

Public finances

General government budget

The public finance situation showed a further significant improvement last year. After the general government deficit fell to 1.6% of gross domestic product (GDP) in 2006, a balanced government budget was achieved in 2007 for the first time since German reunification according to provisional data from the Federal Statistical Office from January 2008.¹

Balanced general government budget in 2007 for first time since German reunification

The favourable general economic setting and the further strong increase in revenue from profit-related taxes, which is subject to large and erratic fluctuations, contributed in part to the deficit reduction. However, the improvement in the financial situation is mostly due to structural factors, such as notably the increases in taxes and social security contributions that came into force at the beginning of 2007 and moderate expenditure growth (see box on pages 54 and 55).

Government debt is likely to have risen slightly last year. However, the debt-to-GDP ratio looks to have declined by about 2½ percentage points compared with 2006 to around 65% owing to the robust nominal economic growth. While this would be well below the historical high of 67.8% that was reached in 2005, it still clearly exceeded the 60% reference value stipulated in the EC Treaty.

Marked fall in debt-to-GDP ratio

In 2007, government revenue amounted to not quite 44% of GDP. Thus the ratio hardly

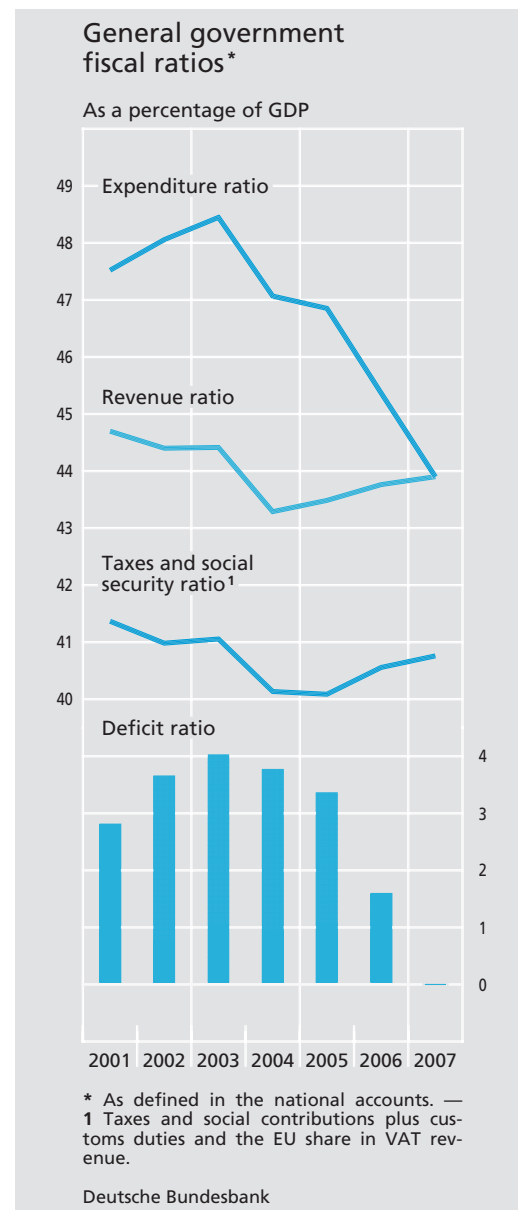
Revenue ratio hardly rose despite higher taxes and social contributions

¹ With the exception of the surplus in 2000 (1.3% of GDP) owing to one-off proceeds from the sale of UMTS mobile telephone licences (2.5% of GDP).

rose at all on the year, although, on balance, the fiscal measures taken led to considerably higher revenue. The main reason for this was that major macroeconomic reference variables for government revenue, such as gross wages and salaries and above all pre-tax private consumption, increased more slowly than nominal GDP. However, tax receipts increased strongly, not least as a result of the rise in the standard rate of VAT and of insurance tax. By contrast, social security contributions decreased slightly because the lowering of the contribution rate to the Federal Employment Agency far outweighed the rise in contribution rates to the statutory health and pension insurance schemes and income subject to contributions only rose moderately. Revenue from profit-related taxes continued to grow much more strongly than would have been expected given legislative changes and the growth in entrepreneurial and investment income, which are used as indicators for the tax assessment base.

Expenditure ratio well down

Government expenditure grew by a moderate 1% last year, which meant that in relation to GDP it went down perceptibly to just under 44%. The positive general economic setting made a significant contribution to this decrease. It not only led to a decline in the ratio as a result of the stronger growth of nominal GDP in the denominator but also thanks to distinctly lower labour market-related expenditure, particularly as a result of the favourable employment trend. The muted increase in pension and personnel expenditure in comparison to nominal GDP also played its part in the decline in the ratio. The moderate overall wage rises were reflected,



in much the same way as on the revenue side, in a reduction in the ratio because adjustment of many social security benefits is closely linked to the (preceding) development of *per capita* earnings.

General government is likely to record a renewed deficit in 2008. Besides a further lowering of the contribution rate to the Federal Employment Agency to 3.3%, the devel-

Deficit expected again in 2008

The structural development of public finances – results of the disaggregated framework for 2007

The public finance situation in Germany improved markedly over the past year. According to provisional data from the Federal Statistical Office from January 2008, a balanced general government budgetary position (as defined in the national accounts) was achieved, following a deficit ratio of 1.6% in 2006. Using the disaggregated framework for analysing public finances¹, 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 2007 are presented below.²

The decline of 1.6 percentage points (pp) in the deficit ratio over the past year was due, in part, to the favourable cyclical development of the economy. Applying the standard adjustment procedure used within the European System of Central Banks, this produced a positive impact of 0.3 pp. However, there were no clearly identifiable temporary special effects influencing the decline in the deficit (such as the proceeds from UMTS sales in the past). Thus, the structural fiscal balance as defined in the disaggregated framework – which is adjusted for these two effects – improved by 1.2 pp in relation to trend GDP.

While the unadjusted revenue ratio increased only marginally, structural revenue grew perceptibly in relation to trend GDP (+0.5 pp). The ratio was boosted slightly by the fact that the – as usual – positive fiscal drag resulting from income tax progression outweighed the negative impact in the case of excise taxes, which are largely volume-based (+ 0.1 pp overall). As in previous years, the negative structural decoupling of the macroeconomic reference variables from GDP growth had a countervailing effect (-0.3 pp). For example, when viewed in isolation, the (trend towards) comparatively small increases in gross wages and salaries and pre-tax private consumption reduced the ratio of revenue from social contributions and wage and turnover tax to trend GDP. This was not fully offset by the additional revenue from profit-related taxes owing to the trend of faster rising entrepreneurial and investment income in relation to GDP. The rise in the structural revenue ratio was attributable mainly to legislative changes. The increase of 3 pp to 19% in the standard rate of VAT and insurance tax and the rise of 0.4 pp and 0.5 pp on average in contribution rates to the statutory pension and health insurance schemes, respectively, had an impact in this respect. Conversely, the contribution rate to the Federal Employment Agency was re-

duced by 2.3 pp. Legislative changes, including a number of quantitatively less significant measures, led to net revenue increases of 0.6% of trend GDP.

Most of the change experienced in the structural revenue ratio in 2007 can be explained by the three factors mentioned above (fiscal drag, the structural decoupling of the macroeconomic reference variables from GDP and legislative changes). The part remaining unexplained in the standardised procedure (residual) came to a total of 0.1 pp. Special factors reducing receipts from turnover tax were offset by factors boosting revenue from profit-related taxes. As in previous years, revenue from profit-related taxes grew at a faster pace than was to be expected given the development of entrepreneurial and investment income (which serves as the macroeconomic reference variable for these taxes in the cyclical adjustment procedure). This may owe something to the fact that large tax prepayments were accompanied by high net backpayments for earlier years. Another fundamental problem is that the reference variable taken from the national accounts does not adequately capture fluctuations in the actual tax base. In contrast to 2006, the increase in turnover tax receipts after adjustment for legislative changes was, however, lower than expected in view of the macroeconomic base applied. Tax-driven advance purchases of consumer goods in 2006 are likely to have contributed to this by correspondingly reducing the proportion of goods in total consumption in 2007 subject to the standard rate of VAT, which was increased at the beginning of 2007. This reduces the average tax rate *per se* (which is derived from the revenue generated), a fact which is not taken into account in the standardised calculations. However, this effect alone is not sufficient to explain the unfavourable development in turnover tax. Tax evasion may also have increased in connection with the tax hike.

At 0.8 pp, the decline in the structural expenditure ratio was significantly smaller than that in the unadjusted ratio. This was due, in part, to adjustment for the sizeable cyclically induced reduction in labour market expenditure. In addition, real GDP growth in 2007 was perceptibly stronger than that of trend GDP. The denominator of the unadjusted expenditure ratio thus increased more markedly than that of the structural expenditure ratio. The interest expenditure ratio remained at roughly the same level as in 2006. Although the debt ratio fell perceptibly, the average

¹ For a more detailed description, 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 subsequent amendment owing to revisions to the preliminary national account figures or revised estimates of the macroeconomic outlook. — ³ Adjusted for cyclical influences and temporary effects. In accordance with EDP defin-

ition, ie including swaps and forward rate agreements in interest rate expenditure and the fiscal balance, or in accordance with ESA 95 (2007). — ⁴ Percentages of nominal GDP. — ⁵ Assessed income tax, investment income taxes, corporation tax, local business tax. — ⁶ Payments attributable to the general government sector, eg social contributions for public sector employees (estimated). — ⁷ Other current

Structural development ³ as percentage of trend GDP

Year-on-year change in percentage points

Item	2001	2002	2003	2004	2005	2006	2007	Total 2001-2007
Unadjusted fiscal balance ⁴	- 4.1	- 0.8	- 0.4	0.3	0.4	1.8	1.6	- 1.3
Cyclical component ⁴	0.0	- 0.4	- 0.4	- 0.2	- 0.4	0.4	0.3	- 0.7
Temporary effects ⁴	- 2.5	0.1	0.0	0.1	0.1	- 0.2	0.0	- 2.5
Fiscal balance	- 1.7	- 0.5	0.1	0.3	0.8	1.5	1.2	1.9
Interest payable	- 0.1	- 0.2	0.0	- 0.2	- 0.1	0.0	0.0	- 0.4
Owing to change in average interest rate ^{pe}	0.0	- 0.2	- 0.1	- 0.3	- 0.1	0.0	0.1	- 0.6
Owing to change in debt level ^{pe}	- 0.1	0.0	0.1	0.1	0.1	0.0	- 0.1	0.2
Primary balance	- 1.8	- 0.6	0.1	0.2	0.7	1.6	1.3	1.4
Revenue	- 1.9	- 0.6	- 0.3	- 1.2	0.1	0.9	0.5	- 2.5
of which								
Tax and social contributions	- 2.0	- 0.5	- 0.2	- 0.9	0.0	0.9	0.5	- 2.2
Fiscal drag	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.6
Decoupling of base from GDP	- 0.2	- 0.4	- 0.2	- 0.3	- 0.1	- 0.1	- 0.3	- 1.6
Legislative changes	- 1.1	0.7	0.4	- 0.6	- 0.2	0.1	0.6	0.1
Residual	- 0.8	- 1.0	- 0.5	- 0.2	0.2	0.9	0.1	- 1.3
of which: profit-related taxes ⁵	- 0.7	- 0.8	- 0.1	0.1	0.2	0.7	0.2	- 0.5
Memo item: included in expenditure ⁶	- 0.2	0.0	0.0	- 0.2	- 0.2	- 0.2	- 0.1	- 0.8
Non-tax-related revenue ⁷	0.1	- 0.1	- 0.1	- 0.3	0.1	0.0	0.0	- 0.3
Primary expenditure	- 0.1	0.0	- 0.4	- 1.4	- 0.6	- 0.7	- 0.8	- 4.0
of which								
Social payments ⁸	0.2	0.5	- 0.1	- 0.8	- 0.4	- 0.2	- 0.6	- 1.6
Subsidies	- 0.1	- 0.1	- 0.1	- 0.1	- 0.1	0.0	0.0	- 0.6
Compensation of employees	- 0.2	- 0.1	- 0.2	- 0.2	- 0.2	- 0.2	- 0.2	- 1.2
Intermediate consumption	0.0	0.0	0.0	- 0.1	0.2	- 0.1	0.0	0.1
Gross fixed capital formation	0.0	- 0.1	- 0.1	- 0.1	- 0.1	0.1	0.1	- 0.3
Other expenditure ⁹	0.1	- 0.2	0.1	- 0.1	0.1	- 0.2	- 0.1	- 0.4
Memo item								
Pension expenditure ¹⁰	0.0	0.1	0.0	- 0.3	- 0.2	- 0.2	- 0.3	- 0.8
Healthcare expenditure ¹¹	0.1	0.0	- 0.1	- 0.4	0.0	0.0	0.0	- 0.3
Labour-market expenditure ¹²	0.0	0.0	- 0.1	- 0.2	- 0.2	- 0.2	- 0.3	- 0.9

interest rate on government debt rose for the first time since the turn of the century. By contrast, the structural ratio of other expenditure (primary expenditure) decreased significantly. As in previous years, expenditure on old-age pensions made a major contribution to this development as the annual average increase in pensions was very modest (+0.3%) and there was only a gradual rise in the number of pension recipients. Furthermore, labour market expenditure fell owing not only to cyclical conditions but also to the marked decline in its medium-term trend. Lastly, the moderate changes in negotiated rates of pay and the continued reduction in central, state and local government staff numbers also caused the compensation of government employees to fall significantly in relation to trend GDP. Overall, therefore, the

transfers receivable, sales and total capital revenue. — **8** Including other current transfers to households. — **9** Other current transfers payable to corporations and the rest of the world, other net acquisitions of non-financial assets and capital transfers. — **10** Spending by the statutory pension insurance scheme, on civil servant pensions and payments by the post office pension fund. — **11** Spending by the

mutated pattern of wage developments not only depressed revenue but was also “automatically” reflected in a declining ratio on the expenditure side as numerous social benefits are linked to wage developments and they also form the basis for negotiated pay rates in the public sector. This was offset to only a minor degree by the sharp rise in investment expenditure *per se*.

On balance, it is clear that the noticeable decline in the deficit ratio in 2007 is attributable to various factors. Alongside the positive cyclical influence, it was mainly the (also structurally) limited growth in expenditure and the higher revenue resulting from legislative changes that led to this very favourable development.

statutory health insurance scheme and assistance towards civil servants’ healthcare costs. — **12** Spending by the Federal Employment Agency (excluding the compensatory amount paid to the Federal Government) and expenditure on unemployment assistance (up to 2004) or unemployment benefit II (from 2005) and on labour market reintegration measures.

opment in profit-related taxes is particularly likely to contribute to the deterioration in the budgetary situation. First, the marked tax losses in connection with the reform of business taxation have to be taken into account. Second, following the sharp growth rates of the past few years, revenue is now likely to have reached a level that is perceptibly higher than normal. Furthermore, as a result of the financial market turmoil, there is an additional risk of a rather weak development of profit-related taxes. Overall, the general government revenue ratio will decrease significantly despite additional revenue due to the effects of tax progression. The expenditure ratio is also likely to contract as the growth particularly of pension and labour market expenditure is likely to remain subdued as things currently stand. However, this will probably not be sufficient to completely offset the fall in the revenue ratio.

Consolidation that has been achieved ...

Germany's budget last year was also balanced in structural terms (ie after adjustment for cyclical influences and temporary effects), meaning that the medium-term fiscal objective set by the Federal Government was therefore already achieved in 2007. Following the dropping of the excessive deficit procedure in June 2007, an additional important provision of the EU fiscal framework has thus been met. If this course of sound public finances is maintained, then the debt-to-GDP ratio could also quickly be brought below the reference value of 60% defined in the EC Treaty. This would mean that a further central demand of the European fiscal rules would be met. Furthermore, the future budgetary strains resulting from the ageing of the population would

then be offset by an easing of the debt service burden.

The renewed incurrence of a deficit in 2008 envisaged by the Federal Government in the latest update to the stability programme is not fully compatible with the European fiscal framework. This is underscored by the fact that the programme was based on the assumption that the macroeconomic setting would be rather positive and revenue from profit-related taxes would remain at an exceptionally high level in 2008.

... must not be endangered

A further loosening of fiscal policy, ie on top of the tax relief granted by the lowering of the contribution rate to the Federal Employment Agency and the business tax reform, as has recently been adopted in the United States, for example, to avert the threat of recession, currently does not seem appropriate in Germany. Although the macroeconomic risks have risen slightly in Germany, too, overall the domestic economy remains in robust shape and within the corridor of normal capacity utilisation. Therefore, there is no justification for jeopardising the consolidation that has been painstakingly achieved over the past few years. Furthermore, it may generally be doubted – not least given past experience – that attempts to actively steer the German economy by fiscal means will be crowned with success. As a rule, it appears to be more appropriate, given a structurally sound financial situation, to let the automatic stabilisers take effect. This is also envisaged in the European fiscal framework. In the light of Germany's particular situation at the present time, embarking upon an expansionary fiscal policy

Further loosening not appropriate

could prove to be an unnecessary and costly venture.

Budgetary development of central, state and local government²

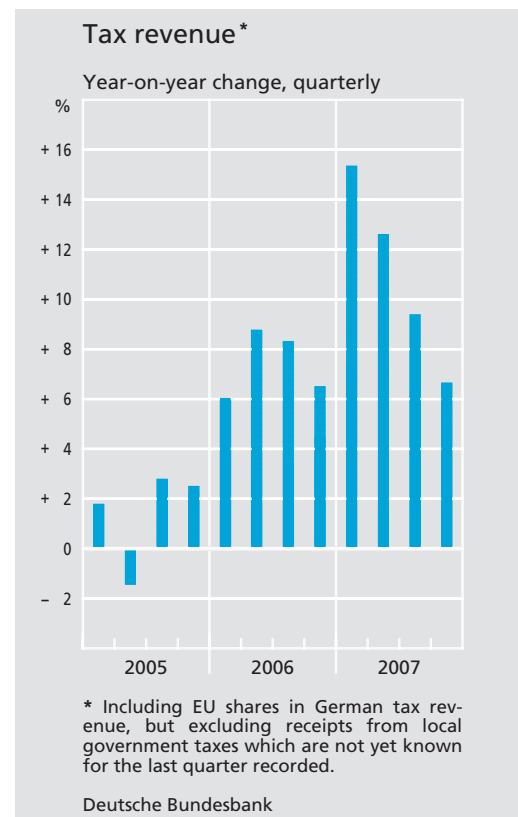
Tax revenue

Tax revenue rose steeply in 2007, but fell short of latest expectations

In 2007 tax revenue³ rose steeply (+10½%), although the growth declined during the course of the year (see chart on this page and table on page 58). In addition to the weakening of the underlying dynamics, special factors also contributed to this. The main reasons for the significant growth in the year as a whole were first the increase in VAT receipts as a result of the rate rise at the start of 2007. Second, income tax revenue also rose considerably in the wake of the buoyant macro-economic momentum. The 2007 outturn exceeded the official forecast from November 2006 by a total of €21 billion, although it was €1½ billion below the expectations of the latest estimate from November 2007.

Growth in income tax reflects economic buoyancy and special factors

Specifically, wage tax revenue increased by 7½% on the year. In addition to the increase in gross wages and salaries, this was mainly due to the reduction in child benefit payments, which are deducted from cash receipts, and to tax progression effects. But the restrictions on the standard travel allowance for commuters for recognising travel expenses between home and work also played a role. Various cases are currently pending at the Federal Constitution Court questioning the constitutionality of the revised rules, and a decision is expected on the matter this year.



This being so, since September 2007 tax payers have been permitted to carry on claiming these tax-free allowances during the year again under the *status quo ante*.⁴ In addition to the smaller reduction in child benefits and a moderate wage development towards the end of the year, this may have contributed to the slight fall in growth in wage tax receipts in the fourth quarter, which generates a larger share of revenue than any other quar-

² The following analysis is based on the budgetary figures as defined in the government's financial statistics.

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.

⁴ The 2007 income tax returns are being assessed subject to possible revision with regard to travel costs.

Tax revenue

Type of tax	Full year				Estimate for 2007 1, 2	Q4			
	2006	2007	Year-on-year change			2006	2007	Year-on-year change	
	€ billion		as %	in € billion	€ billion	€ billion	as %	in € billion	
Tax revenue, total 2	446.1	493.8	+ 10.7	+ 47.7	+ 26.5	128.8	137.4	+ 6.6	+ 8.6
<i>of which</i>									
Wage tax	122.6	131.8	+ 7.5	+ 9.2	+ 4.2	35.5	37.6	+ 6.0	+ 2.1
Profit-related taxes 3	60.0	72.9	+ 21.5	+ 12.9	- 0.4	17.7	19.3	+ 8.8	+ 1.6
Assessed income tax	17.6	25.0	+ 42.5	+ 7.5	+ 1.9	7.5	8.7	+ 15.4	+ 1.2
Investment income taxes 4	19.5	25.0	+ 27.8	+ 5.4	- 0.2	3.7	4.9	+ 31.1	+ 1.2
Corporation tax	22.9	22.9	+ 0.1	+ 0.0	- 2.1	6.5	5.7	- 11.8	- 0.8
Turnover taxes 5	146.7	169.6	+ 15.6	+ 22.9	+ 22.9	38.5	44.0	+ 14.2	+ 5.5
Energy tax	39.9	39.0	- 2.4	- 1.0	- 0.5	15.7	15.3	- 2.4	- 0.4
Tobacco tax	14.4	14.3	- 0.9	- 0.1	- 0.3	4.3	4.1	- 4.5	- 0.2

1 According to official tax estimate of November 2006. —
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 Employee refunds, grants paid to home owners and investors de-

ducted from revenue. — 4 Non-assessed taxes on earnings and withholding tax on interest income. — 5 Turnover tax and import turnover tax. — 6 Actual tax revenue including (estimated) local government taxes was approximately €23 billion higher than the estimate.

Deutsche Bundesbank

ter. Revenue from profit-related taxes⁵ increased steeply again in 2007 (+ 21½%), although their rate of growth decreased in the course of the year. However, the decrease in the rates is overstated by a significant year-on-year decline in the first few months of 2008 in the volume of payments deducted from cash receipts for grants to homeowners, which were being phased out, (in particular in the main payment month of March) and in refunds to employees. Exceptional factors may also have distorted the pattern in the case of corporation tax. Overall, revenue from profit-related taxes also grew more strongly in 2007 than was implied by the financial impact of legislative changes and the increase in the macroeconomic reference variables (entrepreneurial and investment income) – albeit to a much smaller extent than

in 2006. The financial market turmoil has thus far had no discernible impact on the development of tax revenue.

The strong increase in revenue from consumption-related taxes was driven by the rise in the standard rate of VAT (and also of insurance tax). However, the year-on-year rates of expansion declined during the course of 2007. This is likely to be particularly due to the fact that in the latter part of 2006 the cash flow statistics were boosted by precipitated purchases ahead of the announced in-

Growth in consumption-related taxes due to higher tax rates

5 The term "profit-related taxes" comprises assessed income tax, corporation tax and investment income taxes. In contrast to the definition used in the national accounts, the financial statistics definition used here deducts grants to home buyers and investors as well as employees' income tax rebates (section 46 of the Income Tax Act) from profit-related tax revenue and disregards local business tax.

crease in the standard rate of VAT. Turnover tax development was disappointing in that the pre-tax assessment base hardly increased, particularly as a result of continued weak private consumption, and the result was also lower than was to be expected when taking this subdued consumption development into account. However, turnover tax receipts have been fairly volatile over the past few years and have matched developments in the macroeconomic reference variables only to a limited extent. Energy tax revenue – the most important central government excise duty in terms of volume – fell by 2½% in the wake of higher energy prices, the resulting consumer restraint but doubtless also on account of the mild winter in 2007.

2008 characterised by business tax reform and economic risks

In the latest official tax estimate – which also forms the basis of the 2008 Federal budget – total revenue for the current year (including local government taxes) is expected to increase by 3%. This takes into account estimated shortfalls of around €6½ billion resulting from the business tax reform, which entered into force at the beginning of 2008. A certain counterswing to the extreme growth of revenue from profit-related taxes over the past years was also factored into the estimate. Since the starting basis for 2008 has turned out to be lower than forecast in the November estimate and the macroeconomic outlook is now subject to greater uncertainty, overall there is a risk of revenue shortfalls.

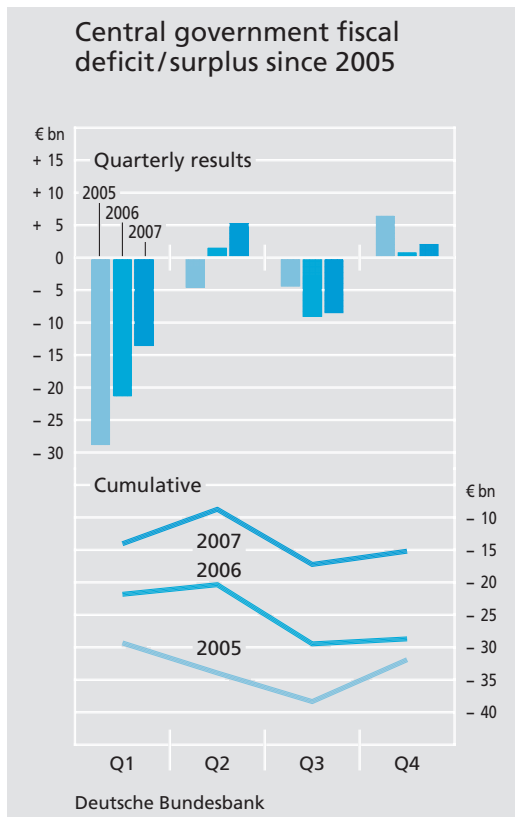
Central government budget

Central government recorded a budget deficit of just over €14½ billion in 2007. This exactly matched the amount envisaged in the supplementary budget. On the revenue side there were shortfalls totalling €4 billion due to a moderate undershooting of the level expected in the November tax estimate, backpayments to the EU and a lower-than-expected compensatory amount paid by the Federal Employment Agency. Half of the shortfalls was offset by increased revenue from asset realisations, payments from the EU and inflows of resources from the liquidation of the flood disaster fund. Expenditure increased by almost 3½% on the year, chiefly as a result of the recently introduced VAT-financed grant to the Federal Employment Agency, but, like revenue, it remained almost €2 billion below the estimate in the budget plans. In addition to savings on interest expenditure and on drawings on underwriting commitments, lower expenditure on benefits for the long-term unemployed and payments to offset the miners' pension insurance fund deficit also contributed to budget relief.

Overall, central government's deficit almost halved in comparison to 2006. At almost €14½ billion, net borrowing in the actual budget implementation was well below total investment expenditure (just over €26 billion). However, this would not have been achieved without the extensive relief from asset realisations in the central government budget and the post office pension fund. Thus, despite the favourable course of development in the economy as a whole, the budgetary situation

Deficit in 2007 as a whole, as envisaged in supplementary budget

Deficit almost halved compared with 2006



of central government remained strained. The positive general government result should not obscure the fact that central government budget consolidation is still a long way from being achieved.

The 2008 Federal budget, approved by the Bundestag at the end of November, envisages only a slight decline in the deficit to €12 billion. Compared with 2007, expenditure growth of 4½% is estimated, almost half of which can be attributed to grants to the post office pension fund which, following the exhaustion of the remaining proceeds from securitisation last year, are now quantified at €6 billion. However, in addition, current expenditure in other areas was also increased, while investment is expected to fall by €1½ billion to €24½ billion. However, asset realisations

of €12½ billion are also envisaged. Without these extraordinary receipts, the borrowing limit defined in Article 115 of the Basic Law will only just be observed this year. If, as the Federal Government envisages in its 2008 Annual Economic Report, overall economic growth remains below expectations and further tax revenue risks materialise, the outlook for the Federal budget would worsen. As things now stand, despite the current situation being somewhat worse than was hoped for, the budget benchmarks still seem achievable. However, against the backdrop of a waning macroeconomic momentum and given the increases in expenditure that have been approved, the envisaged goal of achieving a balanced budget by 2011 seems a tall order.

The deficit of the central government subsidiary budgets amounted to €3 billion in 2007, which was €2 billion less than in 2006. In the case of the post office pension fund, as in 2006, proceeds from a securitisation of claims, treated as a loan, were used up, resulting in a renewed deficit of €4½ billion. The flood disaster fund also recorded a deficit as a result of the remaining €1 billion of resources being distributed. As in 2006, on balance the ERP Special Fund, which was reorganised mid-year under the aegis of the KfW group, recorded a net borrowing requirement of €½ billion. By contrast, the Redemption Fund for Inherited Liabilities recorded a surplus of just under €1 billion, mainly thanks to receiving part of the Bundesbank's profit in early 2007, which must be used for redemption, while the interest on the debt is paid directly from the Federal budget. The

Subsidiary budgets recorded deficit in 2007

Hardly any consolidation progress planned in 2008

newly created Extension of Childcare Fund posted an even more favourable result. Its Federal government grants, in the amount of €2 billion, are not planned to be spent until during the following years.

State government budgets⁶

*Surplus in 2007
for first time
since 1969*

The budgetary outturn of state government in 2007 improved by €13 billion compared with 2006 and, for the first time since 1969, recorded a surplus (€3 billion). By contrast, the draft budgets at the beginning of 2007 had envisaged a total deficit of €15½ billion. This extremely positive outturn was principally attributable to the strong increase in total revenue (7½%) fuelled by the rise in tax receipts. Following a subdued growth pattern in the preceding years, however, expenditure likewise increased at a somewhat faster pace (+2%). While personnel expenditure rose only comparatively slightly (+½%) despite higher transfers to the reserves for state government civil servants' non-contributory pensions, transfers to local government, which are generally linked to the level of tax revenue generated by state government, climbed appreciably and alone probably accounted for just over half of the rise in state government expenditure.

*More muted
outlook for
2008, with
budgetary
situation still
critical in some
states*

The expected shortfalls in profit-related taxes in 2008, not least as a result of the business tax reform and the likely increases in expenditure – also on account of public sector pay rises – are likely to lead to a less favourable outturn for state government budgets. The budgets, which have now largely been adjusted to the latest tax estimate, envisage a

fiscal deficit of €6 billion for 2008 as a whole. However, the fiscal situation of the individual state governments differs greatly. Nevertheless, seven out of 16 states have presented budgets for this year with no new net borrowing and four more plan this by 2011 at the latest. The remaining five states have, as yet, not published any firm target dates for achieving this goal. These include Bremen, Saarland and Schleswig-Holstein whose budgets, although these states already have high *per capita* debt, continue to exceed the constitutional ceiling for new borrowing. Demographic trends and the foreseeable rise in spending on civil servant pensions make it necessary to continue the consolidation efforts and initiatives to reduce debt. To effectively contain debt, a constitutional anchoring of borrowing limits, ultimately aiming at a balanced budget, is needed, not only for central government but also for the state governments. Such a new provision could be implemented as part of the second phase of the reform of Germany's federal structure.

Social security funds⁷

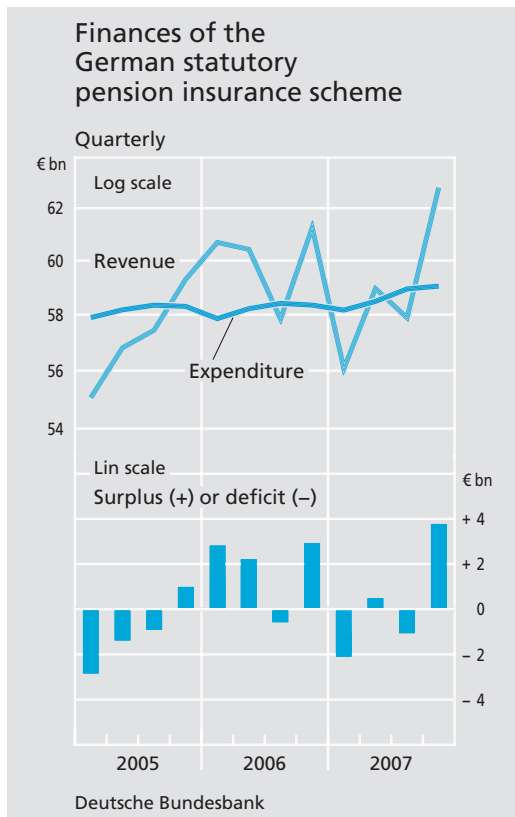
Statutory pension insurance scheme

The statutory pension insurance scheme recorded a surplus of just over €1 billion in 2007. This is a considerable deterioration

*Improvement
in financial
situation in
2007*

⁶ The most recently published data on local government finances were analysed in the short articles in the Bundesbank Monthly Report of January 2008.

⁷ The financial development of the statutory health and long-term care insurance schemes in the third quarter of 2007 was analysed in the short articles of the Monthly Report of December 2007. These are the most recent data available.



compared with 2006, in which a positive balance of €7½ billion was generated. However, there are some special factors to note. First, without the substantial one-off revenue windfalls on account of the advancement of the deadlines for transferring social contributions to the funds there would not have been a surplus in 2006 but rather a deficit of approximately €3 billion. Second, there would have been a deficit of around €1 billion in 2007 if the contribution rate had not been increased from 19.5% to 19.9% (+€4 billion) and contributions paid by central government on behalf of recipients of unemployment benefit II had not been cut (-€2 billion). At the end of 2007, the reserves amounted to €12 billion or just over 0.73 of monthly expenditure. Within the space of a year they increased by just over €2 billion.⁸

Revenue fell by just under 2% in total. But disregarding the special factors referred to, it would probably have increased by just over 1½%. Contribution receipts were curtailed perceptibly by the fact that pension contributions paid on behalf of recipients of unemployment benefit decreased considerably, as not only were the contributions paid on behalf of recipients of unemployment benefit II halved, but also the number of recipients of unemployment benefit I plummeted.

Cyclically-induced positive revenue trend

Total expenditure increased by just under 1%. The main reason for this was the just over ½% increase in pension payments, particularly owing to the slightly increased number of pension recipients, but also as a result of the pension increase on 1 July 2007 (+0.54%). In addition, there was significant extra spending on health insurance for pensioners, half of whose contributions – less the special contribution of 0.9% – are paid from the statutory pension insurance scheme. In this context the marked increases in the contribution rates to the statutory health insurance institutions pushed up expenditure.

Moderate expenditure growth overall

An increase in the surplus and a further topping-up of the reserves are expected in 2008, as income subject to contributions is likely to continue to grow faster than pension expenditure – even if the pension increase planned for 1 July 2008 is likely to be somewhat higher than in 2007. However, in future

Increase in surplus expected in 2008

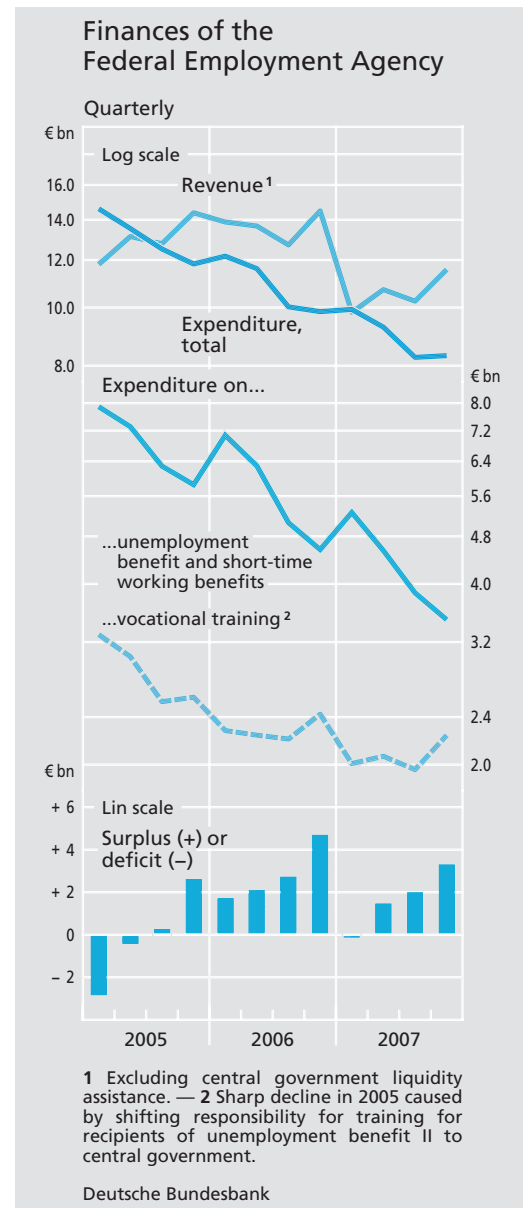
⁸ Since April 2004 new pensions have no longer been paid in advance but rather in arrears. While this improves the year-to-year liquidity situation of the statutory pension insurance scheme, it does not alter the accruals-based accounting of pension expenditure and thus the budget outturn.

the structural financial situation of the statutory pension insurance scheme will be more difficult as, following the fairly small number of annual new retirees in recent years, the much larger cohorts born in the post-war years retire.

Federal Employment Agency

Buoyant job trend made large surplus possible in 2007 despite contribution cut

The Federal Employment Agency recorded a surplus of just over €6½ billion in 2007, while in 2006 income had exceeded expenditure by more than €11 billion. However, it should be noted that in 2006 the Federal Employment Agency, too, recorded one-off revenue windfalls owing to the transfer date for contributions being brought forward. Without this effect the 2006 surplus would have totalled approximately €8 billion. Furthermore, the contribution rate was lowered from 6.5% to 4.2% at the beginning of 2007 and at the same time a new Federal grant was introduced. Without these measures a surplus of around €18 billion would have been recorded in 2007. This illustrates how much the finances of the Federal Employment Agency – in terms of both revenue and expenditure – benefited from improvements on the labour market. Total revenue was down 22½% on the year. Revenue from contributions decreased by 37% on account of the aforementioned effects (although after adjustment there was a noticeable rise).⁹ However, this was offset by additional revenue, in the amount of €6½ billion, arising from the new rule-based Federal grant. This grant corresponds to the volume of revenue generated by 1 percentage point of the standard VAT rate.¹⁰ Conversely, central government is no



longer obliged to offset any deficit run up by the Federal Employment Agency.

In 2007 expenditure fell by 18%. This was largely facilitated by the reduction in un-

Sharp falls in spending, particularly on unemployment benefit I

⁹ In the final quarter of 2007, for which a direct comparison with 2006 is possible, year-on-year growth of just under 3% was recorded after adjustment for the lowering of the contribution rate.

¹⁰ From 2010 the Federal grant will be annually updated in line with the development of turnover tax receipts after adjustment for changes in the VAT rate.

employment benefit I payments by 26% on account of the fall in the number of recipients to an annual average of just under 1.1 million. It probably also owed something to the shortening of the maximum eligibility periods for claiming this benefit. Once again substantial savings were also made in spending on active labour market policy (-9½%), although the savings were much smaller than in 2006. Considerably lower expenditure was incurred in the form of the compensatory amount payable to central government, which at €2 billion was almost €1½ billion lower than in 2006.

Budgetary situation in 2008 to worsen appreciably in connection with the end of spending cuts ...

On account of the surpluses recorded in the past two years, the Federal Employment Agency's reserves grew to around €18 billion at the end of 2007. In 2008, part of the financial reserves will be depleted or reallocated. Thus €2.5 billion will be diverted to a new pension fund for the existing pension claims of working and retired civil servants of the Federal Employment Agency. While the budgets plans envisage a further reduction in expenditure on unemployment benefit I, this will be very small, also on account of the extension of the maximum entitlement period for unemployment benefit I for older claimants.¹¹ Additional expenditure is envisaged again in respect of vocational training. Furthermore, the compensatory amount payable to central government is to be replaced by a reintegration payment which, at €5 billion, is likely to be more than twice as high as the

current outturn. Thus contribution-payers are being called upon to finance half of the central government costs for promotional measures and of the administration expenses associated with long-term unemployment.¹² Overall, a deterioration in the Federal Employment Agency's finances is therefore expected on the expenditure side.

Despite being based on the assumption of a favourable macroeconomic setting, the Federal Employment Agency's budget plan envisages an (operating) deficit of €2½ billion for 2008 after adjustment for the transfer to its civil servants' pension fund. A major factor in the deterioration in its financial situation is the lowering of the contribution rate from 4.2% to 3.3%. This alone will cause revenue shortfalls of just over €7 billion. In cutting the rate, policymakers therefore incurred a considerable risk of having to procyclically raise the contribution rate again in future downturns.

... but particularly resulting from sharp cut in contribution rate

¹¹ The Act Reforming the Labour Market reduced the maximum period of entitlement to unemployment benefit I for new claimants as from February 2006 to 12 months. An extension to 18 months was granted only to persons aged 55 and over. However, from 2008 unemployment benefit I will be paid to persons aged 50 and over for a maximum of 15 months and to persons aged 58 and over for up to 24 months.

¹² Further easing of the burden on central government at the expense of the Federal Employment Agency was planned with the ending of contribution payments for persons raising children. However, to compensate for the savings expected to accrue to central government as a result of extending the maximum period of entitlement to unemployment benefit I for older persons, central government will continue to pay these contributions in the amount of just under €290 million annually.