COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Germany, 2007-2011

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

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

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Germany, submitted on 5 December 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

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

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup;

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(4) the Commission’s assessment of the Autumn 2007 implementation report of the national reform programme.

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the stability programme, covering the period 2006-2010, as follows. “Overall, the Council deems the updated programme consistent with a correction of the excessive deficit as of 2006, one year before the deadline set by the Council, and some progress towards the medium term objective will be made in the subsequent years. However, there are risks linked to the achievement of the budgetary targets”. The Council invited Germany, benefiting from economic “good times”, to “strengthen the structural adjustment in 2008 including by using any extra revenues for deficit reduction, continue the fiscal consolidation towards the medium-term objective thereafter, by maintaining tight control over expenditures, while ensuring that the announced reform of the corporate tax system does not jeopardise the fiscal consolidation”, and also, in view of the level of debt and the projected increase in age-related spending, to “improve long-term sustainability of public finances by achieving the MTO and by implementing reforms, particularly in the health care system”, and finally to “improve the budgetary framework so as to strengthen fiscal discipline at all levels of government, notably by implementing the plans for the second stage of the reform of the federal system”.

2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

[2] The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. In the area of budgetary policies, Germany was recommended to "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". In addition, all euro area Member States were recommended to "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 of at least 0.5% of GDP as a benchmark" and "to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability".

2.4. The Commission assessment of the autumn 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 autumn 2007 implementation report of Germany's national reform programme[4]. 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 and the evidence on progress made, the Commission recommended that Germany is recommended to giving highest priority to the challenges in the areas of: competition in services, and structural unemployment by maintaining the path of the reforms outlined in the national reform programme. In addition, Germany should 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 business start-up times; and the promotion of lifelong learning.

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3 OJ L 92, 3.4.2007, p. 23.

4 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)", COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[5];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[6], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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

6 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated stability programme of Germany, 2007-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [12 February 2008] the Council examined the updated stability programme of Germany, which covers the period 2007 to 2011.

(2) 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 the consolidation measures adopted since 2005, but also to the fact that unexpectedly high tax revenues were not spent, but used for deficit reduction.

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

(3) 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[8], this growth scenario appears plausible until 2008 and cautious thereafter. 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.

(4) For 2007, the updated programme foresees the budget in balance, broadly in line with the Commission services' autumn 2007 forecast, which projects a surplus of 0.1% of GDP, 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[9]. 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.

(5) 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 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.

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8 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.

9 OJ C 70, 27.3.2007, p. 5.

(6) The risks to the budgetary projections in the programme appear balanced. The macroeconomic outlook is plausible in 2008 and 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.

(7) 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 divergence from the MTO 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. The budgetary plans for 2008 remain in line with the April 2007 Eurogroup orientations for budgetary policies. 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.

(8) 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.

(9) While the stability programme does not specify the direct budgetary impact of 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.

(10) 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.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[10].

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 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.

In view of the above assessment and also in the light of the April 2007 Eurogroup orientations for fiscal policies, Germany is invited to:

(i) Preserve the positive results achieved in 2007 by maintaining firm control over expenditures in line with programme targets and by using unexpected extra revenues for debt reduction;

(ii) Improve the long-term sustainability of public finances, by continuing to implement the economic reforms enacted and by underpinning the achieved fiscal consolidation with a strengthening of budgetary institutions, in particular through the ongoing revision of federal fiscal relations.

10 In particular, data on HICP inflation and total social transfers are not provided in the programme and not all basic assumptions underlying the macroeconomic scenario are spelled out.

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**	**61½**	**59½**	**57½**
	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 2007 and 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.