Public finances

Budgetary development of central, state and local government

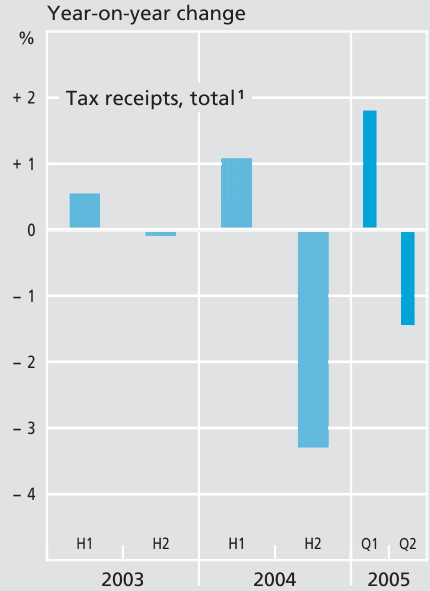
Overview

The deficit of central and state government (the results for local government are not yet known) amounted to €6½ billion in the second quarter and was thus €2½ billion lower than in the second quarter of 2004. Despite a small decline in tax revenue, significantly higher non-tax receipts caused a considerable rise in overall revenue (+5%). Total spending increased by 2½%, as in the first quarter.

Whereas the deficit of central, state and local government went down only marginally in 2004 to €66 billion, a noticeably sharper reduction was planned for this year, although due primarily to higher central government receipts from the sale of financial assets. Following the latest tax estimate, revenue expectations have meanwhile been revised downwards by just over €5 billion. The revised figures for labour market-related expenditure likewise entail additional budgetary burdens vis-à-vis the original plans. Relief in other areas, such as a stringent implementation of the budget and the favourable development of interest expenditure, will come nowhere near compensating for these factors. This means that the budgetary expectations of central government and, to a lesser extent, state government are not likely to be fulfilled. Whereas the gap in the Federal budget is apparently to be plugged above all by utilising as yet unused loan authorisations from previous years, several state governments have already announced supplementary budgets, in which the exception clauses for limiting

Tax revenue

Year-on-year change



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

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new borrowing will have to be invoked again. Conflicts with the upper limits for new borrowing as specified in budgetary law are expected for 2006, too, if no additional measures are taken.

Tax revenue declined in the second quarter

Tax revenue[1] declined by 1½% on the year in the second quarter. This was mainly attributable to a considerable decrease in corporation tax revenue as well as wage tax shortfalls, which were induced by the tax cuts at the start of the year, and a decline in consumption-related taxes. Of the direct taxes, wage tax revenue fell by just under 2%. This was, however, moderate in view of the tax cuts at the beginning of the year. Corporation tax receipts were down by just under €2 billion. This was presumably due to a decline in tax payments in respect of earlier years from an albeit relatively high level in 2004. The favourable trend in profits was reflected in the 20% increase in non-assessed taxes on earnings (particularly investment income tax on dividends). Besides lower refunds to employees, this is also likely to have had a positive influence on assessed income taxes, the revenue of which increased by 10% despite the tax cut. In the case of indirect taxes, receipts from turnover tax – which tend to fluctuate considerably during the course of the year – declined by 2%. Receipts from mineral oil tax – the most important excise tax – declined by 6½%, in part owing to consumer restraint in response to the high energy prices. By contrast, revenue from tobacco tax rose by 3½%. Despite the continued decline in sales of taxed cigarettes, the tax increase in December 2004 resulted in additional revenue.

Tax revenue growth still somewhat below full-year target

In the first half of the year, tax revenue (excluding receipts from local government taxes) remained more or less constant compared with the first six months of 2004 and thus developed somewhat more unfavourably than envisaged in the official estimate from May for the whole year. Besides corporation tax revenue, receipts from turnover tax and mineral oil tax were lower than expected as a result of subdued private consumption. On the other hand, wage tax and assessed income tax, in particular, have developed more favourably to date than anticipated. Overall, the growth rate of taxes on income was thus higher than expected and that of consump-

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

tion taxes lower than anticipated. Although the estimated tax revenue target for 2005 as a whole may still be achieved, a risk arises primarily from the further course of macroeconomic development. There is also uncertainty with regard to the revenue from profit-related taxes, which are very volatile.

Lower central government deficit in second quarter

In the second quarter central government recorded a deficit of €4½ billion compared with €6 billion in the same period last year. Overall revenue went up by 9%. Although tax revenue declined by ½%, this was more than offset by loan repayments, holding arrangements with the publicly owned banking group KfW and the second payment of the compensatory amount from the Federal Employment Agency. Expenditure rose by 6% in total. Spending in connection with the Hartz IV labour market reform in the second quarter was considerably higher than payments for unemployment assistance during the same period in 2004. The decline in expenditure owing to the cessation of compensation payments to cover the deficit of the Post Office pension fund (as a result of selling off fund claims) dampened overall spending growth.

Deficit targets likely to be overshot considerably in 2005 as a whole

In 2005 as a whole it is no longer envisaged that central government will be able to lower the deficit to €22½ billion as planned. According to the tax estimate from May, tax revenue will be €3½ billion lower than originally expected. Furthermore, the Bundesbank profit was just under €1½ billion less than the budgeted figure. On the expenditure side, the Federal Ministry of Finance is now anticipating additional burdens of €8 billion in connection with the Hartz IV labour market reform. Unexpectedly high repayments of loans and the muted development of interest expenditure can only partly offset this. In addition, even following the holding arrangement with the KfW from July amounting to €5 billion, it is still uncertain to what extent the budgeted proceeds from asset disposals of just over €17 billion will actually materialise. Just over €2 billion was raised in the first half of the year. The Federal Minister of Finance has already announced that he does not intend to present a supplementary budget. The outstanding loan authorisations of nearly €20 billion which are still available could suffice to finance not only the aforementioned burdens but also possible revenue shortfalls in connection with asset disposals.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion, H1, 2004	2005	Annual percentage change
Wage tax	59.1	56.9	– 3.7
Assessed income tax	– 2.8	– 0.4	.
Corporation tax	6.7	7.1	+ 7.1
Turnover tax	67.9	67.9	+ 0.0
	of which Q2		
Wage tax	29.6	29.0	– 1.8
Assessed income tax	3.1	3.4	+ 10.0
Corporation tax	4.5	2.7	– 39.4
Turnover tax	33.7	33.0	– 2.0

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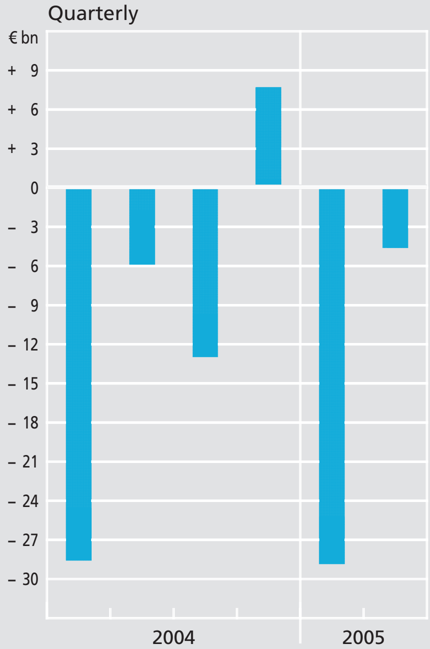
The Federal Government's balance of revenue and expenditure

Quarterly



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Federal budget 2006 characterised by large-scale asset disposals

The draft Federal budget for 2006, which was merely discussed by the Federal Cabinet in mid-July and is to be adopted by the Federal Government only after the next German parliamentary elections, envisages expenditure growth of just under 1% vis-à-vis the budget plans for 2005. However, compared with the current estimates for 2005, this would mean a decline of just over 2%, with a key factor in this decline being the assumed cessation of the compensation payment to cover the deficit of the Federal Employment Agency (2005 budget: €4 billion). Accordingly, net government borrowing would amount to €21½ billion, which is almost €1 billion less than total investment, thus complying with the borrowing limit pursuant to Article 115 of the Basic Law. Not least owing to tax shortfalls of €11 billion vis-à-vis last year's financial plan, however, the budgeted figure for proceeds from asset disposals was sharply increased again to €23 billion. Including loan repayments and continuing relief from not needing to subsidise the Post Office pension fund, the financial benefit from asset realisations will total over €30 billion. However, selling off public assets in order to comply with the constitutional ceiling for government borrowing is not consistent with the budgetary principle, which ties new borrowing to new investment so as to avert the depletion of the stock of government assets.[2]

Medium-term financial planning contains large financial gap

The planned exceptionally large asset disposals are likely to mean that most of central government's readily realisable financial assets will have been sold off by the end of next year. Such revenue will then no longer be available in subsequent years to close the total annual financial gap of nearly €50 billion. In accordance with the constitutional regulations, only around €20 billion at most (the amount of investment expenditure) may be financed by running up new debt. The new medium-term financial planning of central government envisages a moderate decline in net borrowing vis-à-vis 2006 to €16 billion by the end of 2009. Although under the plan new borrowing will be kept below the constitutional ceiling in each year, the financial planning for 2007 onwards indicates an annual extra requirement of €25 billion, for the funding of which no concrete proposals have been made. Besides tax shortfalls of up to €13 billion compared with the

2 See Deutsche Bundesbank, Deficit-limiting budgetary rules and a national stability pact in Germany, *Monthly Report,* April 2005, pp 23-37.

2004 financial plan, this evidently also reflects lower revenue in connection with the extensive asset disposals which will have been effected by then (and which correspondingly reduce the government's investment income). Furthermore, additional spending is likely to arise primarily from the Hartz IV reform.

Special funds

The special funds recorded a surplus of just over €1 billion in the second quarter compared with just under €2 billion in the same period last year. Since the German Unity Fund's debt has been jointly assumed by central government, its financial balance is now included in the Federal budget. In the same period last year, it generated a surplus of €½ billion. The flood disaster fund again recorded a marginal deficit. Of the resources received in 2003, around €2 billion is likely to still be available. The ERP Special Fund again recorded a surplus (€1½ billion) since repayments, in particular, exceeded lending. For 2005 as a whole, as in 2004, the special funds may record a small surplus.

Lower state government deficit in second quarter

In the second quarter state government recorded a deficit of €3 billion, which was €2 billion less than in the second quarter of 2004. Although tax revenue continued to decline (-1%), non-tax revenue rose considerably, thus resulting in an increase of 1½% in overall revenue. By contrast, expenditure went down by 1½%. Since state government has not yet concluded a new collective pay agreement, and extended working hours and staff cuts have had a dampening effect, expenditure on personnel – a key cost factor for state government – also continued to develop moderately.

The Federal Government's financial planning over the medium term

€ billion

Item	Actual 2004	Target 2005 3	Draft 2006 4	Financial plan		
				2007	2008	2009
Expenditure	251.6	254.3	256.5	258.7	261.1	263.5
of which Investment	22.4	22.7	22.4	22.4	21.3	21.3
Revenue 1	212.1	242.3	245.0	238.7	242.1	247.5
of which Taxes	187.0	190.8	191.5	197.4	203.8	212.1
Net borrowing	39.5	22.0	21.5	20.0	19.0	16.0
Structural extra requirement 2				25.0	25.0	25.0
Memo item Change in expenditure in %	-2.0	+1.1	+0.9	+0.9	+0.9	+0.9

1 Including coin seigniorage. — **2** The implementation has already been factored into the values for revenue and expenditure recorded here. — **3** The Federal Ministry of Finance currently anticipates an additional financial gap of €12 billion. — **4** This contains asset disposals of just over €30 billion including relief from sales of claims of the Post Office pension fund.

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Numerous state governments breaching borrowing limit

For 2005 as a whole, the budgetary plans for state government envisage a deficit reduction of €1½ billion to €23½ billion compared with 2004. However, tax revenue forecasts have not yet been adjusted to the last tax estimate from May, which predicted €2½ billion in shortfalls for state government. Although the revenue shortfalls should largely be offset by cost containment, supplementary budgets – which are likely to envisage a significant increase in the deficits – have been announced by some state governments. After the budgetary plans for Berlin, Bremen, Hesse, Lower Saxony and Saarland had already breached the statutory limit for new borrowing – even before taking account of the new tax estimate – Schleswig-Holstein and North Rhine-Westphalia, following a change of government in those two states, likewise an-

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

€ billion

Period	Total	of which Securities [1]	of which Loans against borrowers' notes [2]	Memo item Acquisition by non-residents
2003	+ 81.2	+ 73.4	– 0.8	+ 26.9
2004	+ 72.3	+ 70.7	– 16.8	+ 42.9
of which				
Q1	+ 45.3	+ 34.6	+ 4.1	+ 16.9
Q2	+ 8.2	+ 14.6	– 9.6	– 3.6
Q3	+ 17.6	+ 17.1	– 0.9	+ 18.6
Q4	+ 1.2	+ 4.4	– 10.4	+ 11.0
2005				
Q1 p	+ 26.7	+ 17.3	+ 7.5	+ 24.7
Q2 pe	+ 7.5	+ 13.4	– 7.1	...

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

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nounced that their borrowing plans would exceed the permissible ceiling more or less throughout the legislative term. Following the most recent rulings of the State Constitutional Court in Mecklenburg-West Pomerania, which considered two budget acts to be void and requires the state parliament to issue a new 2005 budget that includes retrospective financing of deficits from 2003, this state government may also exceed the borrowing ceiling. With regard to the necessary justification for claiming exemption from the constitutional rule pegging borrowing to the investment level, the court (in line with a ruling by the Federal Constitutional Court) is demanding a differentiated analysis of the causes of the alleged macroeconomic disruption and of the strategy to counter it. The court's ruling means that regular recourse to the exemption clause must be avoided in favour of structural consolidation.

Financial situation of local government still strained

Local government was able to reduce its budgetary deficit in the first quarter of 2005 (latest available data) compared with the same period in 2004 by €½ billion to €3½ billion. Revenue rose by just under ½%. Although tax revenue rose by almost 12½% thanks to a jump in local business tax receipts, proceeds from asset disposals went down sharply. The important key grants from state government were also reduced noticeably. Expenditure fell again by just over 1%. Minor decreases in expenditure on personnel and other operating expenditure were accompanied by another rise in social benefits (+2%). The impact which the amalgamation of unemployment assistance and social assistance will ultimately have on local government budgets cannot be read off the outcome for the first quarter. Whereas central government finances unemployment benefit II, local government initially assumes just over 70% of the costs of accommodation and heating for benefit recipients. Whether this share needs to be changed is an issue that will be considered during a review in the fourth quarter. Finally, relief worth €2½ billion has been agreed for municipal budgets in respect of social assistance payments compared with the status quo. The decrease in local government spending in the first quarter was due mainly to a further fall in real investment by just over 10½%. Another increase in cash advances, which actually are envisaged solely for covering liquidity shortfalls, to €21½ billion underscores the constantly strained situation of local government budgets, too.

Social security funds

Statutory pension insurance scheme showing larger deficit in second quarter

In the second quarter the statutory pension insurance scheme recorded a deficit of €1½ billion, which was just under €½ billion more than in the same period last year. Whereas revenue grew by barely ½%, expenditure recorded a marked rise – of almost 1% – for the first time in twelve months. The main reason for this was the fact that the dampening effect of the change introduced on 1 April 2004 obliging pensioners to pay the full contribution to the long-term care insurance scheme has now dropped out. Revenue from contributions rose marginally by ½%, after declining noticeably in the first quarter.

Need for liquidity assistance expected this year

In 2005 as a whole, the deficit will considerably exceed that of last year (€1½ billion) when a one-off influx of €2 billion accrued from asset disposals. The expenditure of the statutory pension insurance scheme will, however, be eased by around €½ billion following the introduction of the special contribution to the statutory health insurance scheme – which is paid by insured persons alone – on 1 July 2005. By contrast, neither the sustainability factor nor the presumed contribution to a supplementary private pension scheme[3] will be able to curtail the pension adjustment in the wake of the weak growth of wages and salaries last year since the statutory safeguard clause prevents an actual reduction of pension payments. In view of the low level of reserves, financial gaps are to be expected in the fourth quarter; these will have to be covered by liquidity assistance from the Federal Government. At the end of the year, the reserves will fall far short of the statutory minimum of 0.2 month's expenditure.

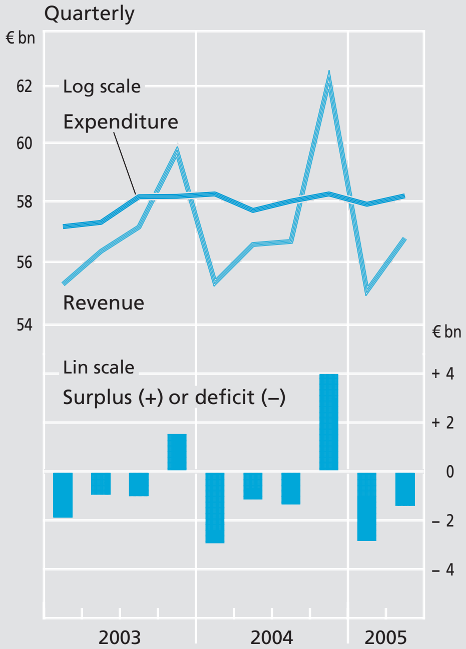
Measures to prevent a rise in the contribution rate next year

In order, in particular, to avoid the resultant need to raise the contribution rate to the statutory pension insurance scheme on 1 January 2006, the deadlines for transferring social contributions have been shortened by half a month. In future the payments are to be made in the same month for which the wages are paid and not, as is now the case, in the subsequent month. This means that next year contributions for almost 13 months will be recorded.[4] The increase in the contribution rate from 19.5% to 20.0% which would probably otherwise have been necessary would have generated additional revenue from contributions to the statutory pension insurance scheme of almost €4½ billion per year. By contrast, bringing forward the contribution transfer deadline should yield a one-off revenue windfall of just over €9½ billion;[5] across all branches of the social security system this equates to €20 billion worth of additional revenue. Assuming that the spending level of the statutory pension insurance scheme remains unchanged, this will burden most employers with additional financing

3 The presumed contribution to a supplementary private pension scheme factors the assumed rising burden of contribution payers for contributions to their private old-age provision under the Riester pension reform into the pension adjustment formula. It rises from 0.5% in 2002 in 0.5 percentage point increments to 4.0% from 2009 onwards, resulting in a reduction in the pension increase of around 0.6 percentage point in each subsequent year.
4 The draft "Act Amending the Fourth and Sixth Books of the Social Security Code" mentions additional revenue of up to 80% of the monthly contribution payments.
5 In the national accounts no additional revenue will be recorded since they are based on accrual accounting. This also means that the general government deficit as defined in the national accounts will increase by the amount of the additional revenue which would have been collected if the contribution rate had been raised.

Finances of the German statutory pension insurance scheme

Quarterly



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costs. By contrast, the initially lower contribution rates will benefit employees and central government (via the Federal grant, which is pegged to the contribution rate) as well as those employers not affected by the changed payment deadline (mainly the public sector).

Federal Employment Agency showing far lower deficit in second quarter

The Federal Employment Agency recorded a deficit of €½ billion in the second quarter, which was €1½ billion lower than in the same period of last year. While revenue grew by 10½%, expenditure declined by just under 2%. Revenue from contributions, which rose by less than ½%, barely influenced this unusually favourable outcome. The key factor was that central government has been refunding administration costs, in particular, since the end of 2004 as part of the latest labour market reform, and these refunds amounted to over €1 billion in the second quarter alone. On the expenditure side, 5% less was needed for unemployment benefit. The decline in the number of recipients, a trend which has been observed for some time, is likely to have continued. With the increasing entrenchment of unemployment, the number of recipients of unemployment benefit has tended to fall while the number of recipients of unemployment benefit II has increased. In addition, further savings were made in respect of active labour market policy measures (-28½%). To a considerable extent, however, these changes mask a reallocation of expenditure to the detriment of the Federal budget, offset by the compensatory amount paid by the Federal Employment Agency. These payments to central government were, however, considerably lower in the second quarter (€1 billion) and in the first half of 2005 (€2½ billion) than would have been expected in the light of the budgeted figure for the whole of 2005 (€6½ billion). Furthermore, in June central government refunded a lump-sum of just over €½ billion to the Federal Employment Agency for outlays relating to benefits granted to recipients of unemployment benefit II. It was originally intended that this amount would be paid over the year in equal monthly instalments.

Deterioration expected in the second half of 2005

The relatively favourable year-on-year financial development in the second quarter cannot be extrapolated for 2005 as a whole, not least because the compensatory amount may increase during the course of the year. Moreover, the Federal Employment Agency must anticipate lower refunds from the Federal Government in the second half of 2005. A sharp rise in revenue from contributions is not to be expected either. By contrast, no Federal grant should be necessary to offset a deficit in 2006 thanks, above all, to the shortened deadline for transferring social security contributions.

Statutory health insurance scheme with lower surplus

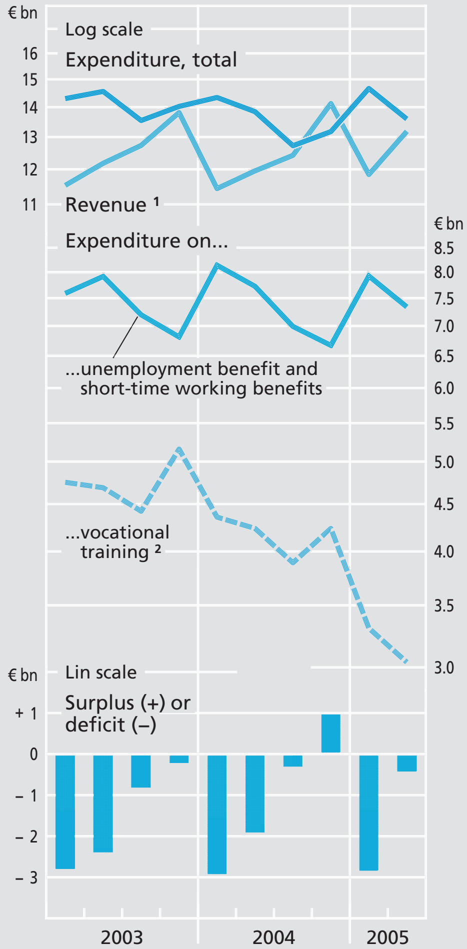
The statutory health insurance institutions were close to balance in the first quarter (more recent data are not yet available) after achieving a surplus of just over €1 billion in 2004. However, the first quarter of 2004 was exceptionally favourable as some outlays were advanced to the last quarter of 2003 in anticipation of the healthcare system reform which came into force on 1 January 2004. Revenue declined by ½% owing to the weak development of contributions. Expenditure grew again by just under 2½% after recording sharp falls last year. As expected, the increase in spending on pharmaceuticals was particularly steep (+18½%), since both a price moratorium and a temporary rise in manufacturers' discounts expired at the end of 2004. By contrast, there was a significant decrease in denture costs (-16%). The switch from percentage-based subsidies to fixed subsidies for dentures at the beginning of 2005 is likely to have contributed to this dampening effect.

Limited scope to lower contribution rate

In 2005 as a whole, despite the increase in the new government grant (which was not yet received in the first quarter) from €1.0 billion to €2.5 billion, a much smaller surplus is expected than that recorded in 2004 (€4 billion). There is therefore likely to be only little leeway for lowering contribution rates during the year.[6] The health insurance institutions have to generate a surplus so that they can fulfil their statutory commitment to redeem their accumulated debts.

Finances of the
Federal Employment Agency

Quarterly



1 Excluding Federal Government liquidity assistance. — **2** Including job creation measures, excluding compensatory amount to central government.

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6 With the introduction of a special contribution of 0.9%, which is paid solely by members, on 1 July 2005, most institutions simultaneously reduced the general contribution rate by the same amount. For the health insurance institutions, the associated rebalancing of the financing burden will thus have virtually no effect on their revenue.

General government budget trends

Reference values will probably be breached again in 2005

The financial position of general government is likely to improve very little this year. Although the general government deficit ratio (as defined in the national accounts) might be somewhat lower than last year's figure of 3.7%,[7] it seems unlikely from the present perspective that the reference value of 3% will be achieved or undershot. By contrast, the general government debt ratio will probably rise again sharply after the reference value was already overshot clearly in 2004 when it reached 66.1%. Whereas the cyclically induced part of the general government deficit is likely to go up again, other temporary factors may afford a certain relief. In addition to the grant repayments from Landesbanks to state governments, the Federal Government is also anticipating relief from the sale of claims of the Post Office pension fund on the successor enterprises to the old Deutsche Post.

Revenue will probably go down again in relation to GDP. The main reason for this is the fact that income tax rates were lowered again at the beginning of the year. Furthermore, the measurement base for social security contributions, wage tax and excise taxes is expected to grow comparatively sluggishly. The expenditure ratio is also likely to be lower than in 2004. According to the Federal Government's budget plans, expenditure on old-age provision is actually expected to decline, particularly as the Post Office pension fund will no longer require grants thanks to the sale of claims. Furthermore, expenditure on personnel may be kept at roughly the same level as in 2004. Interest expenditure is also likely to increase only slightly.

Development in the coming years uncertain

The development of public finances in the coming years is subject to great uncertainty and depends to a large degree on the fiscal policy decisions taken after the German parliamentary elections. Without any new measures, the deficit ratio could fall if the fairly muted expenditure policy of the past few years is maintained. On balance, however, there is a large risk that the 3% ceiling will be breached again. Thus in its recently published medium-term financial planning, the Federal Government assumes that the deficit ceiling will be breached in both 2005 and 2006. For 2007 it projects a marked reduction in the deficit ratio and a significant undershooting of the 3% ceiling. In order to achieve compliance with the national constitutional borrowing limit, the plans are based on the assumption of major structural consolidation in the Federal budget. The exhausted options of privatisation proceeds and other financial transactions (which lower the deficit according to the budgetary definition but not as defined in the national accounts, which is relevant at the European level) are to be replaced by structural consolidation measures. These have, however, not yet been specified.

Constitutional borrowing ceilings need to be heeded

The medium-term financial planning of central and state government shows a radical

7 Under the European budgetary surveillance procedure, GDP excluding financial intermedation services indirectly measured (FISIM) is still being used as the basis for calculating the deficit and debt ratios for the current year. Accordingly, the ratios cited here are higher than those calculated based on April 2005 GDP figures published by the Federal Statistical Office (deficit ratio 3.7% instead of 3.6%; debt ratio 66.1% instead of 65.1%).

need for consolidation. Given the relatively low level of investment expenditure, it is actually far harder to achieve structural compliance with the limits set by national budgetary law than it is to meet the 3% European reference value for the deficit ratio. Since compliance with the constitutional provisions is a mandatory requirement, this means that comprehensive and timely structural consolidation is imperative. The objective of balanced budgets as stipulated in the Budget Principles Act and also enshrined in the Stability and Growth Pact is currently a long way from being achieved.

Compliance with the 3% ceiling required by 2006 at the latest

At the European level, Germany (like France) reaffirmed in January 2005 its pledge to the ECOFIN Council to take all necessary measures to bring the general government deficit below 3% of GDP in 2005 and to keep it below the ceiling in 2006. As this objective now seems unlikely to be achieved in 2005, the European Commission has already indicated that it will review the excessive deficit procedure against Germany in autumn. Although the amended Stability and Growth Pact allows the deadline to be extended under certain conditions without escalating the excessive deficit procedure, it is questionable whether a significant breaching of the reference value is justified in Germany's case. Even if the next stage of the deficit procedure is triggered and Germany is given notice to take remedial measures, the deadline might still be extended. However, if the Pact is interpreted appropriately, the excessive deficit should – from the present perspective – be corrected by next year at the latest. It should also be noted that speedy consolidation is not an end in itself, but is urgently needed in order to widen fiscal policymakers' constrained radius of action and to avoid imposing an additional burden of high government debt on future generations, who will already have to bear a heavier load ensuing from demographic changes.