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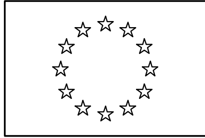

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION OPINION

on the existence of an excessive deficit in Germany – Application of Article 104(5) of the Treaty establishing the European Community

(presented by the Commission)

EXPLANATORY MEMORANDUM

On 13 November 2002, the Commission released its Autumn economic forecast, projecting for Germany a general government deficit of 3.8% of GDP for 2002, clearly exceeding the reference value of 3% of GDP. Based on this prima facie evidence, the Commission initiated the Excessive Deficit Procedure for Germany on 19 November 2002, with the adoption of the report foreseen in Article 104.3 of the Treaty. On 18 December 2002, the Commission received the updated Stability Programme of Germany, which confirmed a government deficit figure of 3 ¾ % of GDP for 2002. The application of the excessive deficit procedure (EDP) is governed by Article 104 of the Treaty (ex 104c), Council Regulation N°1467/97 "on the speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact. It is also affected by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

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In an initial step of the EDP, the Commission prepared a report according to Art. 104.3 of the Treaty. That report was adopted by the Commission on 19 November. It concluded that in 2002, the general government deficit in Germany was likely to reach 3.8% of GDP, significantly exceeding the reference value of 3%. Gross government debt was projected to reach 60.9% of GDP by end-2002, also rising above the respective reference value of the Treaty (60% of GDP). The excess of the German deficit in 2002 over the reference value did not result from an unusual event outside the control of the German authorities, nor was it the result of a severe economic downturn. On developments in 2003 the report concluded that, while it was clear that the deficit would be reduced, it was not yet possible to assess whether the deficit would come to fall below the 3% of GDP reference value. Moreover, given that the debt-to-GDP ratio was projected to rise to close to 62% of GDP by the end of 2003, any slippage in budgetary execution or a deceleration in nominal GDP growth would imply an additional deterioration of the debt ratio.

Treaty Art. 104.4 states that "the Committee provided for in Article 114 (i.e. the Economic and Financial Committee) shall formulate an opinion on the report of the Commission". The Committee issued its opinion on 29 November 2002 (document EFC/ECFIN/593/02), largely subscribing to the Commission's Assessment. In particular, the EFC concluded that budgetary developments in Germany in 2002 were such that both the deficit and the debt criterion of referred to in Article 104(2) were not respected. Consideration of other relevant factors supported the assessment based on these criteria. While taking note of the strong commitment by the German authorities to introduce all the necessary measures to correct the situation, the EFC, following the report by the Commission, considered that there was a risk of the general

government deficit exceeding the Treaty's reference value again in 2003. The Committee also underlined that gross debt was unlikely to reverse its rising trend to comply with the Treaty's reference value of 60 percent of GDP.

The Commission, having examined the relevant factors taken into account in its report and having regard to the opinion of the EFC, is of the opinion that an excessive deficit exists in Germany. This opinion, adopted by the Commission on [8 January 2003], is herewith addressed to the Council, according to Article 104.5 of the Treaty. The Commission recommends that the Council shall decide accordingly, in conformity with Article 104.6. In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Germany with a view to bringing an end to the situation of an excessive government deficit, according to Treaty Article 104.7.

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GENERAL CONSIDERATIONS

On 1 January 1999, the third stage of economic and monetary union has started. According to Article 104 of the Treaty, Member States shall avoid excessive government deficits. Decisions on the existence of an excessive deficit are ruled by the excessive deficit procedure (EDP) specified by article 104 of the Treaty and Council Regulation (EC) No. 1467/97.[1]

Article 104(2) of the Treaty requires the Commission to monitor the developments of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular, the Commission shall examine compliance with budgetary discipline on the basis of two criteria, one for the ratio of the planned or actual government deficit to gross domestic product (GDP) and one for the ratio of government debt to GDP. The statistical data on these variables are provided by the Commission on the basis of reporting by the Member States twice a year[2].

Article 104(3) of the Treaty requires the Commission to prepare a report if the requirements under one or both of the criteria of Article 104(2) are not fulfilled or if, notwithstanding the fulfilment of the requirements under the criteria, the Commission is of the opinion that there is a risk of an excessive deficit in a Member State. On the basis of the most recent information available the Commission has adopted such a report for Germany on 19 November 2002. The Commission report takes account of whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State, as required by Article 104(3) of the Treaty[3].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee has formulated an opinion on the report of the Commission on 28 November 2002.

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[1] The excessive deficit procedure is jointly determined by Article 104 of the Treaty, the Protocol on the excessive deficit procedure annexed to the Treaty and Council Regulation No. 1467/97 “on the speeding up and clarifying the implementation of the excessive deficit procedure”, which is part of the Stability and Growth Pact. It is also affected by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

[2] Government accounts data are to be reported before 1 March and before 1 September, in the terms of Council Regulation (EC) 3605/93 amended by Council Regulation (EC) 475/00 and by Commission Regulation (EC) No. 351/2002

[3] The Commission’s report of November 2002 in accordance with Article 104(3) was established using information available until 4 November 2002.

Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. In order to reach a conclusion on whether an excessive deficit exists or may occur, the Commission considers that account should be taken of: (i) the findings of its own report, namely whether the requirements under one or both of the criteria of Article 104(2) of the Treaty are not fulfilled, and the relevance of all other factors mentioned in article 104(3) and (ii) the opinion of the Economic and Financial Committee on the report of the Commission. On the basis of these elements, the Commission has established a number of considerations for Germany.

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CONSIDERATIONS CONCERNING GERMANY

1. The Commission, in its Autumn 2002 economic forecast, projected for Germany a general government deficit of 3.8% of GDP for 2002, clearly exceeding the reference value of 3% of GDP. A deficit figure of 3 ¾% of GDP has been confirmed by the updated Stability Programme submitted by the German authorities on 18 December 2002. In 2001, the deficit ratio had been 2.8%. Government gross debt at the end of 2002 is estimated to have reached 60.9% of GDP, compared with 59.5% one year earlier. Government debt would thereby also exceed the reference value of 60% of GDP. For 2003, the German authorities are projecting in the updated Stability Programme a general government deficit of 2 ¾% of GDP and estimate the government gross debt ratio to rise further to [61 ½] %.

2. Under the provisions for the excessive deficit procedure, Member States are required to report to the Commission twice a year actual and planned figures for their government deficits and debt levels[1]. In March 2002, the German authorities had reported a deficit of 2.6% of GDP for 2002. This figure was considerably higher than the one originally envisaged for the same year in the updated Stability Programme of December 2001 (2% of GDP in the baseline scenario). Anticipating the deviation from the original target, accompanied by the risk of the 3% of GDP reference value for the budget deficit being exceeded, the Commission recommended in late January 2002 that an early warning be sent to Germany under the framework of the Stability and Growth Pact. 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. In the updated Stability Programme submitted in December 2002, the deficit was revised upwards to 3 ¾% of GDP.

3. While the deficit comes to exceed the reference value only in 2002, the origins of budgetary slippage should also be seen in previous years. Towards the end of the 1990s, when Germany enjoyed relatively strong economic growth, progress in budgetary consolidation had been limited,

with the general government deficit remaining at around 1 ½ % of GDP. In particular, during the 1999/2000 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. According to Commission calculations, the cyclically-adjusted deficit stood at 2.8% of GDP in 2001 (up from a low of 1.4% in 1999).Thus, with the advent of the global business cycle slowdown, budgetary policy did not enjoy sufficient leeway for the operation of automatic stabilisers and for preventing the deficit to rise above the 3% of GDP reference value.

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4. From 2000 to 2002, the government deficit increased from 1.4% to 3.8% of GDP. While economic growth slowed markedly during that period, the increase in the deficit also reflects a continued weakening in the underlying budgetary position. According to the Commission services’ calculations, the non-cyclical component accounts for more than half of the increase in the actual deficit. The latest deterioration in the cyclically-adjusted deficit by ½ percentage point of GDP in 2002, to a ratio of some 3.3% of trend GDP, is due to a number of reasons, relating to developments of both revenues and expenditures: On the revenue side: (i) revenue losses implied by the reform of corporate taxes implemented in 2001 have been underestimated; (ii) receipts from the fight against fraud (TVA) have turned out lower than anticipated. On the expenditure side: (i) social spending, notably on health care, exceeded projections.

The floods which occurred in August 2002, while causing considerable damage and hardship in the regions affected, are not expected to have constituted a serious drag on overall government finances in 2002. Commission calculations show that the deficit-raising effect for that year should not have been higher than one-tenth of a percentage point of GDP.

5. The government gross debt ratio declined from 61.2% of GDP in 1999 to 59.5% at the end of 2001, due to the full use of UMTS receipts for debt redemption. In 2002, however, the debt ratio is likely to have rebounded to close to 61% of GDP, mainly as a result of the rise in the government deficit and the deceleration of GDP growth.

6. The re-elected federal government on 20 November adopted a new draft budget for 2003, projecting considerable additional savings compared with the original draft. The new federal budget includes consolidation measures totalling about 0.6% of GDP, apart from the postponement of the next step of income tax reform from 1 January 2003 to 1 January 2004. The new budgetary target for 2003, as confirmed by the latest update of the Stability Programme, is a general government deficit of [2 ¾%] of GDP, based on the assumption of real GDP growing at [1 ½%].. It can be concluded that, in the absence of the new draft budget, the 2003 deficit would have corresponded to

[1] See footnote 2

at least 3 ¼% of GDP.

7. While it can be expected that the deficit will be reduced in 2003, it appears uncertain at this stage whether the excessive deficit situation will be corrected. The progress in consolidation to be achieved will depend on the determined efforts at all levels of government, but also on overall economic developments. Gross government debt, in any case, is set to rise further above the reference value of 60% of GDP.

CONCLUSION

The monitoring of the budgetary situation in Germany and, in particular, the examination of the compliance with the criteria laid down in Article 104(2) have led the Commission to prepare a report in accordance with Article 104(3) of the Treaty. The Commission, having examined the relevant factors taken into account in this report and having regard to the opinion of the Economic and Financial Committee, is of the opinion that an excessive deficit exists in Germany.

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