Public finances

General government budget

General government budget largely balanced in 2008

The general government budget position was largely balanced in 2008. According to provisional data from the Federal Statistical Office, the deficit ratio decreased further to 0.1%, after falling to 0.2% in 2007. This marginal decline was due partly to the buoyant cyclical momentum in the first quarter and the economy's growth profile, which was relatively favourable for public finances. The structural balance (ie adjusted for cyclical and temporary effects), like the unadjusted balance, improved slightly. Revenue shortfalls owing to cuts in taxes and social contributions were offset by a further steep rise in receipts from profit-related taxes, which are subject to large fluctuations (see the box on pages 60 and 61). The Maastricht debt ratio may have increased again in 2008 – after falling to 65.1% in 2007 – owing to the measures taken to stabilise the financial sector. However, no official figures are yet available and, notably, it has not yet been decided how individual support measures for financial institutions will be booked.[1]

Revenue ratio flat despite tax and social contribution cuts and ...

In 2008, general government revenue amounted to just under 44% of gross domestic product (GDP). The ratio thus hardly fell at all on the year even though, on balance, the fiscal measures taken led to a considerable decline in revenue. This was due mainly to the fact that the revenue development for profit-related taxes remained exceptionally positive. Thus, despite the revenue losses in the wake

1 See Deutsche Bundesbank, The impact of the financial market crisis on public finances, Monthly Report, November 2008, pp 64 and 65.

The structural development of public finances – results of the disaggregated framework for 2008

The general government deficit in Germany changed very little over the past year. According to provisional data from the Federal Statistical Office from January 2009, a balanced general government budgetary position (as defined in the national accounts) was very nearly achieved with a deficit of 0.1% of GDP, following a slightly higher deficit ratio of 0.2% in 2007. Using the disaggregated framework for analysing public finances[1], 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 2008 are presented below.[2]

The marginal decline of 0.1 percentage point (pp) in the unadjusted **deficit ratio** over the past year was favoured by cyclical developments. Applying the standard adjustment procedure used within the European System of Central Banks, a positive impact of 0.2 pp resulted from the very buoyant economic momentum at the start of the year and the growth structure, which was advantageous for public finances. However, clearly identifiable temporary specific effects increased the deficit by 0.2 pp as tax refunds resulting from the Federal Constitutional Court's ruling reinstating the commuting allowance were already recorded in the national accounts in 2008, thus reducing revenue. Expenditure associated with the support measures for financial institutions (0.3 pp) is not included in the temporary specific effects here (and, moreover, also occurred on a similar scale in 2007, meaning that the year-on-year change was minimal). The structural fiscal balance as defined in the disaggregated framework – which is adjusted for cyclical and temporary effects – improved by 0.1 pp in relation to trend GDP.

While the unadjusted **revenue ratio** decreased marginally, structural revenue grew slightly in relation to nominal trend GDP (0.2 pp). The ratio was boosted slightly by the fact that the (as usual) positive fiscal drag resulting from the progressive structure of income tax outweighed the negative impact in the case of excise taxes, which are largely volume-based (+0.1 pp overall). The positive structural decoupling of the macroeconomic assessment bases from the development of GDP had a similar effect (+0.1 pp). By contrast, legislative changes caused a reduction in the ratio. This was due mainly to the further lowering of the Federal Employment Agency's contribution rate by 0.9 pp to 3.3% and the loss of revenue associated with the business tax reform. Legislative changes, including a number of quantitatively less significant measures, led to net revenue losses of 0.5% of trend GDP.

Taken together, the three factors mentioned above (fiscal drag, the structural decoupling of the macroeconomic reference variables from GDP and legislative changes) cause a reduction in the structural revenue ratio. The overall increase in this ratio is attributable to the part remaining unexplained in the standardised procedure (residual), which amounted to 0.4 pp. The residual is largely due to the fact that, 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 disaggregated framework) and legislative changes. This may be partly attributable to the fact that large tax prepayments coincided with high net backpayments for earlier years. A fundamental problem is also posed by the fact that the reference variable taken from the national accounts does not adequately capture fluctuations in the actual tax base.

The structural **expenditure ratio** did not change in 2008, whereas the unadjusted ratio decreased by 0.2 pp. This was due to adjustment for the noticeable cyclically induced reduction in labour market expenditure. This brought to an end the long phase of continually decreasing structural expenditure ratios which began in 2001. The interest expenditure ratio remained at the same level as in 2007. It is not yet possible to conclusively evaluate the influence of the change in the debt-to-GDP ratio and the average interest rate as official figures on the debt level at the end of 2008 are still to be released. The structural ratio of other expenditure (primary expenditure)

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 definition, ie including swaps and forward rate agreements in interest rate expenditure and the fiscal balance, or in accordance with ESA 95 (2008). — **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 transfers receivable, sales and total capital revenue. — **8** Including

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Structural development [3] as percentage of trend GDP

Year-on-year change in percentage points

Item	2002	2003	2004	2005	2006	2007	2008	Total 2002-2008
Unadjusted fiscal balance[4]	– 0.8	– 0.4	0.3	0.5	1.8	1.4	0.1	2.8
Cyclical component[4]	– 0.5	– 0.4	– 0.1	– 0.3	0.5	0.5	0.2	– 0.1
Temporary effects[4]	0.0	0.0	0.0	0.1	– 0.1	0.0	– 0.2	– 0.2
Fiscal balance	– 0.3	0.1	0.3	0.7	1.3	0.9	0.1	3.1
Interest payable	– 0.2	0.0	– 0.1	– 0.1	0.1	0.0	0.0	– 0.3
Owing to change in average interest rate[pe]	– 0.2	– 0.1	– 0.3	– 0.1	0.0	0.0		– 0.6
Owing to change in debt level[pe]	0.0	0.1	0.1	0.1	0.1	0.0		0.3
Primary balance	– 0.5	0.1	0.1	0.7	1.4	0.9	0.1	2.8
Revenue	– 0.6	– 0.3	– 1.2	0.2	0.9	0.7	0.2	– 0.2
Taxes and social contributions	– 0.5	– 0.2	– 0.9	0.0	0.8	0.6	0.2	0.1
Fiscal drag	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.6
Decoupling of base from GDP	– 0.3	– 0.2	– 0.2	– 0.1	– 0.1	– 0.3	0.1	– 1.0
Legislative changes	0.7	0.4	– 0.5	– 0.2	0.1	0.7	– 0.5	0.7
Residual	– 1.0	– 0.5	– 0.2	0.2	0.8	0.2	0.4	– 0.1
of which: profit-related taxes[5]	– 0.8	– 0.1	0.1	0.2	0.6	0.4	0.4	0.8
Memo item: included in expenditure[6]	0.1	0.0	– 0.1	– 0.2	– 0.1	– 0.1	– 0.1	– 0.4
Non-tax revenue[7]	– 0.1	– 0.1	– 0.3	0.1	0.0	0.0	0.0	– 0.3
Primary expenditure	– 0.1	– 0.4	– 1.3	– 0.5	– 0.5	– 0.2	0.0	– 3.0
Social payments[8]	0.5	– 0.1	– 0.8	– 0.4	– 0.1	– 0.4	0.0	– 1.4
Subsidies	– 0.1	– 0.1	– 0.1	– 0.1	0.0	0.0	0.0	– 0.5
Compensation of employees	– 0.1	– 0.2	– 0.1	– 0.2	– 0.2	– 0.2	0.0	– 1.0
Intermediate consumption	0.0	0.0	0.0	0.1	0.0	0.0	0.2	0.4
Gross fixed capital formation	– 0.1	– 0.1	– 0.1	– 0.1	0.0	0.1	0.1	– 0.2
Other expenditure[9]	– 0.3	0.1	– 0.1	0.1	– 0.2	0.3	– 0.1	– 0.3
Memo item								
Pension expenditure[10]	0.1	0.0	– 0.2	– 0.2	– 0.2	– 0.2	– 0.1	– 0.8
Healthcare expenditure[11]	0.0	– 0.1	– 0.4	0.1	0.0	0.1	0.1	– 0.1
Labour-market expenditure[12]	0.0	– 0.1	– 0.2	0.0	0.0	– 0.2	0.0	– 0.5

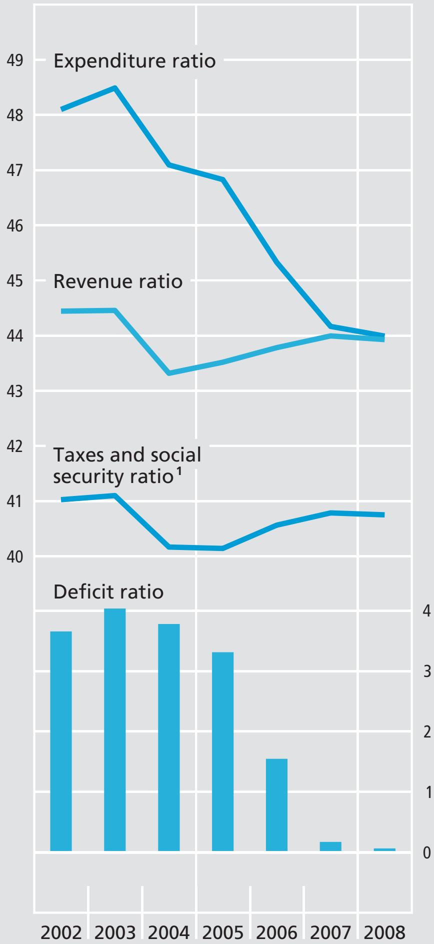
also remained largely unchanged. On the one hand, as in previous years, expenditure on old-age pensions pushed down the ratio since the annual average increase in pensions amounted to less than 1% and the number of pensions barely grew. Capital transfers also reduced the ratio, caused in no small part by the fact that grants to homebuyers are gradually being phased out. On the other hand, these were counterbalanced by high growth rates in government healthcare spending, public investment and intermediate consumption which *per se* tended to lift the ratio.

Overall, it can be seen that in the past year, not only did the deficit ratio itself remain largely unchanged but also most of the individual determinants showed little change. The ongoing favourable cyclical influence was counterbalanced by certain negative temporary factors. With respect to the development of the structural deficit ratio, legislative changes which had a negative effect on revenue were outweighed by other influences, in particular the renewed exceptional positive development in the case of profit-related taxes.

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 statutory health insurance scheme and assistance towards civil servants' healthcare costs. — **12** Spending by the Federal Employment Agency (excluding the compensatory amount/reintegration payment 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.

General government fiscal ratios*

As a percentage of GDP



* As defined in the national accounts. — 1 Taxes and social contributions plus customs duties and the EU share in VAT revenue.

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of the business tax reform and the tax refunds arising from the Federal Constitutional Court's ruling on the commuting allowance – which was already recorded in the national accounts last year – overall tax receipts increased perceptibly. Revenue from social contributions also grew, although the cut in the contribution rate of the Federal Employment Agency led to substantial revenue shortfalls, only around half of which were offset by the rising contribution rates to the statutory health and public long-term care insurance schemes. With a rise of 2½%, expenditure grew more robustly than in the preceding years but in relation to GDP it declined again slightly to 44%. The fall in the expenditure ratio was caused, most notably, by lower labour market-related spending owing to the favourable labour market development and moderate expenditure on old-age pensions. By contrast, government operating expenditure and spending on investment and healthcare increased sharply.

... expenditure ratio marginally lower

Deficit to rise sharply in 2009 owing to downturn and expansionary fiscal policy

The general government deficit is likely to rise sharply in 2009, although it should remain below 3% of GDP as things currently stand. One driving factor behind this is the marked slowdown in the economy. However, as the pattern of macroeconomic development is likely to be very favourable for public finances, the downturn will have a smaller negative impact on the deficit in 2009 than would be expected given the prospective contraction of nominal GDP. Both gross wages and salaries – which are particularly relevant for government revenue – and private consumption are expected to be more stable than the level of GDP. Furthermore, the extensive fiscal policy stimulus measures will push up the deficit significantly. If they are implemented as planned, the stimulus packages of November 2008 and January 2009 are likely to increase the deficit for 2009 by just over 1% of GDP (see box on pages 64 and 65). Additional factors include the renewed cut in the contribution rate of the Federal Employment Agency, the increase in child benefit and the new arrangements for the remuneration of outpatient treatment and hospital financing, which will entail higher expenditure. Overall, the additional receipts arising from the increase in the contribution rate to the statutory health insurance scheme will only partly offset these burdens. Moreover, revenue from profit-related taxes may fall sharply after having reached an exceptionally high level in 2008. In addition, substantial budgetary risks exist, particularly regarding the extensive assistance measures for financial institutions. There will be a very clear rise in the debt ratio, which is likely to reach a new high.

Updated stability programme projects high deficit ratios

At the end of January, the German government presented an update to the stability programme of December 2008 as the economic outlook had deteriorated significantly in the intervening period and a second fiscal stimulus package had meanwhile been approved. According to this, the deficit ratio will rise to around 3% in 2009 and around 4% in 2010, and is expected to fall back below the 3% limit in 2011 and 2012 (see table on page 66). All projections are currently subject to particular uncertainty. For example, the effects of the financial market crisis are difficult to gauge and substantial consolidation measures which the Federal Government considers necessary for the coming years are not yet included in the stability programme. According to the Stability and Growth Pact, a deficit ratio of over 3% can be justified during severe economic downturns and does not automatically trigger an excessive deficit procedure. However, the deficit must be temporary and remain at least close to the reference value. The fact that most of the second stimulus package will not have an impact on the general government deficit until 2010 is therefore problematic. The Federal Government's forecast predicts that Germany will exhaust its original fiscal leeway.

Fiscal stabilisation measures justifiable in an extraordinary crisis ...

Germany is currently experiencing an exceptionally pronounced and abrupt economic downturn which is, moreover, being accompanied by a crisis on the financial markets. In this exceptional situation, the decision not to rely solely on the automatic stabilisers, as in a normal cyclical downturn, but also actively to take fiscal policy measures aimed at reviving the economy is justifiable. With this aim in mind, the German government adopted two economic stimulus packages of a considerable joint magnitude in November 2008 and January 2009. They could provide a noticeable boost to the economy as a whole in 2009 and 2010 and thus mitigate the expected marked economic downturn.

... but the associated problems must be contained

However, the problems associated with the selected fiscal measures must likewise be borne in mind. For instance, ensuring the efficient use of government funds in connection with the planned rapid and sharp increase in government investment poses a particular challenge. While the economic stimulus needs to take prompt effect, there is a danger with investments of this scale – which amount to no less than around half of the annual government investment budget – that the additional expenditure will in part merely inflate prices. Overall, the measures must be selected and implemented on the basis of suitable cost-benefit analyses in order to ward off the danger of wasting government resources.

Central government's package of measures aimed at stabilising economic growth

The first fiscal stimulus package which was approved by the Federal Cabinet on 5 November 2008 is likely to amount to just under €4 billion in the current year and somewhat more than €7 billion in 2010. In addition to an increase in public investment the implemented measures consist, in particular, of a temporary reintroduction of declining-balance depreciation for movable assets for a period of two years, an extension of the tax deductions permitted for handicraft services and temporary exemption from motor vehicle tax for new cars.

On 27 January, the Federal Cabinet adopted a further set of measures to bolster economic growth, largely spread across two years, which are expected to add a strain of around €50 billion to general government budgets. According to the corresponding plans, approximately two-fifths of this amount is to be allocated to this year's budget. However, ultimately this will very much depend on the speed at which the large sums earmarked for infrastructural investment are drawn down. In total, the measures of these two economic stimulus programmes will cause the general government deficit to widen by around 1% of GDP in the course of this year and by almost 1½% during 2010.[1] Since not all of these measures are of limited duration, they will induce a structural deterioration of the fiscal balance amounting to about ½% of GDP in the coming years.

Specifically, the second stimulus package comprises the following measures.

Infrastructural investment

Funding in the total amount of €17½ billion has been earmarked for the purpose of improving infrastructure between now and the end of 2011. Central government's contribution to this comes to €14 billion. Of this total, €10 billion will take the form of targeted financial assistance for local and state government, which the federal states are expected to top up by a third. While these funds are chiefly designed to help improve educational facilities, they will also be allocated to other forms of infrastructural investment, for example in the area of transportation and information technology. Moreover, there are plans to temporarily simplify public procurement legislation in order to accelerate planned investment activities.

Subsidies and sector-specific measures

One measure under this heading is the loan and guarantee programme, which on its own is aimed at mobilising an additional volume of guarantees in the amount of €100 billion. The stimulus package also encourages the general support of research and development focused on small and medium-sized businesses (€1 billion) and the specific promotion of research work devoted to future-viable means of transportation (€½ billion). €1½ billion, in the form of an "environment bonus", is to be used to encourage motorists to scrap vehicles that are at least nine years old and buy a new or nearly new car with the aid of a government subsidy of €2,500. Complementary to this, the already long planned reform of motor vehicle tax – incorporating a stronger link to CO_2 emissions and a complete transfer of the related tax revenue to central government in return for financial compensation for state government – is scheduled to be implemented from mid-2009. Taken together, these measures are expected to generate fiscal costs of €3½ billion this year and a further €2 billion next year.

Tax policy measures

With a view to providing relief for taxpayers, income tax rates are to be lowered in two stages, retroactively from January 2009 and then at the beginning of 2010. It is planned to increase the basic tax allowance (from

1 If the revenue-reducing measures adopted in October 2008 (above all, increased income tax allowances for contributions to the health and long-term care insurance schemes as of 2010, higher child benefit in 2009 and a cut in the contribution rate to the Federal Employment Agency as of 2009) and the tax shortfalls resulting from the Federal

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the current level of €7,664 to €7,834 in 2009 and to €8,004 starting in 2010) and to reduce the bottom tax rate (from 15% to 14% with effect from 2009) as well as to adjust the taxation schedule by raising the other tax brackets (by €400 in 2009 and a further €330 as of 2010). On account of this, central, state and local government are likely to experience revenue losses of €3 billion during the current year and shortfalls of €6 billion next year.

Cuts in social contributions

With effect from 1 July 2009, the portion of the uniform contribution rate of 15.5% to the new health insurance fund which is financed equally by employer and employee is to be lowered by 0.6%. This is to be offset by raising the Federal grant (in addition to the already planned annual increments of €1.5 billion) during the current year by just over €3 billion and by a further €6½ billion in 2010, thus making it possible to reach the aspired maximum tax-financed grant of €14 billion as early as 2012 and not in 2016, as originally projected. The contribution rate to the Federal Employment Agency will now be put back up from 2.8% to 3.0% not in mid-2010 but in early 2011 instead. This will result in revenue shortfalls of just under €1 billion next year. Central government loans are envisaged to prevent the contribution rate from being raised above 3.0%. These loans do not have to be repaid until the Federal Employment Agency again posts a surplus.

Expansion of active labour-market policy

Over and above the agreed decision to extend the maximum period of entitlement to short-time working benefits (from 12 to 18 months), the claiming of such benefits is to be made more attractive by halving the employer's share of social contributions payable during periods of short-time working both this year and next year and exempting employers altogether from their obligation to pay contributions if employees are retrained. Furthermore, new training programmes are to be launched and a total of 5,000 additional jobs are to be created at job centres. Overall, this will burden central government and the Federal Employment Agency with costs in the region of €2½ billion during 2009 and €3 billion in 2010. At just under €½ billion, the costs of the additional jobs will be permanent.

Family-related measures

In 2009, the sum of €100 will be paid for every child that is entitled to child benefit and will reduce tax revenue accordingly. Within the framework of the basic allowance for job seekers (and correspondingly for recipients of social assistance) the standard child allowances for children aged between 6 and 13 are to be temporarily raised from 60% to 70% of the standard unemployment benefit II rate until the end of 2011. Overall, this is likely to lead to fiscal burdens of €2 billion this year and less than €½ billion in 2010 and 2011.

The total cost to central government of its expenditure on infrastructural investment, the promotion of research and the introduction of an environment bonus payment for cars is estimated at around €17 billion and is to be debited to the newly established "Investment and Repayment Fund". The necessary borrowing (of €21 billion at most) to finance these measures (including interest payments) has thus been hived off from the central government budget. In order to repay this debt, from 2010 onwards, annual transfers are to be made from the central government budget corresponding to part of the revenue from the profit generated by the Bundesbank. This underscores both the temporary nature of these measures and the need to repay the debt incurred. An actual repayment of debt will, however, require the Federal budget and each of its off-budget special funds – and not just the Investment and Repayment Fund – to achieve an appropriate improvement in the fiscal balance.

Constitutional Court's ruling reinstating the standard travel allowance for commuters are likewise classified as stimulus measures, then the financial burden for general government over 2009 and 2010 will total almost €90 billion.

Key data of the Federal Government's updated stability programme

As %

Position	2007	2008	2009	2010	2011	2012
Real GDP growth						
Stability programme January 2009	2.5	1.3	– 2¼	1¼	1¼	1¼
Stability programme December 2008	2.5	1.7	0.2	1½	1½	1½
General government fiscal balance (as % of GDP)						
Stability programme January 2009	– 0.2	– 0.1	– 3	– 4	– 3	– 2½
Stability programme December 2008	– 0.2	0	– ½	– 1½	– 1	– ½
Structural fiscal balance (as % of GDP)						
Stability programme January 2009		– 1	– 2	– 3	– 2	– 2
Stability programme December 2008	– 0.3	– ½	– ½	– 1	– ½	– ½
Debt ratio						
Stability programme January 2009	65.1	65½	68½	70½	71½	72½
Stability programme December 2008	65.1	65	65	64	63	61½

Source: Federal Ministry of Finance.

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Moreover, the follow-up costs must be taken into consideration, too. Any attempt to steer economic processes by means of a flurry of discretionary government interventions – whether through direct spending, tax benefits or guarantees – is always problematic. Special concessions for individual sectors and enterprises are always accompanied by distortions in market processes and can therefore be justified only in the event of clearly identifiable market failure. In terms of the timing of their impact, it would have been macroeconomically more effective to focus the measures more strongly on the immediately coming quarters. As it stands, some will not develop their full impact until the second half of 2009, while others do not become fully effective until next year or even later. For instance, two-thirds of the additional central government expenditure arising from the extension of the Federal grant to health insurance institutions will only become effective after 2010. Some of the measures will ultimately prove a lasting, rather than merely temporary strain on public finances.

Need to safeguard consolidation in the medium term

However, past experience suggests that it is simpler to achieve a consensus on increasing debt financing than on subsequently consolidating public finances. This is attested by the fact that the national debt ratio has followed an expanding trend ever since the Federal Republic of Germany was founded. In Germany, the consolidation of the past few years has created a certain amount of fiscal leeway for increasing deficits – both automatically and actively – during the recession. However, there needs to be a realistic prospect of bringing the expected high deficits back down. Indeed, maintaining confidence in the long-term sustainability of public budgets is a also vital requirement for a successful discretionary fiscal stimulus policy.

Approval of stricter debt rules for central and state government to be welcomed

The reform of the budgetary rules agreed by the Federal Reform Commission II can make an important contribution in this respect, as it also anchors the European fiscal commitments more firmly and more consistently than before at a national level. A restriction of the central government structural deficit to no more than 0.35% of GDP from 2016 is to be enshrined in the German constitution and deficits for the federal states are to be entirely prohibited from 2020 onwards. A parliamentary decree will then be required for any exceptions, which will be temporarily permitted only in the event of a natural disaster or a severe economic crisis and will be subject to repayment conditions. To assist the federal states in achieving the deficit objectives, those with major budgetary difficulties are to receive annual financial assistance subject to strict conditions and on a temporary basis. The ongoing surveillance of budgetary positions is to be intensified. Ultimately, it is imperative – particularly in the case of the Federal budget – to take concrete measures to meet the foreseeable consolidation requirements rather than making vague promises for the distant future. When the economic situation has returned to normal, it will therefore be necessary to rapidly and substantially reduce the structural deficits.

European rules flexible in exceptional circumstances but must be applied consistently

The European budgetary rules are of crucial importance for the stability of monetary union. They, too, require consolidation in the medium term. However, they are flexible enough to temporarily allow deficits exceeding, but close to, the 3% threshold in exceptional circumstances. Nevertheless, in some member states, the scope for an expansionary fiscal policy was significantly smaller than in Germany, or even non-existent. In some cases, the deficits were not sufficiently reduced in the past and the debt levels are therefore very high. Some countries already face substantial risk premiums for financing government borrowing on the capital markets. It is now essential to apply the Stability and Growth Pact as it was intended, not least in order to credibly ensure the sustainability of public finances in the EU member states. To this end, binding undertakings should be made to rapidly reduce the deficits once the economic situation improves until the budgets are virtually balanced in structural terms.

Budgetary development of central, state and local government

Tax revenue

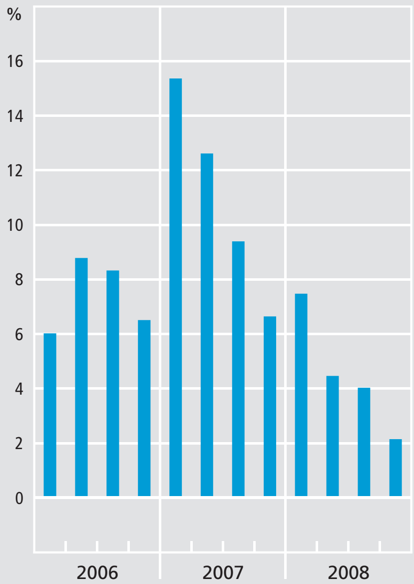
Tax revenue growth in 2008 somewhat stronger than expected

Tax revenue[2] grew by 4½% in 2008 (see also the chart on page 68 and the table on page 69). It was thus almost €1 billion higher than predicted in the latest official tax estimate in November 2008 and €3 billion above the official estimate in November 2007, on which the 2008 Federal budget, in particular,

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.

Tax revenue*

Year-on-year change, quarterly



* Including EU shares in German tax revenue, but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.

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was based. Year-on-year growth fell from quarter to quarter, which was largely due to the effect of various legislative changes on cash receipts. Thus the rise in revenue in the first quarter was amplified by the lingering impact of the VAT increase at the start of 2007 and the perceptible decline in payments of grants to homeowners (which are deducted from revenue), while reimbursements of corporation tax credits from the time before 2001 had a negative impact in the second half of the year.[3] The shortfalls resulting from the business tax reform are likewise likely to have increasingly squeezed cash receipts over the course of the year. By contrast, the macroeconomic downturn had only a relatively limited effect on revenue development during 2008. Indeed, key tax variables developed more favourably overall than GDP, and the underlying dynamics of profit-related taxes remained strong in net terms.

Revenue rise in the wake of the previous upswing despite tax relief

At 7½%, revenue from income-related taxes[4] grew strongly in 2008, with receipts from wage tax and profit-related taxes rising at similar rates. Significant factors in the rise in wage tax revenue were the increase in gross wages and salaries and the effects of tax progression as well as the reduction in child benefit payments, which are deducted from cash receipts. Growth in assessed income tax was particularly strong. In addition to the still rather buoyant underlying dynamics, the declining payments for grants to homeowners (likewise deducted from cash receipts), which are being phased out, and lower assessed income tax refunds to employees made a key contribution to this development. Investment income tax payments (particularly on interest and dividend income) also rose substantially. By contrast, corporation tax revenue fell sharply; its development was weak even after allowing for the disbursement of corporation tax credits and the (estimated) revenue shortfalls resulting from the 2008 business tax reform. Revenue from the consumption-related taxes[5] grew by 2½%. It should be noted, however, that the downturn in nominal private consumption at the end of the year will affect cash receipts only with a time-lag. Furthermore, the rate increase in 2007 con-

3 Since 2008, the remaining corporation tax credits from the time before the systemic changeover in 2001 are generally paid out in ten equal amounts on 30 September each year.
4 Wage tax, assessed income tax, corporation tax and investment income tax plus the solidarity surcharge.
5 Turnover taxes as well as consumption-related taxes for central and state government (especially energy tax, tobacco tax, insurance tax, motor vehicle tax and electricity tax).

Tax revenue

Type of tax	Year as a whole 2007 € billion	2008 € billion	2008 Year-on-year change as %	2008 Year-on-year change € billion	Estimate for 2008 [1, 2] Year-on-year change € billion	Q4 2007 € billion	Q4 2008 € billion	Q4 2008 Year-on-year change as %	Q4 2008 Year-on-year change € billion
Tax revenue, total [2]	493.8	515.5	+ 4.4	+ 21.7	[6] + 18.8	137.4	140.3	+ 2.1	+ 3.0
of which									
Wage tax	131.8	141.9	+ 7.7	+ 10.1	+ 9.2	37.6	40.3	+ 7.1	+ 2.7
Profit-related taxes [3]	72.9	78.6	+ 7.8	+ 5.7	+ 1.0	19.3	18.4	– 4.7	– 0.9
Assessed income tax	25.0	32.7	+ 30.6	+ 7.7	+ 4.9	8.7	9.7	+ 11.9	+ 1.0
Investment income taxes [4]	25.0	30.0	+ 20.3	+ 5.1	+ 1.3	4.9	6.4	+ 31.5	+ 1.5
Corporation tax	22.9	15.9	– 30.8	– 7.1	– 5.1	5.7	2.2	– 60.8	– 3.5
Turnover taxes [5]	169.6	176.0	+ 3.7	+ 6.4	+ 7.2	44.0	45.5	+ 3.4	+ 1.5
Energy tax	39.0	39.2	+ 0.8	+ 0.3	+ 1.4	15.3	15.2	– 0.5	– 0.1
Tobacco tax	14.3	13.6	– 4.8	– 0.7	– 0.2	4.1	4.1	+ 0.2	+ 0.0

1 According to official tax estimate of November 2007. — **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. — **6** For tax revenue including (estimated) local government taxes, the outturn was just over €6½ billion higher than the estimate.

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tinued to have a positive effect on VAT revenue due to its delayed impact on cash receipts.

Revenue fall in 2009 due to legislative changes and economic downturn

The latest official tax estimate in November 2008 predicted a revenue increase of just under 2½% for 2009. However, this estimate is now outdated. In December, the Federal Constitutional Court ruled that the restrictions on the standard travel allowance for commuters that were introduced in 2007 are unconstitutional, so that the previous legal *status quo* now reapplies. As a result, the Federal Government is expecting revenue losses of €5½ billion in 2009 (€2½ billion in relation to one assessment year), added to shortfalls of €10½ billion arising from new legislative changes (primarily, the increase in child benefit and the fiscal stimulus packages, see the box on pages 64 and 65). Moreover, the economic outlook has deteriorated considerably.[6] This is likely to cause a further high single-digit billion loss, even though the pattern of macroeconomic growth is still considered favourable for revenue development. In addition, there is a risk that receipts from profit-related taxes will decline sharply from the exceptionally high level reached in 2008. All in all, a noticeable fall in tax revenue is to be expected for 2009.

Central government budget

Federal budget position in 2008 somewhat better than expected ...

Following a sharp increase in the surplus to €6½ billion in the final quarter, which was

6 For example, in January's Federal Government Annual Economic Report, a rate of change in real GDP of -2¼% (November 2008: +0.2%) and in nominal GDP of -¼% (November 2008: +2%) is forecast for 2009.

driven mainly by privatisation proceeds, the Federal budget recorded a total deficit of just under €12 billion for 2008. This was almost €½ billion below the budget estimate. Although there were unscheduled expenditures amounting to just under €2½ billion arising from support provided to IKB Bank and a subsidy repayment ruling by the European Court of Justice, as well as unforeseen additional expenditure of €1 billion on unemployment benefit II and payments to parents, these extra burdens were more than compensated for by lower-than-forecast spending, mainly on interest payments, integration measures for the long-term unemployed, the Federal Railways Fund – which was able to finance itself to a greater extent than foreseen through asset realisations – and guarantees. Total revenue was likewise below the expected level; there were net shortfalls of €4 billion for privatisations. Nevertheless, this was largely offset, notably by tax receipts, which – owing to lower transfers to the EU budget – exceeded projections by just under €1½ billion, and by a stronger inflow of funds from the EU and administrative revenue amounting to almost €1½ billion.

... but budget situation still tight despite consolidation progress

The deficit was thus down by just under €3 billion on 2007. The fundamental progress made in terms of fiscal consolidation is even greater when account is taken of various special factors. For example, the temporary relief provided in 2007 by one-off proceeds from the securitisation of post office pension fund claims dropped out of the year-on-year comparison. In 2008, the Federal Government had to transfer almost €6 billion of additional resources to the fund and, following the temporary financial easing between 2005 and 2007, it will now incur ongoing additional expenditure on such transfers. The abovementioned one-off extraordinary burdens in 2008 cost around the same amount as the special transfer made to the Child Day-care Enhancement Fund in 2007. By contrast, the one-off proceeds from asset realisations were €1 billion higher than in 2007. The overall reduction in the deficit – adjusted for one-off effects including asset realisations – came to €8 billion. At an absolute level of €17 billion, however, it was significantly above the unadjusted figure. Thus, even given favourable macroeconomic conditions for public finances, central government was still a long way from achieving its medium-term aim of a virtually balanced budget.

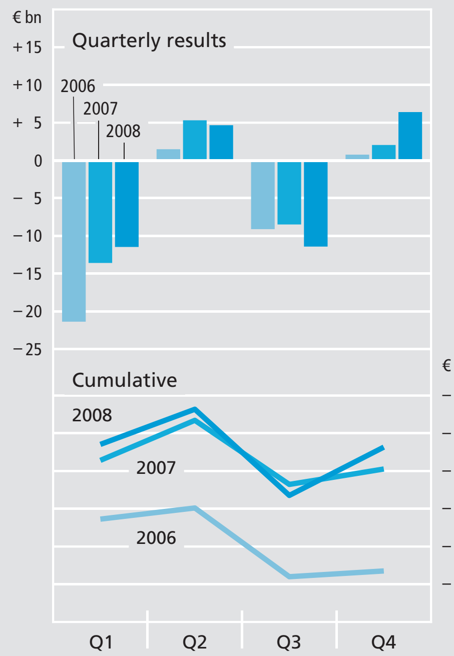
Sharp rise in deficit in 2009 owing to weak macroeconmic development and stabilisation measures

The 2009 Federal budget, which the Bundestag approved at the end of November, envisaged a renewed rise in the deficit to €19 billion as a result of the slowdown in economic growth that was expected at the time, the first stimulus measures and lower privatisation proceeds. Given the considerably less favourable course of macroeconomic development now forecast for the rest of this year and further stabilisation measures, a supplementary budget was drawn up which envisages a Federal budget deficit of €37 billion. Combined tax shortfalls of €11 billion will ensue from new tax relief measures of just over €2 billion, revenue losses of just over €2½ billion arising from the court ruling reinstating the commuting allowance and just over €6 billion from the less favourable macroeconomic assumptions. Furthermore, a total of €7½ billion of additional expenditure was budgeted for, which is required for an additional grant to the new health insurance fund (just over €3 billion), in connection with long-term unemployment (just over €2½ billion) and for the utilisation of guarantees (€1½ billion), the appropriation volume of which is also to be increased considerably. Further stabilisation measures totalling €17 billion, which will impact on expenditure by 2011 at the latest, were allocated to the newly established "Investment and Repayment Fund" (see box on pages 64 and 65). The debt accumulated by this fund is to be redeemed out of part of the Bundesbank's profit distributions. Despite this spin-off of financial burdens from the main budget, central government will now not manage to achieve a balanced budget by 2011, as was still its avowed intention in the third quarter of 2008. This is due to the deteriorating macroeconomic setting and also the stabilisation measures, most of which will place a strain on the Federal budget beyond 2010.

Reliable consolidation perspective required

In order to ensure long-term sustainability and prevent a loss of confidence in the light of permanently higher burdens, there appears to be a pressing need to achieve budgetary consolidation in the medium term. It should be noted in this context that in 2008, too, the Federal budget was still a long way from achieving the underlying objective of a close-to-balance structural position, and that now additional burdens are arising from measures taken to stabilise the financial markets and bolster the economy which are not just temporary but will also make themselves felt in the medium and longer term. The Federal Reform Commission II's recent decision to

Central government fiscal deficit/surplus since 2006



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define a strict constitutional borrowing limit is an important step towards safeguarding the key fiscal policy objective of a consolidated Federal budget. However, this proclaimed aim must be backed up by concrete action once the economy begins to revive.

Special funds with markedly higher full-year deficit

The deficit of central government's off-budget entities is likely to have almost trebled in 2008 to €6 billion. This was chiefly attributable to the Special Fund for Financial Market Stabilisation (SoFFin), which was set up in the fourth quarter of 2008 with a borrowing authorisation of up to €100 billion until the end of 2009. It ran up a deficit of €8 billion as a result of the first outflows intended to top up banks' capital. Furthermore, the surplus which the Child Day-care Enhancement Fund recorded in 2007 thanks to the one-off allocation of resources in the amount of €2 billion by central government dropped out of the year-on-year comparison. By contrast, the Post Office Pension Fund is likely to have posted a small surplus in 2008 compared with a deficit of €4½ billion in 2007. Once this subsidiary budget's reserves stemming from the securitisation of claims had been used up in 2007 and regular inflows from the postal services' successor enterprises were no longer available to finance payments, it fell to central government to provide all pension benefits for retired civil servants previously employed by the post office. The Redemption Fund for Inherited Liabilities was able to slightly increase its surplus as a result of the Bundesbank's profit being somewhat higher.[7] The deficit of the subsidiary budgets is expected to balloon in 2009. As a precautionary measure, central government has earmarked a borrowing requirement of €60 billion for the Financial Market Stabilisation Fund in its bond issuance calendar. In addition, a deficit is envisaged for the Investment and Repayment Fund in connection with measures to support the economy which could reach €10 billion if there is a rapid outflow of funds.

State government budgets[8]

Renewed surplus for 2008 as a whole …

State government's budgetary position was considerably less favourable in the fourth quarter of 2008 than it had been one year previously (-€6½ billion, compared with -€1½ billion in 2007). This was mainly due to the recapitalisation of the Bavarian state bank Bayern LB.[9] Nevertheless, a small surplus of just over €½ billion was achieved in 2008 as a whole (compared with €3 billion in 2007[10]). Excluding the one-off effect of Bayern LB, the fiscal balance improved slightly on the year, and the similarly adjusted deficit target (€6½ billion) was likewise clearly undershot. Overall, once again half of the federal states did not record a deficit. However, revenue grew by barely 3% in the wake of the recent distinct fall-off in tax receipts. At just over 3½%, expenditure rose somewhat more strongly owing to the above-mentioned recapitalisation measure. Even so, transfers to local government, which are generally linked to the level of tax revenue generated by state government, apparently also rose substantially, while the key item of personnel expenditure grew only moderately (+1%) despite adjustments in negotiated pay rates for salaried staff and for civil servants' pay and pensions.

… but high deficit expected in 2009

By contrast, a high state government deficit, in terms of actual cash flow, is forecast for 2009. Alongside the recession, another contributory factor is expected to be the recapitalisation of the state banks (Landesbanken), including, in particular, the second tranche of €7 billion for Bayern LB. Furthermore, in addition to its own special investment pro-

7 It is likely that at the end of the year the Redemption Fund for Inherited Liabilities no longer recorded any debt of its own and can thus be dissolved. However, the bulk of its debt was not actually repaid in net terms but was rather merely replaced (refinanced) by (new) central government debt.
8 The development of local government finances was analysed in greater detail in the short articles in the Bundesbank Monthly Report of January 2009.
9 In December, in its second supplementary budget for 2008, the Free State of Bavaria approved support measures for Bayern LB. These include, in particular, a capital injection of €10 billion; the initial tranche in the amount of €3 billion was paid out in 2008.
10 The monthly statistics of the government cash offices, which are used here, are based on the core budgets and thus notably exclude Berlin's proceeds of €4½ billion from the sale of its Landesbank in 2007.

grammes, state government is also taking part in central government's recent investment programme of €10 billion with a further €3½ billion. However, probably only a smaller part of this will come out of the 2009 budget. Further burdens will arise from the two fiscal stimulus packages (€3 billion in total) – including, in particular, the revenue shortfalls associated with the changes in income tax – as well as the court ruling reinstating the commuting allowance (€2½ billion). Should the high 2008 pay settlement agreed for central and local government salaried staff be largely adopted by state government with a time-lag and, as in the case of central government, be applied to civil servants and civil servant pensioners as well, in its entirety, this would imply considerable additional burdens of up to €8 billion for state government budgets. Given only moderate macroeconomic growth prospects and further, in part permanent, burdens resulting from the recent stabilisation measures, it is likely that in 2010 the deficits will, at best, decrease moderately, provided that the Landesbanken do not receive any further injections of capital. The plan to set an effective constitutional borrowing limit for state government, too, from 2020 could make an important contribution to preventing this budgetary situation from becoming entrenched and thus to creating long-term financial flexibility. From 2011, subject to strict conditions, it is planned to support the heavily indebted federal states of Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein over a period of nine years with consolidation assistance totalling €0.8 billion per year. However, a shorter transitional period before the new debt rule completely enters into force would have been desirable for state government, particularly also given the foreseeable sharp rise in the civil servant pension burden.

Social security funds[11]

Statutory pension insurance scheme

Higher surplus in 2008 thanks to plentiful contributions ...

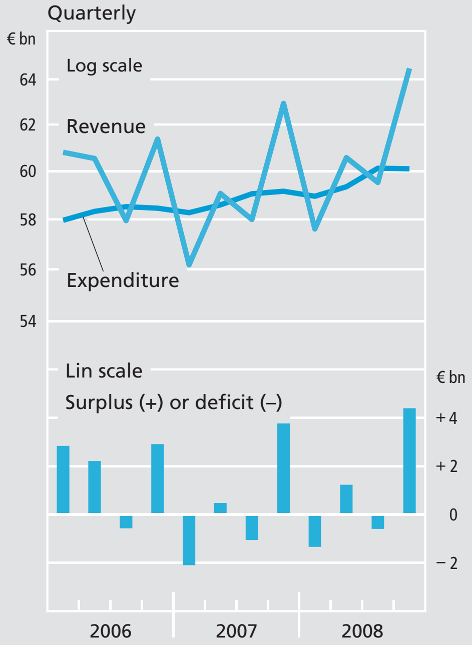
In 2008, the statutory pension insurance scheme recorded a surplus of just over €3½ billion, compared with a little more than €1 billion one year previously. The reserves went up by €4 billion to €16 billion. This is equivalent to around one month's expenditure.[12] Overall, revenue rose by 2½%. This was mainly due to the strong growth in compulsory contributions (+4%), which reflects the favourable development of the labour market and also higher wage and salary increases compared with previous years. Contributions for recipients of unemployment benefits fell by 13%. However, as the relative weight of these contributions is now very low, total revenue was only slightly impaired. Transfers from the central government budget exceeded their prior-year figure by only ½%. At

... alongside further moderate expenditure growth

11 The financial development of the statutory health and long-term care insurance schemes in the third quarter of 2008 was analysed in the short articles of the Monthly Report of December 2008. These are the most recent data available.

12 The increase in the reserves exceeds the surplus, in particular, because the liquidity situation has been improving from year to year as a result of paying new pensions since April 2004 at the end of the current month instead of at the end of the previous month. The constant replacement of old pensions with new pensions means that the liquidity situation of the statutory pension insurance scheme is thus continually improving. By contrast, the budget outturn records pension expenditure according to the accruals-based accounting method, which is not affected by this changeover.

Finances of the German statutory pension insurance scheme



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1½%, the increase in expenditure was again noticeably lower than revenue growth. Pension expenditure, which is by far the largest cost item, went up by just over 1%. The pension increase amounted to 0.54% for the first half of the year and 1.1% for the second half. The number of pensions rose by less than ½% as the population is currently ageing at a fairly moderate pace. At 3%, health insurance contributions for pensioners attributable to the statutory pension insurance scheme increased more sharply. Further contribution rate increases on the part of individual health insurance institutions contributed to this.

Marked financial deterioration in 2009

In 2009, the statutory pension insurance scheme will record a noticeably less favourable result. The surplus of just over €2½ billion which was forecast in the 2008 Pension Insurance Report was based on the Federal Government's macroeconomic assumptions from October 2008.[13] As things currently stand, a significantly lower surplus is to be expected. Revenue growth is again likely to lag behind the rise in expenditure. A contributory factor to this will be the comparatively high mid-2009 pension increase, estimated at 2½%, which is based on the strong wage growth in 2008. As its reserves were topped up previously, the statutory pension insurance scheme can make a contribution to automatic stabilisation.

Federal Employment Agency

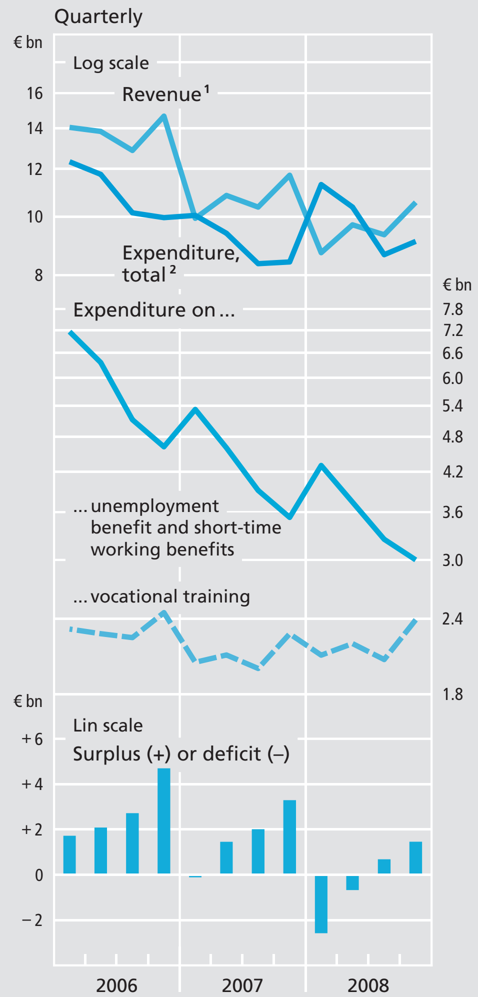
Surplus in consolidated terms, despite cut in contribution rate and higher reintegration payment

Although, viewed in isolation, the Federal Employment Agency recorded a deficit of just over €1 billion in 2008 compared with a surplus of €6½ billion one year previously, this was accompanied by a surplus in the amount of just over €2½ billion posted by the new dedicated pension fund for civil servants employed by the Federal Employment Agency. In consolidated terms, therefore, the Federal Employment Agency and its civil servant pension fund recorded a combined surplus of €1½ billion. A major factor in the financial deterioration was the lowering of the Agency's contribution rate from 4.2% to 3.3%. *Per se* this caused revenue shortfalls of just over €7 billion. However, in actual fact, the inflow of contributions fell by less than €6 bil-

13 While the 2008 Pension Insurance Report's calculations for 2009 were based on growth in total gross wages and salaries of 2.7%, in its 2009 Annual Economic Report, the Federal Government assumes growth of only 1.2%. If additional revenue paid on behalf of unemployed persons is counterbalanced against this, the new assumptions are likely to result in a decrease in income from contributions of around €1½ billion.

lion because employment and earnings increased relatively sharply. Without the lowering of the contribution rate, it would have grown by 4½%. Furthermore, the reintegration payment to central government, via which the Federal Employment Agency has to bear half of central government expenditure on the reintegration and administration of unemployment benefit II recipients, exceeded the previous compensatory amount by €3 billion. However, particularly in the case of unemployment benefit, there were also considerable cost savings (-€3 billion), mainly because the number of recipients was 165,000 lower on an annual average following the favourable labour market development. Finally, the Federal grant, which is linked to turnover tax revenue, was €1 billion higher than in 2007 when the increase in the standard rate of VAT from 16% to 19% had not yet fully impacted on revenue. The Federal Employment Agency's reserves went up to a total of €19½ billion by the end of 2008. However, just over €2½ billion of this is earmarked for its civil servant pension fund,[14] meaning that the level of resources available to finance current expenditure has fallen to below €17 billion.

Finances of the
Federal Employment Agency



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

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Extremely negative financial outlook in downturn

In 2009, the financial situation of the Federal Employment Agency will deteriorate significantly. First, the contribution rate has been lowered again to 2.8%. Second, expenditure on unemployment benefit and short-time working benefits, which is particularly sensitive to the business cycle, is expected to increase substantially as a result of the economic slowdown. Third, much more will be spent on active labour market policy, not least in connection with the measures envisaged in the second economic stimulus package. Owing to these additional financial burdens, the reserves will be considerably depleted. If the unfavourable development on the labour market continues into the coming year,

14 In addition to the one-off transfer of €2.5 billion, the financial reserves of this fund also went up because the current transfers from the Federal Employment Agency's budget in the first few years exceed current expenditure on pension benefits.

which, given its "lagged indicator" property in the business cycle, is to be expected even if the economy quickly revives, the Federal Employment Agency will have to rely on additional central government funds to finance its budget as early as 2010. This is also partly due to the fact that the plan to put the contribution rate back up to 3.0%, which was previously envisaged for mid-2010, has been postponed for six months. Intra-year liquidity assistance could be required already in 2009 because the Federal grant is no longer transferred in equal monthly amounts but is now transferred at the end of the year in one lump sum. Since its own reserves are insufficient, in future the Federal Employment Agency will be reliant on central government loans in order to maintain a stable contribution rate. However, it seems that there is a large risk that the contribution rate of 3.0% will not suffice to finance the Federal Employment Agency in the longer term and thus the Agency will struggle to repay the loans. There is therefore a danger that the Federal Employment Agency's budget will be structurally debt-financed (ie ultimately tax-financed), which as a matter of principle would only be appropriate to finance non-insurance-related benefits.