Public finances

General government budget

Balanced general government budget possible in 2007

The evolution of public finances is currently very positive. After the general government deficit ratio already halved to 1.6% last year, a further marked decline seems likely for 2007. Significant progress has thus been made in the consolidation of public finances and a balanced budget is already possible this year. The favourable macroeconomic trend, which is easing pressure considerably on both the revenue and expenditure side, is contributing to the current improvement. Furthermore, the (very volatile) revenue from profit-related taxes is likely to increase steeply again, although it may now have exceeded the medium-term normal level. This is being reinforced by extensive measures on the revenue side (in particular, the rise in the standard rate of turnover tax) and a still moderate growth in structural expenditure, meaning that the structural fiscal balance, ie adjusted for cyclical effects, will likewise improve significantly. The debt ratio will fall this year for the first time since 2001 and, following the high of 67.9% reached in the two preceding years, approach the 60% ceiling stipulated in the EC Treaty.

Largely constant revenue ratio strongly influenced by countervailing movements

The general government revenue ratio is likely to remain almost unchanged in 2007. On the one hand, the tax ratio will increase, primarily as a result of the raising of turnover tax and insurance tax rates but also owing to a further sharp increase in revenue from profit-related taxes. On the other, social contribution receipts will decrease in the wake of the cut in the contribution rate to the Federal Employment Agency from 6.5% to 4.2% and the lower social contributions from central government for recipients of unemployment benefit II.[1] On balance, this will only be partly offset by higher contribution rates to the statutory pension and health insurance schemes. In addition, the growth of the main macroeconomic benchmarks for taxes and social security contributions (gross wages and salaries, pre-tax private consumption) is lagging behind the marked rise in nominal GDP – due in part to the price effect of the higher excise duties.

Expenditure growth still subdued

There will be a further marked fall in the expenditure ratio this year. Firstly, the positive macroeconomic trend is leading to reduced spending since unemployment figures are lower and – as is customarily the case during an economic upswing – on account of strong nominal GDP growth to a decline in the expenditure ratio. Secondly, the moderate wage trend of the past few years is currently still having a dampening effect on expenditure (as on revenue). For one thing, much government expenditure such as pensions and unemployment benefits is directly affected by wage levels; for another, the current wage moderation in the public sector was itself facilitated by the past development in the private sector. Additional factors are the low number of new pension recipients, the sustained reduction in staff levels and other measures such as the shortening of the maximum period of entitlement to unemployment benefit I, lower social security contribution payments for recipients of unemployment benefit II and lower payments for grants to homebuyers, which are being phased out. By contrast, there could be accelerated growth in nominal expenditure on government investment, which had already seen a sharp rise in 2006.

Further cyclical improvement possible in 2008

The fiscal balance could be somewhat more favourable in the coming year if the positive macroeconomic dynamics persist. According to the budget plans, however, no further improvement in the structural balance is likely. The reform of business taxation, which will come into force next year, will lead to extensive revenue losses. In addition, a certain acceleration of the rise in expenditure, which has been subdued over the past few years, is on the horizon. There is a danger that, as during previous cyclical upswings, the favourable course of budgetary development may be seized as a chance to make additional expenditure hikes or tax and social security cuts without taking due account of the partially temporary nature of the improvement. In that case, the structural budgetary position would worsen. Although, as things currently stand, the debt ratio will decline again noticeably, it will remain above the 60% ceiling. The advantages of consolidation are evident not least in the associated considerable savings on interest expenditure. Thus the declines in the deficit in 2006 and 2007 alone will cut the spending bill by around €4 billion in 2008 compared with the scenario of an unchanged deficit ratio of 3.2% since 2005.

Different budgetary positions for the different tiers of government

The positive overall fiscal picture should not obscure the fact that extensive consolidation measures are still required not only for central

1 However, with social security spending initially unchanged, the latter places increased strains on other contribution payers.

but also for some state and local governments. This is masked when the budgetary position is viewed from a general government perspective. If the surpluses generated by some government entities (eg the Federal Employment Agency or individual federal states) were used for tax and social security cuts or increases in expenditure, the partially unresolved budgetary problems would resurface, also at the general government level.

Surpluses should be aimed at during upturns

The current favourable circumstances provide the opportunity to rapidly eliminate the continuing budgetary imbalances and to attain and lastingly maintain a balanced budget position in the medium term, in line with the goals of the European fiscal framework. After the excessive deficit procedure that had been instigated against Germany in January 2003 was dropped in June owing to the country's favourable budgetary development, the non-binding preventative agreements of the European fiscal framework must now be rigorously implemented. In this way, Germany can set an example within the European Union and simultaneously strengthen the credibility of the Stability and Growth Pact, which was reformed not least owing to pressure from Germany. It will now be seen whether countries whose public finances have not yet been structurally balanced will actually achieve the aim of greater consolidation in good times, which is one of the central reform elements. In Germany, expanding revenue or contracting expenditure should be used for the purpose of deficit and debt reduction. A surplus during an economic upturn means not least that in a later downturn it will still be possible to meet the national and European fiscal requirements without resorting to pro-cyclical policies. It should also be noted that considerable uncertainties exist regarding the assessment of the current budgetary position and, in particular, the further development of profit-related taxes.

Budgetary development of central, state and local government[2]

Tax revenue

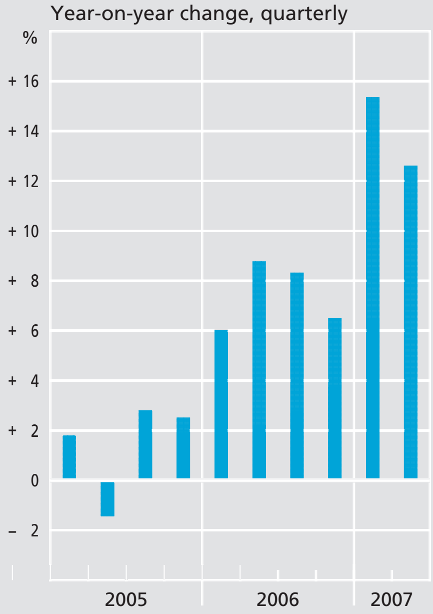
Further strong rise in tax revenue in Q2 ...

In the second quarter, tax revenue[3] was 12½% up on the same period last year (see also the table on page 61). This reflects both the rise in the standard rate of turnover tax and the growth in revenue from income taxes against the backdrop of the favourable macroeconomic trend. Owing to the growth in gross wages and salaries, the restriction of tax rebates claimable by commuters and the comparatively moderate growth in payments deducted from cash receipts (child benefit and subsidies for supplementary private pension plans), wage tax receipts rose by just under 8½%. Revenue from the highly volatile profit-related taxes increased by 28%. This rise reflects the favourable corporate earnings situation and the comparatively low increase in payments deducted from cash receipts (grants paid to home owners and investors, employee rebates, refunds of investment in-

2 The following analysis is based on the budgetary figures as defined in the government's financial statistics. The most recently published data on local government finances are commented on in the short articles in the Bundesbank Monthly Report of July 2007.
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.

Tax revenue*

Year-on-year change, quarterly



* 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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come tax) which comfortably offset the dampening impact of legislative changes on gross revenue (above all the two-year extension of the declining-balance depreciation method). Revenue from turnover tax grew by 16½%, which was largely related to the rise in the standard rate of VAT from 16% to 19%.

... and favourable outlook for the year as a whole

The 14% increase in total tax revenue in the first half of the year is noticeably larger than the growth of 10% expected in the last official tax revenue estimate of May for the year as a whole (excluding local government taxes in each case). At the moment, there are a number of signs that the annual outturn will also be significantly higher than the May forecast. However, there are uncertainties in this regard, not least owing to the generally very volatile nature of revenue from profit-related taxes.[4] It regularly fluctuates distinctly more than can be explained by entrepreneurial and property income, which is used as an indicator for the tax assessment base, and central government estimates of the effect of legislative changes. Following the recent strong growth, the medium-term normal level may now have been exceeded. Given past experience, a prudent approach is to be recommended, particularly as a basis for budgetary planning.

Central government budget

Higher surplus in Q2 owing to growth in tax receipts

Central government recorded a surplus of €5½ billion in the second quarter of 2007 compared with just over €1½ billion in the same period of 2006. The main reason for this favourable development was an increase in revenue of 10½% caused by the particularly strong growth in tax receipts. Non-tax revenue decreased, by contrast, as there was a reduction in the compensatory amount paid by the Federal Employment Agency and capital proceeds also declined. Total expenditure also increased markedly in the second quarter of 2007 (+4½%). The biggest absolute rise was recorded by the new grant to the Federal Employment Agency, which is being financed through the increase in turnover tax. However, increases were also registered not least in the case of operating expenditure and interest payments. The latter was doubtless due chiefly to higher interest rate charges on short-term borrowing, in which central government is engaged with Federal Treasury

4 See also Deutsche Bundesbank, Monthly Report, November 2006, p 55.

Tax revenue

Type of tax	H1 2006 € billion	H1 2007 € billion	H1 2007 Year-on-year change in € billion	H1 2007 Year-on-year change as %	Q2 2006 € billion	Q2 2007 € billion	Q2 2007 Year-on-year change in € billion	Q2 2007 Year-on-year change as %	Estimate for 2007 1,2 Year-on-year change as %
Tax revenue, total 2	207.1	235.8	+ 28.8	+ 13.9	111.2	125.2	+ 14.0	+ 12.6	+ 10.1
of which									
Wage tax	57.9	62.7	+ 4.8	+ 8.4	29.8	32.2	+ 2.5	+ 8.3	+ 7.1
Assessed income tax	3.8	9.0	+ 5.3	+ 140.4	5.9	8.2	+ 2.3	+ 39.9	+ 26.1
Investment income taxes 3	12.5	15.7	+ 3.2	+ 25.7	7.0	8.7	+ 1.7	+ 23.4	+ 11.7
Corporation tax	10.4	11.7	+ 1.3	+ 12.6	5.2	6.2	+ 1.1	+ 20.3	+ 3.1
Turnover taxes 4	71.1	83.0	+ 11.9	+ 16.8	35.2	41.0	+ 5.8	+ 16.4	+ 17.7
Energy tax	14.2	13.8	– 0.4	– 3.1	9.7	9.2	– 0.5	– 5.1	+ 0.2
Tobacco tax	6.4	6.4	– 0.0	– 0.2	3.6	3.5	– 0.1	– 3.9	+ 0.8

1 According to May 2007 official tax estimate. — **2** Including EU shares in German tax revenue, but excluding receipts from local government taxes which are not yet known for the last quarter recorded. — **3** Non-assessed taxes on earnings and withholding tax on interest income. — **4** Turnover tax and import turnover tax.

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notes (Schätze) and Treasury discount paper (Bubills) totalling around €150 billion as well as extensive cash advances.

Net borrowing could fall well below budgeted figure

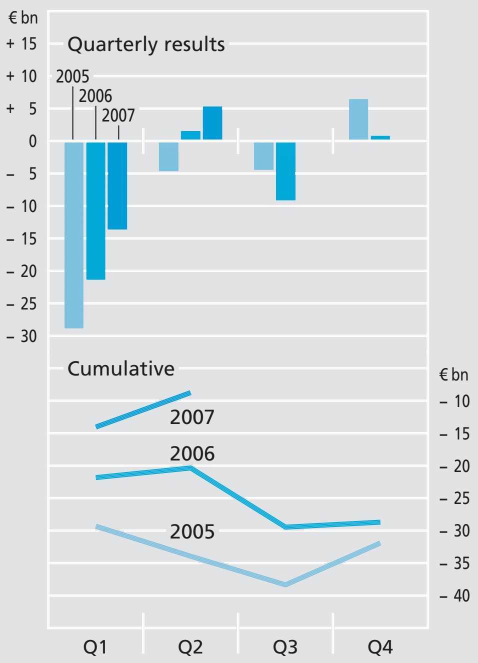
The budget approved at the end of 2006 envisaged a deficit of €20 billion for 2007. With the additional revenue of €10 billion forecast in the May tax estimate, this could be halved. It should be possible to offset burdens resulting from the distinctly lower-than-anticipated proceeds from the compensatory amount through savings elsewhere and potentially even stronger tax revenue growth. However, the Federal Ministry of Finance has now announced that it will set up a special fund connected with the planned increase in the number of day care places for infants. It intends to pay tax revenue into this fund with a view to partly pre-financing the committed assumption of costs of €4 billion by 2013.[5] Furthermore, planned proceeds from asset realisations might be held in abeyance for subsequent "difficult times". Of the associated proceeds envisaged in the budget (€11 billion), only €2 billion has been realised to date. It cannot be ruled out that the existing scope to reduce net borrowing by more than the budgeted amount may not be exploited to the full in order to be able to record a continuous decline in the next few years.

Hardly any fiscal consolidation in 2008 budget

The draft budget for 2008 approved by the Federal Cabinet at the beginning of July envisages net borrowing of €13 billion in the context of further sizeable asset realisations.

5 See also Deutsche Bundesbank, Trends in local government finances since 2000, Monthly Report, July 2007, p 40.

Central government fiscal deficit/surplus since 2005



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Progress towards fiscal consolidation compared with 2007 thus remains very limited overall and has been postponed until subsequent years, despite the favourable current economic setting. Expenditure is set to increase by just over 4½% compared with the budget for 2007. This is primarily due to higher payments to offset the Post Office pension fund deficit and also to one-off effects resulting from the overlapping of child-raising benefit, which is being phased out, and parental benefit, which is already being paid in full, as well as the forwarding of a larger amount of turnover tax resources to the Federal Employment Agency. If these effects are disregarded, the increase in expenditure amounts to just under 2%, attributable to additional spending, in particular, on development aid and external and internal security.[6]

This falls a long way short of the Financial Planning Council's target of last year to restrict expenditure growth to 1%. Furthermore, not all expenditure authorisations are included in the recorded total. Thus, extra expenditure appropriations have been earmarked subject to the proviso that as not yet quantified revenue is to be generated through the sale of CO_2 certificates and sales by the Federal armed forces.

On the revenue side, next year's budget envisages 3% more tax receipts compared with the official May estimate for 2007. The result of the tax estimate for 2008 has been adjusted upwards across the board by €2 billion and various additional legislative changes – in particular, the business tax reform – have been taken into account. In addition, it is planned to replace the compensatory amount as of 2008 by a reintegration payment by which the Federal Employment Agency is to bear half of the administration and labour market integration costs for recipients of unemployment benefit II. This should generate €5 billion in receipts. Compared with a continuation of the compensatory amount, this should ultimately yield around €2 billion in additional revenue. As a general principle, in-

6 In general, the task of adjusting expenditure growth for extraordinary factors is not unproblematic and runs the risk of being arbitrary. For example, an increase in the central government grant to the Federal Employment Agency is ultimately a benefit that must be financed. In addition, alongside exceptional burdens, exceptional relief such as on payments for retired rail staff, war victims' welfare benefits and the all-day school programme, which is coming to an end, should also be factored out. In particular, the exceptional savings made through the temporary reduction in transfers to the Post Office pension fund – owing to the associated securitisation transactions – should have been explicitly highlighted in the past.

surance benefits to be funded through contributions should be clearly demarcated from social policy tasks to be financed out of tax revenue. Otherwise there is a danger that the financial relations with the social security funds could be engineered so as to achieve current central government budget targets.

Balanced budget aimed at in 2011 with the aid of one-off receipts

The medium-term financial plan up to 2011 envisages running central government net borrowing down to zero by the end of the planning period. To this end, expenditure growth after 2008 is to be restricted to an annual average rate of ¾%. This target will require far more stringent expenditure discipline in future budgetary negotiations than is the case in the current and coming year. On the other hand, the assumed positive development of tax revenue could encourage additional spending wishes, as has been experienced in 2007. Moreover, even in 2011, it will evidently only be possible to achieve a balanced budget thanks to privatisation proceeds of €6 billion.

Federal Constitutional Court criticises current borrowing limit

A tightening of the debt incurrence rules is being discussed as part of the second phase of the reform of Germany's federal structure. This was also urged by the Federal Constitutional Court in its judgement of the central government budgets for 2004. A majority of the judges ruled that the budgetary acts did not breach the borrowing limits specified in Article 115 of the Basic Law. They thus concluded that – despite growth expectations at the time – the Federal Government was justified in assuming that a serious disruption to overall economic equilibrium existed, thus warranting a breach of the statutory borrowing ceiling, and that the advancement of the tax cut and the subsequent adherence to the fiscal stance were suitable measures to avert this disruption. The German Council of Economic Experts, whose opinion carries particular weight following the ruling of the Federal Constitutional Court in 1989, was highly critical of this assessment in its report. According to the judges, the ineffectiveness of Article 115 of the Basic Law has been demonstrated in practice over the past few years. However, they stressed that the responsibility for amending it lies with the legislature and not with the judiciary. They did not specify any reform requirements in their ruling. However, the opinion was expressed in minority votes that there should at least be a much narrower definition of investment and hence of the associated scope for borrowing. In the

Federal Government's medium-term financial planning

€ billion

	Actual 2006	Target 2007 1	Draft 2008 2	Financial plan 2009	2010	2011
Expenditure	261.0	270.5	283.2	285.5	288.5	289.7
of which Investment	22.7	24.0	24.3	24.1	24.1	23.7
Revenue	233.1	250.9	270.3	275.0	282.5	289.7
of which Taxes	203.9	220.5	237.1	247.9	252.6	260.3
Net borrowing	27.9	19.6	12.9	10.5	6.0	–
Memo item Percentage increase in expenditure	+ 0.5	+ 3.6	3 + 4.7	+ 0.8	+ 1.1	+ 0.4

1 This contains asset disposals of around €15 billion including relief arising from sales of claims on the Post Office pension fund. — **2** Including asset realisations of around €12 billion. — **3** Adjusted for special and one-off effects (expiry of relief arising from sales of claims on the Post Office pension fund, changeover to parental benefit, higher VAT-financed subsidies to the Federal Employment Agency), the increase amounts to 1.9%.

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second stage of the reform of the federal structure, it is now especially important to effectively restrict net borrowing in the constitutions. Inserting the requirement of a structurally virtually balanced budget, as enshrined in the Stability and Growth Pact, would be a suitable element towards eliminating the discretionary leeway currently associated with investment-related borrowing limits and avoiding inconsistencies with European fiscal commitments.

State government budgets

Further favourable development in state government budgets in Q2

The state government budgets recorded a clear surplus of €5½ billion in the second quarter compared with a balanced budget in the same period of 2006. Revenue increased overall by 10½% owing, in particular, to the favourable trend in tax revenue. Expenditure grew by the far smaller margin of 2%. Transfers to local government are likely to have been considerably larger owing to increased tax receipts, but the key item of personnel expenditure decreased slightly.

State government budgets close to balance in 2007, but continuing need for consolidation

Given the strong growth in tax revenue and the much smaller increase in expenditure, it can be expected that the state government budgets for 2007 will be close to balance on the whole. Bavaria, Mecklenburg-Western Pomerania, Saxony and Thuringia are expecting at least balanced budgets as early as this year. Baden-Württemberg, Berlin and Saxony-Anhalt plan to manage without any new borrowing from 2008 at the latest. By contrast, a number of Federal states are still dragging their feet about aiming to rapidly achieve a balanced budget. This is particularly true of Saarland and Bremen, which are still suing central government to obtain restructuring aid, and of North Rhine-Westphalia and Schleswig-Holstein. Although Rhineland-Palatinate anticipates a longer transitional period until a balanced budget is achieved, it is taking account of growing future burdens for civil servant pensions by setting up relatively large reserves.

Further efforts would – as in the case of central government – facilitate the rapid implementation of tighter borrowing limits. However, the Federal states are still reluctant to set more ambitious legally-binding limits. Hitherto, only Bavaria has had a legal ban on borrowing not warranted by the economic climate or exceptional circumstances. Now, Baden-Württemberg is planning a similar regulation in its state budgetary rules as of 2008. In order to strengthen the binding effect, however, it would be fundamentally preferable to enshrine this in the state government constitutions. In this respect, the second phase of the reform of the federal structure has a particularly important role to play.

Social security schemes[7]

Statutory pension insurance scheme

In the statutory pension insurance scheme, revenue exceeded expenditure by €½ billion

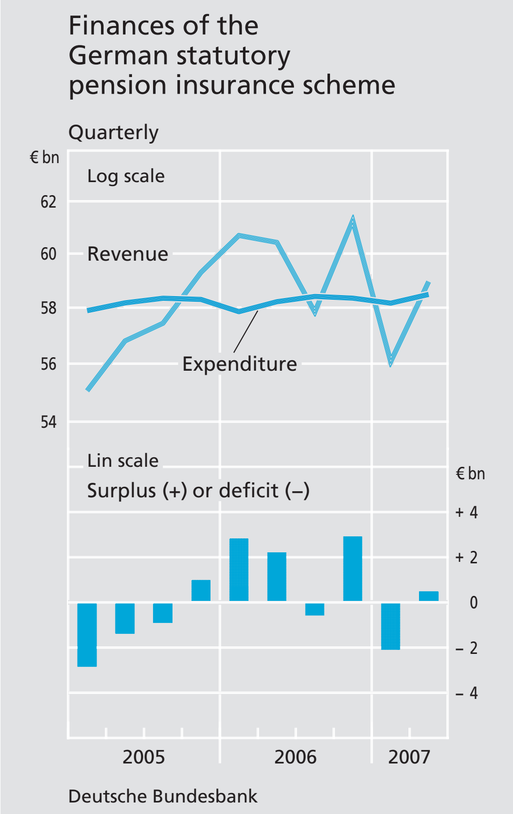
7 The financial development of the statutory health and long-term care insurance schemes was analysed in greater detail in the short articles of the Monthly Report of June 2007.

Improvement in the financial situation owing to higher contribution rate and favourable economic setting

in the second quarter. At just over €2 billion, the surplus recorded in the same quarter of 2006 was larger, although this was mainly attributable to a one-off revenue windfall caused by the transitional regulation lasting until July 2006, which brought forward the transfer deadlines for social contributions. At €2½ billion, the customary seasonal improvement in the financial situation from the first to the second quarter was well above the medium-term average. This is particularly noteworthy given the mild winter and the consequently already relatively strong financial outturn in the first quarter. Overall, the rise in contribution rates from 19.5% to 19.9% at the beginning of the year, along with the favourable trend in employment and improved pay levels, had a positive effect on the statutory pension insurance scheme in the first half of the year. The increase in expenditure was only slight. While pension payments hardly increased, pension insurance spending on health insurance contributions for pensioners, at 5½%, grew much faster owing to the sharp rise in contribution rates at the beginning of the year.[8]

Largely balanced result expected for 2007 as whole

On the one hand, a further significant increase in pay subject to compulsory contributions is to be expected in the second half of the year. On the other, the adjustment of pensions by 0.54% on 1 July 2007 will amplify the increase in expenditure. In this connection last year's favourable employment trend is boosting pension levels via the sustainability factor. Overall, the statutory pension insurance scheme will probably record a largely balanced budget at the end of the year. Given the sharper rise in average pay and the positive employment trend this year, there could be a higher pension increase in 2008. The cyclically induced positive revenue trend would then soon be followed by higher expenditure.



Federal Employment Agency

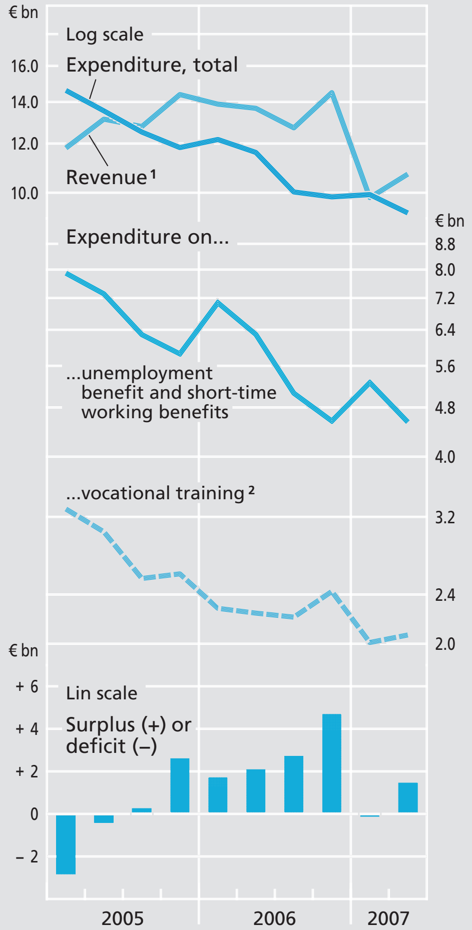
Surplus in Q2

The Federal Employment Agency recorded a surplus of €1½ billion in the second quarter. Owing to the baseline effect caused by bringing forward the transfer deadlines for social contributions as of January 2006, no direct comparison is possible with the second quar-

8 Changes in statutory health insurance institutions' contribution rates come into effect for pensioners from the third month following the relevant change (section 247 of the Fifth Book of the Social Security Code). The contribution rate increases in January (an average year-on-year rise from 14.2% to 14.8%) thus affected expenditure as of April 2007.

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.

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The main contributory factor to the ongoing marked decline in expenditure was the reduced costs of unemployment benefit I, which fell by 28½%. The decisive factor for this was the decrease of 27% in the number of recipients. This reflects not only the favourable labour market situation which, in particular, makes it easier for the short-term unemployed to find new jobs, but also the shortening of the maximum entitlement period to unemployment benefit I to 12 months (or 18 months for persons aged 55 or over), which has had a financial impact as of 1 February 2007. In addition, the compensatory amount was significantly lower in the second quarter than in the same period of 2006. Furthermore, almost 8% less was spent on active labour market policy measures.

Lower spending on wage substitutes owing to buoyant economic activity and shortening of maximum period of entitlement

The Federal Employment Agency will record a clear surplus for 2007 as a whole and will therefore be able to further replenish its reserves. On 1 January 2008, the compensatory amount is to be replaced, mainly by means of a reintegration payment (estimated as €2 billion higher). In this way the Federal Employment Agency is to meet half of the central government costs of administration and labour market integration measures for recipients of unemployment benefit II. In addition, it is planned to reduce the contribution rate by a further 0.3 percentage point to 3.9%. Overall, extra costs of around €4½ billion will arise. That would appear viable as long as the long-term average number of recipients of unemployment benefit I does not exceed the current annual average level of around 1.1 million. Between 1999 and 2006, however, the average number of recipients was

Surplus also expected for year as whole

ter of 2006 (+€2 billion). In addition, the Federal Employment Agency's contribution rate was reduced from 6.5% to 4.2% on 1 January 2007. Moreover, the Federal grant brought in at the same time, which amounted to €1½ billion in the second quarter, must also be taken into account. Despite this, total revenue was down 21½% on the year. However, this was almost matched by the fall in expenditure (-20%).

considerably higher, at an average of just under 1.8 million per year. Although the labour market reforms may have contributed to the marked average reduction of the number of recipients of unemployment benefit I – in some cases, at the expense of higher numbers of recipients of unemployment benefit II – this is based on estimates that are subject to major uncertainty.

Demarcation of insurance benefits from income redistribution transfers

The current discussion on the use of the Federal Employment Agency's surpluses shows that a clear and transparent demarcation of contribution-funded insurance benefits from tax-funded transfers should be an important aim for future fiscal reforms. This could enhance public satisfaction with the social security systems, support a coherent and more selective income redistribution policy and thus improve the quality of public finances. In particular, this would help to avoid a situation in which contribution payers alone finance certain general societal tasks.