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REPORT FROM THE COMMISSION

Excessive deficit in Germany

Report prepared in accordance with article 104, paragraph 3 of the Treaty

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1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 13 November 2002, the Commission published its Autumn 2002 economic forecast. According to the projections for the year 2002, the general government deficit in Germany will rise to a ratio of 3.8% of GDP, from a revised deficit estimate of 2.8% of GDP for the year 2001. In all likelihood, therefore, the deficit will exceed the reference value of 3% by a significant margin[1]. General government gross debt is projected to move from 59.5% to 60.9% of GDP in 2002, also rising above the respective reference value of 60%.

Table 1: GENERAL GOVERNMENT DEFICIT AND DEBT, 1998 - 2002

(% of GDP)

	1998	1999	2000	2001	2002*
Deficit	2.2	1.5	1.4	2.8	3.8
Debt	60.9	61.2	60.2	59.5	60.9

*Commission Autumn 2002 forecast

Significant divergence of the budgetary position from targets had become apparent already in late 2001. Indications in this regard became confirmed with the release of the preliminary figure for the general government deficit in 2001, which at 2.6% of GDP exceeded the stability programme target by more than 1 percentage point. This prompted the Commission in January 2002 to recommend to the Council to address an early warning to Germany in line with Article 6 of Council Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies. On 12 February, the Council decided that given the commitments made by the German government, the Commission recommendation would not be put to vote and to close the procedure. Germany inter alia confirmed its endeavour to ensure that the 3% of GDP reference value for the general government deficit would not be breached in 2002.

1 The Commission Autumn forecast clearly implies that the 2002 general government deficit would have breached the Treaty's reference value also in the absence of the floods in eastern Germany and Bavaria. The overall damage caused by the floods is currently estimated at € 9.2 billion (0.45 % of GDP) by the Federal government, but the budgetary cost in 2002 should be limited to around € 2 billion or 0.1 % of GDP

In line with these commitments, the Federal government in March, in the context of the semi-annual reporting of deficit and debt figures, notified to the Commission a deficit of 2.6% of GDP for 2002. Gross debt by the end of the year was expected at a ratio of 60.6% of GDP.

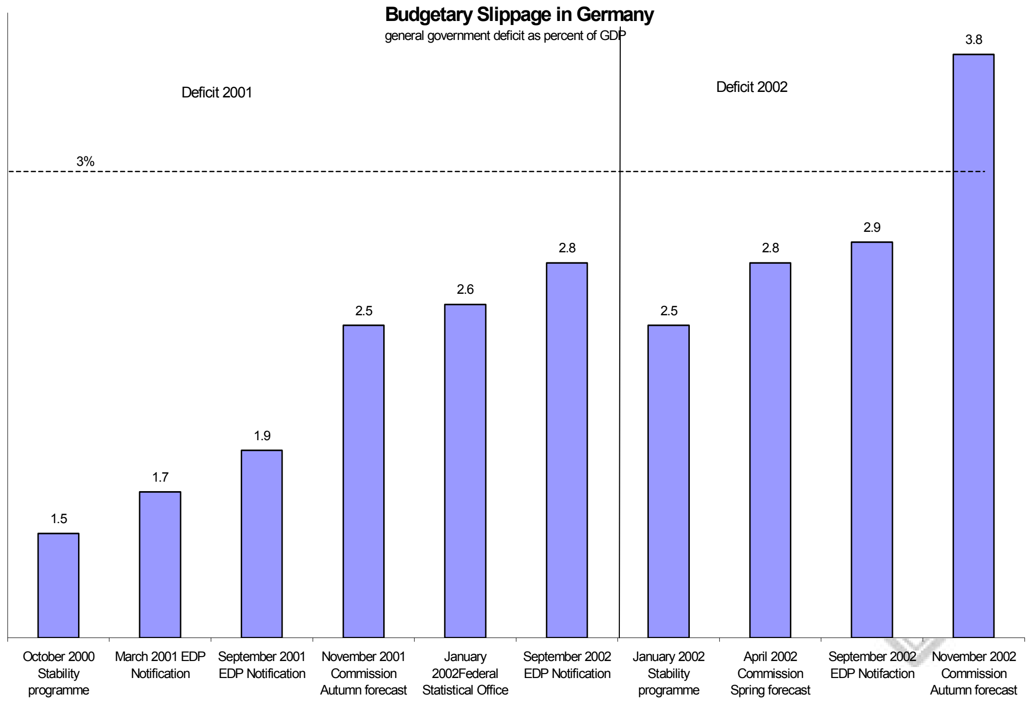
Following general elections on 22 September 2002, the re-elected Federal government on 24 September belatedly submitted the autumn notification of budgetary data, showing a deficit of 2.9% of GDP and confirming a debt ratio of 60.6% for 2002. More recently, on 16 October, the Minister of Finance publicly stated that the deficit for 2002 was likely to exceed the Treaty's reference value.

On the basis of the evidence available and developments indicated by the Autumn 2002 forecast showing that the 2002 deficit was likely to exceed the Treaty's reference value, the Commission has prepared this report according to Art. 104.3, thereby initiating the Excessive Deficit Procedure (EDP) for Germany.

The application of the EDP is governed by Article 104 of the Treaty (ex 104c), Council Regulation N°1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP). It is also driven by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

Art. 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria [i.e. the ratio of the government deficit and of the government debt to GDP not exceeding the respective reference value], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State.

The Commission may also prepare a report, if notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State



The present report assesses recent and current budgetary developments in Germany and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

Germany's growth performance during the last decade has been very weak. The economy suffered from the financial consequences of unification, which implied the transfer of large amounts each year to the eastern *Länder* and a protracted decline of the construction sector following a short-lived boom in the early nineties. In addition to these special factors, growth in Germany is held back by numerous structural impediments: an inflexible labour market; a complex and rigid system of rules and regulations compounded by an intransparent tax code; a social welfare system which often discourages taking up work, while its high non-wage labour cost tends to act as a barrier to job creation; a pension system granting benefit levels likely to prove unsustainable in the face of future demographic challenges; and finally an expensive and in many instances inefficient health care system[2]. However, progress in addressing these problems has been slow, weighing on private sector confidence and being at least partly responsible for the slow pace of activity. Indeed, the average annual GDP growth rate for the ten years from 1992 to 2002 was only 1.3%. Fluctuations around this average have been fairly moderate.

[2] These issues were addressed *inter alia* by the Commission, notably in its study "Germany's Growth Performance in the 1990s" (DG ECFIN Economic Paper 170, May 2002), and the Broad Economic Policy Guidelines; also by, the IMF (e.g. 2002 Article IV Consultation), the OECD (2002 Annual Review-Germany) and the German Council of Economic Advisers (*Sachverständigenrat*).

At the end of 1999 and in early 2000 the economy witnessed a strong but brief surge in economic activity. Growth accelerated from 2.0% in 1999 to 2.9% in 2000, the highest rate since the unification boom. Economic growth would have been still higher by a full percentage point, if the construction sector had kept pace with the rest of the economy. Much of the stronger growth was owed to a substantial contribution from the external balance, as Germany benefited from the expansion of world trade Domestic demand also briefly gained momentum in 1999.

By mid-2000 the short boom was over, and growth has not picked up markedly since. First, domestic demand started to decline, when strong terms-of-trade losses occurred as a result of rising oil prices. Equipment investment fell, when falling stock market values announced a global economic slowdown. Nevertheless, in 2001 Germany's economy could still benefit from a strong net growth contribution from the external side, because the domestic economy slowed down much faster than those of Germany's trading partners, notably the United States. As the slackening of final demand was accompanied by a downward adjustment of inventories, quarterly GDP growth turned negative between the second and fourth quarter of 2001, pushing GDP growth for the year as a whole down to a mere 0.6%.

Since the beginning of 2002, the economy has resumed growing, albeit at low quarterly rates of barely 0.3% in the first two quarters. Such growth was entirely due to decelerating inventory depletion and a rising net external contribution. The latter was, however, less the result of rising exports but of falling imports, which reflected a decline in final domestic demand by about ½ % in each quarter. Notably, equipment investment continued to fall markedly for the seventh quarter in a row, adding to the persistent drag from receding construction activity. Private consumption also fell, while public consumption rose only slightly. As the crawling pace of demand and output can be expected to continue until the end of 2002, annual GDP growth is projected at a modest 0.4%.

Stagnation was accompanied by a rise in seasonally adjusted unemployment, which in 2002 on average exceeds the number of 4 million and weighs on consumer spending as well as on public finances. On the positive side, effective wages increased only moderately. For this reason, and due to falling import prices and weak demand, inflation in Germany is very low. Consumer price inflation in 2002 is expected at an annual rate of only 1.4%.

In 2002, the German economy is clearly below its productive potential, with an estimated output gap of 1.4 percentage points. However, with barely above 1 ½%, Germany trend output growth is also very low, which suggests that a substantial part of the growth difference between Germany and the rest of the EU is structural rather than cyclical in nature. Hopes that the 1999/2000 boom might lead to a sustained higher growth path for Germany were plainly disappointed. The country now finds itself in a structurally more difficult situation than before.

Table 2: Main features of the German economy

		2001		Annual percentage change					
	bn Euro	Curr. prices	% GDP	1992-98	1999	2000	2001	2002*	2002+
GDP at constant prices		2071.2	100.0	1.3	2.0	2.9	0.6	0.4	1/2
Private consumption		1232.2	59.5	1.3	3.7	1.4	1.5	-0.7	-1/2
Public consumption		393.5	19.0	1.9	1.0	1.2	0.8	1.0	1
GFCF		416.3	20.1	0.8	4.1	2.5	-5.3	-4.8	-4 1/2
of which : equipment		166.3	8.0	-1.1	7.2	9.5	-5.8	-6.8	-7
Change in stocks as % of GDP		-9.4	-0.5	0.0	-0.3	-0.1	-0.8	-0.6	-1/2
Exports (goods and services)		726.9	35.1	4.4	5.6	13.6	5.1	2.1	1 1/2
Final demand		2759.5	133.2	1.9	3.4	4.6	0.7	-0.3	-1
Imports (goods and services)		688.3	33.2	3.9	7.7	10.7	0.0	-2.2	-2 1/2
Contribution to GDP growth :	Domestic demand			1.3	3.2	1.6	-0.2	-1.2	-1
	Stockbuilding			-0.4	-0.4	0.2	-0.6	0.1	0
	Foreign balance			0.5	-0.7	1.0	1.4	1.4	1 1/2
Output gap				0.6	-0.2	1.0	0.0	-1.3	
Employment				-0.3	1.2	1.8	0.4	-0.6	-0
Unemployment (a)				8.3	8.4	7.8	7.7	8.2	.
Compensation of employees/head				3.5	1.2	2.0	1.7	2.0	2
Unit labour costs				-1.0	0.4	1.0	1.5	1.2	1 1/2
Real unit labour costs				-0.8	-0.1	1.2	0.1	-0.1	
Savings rate of households (b)				15.6	15.4	15.4	15.7	16.1	.
GDP deflator				1.5	0.5	-0.3	1.4	1.4	1 1/2
Harmonised index of consumer prices				-	0.6	2.1	2.4	1.4	
Private consumption deflator				2.2	0.4	1.5	1.9	1.4	1 1/2
Trade balance (c)				2.6	3.4	3.1	4.8	6.3	
Balance on current transactions with ROW (c)				-0.6	-0.8	-1.0	0.2	1.9	
Net lending(+) or borrowing(-) vis à vis ROW (c)				-0.6	-0.8	-0.3	0.1	0.9	
General government balance (c)(d)				-2.8	-1.5	1.1	-2.8	-3.8	
General government gross debt (c)				54.0	61.2	60.2	59.5	60.7	

(a) as % of civilian labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.
(d) Including proceeds relative to UMTS licences in 2000. The UMTS amount as a % of GDP would be : 2.5%.
Sources: Commission sources (AMECO); * Commission forecast; + Germany, Ministry of Economics and Labour, Autumn Forecast (31 Oct. 2002)

3. THE SITUATION OF PUBLIC FINANCES

3.1 Development of the actual and structural deficit up to the year 1998

From a peak in 1995, when it rose to 3.5% of GDP, the general government deficit fell steadily to 2.2% in 1998 (table 3). The trend decline reflects the endeavour of the government to restore sound budgetary positions from the early challenges of German reunification. The strategy adopted relied on both revenue increases and expenditure restraint which, from an ex-post perspective, contributed to a roughly equal extent to the reduction in the deficit. As a percent of GDP, government revenues were higher and expenditure lower in 1998 than in 1995, respectively.

In order to cope with the heavy financial burden of reunification[3] the federal government had in 1991 first introduced an income tax ("solidarity") surcharge which actually helped to rein in the deficit. However, the adverse impact of the recession in 1993 raised the deficit to 3.1% of GDP, leading the Council in 1994, when stage II of EMU started, to decide that an excessive deficit existed in Germany.

3 While difficult to calculate for the more recent years, the annual net transfers form the western to the eastern part of the country are estimated at around 4% of GDP per year in the 1990s

This decision was abrogated in early 1995, given the clear improvement in public finances observed in 1994.

Table 3 : Deficit, growth and debt (in % of GDP)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000*	2001	2002
Actual deficit	2.9	2.6	3.1	2.4	3.5	3.4	2.7	2.2	1.5	1.4	2.8	3.8
Real GDP growth	--	2.2	-1.1	2.3	1.7	0.8	1.4	2.0	2.0	2.9	0.6	0.4
Cyclically adjusted deficit	4.8	4.4	3.4	2.8	3.7	3.2	2.3	1.9	1.4	1.9	2.8	3.3
Debt	40.4	42.9	46.9	49.3	57.0**	59.8	61.0	60.9	61.2	60.2	59.5	60.9

*: without one-off UMTS receipts corresponding to 2.5% of GDP,
**: strong rise in the debt ratio due to assumption of several funds directly linked to reunification
Source: Commission sources (AMECO); figures for 2002 based on Autumn forecast

The deceleration of growth in 1995 again pushed the deficit above the Treaty's reference value. As a consequence, in early 1996, the Council decided that an excessive deficit existed in Germany. This decision was abrogated in early 1998, as Germany had succeeded in reducing the deficit below the 3% of GDP ceiling in 1997, the reference year for the decision on membership in EMU.

Composition of revenues

Government revenues rose from 44.1% of GDP in 1991 to 46.6% in 1998, with the increase extending to all major components. Receipts from indirect taxes were boosted by a raise in the standard VAT rate by two percentage points. The introduction of the 'solidarity' tax surcharge in 1991 and the impact of bracket creep (i.e. the non-adjustment of tax thresholds to the upward drift in nominal incomes) raised direct tax revenues. The implications of reunification, weak economic growth and population ageing for the welfare system is clearly reflected by higher social security contributions, which saw their share in GDP rise from 17.2% in 1991 to a peak of 19.7% in 1997.

Table 4: Development of General Government Revenues (in % of GDP)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Revenues (in % of GDP)	44.1	45.5	46.2	46.6	46.1	46.9	46.6	46.6	47.3	47.0	45.5	44.7
Of which :												
-Taxes on products & imports	11.1	11.1	11.5	11.8	11.4	11.4	11.4	11.6	12.2	12.0	11.9	11.7
-Taxes on income & wealth	11.4	11.7	11.5	11.0	11.1	11.5	11.2	11.5	12.0	12.5	11.1	10.6
-Soc. Sec. Contribution	17.2	17.6	18.2	18.6	18.8	19.4	19.7	19.3	19.0	18.6	18.5	18.5

Source: Commission sources (AMECO); figures for 2002 based on Autumn forecast

Composition of expenditure

On the expenditure side, social benefits and interest payments rose considerably in the earlier part of the 1990s, first of all due to the rise in social transfers to the new Länder and the considerable rise in debt linked to reunification. With reforms designed to contain expenditure, implemented from 1996 onwards, the share of welfare expenditure declined slightly. Nevertheless, in 1998 the latter claimed around 30% of GDP, compared with some 26.2% of GDP at the beginning of the decade. In order to dampen the overall upward pressure on expenditure, all levels of governments have since reunification relied on cuts in public investment, as well as on reductions in public sector employment and wage moderation.

Table 5:Development of General Government Expenditures (in % of GDP)

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Expenditures (in % of GDP)	47.1	48.1	49.3	49.0	49.6	50.3	49.3	48.8	48.8	45.9 *	48.3	48.5
Of which :												
Social benefits (total)	26.2	27.4	28.5	28.9	29.5	30.8	30.6	30.1	30.0	29.9	30.0	30.4
Interest	2.8	3.3	3.3	3.3	3.7	3.7	3.6	3.6	3.5	3.4	3.3	3.3
Compensation of employees	9.0	9.2	9.3	9.0	9.0	8.9	8.7	8.5	8.4	8.2	8.0	7.9
Gross fixed capital formation	2.7	2.9	2.8	2.7	2.3	2.1	1.9	1.9	1.9	1.8	1.7	1.6

* excluding UMTS receipts; Source: Commission sources (AMECO); figures for 2002 based on Autumn forecast

3.2 Budgetary developments since 1999

The new government that came into office in late 1998 announced an ambitious programme of fiscal reform for the years 1999 to 2002, implying substantial tax relieves for households and corporations. Relying on the assumption of sustained lively economic growth, the consolidation path towards budgetary balance thus became distinctly “back-loaded”. Although the commitment to a reduction of the deficit was strengthened in the following months, at the end of 1999, against the background of a clearly better deficit outcome than projected, the Federal government announced that the 2002 step of income tax cuts would be brought forward to 2001.

Developments in 1999 itself were characterised by an important rise in the revenue ratio, due to the relatively high growth rate for a second year in a row, the introduction of the *Ökosteuer* (‘ecological tax’) and the abolition of some income tax exemptions. Against this background, the improvement in the nominal and in the cyclical-adjusted deficit from 1998 to 1999 could have been more important had the cautious expenditure policy practised at the Länder level also been followed at the federal level. Indeed while expenditure at the regional level rose by 1.8% from the previous year, it went up by 3.5% at the federal level (‘*Kernhaushalt*’).

Table 6: Deficit for Different Levels of Government (in % of GDP)

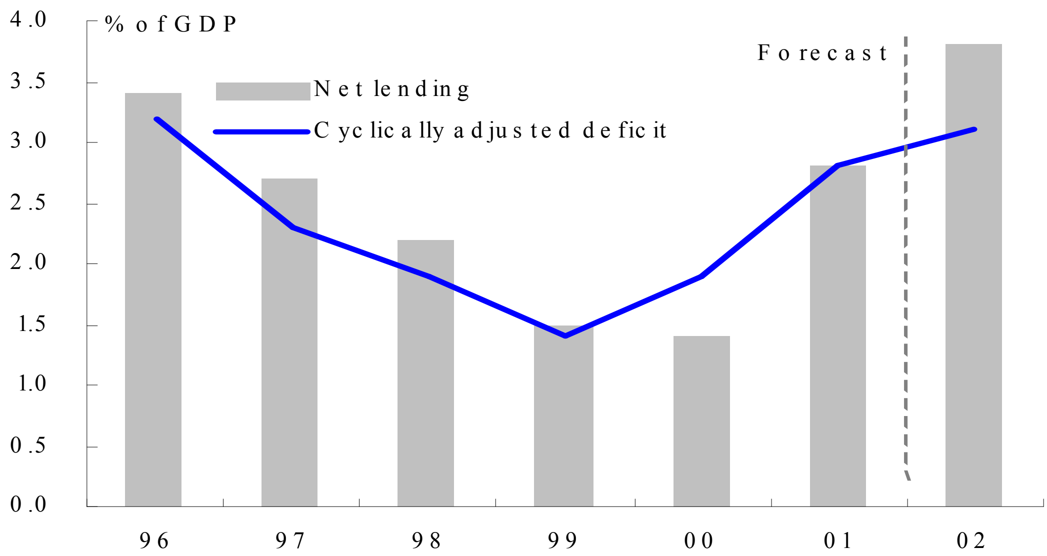
Year	Bund	Länder	Local	Soc. Sec.	Germany
1998	1.84	0.73	-0.22	-0.14	2.22
1999	1.56	0.48	-0.27	-0.26	1.50
2000	1.21	0.38	-0.27	-0.05	1.38
2001	1.38	1.31	-0.04	0.13	2.78

Source: Statisches Bundesamt and EDP notifications; Results for the year 2000 exclude UMTS revenues

In the year 2000, expenditure patterns almost reversed, with the federal government succeeding in keeping nominal expenditure close to the 1999 level, while the Länder spent more freely (nominal expenditure went up by 2.2% on the year).

All in all, the decline in the nominal deficit from 1999 to 2000 was marginal[4]. Given the clear acceleration in GDP growth from 2.0% in 1999 to 2.9% in the following year, the structural balance deteriorated by ½ percentage point of GDP.

Graph 2: **Germany - Actual and cyclically adjusted deficits** (without UMTS revenues)



In 2001, however, the trend of improving nominal balances was reversed and the general government deficit jumped by 1.4 percentage points to a ratio of 2.8% of GDP. The January 2000 update of the Stability Programme had implied a deterioration in the structural balance from 2000 to 2001 by 0.7 percentage points of GDP due to the carrying-forward of the third step of income tax reform and the

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4 The first deficit estimate by the Federal Statistical Office in January 2000 put the 1999 general government deficit at 1.2% of GDP

corporate tax reform from 2002 to 2001[5]. With GDP growth expected at 2 ½ % for 2001, the January 2000 update at that time projected a rise in the nominal deficit from an estimated 1% in 2000 to 1 ½% in 2001.

Based on today's figures, the final 2001 deficit outcome was worse than projected, not only in nominal but also in structural terms: of the 1.4 percentage point increase in the actual deficit ratio 0.9 points were accounted for by a weakening in the underlying budgetary position. The slight deterioration in the structural balance compared with the original projection is at least partially due to expenditure overruns in the health care sector.

In 2002, with sluggish activity persisting and GDP growth on annual average still lower than the year before, the general government deficit is expected to rise further, to an estimated 3.8% of GDP, well above the 3% reference value. With domestic demand virtually flat and employment receding, government revenue is forecast to decline compared with the previous year, leading to a further fall in the revenue/GDP ratio. While most of the deficit increase is due to the cyclical impact, the cyclically-adjusted balance is nevertheless set to go up by a further ½% of GDP, suggesting some impact from other factors: in this regard, the performance of corporate taxes and of developments in the health care system warrant special attention.

Table 4 shows a conspicuous decline in the GDP ratio of direct tax revenues since 2000: While the share of these taxes had increased by about 1 percentage point over the whole period from 1991 to 2000, it is projected to have declined by almost 2 percentage points in just the two years 2001 and 2002. In the current year, the decline is largely due to the disappointing performance of corporate taxes**.** In this regard, the effect of a special provision in the 2001 corporate tax reform has been severely underestimated by the Ministry of Finance[6]. While this proved less important for 2001, the effect has been much more negative in 2002: by end September 2002, corporate tax receipts were more than 0.5 percentage point of GDP below the official May estimate[7] and in stark contrast to 2001, this was not compensated for by higher than assumed capital revenue tax yields ('*Ertragsteuern*').

Expenditure trends in the health care sector have been disappointing once again. In its recommendation to the Council to give an 'early warning' to Germany, the Commission had already hinted at the ongoing problems in that sector. In the current year, developments have not been as expected either, with the important average rise in contributions from 13.6% of gross income in 2001 to 14.0% in 2002 insufficient to avoid another deficit in that sector.

The floods which occurred in August 2002 are not expected to have constituted a serious drag on public finances in 2002: Commission calculations show that the 2002

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5 The 2001 tax relief was projected at around 0.9 % of GDP in the January 2000 update of the Stability Programme

6 Following the decline in corporate tax rates implemented in 2001, corporations can now distribute their profits from the past (back to 1994) at the new and lower rate. The Ministry of Finance had originally projected that this would have no effect on corporate tax revenues in 2001 and only a minor one in 2002.

7 The May 2002 tax estimate had still projected revenues from corporate taxes of € 7.9 billion. In the first nine months of the current year, corporate taxes were actually 'negative' (€ -2.68 billion); at the same time, capital revenue tax yields reached € 9.323 billion 'only', compared with a figure of € 11.13 billion projected in May.

overall deficit-raising effect should not be higher than one tenth of a percentage point of GDP (i.e. around € 2 billion), given that the bulk of repair works will start only next year; this is implicitly recognised by the fact that the special fund set up by the Federal government will officially begin its operations on 1 January 2003.

3.3 The debt level

In the early 1990s, gross government debt as percent of GDP jumped from around 40% to over 57%, bringing the ratio close to the Treaty's reference value (cf. table 3). The reason was that government financial commitments related to reunification became included into official government debt. In the following years, weak nominal GDP growth and regular current deficits drove the debt ratio up to a first peak of 61.0% of GDP in 1997, a level where it more or less stayed up to 1999.

In 2000 and 2001, the Minister of Finance succeeded in allocating all UMTS receipts – corresponding to 2.5% of GDP - to debt redemption, thereby bringing the 2001 debt level back to a value below the reference value. Since then, sluggish nominal GDP growth and the widening of the deficit gap have once again been driving the debt level up to around 61% of GDP in 2002, according to the Commission's Autumn forecast. For 2003, the projections expect a further rise in the debt ratio, which should be reversed only in 2004 on the back of the expected acceleration in GDP growth and the projected decline in the deficit.

3.4 Other relevant factors

3.4.1 Government investment expenditure

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure…".[8] In 1998 and again since 2001, the general government deficit has been clearly higher than public investment, with the discrepancy expected to widen considerably in the current year. In 2003, higher public investment induced by the flood damages and the projected decline in the general government deficit should make for a narrowing of the gap.

Table 7: GENERAL GOVERNMENT FIXED INVESTMENT AND DEFICIT (billion €)

	1998	1999	2000	2001	2002	2003
Gross fixed capital formation	35.7	37.8	37.0	35.8	34.4	37.4
General Government Deficit	42.8	29.7	22.8	57.5	80.6	65.9

Source: Commission sources (AMECO); ***2002 Autumn forecast***

8 The underlying hypothesis is that public investment raises the economy's growth potential which in turn will sustain a higher level of government spending without giving rise to permanent debt accumulation. In the same vein, Article 115 of the German constitution stipulates that government borrowing must not be exceed planned government investment outlays (unless for the purpose of preventing a disturbance in the macro-economic equilibrium). Nevertheless, the Treaty nowhere suggests that an excessive deficit could be justified if it was lower than government investment.

3.4.2 Medium-term economic and budgetary position - prospects for 2003

At the current juncture, budgetary developments in 2003 are clearly subject to many imponderables. Following its re-election, the two government parties signed a coalition agreement on 16 October 2002, foreseeing a rise in some taxes and expenditure cuts by the Federal Labour Office and regarding '*Arbeitslosenhilfe*' (unemployment assistance). However, the measures on the expenditure side are not yet sufficiently specified to allow for a final assessment, while most of the measures on the revenue side (rise in VAT and some less important taxes) are subject to approval by the first chamber of Parliament, where at the moment the opposition parties have a clear and absolute majority. Given these major uncertainties, the Commission projects a deficit of 3.1% of GDP for 2003.

Only in the event that all the proposed measures were implemented, and if GDP growth next year is at least in line with the Commission's Autumn forecast of 1.4%, and assuming further that the 2002 budgetary "point of departure" does not further deteriorate, Germany's general government deficit could fall below the Treaty's reference value in 2003. Nevertheless, gross debt is unlikely to decline sufficiently next year to comply with the reference value of 60% of GDP. Assuming higher GDP growth in 2004 and the full implementation of the expenditure cuts and tax rises foreseen in the coalition agreement, the 2004 general government deficit should decline further, in spite of the next step of income tax reform with a projected tax relief of 0.3 percentage points of GDP.

4. CONCLUDING REMARKS

According to the Commission's Autumn forecast of 13 November 2002, the general government deficit is projected at 3.8% of GDP. While budgetary developments have been adversely affected by continued weakness of economic activity and, to a minor extent, by the one-off impact of flood damages, the projected excess of the deficit over the 3% reference value would not result, in the sense of the Treaty, from an unusual event outside the control of the German authorities, nor would it be the result of a severe economic downturn.

The protracted cyclical sluggishness, affecting in particular the domestic components of aggregate demand, have led to a fall in government revenues by almost 2% from last year, while expenditure rose at a somewhat higher pace than last year, partly related to higher claims for social transfers. Thus, the weakening of the budgetary position in 2002 is partly due to cyclical factors. Nevertheless, the underlying structural balance also deteriorated by an estimated ½ percentage point, due to a special provision in the 2001 corporate tax reform leading to substantial amounts of revenue foregone, as well as to expenditure overruns in the health care sector.

While the deficit comes to exceed the reference value in 2002, the origins of budgetary slippage should also be seen in previous years. Thus, during the 1998-2000 boom period, insufficient efforts were made to strengthen the underlying budgetary position. Indeed, the cyclically-adjusted deficit started to rise again as from 2000, not least due to stronger expenditure growth at the regional level. Trusting in continued strong economic growth and its "dividend" for public revenues, the government opted for the carrying-forward to 2001 of the 2002 stage of the tax reform and for a back-loading of the necessary consolidation efforts. Thus, with the advent of the global business cycle slowdown, budgetary policy did not command over sufficient leeway for the operation of automatic stabilisers and for preventing the deficit to rise above the 3% of GDP reference value.

Going forward, an early correction of the excessive deficit situation in 2003 appears uncertain. Still, the full implementation of the coalition agreement should ensure a substantial decline in the actual and the structural deficit next year, as long as GDP growth turns out as expected. Even in the event of growth picking up further into 2004, the budgetary room for manoeuvre is set to remain clearly limited, in view of the further steps of income tax cuts envisaged. A sustained improvement in the budgetary position will thus require government expenditure to remain under firm control. The debt level is forecast to rise further in 2003 and not to decline substantially in 2004.