

Public finances*

General government budget

In 2008, the state of public finances is likely to deteriorate somewhat. After the general government deficit was reduced markedly in the past few years and a balanced budget was achieved in 2007, a slight reversal is expected in the current year. The cyclical setting will continue to make a positive impact, not least owing to the beneficial economic growth profile from the point of view of general government. The unfavourable budgetary development is due more to structural factors such as sizeable tax and social security cuts and, in addition, to a probable weak trend in revenue from profit-related taxes. The rate of increase in expenditure which, although moderate, is still higher than in previous years, will not provide an adequate counterweight. The overall development is fraught with uncertainty, however, owing to the financial market turbulence and increased risks to the macroeconomic outlook. The debt ratio, which in 2007 recorded a clear decline for the first time in years, is likely to decrease further. Nevertheless, the 60% ceiling stipulated by the EC Treaty will continue to be overshot.

Public finance situation will worsen somewhat in 2008

The two factors mentioned above, in particular, will have a marked dampening effect on revenue. On the one hand, tax and social security cuts, especially the reform of business taxation and a further lowering of the

Marked fall in revenue ratio mainly due to tax and social security cuts

* The "General government budget" section starts with an analysis of general government budget developments, which is predominantly based on figures from the national accounts. The subsequent reporting on budgets of the various levels of government and the social security schemes is based on the budgetary figures as defined in the government's budgetary financial statistics.

contribution rate to the Federal Employment Agency from 4.2% to 3.3%, will result in significant revenue shortfalls. Rising contribution rates to the statutory health and long-term care insurance schemes will have a lesser impact. On the other hand, revenue from profit-related taxes, which has surged in recent years and of late has probably been well above its trend value, is likely to drop owing *inter alia* to the financial market turmoil. However, the forecast is subject to major uncertainty, especially as the financial impact of the business tax reform is also hard to estimate. Overall, government revenue is likely to fall distinctly in relation to gross domestic product (GDP) during 2008 despite progression-related additional tax receipts.

Faster spending growth will slow drop in expenditure ratio

Growth in government expenditure will increase at a noticeably faster pace and probably reach its highest level since 2002. However, the expenditure ratio is likely to fall further as spending is likely to grow more slowly than nominal GDP. Cyclically-related labour market expenditure, for instance, will again decrease perceptibly. Furthermore, the moderate macroeconomic growth trend in wages and salaries up until 2007 will have a lingering effect, as there is a time-lag before major social benefits, especially for pensioners and the unemployed, are adjusted to the wage trend. Personnel expenditure, which made a major contribution to the decrease in the expenditure ratio in previous years, is not likely to have a dampening effect in 2008 owing to the sharp pay rises in parts of the public sector. Stronger expenditure growth is expected for government investment and in the health-care sector.

The public finance situation is likely to remain more or less unchanged in the coming year. A small structural deficit is again likely provided any additional increases in expenditure or cuts in taxes and social security contributions are fully counterfinanced.

Situation largely unchanged in 2009

On the one hand, the outlook indicates that the structural general government deficits in 2008 and 2009 are likely to be rather low and that the budgetary situation should therefore be much better than in recent years. The debt ratio is also falling closer towards the 60% ceiling. On the other hand, it is becoming clear that it will not be easy to achieve the structural improvements in 2009 announced by Federal Government in the latest stability programme. According to the most recent European Commission forecast, Germany is likely to fall well short of the objective set down in the Stability and Growth Pact of achieving a structurally balanced budget.¹ Contrary to the impression sometimes created by current fiscal policy discussions, there is therefore no scope for additional deficit-increasing measures without corresponding counterfinancing. Instead, policymakers should bear in mind the fact that the recalculation of the socio-cultural minimum subsistence level means that the relevant tax allowances (and possibly child benefit payments, too) as well as basic allowances will need to be raised starting in 2009. This is likely to place a strain on the budget for which no counterfinancing yet exists. A substantial drop in revenue levels is also likely to result from 2010 onwards from the

No scope for additional financial strains on government budgets

¹ For information on the Commission's forecast, see the box on page 22-23.

implementation of a ruling by the Federal Constitutional Court referring to the offsetting of health and long-term care insurance contributions against tax. These strains could be borne more easily if a more favourable situation were to be achieved in 2009.

Risks for government budgets from support measures for financial institutions

Government support measures for fragile financial institutions will be reflected in the general government fiscal balance and debt level in 2008. The public banking sector presents a particular risk as central, state and local government could be affected as owners by profit setbacks and may even be directly affected by having to provide financial resources and absorb losses.

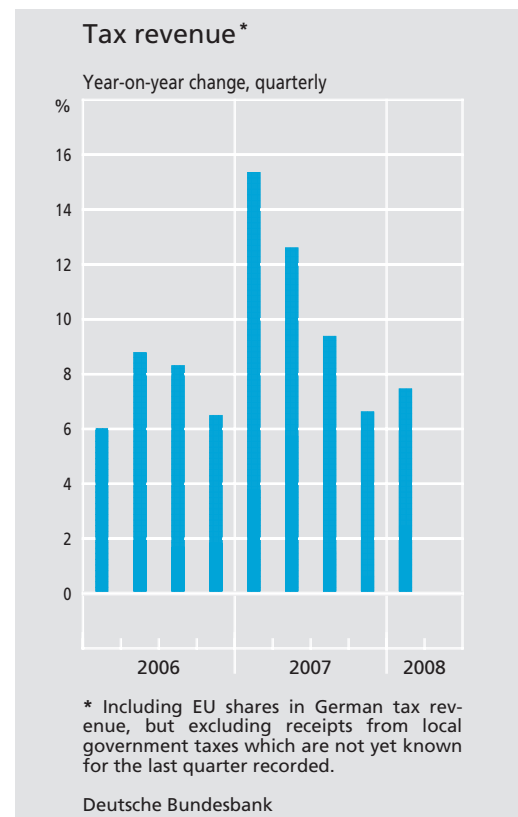
Budgetary development of central, state and local government

Tax revenue

Sharp increase in tax revenue in Q1

Revenue from the major individual taxes increased sharply in the first quarter of 2008 compared with the same period last year. This continued in part into April. Total tax revenue² grew by 7½% in the first quarter (see also the adjacent chart and the table on page 68). Revenue from income taxes³ increased by a total of 13½%. The increase in wage tax (+7½%) reflects not only the growth in gross wages and salaries but also the progression effect and the decline in child benefit payments deducted from cash receipts. Revenue from profit-related taxes⁴ also recorded strong growth (+27½%). Assessed income tax receipts exceeded last year's corresponding level by €3 billion. Along with

Income tax growth reflects upturn and special factors



the persistently buoyant macroeconomic momentum – albeit a little weaker than in 2007 – payments deducted from cash receipts for grants to homeowners (main payment month: March), which are being phased out, and refunds to employees decreased sharply (by a total of €2 billion). Although corporation tax receipts sank markedly (-13%), the drop could have been larger in the wake of the business tax reform. The consequences of the financial market turmoil do not appear to have had a noticeable negative effect

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 Wage tax, assessed income tax, corporation tax and investment income taxes plus the solidarity surcharge.

⁴ These comprise 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 from profit-related tax revenue.

Tax revenue

Type of tax	Q1		Estimate for 2008 1, 2	
	2007	2008	Year-on-year percentage change	Year-on-year percentage change
	€ billion			
Tax revenue, total 2	110.6	118.8	+ 7.5	+ 3.8
<i>of which</i>				
Wage tax	30.5	32.8	+ 7.6	+ 7.5
Profit-related taxes 3	13.2	16.9	+ 27.4	+ 4.4
Assessed income tax	0.8	3.7	.	+ 20.1
Investment income taxes 4	7.0	8.5	+ 21.5	+ 9.2
Corporation tax	5.4	4.7	- 13.0	- 17.8
Turnover taxes 5	42.0	44.3	+ 5.4	+ 3.9
Energy tax	4.5	4.7	+ 2.8	+ 2.4
Tobacco tax	2.9	2.5	- 12.7	- 5.9

1 According to official tax estimate of May 2008. — 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes, which are not yet known for the quarter recorded. — 3 Employee refunds, grants paid to home owners and investors deducted from revenue. — 4 Non-assessed taxes on earnings and withholding tax on interest income. — 5 Turnover tax and import turnover tax.

Deutsche Bundesbank

yet either. Investment income taxes soared (+21½%). Of the consumption-related taxes, revenue from turnover tax increased by 5½% in the first quarter. This reflects, in particular, the delayed effect on cash receipts in the first quarter of last year of the rate rise at the beginning of 2007.

Rise in consumption-related taxes still boosted by VAT hike

The latest official tax estimate from May predicts a rise of 3% in receipts for the year as a whole (including local government taxes) and a slight decline in the tax ratio (as defined in the government's financial statistics) to 22.1%.⁵ The slight decline in the ratio can be explained by the net revenue-reducing effect of legislative changes (in particular, from the business tax reform). Although the additional revenue due to the effects of tax progression *per se* causes the ratio to rise, this will be

Slight shortfalls expected for 2008

partly offset by the weaker development of consumption-related taxes. The revenue estimates have been revised downwards by €1 billion compared with the last official tax estimate from November 2007.

The projection for 2009 envisages that tax revenue will increase by 3% and that the tax ratio will again rise slightly. The figures have been revised upwards by €6½ billion compared with the forecast from May 2007 to the extent that adjustments have been made for legislative changes⁶ (the reform of business taxation, in particular). For one thing, wage tax receipts are now estimated to be significantly higher owing to the sharper growth in the underlying assessment bases. For another, the more favourable outturn for profit-related taxes last year has been largely projected forward to the following years. Estimation uncertainties ensue from the risks surrounding the underlying macroeconomic assumptions. Furthermore, it is difficult to forecast the further development of revenue from profit-related taxes, which is extremely volatile – sometimes even from one quarter to the next. There is much uncertainty, too, con-

Outlook fraught with uncertainty

5 The estimate is based on the Federal Government's latest macroeconomic forecast, according to which real GDP is expected to grow by 1.7% in 2008 (November 2007: 2%) and nominal GDP by 3.4% (November 2007: 3.5%). In 2009, real growth is expected to be 1.2% and nominal growth 2.7%.

6 Including the adjustment for estimated losses following the ruling of the European Court of Justice in the Meilicke case. In May 2007 the shortfalls, which the Federal Ministry of Finance put at €5 billion, were expected to arise for the most part in 2008. Since the November 2007 estimate, it has been assumed that the effect on cash receipts will be felt one year later. As the estimate is based on the legislative status quo, the expected increase in relevant allowances (and probably child benefit payments, too) following the pending recalculation of the socio-cultural minimum subsistence level were not taken into account.

cerning the effects of the business tax reform, the consequences of the financial market turbulence⁷ and the extent to which profit-related taxes may return to their trend level, which probably is currently being surpassed.

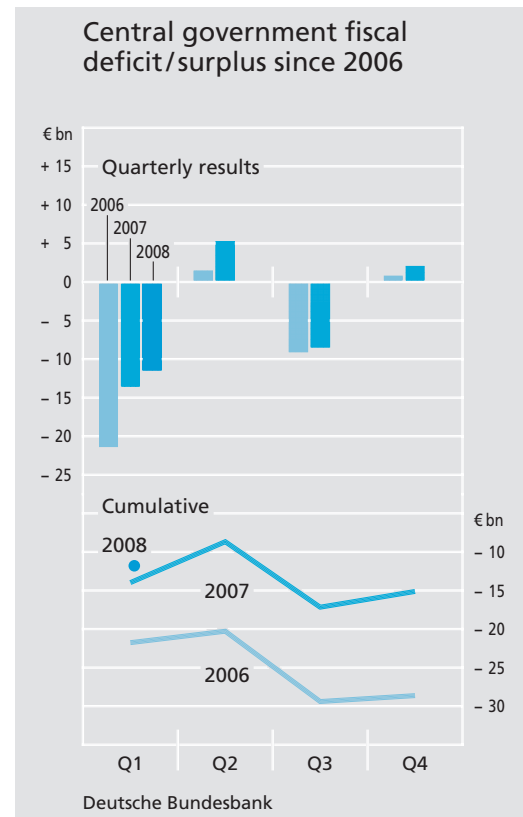
Medium-term development dependent on macroeconomic trend-growth

Tax revenue is expected to rise by 4% on average from 2010 to 2012 and the tax ratio to 22.8%. The ratio will be boosted *inter alia* by the progression effect. However, this does not include foreseeable lower revenue in the wake of the rearrangement of the special income tax deductibility of expenditure on health and long-term care insurance contributions from 2010 necessitated by a ruling of the Federal Constitutional Court. The assumptions regarding economic trend-growth are especially important for medium-term projections. After such projections were revised downwards on several occasions in recent years, a more favourable development of trend-GDP is now assumed. Overall, tax revenue in 2011 has been revised upwards by €13 billion vis-à-vis the last medium-term estimate from May 2007, taking account of the effects of legislative changes that have taken place in the meantime. The contributory factors include upward revisions for wage tax and the projection of a continued higher basis for profit-related taxes.

Central government budget

Deficit down slightly in Q1

Central government recorded a deficit of €11½ billion in the first quarter of 2008 compared with €13½ billion in the first three months of 2007. Revenue rose by 5% (€3 billion). While the rise in tax receipts was significantly curbed by larger contributions to the



EU (+€1¼ billion), at 4½% (€2½ billion) it was still larger than expected for the year as a whole (+3%). There was also an increase in non-tax revenue. Income from the Federal Employment Agency, in particular, was €¾ billion up on the corresponding period of 2007 as the reintegration payment was considerably higher than the compensatory amount levied previously. Expenditure was over 1% (€1 billion) higher than last year. Current transfers recorded sharp growth of 5% (€2 billion), €1 billion of which was attributable to payments by the post office pension fund, which are now effectively being

⁷ Irrespective of the direct consequences for the development of corporate earnings according to the macroeconomic assumptions upon which the tax estimate is based, it is to be expected that the extensive balance sheet write-downs will additionally reduce taxable profits, at least to a certain degree.

completely financed out of the Federal budget. However, more was also spent on parental benefits and child-raising benefit than one year ago (€½ billion). Military procurements caused other operating expenditure to climb by a considerable €½ billion. However, transfers to the Federal Railways Fund recorded lower expenditure of €1 billion as the Fund financed most of its expenditure in the early part of the current year itself from asset realisations. Interest expenditure also declined significantly (-€½ billion), whereas a sharp increase was budgeted for the year as a whole.

Planned deficit cut in 2008 currently seems feasible

For 2008 as a whole, the central government budget envisages only a moderate decrease in the deficit of €2½ billion to just over €12 billion. Following the good start to the year, this target certainly seems achievable even though unplanned new burdens have arisen in the meantime. Thus the collective labour agreement for salaried staff in the public sector concluded at the end of March, and which is to be applied also to staff with civil servant status and – with reductions – to retired civil servants, means that an increase in negotiated rates of pay of over 5% in 2008 will result in a total burden on the budget of just over €1 billion (including additional costs for retired civil servants previously employed by the post office and the railways), whereas the extra appropriation in the budget amounts to only €½ billion. Furthermore, an extraordinary payment of over €1 billion has been approved to support IKB Bank after the KfW Group had already largely exhausted its corresponding financial resources in the wake of support measures totalling approximately

€7 billion. However, it should be possible to make savings in other areas through stringent budget management. Moreover, additional revenue of €½ billion is expected according to the latest tax estimate. Given the ongoing financial market crisis and the uncertainty concerning the burdens resulting from the business tax reform, however, this likely out-turn may not yet be interpreted as signalling the all-clear.

In addition to the projected budget deficit, it should be observed that relief from asset realisations totalling approximately €13 billion is planned for 2008. According to the concept for a new debt rule presented by Federal Government at the end of February, this implies a fiscal consolidation requirement of approximately €20 billion. If the objectives of achieving a consolidated central government budget and credible debt rules are to be upheld, this needs to be factored into the forthcoming budget preparations for 2009, especially as the tax estimate envisages additional revenue of only €1 billion compared with the medium-term financial plan in 2007 – which is effectively required for the foreseeably much higher personnel costs. The slowing of tax revenue growth compared with recent years and higher expenditure on transfers to the statutory health insurance and pension insurance schemes, which is already apparent, considerably limit the discretionary fiscal scope in other areas. Any burdens that arise from 2009 due to expected increases in tax allowances and social benefits will have to be counterbalanced elsewhere. From 2010, the increase in special tax allowances for contributions to the health and the long-term care

Still extensive need for consolidation of central government budget

insurance schemes stipulated by the Federal Constitutional Court is likely to place an additional strain on the central government budget, although the size of the extra burden will depend greatly on the precise nature of the corresponding legislative measures. Given at most a marginal rise in tax revenue compared with the last medium-term financial plan and no corresponding counterfinancing concepts, the recent public discussions about boosting benefits and cutting taxes stand in sharp contrast to the publicised medium-term objectives for the central government budget.

*Off-budget
entities in
surplus in Q1*

Central government's off-budget entities recorded a surplus of €1½ billion in the first quarter of 2008 compared with a deficit of €1 billion in the same period last year. In 2007, the ERP Special Fund, prior to its reorganisation under the aegis of the KfW Group, recorded a deficit of over €1 billion. The post office pension fund had likewise incurred a deficit of €½ billion in the first three months of 2007, which was financed by resources raised from securitisation transactions in 2005 and 2006. From the current year, however, all expenditure on pensions for retired post office civil servants has been effectively paid from Federal grants. As the ongoing contributions from the successor enterprises of Deutsche Post are now being used for the interest expenditure and set aside for the subsequent repayments in connection with the securitisations, a surplus of €½ billion was recorded. As in the first quarter of last year, the Redemption Fund for Inherited Liabilities received part of the Bundesbank's profit, which had risen slightly. At almost €4½ billion, this again exceeded the portion

of €3½ billion that is reserved for transfer to the central government budget.

State government budgets⁸

The state governments' combined deficit decreased considerably year on year during the first quarter of 2008, from €3 billion to €½ billion. Revenue increased substantially (+6½%) thanks to the positive development of tax receipts but also to sizeable non-tax income in Berlin (apparently resulting from the repayment of an undisclosed contribution to Landesbank Berlin). The concurrent increase in expenditure was much smaller (+2½%). Transfers to local government appear to have again expanded perceptibly. In addition to the increase in receipts included in the tax-revenue-sharing schemes with local government, this rise in income may be attributable to the implementation of a ruling by the Constitutional Court in the Federal State of North Rhine-Westphalia that the state government is ultimately obliged to make backpayments to local governments of €½ billion. By contrast, personnel expenditure, which is a key cost item, rose by only 1%. In 2006, an increase of 2.9% in remuneration for salaried employees from the beginning of 2008 was agreed in principle. However, the federal states, which since the first stage of the reform of Germany's federal structure have been free to determine the pay and conditions of their employees themselves, have so far only partly applied the pay adjustment to

*Marked decline
in deficit in
2008 Q1 ...*

⁸ The development of local government finances is analysed in greater detail in the short articles in the Bundesbank Monthly Report of April 2008.

their civil servants and retired civil servants, who account for the bulk of staff costs.

... but slightly less favourable outturn expected for 2008 as a whole

Despite the positive development in the first part of the year and the improvement of almost €1 billion in the figures of the latest tax estimate, the outlook for the year as a whole is more subdued, meaning that a slightly less favourable outturn is expected than in 2007.⁹ Expected revenue shortfalls resulting from the business tax reform and additional costs in the local government revenue-sharing scheme will have a particular effect here. In addition, the progressive application of the pay agreement to civil servants and retired civil servants is likely to cause personnel expenditure to climb more steeply over the remainder of the year. Furthermore, budgetary costs may arise from the tense financial situation of some Landesbanken if the risk shields covering a total amount of almost €10 billion are drawn on and supplementary equity injections are needed.

Use second stage of federal structure reform to limit borrowing capacity

Although most of the federal states also want to conclude 2008 without incurring any new debts, those states with particular budget difficulties and high *per capita* debt (Bremen, Saarland and Schleswig-Holstein) in part expect a clear increase in their deficits in 2008. As part of discussions in the Federalism Commission, these states have announced that they will not manage to achieve a balanced budget by 2019. However, this should be put into perspective.¹⁰ The increase in debt over the past few decades suggests that it would be advisable to agree uniform stricter budget rules as part of the second stage of federal structure reform.

Social security funds¹¹

Statutory pension insurance scheme

The statutory pension insurance scheme recorded a deficit of €1½ billion in the first quarter of 2008, which was €½ billion lower than in the first three months of last year. While expenditure increased by over 1%, income grew at the noticeably faster pace of 2½%. The inflow of contributions rose by 3½%. Both the favourable employment trend and higher average remuneration had a positive effect here. However, contributions for recipients of unemployment benefit decreased again. On the expenditure side, pension payments increased by almost 1%. This was due to the pension adjustment of 0.54% in mid-2007 and a rise in the number of pensioners of almost ½%. By contrast, health insurance contributions for pensioners attributable to the statutory pension insurance scheme again increased sharply (6%) as the marked rise in contribution rates introduced by the health insurance institutions at the be-

Lower deficit due to strong inflow of contributions in Q1

⁹ This is based on monthly figures for the core budgets, according to which the surplus for the federal states in 2007 amounted to €3 billion. But according to figures from the Federal Statistical Office, which include, in particular, Berlin's proceeds from the sale of its Landesbank investment (€4½ billion) – which was transferred to a reserve not included in the state budget – the surplus amounted to €8 billion. If the surplus is calculated using the sectoral definitions from the national accounts (ie including outsourced universities, state-owned road construction enterprises, transport and statistics as well as civil servant pension reserves), the surplus amounted to as much as €9½ billion.

¹⁰ See the concluding report by the budgetary analysis working group under <http://www.bundestag.de/parlament/gremien/foederalismum2/drucksachen/kdrs102.pdf>.html.

¹¹ The financial development of the statutory health and public long-term care insurance schemes in 2007 was analysed in the short articles of the Monthly Report of March 2008.

ginning of 2007 did not come into effect for pensioners until April 2007.¹²

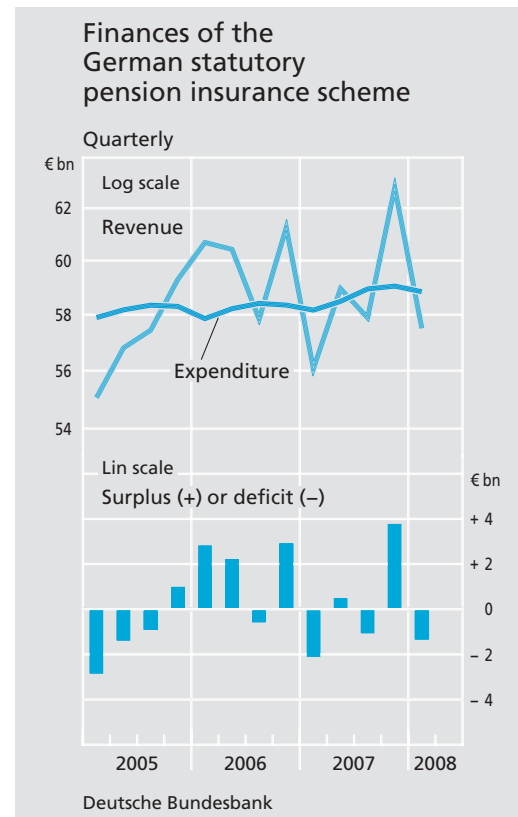
Higher surplus expected in 2008

A continued sharp rise in contribution receipts is expected in the remainder of the year. However, on 1 July 2008 pensions will not be increased by 0.46%, as warranted by the agreed pension adjustment rules, but rather by 1.1% owing to the suspension of the envisaged pension adjustment-curbing factors. For 2009, too, it was decided to waive the pension adjustment curb of just over 0.6 percentage point accounted for by employees' supplementary private provisions for old age. This will entail additional expenditure of €¾ billion in 2008, €2 billion in 2009 and €3 billion in 2010. If – and only if – the postponed adjustment curbs are then actually made in 2012 and 2013, this would impose additional costs of approximately €12 billion on contribution and tax payers. If not, there is a danger that the contribution rate will be raised permanently 0.3 percentage point higher.¹³ Overall, the statutory pension insurance scheme is nonetheless likely to record a significantly larger surplus in 2008 than last year (over €1 billion).

Federal Employment Agency

Deficit in Q1 due to lowering of contribution rate and special factors

In the first quarter of 2008, the Federal Employment Agency recorded a deficit of €2½ billion, whereas the corresponding outturn for the same quarter of 2007 was close to balance. However, this also reflects the fact that expenditure was pushed up by transfers of €1.6 billion to date to the newly established dedicated pension fund for civil servants employed by the Federal Employment



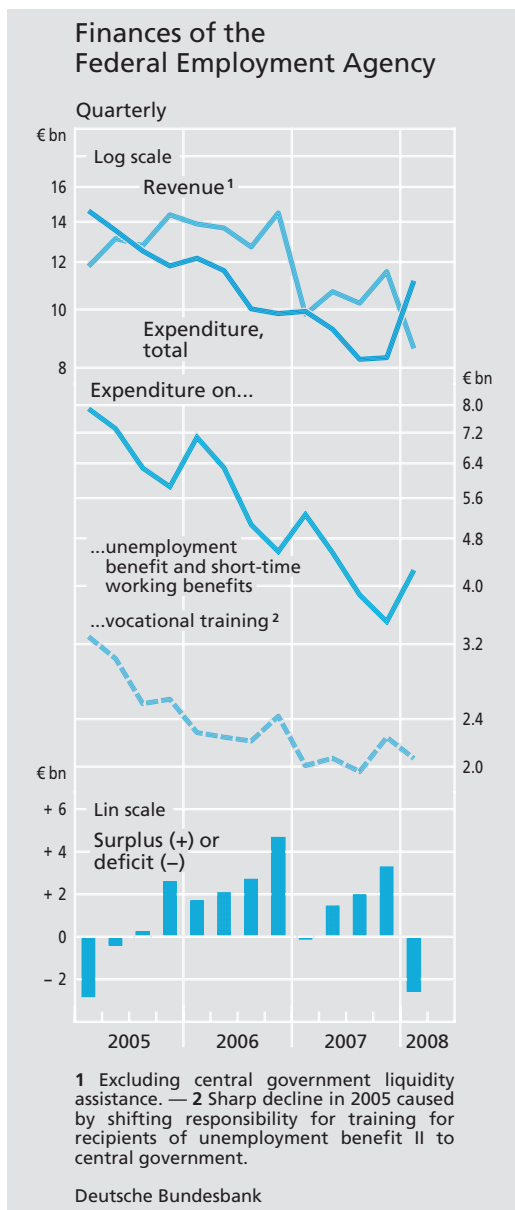
Agency. Adjusted for this effect, the (operating) deficit amounted to almost €1 billion. However, the lowering of the contribution rate from 4.2% to 3.3% alone curtailed revenue by €1¾ billion. Overall, therefore, the ongoing advantageous labour market trend is continuing to have a positive effect on the Federal Employment Agency's finances.

In the first quarter of 2008, contribution receipts were 23% down on the year. After adjustment for the reduction in the contribution rate, this still amounted to a decrease of 2%. This was solely attributable to special fac-

Contribution trend distorted in Q1

¹² The time-lag is due to the fact that changes to statutory health insurance schemes' contribution rates are not applied for pensioners until the third month following the change.

¹³ See Deutsche Bundesbank, Outlook for Germany's statutory pension insurance scheme, Monthly Report, April 2008, pp 63-65.



tors¹⁴ that will balance out again during the course of the year and without which an increase of 3½% would have been recorded. At €2 billion, the Federal grant to the Agency was 17½% higher and therefore in line with the assumed (for the first time, full) effect on revenue of 1 percentage point of the increase in the standard rate of VAT.

Expenditure was up by 12½% on the year. However, after the elimination of transfers to the civil servants' pension fund, it actually fell by 3½%. Spending on unemployment benefit I dropped by a further 20% (€1 billion). On the other hand, the new reintegration payment, via which the Federal Employment Agency refunds central government half of its expenditure on active labour market policy measures and administrative expenses for recipients of unemployment benefit II, was significantly larger than the compensatory amount levied previously. Furthermore, for the first time since the beginning of 2003, an additional amount (+3%) was spent on active labour market policy.

Operating expenditure down despite higher reintegration payment

The upturn for the first quarter supports the prediction that the financial situation in 2008 will be a lot better than estimated in the Federal Employment Agency's budget plan. The budgeted deficit of €5 billion (of which €2.5 billion due to transfers to the civil servants' pension fund) could turn out to be less than half that amount so that, in operational terms, the Agency could actually generate a surplus. However, it must not be forgotten that the ongoing upturn on the labour market currently provides exceptionally favourable conditions for the Federal Employment Agency's financial situation which cannot be simply projected into the future.

Financial situation better than estimated in budget

¹⁴ Firstly, contributions for persons raising children of €290 million pursuant to section 345a of the Third Book of the Social Security Code had not yet been received in the first quarter – in contrast to 2007. Secondly, contributions due at the end of March were partly not booked until April.