Public finances*

General government budget

Slight improvement in public finance situation in 2008

The public finance situation could undergo a further slight improvement this year, despite the overall economic downturn since the second quarter, and the general government budget could post a surplus for the first time since German reunification.[1] One reason for this is the positive cyclical momentum on an annual average following the economy's strong performance in the first quarter. However, there is particular uncertainty with regard to the support measures for financial institutions (see the box on pages 64-65). In this context, it also cannot be ruled out that, rather than recording a further marked decline, which would otherwise be expected, the debt ratio will increase.

At most small decline in revenue ratio despite tax and social contribution rate cuts

Government revenue is expected to, at most, decline slightly in relation to GDP during the course of 2008. On the one hand, legislative changes have led to significant revenue shortfalls. The business tax reform and a further cut in the contribution rate of the Federal Employment Agency from 4.2% to 3.3% have resulted in substantial revenue shortfalls, only a fraction of which will be offset by the rising contribution rates to the statutory health and public long-term care insurance schemes. On the other hand, the exceptionally robust

* The "General government budget" section contains an analysis based on figures from the national accounts and the Maastricht reference values. 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.
1 The surplus in 2000 was solely attributable to the one-off UMTS receipts. The Federal Statistical Office recently revised the 2007 fiscal balance to -0.2% of GDP, whereas previously a small surplus had been recorded.

growth trend in revenue from profit-related taxes (after adjustment for legislative changes and cyclical influences), which has been evident for several years now, has thus far continued. In addition, the revenue ratio is likely to be bolstered by the fact that the high revenue-yielding source of gross wages and salaries is increasing at a more rapid pace than nominal GDP for the first time since the year 2000. Wage tax receipts will be boosted in addition by tax progression effects, particularly following the relatively high wage settlements.

Expenditure ratio likely to fall markedly again

The government expenditure ratio is likely to fall markedly again in 2008, albeit more moderately than in previous years. Alongside the relatively high average nominal GDP growth, which reduces the ratio via the denominator, in particular the declining number of unemployed persons is leading to lower expenditure. Furthermore, the moderate wage growth of the past few years is continuing to have a dampening effect because there is a time-lag before many government expenses (for example, pensions) are adjusted to the wage trend. By contrast, strong expenditure growth is expected for government investment and in the healthcare sector.

Deterioration in public finances in 2009

The public finance situation will probably deteriorate noticeably in the coming year, resulting in a renewed deficit. In a baseline scenario, which includes recently agreed fiscal measures and a marked decline in revenue from profit-related taxes but excludes additional spending in connection with government support measures for financial institutions, the deficit could reach sizeable proportions. It should be noted that, although the overall course of macroeconomic development next year is currently expected to be weak, a particularly beneficial economic growth profile can be assumed from the point of view of the general government budgets. However, there are also considerable aggregate risks. Firstly, the macroeconomic outlook and the impact of the government support measures for the financial markets are very uncertain. Secondly, the currently high level of revenue from profit-related taxes harbours greater setback potential.

On balance, little change in revenue ratio

The revenue ratio may stay roughly at its 2008 level, even assuming that revenue from profit-related taxes returns to a normal level. For one thing, progression-related additional tax receipts are also expected in 2009, while gross wages and salaries could once again rise more rapidly than nominal gross domestic product. Lastly, an amendment to the financing of the EU budget, that was agreed in 2007 and is provisionally planned to be implemented in 2009, means that Germany has to transfer less turnover tax revenue (but more resources based on gross national income, which are recorded on the expenditure side) to the EU, thus leaving central government with higher tax receipts. This effect will be particularly pronounced in 2009, as backpayments from 2007 and 2008 are also expected. By contrast, increases and decreases in tax and social contribution rates are likely to largely cancel each other out. A further cut in the contribution rate of the Federal Employment Agency by ½ percentage point and other tax breaks will be more or less offset by rising contribution rates to the statutory

The impact of the financial market crisis on public finances

The current crisis on the financial markets is also impacting on the development of public finances. At present, however, these effects cannot be quantified reliably. This box first outlines the various impact channels and then describes how the corresponding amounts are recorded statistically. Direct assistance is recorded differently in the budgetary accounts (government's financial statistics) and in the national accounts, which are used as a basis for assessing the Maastricht criteria for the deficit and debt levels agreed in the EU.

The channels through which the financial market crisis is influencing public finances

Indirect effects on the real economy

To the extent that the financial market crisis impairs real economic growth and, therefore, also the macroeconomic reference variables for taxes and social contributions (especially corporate earnings, wages and salaries, and consumption), government revenue will be lower. Moreover, government expenditure will increase if unemployment rises. In addition, government interest expenditure and property income may be affected.

Particular impact on revenue from profit-related taxes

Another possible consequence are substantial revenue shortfalls that may be independent of the macroeconomic reference variables which are usually used for taxes. Thus the annual development of the national accounts variable "entrepreneurial and property income" deviates in part significantly from that of the actual assessment base for profit-related taxes. For example, write-downs on impaired assets are not recognised in the national accounts variable but they may still be relevant for tax revenue. However, the massive write-downs in the financial sector that are currently being talked about would have no (direct) effect on tax revenue if the profits were not first taxed in Germany or if high tax-loss carryforwards already existed. The development of profit-related taxes, which has, on the whole, been favourable so far this year, indicates that the financial market crisis has resulted at most in small tax shortfalls, at least up to October. In the coming year – according to the official tax estimate – profit-related taxes are expected to decline in a counter-movement to the sharp growth in revenue in the past few years. Even in retrospect, however, it is still likely to be hard to quantify the direct impact of the financial market crisis on revenue.

Direct government support measures for financial institutions

Public sector support measures for financial institutions ultimately mean that public finances could be affected directly. This is true for recapitalisations or purchases of impaired assets, for example. However, it is also possible for public entities to issue guarantees, which do not lead directly to payments. Such measures may be carried out via central, state and local government's core budgets but also via special funds, public (financial) enterprises or special-purpose vehicles.

Recording of support measures for financial institutions in general government budgets and government accounts

Recording in general government budgetary accounts

The government stabilisation measures are in part recorded differently in central, state and local government's individual budgets and in the government's financial statistics than they are in the government accounts within the national accounts. Thus, in 2007 support measures did not give rise to any payments from the Federal budget, and in the current year only one capital transfer of €1.2 billion has been recorded so far to the KfW Group in connection with support measures for IKB Bank. Future burdens could arise from central government guarantees in connection with the sale of IKB Bank and support measures for HypoRealEstate if these result in payment obligations. Support measures undertaken to date by state government for financial institutions which they own have placed little strain on state government finances. Total guarantees of €7 billion for the Landesbanken in Saxony and in North Rhine-Westphalia have evidently been drawn only to a limited extent so far, and the capital injection of €½ billion to HSH Nordbank was financed outside the core budgets of Schleswig-Holstein and Hamburg.

Further support measures are likely to come mainly from the Financial Market Stabilisation Fund, which was set up in October as a Federal (ie central government) special fund. The Fund's entire expenditure on recapitalisations, asset purchases and interest is classified as budgetary expenditure and therefore included in the special fund's deficit. Guarantees are not recorded as increasing the deficits until they actually result in cash flows. Any interest income, fees from issuing guarantees and subsequent proceeds from the sale of participating interests and asset disposals will improve the Fund's fiscal balance. If the Fund (and therefore general government) incurs debt, this will be recorded in the government's financial statistics if the Fund finances this debt by borrowing. The Fund's activities will be recorded in the core budgets only after it has been liquidated, that is if there are additional debt servicing costs owing to accumulated debt. The legis-

1 The proportional allocation to the individual states will be based equally on each state's total inhabitants and GDP. Central and state government will also bear the burden of those institutions in which they hold participating interests in the amount of their share. — **2** At European level, the outstanding recording issues concerning govern-

Deutsche Bundesbank

lation stipulates that the Fund's final result is to be split between central and state government in the ratio of 65:35, although state government's participation is limited to a maximum amount of €7.7 billion.[1]

Recording in the national accounts (Maastricht criteria for general government)

The Maastricht criteria are based on the national accounts and the supplementary information contained in the "ESA 95 manual on government deficit and debt" issued by the EU statistics authority, Eurostat. They record general government in its entirety, including special funds (ie including the Financial Market Stabilisation Fund) and any associated entities. Figures are shown in line with reporting rules harmonised at European level, and it is on this basis that the budgetary accounts data are transferred to the national accounts.

In contrast to the budgetary accounts, transactions involving government financial assets, as a rule, do not have an impact on the deficit in the national accounts. Purchasing or selling a participating interest or another type of financial asset, therefore, normally does not affect the national accounts balance. One exception to this is if the purchase price or the expected return on the investment is not in line with market prices. However, the EU's rules on competition set strict limits for such capital injections at preferential rates that are to be classified (at least partially) as deficit-increasing capital transfers. By contrast, the effect of the above-mentioned financial transactions on the debt level is usually consistent with that stated in the government's financial statistics.

Guarantees are treated as contingent liabilities in the national accounts, too, and so are generally not recorded as expenditure until they are actually drawn on. However, according to Eurostat, government guarantees to financially distressed enterprises that would not have access to capital markets without such support and that are highly likely to make (partial) use of such guarantees are to be recorded – unlike in the financial statistics – as increasing the debt level as soon as they are issued. The amount of the guarantee that is expected to be drawn is then to be recorded as a deficit-increasing capital transfer. Public bodies that take on impaired assets from financial institutions and which are protected from losses by government guarantees are ascribed to the government sector along with their debts. The effect that taking on impaired assets has on the deficit corresponds to the difference between the assets' purchase price and their market price.

In the national accounts, transactions and entities are assigned to the government to a greater extent than in the budgetary accounts. If they are assigned to the government sector, then the rules outlined above apply to the way in which deficit and debt are recorded. This means, for instance, that the national accounts deficit rises if a public enterprise incurs an expenditure which is identified as a transfer carried out on behalf of general government. In this case, the debt level likewise generally increases if it is not possible to offset this amount against a withdrawal of equity capital by the government.

However, in specific cases, recording is subject to uncertainty. On the one hand, this is due to the fact that individual cases are sometimes extremely complex and the statisticians do not always have all of the relevant information available. On the other hand, the accounting rules themselves are not always detailed enough to be able to classify each individual case unambiguously.[2] Against this backdrop, Eurostat, in particular, is charged with the important task – at the European level and independent of any political considerations – of documenting strains on government budgets in the statistics and combating "creative accounting" by means of suitable basic principles. A solid statistical basis is a key requirement for the proper application of budgetary rules at European level and is also essential for assessing the development of public finances at national level.

Since the first rescue package for IKB Bank at the end of July 2007, a number of banks in Germany have received support from central government, individual state governments or public sector financial institutions commissioned by general government. The Federal Statistical Office, in consultation with Eurostat, has recorded central government support measures of €7.3 billion as increasing the deficit in the national accounts for 2007. Ultimately, this had little impact on the debt level. As KfW's support measures for IKB Bank in 2007 mainly reflected a decrease in KfW's capital position by the end of the accounting year, government debt rose only marginally. Instead, the stock of government financial assets – the participating interest in the KfW – decreased. For the first six months of 2008 the effect on the deficit amounts so far to €3½ billion. As regards the debt level, there has not yet been a final decision as to whether borrowing in the order of €40 billion that was taken up in connection with the special-purpose vehicles established to support SachsenLB and WestLB should be allocated to the Maastricht debt level. It is currently uncertain which individual burdens will arise in the second half of 2008 owing to the rescue package for HypoRealEstate, additional assistance for the Landesbanken and to the Financial Market Stabilisation Fund, which is allocated to the government sector.

ment support measures for financial institutions are currently being discussed in a statistical task force.

health insurance scheme and – as a baseline effect of the increase in mid-2008 – the public long-term care insurance scheme.

Cyclical rise in expenditure ratio

Owing to unfavourable cyclical influences, the expenditure ratio will increase again in 2009 for the first time since 2003. However, growth in expenditure is likely to accelerate markedly for non-cyclical reasons, too. For example, exceptionally strong growth in health-care spending is expected, not least owing to new arrangements for the remuneration of outpatient treatment and hospital financing. Furthermore, government investment will probably once again be stepped up noticeably. Finally, the above-mentioned change in EU financing arrangements means that Germany will have to make higher own resource payments, which are based on gross national income and are recorded on the expenditure side.[2]

Fiscal stimuli appropriate only in exceptional circumstances

The German government has responded to the economic slowdown using a number of different instruments assembled in a fiscal stabilisation programme. It is important to bear in mind that, irrespective of this, extensive contributions to steadying the level of economic activity are already being made. By means of the financial market stabilisation measures, fiscal policymakers have helped to avert the danger of a systemic financial crisis in Germany. Monetary policymakers are making a contribution through a wide range of interest rate and liquidity policy operations. While the supplementary fiscal measures, which are currently going through the parliamentary process, could provide a certain additional economic impetus, their influence should not be overestimated. Attempts by general government to actively fine-tune economic policy inevitably entail substantial problems and are at most appropriate in uniquely identifiable exceptional circumstances.

Goal of sound public finances should not be forgotten

The fundamental objective of achieving a structurally balanced general government budget in the medium term, as well as sound public finances, should not be abandoned despite the recent developments. This will generally not limit the effect of the automatic stabilisers. Moreover, if the economic situation proves very unfavourable, further unexpected tax shortfalls could initially also be absorbed at present in Germany – in line with the European fiscal framework (see box on page 67). This would exploit the considerable potential for automatic stabilisation. The fiscal consolidation achieved in recent years means that Germany has a certain radius of action without risking a breach of the 3% deficit limit. Substantial fiscal stabilisation programmes might be warranted if an extraordinary recession were thought likely. Possible unfunded measures to boost the economy should be of limited duration and should avoid causing unnecessary distortions of economic activity. In particular, substantial growth losses could ensue in the longer term in the event of a stampede to grant (sector-) specific subsidies at national and international levels, thereby distorting competition. In any case, once the downturn has been overcome, measures should rapidly be introduced to

2 Germany's contribution to financing the EU budget is likely to go down slightly overall as a result of the change in the own resources regulation.

Budgetary rules and the financial market crisis

The Treaty establishing the European Community, and the Stability and Growth Pact agreed common rules for EU countries' fiscal policy. The essential aim of these provisions is to ensure sound public finances in the EU. The financial market crisis and its subsequent effects on the real economy could place strains on public finances. However, this does not invalidate the European fiscal rules. These provide enough flexibility to deal even with the current very unusual circumstances. Thus, fiscal support to financial institutions to fend off a systemic financial market crisis is, in principle, compatible with the provisions. Even in a serious economic downturn, observing the rules generally does not require a fiscal policy stance that amplifies recessionary economic developments.

In particular those countries that have achieved a sound fiscal position, ie a close-to-balance budget or a surplus and a low debt ratio, are well equipped to withstand the current fiscal challenges. The automatic stabilisers can freely take effect and, in most cases, additional amounts can be spent as part of support measures for financial institutions without this exceeding the 3% ceiling for the deficit ratio. Moreover, support measures in the form of guarantees and recapitalisations are often likely to be only partly deficit-increasing (see box on pages 64 and 65). However, countries that – in breach of the agreements – have failed to achieve their structural budgetary objective in good times and, for example, have neglected to use unexpected revenue growth in the past few years for consolidation have a much smaller budgetary room for manoeuvre than countries with a sustainable starting position. If the deficit ceiling were to be exceeded during the current crisis, the following three factors, in particular, would have to be examined before an excessive deficit procedure is launched: whether the overshooting is clearly attributable to direct support for financial institutions or to a major economic downturn, whether it is temporary and whether the deficit ratio remains close to the reference value.

It is precisely in times of crisis that one sees just how quickly and radically confidence is lost and the market players' assessment of a country's risk profile and fiscal situation can change. This underlines the importance of the requirement that all countries rapidly achieve a sound fiscal position once they have overcome the financial market crisis so as to safeguard long-term fiscal sustainability. The need for credible fiscal rules in the EU and in the monetary union has recently been emphatically underscored.

This experience is also of relevance for the current fiscal policy debate in Germany. The stronger anchoring of the aim of achieving a structurally balanced budget, which was high up on the agenda of the Federalism Reform Commission II, has recently been eclipsed by current issues. What is more, there are now some calls for central government to abandon its medium-term budgetary objectives altogether. However, this does not appear warranted. It should be noted that exceptional circumstances, such as the danger of a systemic banking crisis, can be overcome within the fiscal framework that is currently being discussed. The extraordinary expenditure on support measures is likely to be predominantly temporary and to be initially reflected primarily in the Financial Market Stabilisation Fund that was established to manage the financial market crisis outside of the core budgets.[1] In addition, it must also be borne in mind that the anchoring of a structurally balanced budget in budgetary legislation would also take due account of the respective cyclical situation. For example, deficits in a given year would be in line with this objective if they result from the effect of the automatic stabilisers and are therefore temporary. Furthermore, consideration could also be given to temporarily tolerating unexpected developments in tax revenue that exceed the presumed effect of the automatic stabilisers subject to a rule-based provision ensuring that they will be offset in the following years.[2]

Plans to reform national budgetary rules should therefore not be abandoned. Ultimately, the crucial factor is that the rules take fiscal policy requirements into account even in exceptional circumstances and, at the same time, that they safeguard a sustainable budgetary policy. This includes ensuring that any structural aberrations are promptly corrected as soon as the situation returns to normal. A symmetric approach, designed to prevent further debt accumulation, requires not only that deficits are permitted in bad times but also that surpluses are achieved in good times.

1 This expenditure, even if it is not clearly shown in the core budgetary accounts at first, represents a financial burden on general government. However, once the Fund has been liquidated, any accumulated debt will be transferred to the core budgets, out of which the resulting interest payments would have to be financed. To keep this debt to a minimum, it is essential that resources are used efficiently, on the one hand to ensure the stability of the financial market but, on the other hand, to take adequate consideration of the fiscal burden resulting from these measures. — **2** See the reference in footnote 8 on page 72.

Deutsche Bundesbank

ensure that the structural budgetary objectives are quickly achieved.

Budgetary development of central, state and local government

Tax revenue

Marked rise in tax revenue in Q3

Tax revenue[3] rose markedly by 4% in the third quarter compared with the same period last year (see the chart on page 69 and the table on page 70). As in the preceding quarters, revenue from income-related taxes increased sharply (+7%). Wage tax receipts grew considerably, owing to the increase in gross wages and salaries – including tax progression effects – but also the reduction in child benefit payments, which are deducted from cash receipts. Once again, assessed income tax recorded a particularly strong increase. In addition to buoyant underlying dynamics, lower refunds to employees made a crucial contribution to this development. Investment income tax payments (particularly on interest and dividend income) also rose substantially. By contrast, corporation tax revenue fell sharply, which was connected with the disbursement of corporation tax credits which accrued prior to 2001,[4] as well as with the relief afforded by the business tax reform, which entered into force in 2008. Although there is considerable uncertainty about the level of shortfalls caused by the reform of business taxes, the underlying development of corporation tax receipts likewise still appears to be positive and, at least until September, no serious effects on revenue were evident as a result of the financial market crisis. Revenue from consumption-related taxes – which sometimes swings erratically from one quarter to the next – increased by a total of 2½%. Marked growth in turnover tax revenue contrasted with a decline in the two most important excise duties, energy tax and tobacco tax.

Marked rise in revenue also expected for 2008 as a whole

The latest official tax estimate predicts a rise in tax revenue for the year as a whole, including growth in local government taxes, of 4½% and an increase in the tax ratio (as defined in the government's financial statistics) of 0.3 percentage point to 22.5%.[5] The tax ratio will increase, firstly due to the relatively high growth in wages, including the effects of tax progression on income tax, and, secondly, owing to the continued marked growth in profit-related taxes, despite shortfalls as a result of the business tax reform. By contrast, revenue from consumption-related taxes will grow at a somewhat slower pace than nominal GDP, although the increase in VAT at the start of 2007 still had a positive effect on cash receipts at the beginning of 2008. The macroeconomic slowdown of recent months will only have a limited impact on the revenue outcome for 2008 as, on an

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 method of refunding corporation tax credits stemming from the time before the system changeover in 2001 has been altered several times and temporarily suspended. Since 2008, the remaining credits are generally paid out in ten equal amounts on 30 September each year.
5 The estimate is based on the Federal Government's latest macroeconomic forecast. This estimates real GDP growth of 1.7% in 2008 (unchanged compared with May 2008) and nominal GDP growth of 3% (May 2008: 3.4%). Real GDP growth of 0.2% (May 2008: 1.2%) and nominal growth of 2.0% (May 2008: 2.7%) are estimated for 2009.

annual average, important tax reference variables have been relatively stable. However, profit-related taxes are subject to considerable forecast uncertainties with regard to the actual impact of the business tax reform, as well as with respect to the short-term effects of the financial market crisis and the deteriorating earnings outlook.

Revenue up on previous estimates

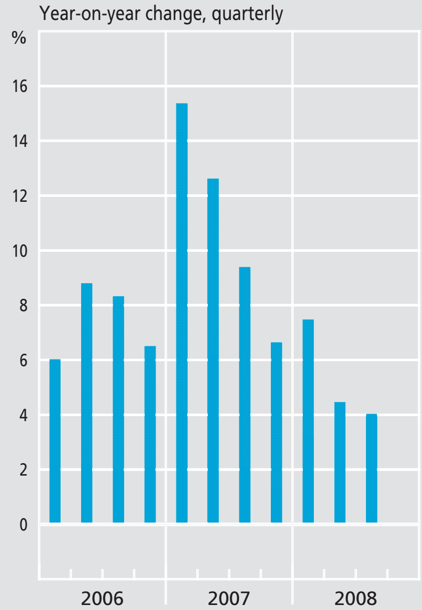
Overall, compared with the last official tax estimate in May 2008, revenue expectations have now been raised by €7½ billion, particularly since revenue from profit-related taxes has so far been surprisingly positive in 2008. Compared with the November 2007 estimate on which the 2008 Federal budget is based, an extra €6 billion will be received by general government. However, the revision results in an increase of merely €½ billion for central government, as the corrections largely affect local business tax, which mainly goes to local government and, moreover, have a negative effect on taxes which accrue exclusively to central government.

Poorer expectations for 2009...

Revenue growth of 2% and a virtually unchanged tax ratio are forecast for 2009. Further marked growth in wage tax receipts is expected, also owing to the effects of tax progression. However, revenue from profit-related taxes will decrease. This is connected with subdued earnings expectations in the wake of the economic slowdown. Furthermore, a certain natural counterswing to the sharp rise in previous years is anticipated. Compared with the May estimate, the figures have been revised downwards by a total of €2 billion after adjustment for differences in taking account of legislative changes. However, the estimates are supported in the short term by the fact that the Federal Government now expects shortfalls following the ruling of the European Court of Justice in the Meilicke case to mainly fall in 2010, rather than in 2009.[6] The overall revenue figure has therefore been raised by €1 billion. However, it is important to remember that the measures already approved by the Federal Government but which have not yet been formally adopted by parliament (particularly the increase in child benefit and the children's tax allowance, the reintroduction of the declining-balance depreciation method, tax breaks for motor

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.

Deutsche Bundesbank

6 This case relates to a claim to include foreign corporation tax payments when taxing dividends under the corporation tax imputation system, which was abolished in 2001. Originally, the majority of the shortfalls had been expected in 2008. However, the conditions for retroactive reimbursements have still not yet been clarified. Legal proceedings are still pending on this matter, too.

Tax revenue

Type of tax	Q1–Q3 2007 € billion	Q1–Q3 2008 € billion	Q1–Q3 Year-on-year change € billion	Q1–Q3 Year-on-year change as %	Q3 2007 € billion	Q3 2008 € billion	Q3 Year-on-year change € billion	Q3 Year-on-year change as %	Estimate for 2008 [1, 2] Year-on-year change as %
Tax revenue, total [2]	356.5	375.2	+ 18.7	+ 5.3	120.6	125.5	+ 4.9	+ 4.0	+ 4.2
of which									
Wage tax	94.1	101.6	+ 7.4	+ 7.9	31.4	34.1	+ 2.6	+ 8.4	+ 7.6
Profit-related taxes [3]	53.7	60.2	+ 6.6	+ 12.2	17.3	18.1	+ 0.7	+ 4.3	+ 7.3
Assessed income tax	16.3	22.9	+ 6.6	+ 40.6	7.3	8.9	+ 1.6	+ 21.6	+ 29.7
Investment income taxes [4]	20.1	23.7	+ 3.5	+ 17.6	4.5	5.1	+ 0.7	+ 14.6	+ 14.3
Corporation tax	17.2	13.6	– 3.6	– 20.9	5.6	4.1	– 1.5	– 26.7	– 24.8
Turnover taxes [5]	125.7	130.5	+ 4.9	+ 3.9	42.6	44.3	+ 1.7	+ 4.1	+ 3.7
Energy tax	23.7	24.0	+ 0.4	+ 1.6	9.9	9.8	– 0.1	– 1.0	+ 1.4
Tobacco tax	10.2	9.5	– 0.7	– 6.8	3.8	3.6	– 0.1	– 3.3	– 6.0

1 According to official tax estimate of November 2008. — **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 deducted from revenue. — **4** Non-assessed taxes on earnings and withholding tax on interest income. — **5** Turnover tax and import turnover tax.

Deutsche Bundesbank

vehicle tax and special household services) are not included in the official tax estimate. These measures could burden government budgets in 2009 by around €5 billion, with rising shortfalls initially expected until 2011.

... alongside considerable uncertainty

The official tax estimate contains considerable risks. For one thing, the likely course of macroeconomic development is currently fraught with a particularly high degree of uncertainty – and since October, when the government made its forecast, the risks have, if anything, increased. For another thing, estimation problems are associated with forecasting the (at present very high) level of revenue from profit-related taxes. It is difficult to estimate how quickly and radically the ballooning growth rates of recent years will reverse and what impact the business tax reform and the financial market crisis will have.[7]

Central government budget

Higher deficit in Q3

At €11½ billion, central government's budget deficit in the third quarter was €3 billion higher than in the corresponding quarter of last year. Revenue continued to increase significantly by almost 4½% (or €3 billion). At 6% (or €4 billion), tax revenue grew strongly – supported by lower transfers to the EU budget (€1½ billion). Furthermore, the new reintegration payment from the Federal

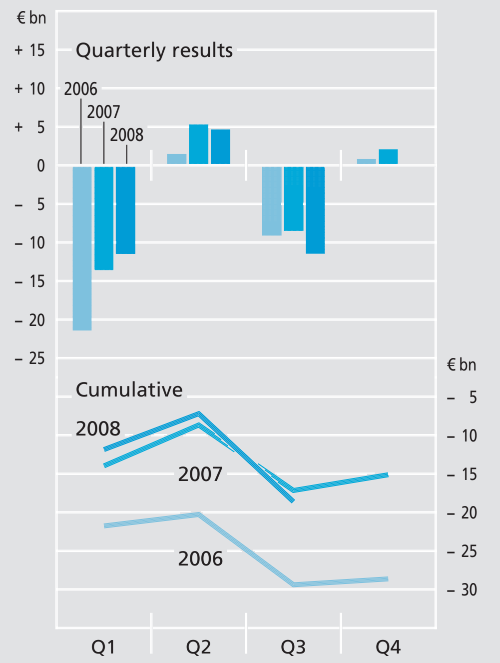
7 For more information on the fundamental forecasting problems regarding the tax estimate, see Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, p 33 ff.

Employment Agency once again significantly exceeded the old compensatory amount received in the same quarter of last year (by almost €1 billion). By contrast, central government received €2 billion less from asset realisations. Growth in expenditure amounted to a total of €7½% (or €6 billion). Additional outlays of €1½ billion resulted from payments due to the post office pension fund following the exhaustion of the proceeds from securitisation. Moreover, one-off extraordinary capital transfers of almost €2½ billion were made – to support IKB Bank and as a result of the European Court of Justice's ruling repealing an old subsidy repayment obligation of the post office. Furthermore, additional transfers of €½ billion were made to both the Federal Employment Agency and the Federal Railways Fund. Growth in personnel expenditure of 9½% (or €½ billion) is no doubt due to the extension of the relatively high (retroactive) pay settlement concluded in spring to public sector employees with civil servants status and to retired civil servants, while the increase in other operating expenditure by 10½% (or €½ billion) is chiefly attributable to military expenditure.

Basic budget position in 2008 somewhat better than planned

The Federal budget recorded a cumulative deficit of just over €18 billion at the end of the third quarter, compared with just over €16½ billion one year previously. The desired aim of reducing the full-year deficit by €2½ billion to just over €12 billion thus requires a considerable surplus in the fourth quarter. One question that is of particular significance for the annual outturn is whether the privatisation proceeds of just over €10½ billion envisaged in the budget will actually be received

Central government fiscal deficit/surplus since 2006



Deutsche Bundesbank

in full. Only just over €1½ billion have been realised to date. In addition, in response to the slump in share prices in the stock markets, the planned initial public offering of the national rail company Deutsche Bahn has been postponed. Following sizeable asset realisations over the past few years, it is becoming more difficult to find an alternative offset in the short term. However, excluding privatisation proceeds and the additional one-off payments mentioned, central government's end-of-year budgetary position is likely to be better than planned.

Additional burdens for 2009 Federal budget

It is envisaged that the Budget Committee's adjustment meeting will amend the previous deficit target of almost €11 billion for the 2009 Federal budget. In addition to the changes in the latest official tax estimate, which predict revenue shortfalls of just over €2 billion for 2009, in particular the package of fiscal measures adopted by the Federal Government at the beginning of November with the aim of stabilising macroeconomic momentum still has to be factored into the equation. The resulting extra burdens for the Federal budget amount to €2½ billion. This alone would increase the deficit to a total of €15½ billion. Furthermore, one-off proceeds from asset disposals totalling almost €4½ billion to date could be lowered – also owing to the presently low company valuations on the stock markets. Additional burdens are looming, too, in connection with unemployment benefit II and the Federal Employment Agency's reintegration payment.

Medium-term budgetary objectives must not be abandoned

As the budgetary burdens ensuing from measures to boost the economy should be very temporary, there is no reason to call into question central government's medium-term structural budgetary objectives (ie adjusted for cyclical influences and proceeds from asset realisations – see the box on page 67). Expenditure to support financial institutions will initially be borne by the Financial Market Stabilisation Fund, and the Federal budget will only be burdened if there are outstanding debts on the fund's liquidation, which will probably not occur until after the end of the medium-term financial planning period (see the box on pages 64-65). However, the generally expected slowdown in macroeconomic growth rates is likely to delay reducing the remaining overall deficit. As in the case of general government, cyclically induced borrowing will have no impact on central government's structural position. Moreover, further unexpected tax shortfalls could, if need be, also be absorbed.[8] However, once the economic slowdown has been overcome, the Federal budget should be rigorously and rapidly consolidated to achieve a solid basic fiscal position. To underpin this aim, it remains important to agree on a reform of the debt rule within the framework of the second phase of the reform of Germany's federal structure ("Federalism Reform II").

State government budgets[9]

Declining state government surplus in 2008 Q3

In the third quarter of 2008, state government's budgetary position deteriorated moderately on the year. The surplus fell by just over €½ billion to just under €1½ billion. With slower growth in tax revenue (+3%) and a decline in other receipts, overall revenue increased by only 1½%. At the same time, expenditure increased further (+2½%), probably not least as a result of renewed perceptible growth in transfers to local government.

Renewed surplus for 2008 as a whole, ...

Around half of the 16 states look likely to record a budget surplus for the year as a whole and – contrary to the budget plans – the same applies to the state government sector as a whole. Despite burdens from higher personnel expenditure, the business tax reform

8 For more information on taking account of unexpected tax shortfalls in budgetary rules, see Deutsche Bundesbank, Reform of German budgetary rules, Monthly Report, October 2007, pp 47-68 and J Kremer und D Stegarescu (2008), Eine strenge und mittelfristig stabilisierende Haushaltsregel, in Wirtschaftsdienst, Vol 3, pp 181 ff.
9 The development of local government finances in the second quarter is analysed in greater detail in the short articles in the Bundesbank Monthly Report of October 2008.

and the economic slowdown, the surplus could well match the level achieved last year (€3 billion).[10] Expenditure resulting from the financial market crisis has so far barely been reflected in the cash balances. Further support in the wake of the crisis is likely to be provided primarily by the Financial Market Stabilisation Fund. However, state governments must also make a contribution to the support measures (in addition to paying a share of a potential cumulative debt of the Fund) which is commensurate with their shareholdings in institutions that request financial assistance (see the box on pages 64-65).

... but deterioration expected in 2009

The budget plans available so far, which would hardly have needed any additional revision in terms of tax revenue in the light of the largely unchanged tax estimate, envisage almost no new net borrowing for around half of the states in 2009. The east German states and Berlin are still planning at least close-to-balance budgets and are thus preparing for the accelerated reduction in Solidarity Pact funding from 2009 (by just over €700 billion annually). By contrast, no significant progress towards consolidation is planned in those states that still have considerable deficits. This particularly applies to the heavily indebted states of Bremen and Saarland as well as Schleswig-Holstein, but it also applies to Hesse, Lower Saxony, North Rhine-Westphalia and Rhineland-Palatinate. State government will be particularly burdened by marked growth in personnel expenditure, but also by scheduled further increases in transfers to local government. Furthermore, it will now also be burdened by tax shortfalls in connection with the fiscal stabilisation programme.

Social security funds[11]

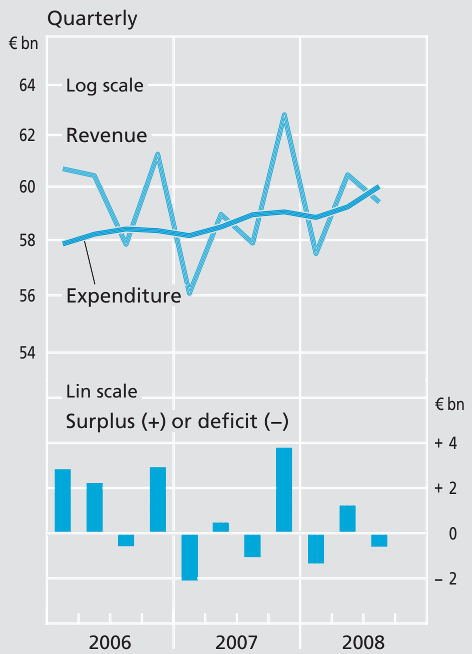
Statutory pension insurance scheme

Favourable financial situation owing to continued robust contribution receipts

In the third quarter, the statutory pension insurance scheme's deficit almost halved on the year to €½ billion. Revenue growth of 2½% in total was mainly due to income from employees' compulsory contributions, which increased by just over 3½%. Since the contribution amounts for recipients of unemployment benefits are relatively low, their renewed sharp decline (-12%) only slightly dampened the overall rise in income from contributions. Growth in revenue was curbed by transfers from the Federal budget, which, overall, were only ½% up on the year. At almost 2%, expenditure increased perceptibly faster than in the preceding quarters. The main reason for this was the higher pension increase in the amount of 1.1% on 1 July 2008 owing to the suspension of the "Riester factor", which is designed to dampen the level of pension adjustments by making a deduction allowance for employees' presumed supplementary private pension provision. The pension adjustment in mid-2007 was only half as high (+0.54%). All in all, pension ex-

10 The definition used in the monthly statistics of the government cash offices, on which these figures are based, notably excludes Berlin's proceeds of €4½ billion from the sale of its Landesbank investment in 2007.
11 The financial development of the statutory health and public long-term care insurance schemes in the second quarter of 2008 was analysed in the short articles of the Monthly Report of September 2008. These are the most recent data available.

Finances of the German statutory pension insurance scheme



Deutsche Bundesbank

penditure rose by just over 1½%. By contrast, the rise in rehabilitation spending was well above average (+10%).

Surplus up in 2008 but down in 2009

Overall, the 2008 surplus could be more than three times higher than last year (just over €1 billion) and the reserves could then be replenished so that they amount to up to one month's expenditure. In view of the poorer macroeconomic outlook, weaker employment dynamics are likely in 2009. Despite the expected continued marked growth in average earnings, income from contributions is therefore likely to increase less strongly. Furthermore, a pension increase of more than 2½% can be expected mid-2009, owing particularly to the significant rise in average earnings in 2008. This is attributable, on the one hand, to the continued suspension of the "Riester factor" and, on the other, to the fact that the demographic sustainability factor will probably boost pension levels, firstly because of the favourable 2008 employment trend and secondly because the number of pension recipients is currently expanding only moderately. The statutory pension insurance scheme's surplus is therefore likely to decline significantly in 2009.

Federal Employment Agency

Financial situation worse in Q3

The Federal Employment Agency recorded a surplus of just over €½ billion in the third quarter. Compared with the outturn at the same stage of last year, this amounts to a financial deterioration of almost €1½ billion, which is primarily due to the lowering of the contribution rate from 4.2% to 3.3% on 1 January 2008. Furthermore, the replacement of the compensatory amount with the reintegration payment led to a much bigger transfer to the Federal budget (+€1 billion). This could only be offset to a limited extent by the further reduction in expenditure on unemployment benefit I (-17% or -€½ billion) as a result of the favourable employment trend and the somewhat higher Federal grant. Only a little more was spent on active labour market policy measures.

Consolidated surplus expected in 2008

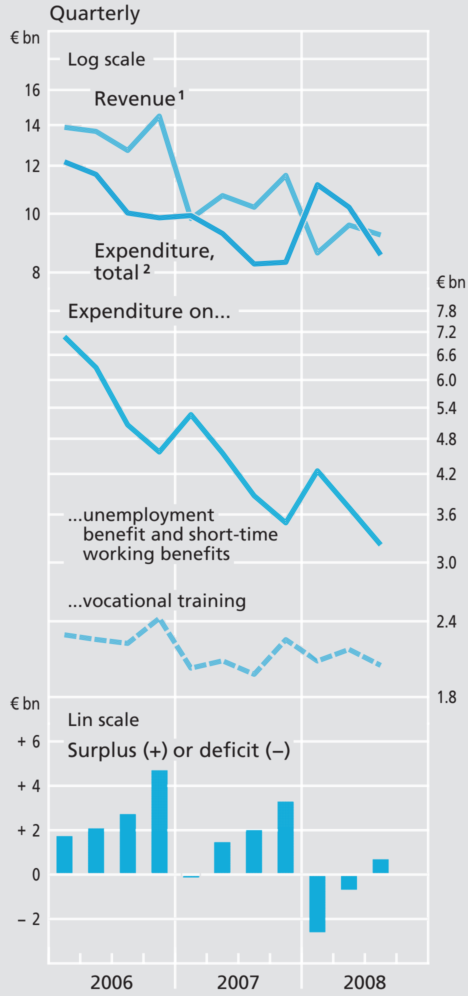
If the Federal Employment Agency's budget is viewed in isolation, the cumulative deficit for the first three quarters amounts to €2½ billion. During the same period of last year, the Agency posted a surplus of €3½ billion. However, it should be borne in mind that in the first half of 2008 expenditure was inflated by the recording of an amount of €2½ billion as a one-off transfer to the newly established civil servant pension reserve. If the Federal Employment Agency and its pension reserve are viewed in consolidated terms, the budget was practically balanced from January to September.[12] A marked surplus is expected in the fourth quarter, which is usually a strong financial quarter. Overall, the reserves are thus likely to be topped up again. The increase in the civil servant pension reserve is partly offset by an (albeit smaller) reduction in the Federal Employment Agency's non-earmarked reserves.

Cut in contribution rate on 1 January 2009 not sustainable

On 1 January 2009, the contribution rate will be reduced further to 2.8%. This will produce revenue shortfalls of just over €4 billion in 2009. Furthermore, as a result of the macroeconomic slowdown, expenditure on unemployment benefit I and probably also spending on active labour market policy measures are likely to increase on an annual average in 2009. A considerable deficit is therefore expected, which will have to be covered by drawing on the non-earmarked reserves. The Federal Government itself considers a contribution rate of 2.8% to be unsustainable. It is therefore planned to put the rate back up to 3.0% in mid-2010. However, it seems doubtful whether this will suffice to ensure the ongoing independent financing of the Federal Employment Agency. Assuming other expenditure largely remains stable, a 3% contribution rate can hardly finance more than 900,000 recipients of unemployment benefit, which roughly corresponds to the very low figure in 2008.

Finances of the Federal Employment Agency

Quarterly



1 Excluding central government liquidity assistance. — **2** Including transfers to the civil servants' pension fund set up in 2008.

Deutsche Bundesbank

12 In the consolidated accounting view, the Federal Employment Agency's expenditure is reduced not only by the amount of the one-off transfer to the pension reserve. Current payments to the reserve should also be deducted from expenditure. Conversely, the pension reserve's spending, chiefly on current pensions and healthcare assistance for retired civil servants, should be added to the unconsolidated total.