

Public finances

Central, state and local government

In the fourth quarter of 2003, the budget deficits of central, state and local government were noticeably lower than in the fourth quarter of 2002. On the one hand, this was due to sizeable privatisation proceeds. On the other, expenditure is likely to have gone down, not least as a result of the reduction in Christmas bonuses for civil servants at state government level. In 2003 as a whole, however, the deficits expanded again sharply. They probably amounted to €70 billion, thereby exceeding the figure for 2002, which was already very high, by around €10 billion. Tax revenue stagnated in the wake of the weak macroeconomic development. Other revenue was depressed by the much smaller Bundesbank profit transfer. By contrast, expenditure increased markedly. This was mainly attributable to the further sizeable increase in Federal grants to the statutory pension insurance scheme but also to additional labour market-related expenditure and flood disaster relief.

Overview

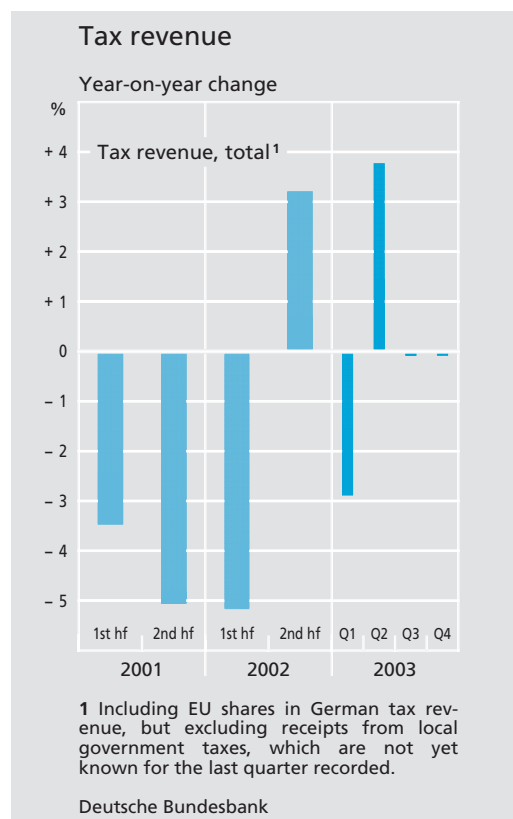
This year, the income tax cuts will place a major strain on general government revenue. This will, however, be compensated by consolidation measures. On balance, the budget plans of central and state government envisage significantly lower deficits than in 2003. This presupposes, however, that the additional revenue anticipated, for example, from the planned tax amnesty will indeed be raised and that a rigorous cost retrenchment policy is pursued.

*Tax revenue
in fourth
quarter...*

The level of tax revenue¹ continued to stagnate in the fourth quarter against the background of persistently weak domestic economic activity. Although receipts from the taxation of energy consumption rose again steeply as a result of the last stage of the ecological tax reform, which came into force at the beginning of 2003, this was offset by a decline in revenue from turnover tax and income taxes. In the case of turnover tax, this was primarily related to the decline in retail trade turnover. Wage tax receipts were lowered by the fact that end-of-year bonus payments were reduced or held back until 2004 for tax reasons. Assessed income tax and investment income taxes likewise yielded less than in the same period in 2002. By contrast, revenue levels for corporation tax continued to recover.

*... and in 2003
as a whole*

According to the preliminary outturn – which includes only an estimate for local government taxes – tax revenue in 2003 as a whole merely matched the 2002 level. Despite the rise in excise taxes, the overall tax ratio (as defined in the government's financial statistics) receded by 0.2 percentage point to 20.7%, after already decreasing considerably in the two previous years, mainly as a result of the tax reform. Although tax receipts marginally exceeded the most recent official estimate from November, they still fell over €18 billion (almost 0.9% of GDP) short of the comparable tax estimate from autumn 2002. This means that tax revenue was far lower than the original expectations for the third year in a row. This was largely attributable to the unexpectedly weak level of overall economic activity.



With regard to the major individual taxes, wage tax and turnover tax recorded the most disappointing results. Wage tax receipts grew by little more than ½% and were consequently €6½ billion lower than expected in the autumn 2002 forecast. This was mainly attributable to the fact that gross wages and salaries stagnated – in contrast to the original expectations. Turnover tax receipts declined for the third consecutive year with a drop of nearly 1%, turning out almost €5½ billion lower than anticipated. This was only partly due to the much weaker growth in nominal domestic demand compared with the original assumptions. Besides the extension of the input tax offsetting facility for purchased ve-

¹ Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Annual percent- age change
	Full year		
	2002	2003	
Wage tax	132.2	133.1	+ 0.7
Assessed income tax	7.5	4.6	- 39.4
Corporation tax	2.9	8.3	+ 188.9
Turnover tax	138.2	137.0	- 0.9
	<i>of which Q4</i>		
Wage tax	38.9	38.7	- 0.6
Assessed income tax	4.5	4.4	- 2.2
Corporation tax	3.2	3.4	+ 7.4
Turnover tax	36.0	35.8	- 0.5

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hicles used partly for private and partly for business purposes, this may also have been caused by further insolvency-related shortfalls and, possibly, by greater tax evasion. Of the profit-related taxes, non-assessed taxes on earnings raised €9 billion; this was just over one-third less than in the previous year and consequently almost €4 billion below the expectations. The main reason for this was the further decrease in company dividend distributions, the effect of which was magnified by the moratorium for claiming corporation tax credits that had accumulated prior to the tax reform. Conversely, this same factor – together with the temporary raising of the tax rate by 1.5 percentage points to 26.5% – helped to push up corporation tax receipts, which totalled just over €8 billion (compared with less than €3 billion in 2002) and margin-

ally exceeded the expectations from autumn 2002. The negative exceptional factors resulting from the change in the corporation tax regime in 2001 thus continued to dwindle in importance.

As a result of the emerging cyclical recovery, a significant increase in tax revenue is envisaged for 2004. In the official estimate from November 2003, an increase of 2¾% is forecast, based on nominal economic growth of 2½%. This estimate already took account of the revenue shortfalls expected from the originally planned second stage of the tax reform. The partial advancement of the third stage of the tax reform will, however, further reduce the marginal tax rates for income tax to a range of 16% to 45%; this will lead to additional revenue shortfalls of around €9 billion. Only roughly one-third of this amount will be offset by the abolition of tax breaks and accounting conveniences as well as the rises in tobacco tax which will come into force in March and November. Although additional revenue is also envisaged from the decreed tax amnesty, it is uncertain whether this will amount to €5 billion as anticipated by central government. All in all, therefore, there are a number of factors indicating that the overall tax ratio may well decline a little further.

In the fourth quarter the Federal Government budget recorded a surplus of €8½ billion; this was €5½ billion higher than in the fourth quarter of 2002. This was, *inter alia*, attributable to sizeable privatisation proceeds. In 2003 as a whole, however, the deficit rose steeply by €6½ billion to over €39 billion.

Outlook for 2004

Federal budget in 2003 ...

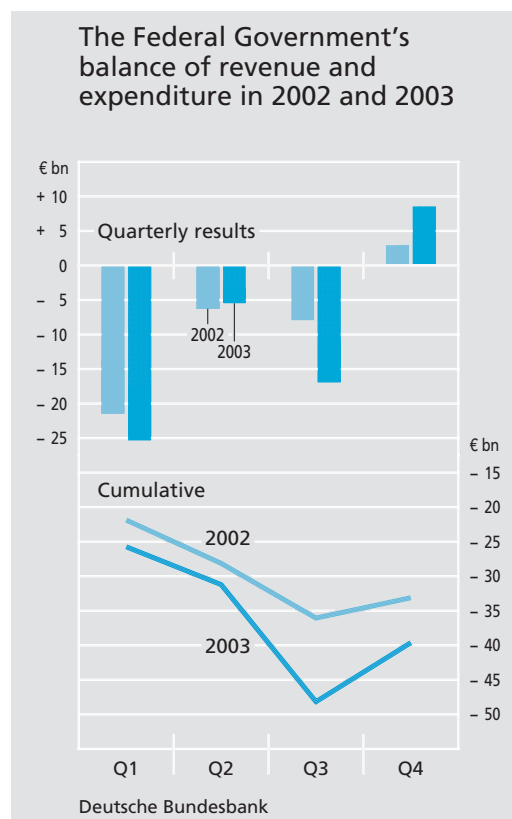
Consequently, the budget estimate from spring 2003 was overshoot by €20 billion.² Tax shortfalls vis-à-vis the estimates, including shortfalls arising from draft legislation that was finally not adopted, amounted to €11½ billion. In addition, labour market-related cost burdens exceeded the original estimates by €10½ billion. Cuts in expenditure on interest payments and guarantees as well as the new all-day school programme created only a moderate counterbalance. Total expenditure went up by 3%, whereas a decline of ½% was envisaged in the original budgetary plans.

... and in 2004

The 2004 Federal budget – which takes account of the Federal Government plans from autumn but not the results of the parliamentary mediation committee hearing on the reform legislation – envisages a significant deficit reduction vis-à-vis the outturn for 2003 to €29½ billion. This includes a further rise in privatisation proceeds by €2 billion to €7 billion after it was originally intended to have virtually no recourse to financing via asset disposals.

Situation after the conclusion of the mediation proceedings

In the course of the mediation proceedings concluded in mid-December, it was decided to bring forward only some of the tax cuts planned for 2005. At the same time, the originally planned subsidy reductions to counterfinance the tax cuts were likewise downsized. The changeover to “Unemployment benefit II” was postponed by six months until the start of 2005. In the aggregate, the decisions provide relief of €3 billion compared with the 2004 Federal budget plans. Those budget plans are also subject to some uncer-



tainty, however. Firstly, the projected net income from the motorway toll for heavy goods vehicles of just over €2 billion will not be realised. Secondly, the financial impact of several reform laws and reform projects, such as the tax amnesty or combating illicit working, are very difficult to assess. Thirdly, an across-the-board cut in expenditure of €2½ billion is required, above all owing to the decision not to reduce the Federal Government grants to the statutory pension insurance scheme.

For the period of the medium-term financial plan, for which the third stage of the income tax cuts had already been factored in, the Federal budget faces greater handicaps,

² However, the supplementary budget actually envisaged a deficit of almost €44 billion.

mainly because of the smaller reduction of subsidies decided by the parliamentary mediation committee. Since, in addition, the projected level of tax revenue will need to be revised downwards vis-à-vis the estimates in the medium-term financial plan, further adjustment measures are essential if the envisaged lowering of the deficit to €10½ billion in 2007 is to be achieved.

Special funds

The special funds recorded a surplus of €10 billion in 2003. This exceeded the figure for 2002 by just over €1 billion, even though the share of the Bundesbank's profit accruing to the Redemption Fund for Inherited Liabilities was almost €6 billion lower. This was offset by the new "Reconstruction Aid" Fund set up to deal with the consequences of the flood disaster, which recorded a surplus of €3½ billion last year, and the ERP Special Fund, which expanded its surplus by €3½ billion to €4 billion as a result of a big increase in loan repayments. A financial deterioration is expected this year, however. This will be attributable, firstly, to the further lowering of the Bundesbank profit and, secondly, to the likely utilisation of the resources accrued in the "Reconstruction Aid" Fund.

State government

State government apparently recorded a much smaller deficit in the fourth quarter than during the same period in 2002. This was due not least to the noticeable reductions in Christmas bonuses paid to working and retired civil servants in many Federal states. But in 2003 as a whole, the deficit of state government probably again overshoot the record high of the previous year. Primarily in response to the weak development of tax

revenue, numerous state governments were obliged to adopt supplementary budgets in which the authorised level of borrowing exceeds the ceiling allowed by law. With its ruling of 31 October 2003, in which the state of Berlin's 2002/2003 budget was declared unconstitutional, the Berlin Constitutional Court demanded an adequate justification for such overstepping of the legally stipulated borrowing limit. Applying these criteria, other states, too, would need to explain their excessive borrowing. In the light of the high deficits and the sizeable tax cuts in 2004 and 2005, there is no alternative to pursuing a policy of rigorous fiscal consolidation.

In 2004 state government budgets will remain very tight. However, in the meantime considerable savings have been agreed. For example, civil servants' Christmas bonuses will be reduced in additional Federal states and in most states their annual holiday bonus will be abolished. Furthermore, in some states civil servants' weekly working hours are being raised considerably, thereby reducing the need to appoint new staff. In addition, state governments are lowering the grants they pay on a voluntary basis, in some cases substantially. Even so, some states have still not succeeded in lowering their estimated net borrowing to the constitutional upper limit.

For local government only the results for the third quarter are currently available, according to which the deficit of €1½ billion was the same as in the previous year. Although tax revenue increased marginally by 1%, this was offset by a further steep drop in the grants from state government, which meant

Local government

that overall revenue stagnated. Expenditure likewise remained at the same level as in 2002. Whereas social benefits grew by just under 10%, expenditure on capital formation contracted by the same margin of almost one-tenth (despite the flood-related increase in Saxony). The deficit for 2003 as a whole, judging from the present perspective, could amount to €4½ billion and thus be about twice as high as in 2002. Although the budgetary situation is likely to improve this year, particularly owing to measures adopted in the mediation process (primarily the marked lowering of local business tax transfers), local government is again likely to run up sizeable deficits.

Debt

In the fourth quarter the indebtedness of central, state and local government rose by €13 billion. Whereas money market liabilities were redeemed to the value of €11 billion, €24 billion net was raised on the capital market. The largest borrower was state government with €10 billion on balance. Central government had a significantly lower borrowing requirement of €2 billion, in part owing to sizeable one-off privatisation proceeds. Local government debt probably increased by €1 billion, whereas in the case of the special funds redemptions marginally outweighed new borrowing.

Social security funds

Wage and salary earners' pension insurance scheme

In the fourth quarter, the wage and salary earners' pension insurance scheme recorded a seasonal surplus of €1½ billion; this exceeded the figure for the same period last

Net borrowing in the market by central, state and local government

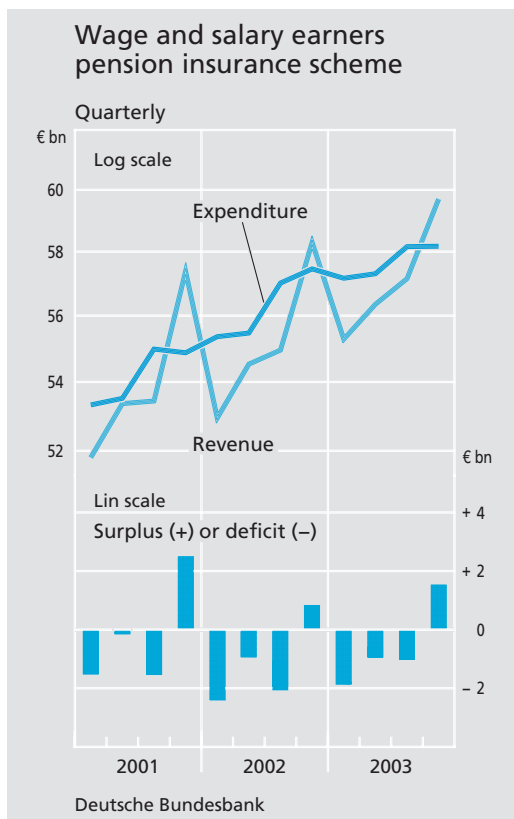
€ billion				
Period	Total	of which		Memo item Acquisition by non-residents
		Securities 1	Loans against borrowers' notes 2	
2002	+ 54.5	+ 67.6	- 11.9	+ 57.4
<i>of which</i>				
Q1	+ 25.6	+ 15.2	+ 10.5	+ 12.2
Q2	+ 1.5	+ 22.9	- 21.4	+ 16.8
Q3	+ 18.6	+ 25.1	- 5.4	+ 19.1
Q4	+ 8.8	+ 4.4	+ 4.4	+ 9.3
2003 <i>pe</i>	+ 80.9	+ 74.1	+ 7.9	...
Q1	+ 34.7	+ 32.6	+ 2.1	+ 19.5
Q2	+ 13.5	+ 11.8	+ 1.6	+ 16.3
Q3	+ 19.9	+ 9.4	+ 11.6	- 6.5
Q4 <i>pe</i>	+ 12.9	+ 20.3	- 7.5	...

1 Excluding equalisation claims. — 2 Including cash advances and money market borrowing.

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year by just over €½ billion. Revenue from contributions grew only weakly by 1% in total despite the higher contribution rate and the significant rise in the ceiling for earnings subject to contributions. The reasons for this were cuts in Christmas bonuses, a further increase in the number of employees opting for company pension plans with direct payments which are not subject to social security contributions as well as the delayed transfer of contributions by public sector employers.³ Total revenue went up more steeply by 2½%, particularly because the grants from the Federal budget increased again sharply as a result of the last stage of the ecological tax reform. Ex-

³ Following the latest pay settlement for the public sector, employers are gradually changing over to paying wages and salaries at the end of the month instead of in the middle of the month. The associated social security contributions are then paid in the following month.



penditure grew fairly weakly (by just over 1%) owing primarily to the fact that the pension adjustment in mid-2003 was less than half as high as in 2002 and to the merely moderate rise in the number of pension recipients. The fluctuation reserve of 0.47 month's expenditure fell slightly below the statutory requirement of 0.5 month's expenditure at the end of the year.

For this year, the lower limit for the fluctuation reserve has been reduced to just 0.2 month's expenditure and another deficit has been budgeted for. Together with the remaining short-term measures that have been adopted,⁴ this means that the contribution rate did not have to be raised above the current rate of 19.5%. However, the medium-term stabilisation of contribution rates pre-

supposes a noticeable recovery on the labour market. In the long term, limiting the rise in the contribution rate will necessitate more extensive amendments to pensions legislation. Important steps in this direction are currently being taken in the form of the draft "Pension Sustainability Act."

The deficit of the Federal Employment Agency – which changed its name at the beginning of the year from Federal Labour Office – in the fourth quarter of 2003 was €¼ billion; this was €¾ billion lower than in the fourth quarter of 2002. The main reason for this was, however, that the contributions to the statutory pension insurance scheme on behalf of recipients of wage substitutes for January were, for the first time, not booked prematurely in December. This one-off effect reduced the deficit by around €½ billion.

Federal
Employment
Agency

Revenue in the fourth quarter was almost 4% below the level in the previous year. This was caused by a steep decline in other revenue and a fall of 1½% in receipts from contributions – despite the significant rise in the ceiling for earnings subject to contributions. Expenditure fell more steeply (by just over 8%), partly as a result of the aforementioned exceptional factor. In the fourth quarter 5% less was spent on unemployment benefit. The additional expenditure necessitated by the rise in the number of unemployed persons and the higher contribution rates to the

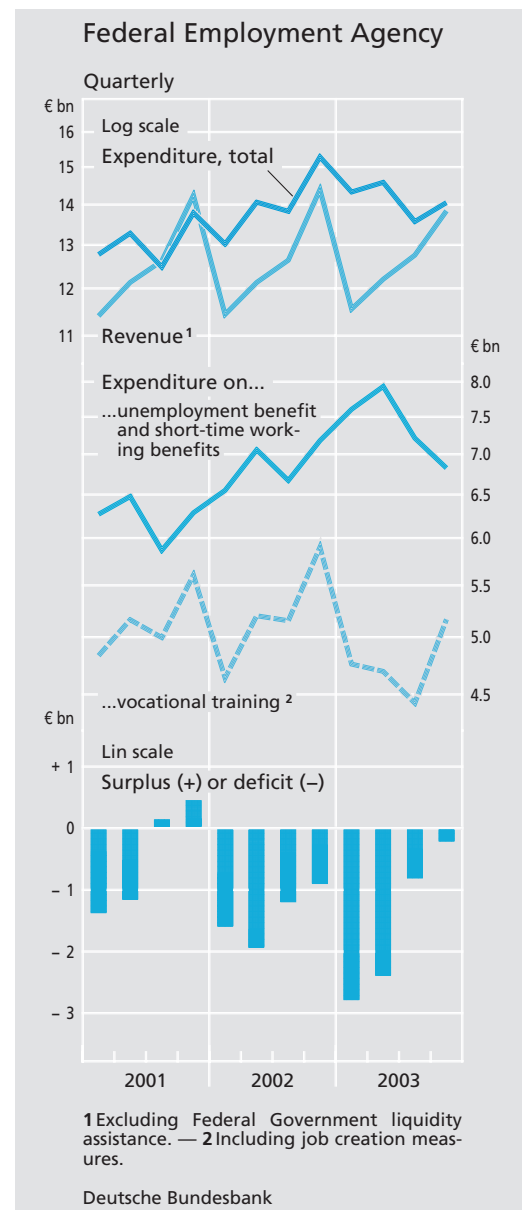
⁴ These include making no pension adjustment in mid-2004, shifting the payment date for new pensions from the beginning to the end of the month, transferring the full contribution burden to the long-term care insurance scheme to pensioners themselves, as well as faster adjustment of the contribution rate to pensioners' health insurance (which is anticipated to decline).

statutory pension and health insurance schemes was offset by a significant decline in the benefit recipient ratio. Expenditure on active labour market measures decreased by 12½% in total. New expenditure in connection with the subsidised establishment of one-person firms and grants to the Personnel Service Agencies (PSA) had virtually no financial impact during the period under review.

The budget of the Federal Labour Office initially envisaged a balanced outturn for 2003. However, the Federal Government's supplementary budget estimated a transfer requirement of €7½ billion. The actual deficit turned out to be just over €6 billion. This was primarily attributable to more stringent budgetary management, particularly as regards job creation schemes as well as vocational training and retraining measures. The budget for 2004 envisages a deficit of just over €5 billion. The projected need for another large government grant appears realistic given that the number of unemployed persons is unlikely to decrease substantially in 2004 and that the reform legislation⁵ adopted at the end of 2003 will yield financial relief only in the coming years.

*Statutory
health
insurance fund*

The statutory health insurance fund recorded a cumulative deficit of €2½ billion up to the end of the third quarter. Although this represents a financial improvement of almost €1 billion vis-à-vis the previous year, it is evident that contribution receipts, even following the raising of the average contribution rate from 14.0% to 14.3%, are still not sufficient to cover expenditure. In the first nine months these receipts (including contribu-



tions to the statutory health insurance fund in respect of "mini jobs") were barely 2% higher than in 2002 despite the increase in the contribution rate. Expenditure on benefits grew only moderately by just under 1%.

⁵ This includes the Third and Fourth Act Promoting Modern Labour Market Services and the Act to Reform the Labour Market.

The outturn for 2003 as a whole will be influenced by the rush to claim healthcare services ahead of the introduction of less generous benefit rules from the beginning of 2004, the pattern of end-of-year bonuses and the trend in company pension payments that are exempt from social security contributions in the fourth quarter. Data on the statutory pension and unemployment insurance schemes indicate a further erosion of the volume of earnings subject to contributions. A considerable annual deficit may therefore be expected for the third year in a row. In 2004 the Act to Modernise the Statutory Health Insurance Fund is intended to produce financial relief of almost €10 billion. This should enable the health institutions to start repaying the debt which they have accumulated – in contravention of the statutory rules – in the first of four annual instalments. However, their potential to lower the contribution rates is considerably reduced both by this redemption requirement and by the need to compensate for their structural underfunding of expenditure. A fall in the annual average contribution rate to well below 14% is therefore unlikely to be achieved.

Outlook for the general government sector as a whole

Rise in the deficit ratio to 4% in 2003

According to provisional data from the Federal Statistical Office, the general government deficit ratio (as defined in the Maastricht Treaty) rose to 4.0% last year after already exceeding the 3% ceiling laid down in the Treaty and reaching 3.5% in 2002. The main reason for this was the weak macroeconomic

development, which was reflected in only a small growth of revenue from tax and social security contributions and a rise in labour market-related spending.

Owing to countervailing effects there was hardly any change in the structural deficit ratio, which has led to some confusion in interpreting this variable. On the one hand, there was a series of restrictive fiscal policy measures geared towards reducing the structural deficits. Indirect taxes and contribution rates to the statutory health and pension insurance funds were raised. Central, state and local government implemented a stringent expenditure policy, which included the continued downsizing of staffing levels, cuts in civil servants' remuneration and the further curbing of investment expenditure. Savings were also made in healthcare and labour market spending. On the other hand, these fiscal policy measures were largely offset by negative developments which were not cyclically induced. For example, payments to the EU increased markedly vis-à-vis the previous year, the Bundesbank profit declined sharply and additional expenditure was required for flood relief. Despite the aforementioned increase in tax and social security contributions, the taxes and social security ratio increased only marginally. Thus, social security contributions grew more sluggishly than was to be expected considering the development of gross wages and salaries and the increases in the contribution rates; this was attributable not least to more people changing from public to private health insurance institutions.

Structural budgetary position virtually unchanged

The next stage in the excessive deficit procedure against Germany

In autumn last year it became apparent that in 2004, not least owing to the scheduled advancement of the tax cuts, Germany would again overshoot the reference value for the general government deficit of 3% of GDP, as defined in the EC Treaty. The European Commission's autumn forecast put the likely figure at 3.9%. The Federal Government, too, now anticipated a renewed overshooting of the deficit ceiling. This means that Germany failed to comply with the Ecofin Council's recommendation. In January 2003, after having established that Germany had run up an excessive deficit, the Ecofin Council had urged the government to bring the deficit back down to the reference value by 2004 at the latest.¹

The European Commission therefore recommended to the Council last November that the next stage of the excessive deficit procedure should be initiated against Germany and France - which was in a similar situation. However, the Commission simultaneously suggested that the deadline for correcting the excessive deficit be extended from 2004 to 2005. Its main argument for doing so was the outlook for economic growth, which in the meantime had worsened significantly in both countries. It is questionable whether even this deadline extension is consistent with the spirit of the Stability and Growth Pact. The ultimate objective of the excessive deficit procedure is to achieve a rapid correction of unwelcome budgetary developments, if necessary using sanctions.²

However, at its meeting on 25 November 2003 the Ecofin Council did not follow the Commission's recommendation to give Germany and France a warning as the last step before sanctions are imposed. Instead, Germany committed itself to take all the measures necessary to lower the deficit ratio to below 3% by 2005 at the latest - on condition that the Commission's growth outlook turns out to be correct. In its concluding remarks, the Council recommended that Germany reduce its cyclically adjusted deficit in 2004 by 0.6% of GDP. In 2005, the reduction must amount to at least 0.5% of GDP, but may have to be higher

if this is necessary to comply with the 3% ceiling. In the subsequent years, too, the rate of budgetary consolidation, measured by the cyclically adjusted financial balance, should amount to at least 0.5% of GDP per annum, so that a budgetary position which is close to balance or in surplus can be achieved in the medium term and the debt ratio can be lowered again. In addition, Germany was told to report regularly on the progress made towards complying with these recommendations. The Council also announced its intention to initiate the next stage in the procedure if Germany does not fulfil these requirements. Similar recommendations were adopted for France.

The Council's conclusions deviate from the normal sequence of the excessive deficit procedure. In order to establish legal clarity also with regard to the future implementation of the Pact's rules, the Commission filed an action at the European Court of Justice in January to verify the legality of the Council's approach.

The procedures against Germany and France have been suspended for the time being, even though the governments of both countries themselves anticipate that the 3% ceiling will be overshot again this year for the third time in a row without the ability to invoke an escape clause. Following this precedent, the threat of imposing sanctions in the event of a continued excessive deficit has lost credibility.

The latest disputes about the interpretation of the Pact have been used as an opportunity to demand its reform. However, in the present situation it is by no means certain that amending the Pact or the EC Treaty will improve the underlying fiscal policy setting and create greater confidence in sound public finances. The negative repercussions of this loss of credibility are more likely to be limited if Germany and France consistently fulfil the consolidation requirements demanded of them and if the member states and the Council implement the Pact's rules strictly in the future.

¹ See also Deutsche Bundesbank, *Monthly Report*, February 2003, p 53 in particular. — ² See also Deutsche Bundesbank, *Monthly Report*, November 2003, p 61 in particular.

Key data of the Federal Government's updated stability programme

in %

Item	2002	2003	2004	2005	2006	2007
Real GDP growth						
Stability programme 2003	0.2	- 0.1	1 ½ - 2	2 ¼	2 ¼	2 ¼
Stability programme 2002	½	1 ½	2 ¼	2 ¼	2 ¼	-
Deficit ratio (-)						
Stability programme 2003	- 3.5	- 4	- 3 ¼	- 2 ½	- 2	- 1 ½
Stability programme 2002	- 3 ¾	- 2 ¾	- 1 ½	- 1	0	-
Debt ratio						
Stability programme 2003	60.8	64	65	65 ½	65 ½	65
Stability programme 2002	61	61 ½	60 ½	59 ½	57 ½	-
Structural deficit ratio (-)	- 3.3	- 3.1	- 2 ½	- 2	- 1 ½	- 1

Source: Federal Ministry of Finance.

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Decline in the deficit ratio expected in 2004

A decline in the deficit ratio is expected this year. Although tax receipts will fall markedly (by €15 billion or ¾% of GDP in total) as a result of the second and – partially advanced – third stage of the income tax reform, these will be accompanied by major relief for the general government budgets. The fact that subsidies will be reduced – even if not to the extent envisaged by the Federal Government – is a welcome development. Furthermore, measures in connection with the tax amnesty and combating illicit work will result in considerable additional revenue, which cannot, however, be reliably quantified. Moreover, it may be assumed that the statutory health insurance fund will not record a deficit again this year. In view of the persistently tense budgetary situation, central, state and local government are likely to adopt a

stringent spending stance. Staffing levels will be trimmed further, the salary adjustment in the public sector will be moderate, and other operating expenditure and investment are likely to be very limited. From the present horizon, however, the deficit ratio is still expected to exceed the 3% ceiling.

The updated German stability programme put forward in December envisaged a decrease in the deficit ratio in 2004 to 3 ½%. Next year the ratio is supposed to fall below the 3% ceiling to 2 ½% and then be reduced gradually to 1 ½% in 2007. This does not, however, take account of the outcome of the parliamentary mediation committee from December. That will lead to relief for public finances this year compared with the Bundestag's previous decisions. The mediation com-

Stability programme

mittee's decision not to bring forward the third stage of the tax reform *in toto* (implying tax shortfalls of only €9 billion instead of over €15 billion) outweighs the fact that budgetary relief from the adopted measures will be lower than initially planned. An updated version of the stability programme presented in January therefore envisages a deficit ratio of 3¼% for 2004 (see table on page 68). In 2005, by contrast, the negative implications for public finances – particularly the smaller-than-planned cuts in the commuting allowance and the grant to home buyers – will be predominant. On balance, revenue will again record only sluggish growth owing to the third stage of the income tax reform, the full impact of which will be felt by that time, and the fact that receipts from the tax amnesty will be negligible.

*Faster deficit
reduction
required*

As things stand today, it is not yet certain that Germany will bring its deficit back below the 3% ceiling next year – as envisaged in the stability programme. This is, however, necessary in order to comply with its European commitments. If the limit is exceeded again in

the coming year, this would not only undermine the already damaged Stability and Growth Pact (see box on page 67), but would also lessen the credibility of German fiscal policy. However, besides achieving a short-term reduction in the deficit next year, it is also necessary to work towards meeting the target set in the Stability and Growth Pact of attaining a budgetary position which is at least close to balance in the medium term. In this context all levels of government are required to seek to comply with this requirement, which is additionally incorporated in German budgetary law. The stability programme envisages a structural consolidation of ½% of GDP per annum. According to an Ecofin agreement reached last year, such a rate of consolidation progress must be seen as a minimum goal for countries with a budgetary position that is not structurally balanced. In the light of the still very high deficit ratio, the debt ratio (well above the reference value of 60%) which will continue to rise until 2005 and the assumed economic recovery, an accelerated reduction of the deficit would be appropriate.