

Public finances

General government budget

The public finances situation is likely to improve somewhat this year. As things now stand, the general government deficit ratio, which amounted to 3.3% in 2005, will decrease to below the 3% ceiling if the government pursues a moderate spending policy. However, this decrease can be attributed mainly to the favourable economic climate. The general government debt ratio is likely to exceed last year's figure of 67.7%, thereby moving further away from the reference value (60%).

Deficit ratio likely to be below 3% limit for 2006

The general government revenue ratio (as defined in the national accounts) is expected to remain stable at almost the same level as in 2005. The social contributions will presumably increase only slightly as a result of moderate growth in gross wages and salaries, and non-tax revenue will actually decrease in absolute terms. However, there is some indication that tax revenue will experience much stronger growth than the nominal gross domestic product (GDP) and that this will cause the tax ratio to increase considerably. The key factor here is not the fiscal measures that, on balance, have a rather neutral effect but the favourable economic climate and the particularly strong growth in profit-related taxes. The expenditure side of the general government budget is also benefiting from the favourable economic climate. In addition, the moderate growth in expenditure on old-age provision and the expected decline in personnel expenditure should help to reduce the expenditure ratio overall, although additional

Revenue ratio expected to remain almost constant ...

... and expenditure ratio to decrease

Developments in the government revenue and expenditure ratio up to 2007

In its Implementation Report to the European Commission, the Federal Government predicts that by the end of 2007 the general government deficit ratio in Germany will have fallen from 3.3 % in 2005 to 2½%.¹ A slight decline in the revenue ratio will be accompanied by a sharper reduction in the expenditure ratio. The economic research institutes' joint assessment from the second quarter of this year presents a similar picture, assuming an even sharper decline in the expenditure and the deficit ratio.

At first glance, this finding appears to contradict the observation that the new Federal Government's consolidation measures – especially in the period under review – primarily concern the revenue side, mainly tax and social security rates.² However, the apparent contradiction disappears when it is remembered that, although rises in tax rates push up the revenue ratio, it is not only current fiscal policy decisions, such as the Growth and Employment Promotion Programme and the new Federal Government's consolidation package, which influence the development of the general government revenue and expenditure ratio. Rather, decisions taken in the past, such as the shortening of the maximum period of entitlement to unemployment benefit I and the reduction of the grant to new home buyers starting in 2004, also have an impact. Moreover, the general structure of the tax and transfer system, for example, the modalities for adjusting social benefits or the progressive effect of the tax system (fiscal drag), may also lead to changes in the revenue and expenditure ratio even without discretionary measures. Finally, cyclical movements and longer-term macroeconomic trends as well as demographic changes have a perceptible impact on the ratio of government income and expenditure to GDP.

Revenue ratio developments³

Fiscal policy measures and fiscal drag

On the revenue side, discretionary fiscal policy measures in 2006 and 2007 would – when viewed in isolation – lead to a total increase of roughly ¾ percentage point in the revenue

ratio. This is due almost entirely to measures by the new Federal Government, in particular, the increase in the standard rate of VAT and insurance tax by 3 percentage points, which will be offset only partly by the reduction in the contribution rate to the Federal Employment Agency. In addition, the structure of the tax and social security system, especially the progressive income tax scale, will lead to a slight increase in the ratio (fiscal drag).

Development in macroeconomic assessment bases of major taxes and social security contributions weaker than nominal GDP

The factors mentioned above will, however, merely offset a decline in the revenue ratio which would otherwise be expected – mainly because highly “revenue-yielding” macroeconomic assessment bases will grow less strongly than nominal GDP. Taxes and statutory social security contributions are largely based on variables included in the national income. If, as is expected this year and next, national income grows more slowly than nominal GDP,⁴ the key macroeconomic basis for taxes and statutory contributions in relation to GDP will decline. The main reason why national income is lagging far behind nominal GDP growth is the increase in the standard rate of VAT by 3 percentage points in 2007, as VAT receipts are among those deducted from GDP to arrive at national income.

Changes in the distribution of national income also have a significant impact – as can be seen from the development of the wage ratio (measured as the share of employee compensation in national income). In fiscal terms, entrepreneurial and investment income is far less lucrative than compensation of employees⁵ mainly because of the burden of social security contributions on the latter.⁶ In 2006 and also in 2007, the decline in the wage ratio observed in recent years is likely to continue. However, it should be borne in mind that the functional distribution of income fluctuates with cyclical developments and, typically, the wage ratio falls during an upswing and rises during a downturn. Furthermore, sectoral shifts in value added and changes in the forms of employ-

¹ The Implementation Report for 2007 quotes rounded figures which make the analysis more difficult. The reason given is the uncertainties associated with projections. — ² The Implementation Report presents a somewhat different picture. This is partly because it also takes into account some expenditure measures from the preceding legislative period. — ³ On the analytical approach see: J Kremer, CR Braz, T Bro-sens, G Langenus, S Momigliano, M Spolander, A disaggregated framework for the analysis of structural developments in public finance, Re-

search Centre of the Deutsche Bundesbank, Discussion Paper Series 1, 05/2006; and Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pp 61-76. — ⁴ The ratio of national income to GDP declines when depreciation or taxes on production increase disproportionately or when subsidies grow more slowly than GDP. The ratio also declines when the balance from the income of non-residents in Germany and the income of residents abroad increases

ment are likely to curb the wage ratio. Moreover, given the continually rapid increase in the degree of openness, particularly in the German economy, it may be assumed that the trend towards the production of capital-intensive goods will increase and, as a result of this progressive specialisation, the wage ratio will fall.

As regards the use of GDP, it is particularly private consumption (before VAT and excise taxes) that is subject to taxes and social security contributions. This highly revenue-yielding assessment base could also grow more slowly than GDP.

Thus, overall, the macroeconomic reference variables of major taxes and social security contributions are likely to grow more slowly than nominal GDP in 2006 and 2007, thus curbing the revenue ratio.

Expenditure ratio developments

In the period under review, the new Federal Government's measures will, on balance, not have a significant impact on the expected decline in the general government expenditure ratio.⁷ By contrast, measures agreed before the formation of the new Government (such as cuts in unemployment benefit I) and the general structure of the transfer system will play a more extensive role – even though the impact is more difficult to quantify here than on the revenue side. For example, the pension adjustment formula – through the presumed contribution to a supplementary private pension scheme ("Riester reform steps") and the sustainability factor, among other things – are partly responsible for the fact that a positive pension adjustment is scarcely to be expected in 2007, either.

Finally, the shifts in the structure of GDP described above, in particular the expected moderate rise in gross wages and salaries, will almost automatically be reflected in lower expenditure growth rates. This applies, first of all, to personnel expenditure when parallel pay developments in the private and public sector are taken as the "normal line".⁸ In add-

disproportionately. — 5 As a rule, this also applies if gross wages and salaries, which constitute the macroeconomic assessment base for wage tax and social security contributions, are considered instead of compensation of employees. — 6 In addition, shifts within employee compensation at the expense of employment subject to social security contributions as witnessed in recent years should be taken into account. — 7 Pursuant to the Federal Government's Implementation Report, the expenditure ratio is expected to fall by roughly 1 per-

centage point, with an annual average rise in expenditure of roughly 0.7% or approximately €15 million in total. Thus, the growth in expenditure is well below the expected rise in nominal GDP. — 8 The relatively modest public sector pay settlement for 2006 and 2007 will also create additional savings. — 9 This also applies to the cut in the pension insurance contributions paid by central government on behalf of recipients of unemployment benefit II from 2007.

Concluding remarks

The general government deficit ratio in Germany could fall considerably by 2007. The new fiscal policy measures, in particular tax increases, are particularly important in this respect. This should lead to a broad stabilisation in the revenue ratio because it will more or less offset the below-average growth in the revenue-yielding macroeconomic assessment bases in relation to GDP. There will not be any perceptible decline in the expenditure ratio as a result of the Federal Government's new fiscal policy measures but rather thanks, in particular, to macroeconomic structural shifts and earlier measures.

With regard to the medium and longer-term repercussions for growth and employment, it would have been preferable to accept the prevailing trend towards a decline in the revenue ratio and to view this revenue development as the starting point for determining the expenditure path, the reason being that, if the tax and social security rates which are predominantly responsible for distortionary effects are raised or the effective burden of taxes and social security contributions on wages, profits and consumption is increased, the fiscal policy setting will deteriorate even if the revenue ratio remains unchanged. To achieve the necessary deficit reduction despite this, measures would have to be taken on the expenditure side in order to accelerate the decline in the expenditure ratio which is – partly quasi automatically – already underway.

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charges are expected as a result of unemployment benefit II in particular.

Marked decline in deficit ratio expected in 2007

In the coming year the government deficit ratio is likely to decrease significantly. The main reasons for this improvement are the central government's fiscal package, which will lead to additional revenue as a result of tax increases, and the moderate increase on the expenditure side, which is expected as a result of stringent budget management and forgoing any additional measures that might increase expenditure. On the other hand, the overall economic assessment bases for significant charges are likely to develop at a much slower rate than nominal GDP (see the explanatory notes on pages 52-53).

Central government submits implementation report as part of excessive deficit procedure

The Ecofin Council stepped up the ongoing excessive deficit procedure against Germany on 14 March 2006. Germany was called upon to correct its excessive deficit as swiftly as possible and by no later than 2007 as well as to reduce the structural deficit ratio by a total of at least 1 percentage point over the course of 2006 and 2007. Once the excessive deficit has been corrected, it is to be reduced further by at least ½ percentage point per year until the medium-term objective of a balanced budget is achieved. The Council demanded that Germany submit a report, first by 14 July 2006 and thereafter twice yearly. This report is to detail the measures that Germany has taken to meet the requirements decided upon by the Council.¹ In the first implementation report of 5 July 2006, central government expects a deficit ratio of 3.1% in the current year and 2½% in the coming year. As a result of the fact that not all additional tax

revenue is deemed to be cyclically induced, the structural deficit ratio will decrease by 0.2 percentage point this year. In 2007 fiscal measures are to ensure that the ratio decreases by approximately 1 percentage point.

On the basis of this implementation report, the European Commission has calculated that the structural balance of revenue and expenditure would increase by a total of only 0.9 percentage point in relation to GDP in 2006 and 2007. However, the Commission believes that Germany has made sufficient progress in correcting its excessive deficit within the deadline specified. The central government, it says, has decreased the structural deficit ratio by almost the required amount. No further action is currently necessary in connection with the excessive deficit procedure. The European Commission has, however, expressed concern that, as things currently stand, structural consolidation after 2007 is not likely to reach the required 0.5% of GDP per year.

Commission suspends excessive deficit procedure against Germany

Calculations by the Commission clearly show that the scope of the planned consolidation measures cannot be reduced and that prudent budget management is required at all levels of government. Germany should make every possible effort to observe the 3% ceiling in 2006. The current favourable development of revenue should on no account be used as an excuse to ease the consolidation course. The explicit aim of the revised European Stability and Growth Pact is to take an even stronger consolidation course if devel-

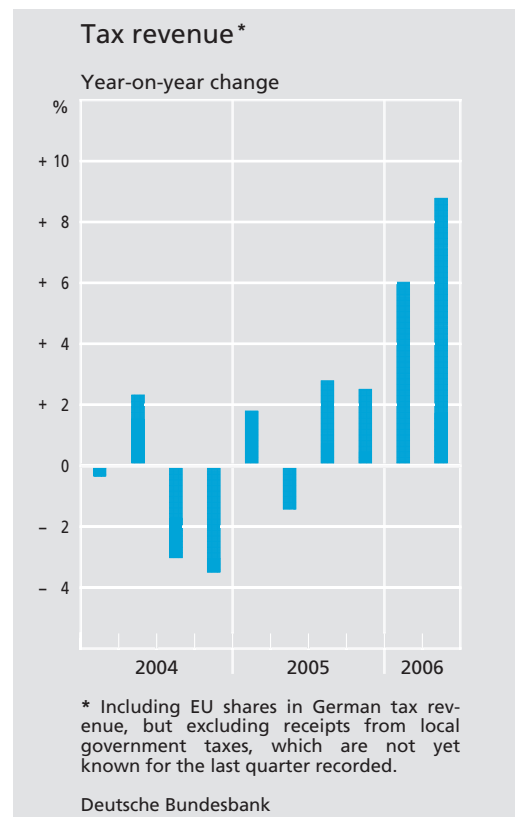
No reduction in scope of planned consolidation measures for 2007

¹ See also Deutsche Bundesbank, Monthly Report, March 2006, p 8.

opments are more favourable than expected and not – as was often the case in the past – to allocate unexpected additional revenue immediately elsewhere. According to the current financial plan, the basic aim of a structurally balanced budget will not be achieved by 2010. If there is less consolidation, the danger increases that the deficit ratios will quickly rise again in the event of unfavourable macroeconomic developments. The central government's budgetary position in particular remains critical even in a positive environment, and the constitutional borrowing limits are not even close to being met structurally. After 2007 it will be necessary to decrease the structural deficit rapidly to take due account of future budgetary strains stemming from demographic developments and to reduce the general government debt ratio. From today's perspective, additional consolidation measures are required to achieve this.

No leeway for budgetary strains in planned reforms

This does not leave any leeway for strains on the budget that may arise as a result of the planned business taxation and health system reforms. Sound counterfinancing measures are of far greater importance. Factoring in self-financing effects on a grand scale would go against prudent budgetary policy. On grounds of efficiency and growth, it would be more advantageous to implement savings on the expenditure side or to decrease tax exemptions as a means of counterfinancing the reforms.



Budgetary development of central, state and local government²

Tax revenue

Tax revenue³ increased significantly in the second quarter and was almost 9% up on the same period last year (see also the table on page 56). Of the direct taxes, wage tax revenue increased by 2½%. The positive trend in profits meant that revenue from profit-related taxes grew especially sharply (by over 54% or €6½ billion), albeit from a rather weak level

Sharp increase in tax revenue in second quarter

² Reporting below is based on the budgetary definition (as defined in the government's financial statistics). The development of local government finances is analysed in greater detail in the short article in the Monthly Report of July 2006.

³ Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.

Overall tax revenue and major individual taxes

Type of tax	H1				Q2				Estimate for 2006 ³
	2005	2006	Year-on-year change		2005	2006	Year-on-year change		Year-on-year percentage change
	€ billion		in € bn	as a percentage	€ billion		in € bn	as a percentage	
Overall tax revenue ¹	192.6	207.1	+ 14.4	+ 7.5	102.2	111.2	+ 9.0	+ 8.8	+ 2.7
<i>of which</i>									
Wage tax	56.9	57.9	+ 1.0	+ 1.7	29.0	29.8	+ 0.7	+ 2.6	+ 1.1
Assessed income tax	- 0.4	3.8	+ 4.2	.	3.4	5.9	+ 2.5	+ 74.3	+ 36.7
Investment income tax ²	11.4	12.5	+ 1.0	+ 8.9	5.6	7.0	+ 1.4	+ 24.8	+ 3.6
Corporation tax	7.1	10.4	+ 3.2	+ 45.3	2.7	5.2	+ 2.5	+ 90.6	+ 14.2
Turnover tax	67.9	71.1	+ 3.2	+ 4.7	33.0	35.2	+ 2.2	+ 6.7	+ 1.8
Mineral oil tax	14.3	14.2	- 0.1	- 0.8	9.9	9.7	- 0.2	- 1.9	- 2.0
Tobacco tax	6.1	6.4	+ 0.3	+ 4.6	3.6	3.6	- 0.0	- 0.2	+ 3.0

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. — ² Non-

assessed taxes on earnings and withholding tax on interest income. — ³ According to official tax estimate of May 2006.

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in the previous year. The effects of the marked decrease in refunds to employees that are deducted from assessed income tax can also be seen here. Of the consumption-related taxes, revenue from turnover tax increased sharply (by over 6½%). Despite the fact that growth was overstated in the previous year as a result of a large refund, the positive underlying trend of the previous few quarters continues. Petrol consumption continued to decline, resulting in a fall in mineral oil tax (-2%). In spite of the increase in tobacco tax in September 2005, revenue remained at almost the same level as the previous year owing to a decrease in consumption.

Tax revenue (excluding local government tax) as a whole increased considerably (7½%) in

the first half of the year compared with the first six months of 2005, and the favourable development continued in July. This means that growth is much higher than the rate forecast (just over 2½%) in the last official tax revenue estimate for the current year in May. However, due consideration should be given to the fact that the tax subsidies agreed in 2006 are likely to start reducing revenue over the course of the year. In addition, various special factors came into effect in the first half of 2006.⁴ Even so, the official estimate will clearly be exceeded as things now stand.

Increase in taxes to date greater than estimated for entire year

⁴ These special factors include greater revenue from motor vehicle tax in the first quarter as a result of taxing previously tax-exempt low-pollutant cars from 1 January 2006; lower expenditure on grants to homebuyers, especially in March (the month in which the largest part of the payment is due), as these grants were progressively reduced beginning in 2004; and the low amount of turnover tax in the previous year.

*Key points of
business
taxation reform
approved*

In July the Federal Government approved the key points of the reform of business and income tax that is to come into effect in 2008. The aim of the reform is to make Germany a more attractive business and investment location and to stabilise local government finances. As details are yet to be specified, however, the legislators still have considerable leeway. Measures are planned to reduce the tax burden on corporations from corporation tax, local business tax and the solidarity surcharge from the current level of almost 40% to below 30%.⁵ This would put tax rates at a high middle position in the EU tax table. Non-corporations are to be granted tax relief by means of preferential treatment for retained profits or self-financed investments and by lowering the inheritance tax and gift tax burden. In addition, a withholding tax for private capital income may be introduced. Counterfinancing measures that are currently being considered include making further restrictions on the tax-deductibility of interest expenditure in connection with local business tax and, possibly, also making restrictions in the case of corporation tax, broadening the tax base to include components of total wages paid or increasing property tax on commercial real estate. Additional adjustments are also likely to be made. In this way, the low tax rates on profits made by German corporations can be partially offset by changing the half-income system for dividends.

*Fundamental
reform not yet
in sight*

A comprehensive assessment is not yet possible on the basis of these key points. It is true that by significantly decreasing the tax rates charged to corporations, which are high by international standards, Germany should be-

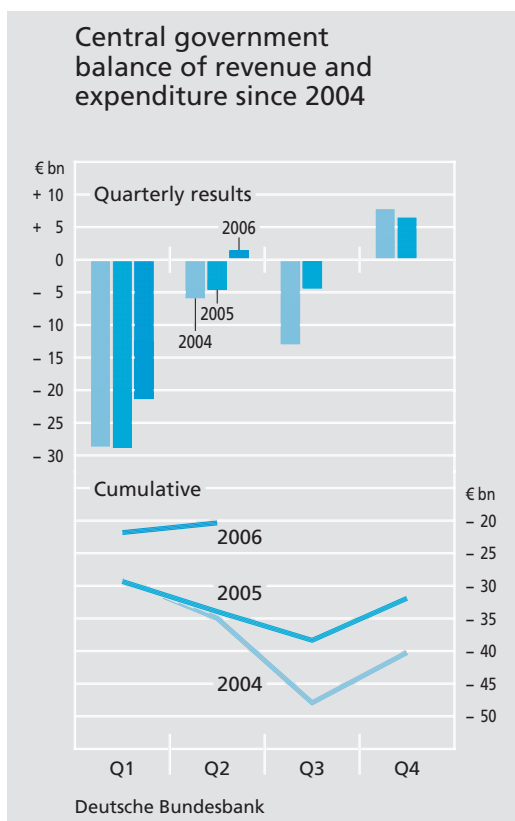
come more attractive as an international business and investment location and this should reduce the incentive to seek accounting options to avoid paying taxes in Germany. However, the impact of tax cuts is watered down by the counterfinancing measures. If the tax system is to be made more incentive-oriented, the reform ought to be counterfinanced by cutting tax breaks or curbing spending. As a rule, important tax principles, such as the neutrality of financing and the timely fiscal recognition of losses, should be observed. There is reason to fear that the planned introduction and extension of special regulations will make tax law even more complicated and opaque.

Central government budget

Central government recorded a surplus of €1½ billion in the second quarter of 2006 compared with a deficit of €4½ billion in the same period last year. The increase of 2½% in revenue is due to both a sharp rise in tax revenue (of just over €4½ billion or 9%) and greater revenue from motorway tolls (+€½ billion). (One-off) proceeds from loan repayments and the disposal of equity interests declined by just over €3½ billion. Expenditure decreased by almost 7% compared with 2005. Two factors alone alleviated the strain on the central government budget by almost €4 billion or just over 6% of expenditure – firstly, the fact that central government no longer had to pay grants to the Federal Employment Agency this year and, secondly, that it received repayment from the Federal

*Slight surplus in
central govern-
ment budget in
second quarter*

⁵ Depending on the local business tax multiplier.



Employment Agency for the liquidity assistance that it had provided at the beginning of the year and that had been booked as negative expenditure. Interest costs were also just over €½ billion lower. The increase in expenditure on social security for job seekers (HartzIV) was not as strong but still amounted to almost €½ billion (+4%).

Particularly favourable development in first half of year not likely to continue for whole year

At €20 billion, the deficit in the central government budget in the first half of the year was €13½ billion lower than in 2005. However, in the second half of 2006 various factors that did not apply last year will probably place an additional strain on the budget. For example, measures taken by central government to stimulate growth are likely to slow additional growth in tax revenue. Furthermore, according to the central government

budget, larger contributions to the EU are to be paid in the second half of 2006. In 2006 central government will not receive repayments of liquidity assistance (€5 billion) from the Federal Employment Agency as it did at the end of 2005. In addition, the central government budget foresees that revenue from asset realisations in the second half of the year will amount to only half of the €15 billion that was received in the same period of 2005. This figure could be even lower if some of these one-off proceeds are shifted to subsequent years as available funds owing to favourable budgetary developments.

For 2006 as a whole, the central government budget envisages an increase in the deficit of €7 billion to almost €38½ billion. Owing to the fact that tax revenue is likely to be greater than expected, it is possible that the outturn will be even more favourable. As things currently stand, the risks on the expenditure side are likely to be limited. Additional expenditure expected as a result of unemployment benefit II and the central government's share in the costs of accommodation is likely to be at least partly offset by savings from integration measures and from interest expenditure.

Deficit may be more favourable than expected for year as a whole

The Federal Cabinet approved the draft budget for 2007 at the beginning of July. The budget envisages bringing down planned net borrowing to €22 billion. This is based primarily on additional revenue from increasing the standard rate of turnover tax and of additional fiscal measures. In addition, expenditure in favour of other public authorities will be drastically reduced. Easing the burden on central government means increasing the burden in

2007 central government budget characterised by tax increases and shifting burdens

other areas of the government budget. A number of measures will be taken to achieve this: first, by cutting the grant for non-insurance-related benefits to the statutory health insurance system (which was introduced only in 2004) by just over €2½ billion; second, by decreasing pension contributions for recipients of unemployment benefit II by around €2 billion to almost half of their previous value; third, by reducing central government's contribution to those costs paid by local government for accommodation for recipients of unemployment benefit II by over €1½ billion in accordance with the draft budget; and fourth, by decreasing contributions to be paid to the state governments for local public transport by €½ billion. Expenditure is estimated to be almost 2½% more than the target for 2006. If the increased grants to the Federal Employment Agency in connection with the rise in turnover tax are excluded, central government expenditure is slightly down. If, however, the cuts made in payments to other levels are also taken into account, this again results in an increase of approximately 2½%. At the end of June the Financial Planning Council agreed to limit growth in expenditure to less than 1%.

Continued structural imbalance in central government budget

In 2007 net borrowing is to be brought back below the limit defined in Article 115 of the Basic Law for the first time since 2001. With investment expenditure at €23½ billion, the difference between that and net borrowing is only €1½ billion. In addition, extensive asset realisations continue to be included in the financial plan. These actually represent disinvestments and impair the government's asset position in the same way as borrowings. Just

over €9 billion is to be raised by selling equity interests alone. The assumption of debt associated with the planned earnings from restructuring the ERP special fund is not to be included in the borrowing limit. Evidently the central government budget will again receive additional relief of approximately €5 billion from the securitisation of claims on the Post Office pension fund at the expense of subsequent financial years. Even with the agreed cuts, the amounts budgeted for social security for job seekers seem rather limited. This indicates that the rather alarming structural imbalance of the central government budget will continue in 2007. On the revenue side, the results of the official May tax estimate were increased not only to include planned legal changes but also a lump-sum premium of approximately €2 billion resulting from the positive outcome for May. Even if additional revenue has been emerging since the July figures (which are now available), such adjustments are inconsistent with the basic intention of maintaining an independent basis for budgetary planning by means of the Working Group on Tax Estimates. Given the need for fundamental consolidation measures, it seems advisable to use any additional revenue not foreseen in the central government budget not to relax fiscal policy but to help decrease the deficit further.

Central government's medium-term financial plan for the period up to 2010 envisages decreasing net borrowing by only €½ billion per year from 2008. In 2010 this will mean net borrowing of €20½ billion and investment expenditure of €23½ billion. The amounts budgeted for non-tax revenue indicate that

Medium-term financial plan envisages only slight decrease in deficit

Federal Government's medium-term financial planning

€ billion

	Actual 2005	Target 2006 ¹	Draft 2007 ²	Financial plan		
				2008 ³	2009	2010
Expenditure	259.8	261.6	267.6	274.3	274.9	276.8
of which						
Investment	22.9	23.2	23.5	23.4	23.6	23.3
Revenue	228.6	223.4	245.6	252.8	253.9	256.3
of which						
Taxes	190.1	194.0	214.5	218.2	226.0	231.1
Net borrowing	31.2	38.2	22.0	21.5	21.0	20.5
<i>Memo item:</i>						
Percentage change in expenditure	+ 3.3	+ 0.7	+ 2.3	+ 2.5	+ 0.2	+ 0.7

1 Including asset realisations of around €16 billion — 2 This contains asset disposals of just over €15 billion including relief arising from sales of claims on the Post Office pension fund. — 3 From 2008 this contains charges of €4 billion from the planned business tax reform (decreasing over the course of time). — 4 Adjusted for the revenue from a turnover tax item given to the Federal Employment Agency, this results in a decrease of 0.2%.

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central government intends to realise a large volume of assets to cover the extent of the structural underfunding. Although the financial plan includes shortfalls of €4 billion, which are expected as a result of the business taxation reform that is to come into effect in 2008, these are expected to decrease as time goes on. However, it obviously does not take into consideration the agreed increase of the Federal grant to the statutory health insurance scheme. This amount is already far too close to the constitutional borrowing limit and could get dangerously close to exceeding it.

Special funds record surplus

The special funds recorded a surplus of almost €1 billion in the second quarter compared with €1½ billion in the same period of 2005. As a result of lower repayments and an

increase in loans granted, the surplus of the ERP special funds decreased somewhat. Withdrawals from the flood disaster fund set up in 2003 decreased again. It is likely that the special funds will show a surplus at the end of the year.

State government budgets

The state government budgets recorded a small surplus of almost €¼ billion in the second quarter compared with a deficit of €3 billion in the same period in 2005.⁶ Revenue increased by 5½% overall – boosted by a sharp increase in tax revenue. At the same time expenditure increased only slightly. The particularly large item of personnel expenditure decreased by just over ½% whereas in the previous quarter, probably as a result of outsourcing, it had recorded a sharper decline. Overall, the deficit of the state government budgets decreased to just over €7 billion in the first half of 2006 from €11½ billion in the same period of 2005.

More favourable results for state government budgets in second quarter

The state government financial plans foresee only a moderate decrease in deficits to just over €23 billion for 2006. If tax revenue continues to develop positively, however, deficits could decrease even further. Nevertheless, over half of the state governments are likely to exceed their upper borrowing limits for structural reasons again this year. Berlin, Bremen, Lower Saxony, North Rhine-Westphalia, Saarland and Schleswig-Holstein are not likely to be able to observe these limits, even if they take the proceeds from asset realisations into

Sharper decrease in deficit possible but upper borrowing limits often exceeded for structural reasons

⁶ Including the figures for Saarland which are now available again.

account. By contrast, Bavaria and Saxony may be able to conclude the year without net borrowing.

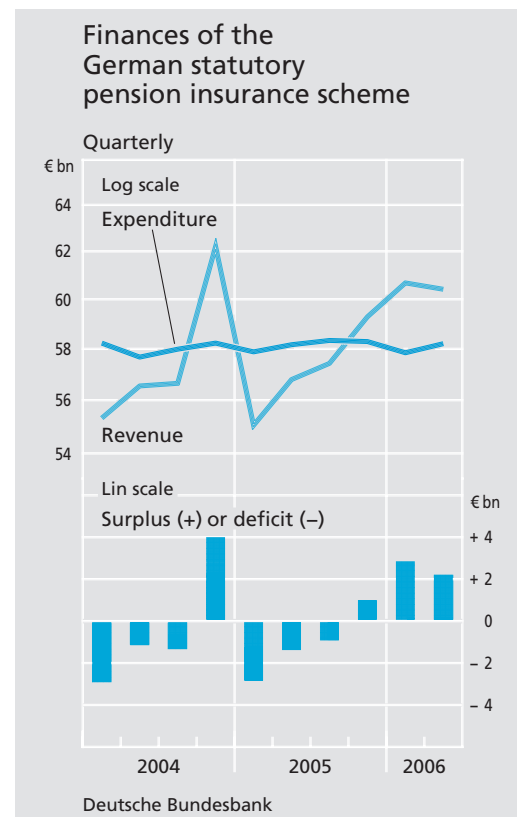
Federal structure reform increases state government responsibility for expenses

The reform of the federal structure that is to come into effect in 2007 shifts responsibility for expenses to state governments – in particular for state civil servants' pay. State governments alone are to be responsible for higher education in the future. This sees the end of both joint responsibility for constructing colleges and universities and planning education as well as of financial assistance to improve local transport and to promote social housing. As compensation, state governments are to receive Federal resources of €2½ billion every year until the end of 2013. However, state governments' participatory rights to influence national legislation will be restricted with the expected result that only half of all laws will require the consent of state governments. Having said this, new participatory rights are to be introduced for any new laws that would entail considerable costs for state governments. Transferring legislative power for land and buildings transfer tax to state governments is a first step to increasing their fiscal autonomy. Stage two of the federal structure reform should see a detailed revision of the financial constitution.⁷

Social security funds

Statutory pension insurance scheme

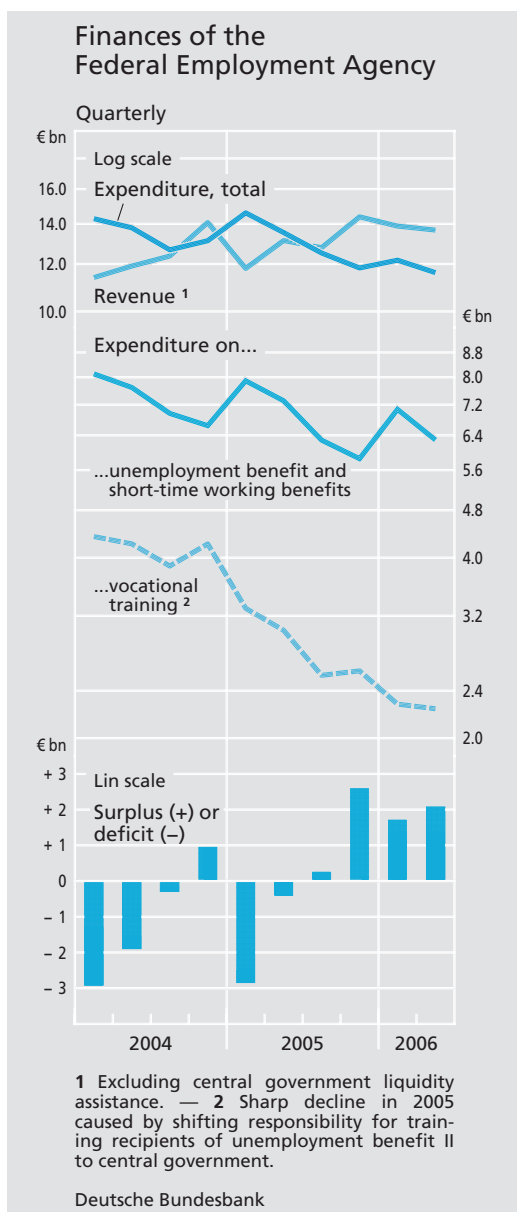
In the second quarter of 2006, the statutory pension insurance scheme recorded a considerable surplus of over €2 billion following a



deficit of almost €1½ billion in the previous year. This was due to considerably increased income from compulsory contributions by bringing forward the transfer deadline for social contributions occurring in January in particular and also, as a result of a transitional regulation, those occurring in subsequent months up to and including July. Whilst revenue from compulsory contributions therefore increased by almost 12%, the increase in total revenue was much lower at 6½% because Federal grants, which cover just over one-quarter of the budget, virtually stagnated. Pension expenditure increased only slightly, namely by ½%. This was due not only to the waiver of a pension adjustment in

Additional revenue from contributions to statutory pension insurance scheme

⁷ See Deutsche Bundesbank, State government finances in Germany, Monthly Report, July 2006, pp 48-49.



July 2005 but also to the moderate growth in the number of pensioners.

Over the remainder of 2006 the positive special effects on the contribution side will peter out, and the less favourable underlying financial trends will make themselves felt again. Nevertheless, at the end of the year, the minimum reserve of 20% of a month's expenditure will be significantly overshoot. Even so,

Higher contribution rate necessary in 2007

this financial buffer will probably not be sufficient to forgo raising contribution rates in 2007. However, the expected erosion of reserves by the end of 2007 indicates a considerable need for adjustment in the coming years.

Federal Employment Agency

The Federal Employment Agency posted a surplus of €2 billion in the second quarter of 2006 after recording a deficit of almost €½ billion in the same period of last year. As was the case in pension insurance, it was bringing forward the transfer date for contributions that provided the essential contribution to this result. Revenue from contributions increased by just over 12% in the second quarter. In total, revenue increased by no more than just over 4% year on year because central government reimbursements of administrative costs and insolvency contributions were much lower.

Surplus attributable to one-off additional revenue from contributions...

Expenditure fell by almost 14½% in the second quarter compared with 2005. Approximately half of this decrease in expenditure can be attributed to the 13% decline in expenditure on unemployment benefit, a development which, in turn, can be attributed to the lower number of persons registered as unemployed. Large savings were also recorded again in connection with active labour market policies (-26%). Additionally, lower administrative expenses and insolvency payments meant that the expenditure side decreased further. However, the compensatory amount to be paid to central government in the second quarter was 9½% higher than in the previous year.

... and a significant decrease in expenditure

Surplus over and above the amount expected for 2006 as a whole

In the first half of 2006 the surplus amounted to almost €4 billion. The surplus of €1.8 billion foreseen in the Federal Employment Agency's budget is likely to be greatly over-shot over the year as a whole. In the second half of the year, after the transitional regulation for transferring contributions comes to an end, revenue from August will be on a much smaller scale, and savings from active labour market policies could be somewhat lower. Nevertheless, it is quite likely that the surplus from the first half of the year will increase even further in the second half of the year if only because of the seasonally-related smaller number of persons registered as unemployed and to the additional revenue from contributions resulting from special payments. In the coming year three factors will make it possible to cut the contribution rate by 2 percentage points to 4.5% and to ensure that the financial situation for the labour market improves as expected – firstly, the new central government grant linked to revenue from turnover tax, secondly, savings, especially those resulting from shortening the maximum period of entitlement to unemployment benefit I and, thirdly, a recourse to the reserves that have been set up to date.

Statutory health insurance scheme⁸

After a deficit of just over €1 billion in the health insurance institutions in the first quarter of 2006, the financial situation is expected to ease somewhat, particularly as a result of the significant increase in Federal resources which are to be granted to health insurance institutions over the remainder of 2006. However, it is almost impossible to significantly de-

crease the health insurance institutions' debt and to replenish the statutory reserves through the use of surpluses. The envisaged health system reform will not be able to hinder a sharp increase in contribution rates in the coming year. This increase is also due to the cutback of just over €2½ billion in Federal resources. The Federal grant is not expected to start increasing until after 2008. However, it is not yet clear which form counterfinancing will take in the central government budget. Furthermore, the current collection system for contributions is to be replaced by a health fund which is to be maintained from contributions from employees and employers and from a Federal grant. The health insurance institutions are to receive risk-adjusted amounts from this fund for each person insured. If the fund is not sufficient for all health insurance institutions, then individual institutions have to charge their members additional contributions. However, these amounts must not exceed 1% of the household income of the persons insured or a total of 5% of the institution's expenditure on health care. Stronger competitive pressure on health insurance institutions will be restricted initially by capping additional contributions, and the planned conversion is likely to entail additional bureaucracy. Depending on the form that the fund model actually takes and how it develops, this may lay the foundations for decoupling employee compensation from the financing of statutory health insurance as well as for a more transparent financing of

... but could lay foundations for decoupling employee compensation from health insurance funding

Health system reform will not prevent rise in contribution rates in 2007 ...

⁸ The financial development of the statutory health and long-term care insurance schemes is analysed in greater detail in the short articles of the Monthly Report of June 2006.

non-insurance-related benefits. The measures agreed on the expenditure side do not appear to be sufficient. There should be enough

scope here to intensify competition among service providers.