COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.11.2003
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EU RESTRICTED

Recommendation for a

COUNCIL DECISION

giving notice to Germany, in accordance with Article 104(9) of the EC Treaty, to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. THE EXCESSIVE DEFICIT PROCEDURE FOR GERMANY

The excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by Regulation (EC) N°1467/97 of 7 July 1997 on the speeding up and clarifying the implementation of the excessive deficit procedure, which is part of the Stability and Growth Pact. It is completed by the political commitments enshrined in the Resolution of the Amsterdam European Council on the Stability and Growth Pact of 17 June 1997.

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. This decision was based on the Commission's Autumn economic forecast released on 13 November 2002, which projected for Germany a general government deficit of 3.8% of GDP for 2002, indicating a clear excess of the reference value of 3% of GDP. The updated Stability Programme of Germany, received by the Commission on 18 December 2002, confirmed a government deficit figure of 3 ¾ % of GDP for 2002. This status is substantially unchanged, even though in the notification of 29 August 2003, the deficit estimate for 2002 has been revised down to 3.5% of GDP.

The Commission, taking into account the EFC opinion on its Article 104(3) Report, adopted on 8 January 2003 an Opinion according to Article 104(5) concluding that an excessive deficit exists in Germany and recommended to the Council to take a decision in conformity with Treaty Article 104(6). On 21 January, the Council decided accordingly. In addition, the Council adopted a Recommendation addressed to Germany with a view to bringing an end to the situation of an excessive government deficit, according to Treaty Article 104(7), notably calling for budgetary consolidation measures amounting to 1% of GDP within four months. The German government responded to the Recommendation by enacting a number of measures, including *inter alia* increases in social security contributions to pensions, savings in health care and unemployment benefits, increases in ecological and tobacco taxes, and some expenditure reductions. On the basis of information available at the time of the expiration of the deadline of 21 May, it was concluded that the consolidation impact of the measures announced by the German government was likely to come close to 1% of GDP. As a consequence, the Commission at the time did not recommend to the Council to take action with respect to Article 104(8) of the Treaty.

The actual budgetary outcome for 2003 turned out to be worse than expected, with the Commission forecasting a general government deficit of 4.2% of GDP in 2003, which marks a deterioration vis-à-vis the 2002 deficit by 0.7 percentage points in nominal terms and by 0.1% in cyclically adjusted terms. Moreover, the general government deficit in 2004 is likely to exceed 3% of GDP. This fact is not disputed by the German authorities and has indeed been admitted on several public occasions by the German Minister of Finance.

If the target of bringing the deficit below 3% of GDP in 2004 is abandoned, Germany is in non-compliance with the Art. 104(7) recommendation. This requires that further steps in the excessive deficit procedure be taken. The Commission has therefore recommended to the Council to take a decision in accordance with Article 104(8) of the Treaty, stating that the action taken by Germany in response to the Council Recommendation of 21 January 2003 is proving inadequate. Art. 10(2) of Regulation 1467/97 specifies that, if action by the Member State "*is not being implemented or, in the Council's view, is proving to be inadequate, the Council shall immediately take a decision under Article 104(9).*"

The timing of the Article 104(9) Council Recommendation is based on three grounds. First it follows directly from the Commission's Autumn forecast. Second, it follows the public confirmation by German authorities that the 2004 deficit will exceed 3% of GDP. Third, the German budgetary procedures for the fiscal year 2004 will not be concluded before the end of December 2003; therefore, Council recommendations released at the present time could still be taken into consideration in the budgetary process in Germany.

2. FISCAL POLICY REQUIREMENTS FOR 2004 AND 2005

The German government's draft proposal foresees a substantial income tax reduction that was originally foreseen for 2005. This is, however, more than compensated by proposals to increase other government revenues and to reduce expenditures. The Commission calculates that a full implementation of the 2004 budget draft would lead to a nominal general government balance in the order of magnitude of 3.5% of GDP in 2004. This is clearly insufficient to ensure that the nominal deficit is brought below 3% of GDP in 2004, as has been confirmed by the German authorities.

While the recommendation of the Council under Article 104(7) set the deadline for the correction of the excessive deficit for the year 2004, the Council, when issuing the "notice" under Article 104(9), can decide to confirm such a deadline or establish a new one. Several elements have to be considered when making this choice.

- The increase in the general government deficit in Germany in recent years is a matter of serious concern and should be rapidly brought to an end. If not corrected, it will lead to a continuous and large increase in the debt-to-GDP ratio, which may in turn weigh on economic agents' expectations and be damaging for growth. Moreover, the impact of population ageing on public finances will start accelerating as from the end of this decade, making it even more urgent to reduce rapidly the general government deficit and debt. Finally, the deterioration in the budgetary situation of Germany, might have negative consequences for growth in the euro area at large, should this lead to a tightening of monetary conditions in the euro area.

- In the view of the Commission, a more contractionary budgetary stance in 2004 would not necessarily depress economic activity. A lack of private confidence is a key factor holding back growth at the present juncture. Indeed, the current high saving rates in Germany suggest that, overall, present income levels are no serious constraint for private consumption. Instead, consumption is held back by high uncertainty, leading households to precautionary savings. Not least, most households and companies are aware that budgetary consolidation is unavoidable. This entails on the one hand that fiscal consolidation now is taken as implying lower fiscal burdens in the future. Thus, higher government saving should be largely compensated by lower private savings. Furthermore, continued uncertainty about what measures will be implemented in the end appears to be more harmful for business activity than the eventual measures themselves, because companies and households cannot plan safely ahead. The positive confidence-raising effects of budget consolidation could therefore even lift growth compared with the Commission forecast, in particular when considering that the latter is, in any case, relatively cautious compared with those of other institutions.

- Even though early budgetary retrenchment should be beneficial, especially when fiscal consolidation addresses the appropriate budgetary components, there are arguments for not demanding a full correction of the deficit in one single year. Germany is at the end of a prolonged stagnation with cumulative growth over the three-year time span between the second quarter of 2001 and the second quarter of 2003 amounting to only 0.7%, and with a forecast for GDP growth in 2004 of only 1.6%, which is a relatively slow recovery by historical standards after such long stagnation. According to the Commission Autumn forecast, the cumulated loss of real GDP growth over the period 2003-2004 compared with what was expected in the earlier Autumn 2002 forecast amounts to about 2 percentage points. Even though the economy is starting to pick up, it cannot be excluded that too large a budgetary consolidation effort in a single year may prove economically costly. This is particularly the case as the fiscal effort necessary to bring the general government deficit below the Treaty reference value of 3% of GDP in 2004 is now larger than what was expected in January 2003, when the Council adopted the recommendation according to Article 104(7). Based on the Autumn 2003 Commission forecast, the required improvement in the cyclically-adjusted balance, is currently estimated to be of the order of 1.3 percentage points. This compares with the forecast of Autumn 2002, according to which only a minimal consolidation effort would have been needed for the 2004 deficit to fall below 3% of GDP. This is partly due to the fact that no improvement in the cyclically-adjusted balance was achieved in 2003. However, as recalled above, it is also the result of the unexpected persistence of sluggish economic activity. Consideration should also be given to the fact that the German government has proposed wide-ranging structural reforms in the context of the Agenda 2010 and the Hartz labour market reforms. Swift implementation of these reform packages would lift the low potential growth of Germany and, as a consequence, would contribute to an improvement in public finances in the medium to long term.

In view of these elements, the Commission considers that extending by one year to 2005 the deadline set by the Council in January for the correction of the excessive deficit in Germany would provide the conditions for a balanced correction, provided that effective measures are taken by the German authorities in order to achieve in 2004 a larger reduction in the general government deficit than currently planned. This would allow to catch up in 2004 for the unexpected lack of progress in 2003, and allow to bring the deficit below 3% of GDP in 2005.

The Commission is of the opinion that roughly two-thirds of the required overall fiscal consolidation of 1.3 % of GDP for 2004-2005 should take place in the first year. Germany should therefore implement an overall budgetary adjustment amounting to 0.8 percentage points of GDP in 2004, that is some € 18 billion. Given the arguments cited above, in the view of the Commission, such an adjustment would not lead to a substantial revision of its growth forecast for 2004. Based on a GDP growth projection of 1.6%, as projected in the Autumn 2003 forecast, such an adjustment would bring the deficit to around 3 ¼ to 3 ½ % of GDP in 2004; this would lay a credible basis for bringing the deficit below 3% in 2005. The proposed adjustment volume is slightly larger, by roughly € 6 billion (0.2% to 0.3% of GDP), than in the German 2004 draft budget, which, according to the German government, provides for a net consolidation effect of € 12 billion (consisting of 28 billion in consolidation measures partially offset by the announced € 16 billion tax reduction).

While, on the basis of the German budget draft for 2004, a small additional consolidation effort would be needed, actual requirements might be somewhat higher in the light of the fact that some of the government estimates are subject to risk, notably the € 5 billion revenues as a result of the tax amnesty. As concerns 2005, it needs to be stressed that the current budgetary proposals made by the German government, notably a number of subsidy reductions and tax changes would affect more strongly the result in 2005 than those of next year. The Commission services estimate that an implementation of the 2004 tax proposals would therefore in any case result in a further consolidation impact of some 0.4 percentage points also in 2005. This is only slightly below the minimum requirement of the Council Recommendation of 21 January 2003 of an annual 0.5% of GDP consolidation effort. Provided that a reduction in the cyclically-adjusted deficit by about 0.8 percentage points of GDP is implemented in 2004, a budgetary effort of 0.5% in 2005 would be sufficient to secure that the general government deficit is credibly reduced below 3% of GDP in 2005. Given that the excessive deficit would have to be corrected in 2005 at the latest, the German authorities should be ready to achieve a larger adjustment than that currently planned should this be necessary to correct the excessive deficit.

In line with the provisions of Article 104(9) of the Treaty, the German authorities should be requested to submit a report to the Commission outlining the decisions to achieve the additional adjustment in the cyclically-adjusted balance required for 2004. Germany should also include in this report a description as precise as feasible of the measures to be implemented in 2005 to reduce the budget deficit. This report should be sent to the Commission before 10 January 2004, and will be examined by the Commission and the Council in view of assessing compliance with the notice given in accordance with Article 104(9).

3. BUDGETARY TARGETS BEYOND 2005

According to Commission calculations, a cyclically-adjusted improvement of 0.8% of GDP in 2004 and 0.5% in 2005 would result in a cyclically-adjusted deficit of 2¼ % of GDP in 2005, which is far from a close to balance budgetary as required by the Stability and Growth Pact. The Commission therefore recommends that also in the years after 2005, Germany should undertake consolidation efforts of at least 0.5% of GDP - and more, if growth accelerates, as it may do if the reform efforts of the German government such as the Agenda 2010 and the Hartz labour market reforms bear fruit.

Achieving an underlying budgetary position of close-to-balance-or-in- surplus is important to ensure a rapid reduction in the debt-to-GDP ratio which is a necessary complement of the recent pension measures to tackle the implications for public finances of the ageing of the population. This will also allow full operation of automatic stabilisers without the danger of breaching the 3% of GDP deficit ceiling in the event of an economic slowdown.

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In view of the findings mentioned above, the Commission recommends the Council to give notice to Germany under Article 104(9) to take measures for the deficit reduction the Council judges necessary in order to remedy the situation of excessive government deficit. The Commission also recommends, as foreseen by the Treaty, a regime of enhanced surveillance, where reports are to be submitted on a regular basis by the German authorities. The Commission and the Council will examine the reports in view of assessing compliance with the notice.

Recommendation for a

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THE COUNCIL OF THE EUROPEAN UNION

Having regard to the Treaty establishing the European Community, and in particular Article 104(9) thereof,

Having regard to the recommendation from the Commission under Article 104(9),

Whereas:

(1) According to Article 104(1) of the Treaty, Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1].

(3) The Amsterdam Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact[2] solemnly invites all parties, namely the Member States, the Council and the Commission to implement the Treaty and the Stability and Growth pact in a strict and timely manner.

(4) By Council Decision 2003/89/EC[3] it was decided, in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in Germany.

(5) In accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council sent a Recommendation to Germany on 21 January 2003 establishing the deadline of 21 May 2003 for Germany to take measures to bring the existence of an excessive deficit to an end in 2004 at the latest.

(6) On the basis of information available upon the expiration of deadline of 21 May 2003, the policies announced by the German authorities satisfied the requirement of budget consolidation measures amounting to 1 % of GDP set out in the Recommendation of 21 January 2003 At the time the Commission therefore did not recommend that the Council take a decision in accordance with Article 104(8) of the Treaty.

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1 OJ L 209, 2.8.1997, p.6.
2 OJ C 236, 2.8.1997, p.1.
3 OJ L 34, 11.2.2003, p. 16.

(7) In its Autumn 2003 forecast published on 29 October 2003, the Commission projects that the general government deficit in Germany in 2003 will be 4.2% of GDP and the debt-to-GDP ratio 63.8 %, which represents a deterioration in both the deficit and debt ratios vis-à-vis the situation in 2002 in nominal as well as cyclically-adjusted terms.

(8) In the Autumn 2003 forecast the Commission projects that the government deficit will also remain above 3% of GDP in 2004. This has been confirmed also in public by the German authorities.

(9) In accordance with Article 104(8) of the Treaty, the Council decided on [25 November 2003] that the action taken by Germany in response to the Council Recommendation of 21 January pursuant to Article 104 (7) of the Treaty is proving to be inadequate in bringing the excessive deficit situation to an end within the period laid down.

(10) According to Article 10(2) of Regulation (EC) No 1467/97, if action by a participating Member State is proving to be inadequate, the Council shall immediately take a decision under Article 104(9) of the Treaty.

(11) When defining the recommendations to be included in this notice, the following factors should be taken into account: (i) the increase in the general government deficit in Germany is a matter of serious concern and should be rapidly brought to an end; (ii) a credible consolidation effort is not necessarily contractionary because it would elicit positive effects on private and business confidence in Germany; (iii) too large a consolidation effort in one single year might nevertheless be problematic in view of the prolonged stagnation in Germany over the last three-years and the expected slow recovery; and (iv) government proposals for structural reforms would boost potential growth and reduce the deficit in the medium to long term

(12) Taking into account these factors, and in order to provide the conditions for a balanced correction, the deadline which was set in January 2003 for the elimination of the excessive deficit in Germany should be extended by one year, provided that effective measures are taken by the German authorities as from 2004.

(13) According to the German government’s own calculations, its budgetary plans of the German government for 2004 would lead to a reduction in the cyclically-adjusted deficit by 0.6 percentage point of GDP in 2004. In order to make realistic the objective of bringing the general government deficit below 3% of GDP in 2005, a larger effort should be made in 2004 than currently planned by the German authorities. Germany should achieve in 2004 an improvement in the cyclically-adjusted balance of 0.8 percentage points of GDP, through the implementation of an overall budgetary adjustment amounting to some EUR 18 billion. To this end, the German authorities need to take measures going beyond their budgetary plans for 2004 amounting to 0.2 to 0.3 percent of GDP or higher, if the German government’s calculations turn out to be too optimistic.

(14) Moreover, budgetary plans for 2005 should secure a reduction in the cyclically-adjusted deficit of at least 0.5 percentage points of GDP, through the implementation of an overall budgetary adjustment amounting to some EUR 11 billions.

(15) It is paramount that Germany moves rapidly towards a situation in which government finances are close to balance or in surplus. Such an underlying budgetary position

must be achieved to ensure a rapid reduction in the debt-to-GDP ratio below the reference value of 60% referred to in the Treaty.

(16) When drawing up the measures to be taken in order to comply with the recommendations included in this Decision, Germany should take into account the recommendations issued by the Council in the framework of the Broad Economic Policy Guidelines, in particular the need to reform the tax-benefit system in order to ensure sufficient incentives to take up work or to move into a higher income bracket. Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancement of the quality of public finances and reinforcement of the growth potential of the economy. Swift implementation of the structural reform proposals of the so-called Agenda 2010 and the Hartz labour market reforms would provide an important contribution in this direction.

(17) Germany should submit a report to the Commission outlining the measures to be taken to respect the recommendations of this Decision in time for the Commission and the Council to analyse it within the time limit set out in Article 6 of Regulation (EC) No 1467/97.

(18) A strategy consistent with this recommendation and based on prudent macroeconomic assumptions should be presented in the Stability Programme.

(19) According to the second sub-paragraph of Article 104(9) of the Treaty, the Council may request Germany to submit reports in accordance with a specific timetable in order to examine the adjustment efforts made by Germany. It is appropriate for the reports to be submitted just after the EDP reporting dates.

HAS ADOPTED THIS DECISION:

Article 1

Germany shall:

(a) put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005;

(b) achieve in 2004 an annual reduction in the cyclically-adjusted balance by 0.8 percentage points of GDP;

(c) achieve in 2005 a further reduction in the cyclically-adjusted deficit by at least 0.5 percentage points of GDP or by a larger amount so as to ensure that the general government deficit is below 3% of GDP;

(d) allocate any higher-than-expected revenue to deficit reduction and, should the recovery in economic activity be stronger than currently expected, accelerate the reduction in the cyclically-adjusted deficit.

Article 2

Germany shall:

(a) submit by 9 January 2004 at the latest a report to the Commission outlining the announced decisions to respect the recommendations of this Decision. As regards 2004, the report shall announce the measures or reforms to be implemented, and the time-horizon for their application. It shall contain estimates of the impact of such measures on the general government deficit, including all the relevant assumptions made for their quantification. As regards 2005, the report shall indicate as clearly as possible the measures or reforms envisaged by the government. This report will be examined by the Commission and the Council with a view to assessing compliance by Germany with this Decision;

(b) submit four implementation reports by the end of April 2004, October 2004, April 2005 and October 2005, examining progress made in complying with the recommendations of this Decision. Each of these reports will be examined by the Commission and the Council with a view to assessing compliance by Germany with this Decision.

Article 3

In addition, Germany shall ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit of at least 0.5 percentage point of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path.

Article 4

This decision is addressed to the Federal Republic of Germany.

Done at Brussels, 2003.

For the Council