Public finances

General government budget

Situation remains extremely tense

The state of public finances in Germany has remained extremely tense in 2005. The general government deficit ratio is likely to be similar to that of 2004 (3.7%), thus exceeding the 3% deficit limit for the fourth year in succession. From today's vantage point, the economic situation will place an even greater strain on government budgets than it did last year. If the sale of claims of the Post Office pension fund is not recorded in a way that effects a reduction in deficits as defined in the national accounts, one-off and temporary effects will have hardly any bearing on the general government deficit. However, at present there is still controversy over the recording of this transaction. On balance, the structural deficit ratio (ie the deficit ratio adjusted for cyclical and other temporary effects) will remain largely unchanged this year. General government debt, which at year-end 2004 amounted to as much as 66.4% of GDP in the definition for the European budgetary surveillance procedure, will continue to increase sharply.[1]

Little change in revenue and expenditure ratios

Government revenue in relation to GDP looks likely to remain largely unchanged. Although the last stage of the tax reform, which came into effect at the beginning of the year, has once again resulted in shortfalls in income tax

1 Under the European budgetary surveillance procedure, this year the basis for calculating the deficit and debt ratios is still GDP excluding financial intermediation services indirectly measured (FISIM). Accordingly, the ratios cited here are higher than those calculated on the basis of the GDP figures for August 2005 published by the Federal Statistical Office (2004: deficit ratio in both cases 3.7% due to rounding; debt ratio 66.4% instead of 65.5%).

receipts and the bases for social security contributions, wage tax and excise taxes are growing only sluggishly, there has been a strong increase in revenue from profit-related taxes. Furthermore, additional revenue is being raised from the recently introduced motorway tolls for heavy goods vehicles as well as subsidy repayments by Landesbanken.

As far as expenditure is concerned, on the one hand, there has been only a relatively moderate rise in compensation of employees and spending on old-age provision. Moreover, despite rapidly growing government debt, the rise in interest payments is still very subdued owing to favourable financing conditions. On the other hand, transfers to the EU budget and health care expenditure are likely to rise markedly again, and labour market-related spending, in particular, looks set to go up sharply. This is due not only to labour market developments but also to the fact that, contrary to original expectations, the Hartz IV reform package has obviously led to higher government expenditure owing to the increased number of recipients, which was largely the result of the new regulations themselves. However, it remains difficult to assess the overall effect of labour-market reforms owing to the uncertainty surrounding the data. Additional expenditure at central government level is likely to be offset at least in part by lower spending at other levels of government, in particular local government.

A moderate reduction in the general government deficit would have been expected next year even without the consolidation measures agreed upon in the coalition deal. On the basis of current legislation, the overall tax ratio in 2006 would have stabilised further vis-à-vis this year, not least because unlike in preceding years no further tax reductions had been planned. Nevertheless, the total revenue ratio would have declined somewhat, since the base for social security contributions, in particular, is likely to have continued to grow sluggishly as it did in previous years. By bringing forward the transfer deadline for social security contributions the Federal Government avoided raising the contribution rate to the statutory pension insurance scheme (or other consolidation measures) that would otherwise have been necessary. However, since this transaction does not affect the general government deficit as defined in the national accounts, the deficit will be correspondingly higher. With regard to expenditure, compensation of employees is expected to decrease in absolute terms on account of moderate wage increases and further staff cuts in the public sector. Favourable financing conditions and the likely freeze in pension payments will provide additional relief.

In 2006, moderate deficit reduction in the absence of further measures

Additional measures required for compliance with national and European budgetary rules

Nevertheless, both national and European fiscal rules call for a more ambitious deficit reduction. Many state governments will find it difficult to comply with the constitutional borrowing ceilings in 2006, too. The 3% ceiling for the general government deficit ratio laid down in the EC Treaty also risks being breached once again, unless additional consolidation measures are taken. Having already been extended by one year, the deadline for correcting the excessive deficit expires this year, however. Under the relaxed rules of the Stability and Growth Pact, a lower than expected macroeconomic outcome might be taken into account when deciding whether to proceed to the next stages of the excessive deficit procedure if the reference value is breached in 2005. Nevertheless, this should be allowed to justify only a limited breach, if at all. At least if this year's deficit ratio were to overshoot the 3% ceiling by a significant margin yet again, a stricter application of the excessive deficit procedure would be warranted. This is the only way to prevent precedents from being set so soon after the adoption of the changes to the Pact which would enable deficit ceilings to be breached over many years without any serious consequences. The deficit ratio ought to be brought down below the reference value as early as next year. This general government task needs to be tackled by central, state, local government and the social security funds alike.

Coalition parties arrive at an agreement

In their coalition agreement, the new governing parties, the Christian Democratic Union (CDU), the Christian Social Union (CSU) and the Social Democratic Party (SPD), approved substantial fiscal policy measures for the new parliamentary term (see box on p. 51). Bearing in mind the critical state of public finances, the fundamental aim of the coalition agreement, ie fiscal consolation, is to be welcomed. A move towards reforming the federal structure, raising the retirement age and the planned reduction in subsidies are important steps in the right direction. The same holds true for cutting contribution rates to the Federal Employment Agency, a move to be financed at least partly through previously agreed reductions in expenditure. On the whole, however, the fiscal policy strategy embedded in the coalition agreement should be regarded with considerable reservation.

Insufficient consolidation in 2006 and ...

For example, the scope of the consolidation planned for 2006 is insufficient. It is true that, if the announced measures are implemented, in 2007 the general government deficit ratio will probably return to well below the ceiling set in the EC Treaty and a significant deficit reduction will be achieved. However, in 2006 national and European budgetary rules will be violated, thus further undermining their credibility. It is highly problematic that central government's net borrowing is set to increase next year, considerably exceeding the constitutional limit. The provisions of the Stability and Growth Pact will not be complied with, either, as the structural consolidation is likely to fall short of the prescribed target of at least 0.5% of GDP in 2006. On balance, the recently approved measures will probably have hardly any effect on the general government deficit in 2006. This means that the 3% ceiling for the deficit ratio is likely to be breached once again. As things stand today, cyclical conditions would not have prevented a more even spread of consolidation measures, enabling distinct progress to be achieved as early as next year.

... altogether very much focused on the revenue side

On balance, the consolidation efforts entail few real expenditure cuts. Admittedly, the tax base will be broadened by reducing tax exemptions, in particular. However, a broader-based approach would have been feasible here, even though the objective of financing a fundamental reform of income tax by reducing tax exemptions should not be relinquished. Moreover, the beneficial effects are

Key fiscal policy elements of the coalition deal

In their coalition deal presented on 12 November 2005, the new governing parties agreed upon numerous fiscal policy measures and some fundamental reforms to be implemented in the coming parliamentary term. The most far-reaching consolidation measures will not enter into force until 2007. The following list outlines the key fiscal policy elements for general government.

Several deficit-reducing measures are envisaged over the next two years.

- Introduction of a general right to demand that parents of recipients of unemployment benefit II aged 25 or under provide financial support for their offspring and restrictions on the financing of a flat for young people leaving home.
- Efficiency gains through improvements in the administrative processes and organisational structures of Hartz IV.
- Reductions in central government administration costs.
- Cuts in individual subsidy payments at the central government level.
- Cuts in the statutory health insurance scheme's expenditure on pharmaceuticals (compulsory discount to be granted by pharmaceuticals manufacturers plus price moratorium, limited to two years).
- Raising the standard rate of VAT by 3 percentage points to 19% from 2007.
- Reduction in tax subsidies, providing relief of €4 billion for central government in 2007, a figure which will increase in subsequent years (measures include the abolition of the grant to home buyers from 2006, abolition of the mineral oil tax exemption for biofuel, tightening of the loss-offset facility for special tax-saving mutual funds, restrictions on the standard travel allowance for commuters).
- Raising the top income tax rate from 42% to 45% as of 2007 for individuals earning more than €250,000 and married couples earning more than €500,000 (not applicable to trade income).
- New arrangements for the taxation of investment income and private capital gains.
- Review of active labour-market policy.
- Acceptance of a significant rise in the contribution rate to the statutory pension insurance scheme to an estimated 19.9% from 2007 in order to offset a cut in central government payments. For the same reason, contribution rates to the statutory health insurance scheme might rise, too.
- Intensifying measures aimed at combating turnover tax fraud.

By contrast, the following increases in expenditure or shortfalls in revenue will place increased burden on the budget.

- Additional infrastructural measures.
- Dynamic adjustment of benefits paid out by the long-term care insurance scheme.
- Introduction of an income-related parental benefit.
- Increase in declining-balance depreciation rates on capital goods (to expire at the end of 2007).
- More preferential treatment given to transfers of ownership of businesses with regard to inheritance tax (to take effect by 2007 at the latest).
- Introduction and/or extension of tax relief measures for households' expenditure on household services, home maintenance and modernisation, and childcare.
- Lowering the contribution rate to the Federal Employment Agency by 2 percentage points to 4.5% as of 2007.
- Continuation of investment grants.

In the longer term, the burden on the budget will be eased by the fact that the statutory retirement age will be raised by one month per year from 2012 onwards up to the age of 67. However, individuals who have paid in compulsory contributions for 45 years will still be entitled to claim a full pension at the age of 65. Moreover, the sustainability factor in the pension adjustment formula is to be applied retroactively if it failed to curtail the pension adjustment in years of weak wage growth. The pension reform provisions are to be applied with the same effect to civil service pensions. In the case of children born in 2008 or after, child-rearing periods (during which the parent is out of the labour market) are to be given more preferential treatment in the form of increased subsidies granted under the Riester pension plan.

The coalition parties also announced more fundamental reforms for the new parliamentary term. In addition to the reform of the federalist structure, the details of which have already been worked out to a large extent, but which is still to be complemented by a further reorganisation of the financial constitution, these will primarily concern the statutory health insurance institutions, income and corporate taxation, and measures aimed at improving incentives for taking up low-paid work.

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watered down by the creation of new tax exemptions elsewhere. The greatest degree of consolidation is to be accomplished through higher tax rates, which is not conducive to longer-term conditions for growth and employment.

Medium-term objective should be to balance the budget by lowering government expenditure ratio

This consolidation package should be seen as a first step towards a radical consolidation of public finances. For the medium term, the Stability and Growth Pact prescribes an annual reduction in the structural general government deficit of, on average, at least 0.5% of GDP (currently around €11 billion) until a close-to-balance structural budgetary position is reached. Furthermore, the general government debt ratio is to be brought swiftly down below the 60% threshold. Therefore it is vital to implement further sustainable cuts in government spending in the medium term. The government must not lose sight of the goal of reducing the government expenditure ratio in order to achieve the objective of a balanced budget and lower the tax burden.

Fiscal reform must remain on the agenda

The coalition agreement envisages fundamental fiscal reforms in key areas for the coming parliamentary term. These include, in particular, income and corporate taxation, the statutory health insurance scheme, the financial constitution and increased incentives to take up low-paid employment. There is scope here for significantly improving the underlying fiscal policy setting. This will hinge upon strengthening individual responsibility and competition, improving incentive structures and enhancing system transparency. This will also entail tax cuts (while broadening tax bases further) and an intensified application of the equivalence principle for the social security funds.

Budgetary development of central, state and local government

Tax revenue

Marked increase in tax revenue in the third quarter

Tax revenue[2] of central, state and local government was almost 3% up on the year in the third quarter of 2005. This was mainly attributable to larger receipts from assessed taxes and turnover tax, which more than offset the decline in wage tax revenue primarily brought about by the tax cuts at the start of the year. The positive result with regard to assessed taxes reflects, not least, the favourable trend in profits. Corporation tax revenue was up by €1 billion. Cash receipts from assessed income tax increased (+€1 billion) despite the tax rate cut, reflecting both a lower figure for gross receipts from the previous year and a continued reduction in rebates to employees. As regards indirect taxes, receipts from turnover tax – which tend to fluctuate considerably during the course of the year – rose sharply, up just under 4%, after they had remained unchanged on the year during the first six months of 2005. The decline in mineral oil tax receipts, which is to be seen in connection with consumers' reaction to high energy prices, was – at 2% – less pronounced than in the preceding quarters. Following the tobacco tax increase, receipts from this tax

2 According to the budgetary definition. Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the third quarter.

surged by 13½% despite a continued decline in sales of taxed cigarettes.

Tax estimate for 2005 revised upwards

According to the new official tax estimate from November 2005, tax revenue (including receipts from local government taxes) is expected to rise by 1.1% for the whole of 2005. Adjusted for the changes in tax legislation which have since been adopted, this figure exceeds previous expectations by €3 billion despite the slight deterioration in the growth outlook.[3] On the one hand, projections for all profit-related taxes (€2½ billion), for wage tax (just under €1 billion) and turnover tax (€½ billion) were revised upwards on account of their relatively favourable development so far this year. On the other hand, significant shortfalls are expected with regard to mineral oil tax revenue (-€1 billion), in particular. The overall tax ratio, as defined in the government financial statistics, would then remain unchanged at 20%.

Upward adjustment of revenue expectations for 2006, too

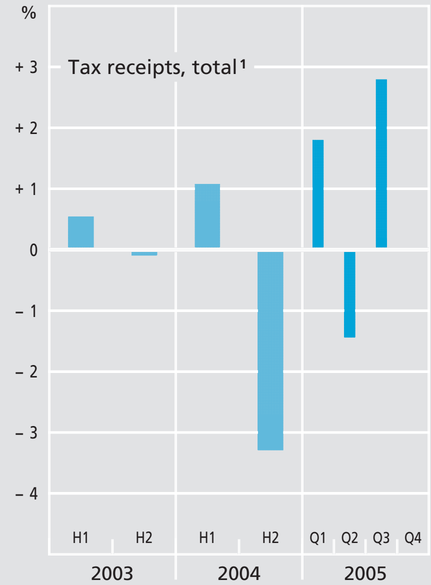
Revenue expectations for 2006 were raised, too (€1¼ billion, adjusted for recent amendments in tax legislation). However, the base effect resulting from the revision of estimates for 2005 is counterbalanced by the fact that the projected development in the underlying macroeconomic bases for tax receipts has deteriorated vis-à-vis last May's estimate. This would result in a net rise of 2.1% in tax revenue with the tax ratio remaining largely unchanged.

Coalition deal aims for significant rise in revenue from 2007

These data do not take account of the agreements reached in the new coalition deal. Next year, the effects of revenue-increasing and revenue-decreasing measures could more or less offset each other. From 2007, revenue will be further boosted, not only by the 3 percentage point rise in the standard VAT rate to 19%, but also by various measures aimed at broadening the bases for direct taxes, and by cuts in tax subsidies. This growth in receipts will, however, be curbed by tax concessions aimed at promoting investment and employment (ie temporary improvement in depreciation conditions for capital goods and tax reductions granted for households' expenditure on household services including home maintenance and modernisation by craftsmen). Nevertheless, the measures agreed upon will

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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3 The Federal Government is now projecting nominal GDP growth of 1.3% and real GDP growth of 0.8% for this year whereas in May growth rates of 1.6% and 1% respectively were anticipated. The projected figures for 2006 are 1.8% (nominal) and 1.2% (real) GDP growth, compared with 2.4% and 1.6%, respectively, in the May estimate.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion Q1 to Q3 2004	2005	Annual percentage change
Wage tax	88.4	85.1	– 3.8
Assessed income tax	0.4	3.7	.
Corporation tax	9.4	10.9	+ 16.3
Turnover tax	101.9	103.2	+ 1.3
	of which Q3		
Wage tax	29.4	28.2	– 4.1
Assessed income tax	3.1	4.2	+ 31.8
Corporation tax	2.7	3.8	+ 38.7
Turnover tax	34.0	35.3	+ 3.8

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result in a marked rise in the tax ratio and – even if the planned cut in the contributions to the Federal Employment Agency is taken into account – in the ratio of total taxes and social security contributions from 2007 onwards.

Central government budget

Central government budget characterised by temporary surge in receipts in the third quarter

In the third quarter of 2005, central government recorded a deficit of €4½ billion, a decrease of €8½ billion on the year. This was due mainly to an unusually sharp rise in receipts by just over €10 billion (+18%). Tax revenue was up by €2½ billion (+4½%) on the year. Growth in other receipts, however, was much higher. Loan repayments from foreign borrowers alone increased by €5 billion. Proceeds from asset disposals rose, too, by €1 billion to €5½ billion. Other significant revenue increases stemmed from the compensatory amount from the Federal Employment Agency introduced earlier in the year, as well as from the motorway tolls for heavy goods vehicles. Although expenditure rose, too, owing to considerable outflows of funds in connection with the Hartz IV reform and to the fact that the Federal grant to the statutory pension insurance scheme had been brought forward and disbursed in September, at 3% this increase fell far short of the rise in receipts.

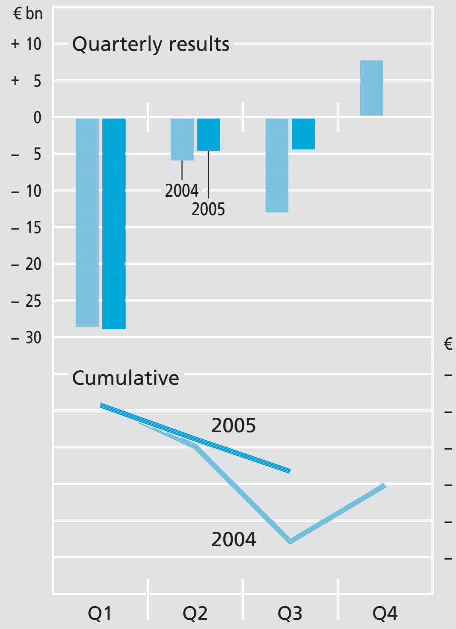
In 2005 as a whole, new borrowing will clearly exceed previous plans

According to estimates presented by the Federal Ministry of Finance in the middle of the year, the deficit estimate of just under €22½ billion envisaged in the Federal budget plan could be overshot by around €12 billion. The most recent tax estimate predicts additional revenue of €1 billion vis-à-vis the May estimate. However, compared with the budget plan, a tax revenue shortfall of more than €2 billion is still expected, due, not least, to the subdued development of central government taxes. Furthermore, the Bundesbank profit was just under €1½ billion less than envisaged. Moreover, the original target figure of just over €17 billion for receipts from the disposal of assets could be undershot. Considerable revenue increases resulting from loan repayments (Poland and Russia having redeemed considerable debt amounts), however, might largely compensate for the risks associated with privatisation proceeds. Expenditure is likely to rise considerably vis-à-vis the budgeted figures owing to the amalgamation of unemployment assistance and social assistance. In the first three quarters, the central government deficit amounted to slightly less than €38 billion. As a surplus is expected for the fourth quarter, however, it is likely to decrease somewhat by the end of the year.

2006 deficit well in excess of constitutional limit

During the next few months, the 2006 draft budget, which was presented to the Federal Cabinet in July and was still awaiting approval, will be revised. It originally foresaw a deficit of almost €22 billion. Asset disposals of just over €30 billion were planned in order to achieve formal compliance with the constitutional limit on new borrowing. Now, the intention is evidently to reduce this figure to around €15 billion. In the wake of the recent tax estimate, the budgeted figure for tax receipts needs to be revised only slightly, by just under €1 billion. On the expenditure side, a significant upward revision of the slightly more than €20 billion budgeted for unemployment benefit II looks likely despite envisaged relief measures amounting to €3 billion. Total net borrowing is now expected to amount to €41 billion. This figure exceeds the level of investment expenditure, which, pursuant to Article 115 of the Basic Law of the Federal Republic of Germany, defines the constitutional ceiling for new borrowing, by almost €20 billion. Given the underlying assumptions for real economic growth, there seems to be little scope for justifying such a move by invoking the exemption clause provided for in the Basic Law, which permits new borrowing to exceed the constitutional limit if this is necessary to avert a disruption to the overall economic equilibrium. This is particularly problematic in view of the fact that, despite the clear breach of the constitutional limit this year, a further increase in net borrowing is planned for 2005. In fact, a more rigorous fiscal consolidation at central government level would be warranted as early as next year.

Central government balance of revenue and expenditure in 2004 and 2005



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Deficit reduction in 2007 mainly through measures on the revenue side

In 2007, net borrowing is to be brought back below the constitutional limit pursuant to Article 115 of the Basic Law. The Federal Government's medium-term plans presented mid-year indicated a deficit of €22½ billion. Given the additional burdens arising from the Hartz IV reform package and the poorer assumptions for the macroeconomic outlook, the borrowing requirement has recently been estimated at as much as €35 billion, and this on the basis of extremely cautious extrapolations. Cuts in expenditure and additional structural receipts are intended to offset approximately €25 billion of that figure. However, measures on the expenditure side rely largely on shifting the burden towards the social security funds, where no savings are envisaged that might offset this. This means that contribution rates are bound to rise. Hence, an increase in the contribution rate to the statutory pension insurance scheme has already been announced for 2007. A cut in tax exemptions of slightly more than €4 billion is planned. Tax increases to the tune of €10 billion are intended to provide further budget relief.

Asset disposals envisaged for 2007, too

In 2007, in addition to structural measures, asset disposals worth €10 billion are to be employed to comply with the constitutional borrowing limit. The plan is evidently to sell off claims of the ERP special fund. Such a move, however, would require the liabilities of this special fund to be assumed as part of central government debt. This transaction would allow the constitutional borrowing limit to be complied with merely in formal terms, if at all. If the structural consolidation of the central government budget is to progress and the burden of taxes and social security contributions is to be lowered again in the future, during the next few years comprehensive cuts in spending are needed.

State government budgets

State government deficit increased in the third quarter

In the third quarter of 2005, state government recorded an aggregate deficit of €6½ billion. This is a year-on-year rise of €1½ billion. Although tax revenue increased slightly, total receipts lagged behind the corresponding level of 2004. By contrast, expenditure rose by 1% on balance, despite a slight decline in compensation of employees. However, this rise does not appear to reflect the recapitalisation of some Landesbanken which have been planned for this year following substantial subsidy repayments made at the turn of 2004/05 in line with a ruling by the European Union. Taking into account the major adjustments in the supplementary budgets of Schleswig-Holstein and North Rhine-Westphalia, in particular, budget plans now envisage a borrowing requirement of €27 billion, rather than the previously predicted deficit reduction from €25 billion (2004) to €23½ billion.

In 2006, many state governments will exceed statutory ceilings for new borrowing

Existing plans do not foresee a noticeable reduction in deficits for 2006, either. As has been the case this year, Lower Saxony, North Rhine-Westphalia and Schleswig-Holstein, which, before the new relief measures were agreed, had indicated that they would breach the regular borrowing ceilings for the entire forthcoming parliamentary term, are unlikely to be able to comply with the constitutional limits for net borrowing in 2006. The same applies to Berlin, Bremen, Hesse and Saarland, while other state governments will have recourse to substantial asset disposals to stay within the ceilings. Next year, too, most state governments in eastern Germany will find it almost impossible to demonstrate appropriate use of the special supplementary Federal grants as their net borrowing will not be sufficiently below the statutory ceiling. On the whole, the financial situation of state government is also extremely unsatisfactory. Although tax receipts are likely to rise perceptibly in 2007 on account of the measures foreseen in the coalition treaty, some states will probably continue to encounter problems in trying to observe the constitutional borrowing limits.

Local government budgets

Slight decline in local government deficits in the first half of 2005

For local government, results are currently available only for the first six months of 2005. By the end of that period, local government was able to cut down deficits by a total of €½ billion to just under €4 billion. Revenue rose by 2½%, with local government tax receipts increasing by 7%. By contrast, key grants from state government decreased by 5½%. Grants stemming from the Hartz IV reform package yielded additional local government receipts of almost €2 billion. Expenditure was up by slightly more than 1½%. However, fixed asset formation continued to decrease markedly (-8½%).

Increase in expenditure on social benefits

The rise in total spending was primarily attributable to an 8½% increase in expenditure on social benefits, which reflected the assumption of the costs for accommodation and heating for recipients of unemployment benefit II. A comparison of the increase in social payments by local government (which varies considerably between individual states) with reimbursements of a certain share in payments for accommodation and heating shows that by mid-2005 the pressure on local government budgets (excluding the city-states) had been eased by around €½ billion. Last year a formula was unanimously adopted by central and state government for calculations to examine the relief provided for local government budgets (under this formula, recipients of unemployment benefit II who did not previously receive social benefits under the Third Book of the Social Security Code (SGB III) are generally classified as former social assistance recipients and it is assumed that state government's savings expected to arise from the reforms will be passed on to local government). On this basis, the Federal Government's October audit report records savings of €6 billion at local government level (including city-states) for the whole of 2005. This figure includes the central government share in housing benefit payments.

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
2004	+ 72.3	+ 70.7	– 16.8	+ 66.8
of which				
Q1	+ 45.3	+ 34.6	+ 4.1	+ 26.6
Q2	+ 8.2	+ 14.6	– 9.6	+ 1.5
Q3	+ 17.6	+ 17.1	– 0.9	+ 24.4
Q4	+ 1.2	+ 4.4	– 10.4	+ 14.3
2005				
Q1	+ 26.7	+ 17.3	+ 7.5	+ 24.9
Q2	+ 8.2	+ 13.4	– 6.3	+ 27.3
Q3 pe	+ 15.4	+ 17.7	– 3.0	...

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

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Social security funds

Statutory pension insurance scheme

Statutory pension insurance scheme receives liquidity assistance

The deficit of the statutory pension insurance scheme amounted to €1 billion in the third quarter of 2005, which was €½ billion less than in the same period last year. This is due mainly to the fact that the payment of central government grants amounting to just under €1 billion had been brought forward to September. As the financial reserves had been used up earlier this year, this move had become necessary to maintain the pension insurance funds' ability to meet current payments. This alone effected an increase in receipts (+1½%). As a consequence, however, in the fourth quarter the seasonal surpluses will be significantly smaller since Federal grants will be reduced by a corresponding amount.

Low contribution receipts with moderate rise in spending

Revenue from contributions was ½% down on the year. The only increase stemmed from contributions transferred by the Federal Employment Agency. Although payments on behalf of recipients of unemployment benefit I and former unemployment assistance recipients decreased, this effect was more than compensated for by contributions introduced earlier this year especially with regard to former recipients of social assistance who now receive unemployment benefit II.[4] The rise in expenditure in the third quarter was moderate, at just over ½%. This was due, in part, to the relatively weak increase in the number of people drawing current pensions. Further relief was provided by the freeze in pension payments in the middle of the year. Moreover, the proportion of pensioners' health insurance contributions borne by the pension insurance funds declined. Since 1 July 2005, pensioners, like employees, have been paying a special contribution of 0.9% to the statutory health insurance scheme. Consequently, the general contribution rate to the health insurance scheme, which continues to be paid in equal parts by pensioners and pension insurance funds alike, has decreased.

Reserves largely exhausted

In 2005 as a whole, the deficit of the statutory pension insurance scheme will be more than twice the amount it was last year (€1½ billion). This rise is attributable not only to the negative trend in contributions but also, in particular, to the one-off revenue inflow of €2 billion from the disposal of shares in the GAGFAH housing company late in 2004. A sharp rise in the contribution rate for 2006 was avoided only by bringing forward the transfer deadline for social security contributions by half a month. Therefore, an increase in reserves is to be expected at the end of 2006, the amount of the reserves being used as a basis for determining the required contribution rate. Without the one-off measure mentioned above, there would be a significant deficit that could no longer be covered by drawing on reserves.

From 2007 additional burden on contribution payers arising from coalition deal

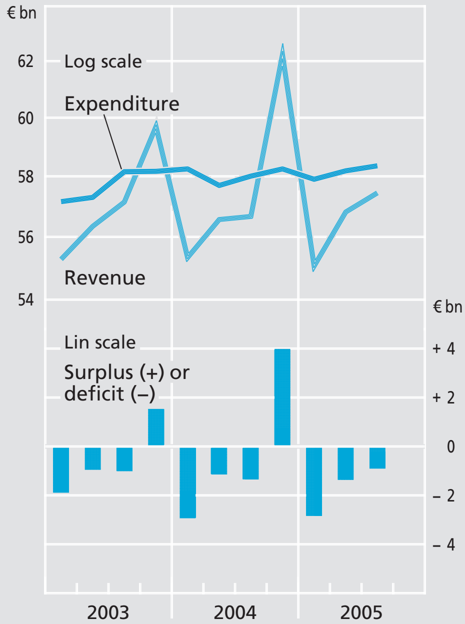
The measures outlined in the coalition deal will initially place additional burden on the statutory pension insurance scheme. In particular, the monthly contribution paid on behalf of recipients of unemployment benefit II is to be virtually halved from €78 to €40. In

4 The uniform contribution base for pension insurance contributions paid on behalf of recipients of unemployment benefit II is €400 per month.

2007, the contribution rate is likely to rise far more sharply than previously expected to 19.9%, partly owing to the lowering of the Federal grant. On the other hand, it has been agreed that over the medium term pension cuts that would have resulted from the application of the sustainability factor but were prevented by the pension-cutting constraint contained in the adjustment formula, will be retroactively implemented in years of stronger growth in wages and salaries. Furthermore, against the backdrop of rising life expectancy, the statutory retirement age is to be raised gradually from 65 to 67 years. The additional curbing of the rise in the contribution rate that this would have entailed, will, however, be largely offset by continuing to allow people who have paid in compulsory contributions for 45 years to claim a full pension at the age of 65. This effectively constitutes a breach of the equivalence principle and a new non-insurance-related benefit.

Finances of the German statutory pension insurance scheme

Quarterly



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Federal Employment Agency

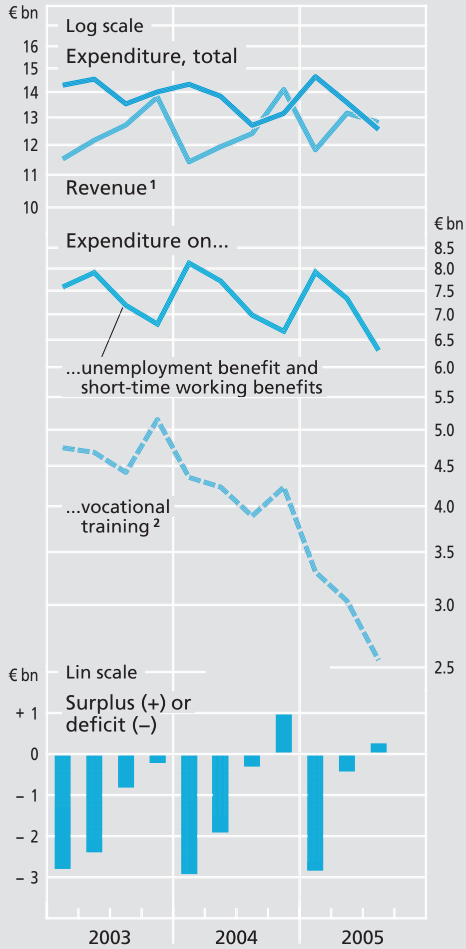
Improved annual outcome of the Federal Employment Agency

In the third quarter, the Federal Employment Agency recorded a slight surplus, following a small deficit during the same time last year. However, the rise of just under 3½% in receipts is attributable entirely to central government reimbursements of administrative costs incurred in connection with the supervision of unemployment benefit II recipients. By contrast, the continued slow growth in regular employment subject to social security contributions, in particular, was reflected in a decline of almost 1% in contribution receipts. Expenditure was down by just over 1% on balance. This was partly due to an accelerated reduction of 10% in spending on unemployment benefit I owing to the decreasing number of recipients mainly as a result of the increase in long-term unemployment. Another factor was the continued sharp decline in spending on active labour market policies (-34½%). This is, however, counterbalanced by the compensatory amount to be paid to central government for individuals changing from unemployment benefit I to the new benefit.[5] Administrative costs rose due to additional requirements created by the recent labour market reform. However, net of the re-

5 In the first three quarters of the year, at €3.8 billion, the compensatory amount markedly undershot the target figure of €6.7 billion for the whole of 2005. This is attributable to the lower than expected number of individuals switching from unemployment benefit I to the new benefit, due in many cases to their available means exceeding the limit for entitlement.

Finances of the Federal Employment Agency

Quarterly



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

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spective central government refunds, they are still perceptibly lower than in 2004.

Need for grants likely to be lower than budgeted figure

Following a deficit of €3 billion in the period between January and September, a significant undershooting of the budgeted figure for the Federal grant (€4 billion) now looks likely for the whole of 2005. Subdued growth in revenue from contributions has been accompanied by an even greater reduction in expenditure, particularly with respect to active labour market policies, whose effectiveness is questionable. Next year the bringing forward of the transfer deadline for social security contributions will have a positive one-off effect on receipts of the Federal Employment Agency, too. Therefore a surplus may even be expected.

Coalition plans significant reduction in contribution rate in 2007

The coalition parties have agreed to scrutinise all active labour market policies and to reduce the range of the different measures on offer. In particular, promotion of one-person businesses ("Me plcs") is to expire from mid-2006. At the start of 2007, the contribution rate is to be cut by 2 percentage points to 4.5%. One percentage point of this reduction may largely be achieved by drawing on the surplus expected for 2006. Also, the first substantial savings resulting from the cut in the maximum period of entitlement to unemployment benefit to 12 months (or 18 months in the case of individuals over the age of 55) and the reduction in active labour market policies may serve to finance that move. The second percentage point will involve further funds from central government, which will dedicate around one-third of the additional receipts expected from the rise in the VAT standard rate to 19% to this purpose.

Statutory health and long-term care insurance schemes

Lower surplus of statutory health insurance scheme

Financial data for the statutory health and long-term care insurance schemes are currently available for the first six months of the year. According to these data, the health insurance institutions generated a surplus of slightly more than €1 billion during the first half of the year. This was a decline of just under €1½ billion on the year despite a rise of almost €1 billion in the first instalment of the new Federal grant which was financed by the increase in tobacco tax.[6] Contribution receipts remained unchanged from their level in 2004. Weak growth in wages and salaries (against the backdrop of largely unchanged contribution rates) was offset by higher contributions paid on behalf of recipients of unemployment benefit II. Previously, lower contributions had been paid for recipients of unemployment assistance while no contributions at all had been paid for social assistance recipients with no earnings subject to compulsory insurance. These additional receipts, however, must be seen in the context of extra spending on former social assistance recipients able to work, whose costs in the event of illness had previously been borne by local government. Overall, revenue rose by 1% in the first half of the year. The 3% rise in total expenditure was driven mainly by additional spending on pharmaceuticals (+20%). The higher discount on pharmaceuticals granted by manufacturers for one year and the price moratorium both expired at the end of 2004, the effect of which far outweighed that of the extension of the price regulation for pharmaceuticals. On the whole, the beneficial effect of last year's health system reform on the financial outcome of the statutory health insurance scheme has already begun to unwind. Thus, a far smaller surplus is to be expected for 2005 as a whole vis-à-vis last year (€4 billion).

Fundamental financial reform has been postponed

The coalition parties agreed to postpone any fundamental restructuring of the way in which the statutory health insurance scheme is financed. Next year, the financial pressure is to be eased by the introduction of a 5% compulsory discount to be granted by pharmaceuticals manufacturers on generic drugs for a period of two years. Moreover, a general price moratorium for pharmaceuticals has been announced for this period, too. By contrast, the Federal grant (€4.2 billion in 2006) to the health insurance scheme to cover non-insurance-related benefits, which was introduced in 2004, is to be reduced from 2007. This will increase pressure to raise contribution rates.

Lower deficit of statutory long-term care insurance scheme

The deficit of the statutory long-term care insurance scheme declined slightly in the first six months of the year. This was attributable mainly to the new additional contribution payable by childless persons. Also, as in the case of the health insurance scheme, extra receipts flowed in with regard to unemployment benefit II recipients, which were still virtually unaccompanied by any additional expenditure. On the expenditure side, the trend towards substituting financial benefits by benefits in kind, which has been observed for a long time, continued. In 2005 as a whole, the deficit is likely to be smaller than last year, when it amounted to just under €1 billion. However, this will only slow down rather than halt the erosion of the reserves.

6 The Federal grant for non-insurance-related benefits rises from €1 billion in 2004 to €2.5 billion in 2005 and eventually to €4.2 billion in 2006.

Dynamic adjustment of benefits accelerates depletion of reserves

The coalition parties have agreed on a dynamic adjustment of the rate of the long-term care insurance scheme benefit, which has remained unchanged since the scheme was introduced in 1995. This will accelerate the depletion of reserves, requiring the contribution rate to be raised earlier than expected. It has not yet been decided to what extent private long-term care insurance funds offering the same range of services will be called upon to pay a grant towards the statutory scheme.