tax share in GDP increased because of direct taxes, with buoyant revenues on rising capital incomes, affecting both corporate tax and assessed income taxes at the household level. Furthermore, indirect taxes contributed considerably, with two effects at work. Firstly, the local trade tax (*Gewerbesteuer*), which depends mainly on profits, performed well. Second, consumers advanced purchases of durable goods (and private construction) taxed at the standard VAT rate of 16%, before this rate was increased to 19% in 2007. This temporarily changed the composition of the tax base for VAT towards products taxed at the standard rate against products taxed at the reduced rate of 7%, which remained unchanged in 2007. In 2008, the tax share is forecast to decline again, due to the implementation of the company tax reform and the reduction in the social contribution rate (for a detailed discussion, see Sections 4 and 6).

In order to disentangle "GDP growth composition effects" arising from diverging tax base developments from "discretionary policy measures" the following section treats each of the four broad tax categories separately.

The approach is as follows. For each of the four categories, the composition effect is calculated as the difference between the actual growth in the relevant tax base and its estimated growth based on the "ex ante" elasticity of the tax base with respect to the cycle as estimated by the OECD.[6] Thus, "baseline" tax revenues are projected using the "ex ante" elasticity of tax base with respect to GDP and the "ex ante" elasticity of tax revenues with respect to the base. "GDP-composition adjusted revenues" are projected using the actual elasticity of tax base with respect to GDP in a given year and the "ex ante" elasticity of tax revenues with respect to the base. If the actual growth in the tax base was higher than the ex ante-elasticity of base to GDP would predict, the composition effect is positive. The difference between GDP-composition-adjusted revenues and actual revenues in a given year can be due to discretionary measures, which can change the actual elasticity of revenues to the respective base, or other factors. The (ex ante) estimates for discretionary measures are taken from government sources[7] for the past and from the Commission services' forecast for the projections. The remaining difference of estimated tax revenue growth, i.e. taking into account tax base developments and discretionary measures, is called "residual" in the graphs below.[8] The

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6 The elasticities are estimated in Girouard and André (2005).

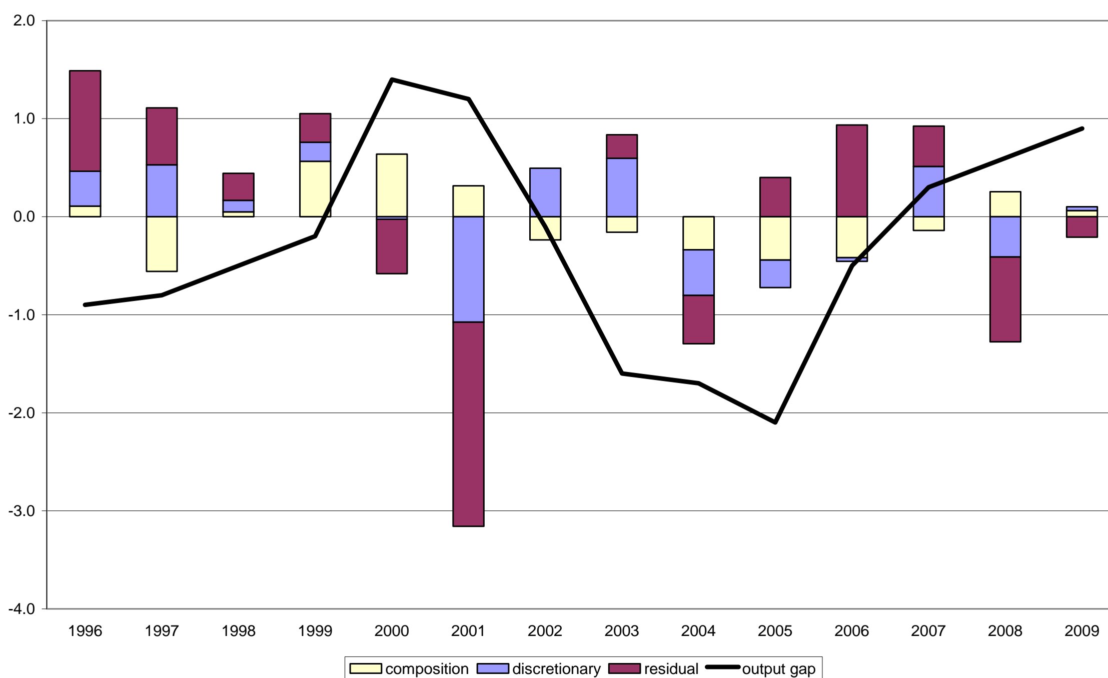
7 Bundesministerium der Finanzen, *Finanzbericht*, various years. The estimates of the budgetary impact of tax measures given in the *Finanzbericht* are provided in cash statistics, which do not fully correspond to the national accounts definition. For example, time-adjustments are made and tax allowances such as the child allowance and that for owner-occupied housing are recorded as expenditure in national accounts. The transformation of cash estimates into national accounts is therefore an additional source of error. Moreover, the authorities usually calculate the revenue impact for a five-year period, presumably on the basis of a certain macroeconomic scenario, which is not specified in the relevant legal act. Errors in the scenario could therefore be only roughly corrected: The nominal GDP growth rate of the government forecast valid at the time of the publication of the *Finanzbericht* was replaced by the actual growth rate. This rough correction procedure thereby had to assume that the growth composition was estimated correctly in the *Finanzbericht*.

8 Interpreting the residual is not easy. It may arise through payments of tax advances or arrears, through movements of tax bases within the four broad categories, through errors in estimating the revenue impact of the discretionary measures, for example caused by unexpected changes in behaviour in response to the tax measure.

size of the residual in the graphs below is relatively large. Therefore, the graphs should be interpreted with caution. The calculations are made on a year-by-year basis, meaning that the actual developments of the previous year are the starting point for estimating a given year.[9] The effects are displayed as percentages of GDP.

Figure 4 provides an overview over composition, discretionary and residual effects since 1996 for the four broad categories, against the output gap. The composition effect moves roughly with the cycle, implying that the elasticity of tax revenues to GDP exceeds unity in the upswing and would fall below unity in the downturn. Discretionary tax measures are not always counter-cyclical. Until 2000, tax policy was rather pro-cyclical: When the output gap was negative in the mid-1990s, taxes were increased, and lowered in the upswing thereafter. After 2000, the picture is uneven. In 2001, with a still positive output gap, taxes were lowered. In the downturn thereafter, taxes (mainly social contributions) were initially raised, then reduced. A similar picture appears for the ensuing upswing since 2006. It is striking that the residual is large throughout the period. Possible explanations for the residual in certain years are given below, when each of the four categories is discussed separately.

Figure 4: Total taxes: composition and discretionary effects (on a year-by-year basis) and output gap (% of GDP)

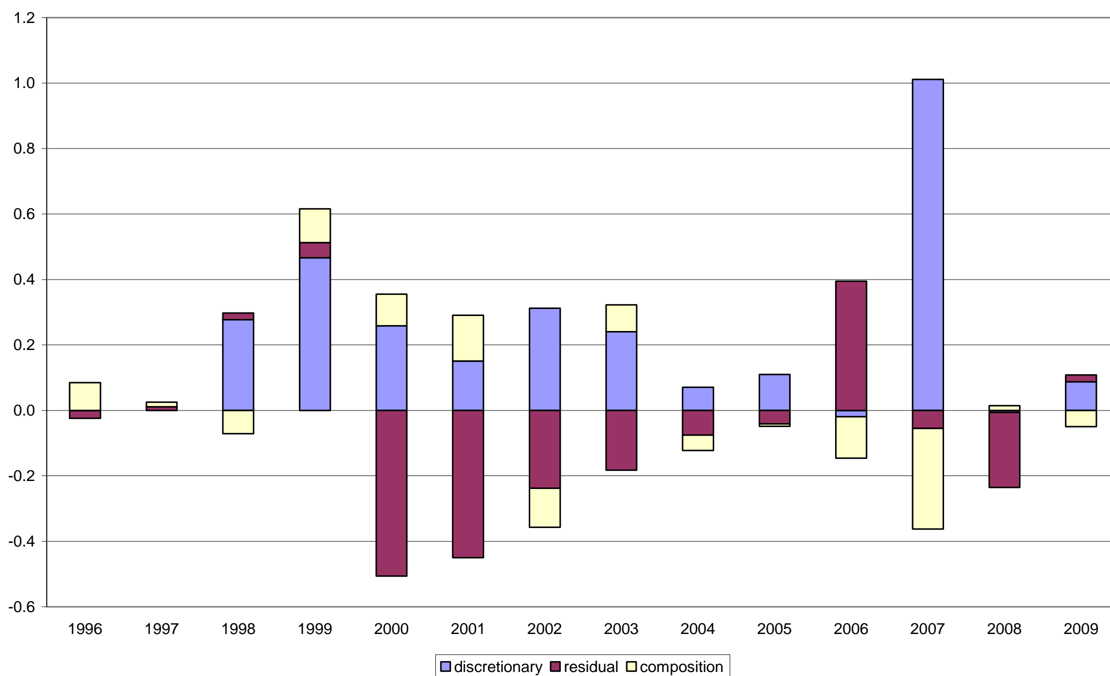


Source: Commission services.

9 The main reason for this year-on-year approach is that there is no "natural" GDP composition, which could be taken as a starting point. Furthermore, errors in the estimated discretionary effects in the previous year might be somewhat corrected for the current year, when the current year estimate takes actual revenues of the previous years are taken as a starting point.

2.3.1. *Indirect taxes*

Figure 5: Indirect taxes, decomposition (% of GDP)



<u>Source</u>: *Commission services.*

As shown in Figure 5, composition effects, i.e. deviations of the tax base, in this case nominal private consumption (as also used by the OECD), from their long-term estimate on the basis of GDP growth do not seem large overall. The deviation of actual revenues of indirect taxes from ex ante expected "baseline" revenues seems to be rather driven by discretionary measures, implemented in basically every year except for 1996-1997 and 2005-2006. The standard VAT tax rate was raised from 15% to 16% in April 1998, followed by annual increases in energy taxes from 1999 on. From 2001 on, other excise tax rates, in particular on tobacco, were increased. The standard VAT rate was increased to 19% in 2007. The residual for indirect taxes is also large and often goes into the opposite direction of the discretionary effect. One reason, especially for the years in which excise taxes were raised, might be that the consumption of the products concerned was reduced in response to the measure, leading to an overestimation of the actual tax revenue effect. In 2006, the residual is positive by a large margin. This might include the effect of advanced purchases of goods before the increase in the VAT rate in 2007, discussed above. But surprisingly, a corresponding counter-effect in 2007 is not visible. Moreover, the impact of advanced purchases should also be visible in the composition effect through depressed private consumption[10]. While the composition effect goes into the expected direction (negative) in 2007, it is also negative in 2006. Indirect taxes in national accounts also include revenues from the local tax (*Gewerbesteuer*), which

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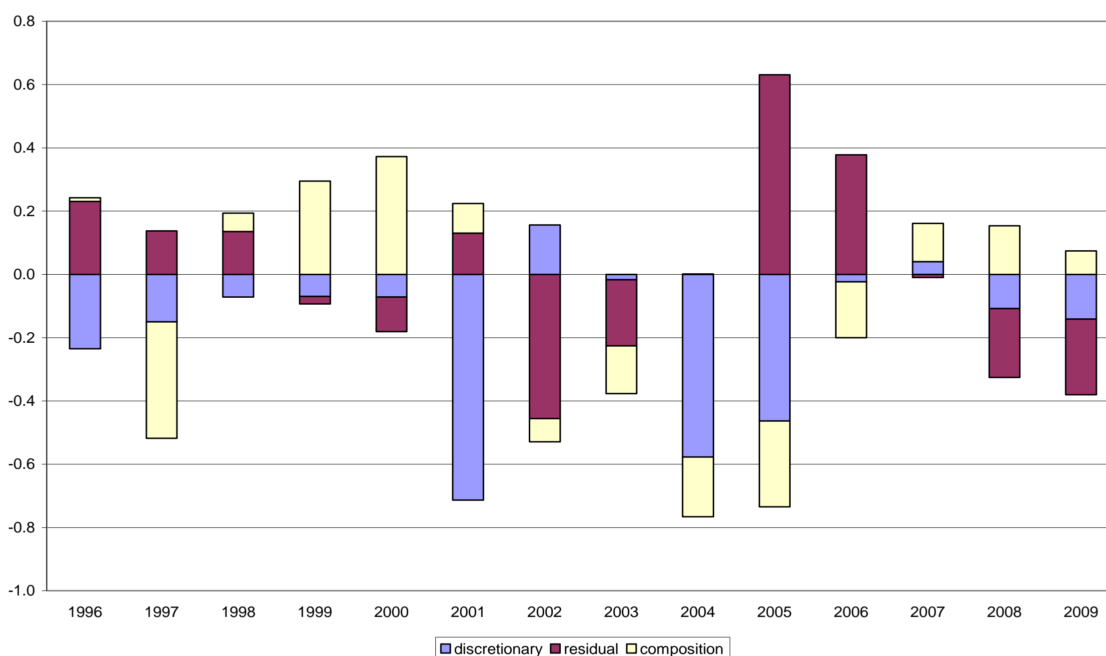
[10] European Commission, DG ECFIN: Economic Assessment of the stability programme of Germany, (update November 2006). Available at: http://ec.europa.eu/economy_finance/publications/publication4229_en.pdf

depends on profits and therefore often changed along with reforms of company taxation (e.g. in 2001 and 2008/09). The negative residual in 2008 would be due to a slowdown in local tax revenues.

2.3.2. Direct taxes on households

Figure 6: Direct taxes on households, decomposition (% of GDP)



<u>Source</u>: Commission services.

As shown in Figure 6, developments of direct taxes on households seem also determined to a considerable extent by discretionary measures. In 1996, the threshold for tax-free income was raised with additional effects in 1997, when also the wealth tax was abolished. In 1998, the solidarity surcharge, introduced in 1995 at a rate of 7.5% on the actual wage and income taxes paid by the household, was reduced to 5.5%. In 1999, cuts in wage tax rates in several steps until 2005 were enacted. Subsequent laws, however, altered the enacted rate reductions in almost every year during this time period. Particularly large rate reductions were implemented in 2001, 2004 and 2005. In 2008 and 2009, direct taxes paid by households are also affected by the company tax reform through its impact on partnerships and the introduction of the withholding tax on capital income at the personal level.

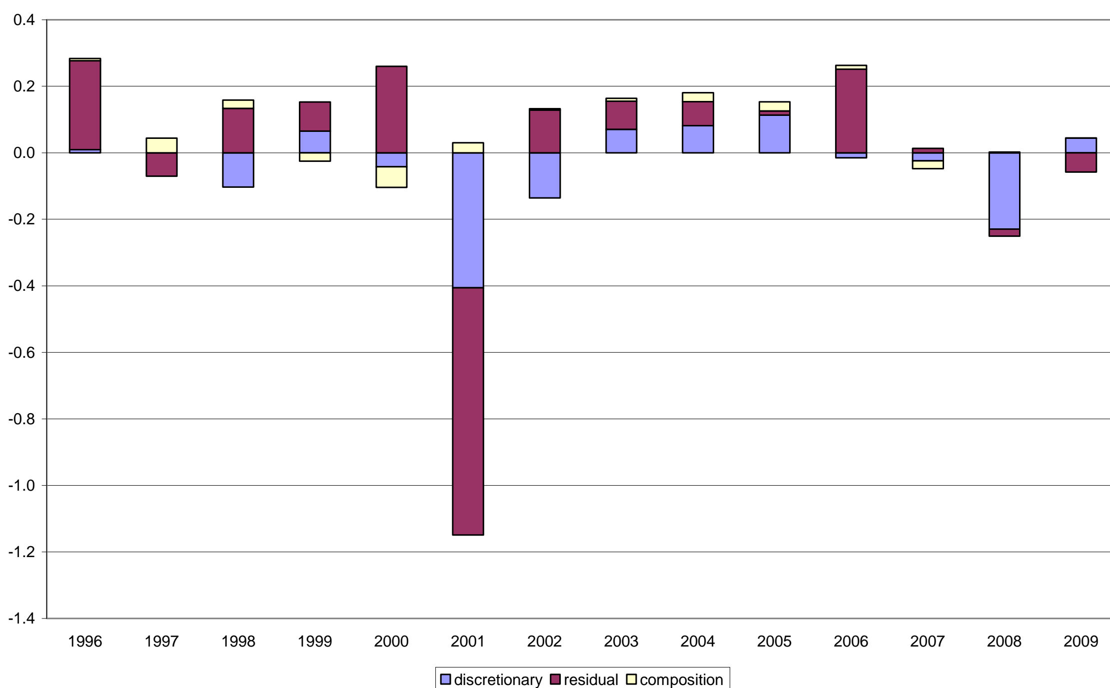
The composition effect might be traced back to the cycle. For direct taxes on households, this analysis takes gross wage developments as the relevant tax base. In the cyclical upswing 1999 and 2000, wages grew relatively strongly, followed by a period of pronounced wage moderation in the downturn after 2001. This development is projected to be somewhat reversed from 2007 on.

The evolution of the residual is uneven. It certainly picks up the fact that contemporaneous gross wages are only a rough approximation of the tax base for direct taxes on households. The wage tax, a withholding tax at the level of the employer, only amounts to 70-80% of direct taxes on households. The remainder are assessed income

taxes (with tax advances and arrears) and capital taxes. The large negative residual in 2002 is difficult to explain. A special effect in the tax reform in 2001 resulted in higher than expected revenues from capital taxation at the personal level in 2001. Companies had an incentive to distribute accumulated retentions to shareholders in order to benefit from a retroactive reduced rate on distributed profits. In turn, this led to an increase in assessed income tax revenues at the household level, since distributed earnings were finally taxed at the personal level. In 2002, there might have been some normalisation through a decrease in distributed profits. Moreover, the fall in interest rates might have affected savings tax revenue. The residual would further be influenced by the fiscal drag, when wage inflation causes households to move into higher tax brackets in a progressive tax system, increasing the revenue-richness of the tax base. The opposite may hold for periods of strong wage moderation. The large positive residuals in 2005 and 2006 might relate to strong growth in capital taxes at the personal level. A more detailed disaggregation, separating labour and capital income, might reduce the residual. Introducing a lag structure might further improve the results.

2.3.3. Direct taxes on corporations

Figure 7: Direct taxes on corporations: decomposition (% of GDP)



Source: Commission services.

The share of direct taxes on corporations in total tax revenue is relatively small. The capital share in national income is lower than the labour share, and part of capital income is taxed at the personal level. The composition effect of the corporate tax, expressed as a percentage of GDP, is therefore also relatively low (Figure 7). Interestingly, it is slightly negative in the cyclical upswing up to the year 2000. As one might expect, it is positive in the years 2004-2006, when profits grew particularly strongly.

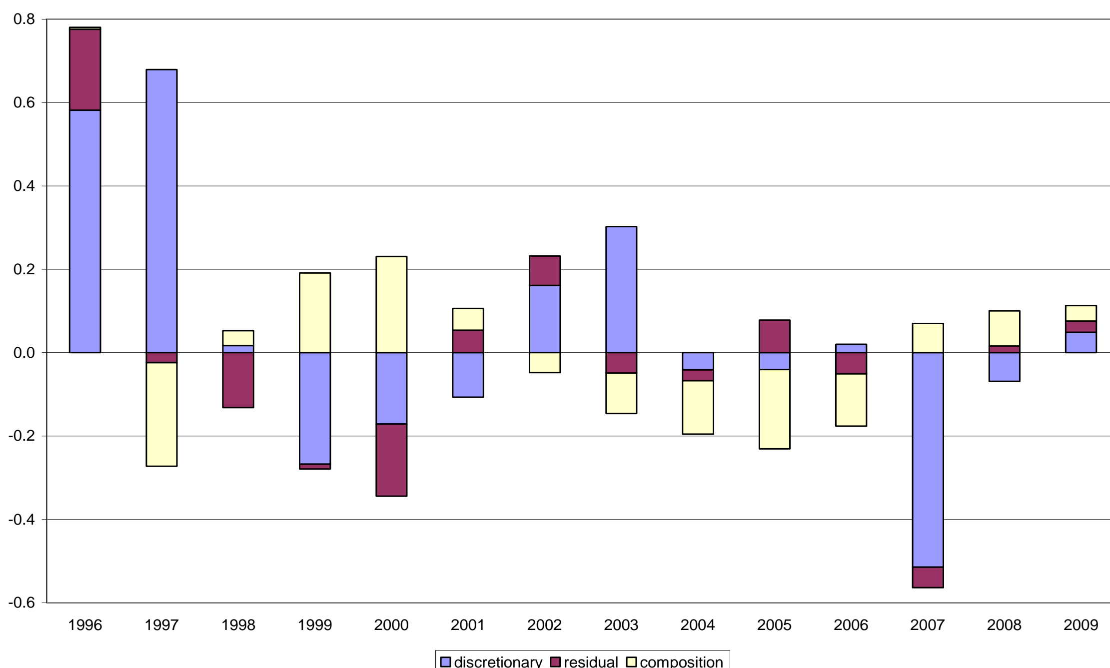
In the system in place before 2001, the corporate tax functioned as a withholding tax on personal income tax for the owners of the company, i.e. the taxes paid at the level of the

corporation were credited at the level of the owner against the personal tax liability (so-called imputation system). After the tax reform 2001, the corporate tax rate was significantly reduced and changed into a source tax, which could no longer be credited at the personal level.

The 2001 tax reform is apparent in the large negative discretionary effect in the same year, at the time estimated to have additional effects in the following year. However, in 2001 the residual is extremely large, catching unexpected shifts in behaviour of companies (perhaps advancing some of the estimated discretionary effect for the following year). In general, the residual for corporate taxes is difficult to explain. Taxable profits at the corporate level may not correspond closely to "gross operating surplus" in national accounts. Corporate taxes are paid with advances and arrears, which depend on economic projections. The residual was positive in the cyclical upswing until 2000. A special effect of the 2001 tax reform prompted companies to distribute retentions to shareholders because, at the company level, distributed profits were taxed at a lower rate than retentions and the tax paid on retentions of previous years was reimbursed. Therefore, the large negative residual in 2001 may mirror to some extent the positive residual in the years before. The positive residual in the following years may thus be an adjustment process at the corporate level after that special effect, which is assumed to have come to an end by 2007.

2.3.4. Social contributions

Figure 8: Social contributions: decomposition (% of GDP)



Source: Commission services.

Social contributions amount to over 40% of total tax revenues. The composition effect is similar to that of direct taxes on households, because the tax base is assumed to be the same (gross wages). The effect is somewhat smaller, however, because the elasticity of social contributions with respect to the base is smaller than that of direct income taxes with respect to the (same) base. The reason for this is the income tax progressivity

(which has been reduced recently), whereas the rate of social contributions is basically linear, or even regressive with a cap at the top end of the income distribution.

In this analysis, discretionary measures on social contributions are approximated by changes in the rate; changes in the tax base could not be taken into account. The contribution rate to the health care system increased steadily throughout the sample period, with a particularly steep rise in 2002 and 2003. In 1996 and 1997, the contribution rate to the pension system was raised, lowered again in 1999, 2000 and 2001, to be raised again in 2007. In that year, however, the contribution rate to the unemployment insurance was reduced by a far higher amount (2.3 percentage points). The residual seems difficult to explain, it may be related to changes in the taxable base, for example by adjusting the wage income thresholds below which public insurance is mandatory or by introducing jobs with reduced rates.

2.4. Conclusions

In Germany, the link between the major government revenue components and economic activity has become more unstable after reunification. The analysis suggests that a sizable portion of the volatility of revenues is due to discretionary policy changes, to some extent increased volatility also can be traced back to shifts in composition of GDP. In particular, the boost of government revenues in Germany since 2006 goes considerably beyond normal cyclical sensitivity. After a period of slow growth between 2001 and 2005, the current recovery of economic activity only partially explains the rebound of revenues. The increase of standard VAT from 16% to 19% in 2007 as well as the unexpected strong recovery of direct taxes – in particular profit-related taxes - also contributed to a sizable extent to this rebound.

Tax revenue forecasts can only be made with some margin of error. Changes in the composition of growth must be accounted for. The error might be further reduced through a finer disaggregation of tax categories, with statistical tax bases coming closer to "true" tax bases. However, especially in case of profit-related taxes, this is difficult to accomplish. Certainly, the above analysis has been in rather broad terms, and a more disaggregated break-down of taxes and tax bases might provide a richer picture.[11]

It is striking that discretionary policy interventions on the revenue side have become more frequent over the last ten years. It seems that such policy decisions are often taken under the impression of the budgetary outlook in the short-term, rather than long-term trends. This does not only apply to Germany. As observed in the late 1990s, several EU countries used strong revenue inflows to reduce taxes or to increase expenditures on the assumption they would be permanent. Hindsight proved this assessment wrong, giving way to much weaker than expected underlying budgetary developments and the need for significant fiscal consolidation during the protracted economic slowdown afterwards.

In addition, the budgetary impact of such policy interventions seems difficult to estimate ex ante. This is certainly true for complex reforms like that on corporate taxation in 2001. It might, however, also be of relevance for direct taxation at the household level, where a change in tax rates is often accompanied by changes in the tax base. The changes in the

[11] Deutsche Bundesbank (2006), 'A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005', *Bundesbank Monthly Report*, March, p. 61-76.
J. Kremer, C. Rodrigues Braz, T. Brosens, G. Langenus, S. Momigliano, M. Spolander (2006), 'A disaggregated framework for the analysis of structural developments in public finances', *Deutsche Bundesbank Discussion Paper* 05/2006.

tax base (usually tax allowances) may each be quite small and hard to assess, and small estimation errors might add up in the aggregation.

For the medium-term budgetary path in Germany at the current juncture, it is important to know whether the unexpectedly strong tax intensity (net of discretionary measures) will continue in the following years. Two major effects should be separated. First, the composition of GDP growth might become more "tax-rich" Second, profit-related taxes (in their broad definition given above) have since 2003 (the second year after the previous company tax reform) surprised on the upside. This development may have normalised by now, and an adverse effect may not be excluded. Which of the two effects would dominate?

From an institutional viewpoint, the fact that the volatility in the apparent tax elasticity has increased, should be taken up in the budgetary planning. The current budgetary process is oriented on the most recent revenue developments. A high revenue volatility would call for greater emphasis on medium-term budgetary plans (including their enforcement), with budgetary adjustment focused on the expenditure side.

However, the high volatility might be related to the frequency of discretionary measures. Policy makers should be reminded that the central idea of the Stability and Growth Pact is the emphasis on automatic stabilisers. On average (and with all the caveats mentioned above), total tax revenues move in line with the cycle, while expenditure (at least in the short-run remains relatively stable. There are good reasons to assume that discretionary tax policies do not always have the intended counter-cyclical effects. This should not, however, preclude policy makers from making the tax system more efficient. With the direct tax reforms beginning in 1999 and the reduction in the social contribution rate 2007, accompanied by an increase in the VAT rate, a shift was made from direct to indirect taxation. Overall, this may have improved the quality of public finances.

Box 1: Overview over discretionary measures

Direct taxes

1991: A solidarity surcharge is temporarily introduced, in order to fund reunification-related expenditure (mid 1991 – mid 1992).

1993: A withholding tax for interest income is introduced (replaces the source tax on interest income declared in the personal income tax declaration). Against this, tax allowances for a maximum interest income are introduced.

1994: The corporate tax rate for retained earnings is lowered from 50% to 45% and for distributed profits from 36% to 30%.

1995: The solidarity surcharge is introduced (7.5% on the personal and corporate tax liability), in order to fund reunification-related expenditure.

1996: The tax allowance for low incomes is increased.

1997: The wealth tax is abolished.

1998: The solidarity surcharge (levied on personal and corporate tax liabilities) is reduced from 7.5% to 5.5%.

1999: The government adopts a reduction of income tax rates in three steps. The first step enters into force, which involves a reduction in the corporate tax rate on retained earnings and the personal income tax on earnings from small businesses. This law foresees 74 small financing measures, which might be described as base-broadening. In total, the government expects additional revenues despite the law's title (Law on Tax Relief 1999/2000/2002). In addition, the lower bound of the personal income tax rate is reduced to 23.9% (law adopted in 1998).

2000: The second stage of the personal income tax reform from 1999 is introduced. The lower bound for the progressive income tax rate is reduced to 22.9%, the upper bound to 51%. Tax allowances for low incomes are raised.

2001: The first stage of the personal income tax reform enters into force (which corresponds to the third stage of the personal income tax reform 1999, originally foreseen for 2002). The lower bound for the progressive income tax rate is reduced from 22.9% to 19.9%, the upper bound from 51 to 48.5%. Tax allowances are increased. The company tax system is completely changed. The imputation system, whereby shareholders are taxed at their personal income tax rate but could deduct taxes paid at the corporate level, is replaced by a "half-income" (split-rate) system, in which the corporate tax is final but non-deductible at the shareholder level. Shareholders are then taxed at half their personal income tax rate. In addition, companies are given the opportunity to claim a tax refund for distributed profits, which were taxed under a lower rate than retained profits under the old system. Although the company tax reform intended net tax relief, the unexpected strong response to the latter measure (tax refund) resulted in large revenue losses. (See "moratorium" in 2003.) Depreciation allowances are reduced. The personal income tax relief (in three stages until 2005) and the company tax reform were adopted in one law in July 2000.

2003: In order to build up a fund for flood-related expenditure, the second stage of the personal income tax reform is postponed to 2004 and the corporate tax rate is temporarily increased in 2003 from 25% to 26.5%. A 3-year moratorium on claims for tax refunds for distributed profits under the old corporate tax system before 2001 is introduced.

2004: The second stage of the income tax reform from 2000 enters into force. In addition, part of the tax relief foreseen in the third stage for 2005 is advanced to 2004. In total, the lower bound for the progressive income tax rate is reduced to 16%, the upper bound to 45%. Tax allowances for low incomes are increased.

2005: The third and last stage of the personal income tax reform from 2000 enters into force. The lower bound for the progressive income tax rate is reduced to 15%, the upper bound to 42%. Tax

allowances for low incomes are increased. A tax amnesty for undeclared interest income abroad yields far less revenue than planned.

2006: several small measures that remove tax allowances and others that introduce new ones. The depreciation allowance is extended.

2008: Company tax reform (see Section 6 of this document).

Indirect taxes

1991: The mineral oil and insurance tax rates are raised.

1993: The standard VAT rate is raised from 14% to 15%. The insurance tax rate is raised.

1994: The mineral oil and are raised.

1995. The insurance tax rate is raised.

1998: The standard VAT rate is raised from 15% to 16%. The tax on the purchase of land is raised by 2 percentage points.

1999: Electricity and mineral oil tax rates are raised.

2001: Insurance tax and tobacco tax are raised.

2003: Mineral oil tax is raised.

2004: Tobacco tax is raised.

2005: Tobacco tax is raised.

Social contributions

Note that the health insurers set their contribution rates autonomously, driven by laws that concern their expenditures. The average rate has been rising steadily throughout this period. Rates for the pension and unemployment insurance are set by decree and law, respectively.

1993: The contribution rate to the unemployment insurance rises from 6.3% to 6.5%.

1994: The contribution rate to the pension insurance rises from 17.5% to 19.2%.

1995: The contribution rate to the pension insurance declines to 18.6%.

1996: The contribution rate to the pension insurance rises again to 19.2%.

1997: The contribution rate to the pension insurance rises to 20.3%.

1999: The contribution rate to the pension insurance declines to 19.7%.

2000: The contribution rate to the pension insurance declines to 19.3%.

2001: The contribution rate to the pension insurance declines to 19.1%.

2003: The contribution rate to the pension insurance rises to 19.5%.

2007: The contribution rate to the pension system rises to 19.9%, the contribution rate to the unemployment insurance declines to 4.2%.

2008: The contribution rate to the unemployment insurance declines to 3.3% (see Section 6).

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail.

3.1. Economic activity

After having grown only sluggishly in the first half of the current decade, growth has become significantly stronger, reaching 2.9% in 2006. Temporary factors influencing the growth profile have been well accommodated. The stability programme forecasts a slight deceleration to 2.5% in 2007 and a further slowdown to 2.0% in 2008. According to the programme, in the period 2009 – 2011 growth will on average be 1½%.[12]

While the contribution of domestic demand to growth was negative on average in the period 2001 to 2005, it became positive in 2006 with 1.8 percentage points. According to the programme, this contribution is going to remain positive until 2011 at around 1¼ %. Private consumption will turn into one of the main growth drivers between 2008 and 2011. A significant stimulus is coming from the recent labour market improvement, clearly profiting from structural reforms as well as a lasting wage restraint.

Similarly to employment, also international competitiveness profited from the structural reforms implemented and the wage restraint in recent years. As a consequence, net external demand contributed annually around 1 percentage point to growth in the first half of the decade up to 2006. According to the programme, in 2007 a similar development is to be expected, while in 2008 the growth contribution of net exports is expected to fall but remain positive against the weakening of the international environment and a strengthening of domestic demand. Between 2009 and 2011, a growth contribution of net exports of around a quarter of a percentage point is included in the macroeconomic forecast of the stability programme.

[12] The external outlook behind the stability programme's macroeconomic scenario is broadly in line with that in the Commission services' autumn 2007 forecast.

Table 1: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2011
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	2.5	2.4	2.1	2.0	2.2	1½	1½	1½
Private consumption (% change)	-0.1	-0.2	2.0	1.8	1.4	1½	1½	1½
Gross fixed capital formation (% change)	5.8	6.2	2.9	3.7	3.1	2	2	2
Exports of goods and services (% change)	7.7	7.8	6.8	6.3	7.0	5½	5½	5 ½
Imports of goods and services (% change)	6.2	6.3	7.4	6.8	6.8	5½	5½	5 ½
Contributions to real GDP growth:								
- Final domestic demand	1.3	1.3	1.9	1.9	1.6	1¼	1¼	1¼
- Change in inventories	0.2	0.1	0.0	-0.1	0.0	0	0	0
- Net exports	1.0	1.0	0.2	0.2	0.5	¼	¼	¼
Output gap[1]	0.3	0.7	0.6	1.1	0.9	0.8	0.5	-0.1
Employment (% change)	1.7	1.7	0.7	0.8	0.4	¼	¼	¼
Unemployment rate (%)	8.1	8.4	7.7	8.0	7.6	7.7	7.5	7.3
Labour productivity (% change)	1.1	0.7	1.6	1.3	1.8	1¼	1¼	1¼
HICP inflation (%)	2.2	n.a.	2.0	n.a.	1.8	n.a.	n.a.	n.a.
GDP deflator (% change)	1.8	1.9	1.4	1.5	1.3	1½	1½	1½
Comp. of employees (per head, % change)	1.9	1.4	2.7	n.a.	2.5	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	5.8	6.1	5.8	6.1	6.1	6.3	6.3	6.3

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

For the period 2007 – 2008, the macroeconomic scenario is plausible and in line with the autumn forecast of the Commission. Both forecasts differ by only 0.1 percentage points in both years with the stability programme being marginally lower. For 2009, the Commission's autumn forecast is expecting a moderate rebound in economic growth of 2.2% while the stability programme is more cautious with 1½% for the average of 2009 to 2011. It therefore remains below the estimates for potential growth (see Box 2). Consequently, the mid-term outlook for the headline growth figure could be regarded as cautious.

The growth composition in 2007 and 2008 is also closely in line with the Commission's autumn forecast. Only real growth of gross fixed capital formation in 2008 might be regarded as optimistic, being 0.8 percentage points higher in the stability programme than the Commission's forecast of 2.9%. This discrepancy might be due to a different assessment of the impact of the change in depreciation rules as from January 2008 and related anticipation effects by enterprises. For the period 2009 – 2011 growth of public consumption (0%) and gross fixed capital formation (2%) could be regarded as cautious, while the increase in private consumption as well as growth contributions of inventories and net external demand are close to those of the autumn forecast by the European Commission's services for 2009.

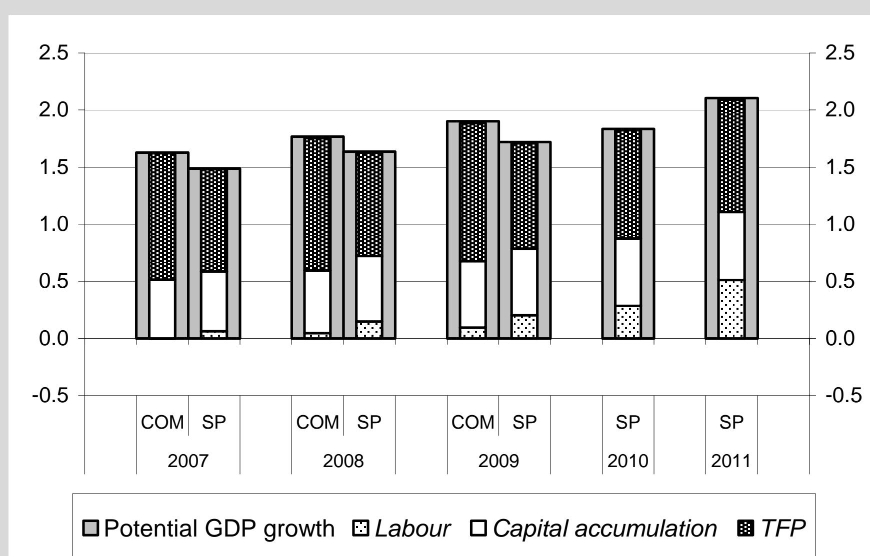
Consequently, the programme is based on plausible macroeconomic assumptions for the period 2007-2008 and on cautious growth assumptions thereafter.

Box 2: Potential growth and its determinants

In the first half of the decade potential growth in Germany was estimated to be around or only slightly above 1%. Now, those estimates are clearly on an upward trend. This also holds true for the estimates according to the Commission services' recalculations using the commonly agreed methodology based on the information provided in the programme as well as the Commission's autumn forecast. While currently standing at or slightly above 1½%, potential growth is expected to increase to around 1¾% in 2009 and, according to the information in the programme even higher thereafter.

This clear increase in the estimates can partly be explained by methodological difficulties. Independently from the specific measures to estimate potential growth, the result is to a high degree dependent on the latest growth rates included. As growth has been high in 2006 and is supposed to remain at or above 2% in 2007 and 2008, this drives the estimated potential growth upwards. However, at the same time, several structural reforms have recently been undertaken, contributing as well significantly to a higher potential growth. This is most clearly visible on the labour market, which is showing a remarkable improvement.[13]

Potential growth and its determinants



Both estimates are based on a similar contribution of capital accumulation. According to the estimate based on the Commission's autumn 2007 forecast, growth contribution of total factor productivity (TFP) is higher. In contrast, the programme assumes a slightly higher and rising contribution of total labour contribution. The strong increase in the labour contribution and hence potential growth in the years 2010 and 2011 according to the estimation based on the programme is partly due to relatively optimistic projections on growth of working age population of Eurostat that is used according to the commonly agreed method and not directly the result of the programme itself.

With high growth rates well above potential, the negative output gap is expected to be closed in 2007 and to arrive at about 1% in 2008/09. According to this indicator the German economy is therefore in good cyclical conditions (see also Box 3) until 2009. As the estimates of the output gap show relatively high instability, it is reassuring that this

[13] For the assessment of the impact of structural reforms on the German economy see also: European Commission, DG ECFIN (2007): Country Study: Raising Germany's growth potential, published as European Economy. Occasional papers. No. 28.

assessment is supported by a currently high capacity utilisation and a strong improvement of the labour market.

3.2. Labour market and cost and price developments

According to the forecast in the programme, the labour market continues to strengthen over the programme period. Employment is projected to increase by 1.7% in 2007 and 0.8% in 2008. For the medium term, a slower but continuous increase is expected. The picture drawn in the programme is close to that of the Commission's autumn forecast for 2007 and marginally more cautious for 2008 and 2009. As in the programme GDP growth is assumed to remain below potential until 2011 but employment continues increasing, this suggests that there is the assumption of a lasting dividend from past labour market reforms despite latest reversals in some parts.

The programme projects an increase in effective wages by 1.9% in 2007 and 2.4% in 2008. Unit labour costs on an hourly basis are expected to increase by 0.6% and 0.9% in both years respectively. Also for the medium term a moderate wage development is foreseen with real effective wage increases remaining below productivity growth. Consequently, price competitiveness remains high and inflationary pressure from the wage side is not to be expected.[14] This assessment is consistent with the Commission's autumn forecast. Tightening labour markets might however lead to higher wage settlements, with a reversal in the downward trend of the wage drift.

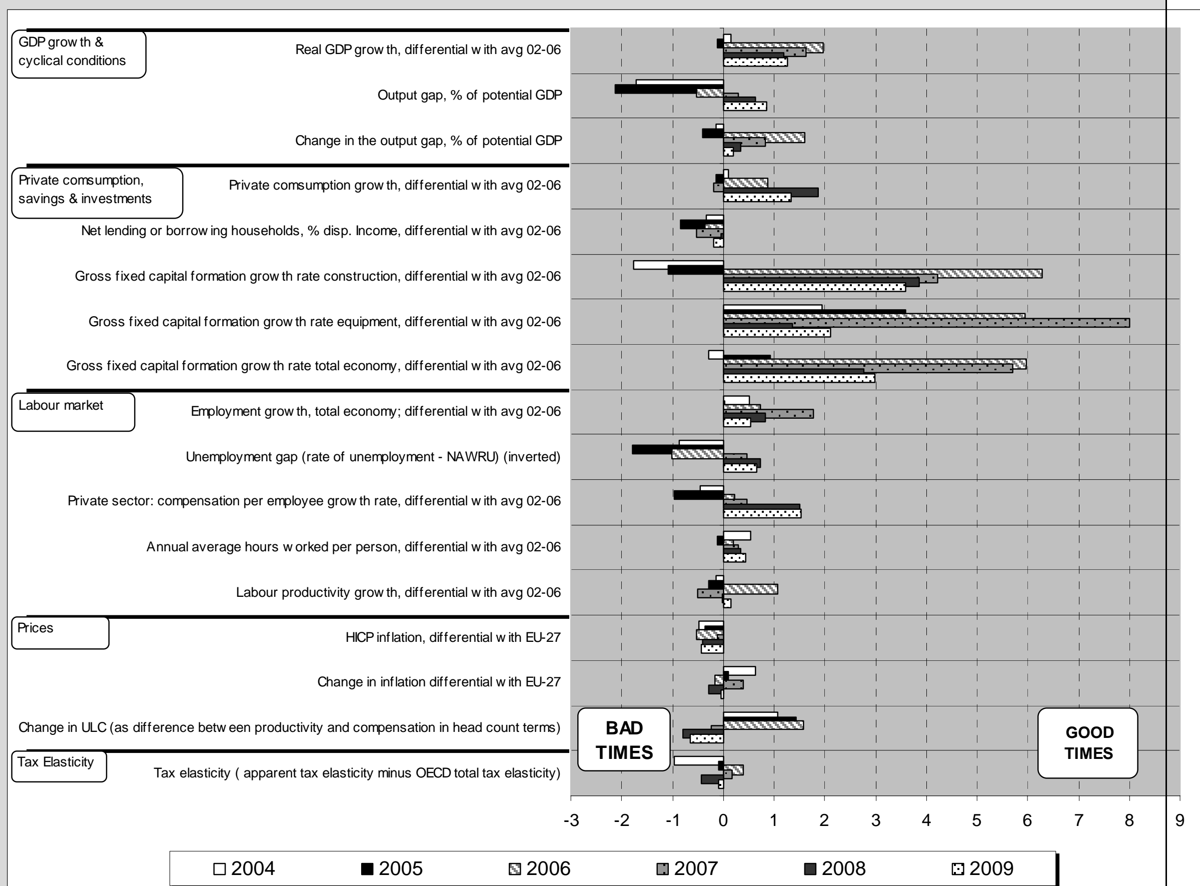
[14] Data supplied informally to the Commission services.

Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be entering into good economic times taking into account tax elasticities in the period 2007-2009.

This assessment is supported by high growth rates in 2006 and 2007. Consequently, the negative output gap is being closed in 2007 and is expected to become positive in the coming years. Similarly, private consumption and particularly gross fixed capital formation are relatively buoyant compared with the earlier half of this decade, the latter also reflecting a relatively high capacity utilisation of above 87%. In addition, also due to the recent labour market reforms the labour market is experiencing a significant improvement. Finally, tax elasticities are close to neutral times while fluctuating due to fiscal measures (see also section 4).

Good versus bad times



4. General government balance

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 2 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the stability programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[15]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (both because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.

- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher than anticipated in the previous update of the programme (therefore increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

[15] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

Table 2: Budgetary implementation in 2007

	2006		2007	
	Planned SP Nov 2006	**Outcome COM**	**Planned SP Nov 2006**	**Outcome COM**
Revenue (% of GDP)	43 1/2	43.8	43 1/2	43.9
Expenditure (% of GDP)	45 1/2	45.4	45	43.8
Government balance (% of GDP)	-2.1	-1.6	-1 1/2	0.1
Nominal GDP growth (%)			2 1/2	4.4
Nominal revenue growth (%)			1 1/2	4.7
Nominal expenditure growth (%)			1	0.8
Revenue surprise compared to target (% of GDP)			**0.6**	
Of which [1] *:* 1. Base effect			0.1	
2. GDP growth effect on denominator			-0.7	
3. Revenue growth effect			1.2	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*0.5*	
Expenditure surprise compared to target (% of GDP)			**-1.2**	
Of which [1] *:* 1. Base effect			-0.3	
2. GDP growth effect on denominator			-0.8	
3. Expenditure growth effect			-0.1	
Government balance surprise compared to target (% of GDP)			**1.7**	
Of which: 1. Base effect			0.4	
2. GDP growth effect on denominator			0.0	
3. Revenue / expenditure growth effect			1.3	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2]Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source :
Commission services

The figures in Table 2 can be interpreted as follows. The 2007 deficit ratio was projected in the previous programme at -1½% of GDP, but according to the Commission services' autumn forecast is likely to turn into a surplus of 0.1% of GDP. Of the difference in the projections, about 0.4 percentage points are due to a "base effect". In 2006, the budget deficit turned out better than anticipated in the November 2006 stability programme (actual deficit at -1.6% of GDP against an estimated -2.1% of GDP). This was due to expenditure being lower than expected by the November 2006 update of the programme but also a higher tax-revenue-intensity of growth during the last months of 2006. This will have an impact on the 2007 deficit, if this effect persists in 2007.

Nominal GDP growth in 2007 would, according to the Commission autumn forecast (and the updated programme), turn out considerably higher than previously projected. Revenues grew unexpectedly by 1.2% of GDP. There are two reasons for this. First, tax revenues are boosted automatically by GDP growth. On average, a one percent increase in growth would increase tax revenues by about one percent as well (keeping changes in tax rates constant between projections) in Germany, leaving the revenue-to-GDP ratio unchanged. Second, tax revenues in 2007 seem to benefit from a higher tax intensity of growth, compared with the projection in the previous programme. This would amount to 0.5 percentage points (Table 2: '"revenue surprise'", last row) and seems to be due mainly to some personal income taxes, which involve payments of advances and arrears, causing some margin of error to the tax forecast.

The unexpected revenues were not spent in 2007. Even more, in nominal terms government expenditure was slightly lower than planned. This is due to higher-than-expected savings in labour market expenditure (by the Federal Employment Agency), which could even compensate for higher expenditure in other lines, in particular on investment. The automatic effect of the cycle on government spending is usually quite small. Therefore, with stronger GDP growth, the expenditure-to-GDP ratio declines, unless discretionary spending is increased. Since, on balance, the German government abstained from spending the additional revenue, the expenditure ratio declined by about 0.8 percentage points compared with plans (net of the base effect) in addition to the lower-than-planned expenditure of 0.1% of GDP.

In sum, these three effects (base effect, buoyant tax revenue and tighter spending) explain the better-than-expected budgetary outcome in 2007. However, recent data point to a slowdown in tax revenues in the last months of 2007. Therefore, the Commission services' autumn forecast of a 2007 budget surplus of 0.1% of GDP might now appear slightly optimistic. The update of the stability programme projects the 2007 budget in balance.

The Council opinion of 27 February 2007 on the previous update of the stability programme invited Germany to achieve its medium-term objective of a balanced budget in structural terms. The structural deficit in 2007 (Table 3 in the next section) was reduced so as to reach balance (according to the Commission services' autumn forecast) or almost balance (according to Commission services calculations based on programme data). Underlying last year's programme was a reduction in the structural deficit by about ½% of GDP. Table 3 below shows that the reduction is likely to amount to over 1% of GDP. The stronger improvement in the structural balance would be largely due to the above-mentioned tax revenue growth exceeding the average cyclical effect on revenues (0.5% of GDP) and the tighter spending (0.1% of GDP). Budgetary execution in 2007 was therefore fully in line with the Council opinion.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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

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. Germany is planning to reach its MTO (a balanced budget in structural terms, i.e. the cyclically-adjusted net of one-off and other temporary measures, calculated according to the commonly agreed methodology) again by 2010 (after it was reached in 2007, see above). The previous programme did not foresee a target date.

Having reached almost balance already in 2007 (a deficit of ¼% of GDP, according to the Commission services' calculations on the basis of the information in the programme), the programme projects the structural deficit to widen again in 2008, thus moving away from the MTO, and then to improve subsequently, eventually achieving a structural surplus by 2011. The structural effort over the programme period is somewhat lower than that envisaged by the previous programme; however, the initial conditions have, through the better-than-expected budgetary outturn both in 2006 and 2007, improved

significantly. Therefore, the structural deficit remains below 1% of GDP throughout. In addition, economic good times would positively impact on the headline deficit until 2009, whereas in the last year of the programme period the structural balance would be close to the headline deficit ratio. The improvement in the primary balance follows the same pattern, with the surplus reaching 3½% of GDP by 2011.

Table 3: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Dec 2007**	**-1.6**	**0**	**-½**	**0**	**½**	**½**
	SP Nov 2006	*-2.1*	*-1½*	*-1½*	*-1*	*-½*	*n.a.*
	COM Nov 2007	-1.6	0.1	-0.1	0.2	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2007**	**45.4**	**44**	**43½**	**43**	**42**	**41½**
	SP Nov 2006	*45½*	*45*	*44½*	*43½*	*43*	*n.a.*
	COM Nov 2007	45.4	43.8	43.3	42.8	n.a.	n.a.
General government revenue (% of GDP)	**SP Dec 2007**	**43.8**	**44**	**43**	**43**	**42½**	**42**
	SP Nov 2006	*43½*	*43½*	*42½*	*42½*	*42*	*n.a.*
	COM Nov 2007	43.8	43.9	43.2	43.0	n.a.	n.a.
Structural balance[1] (% of GDP)	**SP Dec 2007**	**-1.5**	**-0.3**	**-0.7**	**-0.3**	**0.0**	**0.7**
	SP Nov 2006	*-2.0*	*-1.5*	*-1.5*	*-1.0*	*-0.6*	*n.a.*
	COM Nov 2007	-1.3	0.0	-0.4	-0.2	n.a.	n.a.
Real GDP (% change)	**SP Dec 2007**	**2.9**	**2.4**	**2.0**	**1½**	**1½**	**1½**
	SP Nov 2006	*2.3*	*1.4*	*1¾*	*1¾*	*1¾*	*n.a.*
	COM Nov 2007	2.9	2.5	2.1	2.2	n.a.	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.1% of GDP in 2008 and 2009; all deficit-increasing, according to the most recent programme; and 0.1% of GDP in 2007, 2008 and 2009; all deficit-increasing, according to the Commission services' autumn forecast.

Source :

Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM)

Table 4: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	2011	Change: 2011-2007
Revenue	**43.8**	**44**	**43**	**43**	**42½**	**42**	**-2**
of which:							
- Taxes	23.0	24	23 1/2	24	24	24	**0**
- Social contributions	17.3	16½	16	16	16	15 1/2	**-1**
- Other (residual)	3.5	3 1/2	3	n.a.	n.a.	n.a.	**n.a.**
Expenditure	**45.4**	**44**	**43½**	**43**	**42**	**41½**	**n.a.**
of which:							
- Primary expenditure	42.6	41	41	40 1/2	39 1/2	39	**-2**
of which:							
Compensation of employees, social transfers in kind, intermediate consumption and other taxes on production	18.8	18 1/2	18	18	18	18	**- 1/2**
Social transfers other than in kind	18.5	17 1/2	17	16 1/2	16 1/2	16	**-1 1/2**
Subsidies	1.2	1	1	1	1	1	**0**
Gross fixed capital formation	1.4	1½	1½	1½	1½	1½	**0**
Other (residual)	2.8	2½	3	2½	2½	2½	**0**
- Interest expenditure	2.8	3	2½	2½	2½	2½	**- 1/2**
General government balance (GGB)	**-1.6**	**0**	**-½**	**0**	**½**	**½**	**1/2**
Primary balance	**1.2**	**3**	**2½**	**2½**	**3**	**3½**	**1/2**
One-off and other temporary measures	0.0	0.0	-0	-0	0	0	**0**
GGB excl. one-offs	**-1.6**	**0.0**	**-0.5**	**0.0**	**0.5**	**0.5**	**1/2**
Output gap[1]	-0.2	0.7	1.1	0.8	0.5	-0.1	**-0.8**
Cyclically-adjusted balance[1]	-1.5	-0.3	-0.8	-0.4	0.0	0.7	**1.1**
Structural balance[2]	**-1.5**	**-0.3**	**-0.7**	**-0.3**	**0.0**	**0.7**	**1.1**
Change in structural balance		*1.1*	*-0.4*	*0.4*	*0.4*	*0.7*	
Structural primary balance[2]	1.3	2.5	2.0	2.4	2.7	3.3	**0.9**
Change in structural primary balance		*1.1*	*-0.5*	*0.4*	*0.4*	*0.6*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

As revenue measures (company tax reform, cut of unemployment insurance contribution rate) weigh on the deficit in 2008 and beyond, the envisaged consolidation is entirely expenditure-based. Indeed, the expenditure ratio would fall by 2½ percentage points to 41½% of GDP between 2007 and 2011. Similarly, the previous programme projected an expenditure restraint of the same magnitude between 2006 and 2010.

As **Error! Reference source not found.** shows, the revenue ratio is projected to decline by some 2 percentage points between 2007 and 2011. In 2008, two significant revenue measures have been implemented. First, the company tax reform (described in Chapter 6) is expected to burden the budget by about 0.3% of GDP (according to details given in the programme). Second, the contribution rate to the unemployment insurance has been reduced from 4.2% to 3.3% of the gross wage, also burdening the budget by 0.3% of GDP. On 1 July 2008, the contribution rate to the long-term care system will be raised by 0.25 percentage points. After 2008, tax revenue is projected to remain constant as a share of GDP, so that the decline in the revenue share after 2008 would have to derive from

either social contributions or other revenues. Unfortunately, this is not specified in the programme.

The overwhelming part of the envisaged expenditure reduction by over 2 percentage points would derive from social expenditure. In particular, social transfers other than in kind as a share of GDP are projected to decline steadily over the programme period. A small consolidation contribution (confined to 2008) would also come from the category "compensation of employees, social transfers in kind, intermediate consumption and other taxes on production (paid)". Interest expenditure are projected to increase roughly in line with GDP, similarly public investment.

One-off and temporary measures are not envisaged to influence the budget in any significant manner over the programme period.

Box 4: The budget for 2008

The federal budget for 2008 was approved by the *Bundestag* on 30 November and passed the *Bundesrat* on 20 December, so that it entered into force on 1 January 2008. 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 fiscal flows between levels of government. Figures given below usually apply to general government.

The general government balance is projected to relapse from balance in 2007 into a deficit of ½% of GDP in 2008.

The two main measures in the general government budget are the company tax reform and the reduction in the overall social contribution rate. The contribution rate to the unemployment insurance will be reduced from 4.2% to 3.3% of the wage on 1 January 2008. In addition, the contribution rate to the long-term care insurance (*Pflegeversicherung*) is planned to rise from 1.7% to 1.95% (for persons without children from 1.95% to 2.2%) on 1 July 2008. Additional public expenditure will be made on childcare facilities and long-term unemployment (job placement programmes, wage subsidies). Moreover, the unemployment benefit duration for older workers will be extended to 24 months, after it was shortened in 2006 from a maximum of 32 months to 18 months.

Public finances in 2008 will furthermore benefit from action taken well before this budget. The public wage agreement for the Länder, concluded in 2006, extends into 2008, for when it foresees a rise in the wage rate of just below 3%. The wage agreement for the federal and the local level expired at the end of 2007; negotiations will begin in early 2008.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Company tax reform (-0.3% of GDP) o Social contribution rates (-0.3% of GDP)	o Labour market, childcare (-0.1% of GDP)

* 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 enacted in 2008. Measures adopted in previous years, which may impact on the 2008 budget, are not listed.
Sources: Commission services, federal government.

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

Table 4: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010	2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue	**43.8**	**43.9**	**44**	**43.2**	**43**	**43.0**	**43**	**42½**	**42**
of which:									
- Taxes on production and imports	12.1	12.7	12½	12.5	12½	12.6	n.a.	n.a.	n.a.
- Current taxes on income, wealth, etc.	10.8	11.2	11	11.0	11	10.9	n.a.	n.a.	n.a.
- Social contributions	17.3	16.5	16½	16.3	16	16.1	16	16	15 1/2
- Other (residual)	3.7	3.6	n.a.	3.5	n.a.	3.4	n.a.	n.a.	n.a.
Expenditure	**45.4**	**43.8**	**44**	**43.3**	**43½**	**42.8**	**43**	**42**	**41½**
of which:									
- Primary expenditure	42.6	41.1	41	40.6	41	40.2	40 1/2	39 1/2	39
of which:									
Compensation of employees social transfers in kind, intermediate consumption and other taxes on production	18.8	18.4	18 1/2	18.4	18	18.3	18	18	18
Social transfers other than in kind	18.5	17.4	17 1/2	16.9	17	16.6	16 1/2	16 1/2	16
Subsidies	1.2	1.1	1	1.1	1	1.1	1	1	1
Gross fixed capital formation	1.4	1.5	1½	1.6	1½	1.6	1½	1½	1½
Other (residual)	2.8	2.7	2½	2.6	3	2.5	2½	2½	2½
- Interest expenditure	2.8	2.8	3	2.7	2½	2.6	2½	2½	2½
General government balance (GGB)	**-1.6**	**0.1**	**0**	**-0.1**	**-½**	**0.2**	**0**	**½**	**½**
Primary balance	**1.2**	**2.8**	**3**	**2.6**	**2½**	**2.8**	**2½**	**3**	**3½**
One-off and other temporary measures	0.0	0.0	0.0	0.0	-0	-0.1	-0	0	0
GGB excl. one-offs	**-1.6**	**0.1**	**0.0**	**-0.1**	**-0.5**	**0.3**	**0.0**	**0.5**	**0.5**
Output gap[2]	-0.5	0.3	0.7	0.6	1.1	0.9	0.8	0.5	-0.1
Cyclically-adjusted balance[2]	-1.3	-0.1	-0.3	-0.4	-0.8	-0.2	-0.4	0.0	0.7
Structural balance[3]	**-1.3**	**0.0**	**-0.3**	**-0.4**	**-0.7**	**-0.2**	**-0.3**	**0.0**	**0.7**
Change in structural balance		*1.3*	*1.1*	*-0.4*	*-0.4*	*0.2*	*0.4*	*0.4*	*0.7*
Structural primary balance[3]	1.5	2.7	2.5	2.3	2.0	2.5	2.4	2.7	3.3
Change in structural primary balance		*1.3*	*1.1*	*-0.4*	*-0.5*	*0.2*	*0.4*	*0.4*	*0.6*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

Section 3 above laid out that the programme is based on plausible macroeconomic assumptions for the period 2007-2008 and is based on cautious growth assumptions thereafter. Therefore, the macroeconomic projections do not pose a risk to the budgetary outcome.

The revenue share is projected to decline both according to the updated programme as well as to the Commission services' autumn forecast (see Table 5). The company tax reform will weigh both on direct taxes (on the corporate as well as on the personal level)

and on indirect taxes, because the local tax (*Gewerbesteuer*) is classified in national accounts under "other taxes on production".[16] From 2009 on, the tax revenue share in GDP is projected to increase minimally. In the absence of new measures, this is plausible.

The social contribution rate will be lowered in 2008. At the cut-off date to the autumn forecast, only a third of the finally adopted rate cut had been decided, so that the decline of social contributions as projected by the programme should be more pronounced than assumed by the autumn forecast. Furthermore, the programme expects the contribution rate to the pension insurance to decline in 2011.[17] Finally, the programme seems to project "other revenues" (such as dividend, interest and property income) to decline slightly over the programme period. In view of the privatisations of the past years, this seems credible. Overall, the programme's revenue projections are plausible.

Table 5: Assessment of tax projections

	2008			2009			2010	2011
	SP	COM	OECD[3]	SP	COM[1]	OECD[3]	SP	SP
Change in tax-to-GDP ratio (total taxes)	-0.8	-0.6	0.0	n.a.	-0.2	0.0	n.a.	n.a.
Difference (SP – COM)	-0.2		/	n.a.		/	/	/
of which [2] *:*								
- discretionary and elasticity component	*-0.2*		*/*	*n.a.*		*/*	*/*	*/*
- composition component	*0.0*		*/*	*n.a.*		*/*	*/*	*/*
Difference (COM - OECD)	/	-0.6		/	-0.2		/	/
of which [2] *:*								
- discretionary and elasticity component	*/*	*-0.7*		*/*	*-0.2*		*/*	*/*
- composition component	*/*	*0.2*		*/*	*0.1*		*/*	*/*
p.m.: Elasticity to GDP	0.4	0.5	1.0	n.a.	0.9	1.0	n.a.	n.a.

Notes:

[1]On a no-policy change basis.

[2]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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

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

Source :

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

Table 6 confirms this assessment (at least for 2008). The difference between the COM and the SP projections is due to the cut in the social contribution rate decided after the cut-off date of the COM forecast. The difference with regard to the OECD standard elasticities results partly from the rate cut included in the autumn forecast as well as the company tax reform.

The programme projects the expenditure share to decline by 2½ percentage points over the programme period. The largest part of the expenditure restraint (1½ percentage points) would be achieved by reducing social transfers other than in kind. This encompasses pension outlays, unemployment benefits (*Arbeitslosengeld I*) and social

[16] For a description of the company tax reform, see Chapter 6.

[17] The *Rentenversicherungsbericht 2007* projects in its central scenario the contribution rate to decline from 19.9% to 19.4%.
http://www.bmas.de/coremedia/generator/22472/rentenversicherungsbericht__2007.html

benefits (*Arbeitslosengeld II, Geldleistungen der Sozialhilfe*). The government's *Rentenversicherungsbericht 2007* projects pension expenditure until 2011 to grow by less than nominal GDP. This is plausible until 2009, as pensions are determined by the previously moderate wage developments. Beyond 2009, the *Rentenversicherungsbericht* assumes continued moderate wage developments and also rising employment (see Chapter 3 above on labour market developments). Pensions also depend on a demographic factor, i.e. the ratio of contributors to recipients. This might dampen the increase in pension from a higher-than-expected wage growth. In addition, in that case the above-mentioned expected contribution rate cut of ½ percentage point in 2011 might not be carried out, thus leaving the general government balance largely unaffected.

Despite GDP not being projected growing above potential between 2009 and 2011, the programme expects employment gains throughout the programme period. The programme seems to assume the structural improvement from labour market reforms to be continuing over the programme period, although no further reforms are planned and some were reversed.

Until 2009, the programme's projection of 'social transfers other than in kind' corresponds roughly to the Commission services' autumn forecast, which projected this kind of expenditure to decline by one percentage point of GDP. Of the remaining ½ percentage point restraint in monetary transfers, which is to be achieved in 2010/11, only some part is plausible (expenditure on pensions). However, it should be borne in mind that the Commission services' autumn forecast is based on a no-policy change assumption. The fact that the programme scenario corresponds to the Commission forecast until 2009 would imply a similar assumption implicit in the programme. However, with the economy in economic good times, rising wage demands and currently high inflation, there is a risk that benefit rates are adjusted upwards. Therefore, the envisaged restraint in social spending would be credible only at current policies and if there is no backtracking from reforms already put in place.

The small consolidation contribution of ½ percentage point from the category "compensation of employees, social transfers in kind, intermediate consumption and other taxes on production (paid)" is mostly confined to 2008. Unexplained in the programme, this might derive from public wage developments, if the trend reduction in the number of public employees is assumed to continue in 2008. This trend, however, might not extend to the future, especially as the pressure to consolidate at all levels of government has now diminished. Even more, wages and salaries for civil servants and public employees have barely increased in nominal terms between 2005 and 2007 and bonus payments for holidays and Christmas were cut, so that public sector unions demand compensatory wage increases in the negotiations following the expiry of the wage contracts at the end of 2007 and 2008. On 19 December 2007, public sector unions demanded a rise in the wage rate by 8% for 2008. Negotiations began mid-January 2008.

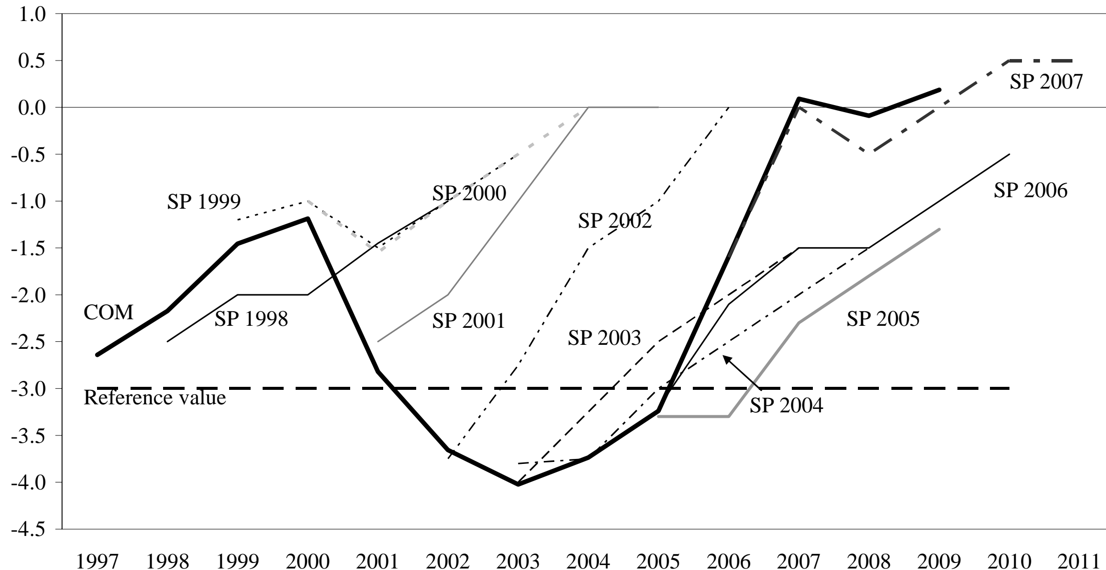
In view of the good budgetary situation at all levels of government, public investment might increase by more than GDP.

The programme projects public finances at different sectors of government as follows. The federal level is projected to slowly reduce its deficit of 1% of GDP to a balanced budget by 2011. In some years, the social security system, controlled by the federal government, is assumed to achieve slight surpluses. As the programme explains, this would be due to the pension system, which is legally required to build up a reserve fund to provide liquidity. With the cut in the contribution rate, the unemployment insurance

would move from a surplus in 2007 into deficit in 2008.[18] The programme remains silent about the public health care system; however it is most likely that it would be in balance over the programme period. The Länder (plus local governments) are projected to achieve surpluses throughout the programme period. This might seem optimistic, 2007 was the first year since German unification, in which this government level was able to achieve a budgetary surplus. Public finances at this level depend to a large extent on public wage developments (78% of the general government wage bill is spent at that level). Therefore, the above-mentioned risks regarding public wage developments apply particularly to the Länder level. Even though some Länder (e.g. Bavaria) are committed to balanced budgets, the projection of a surplus for the Länder average seems optimistic until a firm (institutional) commitment of the Länder will be reached in the context of the ongoing reform discussions on fiscal relations in the federal system.

In sum, the budgetary risks to the programme are neutral. As figure 9 shows, the track record of the programme projections has been good over the last few years (especially during the economic upswing), while it had been less so during the downswing beginning in 2001. The programme scenario seems to be based on a no-policy-chance scenario, i.e. the measures that resulted in the recent consolidation are by and large projected to remain implemented. The commitment of the budgetary authorities at all levels of government to stay on this virtuous path in view of the "benign" budgetary situation is possibly the main risk to the projections. The ongoing reform discussions on fiscal relations in the federal system are not expected to deliver results before 2009, so that institutionalised commitments to maintaining balanced budgets at different levels of government might not be in place before the end of the programme horizon.

Figure 9: Government balance projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2007 forecast (COM) and successive stability programmes

18 The deficit will be covered by the financial assets accumulated in 2006 and 2007. Covering the deficit from assets in economic good times might entail the risk that in case of an economic downturn, the contribution rate to the unemployment insurance would have to be raised again – resulting in pro-cyclical policy (see Section 6 below).

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 analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Table 6: Overview of compliance with the Stability and Growth Pact

	Based on programme[4] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	Broadly in 2007/ from 2010 onwards	Broadly in 2007/ from 2010 onwards
c. Adjustment towards MTO in line with the Pact (after the deviation from MTO in 2008)[2]?	broadly in line	broadly in line
d. Fiscal stance in line with Pact[3]?	may not be fully in line (2008)	may not be fully in line (2008)

Notes:
[1]The 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]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[4]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

According to the Commission services' autumn forecast, Germany would have reached its medium-term objective of a balanced budget in structural terms already in 2007; according to the programme, the MTO would have been almost reached. The difference arises mainly from a slightly lower potential growth rate underlying the programme compared with the Commission services' autumn forecast, but also the slightly better budgetary outcome for 2007 as projected by the Commission services.

The structural balance is projected to deteriorate in 2008. The adjustment towards the MTO thereafter is broadly in line with the Pact, so that the renewed attainment of the MTO by 2010 seems plausible, also in view of the above risk assessment.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

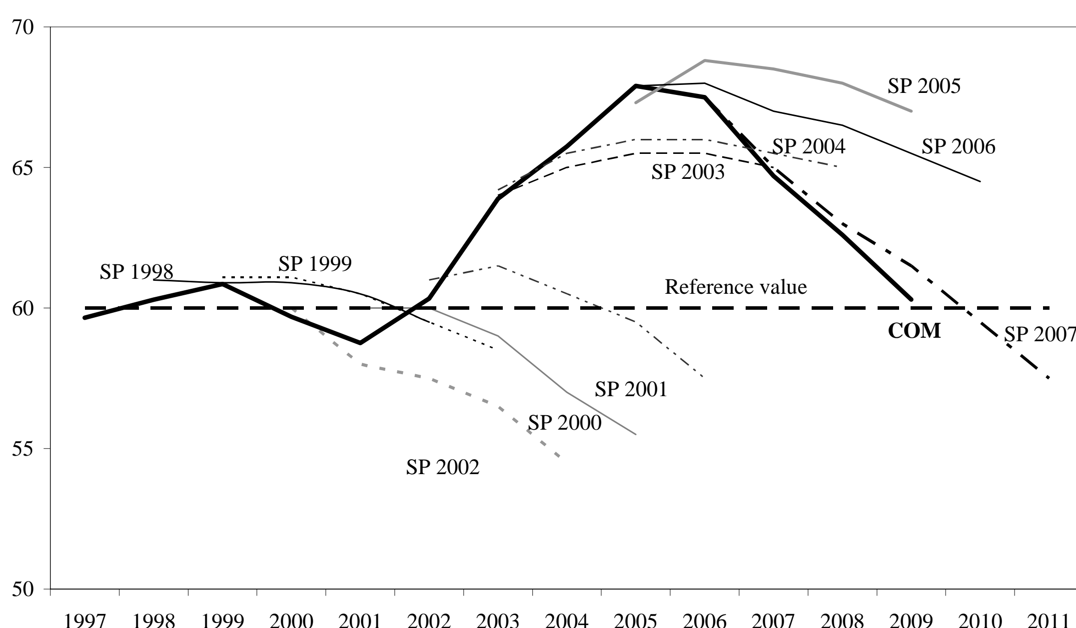
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

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 65% of GDP at the end of 2007, after the debt ratio peaked at 67.8% of GDP in 2005. The debt ratio is projected to fall below the 60%-of-GDP reference value by 2010.

Figure 10: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

Table 7 shows that the progressive increase in the primary surplus contributes to the reduction in the debt ratio from 2006 on. Moreover, from that year 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 (except for 2008), the update assumes the "stock-flow adjustment" (SFA) to dampen debt reduction somewhat (unlike previous assessments, which projected debt-reducing adjustments). This development is not explained in the programme, but might be related to the projected surpluses in the social security systems. In 2006 and 2007, the social security system accumulated surpluses, which were not invested in government bonds. Following the cut in the unemployment contribution rate in 2008, some of these assets will have to be used to cover the deficit in the

unemployment insurance. However, the programme projects surpluses in the social security system thereafter, which, under the assumption that they are not invested in government bonds, would not serve to reduce government debt according to the Maastricht criteria.

Table 7: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010	2011
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**64.4**	**67.5**	**64.7**	**65**	**62.6**	**63**	**60.3**	**61 1/2**	**59 1/2**	**57 1/2**
Change in the ratio	2.3	-0.2	-2.8	-2 1/2	-2.1	-2	-2.3	-1 1/2	-2	-2
Contributions[2] *:*										
Primary balance	**0.8**	**-1.2**	**-2.8**	**-3**	**-2.6**	**-2 1/2**	**-2.8**	**-2 1/2**	**-3**	**-3 1/2**
"Snow-ball" effect	**1.9**	**0.5**	**-0.1**	**-0.1**	**0.5**	**0.5**	**0.5**	**1.0**	**1.0**	**1.0**
Of which:										
Interest expenditure	2.9	2.8	2.7	2.8	2.7	2.7	2.6	2.7	2.7	2.7
Growth effect	-0.3	-1.9	-1.6	-1.6	-1.3	-1.3	-1.3	-0.9	-0.9	-0.9
Inflation effect	-0.7	-0.4	-1.2	-1.3	-0.9	-0.9	-0.8	-0.8	-0.8	-0.8
Stock-flow adjustment	**-0.5**	**0.4**	**0.1**	**0.2**	**0.0**	**-0.1**	**0.0**	**0.3**	**0.3**	**0.3**
Of which:										
Cash/accruals diff.	0.0	-0.8		n.a.		n.a.		n.a.	n.a.	n.a.
Acc. financial assets	-0.5	1.3		n.a.		n.a.		n.a.	n.a.	n.a.
Privatisation	*-0.4*	*-0.3*		*n.a.*		*n.a.*		*n.a.*	*n.a.*	*n.a.*
Val. effect & residual	0.0	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 decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :
Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The Commission services project the debt ratio to fall over the coming years even at a slightly higher pace than in the programme, although the projections for the primary surplus and GDP growth are rather similar. This is because in the Commission services' forecast the stock-flow adjustment was set to zero, since not sufficient detail is known. The discussion of the risks attached to the deficit development also applies to the debt development.

Box 5 illustrates that the debt path as projected in the update would meet the debt reduction benchmark throughout the programme period. Taking the above risk assessments on the deficit (broadly balanced) into account, the debt ratio can be said to be sufficiently diminishing towards the reference value over the programme period.

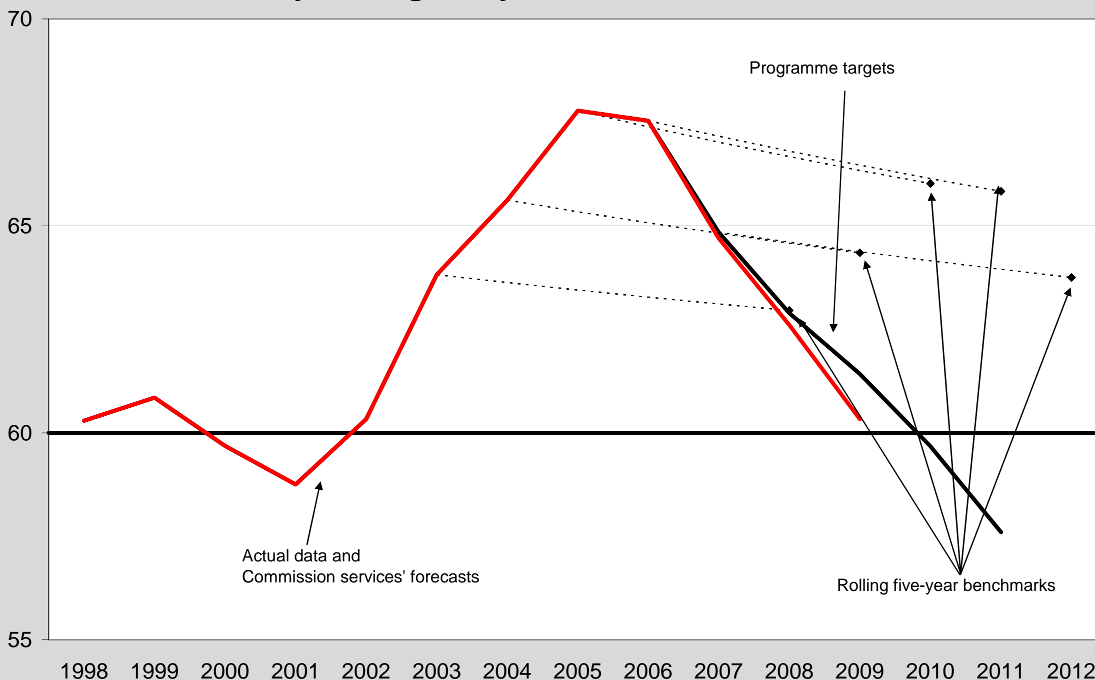
In view of the still quite low potential growth, it is clear that it would not suffice bringing the deficit to just below 3% of GDP for stabilising the debt ratio. Rather, the analysis shows that Germany should aim at keeping to the achievement of its MTO.

Box 5: The rolling debt reduction benchmark

The debt ratio has exceeded 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 2007 forecasts until 2009 (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 2008 is compared with the value obtained for the same year by applying the formula starting in 2003. 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 clearly shows that the planned reduction of the debt ratio in the update is more than implied by the five-year rolling debt reduction benchmark.



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:

$$\left(\frac{D_{t+1}}{Y_{t+1}}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right],$$

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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 9 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 and property income received by general government according to an agreed methodology. [19] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 9: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2004-50
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
Property income received	0.6	0.6	0.6	0.5	0.4	0.4	-0.2

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 p.p. 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. [20] The increase in health-care expenditure is projected to be 1.2 p.p. of GDP, lower than on average in the EU. For long-term care, the projected increase of 1.0 p.p. of GDP up to 2050, is above the average in the EU.

Table 10: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	0.5	1.8	4.4	-0.4	0.9	4.4
of which:						
Initial budgetary position (IBP)	-1.4	-1.3	-	-2.3	-2.2	-
Debt requirement in 2050 (DR)	0.0	-	-	0.0	-	-
Long-term change in the primary balance (LTC)	2.0	3.1	-	2.0	3.1	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 10 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the

[19] See the accompanying "methodological paper" for a description of the property income projections.

[20] The long-term projections do not include the effects of the most recent reform (2007), see also 'additional factors'.

programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 1.8% of GDP.[21] The sustainability gap is significantly smaller in the present assessment than in last year's assessment, by about 1½ % of GDP. This is mainly due to a higher estimated structural primary balance in 2007 (2.5% of GDP) compared with the structural primary balance in 2006 (1.3% of GDP as estimated today and 0.8% of GDP as estimated in the assessment of the 2006/07 stability programme).

The initial strong budgetary position with a structural primary balance of 2.5% of GDP contributes to the reduction of gross debt. According to both sustainability gaps, the long-term budgetary impact of ageing is limited in particular thanks to the pension reform measures enacted since the 1990s.

The programme plans a structural primary budgetary consolidation of 0.8 p.p. of GDP between 2007 and 2011. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by reducing the S2 sustainability gap to 0.9 p.p. of GDP ("programme scenario"). The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the stability programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is almost 4.4% of GDP, somewhat higher than the structural primary balance of about 3.3% of GDP in the last year of the programme's period.

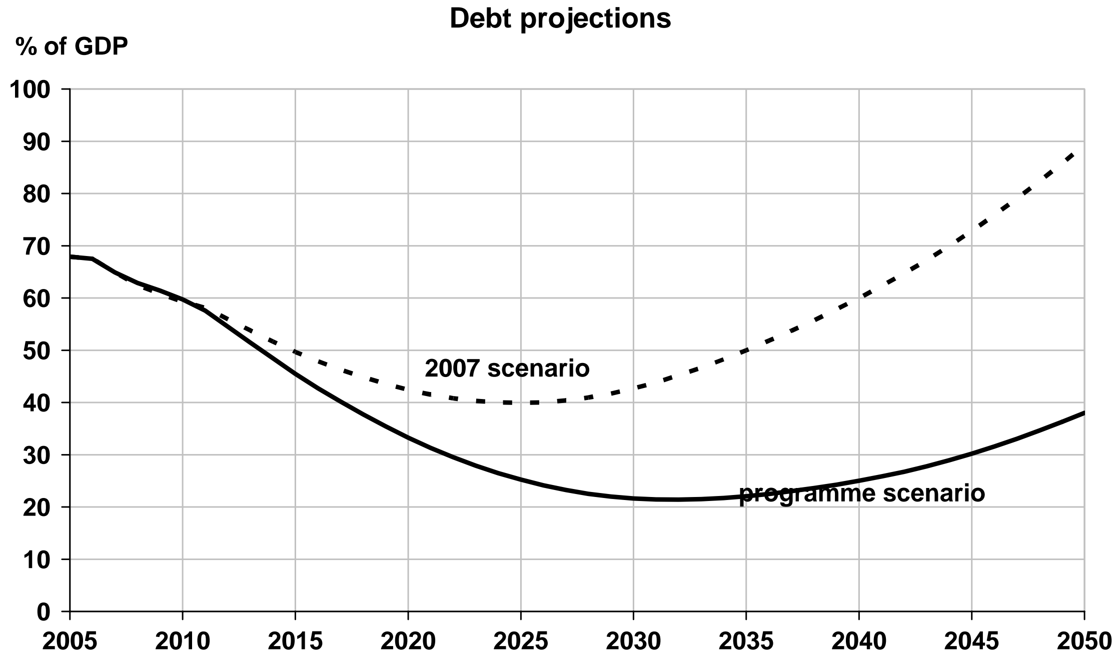
The sustainability gap indicators would increase by up to 0.2p.p. of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

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 the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 11.

The gross debt ratio is currently above the reference value, estimated in the programme at close to 65% of GDP in 2007. According to the "2007 scenario", the debt ratio is projected to decrease up to the mid 2020s and thereafter increase throughout the projection period up to 2050. In the "programme scenario", thanks to the stronger budgetary position in 2011, debt would remain below the 60% of GDP threshold as of 2010 and over the projection period.

[21] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be ½% of GDP.

Figure 11: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, Germany's current level of debt is around 65% of GDP in 2007. A reduction of debt to below the 60% of GDP reference value at a satisfactory pace would strengthen the resilience of the public finances to adverse shocks and reduce the risks to public finance sustainability.

Second, the long-term projections do not include the effect of the pension reform enacted in April 2007. This reform increases the retirement age from 65 to 67 years between 2012 and 2029.[22] Moreover, the effects of the so-called 'safety clause'[23], which prevented pensions to decrease in nominal terms in 2005 and 2006, will be compensated from 2011 on. The programme does not provide an estimate of the impact of the pension reform on expenditure.

The law also contains a provision that the federal government has, from 2010 onwards every four years, to provide an assessment whether raising the statutory retirement age would remain justified in view of the labour market situation and the socio-economic situation of older workers. Given the budgetary savings that can be expected from the 2007 reform, the labour market situation of older workers should be addressed by labour

[22] This reform has not yet been enacted for civil servants.

[23] The PAYG pension is primarily indexed on wage developments and depends on others factors, such as the ratio between retirees and contributors (sustainability factor). The 'safety clause' ensures that the other factors do not apply in case they led to a decrease of pensions in nominal terms.

market policy. The government implemented measures in that direction, such as fostering training for older workers, but also took steps to the contrary, such as reversing the reduction in the unemployment benefit duration for older workers, which would now reduce incentives for active job search.

Third, the government adopted a draft law on 17 October 2007, which will increase public expenditure for long-term care, by almost 0.08 p.p. of GDP annually until 2012, both through an extension of services and an increase in benefits. From 2014 on, benefits would rather be based on prices than fixed in nominal terms as is currently the case. However, this new law would not change the current assessment. The long-term care projections in the reference scenario of the Ageing report (which is used for the sustainability indicators) are conducted on the common understanding that the cost of long-term care services, being labour-intensive, would follow wage growth over the long term for all countries.[24]

Fourth, the benefit ratio[25] 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 ensure that workers can accumulate more pension rights. The reform to increase the retirement age from 65 to 67 should therefore contribute to higher accumulated rights. Furthermore, the current rule that transfers from salary to occupational pension schemes are exempt from social contributions was extended beyond 2008. This change should favour the take-up of private pension schemes in Germany which may partly compensate for the projected decrease in the public benefit ratio.

Fifth, the programme projects that pension contributions will rise by 1.6 p.p. of GDP between 2010 and 2050.[26] Such an increase, which is not considered when calculating the sustainability gaps, would fill part of the gap that would emerge in that period between pension expenditure and contributions.[27]

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[24] See also the Ageing report (2006), page 148. The German authorities considered that the projected increase in expenditure on long-term care in the AWG reference scenario did not reflect current legislation in Germany at that time as long-term care benefits were fixed by law without any indexation. A scenario in which long-term care expenditure were indexed on price would come closer to the current legislative setting, and would imply that long-term care benefits would remain roughly constant as a share of GDP (instead of increasing by 1% point of GDP). However, over the long-term if the unit costs of supplying long-term care increase more than the general price level of the economy, this could lead to an increasing gap between the needs and provisions of public long-term care.

[25] i.e. average pension relative to GDP per worker.

[26] Following the above-mentioned pension reform, the rise in contribution rates should be lower.

[27] 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.

5.2.3. Assessment

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

The long-term budgetary impact of ageing is close to the EU average, with pension expenditure showing a somewhat more limited increase than in many other countries, as a result of the pension reforms already enacted. The recent pension reform (2007) will increase the statutory retirement age to 67 years, from 2012 onwards, and should reduce further the expected increase in age-related expenditure.

The budgetary position in 2007 as estimated by the programme, which significantly improved compared to 2006, contributes to offset the projected long-term budgetary impact of ageing populations. However, this is not sufficient to fully cover future spending pressures and the current level of gross debt is still above the Treaty reference value. Maintaining high primary surpluses over the medium term would contribute to reducing risks to the sustainability of public finances.

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

Germany has undertaken several reforms in the past years, on the labour market, on social security, on health care and on the pension system. For 2007, particularly the health care reform as well as the reform of the statutory retirement age is noteworthy.[28]

The health care reform entered into force on 1 April 2007. Efficiency gains and therefore reduced expenditure growth are expected as a result of different measures aiming at more competition between health insurers and between health service providers, increased freedom of choice for customers, as well as more cost control.[29] However, central elements of the reform - like the "health care pool" (*Gesundheitsfonds*) acting as a transparent financial "mediator" between insurant and insurer as well as the general obligation to contract insurance - will not become effective until 1 January 2009.

On 20 April 2007 the reform of the statutory retirement age became law. The reform foresees a stepwise increase of the statutory retirement age from 65 years to 67 years between 2012 and 2029. In view of future demographic trends, the reform aims at limiting the increase of the contribution rate to the pension system of currently 19.9% of wage income to 21.9% by 2030.[30]

The 2007 update of the German Stability Program states that to ensure the medium-term objective of a balanced budget, further structural reforms are needed. This chapter discusses three current reform projects: (i) the corporate tax reform, (ii) the reform of the inheritance tax and (iii) labour market policy measures with respect to the sustainability of the budget German Federal Labour Agency.

The corporate tax reform

The corporate tax reform came into force on 1 January 2008. The reform was designed to improve the attractiveness of Germany as a business location ("Standort Deutschland") for domestic and foreign investments, while safeguarding sustainable corporate tax revenues by preventing intra-company transfer pricing from being used for shifting profits to low-tax countries. This was a sizable problem because Germany had the highest statutory corporate tax rate of nominal 38.65% in the EU-25. The *Deutsches Institut für Wirtschaftsforschung (DIW)* calculated that the tax gap between corporate

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[28] For a discussion, see Commission Services: Technical Assessment of the December 2006 update of the stability programme of Germany.

[29] In that respect, the "Allgemeine Ortskrankenkasse" was one of the first of the public insurance that contracted directly with pharmaceutical companies (discount contracts in particular for generic medicinal products) as well as to tender medical services to the market. However, the overall financial situation of the 242 public health care insurers has not improved yet. In 2007 the tendency of rising expenditures continued: During the first three quarters total expenditure rose by 3.5% in comparison to 2006 and expenditures for medicine increased by 6.2% (3.5 % net of VAT increase). The surplus of € 173 Mio after three quarters is mainly due to the increase of the contribution rate by 0.6 percentage points on average before the reform came into force as well as the rebound of employment and wages. The contribution rate now amounts to 14.8% on average but can be expected to increase further to above 15%. See *Bundesministerium für Gesundheit*, Pressemitteilung Nr. 106, 2007.

[30] See "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

gains recorded in national accounts and the de facto taxed gains would amount to about € 100 bn.[31] Insofar, the reduction of such profit-shifting activities (dubbed "repatriation of the national tax base" in the draft law of the reform) is assumed to provide substantial budgetary gains over time to limit the revenue loss from cutting the tax rate.

As the draft of the corporate tax reform has been discussed in the technical assessment of the previous Stability Program of December 2006, here an update on the finalized law and on its projected financial impact is given. The main elements of the reform are summarised in Box 5.

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31 See *DIW*, Wochenbericht 5, 2007.

BOX 5: The corporate tax reform 2008

Germany has a double-taxation system of income. Corporate profits are taxed at the level of the corporation *(Kapitalgesellschaft)* with the corporate tax rate and with the local trade tax. At present, only about one fifth of all companies are liable to corporate tax (of which over 90% are limited companies, i.e. *GmbH*). All other companies, i.e. partnerships (*Personengesellschaften*), fall under personal income tax and the local trade tax.

The main elements of the reform are:

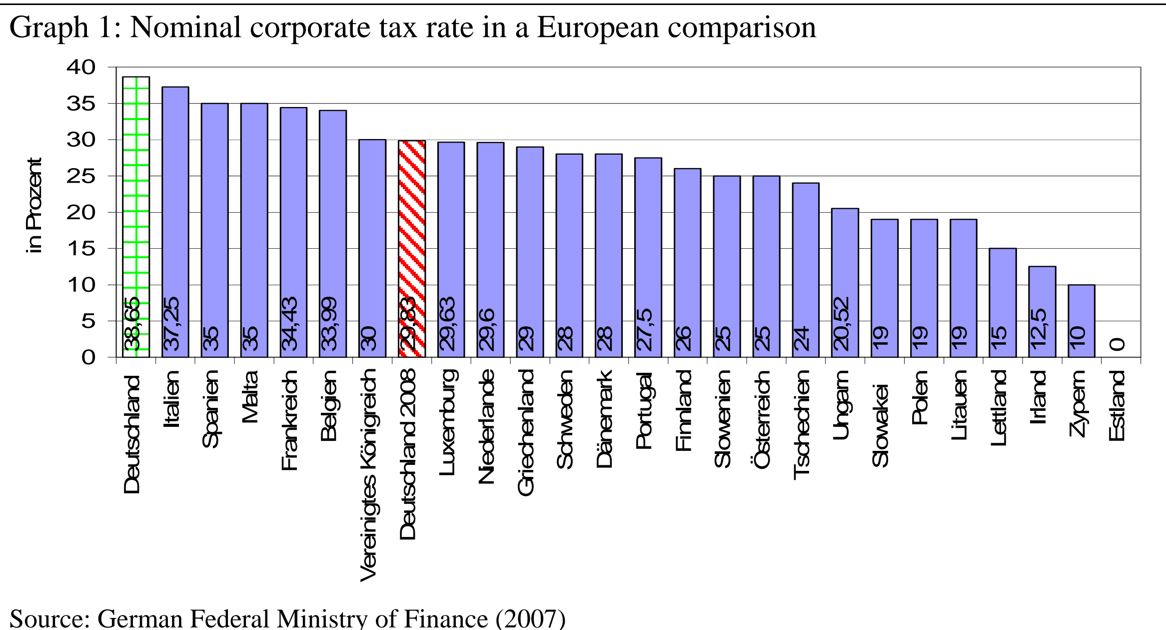
- The **corporate tax rate** is lowered from 25% to 15% of profits and the local trade tax (*Gewerbesteuermesszahl*) is lowered from 5% to 3.5% of profits. Parallel the deductability of the local trade tax from the corporate tax and from the income tax was abolished. The nominal statutory tax burden therefore decreases from 38.65% to 29.83%. This lowers the fiscal incentive to shift profits abroad and Germany becomes more attractive for foreign direct investment.
- To ensure **neutrality of burdens** between corporations and partnerships, the latter now have the opportunity to tax retained gains with a reduced rate of 28.25% (plus solidarity surcharge). This improves the possibility to build up own capital resources from gains for investment. Furthermore, small companies of maximum € 235.000 working capital benefit from a deduction of €200.000 for investment, provided the investment takes place within a period of 3 years. The real acquisition cost then can be depreciated with 40%. The measures aim to set incentives for an increased internal financing of investments.
- In order to **reduce profit-shifting** abroad, corporations and partnerships with large interest expenditure will be able to deduct interest expenditure only up to 30% of gross profits. This "interest cap" (*"Zinsschranke"*) applies for interest expenditure exceeding an allowance of € 1 Mio (after subtracting of interest receipts). This also reduces the incentive of external financing to reduce taxable gains. The instrument includes an escape-clause: Can a company prove that its high external financing corresponds with the financing structure of its corporate group, the "interest cap" doesn`t apply. The escape-clause and the allowance secure that SME are not affected by the "interest cap".
- Less an allowance of €100.000, 25% of all interest expenditure and their substitutes and - at different rates - expenditures for licences, rents and leasing have to be added to the tax base of the local trade tax. Up to now 50% of only the long-term interest expenditure had to be added. In sum, the fiscal incentive to shift profits abroad is lowered. Also the discrimination of equity financing (*Eigenkapitalfinanzierung*) against short-term external financing is reduced.
- The reform also foresees a **withholding tax** (*"Abgeltungssteuer"*) at the personal level coming into force on 1th January 2009. At present, all interest revenues 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 will tax all dividends, interest revenues and realised capital gains at a reduced rate of 25% (plus solidarity surcharge). However, there remains the option to further tax capital gains under the personal income tax.

As detailed in the Fiscal Report (*Finanzbericht*) 2008 of the German Federal Ministry of Finance, the overall fiscal impact of the corporate tax reform will be negative. The reform is projected to result in a revenue loss of about €6.6 bn or 0.3% of GDP in 2008 (in comparison to the prior law). After a peak of €7.1 bn in 2010, the loss decreases to € 3.4 bn in 2012. Most of the loss arises from the reduction of the corporate tax rate by 10 percentage points. This is partly counterbalanced by additional revenues from the abolition of the deductability of the local trade tax from corporate tax and income tax and

the projected repatriation of the national tax base. The latter is expected to increase gradually, resulting in revenues of € 4.7 bn in 2012. Taxation of cross-border value transfers within companies (*"Funktionsverlagerungen"*) is envisaged to result in revenues of about €445 Mio in 2010 rising to €2.1 bn in 2012. In total, this would sum to €6.8 bn additional revenues. Indeed, Huizinga and Laeven (2007)[32] 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. However, their estimate is less than half of what the German authorities expect to collect from limiting such activities, namely €3 billion.

In qualitative terms, the corporate tax reform aims at (i) decreasing the incentives for international profit shifting at the expense of Germany, (ii) strengthening the incentive to build up capital resources for investments and (iii) making corporate tax law more simple and transparent. The incentive for profit shifting for international enterprises is lowered in particular by the reduction of corporate tax rate and local trade tax. With a nominal statutory tax burden decreasing from 38.65% to 29.83%, Germany shifts from the last rank to a middle rank in a European comparison (see Graph 1). This also implies a considerable reduction of the effective tax rate.[33] The same impact on profit shifting can be expected from the "interest barrier" as well as the taxation of value transfer abroad. However, as the taxation of interest revenues widely is lower abroad, the withholding tax presumably will not lead to a repatriation of financial capital.

Graph 1: Nominal corporate tax rate in a European comparison



Source: German Federal Ministry of Finance (2007)

The incentive to build up capital resources for partnerships has been increased by a reduced tax rate on retained profits of 28.25% (plus solidarity surcharge) that is aligned with the reduced tax rate of 29.83% of corporations.[34] Together with the broadening of

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

33 See *ZEW*, "Schriftliche Stellungnahme des ZEW für die öffentliche Anhörung zum Gesetzentwurf 16/4841", 25. April 2007 (http://www.zew.de/de/publikationen/taxation/ZEW_Stellungnahme_25042007.pdf).

34 However, the aim of neutrality of burden between partnerships and corporations with respect to retained profits is not reached, as in partnerships also the income tax on the withdrawal for the tax on

deductibility from local trade tax, the conditions for investment have improved. The improvement for internal financing, however, could be compensated by the introduction of the withholding tax in 2009. As the "*Zentrum für Europäische Wirtschaftsforschung (ZEW)*" as well as the "Council of economic advisers" (*Sachverständigenrat)* calculate, the capital costs of internal financed investments for corporations and in particular for partnerships increase compared with the status quo - while capital costs for long-term external financing of investments will decrease. This discrimination of internal financed investments is mostly due to the double taxation of internal financed gains with corporate tax as well as with the withholding tax on dividends and realised capital gains. The incentive to increase the share of external financing therefore could rise.[35]

Abolishing the deductability of the local trade tax from the corporate tax and from the income tax leads to higher transparency. Revenues of the different levels of government will be disentangled and can be associated more clearly to the local governments and the federal government. Otherwise, the corporate tax reform is accompanied by 40 new reporting requirements (against three abrogated reporting requirements). Bureaucratic burden therefore increases by about €40 Mio p. a.

The inheritance tax reform

On the 11th December 2007 the draft law for a reform of the inheritance tax passed the government and has now to be approved by *Bundestag* and *Bundesrat*. The reform has become necessary after the German constitutional court in its decision from January 2007 had called on the government to establish a non-discriminating assessment of the taxable value for all kind of assets (in particular for real estate and companies in comparison to other assets). The deadline for a new law is the end of 2008, otherwise – as stated by the constitutional court – the inheritance tax would have to be fully abolished. Aside the non-discriminating assessment of the taxable value of assets, the reform aims at (i) ensuring the tax free inheritance of minor personal assets inside the family (homes, money etc.) and (ii) relieving the inheritance of SME. The latter in particular is to safeguard employment. The proposed elements of the reform are presented in Box 6.

retained profits has to be taken into account. The *Sachverständigenrat* calculates the effective tax rate for partnerships at 36.16%. See *Sachverständigenrat*, Jahresgutachten 2007/2008.

[35] See *ZEW*, "Schriftliche Stellungnahme des ZEW für die öffentliche Anhörung zum Gesetzentwurf 16/4841", 7. Mai 2007 (http://www.zew.de/de/publikationen/taxation/ZEW_Stellungnahme_07052007.pdf) and *Sachverständigenrat*, "Jahresgutachten 2007/2008".

BOX 6: The proposed inheritance tax reform

The new law is planned to come into force on 1 April 2008. Inheritors will have the possibility to opt retroactively up to 1 January 2007 between the new and the current law (however under consideration of the current allowances). The inheritance tax generally differentiates between kind and amount of the transferred assets as well as between the relationship of the bequeather and the heir.

The main elements of the reform can be summarized as follows:

- Depending on the amount of the inheritance, inheritance tax rates range from 7% to 30% for close relatives. However, for siblings as well as nephews, nieces and also third persons, tax rates of 30% or 50% are foreseen. Change of tariffs leads to additional receipts of about €585 Mio.
- Personal allowances increase from € 307.000 to € 500.000 for marriage partner, from € 205.000 to €400.000 for children and from €51.000 to €200.000 for grandchildren. Not married partners receive an allowance of € 500.000. The increased allowances lead to lower receipts of about €785 Mio.
- As requested by the constitutional court, the assessment of the value of assets will be harmonized for all kind of assets. While currently e. g. real estate is systematically undervalued, the value of real estate, corporate capital, agricultural- and forest-assets as well as not quoted shares of corporate enterprises will be assessed consistently at current market prices (against for example the currently used balance sheet value for companies or the capitalized earnings value for rented real estate). The use of current market prices broadens the tax base and leads to additional receipts of about €1.6 bn.
- To compensate the surplus load of the broadened tax base, discounts and allowances are increased:
- For corporate assets a discount of 85% of the market value is awarded ("*Verschonungsregel für Betriebsvermögen*"). Especially smaller companies benefit from an additional allowance of € 150.000 on the remaining 15% taxable value. The current discount of 35% on balance sheet value for companies will abolished. The 85% discount leads to lower receipts of about €2.1 bn. To avoid tax fraud by shifting private assets to corporate assets, within 10 years the wage bill of the bequeathed company should not fall below 70% of its average wage bill of the last five years and within 15 years the company or major parts of its working capital is not allowed to liquidate. Breaking the rule leads to an "abolishing" of (at least parts of) the 85% discount.

The revenues of inheritance tax are relatively low in comparison with other tax aggregates and go to 100% to the *Bundesländer*. For 2008 revenues of about €4.4 bn are projected, with a slight tendency to increase in 2009. The proposed new inheritance tax law is designed to be neutral with respect to the overall tax burden. As pointed out in the tableau of fiscal impact of the draft law, the reform of inheritance tax would lead to only a small loss in revenues of about € 190 Mio in 2008 and 2009 compared with the projected revenues under current law. Until 2012 the loss in revenues is expected to decrease to €20 Mio.

In an international comparison, the current German inheritance tax law benefits from a relatively favorable assessment of the value of assets as well as high personal allowances for marriage partner and children.[36] Despite the relatively high inheritance tax rates, in

[36] See an analysis of the *ZEW* "Erbschaftsteuerbelastung im internationalen Vergleich", Schriftenreihe des *ZEW*, Band 75, 2004. The ZEW compared 13 European countries, Japan and the USA.

particular for marriage partner and children, the tax burden for minor assets is comparatively low. However, the inheritance of large private properties and corporate properties is taxed at a comparatively high rate. With some exceptions (siblings, nieces and nephews), under the proposed new law, personal allowances will be increased to further reduce the inheritance tax on minor personal assets (homes, money etc.). For siblings, nieces and nephews as well as for third persons the allowance is €20.000 and tax rate ranges from 30% up to 50% (the latter starting for assets of an amount of more than €6 Mio.). Insofar, in particular higher inheritance "outside" the family is burdened stronger.

Main criticism on the reform is focused on the *Verschonungsregel* for corporate assets (see Box 6). First, with the new evaluation of the taxable value on the basis of market values, the taxable value can increase to a multiple of the balance sheet value. Even with an allowance of 85%, the tax burden of SME can rise considerably. As this might exceed financial capability of an heir, continuity of the company and employment are jeopardized. Second, the barriers of 10 years for the wage bill and 15 years for the (non-) liquidation of corporate working capital are a long period - especially in the "market life cycle" of SME. This could mark a competition-disadvantage in international comparison. The arising problems in restructuring a company as well as the risk to get burdened with the inheritance tax even 15 years afterwards, might contradict the overall aim of safeguarding employment. Third, the implementation of the new law leads to an increase in the bureaucratic burden of about € 3.5 Mio (for reporting requirements), which in particular SME have to shoulder. Of course, the bureaucratic burden would also increase on the side of the tax administration. Under current legislation, an inheritance case is a one-time event for tax purposes. Under the proposed legislation, a single case might drag over 15 years, as the tax authorities would have to check whether the conditions for tax exemption would be fulfilled with every annual tax declaration.

Finally, the tax reform is not neutral with respect to financing decisions. If an heir delegates decision authority to a manager but remains the private owner of the company, he might benefit from favourable tax treatment. If the heir decides to sell the company (and to reinvest the proceeds elsewhere through the financial market), he is fully liable to the tax, even if the new owner would install the same manager with the same policies. Private ownership of assets would receive a different inheritance tax treatment than financial assets, which does not seem to have economic foundations. Overall, it is not clear whether the reform would improve the quality of public finances.

Labour Market Reform and the German Federal Labour Agency

The financial situation of the *German Federal Labour Agency (Bundesagentur für Arbeit)*, which is the central public service agency on the labour market (e. g. placement of employees, payment of unemployment compensation and provision of job training) has improved considerably during the years 2006 and 2007. After a balanced budget in 2005, the *Bundesagentur* achieved a surplus of €11.2 bn in cash terms in 2006. This is to a good extent due to a special effect.[37] With an estimated surplus of €6.8 bn in 2007 in cash terms, the financial reserve in 2008 amounts to about €18 bn. This surplus is due to

[37] 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.

the rebound of the German labour market as a consequence of the still ongoing recovery of the German economy and the structural reforms under the "Agenda 2010", but also to the special cash effect in 2006.

Against this background, in December 2007 the German *Bundesrat* approved the reduction of the contribution rate for the unemployment insurance from 4.2% to 3.3% of wages, starting from January 2008.[38] Furthermore, in December 2007 the government (*Bundeskabinett)* decided, to prolong the unemployment benefits (*Arbeitslosengeld I*) for older workers, which still has to be approved by *Bundestag* and *Bundesrat*.

These decisions are problematic for three reasons. First, they burden the budget of the *Bundesagentur* considerably. Taking into account the implementation of these reforms, for 2008 the *Bundesagentur* expects revenues of €38.1 bn and expenditures of €43.1 bn.[39] This constitutes a deficit of about €5 bn.[40] The reduction of the contribution rate is expected to reduce unemployment premiums by € 7.1 bn, the prolongation of unemployment benefits for older workers is expected to increase expenditures by €0.8 bn. For active labour market policy measures the 2008 budget foresees €12.3 bn in total, which is an increase of €1.8 bn in comparison to 2007.[41]

Second, the unemployment insurance of the *Bundesagentur* normally serves as an important automatic stabiliser over the cycle by compensating revenue losses in economic "bad times" and therefore smoothing consumption. However, any pro-cyclical determination of the contribution rate for the unemployment insurance dampens this stabilising effect, notably because the rates would need to be increased in a downturn burdening further private consumption and costs for corporations. The "Council for economic advisers" (*Sachverständigenrat)* therefore proposes the determination of a sustainable contribution rate, which is constant over the cycle and guarantees planning reliability for households and corporations. The constant contribution rate would be sustainable, if it balances the budget of the *Bundesagentur* over the cycle in structural terms. This includes a negative budget balance in economic "bad times". Basing on the legislation in 2007, the *Sachverständigenrat* calculates the sustainable contribution rate at 3.9%. The calculation thereby is widely independent from the level of the financial reserves (except for interest payments on the reserves), because with a sustainable rate the financial reserves of the *Bundesagentur* on average stay unchanged over the cycle.[42]

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[38] A reduction of the contribution rate of 0.1 percentage points leads to a revenue loss of about €0.8 bn p. a. in structural terms, a decrease of the number of unemployed of 50.000 would allow for a lowering of the contribution rate of 0.1 percentage points.

[39] Expenditures include about €2.9 bn pension reserves.

[40] In 2007 the *Bundesagentur* achieved a surplus in spite of the reduction of the contribution rate from 6.5% to 4.2%. This was mainly due to the strong rebound of the labour market. The loss in revenues was partly compensated by a newly introduced allowance from the government of €6.5 bn (to be increased to €7.6 bn in 2008) stemming from the VAT increase.

[41] See *Bundesagentur für Arbeit*, Presse Info 081 vom 20.12.2007, "Verwaltungsrat stellt BA-Haushalt 2008 nach Genehmigung durch Bundesregierung erneut fest" and *Deutscher Bundestag*, Drucksache 16/7460, Gesetzentwurf der Fraktionen der CDU/CSU und SPD: Entwurf eines Siebten Gesetzes zur Änderung des Dritten Buches Sozialgesetzbuch und anderer Gesetze vom 11.12.2007.

[42] For details see *Sachverständigenrat*, Jahresgutachten 2007/2008. In the calculation the planned prolongation of unemployment benefits for older worker is not taken into account.

Third, the remaining financial reserve sets incentive to burden the budget of the *Bundesagentur* with expenditures not related to the unemployment insurance like the *"Eingliederungsbeitrag"* or the possible wage supplement (*Erwerbstätigenzuschuss).* Such measures counteract the positive disentangeling of labour market policy measures and their respective financing implemented with the "Agenda 2010".[43]

[43] This holds also true for the political argument to compensate the 0.3 percentage point increase of contribution rate of the long term care insurance *(Pflegeversicherung*) with the decrease of the unemployment insurance contribution rate. See *BMF*, Finanzbericht 2008.

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

The stability programme seems to be integrated to some extent with the Autumn 2007 implementation report of the national reform programme. The budgetary strategies outlined in both documents seem consistent. Principal measures with a direct budgetary impact put forth in the NRP implementation report are mentioned in the stability programme, for example the company tax reform, the increase in the statutory retirement age, the social contribution rate cut, childcare facilities and the second stage of the reform of the federal system with a review of the fiscal relations between levels of government in order to ensure budgetary discipline. However, neither the update nor the NRP implementation report specifies the direct budgetary impact of the NRP in total or of its main reforms.

Box 8: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Germany's national reform programme[44].

The national reform programme 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.

The Commission's assessment is that Germany has made good progress in implementing its National Reform Programme over 2005-2007.

Against the background of strengths and weaknesses identified, the Commission recommends that Germany is recommended to take action in the areas of: competition in services; structural unemployment by maintaining the path of the reforms outlined in the National Reform Programme. Against the background of progress made, the Commission recommends that Germany is encouraged to also focus on the areas of: the long-term sustainability of public finances; the framework for competition in the rail sector and in the gas and electricity networks; the establishment of one-stop-shops and the improvement of start-up times; and the promotion of lifelong learning.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations / points to watch and the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is broadly consistent with the country-specific recommendations / points to watch and the recommendations for the euro area.

[44] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

Table 8: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated 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

Table 9: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
– 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		X		
2. Points to watch				
– none				X
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment				X

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
of at least 0.5% of GDP as a benchmark				
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability		X		
Source: *Commission services*				

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Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The update broadly follows the model structure in Annex 1 of the code of conduct.

(ii) Data requirements

Compulsory data: In Table 2 (budgetary prospects) "property income" is missing and the categories of "social expenditure" and "compensation of employees and intermediate consumption" are displayed in a different aggregation (like last year), state and local government are aggregated (like last year). Table 8 (basic assumptions) missing, although some data are mentioned in the text.

Optional data: Missing are: HICP in Table 1b (prices), Table 3 (COFOG), Table 5 (cyclical developments); "long-term care" and "health care" are not separated in Table 7 (sustainability), where also employment rates are defined for age groups 15-64, not 20-64.

The tables on the following pages show the data presented in the December 2007 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

The German authorities provided additional information to the Commission services, so that the gaps in the data requirements did not inhibit a thorough scrutiny of the updated stability programme.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

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The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	x		
… indicates whether Council opinion on previous programme has been presented to national parliament.	x		
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.		x	
… explains significant divergences with Commission services' forecasts[1].		x	
… bears out possible upside/downside risks to economic outlook.	x		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.		x	
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	x		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	x		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on	x		

The SCP…	Yes	No	Comments
balance.			
… specifies state of implementation of measures.		x	
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.			Partly (only on growth assumptions)
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	x		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	x		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	x		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	x		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.		x	

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]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:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Real GDP	B1*g	2183.0	2.9	2.4	2.0	1½	1½	1½
2. Nominal GDP	B1*g	2322.2	3.5	4.4	3.5	3	3	3
Components of real GDP								
3. Private consumption expenditure	P.3	1242.1	1.0	-0.2	1.8	1½	1½	1½
4. Government consumption expenditure	P.3	400.7	0.9	1.8	1.4	0	0	0
5. Gross fixed capital formation	P.51	427.2	6.1	6.2	3.7	3	3	3
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	n.a.	-0.1	0.1	-0.1	0	0	0
7. Exports of goods and services	P.6	1038.4	12.5	7.8	6.3	5½	5½	5 ½
8. Imports of goods and services	P.7	911.0	11.2	6.3	6.8	5½	5½	5 ½
Contributions to real GDP growth								
9. Final domestic demand			1.9	1.3	1.9	1¼	1¼	1¼
10. Changes in inventories and net acquisition of valuables	P.52 + P.53		-0.1	0.1	-0.1	0	0	0
11. External balance of goods and services	B.11		1.1	1.0	0.2	¼	¼	¼

Table 1b. Price developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. GDP deflator		*106.4*	0.6	1.9	1.5	1½	1½	1½
2. Private consumption deflator		*109.3*	1.4	1.8	1.6	1½	1½	1½
3. HICP[1]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Public consumption deflator		*106.3*	0.2	0.6	1.6	1	1	1
5. Investment deflator		*99.9*	1.4	2.6	1.1	1	1	1
6. Export price deflator (goods and services)		*100.8*	1.3	0.4	1.0	1½	1½	1½
7. Import price deflator (goods and services)		*101*	2.8	-0.1	1.0	1½	1½	1½

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Employment, persons[1]		*39088*	0.6	1.7	0.8	¼	¼	¼
2. Employment, hours worked[2]		*56.0*	0.5	1.6	0.9	½	½	½
3. Unemployment rate (%)[3]		*n.a.*	9.8	8.4	8.0	7.7	7.5	7.3
4. Labour productivity, persons[4]		*106.0*	2.2	0.7	1.3	1¼	1¼	1¼
5. Labour productivity, hours worked[5]		*109.0*	2.4	0.8	1.1	1¼	1¼	1¼
6. Compensation of employees	D.1	*1150.0*	1.7	3.2	3.0	2	2	2
7. Compensation per employee		*33145*	1.1	1.4	optional	optional	optional	optional

[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	2006	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	5.2	6.1	6.1	6.3	6.3	6.3
of which :							
- Balance on goods and services		5.4	6.4	6.4	6.7	6.7	6.7
- Balance of primary incomes and transfers		1.0	0.8	0.7	0.7	0.7	0.7
- Capital account		-1.2	-1.1	-1.0	-1.0	-1.0	-1.0
2. Net lending/borrowing of the private sector	B.9	6.0	6.0	5.9	5.7	5.7	5.7
3. Net lending/borrowing of general government	EDP B.9	-1.6	n.a.	n.a.	n.a.	n.a.	n.a.
4. Statistical discrepancy		n.a.	optional	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	*-37.0*	-1.6	0	-½	0	½	½
2. Central government	S.1311	*-34.7*	-1.5	-1	-1	-½	-½	0
3. State government	S.1312	*-5.8*	-0.3	½	½	½	½	½
4. Local government	S.1313	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
5. Social security funds	S.1314	*3.5*	0.2	½	0	0	½	0
General government (S13)								
6. Total revenue	TR	*1017.2*	43.8	44	43	43	42½	42
7. Total expenditure	TE[1]	*1054.2*	45.4	44	43½	43	42	41½
8. Net lending/borrowing	EDP B.9	*-37.0*	-1.6	0	-½	0	½	½
9. Interest expenditure	EDP D.41	*64.6*	2.8	3	2½	2½	2½	2½
10. Primary balance[2]		*27.6*	1.2	3	2½	2½	3.0	3½
11. One-off and other temporary measures[3]		*0.0*	0.0	0	-0	-0	0	0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		*534.2*	23.0	24	23½	24	24	24
12a. Taxes on production and imports	D.2	*279.9*	12.1	12½	12½	optional	optional	optional
12b. Current taxes on income, wealth, etc	D.5	*250.6*	10.8	11	11	optional	optional	optional
12c. Capital taxes	D.91	*3.8*	0.2	0	0	optional	optional	optional
13. Social contributions	D.61	*401.1*	17.3	16½	16	optional	optional	optional
14. Property income	D.4	*n.a.*	n.a.	n.a.	n.a.	optional	optional	optional
15. Other[4]		*81.9*	3.5	3½	3	optional	optional	optional
16=6. Total revenue	TR	*1017.2*	43.8	44	43	43	42½	42
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		n.a.	40.1	40½	39½	39½	39½	39
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	D.1+P.2	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
17a. Compensation of employees	D.1	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
17b. Intermediate consumption	P.2	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
18. Social payments (18=18a+18b)		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
18b. Social transfers other than in kind	D.62	*428.5*	18.5	17½	17	16½	16½	16
19=9. Interest expenditure	EDP D.41	*64.6*	2.8	3	2½	2½	2½	2½
20. Subsidies	D.3	*26.8*	1.2	1	1	1	1	1
21. Gross fixed capital formation	P.51	*32.8*	1.4	1½	1½	1½	1½	1½
22. Other[6]		*64.5*	2.8	2½	3	2½	2½	2½
23=7. Total expenditure	TE[1]	*1054.2*	45.4	44	43½	43	42	41½
p.m.: Government consumption (nominal)	P.3	*425.9*	18.3	18	18	17½	17½	17½

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

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

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

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	n.a.	n.a.

[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	ESA Code	2006	2007	2008	2009	2010	2011
1. Gross debt[1]		67.5	65	63	-61½	-59½	-57½
2. Change in gross debt ratio		0.3	-1½	-2	-1½	-2	-2
Contributions to changes in gross debt							
3. Primary balance[2]		1.2	3	2½	2½	3	3½
4. Interest expenditure[3]	EDP D.41	2.8	3	2½	2½	2½	2½
5. Stock-flow adjustment		-½	-0	-½	-0	-0	-0
of which:							
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
of which:		-	-	-	-	-	-
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other[6]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other relevant variables							
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[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

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

[7]Proxied by interest expenditure 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	2006	2007	2008	2009	2010	2011
1. Real GDP growth (%)		2.9	2.4	2.0	1½	1½	1½
2. Net lending of general government	EDP B.9	-1.6	n.a.	n.a.	n.a.	n.a.	n.a.
3. Interest expenditure	EDP D.41	2.8	3	2½	2½	2½	2½
4. One-off and other temporary measures[1]		n.a.	n.a.	-0	-0	n.a.	n.a.
5. Potential GDP growth (%)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
contributions:							
- labour		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
6. Output gap		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7. Cyclical budgetary component		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
8. Cyclically-adjusted balance (2 - 7)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
9. Cyclically-adjusted primary balance (8 + 3)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
10. Structural balance (8 - 4)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
Previous update		2.3	1½	1½	1½	1½	n.a
Current update		2.9	2.4	2.0	1½	1½	½
Difference		0.6	1	½	-0	-0	n.a
General government net lending (% of GDP)	EDP B.9						
Previous update		-2.1	-1½	-1½	-1	-½	n.a
Current update		-1.6	0	-½	-0	½	½
Difference		0.5	1½	1	1	1	n.a
General government gross debt (% of GDP)							
Previous update		67.9	67	66½	65½	64½	n.a
Current update		67.5	65	63	61½	59½	57½
Difference		0.4	2	3½	4	5	n.a

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension expenditure	n.a.	11.4	10.5	11.0	12.3	13.1
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other pensions (disability, survivors)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health and long-term care	n.a.	7.0	7.3	7.7	8.0	8.3
Long-term care (*this was earlier included in the health*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	n.a.	4.0	3.6	3.3	3.3	3.3
Other age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: property income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	7.7	7.3	7.3	8.3	8.9
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	n.a.	1.1	0.8	1.5	1.8	1.7
Real GDP growth	n.a.	1.5	1.8	1.8	1.0	1.2
Participation rate males (aged 20-64)	n.a.	79.8	83.3	85.1	84.5	85.0
Participation rates females (aged 20-64)	n.a.	66.0	71.3	72.9	72.5	72.9
Total participation rates (aged 20-64)	n.a.	73.0	77.4	79.1	78.6	79.0
Unemployment rate	n.a.	9.5	8.5	7.0	7.0	7.0
Population aged 65+ over total population	n.a.	18.1	20.3	22.2	26.6	30.0

Table 8. Basic assumptions

	2006	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€exchange rate (annual average) (euro area and ERM II countries)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal effective exchange rate	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
EU GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Growth of relevant foreign markets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World import volumes, excluding EU	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Oil prices (Brent, USD/barrel)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Germany. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

Table: Key economic indicators

	Federal Republic of Germany						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	1.3	2.0	0.6	0.8	2.9	2.5	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*0.7*	*1.7*	*-0.4*	*0.3*	*1.8*	*1.5*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*0.6*	*0.3*	*0.9*	*0.5*	*1.1*	*1.0*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	116	119	113	111	111	111	113	114	112	110	110	109
Real GDP per capita (% change)	1.2	1.9	0.5	0.8	3.0	2.6	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	1.3	1.1	1.6	1.9	1.8	2.2	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	1.8	2.2	1.3	1.3	2.7	1.1	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	-0.4	-0.1	-0.7	-1.5	-1.6	-1.0	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	0.3	0.8	-0.2	-0.1	0.6	1.7	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	8.9	8.6	9.1	10.7	9.8	8.1	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	-2.1	-4.4	0.2	-3.2	-2.3	0.2	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	1.0	0.2	1.8	1.3	4.5	1.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.9	-0.9	2.7	4.7	5.2	5.8	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	-2.6	-1.7	-3.5	-3.4	-1.6	0.1	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	61.5	59.8	63.3	67.8	67.5	64.7	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	-2.9	-2.4	-1.3	0.0	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	2.5	3.3	1.7	1.5	2.5	2.4	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	4.0	5.0	3.0	2.6	3.2	2.4	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source :
Commission services