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GERMANY: MACRO FISCAL ASSESSMENT

**AN ANALYSIS OF THE DECEMBER 2008 UPDATE OF THE STABILITY
PROGRAMME**

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not.

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 18 February 2009. Comments should be sent to Karolina Leib (Karolina.Leib@ec.europa.eu), Norbert Wunner (Norbert.Wunner@ec.europa.eu) or Carsten Eppendorfer (Carsten.Eppendorfer@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’ January 2009 interim 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 18 February 2009. The ECOFIN Council is expected to adopt its opinion on the programme on 10 March 2009.

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

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

1. INTRODUCTION

This document assesses the December 2008 update of the German stability programme. It takes into account all currently available information, notably the Commission services' January 2009 interim forecast and the short-term fiscal stimulus measures adopted by the German authorities in response to the economic downturn. The programme, which was submitted on 3 December 2008¹, covers the period 2008-2012 and builds on the 2009 budget law and the 2009-2012 federal medium-term fiscal plan. It was approved by the government and presented to the *Bundestag*. Addenda to the programme were submitted on 23 December and 30 January, detailing the measures adopted by the German authorities in response to the economic downturn. The January addendum contains an updated macroeconomic scenario and budgetary projections reflecting the impact of the fiscal stimulus measures.

2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

As a heavily export-oriented economy, strongly specialised in investment goods and running a sizeable current account surplus, Germany is severely hit by the global recession. Dragged down by an unprecedented slump in world trade, real GDP decelerated sharply from 2½% in 2007 to 1¼% in 2008. Investment activity is quickly weakening as a result of the worsening economic outlook and waning business confidence. At the same time, rising unemployment has put a halt to the tentative recovery of private consumption which started in the second half of 2008. While the financial crisis has revealed certain weaknesses of the German financial system, direct effects on economic activity have so far been limited by relatively sound corporate balance sheet positions, limited reliance on outside financing, and the fact that Germany is not facing a correction in the housing market. Nevertheless, investments in international financial markets of a number of banks, including the *Landesbanken*, have implied heavy losses, borne to a large extent by public banks and the government. Moreover, liquidity and lending conditions are clearly tightening, albeit to a more limited extent than in other countries. According to the Commission services' January 2009 interim forecast, the economic downturn is set to continue in 2009, with GDP expected to shrink by around 2¼%, followed by a moderate recovery in 2010. The positive output gap has been closing rapidly and is projected to turn strongly negative in 2009. Germany is thus expected to be in economic bad times in 2009 and 2010 (see Figure 1 in the Annex 2).

Thanks to successful consolidation efforts, favourable cyclical developments and buoyant tax revenue, the general government budget was close to balance in 2007 and 2008. In line with the European Economic Recovery Plan (EERP) agreed in December by the European Council, Germany decided on a sizeable fiscal stimulus package for 2009 and 2010. The German response to limit the impact of the economic crisis on the economy consists of two packages: an autumn package with measures adopted in October and November 2008 (*Konjunkturpaket I*) and a second package adopted in January 2009 (*Konjunkturpaket II*). These measures focus on income support, public and private investment, ensuring access to finance, avoiding lay-offs, improving access to training, and include instruments that support the automotive industry. An additional stimulus results from the re-introduction of the commuter allowance in reaction to a decision of the Federal Constitutional Court². Importantly, the fiscal stimulus is accompanied by a debt repayment plan and political

¹ The English language version was submitted on 3 December 2008.

² BVerfG, 2 BvL 1/07 vom 9.12.2008, Absatz-Nr. (1 - 91),
http://www.bverfg.de/entscheidungen/Is20081209_2bv1000107.html

commitment to strengthen the budgetary framework by introducing a new, more effective budgetary rule into the German Constitution. The new rule envisages a 0.35% of GDP limit for federal government borrowing in normal times from 2016 onwards, and the Länder budgets are to be balanced as of 2020. Furthermore, the recovery will be supported by structural measures such as innovation support for the private sector, improved employment services and better broadband access within the framework of the planned Broadband Strategy. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon strategy for Growth and Jobs. Moreover, temporary changes in the public procurement procedures aim at accelerating infrastructure investment,

With a view to stabilising the financial sector, the German authorities established a Financial Market Stabilisation Fund (FMSF) operational until 31 December 2009 to secure refinancing of German financial institutions through credit guarantees (€400bn, around 16% of GDP), re-capitalisation and purchasing of troubled assets (€80bn, around 3% of GDP). Already in 2007 and 2008 the German government at the federal and regional level was involved in large-scale bank rescue operations, providing capital and guarantees. Moreover, the German government offered an unlimited guarantee for all private bank deposits. Further initiatives to alleviate bank balance sheets from troubled assets are under discussion.

Discretionary measures taken in response to the crisis and automatic stabilisers will entail sizeable revenue shortfalls and higher expenditure, resulting in a marked increase in the general government deficit. Moreover, contingent liabilities resulting from the large-scale bank rescue operations pose significant additional risks to the budget.

Given strong price competitiveness and overall healthy company balance sheets, the medium-term outlook for the German economy is still favourable. However, in the near-term the economic crisis poses a number of challenges, including restoring confidence in the financial sector to ensure access to financing and strengthening the adjustment capacity in the labour market to cope with rising unemployment. Moreover, the accumulation of rising external surpluses has not been translated into an increased level of overall welfare and may have increased Germany's exposure to international financial market problems; therefore, a re-balancing of the growth drivers towards domestic demand components would be important. Finally, given the anticipated increase in the general government deficit, an effective budgetary framework will be key to support fiscal consolidation once the crisis abates.

3. MACROECONOMIC SCENARIO

The January addendum to the programme projects real GDP growth to fall from 1¼% in 2008 to - 2¼% in 2009 before recovering to around 1¼% from 2010 onward. The downturn in 2009 would be triggered by massively shrinking exports and a major drop in investment, whereas the recovery in 2010 would be driven by stronger domestic demand as well as a pick-up in world trade. The growth contribution of net exports is expected to turn strongly negative in 2009 and remain subdued thereafter. In contrast, private consumption is projected to accelerate noticeably from 2009. After the contraction in 2009, gross fixed capital formation is also expected to resume robust annual growth of around 2% per year. According to the programme, the economic downturn in 2009 would imply temporarily lower employment levels and higher unemployment. Inflationary pressures are projected to ease noticeably in 2009 and to remain contained over the remainder of the programme period. The programme takes into consideration the trade-related impact of the global economic crisis on the German economy, including a possible dampening of potential growth as a consequence, and the stimulus measures, even though the expected macroeconomic impact is not quantified.

Cyclical conditions (as measured by the output gap recalculated by the Commission services based on the data provided in the programme using the commonly agreed methodology) show a rapid decrease of the output gap, turning strongly negative in 2009 and remaining negative throughout the whole programme period.

Assessed against currently available information³, the scenario appears to be based on plausible growth assumptions until 2009 and somewhat favourable assumptions from 2010. Beyond 2010, the real GDP growth projected in the programme is slightly above the Commission services' estimate of average potential growth for the period 2008-2010 (as calculated according to the commonly agreed methodology). The Commission services' forecast expects a deeper and more protracted economic downturn, with real GDP growth remaining clearly below potential still in 2010. Accordingly, in the Commission projections labour market developments are less favourable in 2010 and the outlook for private consumption growth is more subdued than envisaged in the programme. Together with a more moderate expansion of world trade, the Commission services also project a more gradual recovery of investment. The challenges highlighted above, notably the need to stimulate domestic demand, ensuring access to finance and cushioning the impact of the economic crisis on the labour market are addressed in the January addendum to the programme.

Table I: Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011	2012
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.3	1.3	-2.3	-2¼	0.7	1¼	1¼	1¼
Private consumption (% change)	0.0	0.0	0.8	0.8	0.0	1	1	1
Gross fixed capital formation (% change)	4.4	4.1	-5.2	-5.0	1.1	2	2	2
Exports of goods and services (% change)	3.9	3.9	-6.1	-8.9	1.4	4½	4½	4½
Imports of goods and services (% change)	5.0	5.1	-2.4	-5.0	1.2	4½	4½	4½
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	1.2	1.2	-0.2	-0.1	0.6	1	1	1
- Change in inventories	0.3	0.3	-0.2	0.0	0.0	0	0	0
- Net exports	-0.2	-0.3	-1.9	-2.2	0.1	0	0	0
Output gap ¹	2.3	2.2	-1.0	-0.9	-1.2	-0.7	-0.7	-1.0
Employment (% change)	1.5	1.5	-0.7	-0.7	-0.5	0	0	0
Unemployment rate (%)	7.1	7.2	7.7	7.9	8.1	8	8	8
Labour productivity (% change)	0.0	-0.2	-1.6	-1.5	1.2	1	1	1
HICP inflation (%)	2.8	n.a.	0.8	n.a.	1.4	n.a.	n.a.	n.a.
GDP deflator (% change)	1.8	1.4	1.3	2.1	1.3	1	1	1
Comp. of employees (per head, % change)	2.6	1.9	2.2	2.0	1.4	2½	2½	2½
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	7.1	7.1	5.2	7.0	5.4	7	7	7
<u>Note:</u>								
¹ In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.								
<u>Source:</u>								
Commission services' January 2009 interim forecasts (COM); Stability programme (SP)								

³ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

4. BUDGETARY STRATEGY

4.1. Budgetary implementation in 2008

The 2008 general government balance was close to balance (-0.1% of GDP), which is in line with the Commission services' interim forecast. The previous programme projected still a deficit of ½% of GDP. The better than expected outcome in 2008 was driven by substantially higher revenue growth, despite the corporate tax reform and reduced contribution rates to unemployment insurance⁴.

Revenue surprises amounted to almost 1% of GDP, benefiting from a higher tax intensity of growth, compared with the projection in the previous programme, whereby the actual revenue windfalls amount to ½% of GDP (see Table 1 in Annex 2). This appears to be the consequence of higher-than-expected revenues from income-related taxes due to higher wage and employment growth and related fiscal drag effects. Part of the windfall revenue was used to finance the reduction in social contributions rate and additional spending. Expenditure was around ¾% of GDP higher than previously expected mainly due to one-off measures in connection with the bank operations and higher outlays for retirement benefits as a result of *ad hoc* changes in the pension adjustment formula⁵. Around ¼% of GDP can be directly attributed to expenditure overruns (see Table 1 in Annex 2). Moreover, savings in labour market expenditure still had a moderating effect on the spending ratio.

With less than ½% of GDP the direct effects of the financial crisis on the budget balance have been limited so far. The debt-to-GDP ratio has increased by around ½ percentage point, mainly as a result of state guarantees granted to the troubled Landesbanken (around 2% of GDP)⁶.

4.2. Near-term budgetary strategy

The general government budget deficit is projected to increase to 3% of GDP in 2009 and to 4% of GDP in 2010. The widening of the deficit will be fuelled by sizeable tax revenue losses and higher expenditure due to automatic stabilisers and by stimulus measures taken in response to the economic crisis.

The federal budget for 2009 was approved by the *Bundestag* on 28 November and passed by the *Bundesrat* on 19 December, entering into force on 1 January 2009. A draft supplementary budget, including the second fiscal stimulus package, has been adopted by the German government on 27 January 2009. In 2009 the federal government deficit target is around 1½% of GDP. A substantial part of the measures, e.g. the planned infrastructure investments, is not included in the supplementary federal budget but will be administered and disbursed separately as part of a special 'investment and debt repayment fund' (*Investitions- und*

⁴ In 2008, the contribution rate to the unemployment insurance was reduced by 0.9 percentage point as of 1 January 2008, while the contribution rate to the long-term care insurance was raised by 0.25 percentage points as of 1 July 2008.

⁵ Law on pension adjustment (Gesetz zur Rentenanpassung 2008 vom 26 Juli 2008), BGBl. 2008 I, s. 1076 (<http://www.bgbportal.de/BGBL/bgb11f/bgb1108s1076.pdf>)

⁶ In 2008, the German authorities have recorded the guarantees given to the troubled Landesbanken as debt-increasing, but without any impact on the deficit. These guarantees will only affect the deficit if and when called.

Tilgungsfonds) in 2009 and 2010⁷. The aggregated budgets of the regional and local governments and of the social security system are projected to relapse into deficits of ½% of GDP, respectively⁸.

In 2009, major measures in the general government budget include the response to the economic crisis as adopted in the two stimulus packages: (1) the autumn package (*Konjunkturpaket I*) with measures adopted on 5 October 2008 and of 5 November 2008; and (2) the package of 27 January 2009 (*Konjunkturpaket II*). An additional fiscal impulse results from the re-introduction of the commuter allowance in reaction to a decision of the Federal Constitutional Court⁹. The total budgetary impact of the adopted measures is estimated at around 1½% and the automatic stabilisers at around 1½% of GDP in 2009¹⁰. The planned stance of fiscal policy in 2009 is expansionary, with the structural deficit projected to increase by 1½ percentage points. The revenue-to-GDP ratio is expected to fall by ½ percentage point down to 43½% of GDP, whereas the expenditure-to-GDP ratio is projected to increase by 2½ percentage points up to 46½% of GDP.

Table II. Main budgetary measures for 2009

Revenue measures ¹	Expenditure measures ²
Measures in response to the downturn	
<ul style="list-style-type: none"> • Reduction in social contributions rates (-0.3% of GDP) • Income support, incl. lower income tax (-0.2% of GDP) • Support to private investment, incl. more favourable depreciation rules (-0.1% of GDP) • Re-introduction of commuter allowance (-0.2% of GDP) 	<ul style="list-style-type: none"> • Investment, incl. infrastructure (+0.4% of GDP) • Environmental premium (+0.1% of GDP) • Industry support (+0.1% of GDP) • Labour market support (+0.1% of GDP)
Other measures	
	<ul style="list-style-type: none"> • Higher expenditure on the health-care sector (+0.2% of GDP)
<p><u>Note:</u></p> <p>¹ Estimated impact on general government revenue</p> <p>² Estimated impact on general government expenditure</p> <p><u>Source:</u> Commission services and the Federal Ministry of Finance.</p>	

⁷ According to the addendum of the programme, the fund is authorised to borrow up to €1bn (around 0.9% of GDP). From 2010, its debt repayment is to rely on the transfers of the part of the German Central Bank's (*Bundesbank*) profit that exceeds the sum entering the federal budget. The profit of the German Central Bank entering the federal budget is estimated at €3.5 bn. This sum will be reduced by €0.5bn in 2011 and by €1bn in 2012.

⁸ According to Commission services calculations, the share of the federal and regional level in total government expenditure is about 40%; of the local government around 15% and of the social insurance around 45%.

⁹ BVerfG, 2 BvL 1/07 vom 9.12.2008, Absatz-Nr. (1 - 91), http://www.bverfg.de/entscheidungen/ls20081209_2bvl000107.html

¹⁰ All figures regarding the budgetary impact of the fiscal stimulus measures, measures related to the bank rescue operations as well as automatic stabilisers are Commission services' estimations.

The German stimulus programme for 2009 includes a mix of revenue and expenditure instruments *targeted* at income support (e.g. lower income tax, reduction of the contribution rates to health-care insurance as of 1 July 2009, higher child benefits, one-time child bonus), public and private investment (e.g. infrastructure projects, more favourable depreciation rules, support for R&D activities), avoiding lay-offs (e.g. support of short-time work), and training as well as measures that support the motor car industry (e.g. an environmental premium for the scrapping of an old car and replacing it by a new one, temporary tax break on purchase of new environment-friendly cars.)

While many of the measures are of a temporary nature (e.g. one-time child bonus, one-time environmental premium, more favourable depreciation rules), a substantial part of them is permanent (e.g. lower income tax, reduction of the contribution rates to health-care insurance). However, the government envisages introducing a new budgetary rule into the Constitution to support the consolidation process once the crisis abates. The economic effects of the packages will be more pronounced in 2010, as some instruments will become effective only with a lag and additional measures (e.g. tax deductibility of health-care contributions, infrastructure investment) will enter into force only as of 2010. The overall budgetary impact in 2010 will amount to around 2% of GDP. The planned stance of fiscal policy in 2010 is expansionary, with the structural deficit projected to increase further by around 1 percentage point. The revenue-to-GDP ratio is expected to fall by a full percentage point down to 42½% of GDP, while the expenditure-to-GDP ratio is projected to remain at the level of 46½% of GDP.

In direct response to the financial crisis, the German government established a temporary Financial Market Stabilisation Fund (FMSF) operational until 31 December 2009. The fund provides guarantees of up to €400 bn (around 16% of GDP) in return for a fee and funds for capital injections and purchasing of troubled assets of up to €80 bn (around 3% of GDP). So far, the fund has granted guarantees to a number of banks amounting to total of around €7 bn (3½% of GDP) and agreed to provide capital injections of €8.2 bn (0.7% of GDP). The FMSF recapitalisation measures increase public debt, but not the deficit, whereas the guarantees affect neither the debt nor the deficit¹¹. In addition, some of the *Länder* transferred capital (around ¼% of GDP) and/or granted guarantees (around 1¾% of GDP) to the *Landesbanken* in difficulty. Moreover, the German government offered an unlimited guarantee for all private bank deposits. Finally, within the framework of the fiscal stimulus packages, the government will increase the credit and guarantee programmes (additional 4% of GDP) for private companies and offer an additional financing instrument for SMEs (up to 0.6% of GDP) until 31 December 2009.

¹¹ The FMSF guarantees will only affect the deficit and the debt if and when called.

Table III: Composition of the budgetary adjustment

(% of GDP)	2007	2008		2009		2010		2011	2012	Change: 2008-2012
	COM	COM	SP	COM	SP	COM	SP	SP	SP	SP
Revenue	43.9	43.7	44	43.5	43½	42.3	42½	42½	43	-1
<i>of which:</i>										
- Taxes on production and imports	12.6	12.4	n.a.	12.7	n.a.	12.6	n.a.	n.a.	n.a.	n.a.
- Current taxes on income, wealth, etc.	11.2	11.2	n.a.	10.6	n.a.	9.8	n.a.	n.a.	n.a.	n.a.
- Social contributions	16.5	16.3	16½	16.6	16½	16.4	16½	16½	16½	0
- Other (residual)	3.7	3.7	n.a.	3.6	n.a.	3.6	n.a.	n.a.	n.a.	n.a.
Expenditure	44.1	43.8	44	46.4	46½	46.4	46½	45½	45½	1½
<i>of which:</i>										
- Primary expenditure	41.3	41.0	41	43.6	43½	43.6	43½	42½	42½	1½
<i>of which:</i>										
Compensation of employees and intermediate consumption	11.1	11.3	n.a.	11.8	n.a.	11.8	n.a.	n.a.	n.a.	n.a.
Social payments	24.6	24.2	n.a.	25.8	n.a.	25.9	n.a.	n.a.	n.a.	n.a.
Subsidies	1.1	1.1	1	1.2	1	1.2	1½	1	1½	½
Gross fixed capital formation	1.5	1.5	1½	2.0	2	1.9	2½	2½	2½	1
Other (residual)	3.0	2.9	3	2.8	3	2.8	2½	2	2	-1
- Interest expenditure	2.8	2.7	3	2.8	3	2.8	3	3	3	0
General government balance (GGB)	-0.2	-0.1	-0	-2.9	-3	-4.2	-4	-3	-2½	-2½
Primary balance	2.6	2.6	2½	-0.1	0	-1.3	-1	0	½	-2
One-off and other temporary measures	-0.3	-0.3	-½	0.0	0	-0.1	-0	-0	0	½
GGB excl. one-offs	0.1	0.2	-0.3	-2.9	-3.0	-4.0	-4.0	-3.0	-2.6	-3
Output gap ²	2.2	2.3	2.2	-1.0	-0.9	-1.2	-0.7	-0.7	-1.0	-3.1
Cyclically-adjusted balance ²	-1.3	-1.3	-1.2	-2.4	-2.4	-3.6	-3.5	-2.4	-2.1	-1.0
Structural balance³	-1.0	-0.9	-0.8	-2.4	-2.5	-3.4	-3.4	-2.4	-2.1	-1.3
<i>Change in structural balance</i>		0.0	0.1	-1.5	-1.6	-1.0	-0.9	1.0	0.3	
Structural primary balance ³	1.8	1.8	1.9	0.4	0.4	-0.6	-0.5	0.5	0.8	-1.1
<i>Change in structural primary balance</i>		0.0	0.1	-1.4	-1.5	-1.0	-0.9	1.0	0.3	

Notes:
¹On a no-policy-change basis.
²Output 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.
³Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:
Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations

4.3. Medium-term budgetary strategy

Germany's objective over the medium-term is to maintain a general government budget close to balance in structural terms (cyclically-adjusted net of one-off and other temporary measures). According to the programme, this implies a structural deficit of 0-½% of GDP. To follow this objective, the programme proposes to continue budgetary consolidation primarily at the federal level, as soon as the financial crisis and the related economic slowdown have abated. However, the MTO is not expected to be reached within the programme period.

After rapid increases in the general government deficit in 2009 and 2010, the programme projects improvements in 2011 and 2012 by 1 and ½ percentage points respectively. On account of the fiscal stimulus measures in response to the economic downturn (around 1¾% of GDP on average per year), the programme expects a structural deficit above 2% of GDP from 2009 onwards, with the peak at around 3½% of GDP in 2010. The structural position is projected to improve rapidly by a full percentage point to -2½% of GDP in 2011 and to reach -2% of GDP in 2012. Given rising debt and falling interest rates, the primary balance develops in line with the headline deficit. The fiscal policy stance is expansionary in 2009 and 2010, restrictive in 2011 and broadly neutral in 2012.

The projections of the January addendum are based on the no-policy-change scenario and imply a mainly expenditure-based consolidation after 2010. The revenue-to-GDP ratio is expected to fall by 1½ percentage points over 2008-2010 to 42½%, remain at that level in 2011 and to rebound in 2012 by ½ percentage point. The expenditure-to-GDP ratio will increase by 2½ percentage points between 2008 and 2010, and is to fall thereafter by 1 percentage point. The revenue and expenditure developments in 2010 are mainly driven by the fiscal stimulus measures in response to the crisis, implying substantial increases in investment spending and significant tax measures for income support. In addition, the projected increase in the revenue in 2012 up to 43% of GDP is not supported by measures.

Regarding consolidation envisaged after 2010, the programme clearly states that the developments from 2011 onwards reflect the impact of the fiscal stimulus measures but do not take into account the consolidation measures which are the key element of the second stimulus package of 27 January 2009, i.e. the debt repayment plan and a constitutionally anchored new budgetary rule with a limit for the structural deficit of 0.35% of GDP for the federal government in normal times, whereby the Länder are supposed to run balanced budgets as of 2020. Given that, the projections in the programme are not supported by specific measures. Taken as such, they point to a mainly expenditure-driven consolidation, as the expenditure ratio is projected to fall by a full percentage point to 45½% of GDP in 2011 and stabilise at that level in 2012, while the revenue ratio would rise by ½ percentage point to 43% of GDP in 2012. According to the programme, the expenditure cuts are mainly due to lower social expenditure, subsidies and "other expenditure", and it is unclear what factors would contribute to this development. Moreover, according to the programme the increases in the investment expenditure included in the fiscal stimulus package for 2009 and 2010 do not seem to be reversed in 2011 and 2012. The consolidation is only partly supported by the expiry of the fiscal stimulus measures, e.g. certain social transfers and subsidies.

4.4. Risks to the budgetary targets

The underlying macroeconomic assumptions are subject to considerable uncertainty as to the duration, extent and macroeconomic impact of the financial crisis. They appear to be somewhat favourable especially for 2010 and thereafter, when a swift recovery is projected to bring real GDP growth back to potential. The programme scenario is based on no-policy-change assumptions after 2010.

A risk to the projection is the potential lack of sufficient commitment at all levels of government to exert expenditure discipline. However, expiry of certain stimulus measures, the debt repayment plan and the new budgetary rule would support consolidation efforts.

The projections of the revenue ratio are plausible in the light of a weaker economic environment and the tax relief measures adopted. The projections for expenditures are burdened by risk related to the lack of information on the envisaged measures to support the consolidation after 2010, notably given the permanent nature of large part of the fiscal stimulus measures and the marked reliance on social spending restraint and cuts in other expenditure.

Overall, the budgetary outcomes are subject to downside risks due to the economic downturn as well as due to the limited reversibility of expansionary measures in response to the crisis. Revenue projections are broadly plausible, but consolidation after 2010 is not sufficiently backed by measures.

In addition, there is a substantial risk in connection with the rescue plan granted to troubled Landesbanken which is currently assumed to have a direct impact on the debt, but may substantially increase the deficit in the event of public guarantees being called¹². The risk related to the FMSF transactions is currently estimated to be relatively limited, as the operations conducted would have an immediate impact on the deficit only if the granted guarantees are called upon, recapitalisation is not undertaken at market conditions¹³ or the purchase price of assumed risks is higher than the assets' market value. However, additional risks to the government accounts relate to direct implication of the financial crisis, in particular to possible further capital injections and potential bank takeovers (with an impact on the debt, though some effect on the deficit cannot be excluded) or bank guarantees (only the affect the deficit and the debt if and when called). Finally, there is a risk related to the indirect effects of the financial crisis, through revenue losses due to lower tax receipts from credit institutions.

5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

5.1. Debt developments

Having stood at 65% of GDP in 2007, according to the programme the debt-to-GDP ratio has increased by almost ½ percentage point in 2008 and is to rise rapidly by 3 percentage points to 68½% of GDP in 2009 and reach 72½% of GDP in 2012.

As a main driver of the debt developments in 2008, the programme identifies substantial financial transactions of around 2% of GDP resulting from the bank rescue and risk-shield operations undertaken by the German government. A significant increase in the debt ratio in 2009 would be the result of the higher deficit and negative real GDP growth. The pace of the debt-to-GDP increases in 2010 and 2011 will be somewhat mitigated by positive growth effects and unspecified debt-decreasing stock-flow adjustments. Differences between debt projections by the Commission services and in the programme stem mainly from the debt-decreasing stock-flow adjustments and higher nominal GDP growth projections in the programme.

All risks attached to the deficit path referred to above also apply to the debt development. As more than 90% of the debt is issued on a long-term basis (more than one year) and over 98% of the debt is denominated in euro, there are no risks specifically related to debt maturity and currency denomination¹⁴.

¹² In 2008, the German authorities have recorded the guarantees given to the troubled Landesbanken as debt-increasing, but without any impact on the deficit. These guarantees will only affect the deficit if and when called.

¹³ The capital injection undertaken at the market conditions is accompanied by a similar increase in government assets, and would therefore be neutral in terms of net liabilities.

¹⁴ Zarco, I., "Structure of Government Debt in Europe", EUROSTAT, Statistics in Focus 110/2008

Table IV: Debt dynamics

(% of GDP)	average 2002-06	2007	2008		2009		2010		2011	2012
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio¹	65.0	65.1	65.6	65½	69.6	68½	72.3	70½	71½	72½
Change in the ratio	1.8	-2.5	0.5	0.3	4.0	3.3	2.8	1.9	1.0	1.0
<i>Contributions²:</i>										
1. Primary balance	0.4	-2.6	-2.6	-2½	0.1	0	1.3	1	0	-½
2. "Snow-ball" effect	1.7	0.0	0.8	1.1	3.5	3.0	1.4	1.4	1.3	1.3
<i>Of which:</i>										
Interest expenditure	2.9	2.8	2.7	2.8	2.8	2.9	2.8	2.9	2.9	2.9
Growth effect	-0.6	-1.6	-0.8	-0.8	1.6	1.5	-0.5	-0.8	-0.8	-0.8
Inflation effect	-0.6	-1.2	-1.1	-0.9	-0.9	-1.4	-0.9	-0.7	-0.8	-0.8
3. Stock-flow adjustment	-0.3	0.2	2.3	1.9	0.4	0.3	0.0	-0.4	-0.2	0.0
<i>Of which:</i>										
Cash/accruals diff.	-0.1	-0.1		n.a.		n.a.		n.a.	n.a.	n.a.
Acc. financial assets	-0.2	0.4		n.a.		n.a.		n.a.	n.a.	n.a.
<i>Privatisation</i>	-0.4	-0.4		n.a.		n.a.		n.a.	n.a.	n.a.
Val. effect & residual	0.0	-0.1		n.a.		n.a.		n.a.	n.a.	n.a.

Notes:
¹End of period.
²The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). 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' January 2009 interim forecasts (COM); Commission services' calculations

The FMSF recapitalisation measures affect the debt. The guarantees for troubled Landesbanken are at this stage treated as debt-increasing, even though it is unsure to what extent they will be actually called¹⁵. The programme points out that these developments may be of a temporary nature, as the gross debt level will fall when the securities mature or are transferred back to the financial institutions, although this potentially debt-reducing impact is not taken into account in the projections. Moreover, there is a considerable risk of further debt increases, should more financial institutes resort to the FMSF support. Taking into account the risks to the debt projections mentioned above, the debt ratio is not diminishing towards the reference value over the programme period (see Figure 3 in Appendix 2).

5.2. Long-term sustainability

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to an agreed methodology.¹⁶

¹⁵ In 2008, the German authorities have recorded the guarantees given to the troubled Landesbanken as debt-increasing, but without any impact on the deficit. These guarantees will only affect the deficit if and when called.

¹⁶ Economic Policy Committee and the European Commission (2006), 'The impact of aging on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', *European Economy – Special Report No. 1/2006*. European

Table 4 in the Annex 2 shows that the age-related spending is projected to rise by 3.9 percentage points of GDP between 2010 and 2050, close to the EU average. Sustainability indicators for two scenarios are presented in Table 5 in the Annex 2. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2008 level, the sustainability gap (S2)¹⁷ would amount to 2.7% of GDP; about 1 percentage point more than in last year's assessment, which is due to a lower estimated structural primary balance in the starting year. The starting budgetary position would be more than sufficient to stabilize the debt ratio over the long-term and to partly offset the budgetary impact of ageing. However, if the 2009 budgetary position of the Commission services' January 2009 forecast was taken as the starting point, the long-term sustainability would be compounded by the budgetary deterioration. The sustainability gap would widen to about 4% of GDP.

While the "2008 scenario" already reflects the weakening of the budgetary position on account of the current economic crisis, the "programme scenario", which is based on the end-of-programme structural primary balance, projects the budgetary situation to deteriorate. Risks to long-term sustainability of public finances would increase, as shown by the sustainability gap (S2) reaching 3.9% of GDP.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 4 in the Annex 2 displays the projected debt/GDP ratio over the long-term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account. They are summarized in Table 5 in the Annex 2. In particular, new national projections provided in the programme take the latest reforms into account and would point to a more limited increase in pension expenditure.

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. While the budgetary position in 2008 as estimated in the addendum would contribute to partly offsetting the long-term budgetary impact of population ageing, the contrary would result if the budgetary projections materialise. Moreover, the current ratio of gross debt to GDP is above the Treaty reference value. Achieving high primary surpluses over the medium term would contribute to reducing the medium risks to the sustainability of public finances. The above-mentioned risks from financial sector stabilisation schemes (e.g. recapitalisation, guarantees) put in place by Germany could have a potential negative impact on the long-term sustainability of public finances, primarily via their impact on government debt, although some of the cost of the government support could be recouped in the future.

6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The programme emphasises the importance of both qualitative and quantitative consolidation – in order to enhance potential growth and ensure the long-term sustainability of public finances. With the recent reform of the corporate tax system and the reforms of the labour market, some important steps to improve the quality of public finance have been

Commission(2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006. European Commission (2008), *Public finances in EMU – 2008*, European Economy No. 4/2008.

¹⁷The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

implemented. Despite the overall good quality of public finances, there is still room for improvements of Germany's institutional budgetary framework. Current progress towards establishing a new budgetary rule is welcomed in this respect.

Containing the growth of public debt is a central goal of the ongoing second stage of the Federalism Reform (*Föderalismusreform II*). The "Commission on the Modernisation of Bund-Länder Financial Relations" in principle agreed on a new and more effective budgetary rule that is binding for the *Bund* and the *Länder*. The envisaged new budgetary rule is a *close-to-balance rule* that follows the structure of the SGP in the sense that it includes a structural deficit ceiling of 0.35% of GDP (0.0% of GDP) for the federal (*Länder*) level similar to the medium-term objective in the *preventive arm* of the SGP.¹⁸ The necessary constitutional amendments are planned before the federal elections on 23 September 2009 and require a qualified majority of 2/3 of the vote in both the *Bundestag* and *Bundesrat*. The existing budget rule¹⁹ suffers from several shortcomings (e.g. its construction as an investment rule referring to gross-investment with an exemption clause that is not clearly defined, the lack of sanction mechanism when violating the rule etc.), which opens considerable scope for discretionary measures. An effective fiscal rule is a crucial element for Germany to adhere to its medium-term budgetary objectives, and to resume consolidation after 2010. Furthermore, the government plans the modernisation of the federal system of budgeting and accounting with a stronger focus on a performance-based assessment of revenues and expenditures. The Federal Ministry of Finance announced a detailed concept for mid-2009 followed by a pilot phase from 2010 onwards.

7. ASSESSMENT

This section assesses the budgetary strategy, taking into account risks, in the light of (i) the adequacy of the fiscal stimulus package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as agreed in December by the European Council and the overall fiscal stance, (ii) the criteria for short-term action laid down in the above mentioned Commission Communication, and (iii) the objectives of the Stability and Growth Pact.

Benefiting from the fiscal space gained as a result of successful consolidation in recent years, Germany was able to introduce a sizeable fiscal stimulus package for 2009 and 2010 (around 1¾% of GDP on average per year) which is deemed to be an adequate response to the economic downturn. The stimulus is somewhat back-loaded, given that some measures enter into force only in 2010. Positive effects on demand may be dampened by high household saving rates and possible bottlenecks in the construction sector.

In view of discretionary measures in response to the economic crisis, the planned fiscal stance in 2009 and 2010 is expansionary. The structural deficit (as recalculated by the Commission's services on the basis of the information provided in the programme) is estimated to widen by 1½ percentage points in 2009 and by another 1 percentage point in 2010. This is adequate in view of the economic downturn. For 2011, the programme targets a structural improvement by 1 percentage point, followed by a further, albeit small, step for 2012.

¹⁸ For details see Annex 1 and C. Eppendorfer and K. Leib (2008), "Germany: revisiting the budget rule", European Commission, ECFIN Country Focus Vol. 5, Issue 12.

¹⁹ For more information on national budgetary coordination in Germany see European Commission (2007), "Public Finances in the EMU-2007", *European Economy*, No. 3.

The EERP sets out a number of criteria for assessing countries' measures in response to the economic crisis. In particular, measures need to be *targeted*, *timely* and *temporary*. The stimulus programme of the German Federal Government includes a mix of revenue and expenditure instruments which aim at bolstering private consumption, boosting public and private investment, ensuring access to finance, avoiding lay-offs, improving access to training and which include measures that support the motor car industry. By and large, the allocation of funds corresponds to the areas most affected by the crisis. While some of the measures are of limited duration (e.g. one-time child bonus, one-time environmental premium), a substantial part of them are permanent (e.g. lower income tax, reduced contribution rates to health-care insurance). Thus, the full reversibility of the short-term measures adopted in response to the crisis is not ensured. However, the German authorities envisage a debt repayment schedule to facilitate the repayment of debt caused by temporary measures from 2010 onwards. They also intend to introduce into the German Constitution a new budgetary rule to limit the structural deficit in the future. This will be key to bring about the necessary fiscal consolidation process once the crisis recedes. This is fully in line with the EERP which also underscores the need for strengthening national budgetary rules and frameworks.

Regarding the timeliness of the measures, some of the instruments will provide immediate support to economic activity. The reduction of the tax burden and the lowering of social contributions should sustain real disposable income and bolster private consumption. Other initiatives may only become effective with a lag (e.g. public infrastructure investment) or have limited impact in the overall weakened investment climate (e.g. more favourable depreciation rules). Furthermore, the recovery will be supported by structural measures such as innovation support for the private sector, improved employment services and better broadband access within the framework of the planned Broadband Strategy. These measures are broadly in line with the recommendations addressed to Germany under the Lisbon structural reform agenda, adopted by the Commission on 28 January 2009. Moreover, temporary changes in the public procurement procedures aim at accelerating infrastructure investment. The economic effects of the packages will, however, be more pronounced in 2010, as some instruments will become effective only with a lag or come into force as of 2010.

The programme does not foresee the MTO (defined by the programme as a close-to-balance position) to be reached within the programme period as a consequence of the financial and economic crisis. While the pace of deficit reduction after 2010 is broadly in line with the Stability and Growth Pact (SGP), a sufficient safety margin against breaching the 3% of GDP deficit limit would not be reached within the programme period and outlined consolidation path is subject to downside risks. Finally, the higher deficit ratios throughout the programme period and financial transactions linked to bank rescue operations imply that the debt-to-GDP ratio will increase up to 72½% of GDP in 2012.

ANNEX 1: SPECIAL TOPIC IN PUBLIC FINANCES: REFORM OF THE FEDERAL FISCAL RELATIONS: NEW BUDGETARY RULE FOR GERMANY

1. INTRODUCTION

Prior to a recovery in 2007 and 2008, Germany's public finances had deteriorated substantially since reunification. The lack of efficient expenditure and budget rules was a crucial factor in this development. Against this background, the government authorities, major parties and political and economic institutions put forward various proposals for a new budget rule that were discussed in the context of the second stage of the Reform of Federal Fiscal Relations (*Föderalismusreform II*). On 12 February 2009 the "Commission on the Modernisation of Bund-Länder Financial Relations" agreed in principle on a new budgetary rule that is binding for both the *Bund* and the *Länder*. The envisaged rule is a *close-to-balance rule* in line with the Stability and Growth Pact (SGP) in the sense that it includes a *national structural deficit ceiling*, i.e. the federal structural deficit limit is planned to be set at 0.35% of GDP from 2016 onward, while the *Länder* agreed in principle on structurally balanced budgets as of 2020.²⁰ This would constitute a major improvement on the current rule. The remaining issues at the *Länder* level are to be reconciled in the beginning of March 2009. However, they need to be resolved rapidly to capitalise on the current political momentum to pass the necessary constitutional amendments. The necessary constitutional changes are planned before the federal elections on 23 September 2009 but require a qualified majority of 2/3 of the vote in both the *Bundestag* and *Bundesrat*.

2. ON THE NEED FOR A NATIONAL STABILITY PACT

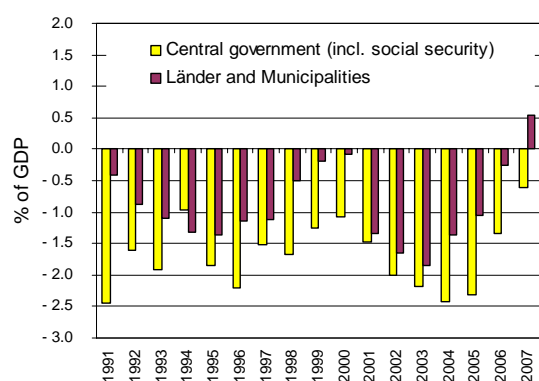
Public finances in Germany deteriorated considerably after reunification²¹ and only in the past two years the deficit has been corrected. Under the rules of the European Stability and Growth Pact (SGP), Germany was subject to the excessive deficit procedure (EDP) for four years in a row from January 2003 to June 2007, breaching the 3%-of-GDP ceiling for the general government fiscal deficit (Figure 1). While public debt was still at 39.5% of GDP in 1991, it amounted to 65% in 2007, down from a peak of 67.8% in 2005. Since 2002, it has continuously exceeded the SGP reference value for the general government debt of 60%-of-GDP (Figure 2). The positive trend in public finances during the last two years is now to reverse due to the overall worsened macroeconomic outlook and as a result of the additional discretionary measures undertaken to address the financial and economic crisis.

From the historic perspective, there are three main factors that contributed to the structural deterioration of German public finances in the past: higher uncertainty due to an increased volatility of revenue elasticity, the lack of expenditure limits and an ineffective budget rule.

²⁰ The rule is planned to become operational by 2011 with transition periods for the federal government until 2015 and for the *Länder* until 2019.

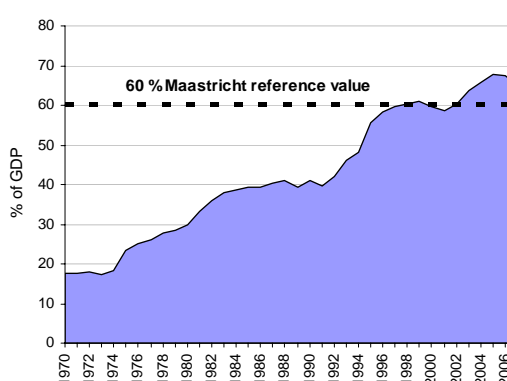
²¹ The federal budget assumed the liabilities of the former GDR government and the restructuring costs of the outdated East German corporate sector. In addition, the 1990-94 operation of the *Treuhand* agency to privatise the East German enterprises was closed with a debt of ca. €130 bn.

Figure 1: Fiscal balances



Source: Commission Services

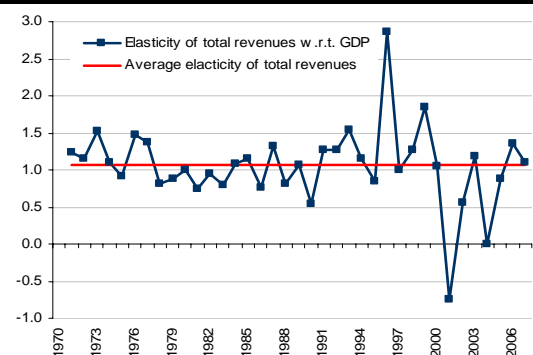
Figure 2: General government debt



Source: German Federal Ministry of Finance

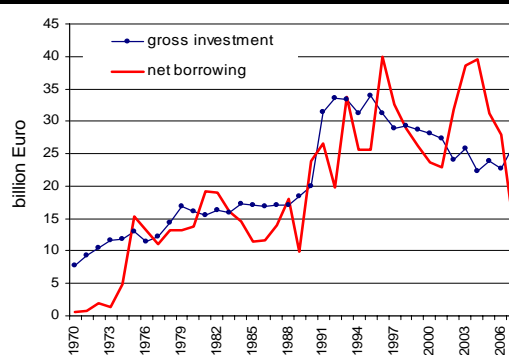
Firstly, on the revenue side, an increased volatility in revenue elasticity complicated budgetary planning after reunification (Figure 3). This was mainly driven by tax composition effects, i.e. the fact that different tax bases do not develop in parallel during different phases of a business cycle. Also discretionary policy measures (e.g. reduction of income tax rates in 1999-2005) added to volatility, as their budgetary impact was often difficult to estimate *ex ante* and they did not always have (the intended) counter-cyclical effect.²² As the link between economic activity and major government revenue components has become less stable, short-term revenue forecasts can only be made with a higher margin of error.²³ As on the expenditure side, such uncertainty would call for more prudent medium-term budgetary planning.

Figure 3: Revenue elasticity



Source: Commission Services

Figure 4: Net borrowing and gross investment of the federal government (cash statistics)



Source: German Federal Ministry of Finance

²² For a detailed analysis of the revenue elasticity in Germany see *European Commission* (2008), "Germany: Macro Fiscal Assessment – An Analysis of the December 2007 Update of the Stability Programme".

²³ While the revenues were overestimated in the downturn after the dot.com bubble had burst in 2000, they were underestimated in the upturn 2006/2007, when the boost in revenues went considerably beyond normal cyclical sensitivity.

Secondly, the expenditure side lacks binding ceilings and sanction mechanisms. The German Constitution grants full autonomy to the budgetary authorities at the federal and *Länder* level.²⁴ Since the beginning of the 1980s, the Fiscal Planning Council (*Finanzplanungsrat*) had been providing annual recommendations for the (nominal) expenditure growth rate for the current year and the following four years. A first step towards expenditure coordination between federal and State level was made in 2002, when the Law on Budgetary Principles (*Haushaltsgrundsätze-gesetz*) was amended, stressing the common responsibility of both levels for complying with the commitments made by Germany within the SGP framework²⁵. The key objective was to weaken the incentive to free-ride on budgetary consolidation, with only the federal government - while accounting for less than 20 percent of total expenditure²⁶ - being fully responsible for meeting SGP criteria at the EU level²⁷. Since then, the *Finanzplanungsrat* began to issue biennial recommendations on the consolidated expenditure lines for the governments at the federal and *Länder* levels (including local authorities). While this was an institutional improvement, expenditure targets were still violated frequently, given their imprecise definition, opaque monitoring and the lack of a sanctioning device. Furthermore, the largely short-term orientation of expenditure targets favoured pro-cyclical behaviour which ran against the SGP objective to let the automatic stabilisers operate in a symmetric way.²⁸

Thirdly, the current German budget rule suffers from certain inherent shortcomings²⁹. The rule laid down in Article 115 of the German Constitution limits net borrowing to the amount of gross public investment, except in the case of a *disturbance of the macroeconomic equilibrium*. However, this exception clause is not clearly defined.³⁰ The legislator has a scope for judgmental evaluation which is to be based on economic reasoning, and needs to be backed by the recommendations of the institutions in charge of the economic analysis³¹. Moreover, the investment rule does not take into account depreciation of the public capital stock³². Thus, the limit set for new borrowing leaves considerable discretionary leeway. Furthermore, the rule does not operate symmetrically over the business cycle, i.e. while in the cases of a *disturbance of the macroeconomic equilibrium* net borrowing is unlimited, there is no obligation for counterbalancing in economic "good times". In addition, there are no sanctions when the rule is violated. From an EU perspective, the rule turned out to be "SGP-incompatible" most of the time. It could neither prevent excessive deficits in 2002-2005 nor the accumulation of general government debt - since 1970 the rule was breached in almost

²⁴ All tax legislation and expenditure legislation that significantly impacts the *Länder* budgets has to be passed jointly by the *Bund* (*Bundestag*) and the *Länder* (*Bundesrat*).

²⁵ For more information on national budgetary coordination in Germany see *European Commission* (2007), "Public Finances in the EMU-2007", *European Economy*, No. 3.

²⁶ However, the federal government also controls social security through legislation.

²⁷ From 2006, an amended Article 109 of German Constitution provides that in the case of EU sanctions the *Bund* and the *Länder* share the costs according to a ratio of 65:35. The *Länder* are required to contribute to the 35% designated as their responsibility on the basis of their population.

²⁸ See *European Commission* (2003, 2006 and 2007), "Public Finances in the EMU-2003", *European Economy*, No. 3 and "Public Finances in the EMU-2006", *European Economy*, No. 3.

²⁹ For a detailed discussion of the weaknesses of the existing German budget rule see *Baumann and Kastrop* (2008), "A New Budget Rule for Germany", in *Fiscal Policy: Current Issues and Challenges*, Banca d'Italia, Research Department, Public Finance Workshop 2008.

³⁰ See *Bundesverfassungsgericht* (1989), "Kreditobergrenzen gem. Art.115 I GG", BVerfGE 79, 311.

³¹ Financial Planning Council, Business Cycle Council (*Konjunkturrat*), Council of Economic Experts (*Sachverständigenrat*) and *Deutsche Bundesbank*.

³² In 2007 gross investment in Germany amounted to 1.5% of GDP (national accounts) and depreciation was in turn 1.6% of GDP. Thus, the net investment was actually negative. Furthermore, public investment subsidies to all sectors amounted to 0.8% of GDP.

half of the years (Figure 4). Finally, many of these shortcomings apply also at the *Länder* level, as twelve out of sixteen German *Länder* transposed the federal rule into their constitutions.

Against this background, the Ecofin Council had repeatedly invited the German authorities to agree on a "national stability pact" in order to make the attainment of the medium term objective (MTO) within the SGP framework more credible³³. Also, the Federal Constitutional Court, in its ruling of 9th July 2007, urged the government to provide a more effective debt limit³⁴. In response to that, Germany undertook first steps to formulate a new budget rule and create a framework involving all government levels in fiscal consolidation. The future limitation of new indebtedness is a central goal of the ongoing second stage of the Federalism Reform (*Föderalismusreform II*), whereby the key task of the "Commission on the Modernisation of Federation-*Länder* Financial Relations", appointed in March 2007, was to propose a more effective budget rule that is binding for all levels of the government. On 12 February 2009 the Commission agreed on a new budgetary rule binding for both the *Bund* and the *Länder*. Details of the necessary legislative and constitutional changes still have to be determined. The necessary constitutional changes are planned before the federal elections on 23 September 2009 but require a qualified majority both the *Bundestag* and *Bundesrat*.

3. PROGRESS TOWARDS ESTABLISHING THE NEW BUDGETARY RULE

Similarly to the heated debate on the reform of the SGP³⁵, the discussion on the new budgetary rule for Germany was fuelled by a plethora of proposals³⁶. The abundance of proposals proved a strong political will to change the existing rule that in the end led to the recent compromise solution. This analysis discusses the currently envisaged *consensus rule* from the EU perspective.

The core element of most proposals was the structural deficit ceiling geared to the medium-term objective (MTO) of 0-0.5% of GDP for Germany in the framework of the SGP³⁷ and endorsed by the Ecofin Council. At the upper end, a deficit ceiling of 0.75% of GDP, as envisaged by the SPD, was less strict than the current MTO. The 0.0% of GDP put forward by the CDU/CSU and by the FDP marked the other end of the range. Although in line with the MTO, this proposal incurred the risk of suppressing the fiscal flexibility. Therefore, a deficit of 0.5% of GDP with the respective contributions of 0.35% of GDP by the *Bund* and 0.15% of GDP by the *Länder*, as proposed by the German Ministry of Finance (BMF) has been long seen as a political compromise. Eventually, this proposal for the Federal Government won the support of all interested parties, while the *Länder* agreed on the structurally balanced budgets

³³ See *The Council of the European Union* (2000), "Council opinion of 28 February 2000 on the updated stability programme of Germany for the period 1999 to 2003" and "Council opinion of 27 November 2000 on the updated stability programme of Germany for the period 2000 to 2004".

³⁴ BVerfGE 2 BvF 1/04, 133.

³⁵ See *Fischer, J., Jonung, L. and M. Larch* (2006), "101 Proposals to reform the Stability and Growth Pact. Why so Many? A Survey", *Public Finance and Management*, Vol. 8, No. 3, pp. 502-560.

³⁶ For a detailed discussion of the submitted proposals see *C. Eppendorfer and K. Leib* (2008), "Germany: revisiting the budget rule", *European Commission, ECFIN Country Focus* Vol. 5, Issue 12.

³⁷ While in 2005 the EFC (provisionally) defined a range of 0-0.5% of structural deficit as the MTO, the Council in 2006 referred to a balanced budget (presented in the German stability program of Feb. 2006) as the appropriate MTO for Germany. For Member States that have adopted the euro and for ERMII countries the country-specific MTOs shall be specified within a range between -1% of GDP and 'in balance or surplus', in cyclically adjusted terms, net of one-off and temporary measures. The country-specific MTO can be revised when a major structural reform (e.g. pension reform) is implemented and in any case every four years.

(0.0% of GDP). In any case, none of the proposed deficit ceilings seems to be anchored in a comprehensive analysis taking into account demographic aspects and scrutinising available policy solutions to close the sustainability gap, e.g. the degree of frontloading of the future social security costs or additional pension reforms.

Moreover, the MTO can be revised, as in principle it should be designed in a flexible manner, so that there is enough room for manoeuvre when the social security legislation changes or ageing cost projections are revised.³⁸ In addition, the MTO could take into account public investments³⁹. This could require budgetary targets to be changed. Therefore, the formulation of the rule in the constitution should offer sufficient flexibility to adjust the deficit ceilings. In any case, a limit for the general government deficit of 0.35% of GDP in structural terms would be tighter than the current criterion of gross investment.

The new compromise provides for a rule to be applied symmetrically over the business cycle and recognise the need to limit structural borrowing or build up surpluses in economically good times. This is in line with the SGP requirement to let the automatic stabilisers operate fully. Regarding structural deficit calculations, it would be important to ensure a transparent communication, on which phase of the cycle the economy finds itself in. On the technical side, the use of the SGP methodology and statistical delimitation (system of national accounts), as suggested by the original BMF proposal, would be a major progress from the EU point of view.

The now envisaged rule for the Federal Government foresees an adjustment account (*Ausgleichkonto*) to record the structural deviations from the authorised deficit level, with the overruns booked as debit, and underruns recorded as credit. The account would have a debit ceiling (e.g. 1.5% of GDP) and a clear agenda for the adjustment path in cases of an "overdraft"⁴⁰. The debit ceiling is to reflect unforeseen demand for credit, e.g. due to fluctuations in revenue elasticity or miscalculation of the budgetary impact of policy measures. The incentive of strategic miscalculation of the budget (e.g. by strategic forecasting of potential output or output gap) is limited as the *ex post* budgetary position as well as the actual economic development is taken as a reference for the bookings on the adjustment account. However, only the implementation of a clearly defined sanction mechanism could ensure the application of the adjustment account in a credible manner.

At the federal level, such a mechanism would in principle lead to a stricter adjustment rule than the one laid down in the SGP (i.e. an annual structural adjustment of 0.5% of GDP to reach the MTO⁴¹). Contrary to the SGP, the adjustment account would allow for past deviations to be taken into account ("memory function"), which would also allow previous increases in the debt-to-GDP ratio due to excessive deficits to be corrected (Box 1). Furthermore, the model of the adjustment account seems to be reconcilable with weaker forms of enforcement like the establishment of a Stability Council, time limits for credit repayment or obligatory repayment plans.

³⁸ In 2009 it is planned to revise the MTO of EU Member States in the light of new projections of the "implicit liabilities" due to the costs of population ageing.

³⁹ 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 amended by Council Regulation (EC) No 1055/2005 of 27 June 2005

⁴⁰ The adjustment path has not been yet defined.

⁴¹ Set for the Euro zone and the ERM II countries.

Box 1: SGP vs. adjustment account in practice^{1), 2)}

Year	Structural position			Adjustment path		Adjustment account
	Ex ante		Ex post	According to SGP	According to national authorities	
	According to SGP	According to national authorities				
t=0	0.0	0.0	0.0	0.0	0.0	0.0
t=1	0.0	0.0	-0.5	+0.5	+0.5	-0.5
t=2	0.0	0.0	-0.5	+0.5	+0.5	-1.0
t=3	0.0	0.0	-0.5	+0.5	+0.5	-1.5
t=4 a	0.0	0.5	0.5	-	-	-1.0
t=4 b	0.0	0.5	0.0	-	+0.5³⁾	-1.5

Source: Commission Services.

Notes: ¹⁾ Abstracting from the problems of forecast versus realised GDP growth and related corrections of the cyclical component in the calculation of the structural positions, ²⁾ Assuming that there are no differences between planned and realised balance of financial transactions. ³⁾ Gradual adjustment could be also possible, e.g. obligation to reduce the 50% of the excessive sum in the following year.

This stylised example serves to illustrate the "memory mechanism" of the adjustment account. For simplicity, the national MTO for Germany is assumed to be 0.0% of GDP. Assume further that the national structural deficit ceiling is set at 0.0% of GDP and the debit ceiling of the adjustment account is 1% of GDP. The adjustment account is debited (credited) *only* with the *structural* overruns (underruns) of the deficit ceiling. Thus, the adjustment account does not allow for the *cyclical* deviations from the deficit ceiling which reflect the automatic stabilisers operating in a symmetric way. The cyclical deviations are assumed to be balanced over the cycle.

Starting with a balanced budget and adjustment account in t=0, the MTO is missed by 0.5% of GDP for three years in a row. According to the SGP and the national adjustment path, the structural position needs to be corrected each year by 0.5%. At t=3 the adjustment account would be debited with 1.5% of GDP, which is above the debit ceiling. Therefore, at t=4, the account would have to be credited with the real savings. This requires national authorities to achieve a structural surplus of 0.5% of GDP at t=4 (reflected in their *ex ante* budgetary planning). Compared to the SGP, at t=4 the adjustment account would oblige the national authorities to follow a stricter consolidation path. Importantly, the credits recorded on the adjustment account cannot compensate for the deficit of the current budget, as they are not real savings but just an under-usage of allowed net borrowing.

The compromise foresees exception clauses for breaching the deficit ceiling, notably in case of natural disasters or in particularly bad economic times. However, in particular the latter clause must be clearly defined in order to avoid the ambiguous interpretations as in the case of the current rule (*disturbance of the macroeconomic equilibrium*). Moreover, considering Germany's experience with the systematic violation of the current budget rule, it would be important for the rule to feature some sort of sanctioning device.

To achieve the political compromise between federal and state level, it was necessary to "bail out" the *Länder* with disadvantaged fiscal starting positions (i.e. with high debt levels) namely

Bremen, Saarland, Berlin, Schleswig-Holstein, Berlin and Sachsen-Anhalt which are to receive about €800 million p.a. between 2011 and 2019 paid by the *Bund* (50%) and the "richer" *Länder* (50%). This should allow them to reach balanced budget positions as of 2020 at latest. In any case, the issue of an enforcement mechanism at the *Länder* level to assure good budgetary performance remains unresolved. One possibility would be a peer pressure process, similar to the one applied in the SGP context at the EU level, which could be reinforced by a sanctioning system to penalise the violation of the rule.

4. CONCLUSIONS

The lack of effective expenditure and budget rules seems to have contributed substantially to the deterioration of Germany's public finances in the last two decades. The remarkable budgetary consolidation of 2007 and 2008 was to a large extent driven by the unexpectedly high tax revenues used for deficit reduction. In addition, the massive increase in the VAT rate in 2008 was only partly offset by lower social contributions. The expenditure-based consolidation was greatly aided by the higher-than-expected savings in the labour market expenditure. However, with the rapid deterioration of the German public finances due to the current economic downturn, an effective rule becomes ever more important to ensure the necessary fiscal discipline to reverse the expansionary measures of the fiscal stimulus packages and to support the overall consolidation process once the crisis has abated.

Suffering from numerous shortcomings, the current German budget rule in particular was not able to prevent either the excessive deficits in 2002-2005 or the accumulation of general government debt. This called into question its compatibility with the SGP framework. The key task for the federal and state governments is to implement the new budgetary rule as currently envisaged.

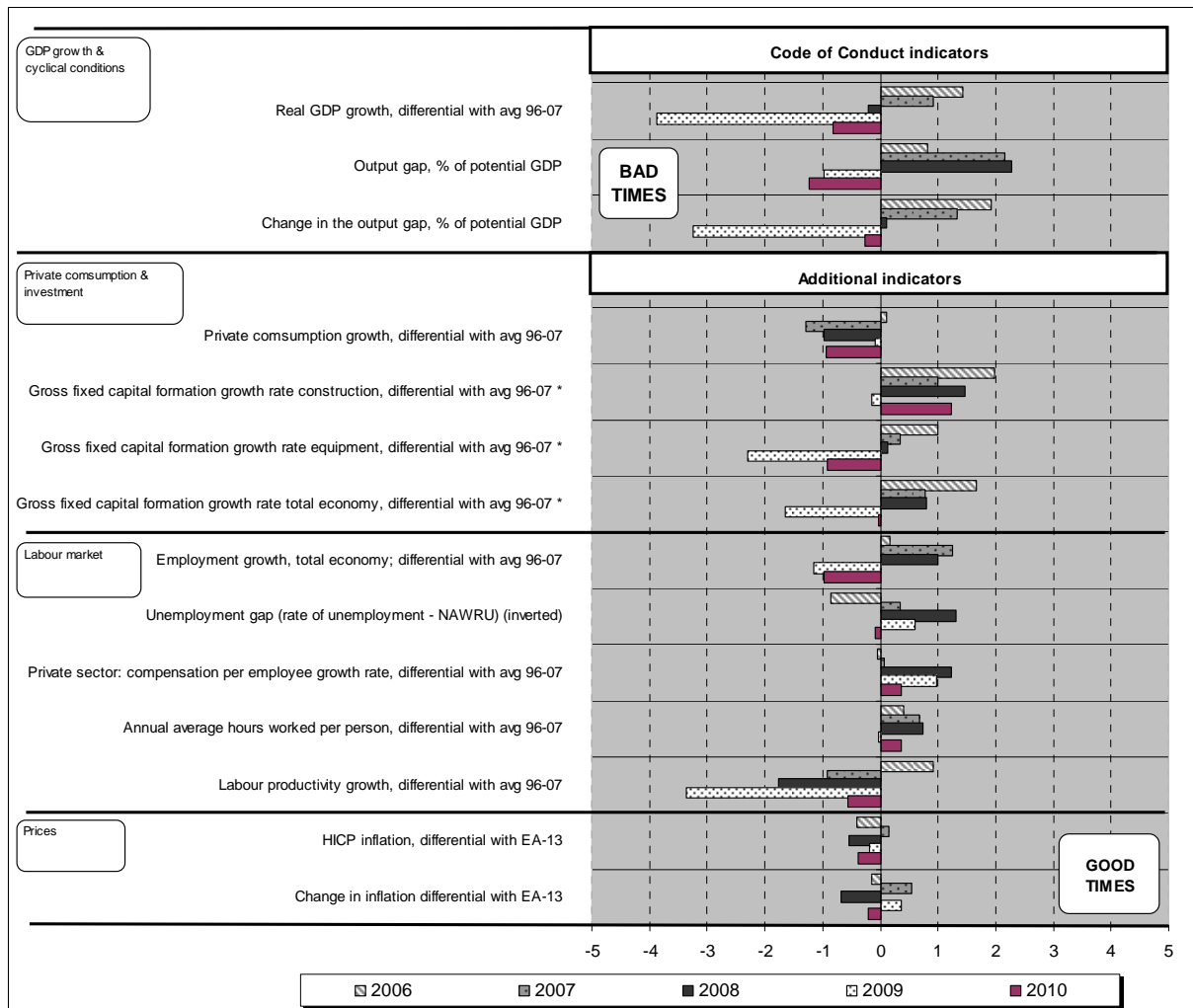
The envisaged new budgetary rule is a *close-to-balance rule* that follows the structure of the Stability and Growth Pact (SGP) in the sense that it includes a *national* structural deficit ceiling à la MTO (*preventive arm*) and proposes an adjustment account. The latter would allow for the correction of the past deviations from the target – a feature absent in the SGP.

However, a close-to-balance rule in the constitution does not necessarily define the economically "correct" national structural deficit. Practical problems might arise from the necessary adjustments to changes in the social security system and revisions of the projected ageing cost. Such adjustments could necessitate a change in the budgetary targets. Therefore, the formulation of the rule in the constitution should offer sufficient flexibility to fine-tune the deficit ceilings if necessary. Another challenge emerges regarding the "adequate" limit on the adjustment account, which is important in the context of the risk of a potential pro-cyclical impact of the rule during downswings.

All in all, the compromise for a new budget rule as currently put forward by the "Commission on the Modernisation of Bund-Länder Financial Relations" constitutes a clear improvement on the current fiscal framework. However, the lack of concrete sanction mechanisms thus far jeopardises its effectiveness which undermines the *ex ante* sustainability of the compromise solution.

ANNEX 2. ADDITIONAL TABLES AND FIGURES

Figure 1: Good and bad economic times



* These variables have been divided by their standard deviation over the period 2003-2010, with a view to reducing their variability relative to other variables in the graph.

Source: Commission services' January 2009 interim forecast

Table 1: Budgetary implementation in 2008

	2007		2008	
	Planned	Outcome	Planned	Outcome
	SP Nov 2007	SP Dec 2008	SP Nov 2007	SP Dec 2008
Government balance (% of GDP)	0	-0.2	-½	-0.1
Difference compared to target	-0.2		0.2	
<i>Of which</i> : due to a different starting position end 2007			-0.3	
due to different revenue / expenditure growth in 2008			0.5	
p.m. Denominator effect and residual ^{2,3}			0.1	
<i>p.m. Nominal GDP growth (planned and outcome)</i>			3.5	2.7
Revenue (% of GDP)	44	44.0	43	44
Revenue surprise compared to target¹	0.1		0.9	
<i>Of which</i> : due to a different starting position end 2007			0.1	
due to different revenue growth in 2008			0.5	
p.m. Denominator effect ²			0.3	
p.m. Residual ³			0.0	
<i>p.m. Revenue growth rate (planned and outcome)</i>			1.4	2.5
Expenditure (% of GDP)	44	44.2	43½	44
Expenditure surprise compared to target¹	-0.4		-0.7	
<i>Of which</i> : due to different starting position end 2007			-0.4	
due to different expenditure growth rate in 2008			0.0	
p.m. Denominator effect ²			-0.3	
p.m. Residual ³			0.0	
<i>p.m. Expenditure growth rate (planned and outcome)</i>			2.3	2.2
Notes:				
¹ A positive number implies that the outcome was better (in terms of government balance) than planned. Starting position in 2007 includes one-off measures of 0.3% of GDP that do not affect the 2008 position. Therefore, after controlling for the one-off measures, only 0.1% of GDP of the higher expenditure ratio in 2008 can be attributed to the different starting position in 2007 and 0.3% of GDP to the higher expenditure growth.				
² The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue				
³ The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.				
<i>Source: Commission services</i>				

Table 2: Evolution of budgetary targets in successive programmes

		2007	2008	2009	2010	2011	2012
General government balance (% of GDP)	SP Dec 2008	-0.2	-0	-3	-4	-3	-2½
	<i>SP Nov 2007</i>	<i>0</i>	<i>-½</i>	<i>0</i>	<i>½</i>	<i>½</i>	<i>n.a.</i>
	COM Jan 2009	-0.2	-0.1	-2.9	-4.2	n.a.	n.a.
General government expenditure (% of GDP)	SP Dec 2008	44.2	44	46½	46½	45½	45½
	<i>SP Nov 2007</i>	<i>44</i>	<i>43½</i>	<i>43</i>	<i>42</i>	<i>41½</i>	<i>n.a.</i>
	COM Jan 2009	44.1	43.8	46.4	46.4	n.a.	n.a.
General government revenue (% of GDP)	SP Dec 2008	44.0	44	43½	42½	42½	43
	<i>SP Nov 2007</i>	<i>44</i>	<i>43</i>	<i>43</i>	<i>42½</i>	<i>42</i>	<i>n.a.</i>
	COM Jan 2009	43.9	43.7	43.5	42.3	n.a.	n.a.
Structural balance ¹ (% of GDP)	SP Dec 2008	-0.9	-0.8	-2.5	-3.4	-2.4	-2.1
	<i>SP Nov 2007</i>	<i>-0.3</i>	<i>-0.7</i>	<i>-0.3</i>	<i>0.0</i>	<i>0.7</i>	<i>n.a.</i>
	COM Jan 2009	-1.0	-0.9	-2.4	-3.4	n.a.	n.a.
Real GDP (% change)	SP Dec 2008	2.5	1.3	-2¼	1¼	1¼	1¼
	<i>SP Nov 2007</i>	<i>2.4</i>	<i>2.0</i>	<i>1½</i>	<i>1½</i>	<i>1½</i>	<i>n.a.</i>
	COM Jan 2009	2.5	1.3	-2.3	0.7	n.a.	n.a.

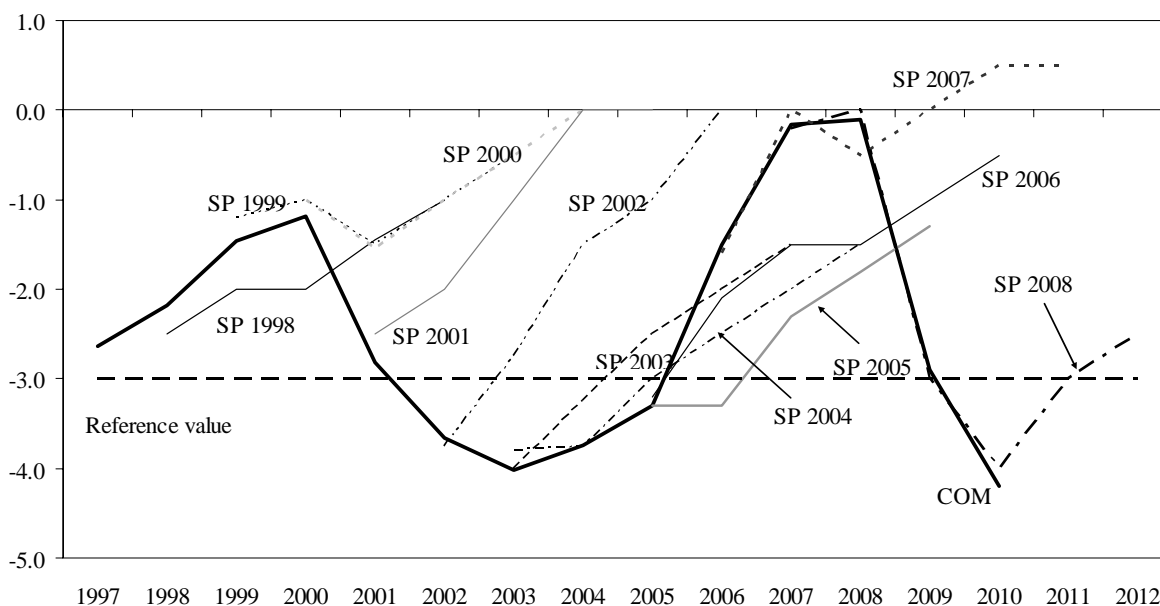
Note:

¹Cyclically-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 0.3% of GDP in 2007 and ½% in 2008; all deficit-increasing according to the most recent programme and 0.3% of GDP in 2007, 0.3% of GDP in 2008 and 0.1% in 2010; all deficit-increasing according to the Commission services' January interim forecast.

Source:

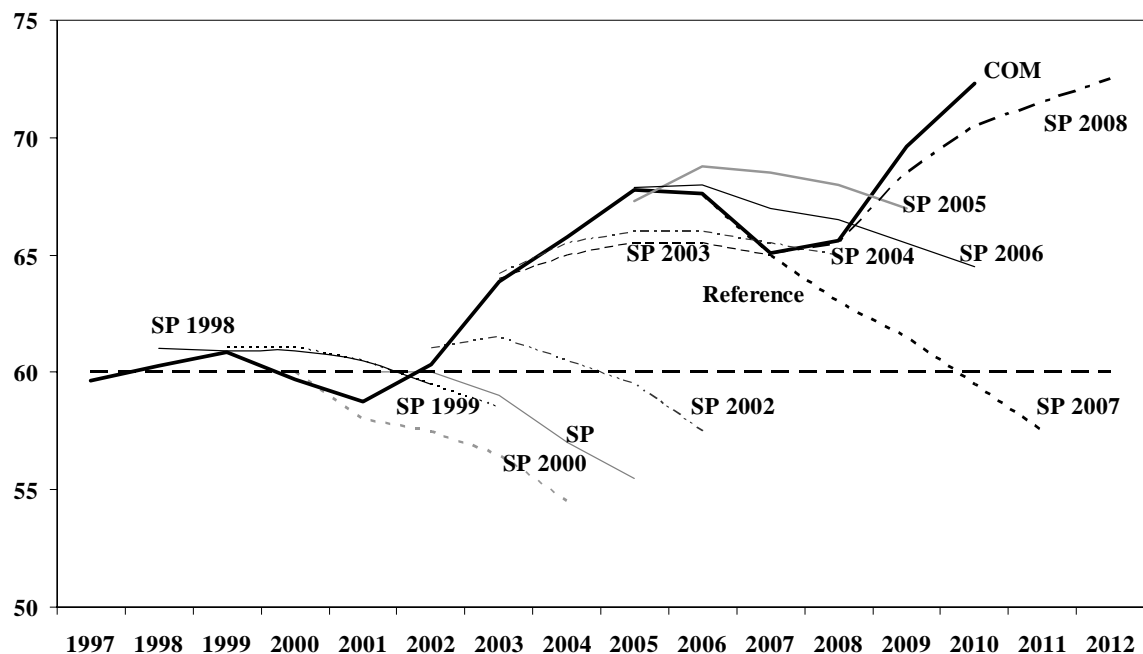
Stability programmes (SP); Commission services' January 2009 interim forecasts (COM)

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Figure 3: Debt projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Table 3: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2010- 50
Total age-related spending	23.7	22.5	22.9	24.7	25.7	26.4	3.9
- Pensions	11.4	10.5	11.0	12.3	12.8	13.1	2.6
- Healthcare	6.0	6.3	6.7	6.9	7.1	7.2	0.9
- 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	-0.4
- Unemployment benefits	1.3	1.1	0.9	0.9	0.9	0.9	-0.2
Property income received	0.6	0.6	0.6	0.5	0.4	0.4	-0.2

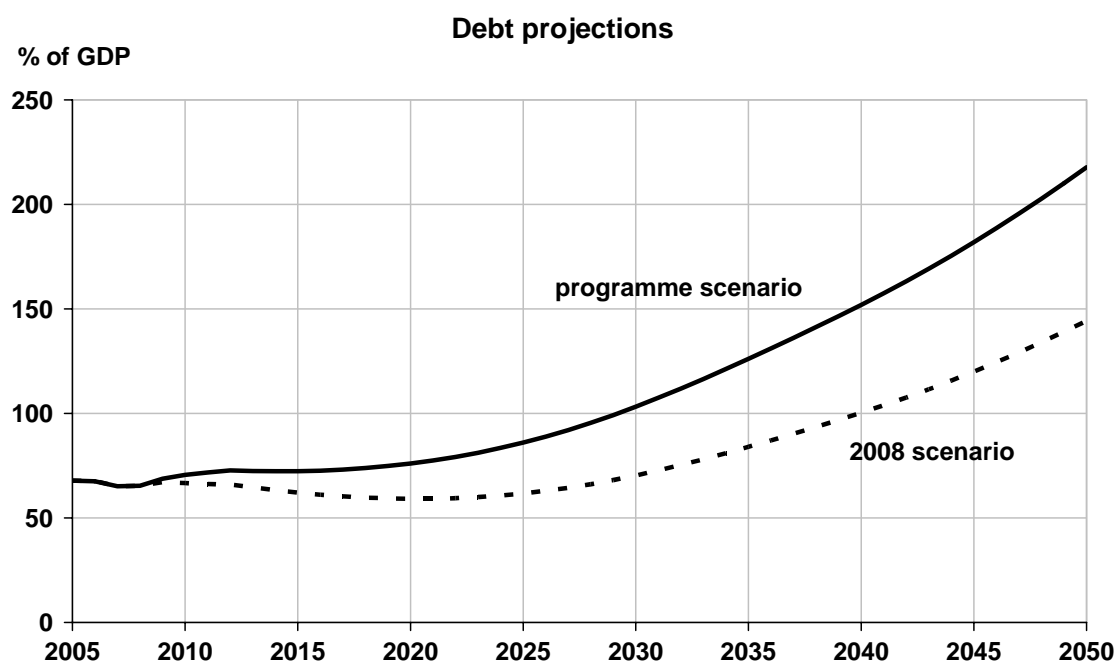
Source: Economic Policy Committee and Commission services.

Table 4: Sustainability indicators and the required primary balance

Value	2008 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
of which:	1.6	2.7	4.5	2.9	3.9	4.6
Initial budgetary position (IBP)	-0.7	-0.6	-	0.6	0.7	-
Debt requirement in 2050 (DR)	0.1	-	-	0.2	-	-
Long-term change in the primary balance (LTC)	2.1	3.2	-	2.1	3.2	-

Source: Commission services.

Figure 4: Long-term projections for the government debt ratio



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

Source: Commission services.

Table 5: Additional factors

	Impact on risk
Debt and pension assets	-
Decline in structural balance until 2010 in COM January forecast 2009	-
Significant revenues from pension taxation	na
Alternative projection of cost of ageing	+
Strong decline in benefit ratio	-
High tax burden	na
Non-age related budgetary measures with intertemporal effect	na

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability.
 'na': not applicable.
 Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".
 An explanation on these factors can be found in chapter IV of: European Commission (2006), *The long-term sustainability of public finances in the European Union*, European Economy No. 4/2006.
Source: Commission services.

ANNEX 3. COMPLIANCE WITH THE CODE OF CONDUCT AND TABLES FROM THE PROGRAMME

The update broadly follows the model structure in Annex 1 of the code of conduct. Regarding the formal data provisions (Annex 2 of the code of conduct), some compulsory and optional data is missing:

Compulsory data: In Table 2 (budgetary prospects) "taxes on products and imports", "current taxes on income, wealth, etc.", "capital taxes" and "property income" are 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) is 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 and education expenditure includes family expenditure 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 2008 update of stability programme and January 2009 addendum to the 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.

Table 1a. Macroeconomic prospects

	ESA Code	2007	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	108.69	2.5	1.3	-2¼	1¼	1¼	1¼
2. Nominal GDP	B1*g	2422.9	4.4	2.7	-¼	2¼	2¼	2¼
Components of real GDP								
3. Private consumption expenditure	P.3	102.11	-0.4	0.0	0.8	1	1	1
4. Government consumption expenditure	P.3	104.97	2.2	2.2	2.4	1	1	1
5. Gross fixed capital formation	P.51	102.22	4.3	4.1	-5.0	2	2	2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	n.a.	0.1	0.3	0.0	0	0	0
7. Exports of goods and services	P.6	163.52	7.5	3.9	-8.9	4½	4½	4½
8. Imports of goods and services	P.7	141.13	5.0	5.1	-5.0	4½	4½	4½
Contributions to real GDP growth								
9. Final domestic demand		-	1.0	1.2	-0.1	1	1	1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.1	0.3	0.0	0	0	0
11. External balance of goods and services	B.11	-	1.4	-0.3	-2.2	0	0	0

Table 1b. Price developments

	ESA Code	2007	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		108.08	1.9	1.4	2.1	1	1	1
2. Private consumption deflator		110.8	1.7	2.2	0.9	1½	1½	1½
3. HICP¹		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Public consumption deflator		105.9	0.2	1.8	2.2	1	1	1
5. Investment deflator		103.1	2.9	1.0	1.2	1	1	1
6. Export price deflator (goods and services)		101.03	0.5	0.8	-1.1	1½	1½	1½
7. Import price deflator (goods and services)		100.51	-0.1	1.7	-3.5	1½	1½	1½

¹ Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2007	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons¹		39768	1.7	1.5	-0.7	0	0	0
2. Employment, hours worked²		57	1.8	1.8	-0.8	0	0	0
3. Unemployment rate (%)³		n.a.	8.3	7.2	7.9	8	8	8
4. Labour productivity, persons⁴		106.99	0.7	-0.2	-1.5	1	1	1
5. Labour productivity, hours worked⁵		109.94	0.6	-0.5	-1.5	1	1	1
6. Compensation of employees	D.1	1183.47	3.0	3.6	1.2	2½	2½	2½
7. Compensation per employee		33510	1.1	1.9	2.0	2½	2½	2½

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	2007	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	7.6	7.1	7.0	7	7	7
<i>of which :</i>							
- Balance on goods and services		7.1	6.8	6.7	6½	6½	6½
- Balance of primary incomes and transfers		1.7	1.4	1.4	¼	¼	¼
- Capital account		-1.1	-1.1	-1.2	0	0	0
2. Net lending/borrowing of the private sector	B.9	5.6	5.5	5.4	5½	5½	5½
3. Net lending/borrowing of general government	EDP B.9	-0.2	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	2007	2007	2008	2009	2010	2011	2012
		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	-4.2	-0.2	-0	-3	-4	-3	-2½
2. Central government	S.1311	-26.19	-1.1	-½	-2	-2½	-2	-1½
3. State government	S.1312	11.63	0.5	0	-½	-1	-1	-1
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	10.4	0.4	½	-½	-½	0	-0
General government (S13)								
6. Total revenue	TR	1065.93	44.0	44	43½	42½	42½	43
7. Total expenditure	TE ¹	1070.09	44.2	44	46½	46½	45½	45½
8. Net lending/borrowing	EDP B.9	-4.16	-0.2	-0	-3	-4	-3	-2½
9. Interest expenditure	EDP D.41	67.35	2.8	3	3	3	3	3
10. Primary balance²		63.19	2.6	2½	0	-1	0	½
11. One-off and other temporary measures³		n.a.	-0.3	-½	0	-0	-0	0
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		576.3	23.8	24	23½	22½	22½	23
12a. Taxes on production and imports	D.2	304.693	12.6	n.a.	n.a.	n.a.	n.a.	n.a.
12b. Current taxes on income, wealth, etc	D.5	270.84	11.2	n.a.	n.a.	n.a.	n.a.	n.a.
12c. Capital taxes	D.91	0.8	0.0	n.a.	n.a.	n.a.	n.a.	n.a.
13. Social contributions	D.61	399.87	16.5	16½	16½	16½	16½	16½
14. Property income	D.4	n.a.	n.a.	n.a.	n.a.	optional	optional	optional
15. Other⁴		89.76	3.7	3½	3½	3½	3½	3½
16=6. Total revenue	TR	1065.93	44.0	44	43½	42½	42½	42½
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)⁵			40.3	40	40	39	39½	39½
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	418.4	17.3	17	17½	17½	17	17
19=9. Interest expenditure	EDP D.41	67.4	2.8	3	3	3	3	3
20. Subsidies	D.3	27.1	1.1	1	1	1½	1	1½
21. Gross fixed capital formation	P.51	35.6	1.5	1½	2	2½	2½	2½
22. Other⁶		73.4	3.0	3	3	2½	2	2
23=7. Total expenditure	TE ¹	1070.1	44.2	44	46½	46½	45½	45½
p.m.: Government consumption (nominal)	P.3	435.6	18.0	18	19	19	19½	19

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

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

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

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

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

⁶D.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	2006	2011
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.

¹Adjusted 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	2007	2008	2009	2010	2011	2012
1. Gross debt¹		65.1	65½	68½	70½	71½	72½
2. Change in gross debt ratio		0.3	2	3	3½	2½	2½
Contributions to changes in gross debt							
3. Primary balance²		-2.6	2½	0	-1	0	½
4. Interest expenditure³	EDP D.41	2.8	3	3	3	3	3
5. Stock-flow adjustment		0.2	2	½	-½	-0	-0
<i>of which:</i>							
- 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.
<i>of which:</i>							
- 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 debt⁷		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other relevant variables							
6. Liquid financial assets⁸		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.

¹As defined in Regulation 3605/93 (not an ESA concept).

²Cf. item 10 in Table 2.

³Cf. item 9 in Table 2.

⁴The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

⁵Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be

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

⁷Proxied by interest expenditure divided by the debt level of the previous year.

⁸AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2007	2008	2009	2010	2011	2012
1. Real GDP growth (%)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
2. Net lending of general government	EDP B.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. Interest expenditure	EDP D.41	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. One-off and other temporary measures¹		n.a.	n.a.	n.a.	n.a.	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.

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

Table 6. Divergence from previous update

	ESA Code	2007	2008	2009	2010	2011	2012
Real GDP growth (%)							
Previous update		2.5	1½	0	1½	1½	1½
Current update		2.5	1½	-2½	1	1	1
Difference		0.0	-½	-2½	-0	-0	-0
General government net lending (% of GDP)	EDP B.9						
Previous update		-0.2	0	-½	-1½	-1	-½
Current update		-0.2	-0	-3	-4	-3	-2½
Difference		0.0	-0	-2	-2½	-2	-2
General government gross debt (% of GDP)							
Previous update		65.1	65	65	64	63	61½
Current update		65.1	65½	68½	70½	71½	72½
Difference		0.0	0	4	6½	9	11

Table 7. Long-term sustainability of public finances ¹⁾

% of GDP	2000	2005	2020 ²⁾	2030 ²⁾	2040 ²⁾	2050 ²⁾
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 ¹⁾	n.a.	11.4	11.3/10.9	12.9/11.9	13.7/12.4	14.2/12.5
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 care ¹⁾	n.a.	7.1	8.2/8.0	8.9/8.4	9.9/9.1	10.8/9.5
Long-term care (<i>this was earlier included in the health care</i>)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
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.	n.a.	n.a.	n.a.	n.a.	n.a.
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 ¹⁾	n.a.	1.0	1.6/1.8	1.6/1.8	1.4/1.7	1.4/1.7
Real GDP growth	n.a.	0.9	1.0/1.7	0.6/1.4	0.9/1.6	0.7/1.4
Participation rate males (aged 15-64) ¹⁾³⁾	n.a.	82.0	83.1/83.9	83.8/85.0	85.0/85.6	85.3/86.0
Participation rates females (aged 15-64) ¹⁾³⁾	n.a.	70.8	73.2/73.7	74.9/75.7	77.0/77.4	77.8/78.1
Total participation rates (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate ¹⁾	n.a.	11.4	7.7/6.9	7.7/4.6	7.7/4.0	7.7/4.0
Population aged 65+ over total population ¹⁾	n.a.	15.9	19.0/18.6	23.0/22.2	24.9/23.8	24.7/23.5

¹⁾ Germany uses alternative variants ("T-"/"T+") for future years

²⁾ Germany uses columns for years: 2020, 2030, 2040, 2050

³⁾ Germany uses (aged 15-64) instead of (aged 20-64)

Table 8. Basic assumptions

	2007	2008	2009	2010	2011	2012
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.

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