Public finances

General government budget

In 2006 deficit ratio below ceiling for first time since 2001

The situation of public finances in Germany improved during 2006 and is now much more favourable than had been expected at the start of that year. According to initial provisional data from the Federal Statistical Office, the general government deficit ratio decreased by 1.2 percentage points to 2.0%. This was the first time since 2001 that it had been below the ceiling of 3% laid down in the EC Treaty. As a result of the pleasing development at the end of the year, which has not yet been fully incorporated into the preliminary outturn, a further downward revision of the deficit ratio is likely.

Debt ratio expected to be largely unchanged

Government debt again rose considerably in 2006. The high debt-to-GDP ratio of almost 68% in 2005 is expected to have remained largely unchanged even though the high nominal rate of economic growth had a dampening effect on the ratio. Thus, despite the clear decline in the deficit, it was still too high to secure a perceptible decrease in the debt ratio.

Favourable economic development and extraordinary increase in profit-related taxes

The rather sharp decrease in the deficit was mainly due to the favourable economic development and the extraordinarily strong increase in profit-related taxes, which are subject to erratic and large fluctuations. The standard calculations (see box on pages 58-59) show that the positive economic effect contributed almost ½ percentage point and the growth in profit taxes another ½ percentage point to improving the deficit ratio.

Marginal rise in revenue ratio

In 2006, the general government revenue ratio rose slightly to 43.7%. While, in relation to GDP, revenue from profit-related taxes climbed steeply by approximately ¾ percentage point (see adjacent chart),[1] with unchanged contribution rates the social security contributions decreased by ⅓ percentage point[2] because, as in the previous years, gross wages and salaries grew at a slower pace than GDP. Consumer restraint in response to higher oil prices depressed receipts from energy tax, which is a volume-based tax.

Expenditure ratio drop mainly due to cyclical reasons

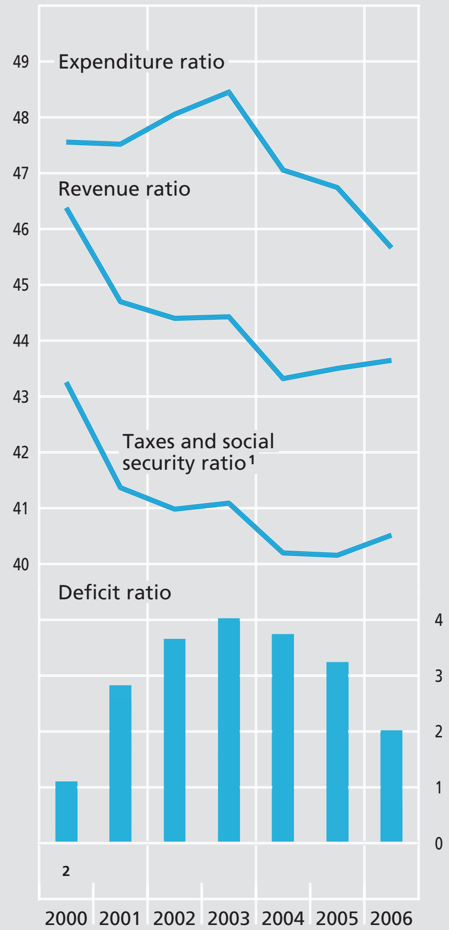
In 2006, expenditure in relation to GDP fell by just over 1 percentage point to 45.7%. The positive economic development made a significant contribution to this decrease, which not only led to a decline in the ratio as a result of nominal GDP growth but also thanks to lower labour market-related expenditure. The subdued wage development implies not only relatively weak growth in revenue but also an easing of the pressure on government expenditure because many social benefits are closely coupled with developments in remuneration. This development also made it easier to limit government personnel expenditure, which decreased considerably in relation to GDP.

Despite increases in tax and contribution rates, revenue ratio could decrease slightly in 2007

In 2007, both the debt ratio and the deficit ratio should fall. This is due to measures on the revenue side, in particular, and to a merely moderate increase in expenditure. Overall, the revenue ratio might decrease slightly. Changes in the legal framework will lead to considerably higher net revenue, and raising the standard rate of VAT, in particular, will give rise to additional revenue far in excess of

General government fiscal ratios*

as a percentage of GDP



* As defined in the national accounts. — **1** Taxes and social contributions plus customs duties and the EU share in VAT revenue. — **2** Excluding proceeds from the sale of UMTS licences.

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the net relief in social contributions. On the other hand, in particular gross wages and salaries, as the most significant macroeconomic reference variable for government revenue, but also pre-tax private consumption, are ex-

1 See Deutsche Bundesbank, The development of profit-related taxes, Monthly Report, November 2006, p 55.
2 The bringing forward of the transfer deadline for most social security contributions does not increase revenue as defined in the national accounts owing to the accruals principle of accounting.

The structural development of public finances – Results of the disaggregated framework for 2006

At first glance, it would appear that the state of public finances in Germany improved significantly last year. According to initial calculations, the general government fiscal deficit fell to 2.0% of GDP, compared with 3.2% in 2005. Using the disaggregated framework for analysing public finances,[1] which was presented in detail in the March 2006 *Monthly Report*, it is possible to estimate the role played by cyclical and specific temporary effects. Structural changes in the revenue and expenditure ratios and their major determinants can also be identified. The main results of this analysis for 2006 are presented below.[2]

The significant decline of 1.2 percentage points in the deficit ratio last year was due, in large part, to the favourable cyclical development of the economy. On the basis of the standard adjustment procedure used within the European System of Central Banks, the contribution from economic activity is calculated as 0.4 percentage point. By contrast, clearly defined temporary special effects (such as the proceeds from UMTS sales in the past) did not, on balance, have any notable impact on the change in the fiscal balance in 2006. Thus, the structural deficit defined using the disaggregated framework – which is adjusted for these two effects – declined by 0.8 percentage point in relation to trend GDP.

Structural revenue rose by 0.7 percentage point in relation to trend GDP and, thus, more strongly than the unadjusted revenue ratio. The ratio was boosted slightly by the fact that the – as usual – positive fiscal drag (in particular, the progression effect) from the progressive income tax rate outweighed the negative impact in the case of excise taxes – which are largely volume-based. This was, however, compensated by the continued negative structural decoupling of the macroeconomic assessment bases from the development of GDP. For example, when viewed in isolation, the (trend towards) comparatively small increases in gross wages and salaries reduced the ratio of social contribution receipts and wage tax receipts to trend GDP. This was not fully offset by the trend of faster rising entrepreneurial and investment income in relation to GDP. Legislation changes had, on balance, no sizeable impact. A number of revenue-boosting measures (including the latest increase in tobacco tax which, for the first time, applied to the whole year, and the broadening of the income tax base) were accompanied by various revenue-reducing measures (such as more favourable depreciation rules).

Ultimately, the decisive factor behind both the sharp rise in the structural revenue ratio and the decline in the structural deficit ratio is the unusually strong growth (which is not explained by the standardised procedure) in taxes and social security contributions in relation to trend GDP (residual: +0.7 percentage point). This was due, in particular, to profit-related taxes (+0.5 percentage point). Receipts from these taxes grew at a much faster pace than was to be expected given the development of entrepreneurial and investment income (which serves as the macroeconomic reference variable for profit-related taxes in the cyclical adjustment procedure). This may be due partly to the fact that in 2006 large tax advances were accompanied by unusually high net back payments in respect of earlier years. After adjustment for legislative changes, the increase in turnover tax receipts was also higher than expected in view of the (standardised) macroeconomic base. Tax-driven advance purchases of consumer goods are likely to have contributed to this because they increased the proportion of goods in total consumption which are subject to the standard rate of VAT which was increased as of 1 January 2007. It is also possible that insolvency-related tax shortfalls and the level of turnover tax fraud declined. As in the preceding years, the comparatively unfavourable development in excise taxes can probably be explained by the fact that consumption habits changed in response to the rise in energy and tobacco prices.

Despite the restrained growth in nominal expenditure, in structural terms there was hardly any reduction in the ex-

1 See Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pages 61-76. — **2** The results are subject to change in the future in the event of revisions to the preliminary national account figures or revised estimates of the macroeconomic outlook. — **3** In addition to the adjustment for the cyclically driven perceptible decline in labour-market-related expenditure, another contributory factor was the very low GDP deflator in 2006. This meant that there was only a comparatively small increase in the structural expenditure ratio denominator, which is comprised of real trend GDP and the GDP deflator. — **4** Adjusted for cyclical influences and temporary effects. In accordance with ESA 95. — **5** Percentages of nominal GDP. — **6** Assessed income tax, investment income taxes, corporation tax, local business tax. — **7** Payments attributable to the

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Structural development [4] as percentage of trend GDP

Year-on-year change in percentage points

Item	2001	2002	2003	2004	2005	2006	Total 2001-2006
Unadjusted fiscal balance[5]	– 4.1	– 0.8	– 0.4	0.3	0.5	1.2	– 3.3
Cyclical component[5]	0.0	– 0.4	– 0.5	– 0.2	– 0.1	0.4	– 0.8
Temporary effects[5]	– 2.5	0.1	– 0.1	0.1	0.1	0.0	– 2.3
Fiscal balance	– 1.7	– 0.5	0.3	0.4	0.5	0.8	– 0.2
Interest payable	– 0.1	– 0.2	0.0	– 0.1	– 0.1	0.1	– 0.4
Owing to change in average interest rate[5]	0.0	– 0.2	– 0.1	– 0.2	– 0.2	0.0	– 0.7
Owing to change in debt level[5]	– 0.1	0.0	0.1	0.1	0.1	0.1	0.3
Primary balance	– 1.8	– 0.7	0.3	0.3	0.4	0.9	– 0.6
Revenue	– 1.9	– 0.6	– 0.3	– 1.0	0.1	0.7	– 3.0
of which							
Tax and social contributions	– 1.9	– 0.5	– 0.1	– 0.8	0.0	0.7	– 2.6
Fiscal drag	0.2	0.1	0.1	0.1	0.1	0.1	0.7
Decoupling of base from GDP	– 0.3	– 0.3	– 0.1	– 0.2	– 0.1	– 0.1	– 1.1
Legislation changes	– 1.1	0.7	0.4	– 0.6	– 0.2	0.1	– 0.7
Residual	– 0.8	– 1.0	– 0.6	– 0.2	0.3	0.7	– 1.5
of which: profit-related taxes[6]	– 0.7	– 0.8	– 0.1	0.1	0.1	0.5	– 0.9
Memo item: included in expenditure[7]	– 0.1	0.0	0.0	– 0.1	– 0.1	– 0.1	– 0.4
Non-tax-related revenue[8]	0.1	– 0.1	– 0.1	– 0.2	0.0	– 0.1	– 0.4
Primary expenditure	– 0.1	0.1	– 0.5	– 1.3	– 0.3	– 0.2	– 2.3
of which							
Social payments[9]	0.2	0.5	– 0.1	– 0.8	– 0.1	0.0	– 0.4
Subsidies	– 0.1	– 0.1	– 0.1	– 0.1	– 0.1	0.0	– 0.6
Compensation of employees	– 0.2	– 0.1	– 0.2	– 0.1	– 0.2	– 0.1	– 1.0
Intermediate consumption	0.0	0.0	0.0	– 0.1	0.2	0.0	0.2
Gross fixed capital formation	0.0	– 0.1	– 0.1	– 0.1	0.0	0.1	– 0.4
Other expenditure[10]	0.1	– 0.2	0.0	0.0	0.0	– 0.1	– 0.2
Memo item							
Pension expenditure[11]	0.0	0.1	0.0	– 0.2	– 0.2	– 0.1	– 0.4
Healthcare expenditure[12]	0.1	0.0	– 0.1	– 0.4	0.1	0.1	– 0.2
Labour-market expenditure[13]	0.0	0.0	– 0.1	– 0.2	0.2	0.0	0.0

penditure ratio.[3] While the interest expenditure ratio increased slightly for the first time in a number of years, the structural ratio of other expenditure (primary expenditure) declined. This was due, not least, to the development in compensation of government employees, which, as in the preceding years, contributed to consolidation thanks to the falling number of public sector employees and the largely unchanged negotiated rates of pay. There was, on balance, moderate growth in social benefits which are, to a large extent, linked to wage developments. Ratio-reducing trends in pension expenditure were offset by ratio-boosting effects in other areas, in particular in healthcare expenditure.

On balance, it is clear that the noticeable decline in the unadjusted deficit ratio in 2006 was largely due to special factors. The positive cyclical influences, which are factored out of the structural development, and the boom in profit-related taxes are the main factor behind the very favourable development.

general government sector, eg social contributions for public sector employees (estimated). — **8** Other current transfers receivable, sales and total capital revenue. — **9** Including other current transfers to households. — **10** Other current transfers payable to corporations and the rest of the world, other net acquisitions of non-financial assets and capital transfers. — **11** Spending by the statutory pension insurance scheme, on civil servant pensions and payments by the post office pension fund. — **12** Spending by the statutory health insurance scheme and assistance towards civil servants' healthcare costs. — **13** Spending by the Federal Employment Agency (excluding its compensatory payment to the Federal Government), and expenditure on unemployment assistance (up to 2004) or unemployment benefit II (from 2005) and on labour market reintegration measures.

pected to grow again at a slower rate than nominal GDP, which will increase additionally as a result of the price effect from raising excise taxes. Furthermore, profit-related taxes may fall following the sharp gains in the previous years.

Perceptible decrease in expenditure ratio expected

The moderate development of wages to date will also continue to curb the expenditure ratio.[3] In relation to GDP, expenditure on old-age provision, the labour market and personnel should therefore decrease considerably. The current relatively small number of new pensioners, the parameters of the pension adjustment formula that have a dampening effect on pension increases, the decline in government personnel, which is likely to continue, as well as the shortening of the periods of entitlement to unemployment benefit I will also help to reduce the expenditure ratio. A contribution to consolidation is also expected from capital transfers due to the fact that grants to homebuyers are gradually being phased out.

European deficit criterion met but debt ratio still over 60% and hardly changed

By reducing the deficit ratio to well below 3%, in 2006 Germany satisfied one essential prerequisite for being released from the excessive deficit procedure. The Ecofin Council's demand for structural consolidation of at least 1 percentage point over the two-year period from 2006 to 2007 should therefore be fulfilled. However, given the emerging trend, it is not yet certain whether the debt criterion stipulated in the Maastricht Treaty will be deemed to have been met. The criterion states that the debt ratio may only exceed the 60% reference value if it is diminishing sufficiently and approaching the reference value at a satisfactory pace. The reform of the Stability and Growth Pact should mean that more emphasis is placed on debt dynamics and sustainability.

Pursuant to Stability and Growth Pact, balanced budget should be aimed at for 2009

To quickly bring the debt ratio below the reference value of 60%, it is essential to rapidly reduce the deficits even further and to achieve the medium-term budgetary objective of a structurally balanced budget as soon as possible. In line with the Stability and Growth Pact, this should happen in 2009. According to the German stability programme of December 2006, a deficit ratio of 1½% is planned for 2007. In view of the fact that the outturn for 2006 was more favourable than expected and that the macroeconomic trend is now forecast to be considerably more advantageous, it should definitely be possible to achieve a ratio of 1% both in cyclically-adjusted and unadjusted terms. When the pact was being reformed, a key aim was to consider the individual economic situation when defining the annual consolidation demands. In concrete terms, this means that, in the economically favourable phase predicted by the Federal Government in the next few years, structural consolidation should exceed the reference value of ½% of GDP. Against this backdrop, counterfinancing would have to be found to compensate for the shortfall in tax revenue as a result of the business tax reform planned for 2008 and the scale of consolidation demanded would have to be ensured. However, the Federal Government has not

3 For further details, see Deutsche Bundesbank, Developments in the government revenue and expenditure ratio up to 2007, Monthly Report, August 2006, pp 52-53.

defined this as an objective in the latest stability programme.

Budgetary development of central, state and local government

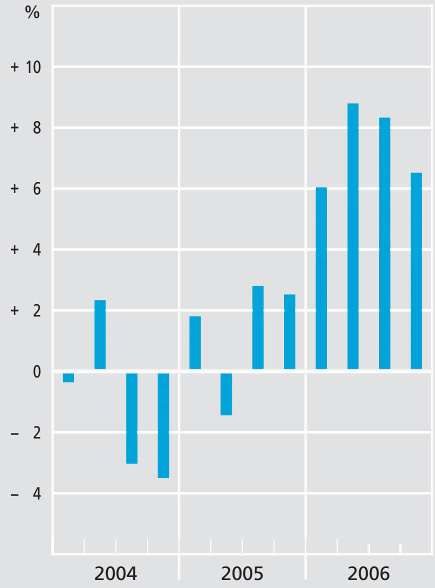
Tax revenue

Assessed taxes make largest contribution to growth in tax revenue in 2006 as a whole

After the clear rise of 6½% in tax revenue[4] in the fourth quarter of 2006 compared to the corresponding quarter of the previous year, an extraordinarily sharp increase of 7½% (€31 billion) has been recorded for the year as a whole. Assessed taxes, which grew by 55% (€14½ billion) as a result of lower refunds, higher additional payments in respect of earlier years and the favourable development of profits in the previous year, made a significant contribution to this. Revenue from the assessed income tax rose by almost €8 billion (80%). This particularly sharp increase also reflects the reduction in tax subsidies thanks to the considerable decline in rebates to employees (-€1½ billion) and grants to homebuyers (-€1 billion), both of which are booked against assessed income tax. Both the renewed rise in the number of persons employed and the increase in average earnings contributed to the growth of 3% (€3½ billion) in wage tax receipts. At 5% (€7 billion), turnover tax recorded the largest rise of all indirect taxes. This also reflects a slight pick-up in domestic private demand, which – not least in the field of new car registrations – was also boosted by anticipatory effects from the early announcement of an increase in the standard rate of VAT from 1 January 2007. However, according to preliminary figures for

Tax revenue *

Year-on-year change



* 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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the macroeconomic reference variables, the increase in revenue clearly exceeds the growth of these variables. Smaller insolvency-related tax shortfalls, but possibly also combating turnover tax evasion more effectively, may have contributed to this increase. The slight decrease in revenue from energy tax and the merely small gain in revenue from tobacco tax, despite the rise in the tobacco tax rate in September 2005, are most likely connected to consumer reactions to price increases.

Expectations for 2006 clearly exceeded

Compared with the tax estimate of November 2005 – which formed the general basis

4 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 fourth quarter.

Overall tax revenue and major individual taxes

Type of tax	Year as a whole 2005 € billion	Year as a whole 2006 € billion	2006 Year-on-year change as %	2006 Year-on-year change in € billion	Estimate for 2006[3] Year-on-year change in € billion	Q4 2005 € billion	Q4 2006 € billion	Q4 2006 Year-on-year change as %	Q4 2006 Year-on-year change in € billion
Overall tax revenue[1]	415.4	446.1	+ 7.4	+ 30.8	[4] + 4.9	120.9	128.8	+ 6.5	+ 7.9
of which									
Wage tax	118.9	122.6	+ 3.1	+ 3.7	+ 1.2	33.9	35.5	+ 4.9	+ 1.7
Assessed income tax	9.8	17.6	+ 79.9	+ 7.8	+ 1.5	6.0	7.5	+ 25.5	+ 1.5
Investment income tax[2]	16.9	19.5	+ 15.3	+ 2.6	− 0.2	2.7	3.7	+ 38.6	+ 1.0
Corporation tax	16.3	22.9	+ 40.2	+ 6.6	+ 0.2	5.4	6.5	+ 19.5	+ 1.1
Turnover tax	139.7	146.7	+ 5.0	+ 7.0	+ 2.5	36.5	38.5	+ 5.5	+ 2.0
Energy tax	40.1	39.9	− 0.5	− 0.2	− 0.2	16.0	15.7	− 2.1	− 0.3
Tobacco tax	14.3	14.4	+ 0.8	+ 0.1	+ 0.3	4.2	4.3	+ 2.0	+ 0.1

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 November 2005, excluding local government taxes. — **4** Actual tax revenue including (estimated) local government taxes was approximately €32 billion higher than the estimate.

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for drawing up the budgets – additional revenue (including estimated local government taxes) of approximately €32 billion was collected. This discrepancy is mainly due to the unexpectedly sharp growth in revenue from profit-related taxes (€23½ billion). Turnover tax revenue (€+4½ billion) and wage tax revenue (€+2½ billion) were also up by more than expected. This reflects, in particular, the more favourable economic development in 2006.

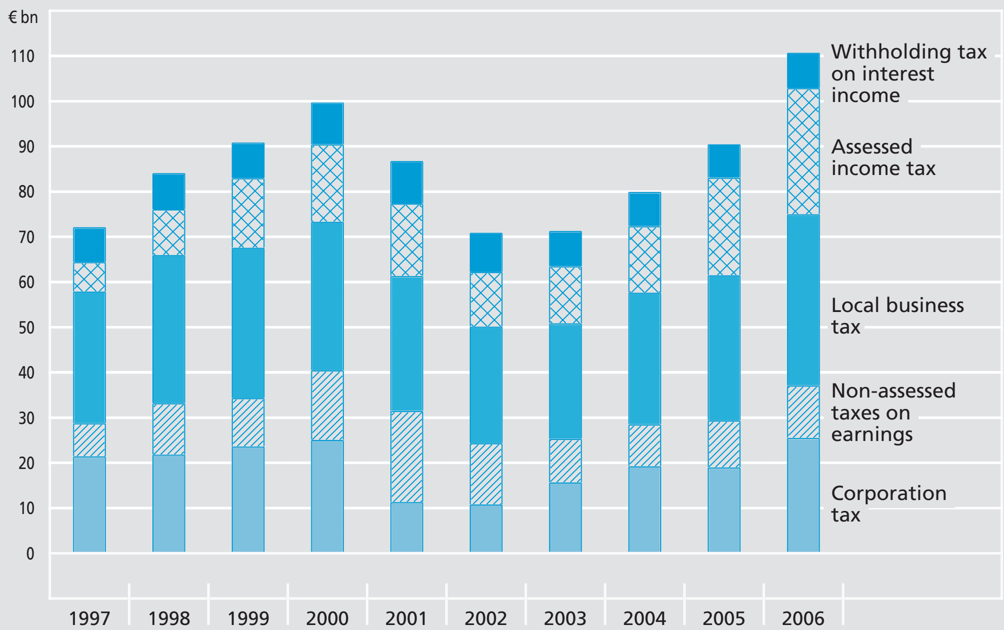
Additional revenue as a result of tax increases expected in 2007

In 2007, considerable additional revenue is expected as a result of the increase in the standard rate of VAT and insurance tax. As all additional receipts from insurance tax and approximately two-thirds of additional receipts from VAT accrue to central government, particularly strong revenue growth will be recorded for this level of government. In contrast to this, state and local government revenue will rise at a much more moderate rate. For local government, local business tax revenue will probably be weakened by the temporary expansion of declining-balance depreciation. Estimates for macroeconomic development in 2007, which are now more positive, as well as the baseline effect from the outturn for 2006, which was more favourable than expected, indicate that tax revenue for 2007 could also exceed the forecast of November 2006.

Business tax reform: cut in rates and widening of tax base

The preliminary draft of the business tax reform was presented at the beginning of February (see box on page 64). The planned decrease in the statutory rates of corporation and local business taxes is designed to lower

Revenue from profit-related taxes*



* As defined in the national accounts. Employee refunds deducted from assessed income tax revenue. Adjusted for the impact of changes in tax legislation in accordance with government estimates.

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the tax rates for German corporations considerably from their current high level. A concession is to be provided for non-corporations in the form of preferential tax treatment of internal financing. The business tax reform should basically enhance Germany's attractiveness as an investment location compared to the *status quo* – even after considering the counterfinancing measures (*inter alia*, tightening depreciation rules). The measures to broaden the tax base which, in part, are intended to counterfinance the tax cuts, in particular, focus on closing tax loopholes. The planned regulations will certainly mean that tax law will become much more complex and are, in some respects, systematically questionable. The fact that the tax framework is still distorting financing decisions to a large degree is especially problematic. For example, the retention of profits by corporations and, in the future, also by non-corporations will be taxed at a much lower rate than distribution, which will hinder the efficient allocation of funds via the capital markets. The introduction of a withholding tax at a rate of 25% from 2009 coupled with the abolition of the system of (50%) income tax relief on dividend payments for individuals and with taxation on capital gains (also including the interest deduction ceiling) puts equity financing at a considerable disadvantage over debt financing.

Burdens expected for general government

With regard to the burdens for public finances, the Federal Government envisages tax shortfalls of approximately €5 billion per year as a result of the business tax reform assuming the reform is put into effect in full and if potential

Key elements of the planned business tax reform

In the draft Business Tax Reform Act (2008), the Federal Government has set out the details of its plans to amend business taxation. The main objectives of the business tax reform are to improve Germany's competitiveness as an international investment location, to create greater neutrality in terms of legal form and financing, and to close tax loopholes. Some of the key elements which should, according to plan, enter into force on 1 January 2008 are as follows.

– The corporation tax rate is to be reduced from 25% to 15% and the basic rate of local business tax is to be cut from 5% to 3.5%. By contrast, the option of deducting local business tax from its own base and from that of corporation tax is to be abolished. This would mean that the tax rate applicable to corporations (assuming a 400% multiplier in the case of local business tax) will fall from its present level of 38.7% to 29.8%.

– The facility to deduct interest paid on loans as operational expenditure is to be restricted in the case of group enterprises which have a below-average equity capital base compared with the other enterprises in their group ("interest deduction ceiling"). Interest expenditure in excess of interest income (where the difference is above the threshold limit of €1 million) is deductible only up to 30% of profits. Recognised financing expenditure which cannot be offset against profits may be carried forward for an unlimited period.

– Non-corporations will have the option of applying a reduced flat tax rate (28.25%) to retained profits. If these funds are later withdrawn, they will then be taxed in the same way as dividends. In future, 3.8 times (instead of the current 1.8 times) the assessment base of local business tax (*Gewerbesteuermessbetrag*) may be deducted from the income tax liability incurred on business earnings. On the other hand, it will no longer be possible to deduct local business tax payments from the income tax base. Smaller businesses will be granted concessions in the form of tax-deductible investment allowances, which will permit them to offset up to 40% of their future purchase prices or production costs against profits (upper limit of €200,000).

– In future, the calculation of the local business tax base will include not only interest on permanent debt at a rate of 50%, but all interest paid on borrowed funds and comparable financing expenses, albeit only at a rate of 25%. Only a portion of rents, leasing payments and licence fees will be recognised as debt financing. A rate of 25% will apply to mobile assets and 75% to immobile assets.

– From 1 January 2009, private capital income is to be subject to withholding tax at a rate of 25%. It is envisaged that this tax will apply not only to interest and dividend payments but also to private capital gains from the sale of securities. The current system of (50%) income tax relief on dividend payments will be abolished for individuals and, in the case of non-corporations, will be replaced by partial relief with a 40% exemption rate. To prevent individual parties from being disadvantaged vis-à-vis the income tax liability, it will be possible to apply for an assessment *ex post.*

– In addition to the points mentioned above, the draft envisages the following counterfinancing measures, in particular.

  – The declining-balance depreciation facility is to be abolished.

  – It should no longer be possible to decrease the taxation burden by means of securities lending.

  – To curb domestic tax evasion through the relocation of functions abroad, the transferred package will be subject to a tax assessment in which the arm's length principle will apply.

  – Further restriction of the use of loss carryforwards to reduce profits following the acquisition of a business (shell purchase).

  – The threshold limit for the immediate write-down of assets is to be reduced from €410 (purchase price or production costs) to €60 as a general rule. The current threshold will still apply in the case of smaller enterprises.

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positive macroeconomic repercussions are factored out of the calculation. Consequently, a large proportion of tax-relevant profits is expected to be transferred back to Germany and fewer profits are expected to be transferred abroad. However, the shortfalls are likely to be higher in the first few years because the rate cuts will apply immediately but some of the counterfinancing measures will not take full effect until later. All in all, it is extremely difficult to forecast the scale of revenue shortfalls as it is very hard to predict how tax payers will react and what the resulting macroeconomic effects will be. It is also possible that local governments may adjust the average local business tax multiplier. Against the backdrop of the continuing need for consolidation and of the rather negative experience gained in the past when estimating revenue from profit-related taxes, it seems advisable to take a cautious approach.

Central government budget

Central government budget in fourth quarter

In the fourth quarter of 2006, central government recorded a lower budget surplus, at just under €1 billion, than in the same period in the previous year (€6½ billion). The main reason for this was that the Federal Employment Agency, in contrast to 2005, received almost no liquidity assistance during the year, meaning that no repayments were necessary at the end of the year. The lack of revenue from the sale of participating interests and loan repayments was offset by additional tax revenue.

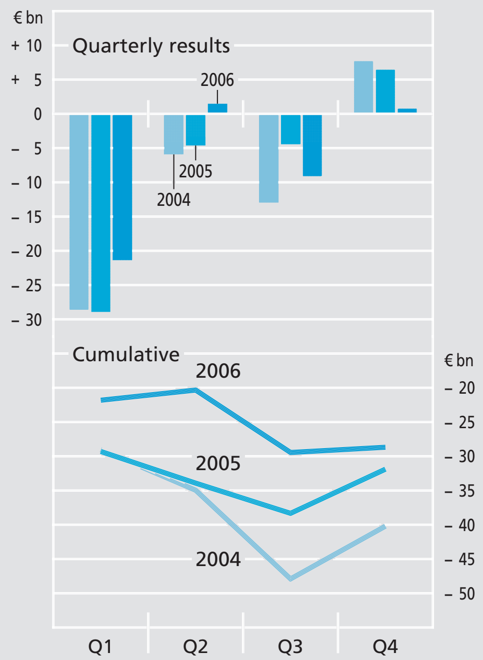
Deficit for the whole of 2006 noticeably below budgeted figure ...

According to provisional year-end figures, the deficit for 2006 as a whole amounted to just over €28 billion and was thus considerably below the budgeted figure of almost €38½ billion. Together with lower than planned net expenditure, the sharper growth of tax revenue in particular, which exceeded the budgeted figure by €10 billion, accounts for the more favourable financial position. Benefits for the long-term unemployed were only €½ billion more than budgeted as additional burdens, particularly for unemployment benefit II but also for the share in costs of accommodation, were largely offset by savings in integration payments.

... but only slightly below previous year

Compared with 2005, the deficit decreased by only slightly over €3 billion. While tax revenue (+€14 billion) and the Bundesbank's profit (+€2 billion) increased considerably, proceeds from asset disposals decreased significantly (-€11 billion) and additional burdens arose from the reform of the labour market (€3 billion including the compensatory amount and taking into account that payments for unemployment assistance were no longer posted as was the case in 2005). However, despite the favourable economic developments, with investment expenditure at €23 billion, the borrowing limit prescribed by Article 115 of the Basic Law could not be adhered to when implementing the budget. Excluding the one-off proceeds envisaged in the Federal budget and transferred to the Post Office pension funds to ease the pressure on the budget, the deficit amounted to as much as €42 billion. After adjustment for these one-off proceeds, the deviation from the borrowing limit specified in the Basic Law amounted to almost €20 billion.

The 2007 Federal budget approved by the Bundestag at the end of November 2006, Central government fiscal deficit/surplus since 2004



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Continued structural over-burdening of Federal budget

plans a further reduction in net borrowing to €19½ billion with investment expenditure at €24 billion. Asset disposals in the core budget and the Post Office pension funds are still providing relief of approximately €15 billion, however. Without these, the limit pursuant to Article 115 of the Basic Law will still be overshot by over €10 billion despite tax increases and a cut of €4 billion in payments to the statutory pension and health insurance schemes. Even if the better outturn for 2006, which is €1½ billion higher than in the tax estimate of November 2006, is carried over as a base effect and if the macroeconomic development, which is now forecast to be somewhat more positive, gives rise to additional revenue, additional consolidation measures are still needed. However, the medium-term financial plan of summer 2006 envisages only a somewhat unambitious decrease in the deficit even after adjustment for declining one-off proceeds for 2008 to 2010.

Special funds with deficit

Central government's special funds finished 2006 with a deficit of €½ billion, having achieved a surplus of €4 billion in 2005. The main reason for this was the development of the ERP Special Fund, which, for the first time since 2001, issued more loans than were paid back. A deficit (€2½ billion) is again envisaged in the 2007 budget. Furthermore, the flood disaster fund set up in 2003 will be dissolved by transferring the remaining funds of just over €1 billion to central government and the states affected by the flood. Against this backdrop, the special funds could also record a deficit in 2007.

State government budgets[5]

Sharp decline in state government budget deficit in 2006

The extremely favourable development of state government budgets continued in the final quarter of 2006. Compared with €6 billion in the final quarter of 2005, the budget deficit amounted to only €½ billion. Over the year as a whole, the deficit was down by more than half on the year (from €24 billion) to €10 billion. The actual outturn was therefore much better than the decrease to €20½ billion (including numerous supplements) forecast in the budgets. Total revenue rose by just over 5½%, predominantly due to an unexpectedly sharp increase in tax revenue (+9½%), which more than compensated for the decrease in other revenue, particularly as

5 The most recently published data on local government finances are analysed in the short articles in the Bundesbank Monthly Report of January 2007.

a result of the fact that Landesbanks were no longer repaying subsidies. Expenditure, however, fell by almost ½%. This was chiefly due to the fact that state-owned enterprises were no longer recapitalised. The proportion of the significant decline in personnel expenditure (-2%) that can be attributed to state institutions being taken out of the core budgets of some state governments (such as universities in North Rhine-Westphalia) is likely to have been largely offset by higher grants to these institutions. Nevertheless, moderate developments in remuneration also helped to rein in expenditure.

Deficit reduction continues in 2007, ...

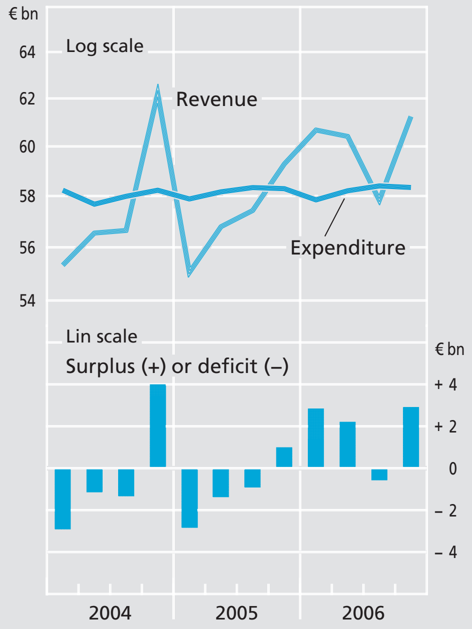
Deficits are expected to be reduced further in 2007 mainly due to revenue from the increase in VAT. The budget plans currently available indicate that the fiscal balance will decrease moderately – compared with the amount budgeted for 2006 – to €16 billion in 2007. As the budgeted figures have, in many cases, not yet been adjusted to take account of the significant upward revisions of the figures in the latest tax estimate, they should be interpreted as predicting changes rather than forecasting actual levels. They therefore indicate that the deficits may be expected to decline further.

... however, budgetary situation is still critical in some states

According to the figures currently available, Bremen, Saarland and Schleswig-Holstein are currently still exceeding the constitutional limits for new borrowing. Berlin's budget envisages a further overshooting of the borrowing limit. According to a ruling by the Federal Constitutional Court, Berlin is not facing acute budgetary hardship and has not yet explored all consolidation options. This means that it will not be able to claim budgetary hardship as justification for its excessive borrowing which far exceeds the level stipulated in the state constitution. While Berlin has announced its intention of keeping within the borrowing limit in 2007 (by continuing the extensive incorrect use of Federal funds earmarked for the reconstruction of eastern Germany), a supplementary budget has not yet been approved. However, other states also require extensive consolidation measures as, according to their budgets, they are relying partly on asset disposals or stretching the definition of self-financed investments in order to adhere to borrowing limits. According to current figures, half of the states have achieved a balanced budget (Bavaria, Saxony, Mecklenburg-Western Pomerania and, thanks to extensive asset disposals, Hamburg) or are actively working towards achieving this in the medium-term (Saxony-Anhalt in 2010; Baden-Württemberg, Brandenburg and Lower Saxony in 2011). As a result of the fact that the reduction of Solidarity Pact funding, which is in part still being used incorrectly, will gather speed from 2009, and the inevitable significant increase in pension costs, the state governments have to continue the firm path to consolidation by strictly limiting the growth in their expenditure even if tax revenue continues to develop positively. The provisions resolved by the Financial Planning Council stipulate a maximum limit of 1% for expenditure growth in the next few years.

Finances of the
German statutory
pension insurance scheme

Quarterly



Deutsche Bundesbank

Social security funds

Statutory pension insurance scheme

Surplus in 2006 as a result of one-off effect due to earlier transfer of contributions

In the fourth quarter of 2006, the statutory pension insurance scheme recorded a surplus of €3 billion resulting in a positive balance of €7½ billion for the year as a whole. Reserves were, therefore, topped up to €9½ billion or to an amount equivalent of 0.6 of a month's expenditure. However, the encouraging results are exclusively based on the fact that since January 2006 social insurance contributions have generally no longer been transferred at the middle of the month following the month in which wages and salaries were paid but at the end of the same month in which payment was made. As a result of this change, contributions were paid in mid-January 2006 for December's pay, in accordance with the old law, and at the end of January for January's pay.[6] The ensuing one-off additional revenue of approximately €10½ billion prevented a deficit of approximately €3 billion that could not be offset by own reserves. Thus, the underlying financial situation continued to be strongly marked by deficit in spite of a clear increase in revenue from contributions and only a slight rise in pension expenditure. This was another factor contributing to the decision to increase the contribution rates in 2007 from 19.5% to 19.9%.

Financial situation showing fundamental deficit

In spite of the higher contribution rate, the favourable employment trend and the fact that if there is to be any pension increase at all it is likely to be slight, a deficit is again expected for 2007. However, the reserves are now safely above the lower limit of 0.2 of a month's expenditure (upper limit of target corridor: 1.5 of a month's expenditure) so that the contribution rate presumably will not need to be raised again for 2008. However, it must be borne in mind that this is currently only a "break" in the demographically-related burdens on pension insurance. While at present a relatively large number of people are of working age, the number of people entering retirement is rather low. This is intensified by the fact that the average retirement age is likely to increase further (to 63 by the end of 2008) owing to pension deductions in the event of early retirement and the raising of the earliest possible age for taking retirement in the event of unemployment or as

6 A transitional regulation made it possible for the second wave of contributions due in January to be spread over the following six months.

part of pre-retirement part-time work. The overall situation will deteriorate noticeably and continually at the beginning of the next decade. In order to counter this, measures are currently being resolved or prepared to curb the increase in contribution rates. One key measure is the raising of the statutory retirement age to 67. The important message that, in order to achieve sustainable public finances in the face of rising life expectancy, the working life must be extended and the retirement age postponed is undermined by the inconsistent exemption granted to people who have paid contributions for at least 45 years. Similarly, this exemption also tones down the curbing effect on the contribution rate.

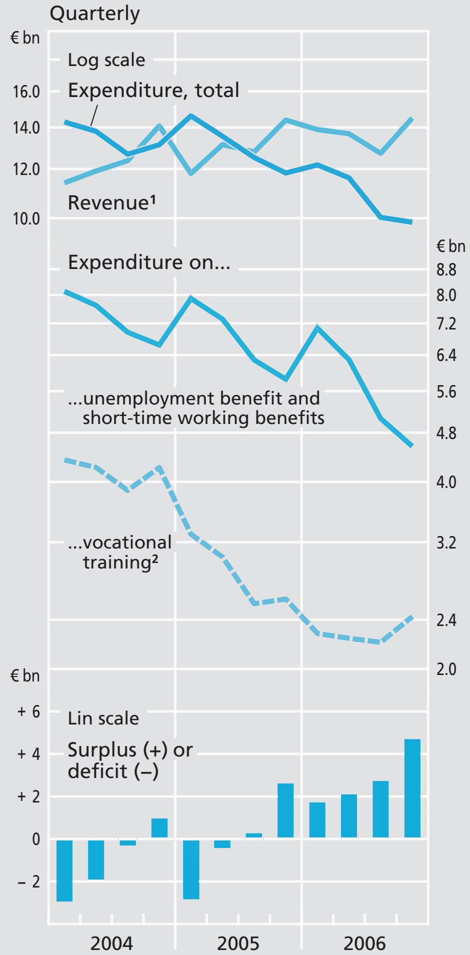
Federal Employment Agency

Surplus in 2006 due to one-off additional revenue from contributions and clear decreases in expenditure

The Federal Employment Agency finished the fourth quarter of 2006 with a surplus of €4½ billion and the year as a whole with €11 billion. A large proportion of this (estimated at €3½ billion) was attributable to the one-off effect arising from the fact that the transfer date for social security contributions has been brought forward. Even more significant, however, was the decline in expenditure, in particular on unemployment benefit I (-15% or €4 billion) which was caused by improvements in the labour market conditions and was accompanied by a reduction in active labour market policies of €2½ billion (-20%). Furthermore, at €3¼ billion the compensatory amount was more than €1 billion lower. The number of income-support households switching from unemployment benefit I to the basic allowance for job seekers (unemployment benefit II) should therefore have decreased by roughly 120,000 to approximately 330,000 households.

Finances of the Federal Employment Agency

Quarterly



1 Excluding central government liquidity assistance. — **2** Sharp decline in 2005 caused by shifting responsibility for training for recipients of unemployment benefit II to central government.

Deutsche Bundesbank

Deficit expected for 2007

In 2007, the Federal Employment Agency will have to cope with revenue falling by just over €14 billion on the year. Only just over one-third of revenue shortfalls resulting from decreasing the contribution rate from 6.5% to 4.2% will be offset by the new rule-based Federal grant. It is also true that the expenditure on unemployment benefit I is expected to fall again due, *inter alia*, to the fact that the financial effect of the reduction of maximum periods of entitlement should gradually be felt from February. Overall, however, a deficit is expected and, therefore, an erosion of the reserves set aside from last year's surplus. In the long term, the contribution rate is likely to be sustainable only if the number of recipients of unemployment benefit I – which, unlike unemployment benefit II, is an indication of cyclical and not structural unemployment – does not, on average, exceed 1.2 million.[7] In 2006, just over 1.4 million people claimed unemployment benefit I, thus exceeding this critical figure. In the future, fewer people on average will claim unemployment benefit I as the maximum periods of entitlement have been shortened. However, it should be borne in mind that the number of people currently claiming unemployment benefit I is probably rather low as a result of the economic situation, but the figure could increase rapidly if the pace of growth slows down. If contribution rates are decreased again or if the (often only marginally successful) active labour market programmes are extended, this will increase the risk that the Federal Employment Agency will not be able to cover economically weak phases with its own financial resources. To avoid a procyclical policy, it is necessary to set up sufficient reserves during positive economic periods as a precaution for difficult times.

Statutory health insurance scheme[8]

Over the course of the first nine months of 2006, the statutory health insurance scheme recorded a deficit of €¼ billion. However, for the year as a whole, a surplus of over €1 billion is expected because the second instalment of the Federal grant coincided with typically high revenue from contributions in the fourth quarter and expenditure has most likely continued to develop at a comparatively moderate rate. The increases in contribution rates at the beginning of 2007, which were, in some cases, rather sharp, are based on burdens arising from cutting Federal grants (by €1.7 billion), which are currently being felt, as well as from higher expenditure as a result of the increase in VAT (approximately €1 billion). Another reason behind the increase in contribution rates is to repay loans taken up in the past. Finally, caution in the face of uncertainties regarding the upcoming healthcare reform must also have had its part to play.

Clear rise in contribution rates at beginning of year

The Act to promote competition among statutory health insurance institutions (*GKV-Wettbewerbsstärkungsgesetz*) has now been approved by the Bundesrat and the first sections can come into effect on 1 April 2007. As opposed to the original plans, some of the savings announced at the last minute concerning hospitals and all of those concerning travel costs have been withdrawn. The burdens on private health insurance schemes have also been softened. In particular, restrictions have been placed on who is entitled to the base tariff and the start of the new regulations in this area has been put back by a year to 1 January 2009. However, the struc-

Healthcare reform approved after final changes

7 See Deutsche Bundesbank, The evolution of labour market-related expenditure, Monthly Report, September 2006, especially pp 75-78.
8 An extensive analysis of the budgetary development of statutory health insurance and long-term care insurance schemes can be found in the short articles in the Bundesbank Monthly Report of December 2006.

ture of the health insurance fund has hardly changed. From 2009, it is to be funded from contributions from insured persons and tax resources, and risk-adjusted premiums are to be passed on to the individual statutory health insurance institutions. This means that the institutions receive flat rates for the people whom they insure, while the social compensation component will be transferred to the health insurance fund. As before, contributions in proportion to income will be levied to finance the fund – but these are charged at a standard contribution rate throughout Germany. Therefore, health insurance institutions will no longer compete using contribution rates but – together with greater scope in terms of expenditure differentiation – by using an additional contribution which may be applied if necessary. This additional contribution is calculated in proportion to income as soon as the upper limit of €8 per month is exceeded.