

## Public finances\*

### General government budget

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Last year, the incipient economic downturn had not yet led to a deterioration in public finances, and at the general government level, the budget was virtually balanced, as it had been a year earlier. Given the escalating economic crisis and the extremely unfavourable outlook, the German government adopted large-scale measures to stimulate the economy in November 2008 and January 2009. This, in conjunction with the effect of the automatic stabilisers, meant it was evident as early as the beginning of the year that the deficit and debt ratios would rise perceptibly in 2009 and 2010. In its updated stability programme of January, for example, the German government envisaged a temporary breach of the 3% threshold in 2010. Since then, the macroeconomic outlook has worsened sharply, however. The deficit ratio is therefore likely to distinctly exceed 3% as early as this year and could even climb to around 6% in 2010. The debt ratio will rise rapidly and could reach a magnitude of 80% in 2010. In view of this dramatic deterioration and the fact that most of the stimulus measures will take time to take effect and that an excessive deficit procedure will probably be initiated against Germany under the Stability and Growth Pact, further debt-financed tax cuts or higher spending cannot be justified. In the medium term, considerable efforts will be ne-

*Fiscal policy in  
times of crisis*

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\* The "General government budget" section starts with an analysis based on data contained in the national accounts and on the Maastricht ratios. The subsequent reporting on budgets of the various levels of government and social security schemes is based on the budgetary figures as defined in the government's budgetary financial statistics.

cessary to correct the dislocations being created in public finances.

*Public finances to deteriorate dramatically in 2009*

The public finances situation will deteriorate dramatically in 2009 and the deficit ratio is likely to rise to over 3%. The effect of the automatic stabilisers accounts for approximately two-fifths of this rise. However, the key macroeconomic aggregates involved, such as gross wages and salaries as well as private consumption, will initially not be as severely affected by the sharp recession as gross domestic product (GDP).<sup>1</sup> But the cyclically adjusted budget balance will also deteriorate considerably. This is due to deficit-increasing measures, especially the fiscal stimulus packages, the total volume of which is likely to reach around 1¼% of GDP in 2009. Moreover, revenue from profit-related taxes is likely to fall noticeably after having reached an exceptionally high level in 2008. Owing to the expected high deficit, a forecast drop in nominal GDP and the measures to support financial institutions,<sup>2</sup> the debt ratio is likely to soar and clearly exceed 70% for the first time. The overall course of development is currently fraught with major uncertainty.

*Revenue likely to fall noticeably...*

Government revenue will fall sharply in 2009 due to a number of factors. In addition to weak macroeconomic growth and the countervailing in profit-related taxes mentioned above, legislative changes are also likely to have an effect. These mainly relate to the decisions to lower income tax rates and to grant firms more favourable depreciation conditions contained in the stimulus packages. In the area of social contributions, the cut in the contribution rate to the Federal Employment

Agency is to be offset by higher average annual contribution rates to the statutory health and public long-term care insurance schemes. However, the revenue ratio, which sets revenue in relation to GDP, is still likely to rise appreciably. While key macroeconomic assessment bases for government revenue will develop weakly, they are still proving much more robust than the sharply declining GDP.

In 2009, government spending is likely to accelerate at a pace not seen since the mid-1990s. For one thing, cyclically sensitive labour market-related expenditure will grow rapidly due to the worsening labour market situation, whereas this item had dampened overall spending growth significantly in the past two years. For another, the underlying expenditure dynamic, which increased in 2008, is also likely to accelerate again. On the whole, additional expenditure incurred as a result of political decisions will make a major contribution to the sharp rise (with the stimulus packages alone weighing in at 0.6% of GDP). For example, government investment is to be expanded greatly. Additional factors are the impact of the car scrapping incentive, which in the meantime has been topped up to €5 billion, the one-off child bonus and the expansion of active labour market policy. Higher expenditure on healthcare and a permanent

*... while expenditure rises rapidly*

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<sup>1</sup> Cyclical adjustment procedures that do not take such structural effects into consideration but are calculated instead based on overall GDP (such as the European Commission's procedure) thus estimate the negative cyclical influence for 2009 to be far higher.

<sup>2</sup> The bulk of these measures are not likely to be reflected in the national accounts deficit. The European statistical office, Eurostat, has not yet reached a definitive conclusion on how support measures for financial institutions should be recorded. See also Deutsche Bundesbank, The impact of the financial market crisis on public finances, Monthly Report, November 2008, pp 64-65.

topping-up of child benefit had been resolved beforehand. Overall, expenditure will increase rapidly in relation to a clearly contracting GDP. The peak level that the expenditure ratio reached during the last downturn (48½% in 2003) could be matched within one year after the ratio had previously fallen steadily.

*In 2010 public finances likely to take another sharp turn for the worse*

The public finance situation is likely to take another sharp turn for the worse next year. The deficit and debt ratios are likely to soar again. Even if economic prospects brighten slightly, the cyclical impact on public finances is still likely to lead to a further noticeable increase in the deficits especially as, in contrast to 2009, the overall growth profile is likely to be detrimental to public finances. Furthermore, fiscal policy measures, in particular greater tax deductibility of contributions to health and long-term care insurance schemes, will place a discernible burden on general government budgets. In addition, revenue from profit-related taxes might well continue to develop very poorly.

*Public finances having clear stabilising effect*

Overall, public finances are making a clear contribution to stabilisation in the current recession. In 2010, the fiscal stimulus compared with 2008, measured by the change in the primary balance (deficit excluding interest expenditure), could well reach around 5 to 6% of GDP, or €120 to €150 billion. Approximately three-fifths of this could be attributable to the automatic stabilisers and the extraordinary decrease in profit-related taxes, and the remaining two-fifths to discretionary measures and other structural changes. This is supplemented by extensive measures to stabilise the financial sector.

It is generally better to rely on the effect of the automatic stabilisers to smooth ordinary cyclical fluctuations. Attempts by government to steer demand give rise to substantial problems and, based on past experience, hold little promise of success. In the unusual situation of a very severe global recession combined with a financial market crisis, however, it was justifiable – given the relatively favourable fiscal situation – to adopt fiscal stimulus measures in order to avert the danger of an even steeper downward slide. Having said that, the fiscal stimulus could have been focused more strongly on 2009. This would not only make better economic sense, it would also limit the 2010 deficit. Pursuant to the Stability and Growth Pact, the deficit ratio may exceed the 3% ceiling in exceptional circumstances. However, this infringement must be temporary and the deficit ratio must remain close to the ceiling. This is no longer the case, in particular owing to the latest downward revision of the macroeconomic outlook. As soon as the ongoing perceptible expansion in the deficit is quantifiable next year, it is therefore likely that an excessive deficit procedure will be initiated against Germany.

*Excessive deficit procedure expected*

The European fiscal rules are sufficiently flexible to provide a framework for fiscal policy in monetary union which is also appropriate in the present circumstances. Especially in the current difficult financial situation of many member states, these rules can help to ensure confidence in the sustainability of public finances. If their soundness is called into question, then prompt consolidation measures are necessary – also to avoid negative spillover effects on other euro-area countries.

*Deficit ratios should be rapidly reduced as soon as macroeconomic situation stabilises*

If a deficit is formally judged to be excessive, the structural deficit then has to be reduced. In an exceptionally unfavourable economic situation, the fiscal rules permit an adjustment that is initially lower than the benchmark of at least 0.5% of GDP per year so as not to stifle the impact of the automatic stabilisers. However, Germany, as well as other EU member states, is obliged to rapidly eliminate the very high deficit ratios (see box "Fiscal developments in the euro area" on pages 22 and 23) as soon as the macroeconomic situation stabilises. In this way, the rapid and, in the long term, unsustainable increase in the debt-to-GDP ratios can be halted and ultimately reversed. This will, in turn, make it easier to shoulder the looming demographic burdens of an ageing population and possible future payments arising from guarantees to support financial institutions. The reform of the German budgetary rules agreed by the Federal Reform Commission II, which are to be adopted by the third quarter, constitutes an important signal in this respect.

### Budgetary development of central, state and local government

#### Tax revenue

Tax revenue<sup>3</sup> fell in the first quarter of this year by 2% compared with the same quarter in 2008 (see chart and table on pages 75 and 76). A noticeable decline in consumption-related tax revenue (-2½%) was accompanied by a slight increase in receipts from income-related taxes. Wage tax receipts did rise, but at a distinctly slower pace than last

year owing to lower growth in gross wages and salaries. By contrast, revenue from profit-related taxes fell markedly (-5%). This was chiefly attributable to a drop in corporate profits and, in the case of assessed income tax, also to refunds necessitated by the Federal Constitutional Court's overturning of the curtailment of commuting allowances, which clearly outweighed the fall in payments of grants to home buyers, which are deducted from the revenue total. Revenue from turnover taxes went down significantly. However, this item swings erratically on a quarterly basis and the decrease may overstate the underlying price dynamic.

Pursuant to the latest official tax estimate, tax revenue (including local government taxes) is expected to decline sharply over the year as a whole (-6% or -€34 billion).<sup>4</sup> Almost half of this fall is due to legislative changes (especially stimulus packages and the rise in child benefit) and tax refunds after the curtailing of commuting allowances was ruled unconstitutional. Moreover, it is assumed that revenue from profit-related taxes will tumble from the exceptionally high level reached in 2008. By contrast, the fact that wage tax and turnover tax are being bolstered by the more favourable development of their assessment bases compared with that of GDP will have a stabilising effect.

*Clear fall in revenue expected for 2009*

*Tax revenue down in Q1*

<sup>3</sup> Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.

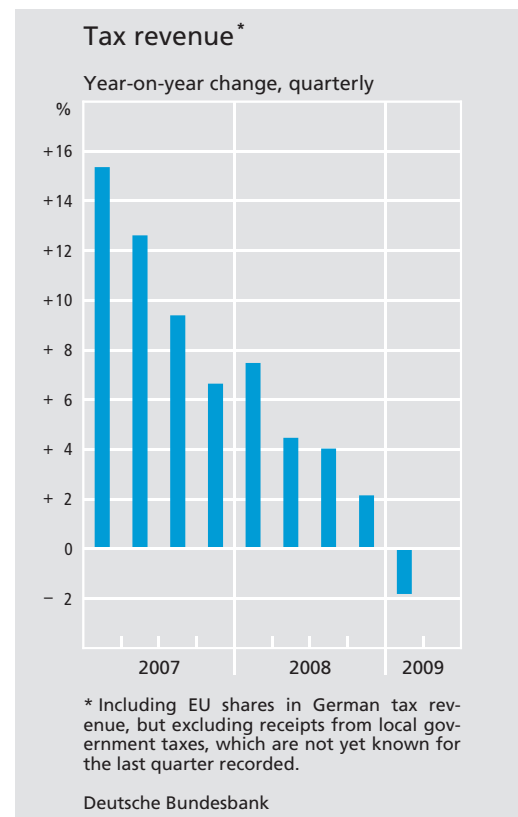
<sup>4</sup> The estimate is based on central government's current macroeconomic prognosis. It forecasts a decline in real GDP of -6% (November 2008: +0.2%) and in nominal GDP of -5.3% (November 2008: +2%). In 2010, real growth is expected to be +0.5% and nominal growth +1.2%. In the medium term (up to 2013), nominal GDP is envisaged to increase by 3.3% per year.

*Stabilisation  
only in medium  
term*

Revenue is expected to fall further in 2010 (by 3%). Overall, additional tax relief measures (in particular, increased tax allowances for contributions to health and long-term care insurance schemes, growing tax shortfalls owing to stimulus packages) will be on a similar scale to those in 2009. While the relatively stable development of consumption will continue to support turnover tax receipts, the accelerated decline in employment will place a heavier strain on revenue from wage taxes in 2010. Moreover, receipts from profit-related taxes are expected to fall further. Average revenue growth of 4% is subsequently forecast for the period from 2011 to 2013. On balance, fiscal drag (positive revenue effect of the progressive structure of the income tax schedule, negative revenue effect owing to the extensive price inelasticity of excise duties) will lead to additional revenue. As a whole, legislative changes will also increase revenue, in particular as more favourable depreciation rules from the first economic stimulus package are being phased out.

*High forecast-  
ing uncertainty  
and...*

The projected growth path of revenue is mainly based on political decisions on tax relief measures and the underlying macroeconomic benchmarks. However, uncertainty is currently at extremely high levels. As well as the fundamental difficulties involved in estimating the financial effect of legislative changes, this predominantly concerns the likely course of economic development. This is further complicated by great uncertainty with regard to the volume of revenue from profit-related taxes, the volatility and trend level of which is very hard to estimate.<sup>5</sup>



The high forecasting risk ultimately means that some tax estimates have to be revised extensively. While in the past two years the forecast figures were, in part, revised substantially upwards, a massive downward revision was necessary vis-à-vis the last tax estimates from May and November 2008. Adjusted for the effects of legislative changes adopted in the meantime,<sup>6</sup> the shortfalls compared with the May 2008 estimate have increased from €30½ billion in the current year to €65 billion in 2012, although, for the

*... extensive  
revisions to  
forecasts*

<sup>5</sup> See Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, pp 33-57.

<sup>6</sup> These figures have also been adjusted for estimated shortfalls in connection with the Meilicke case between May and November 2008 and tax refunds owed for the 2007 and 2008 assessment years due to the court ruling that the curtailment of commuting allowances was unconstitutional.

## Tax revenue

Type of tax	Q1		Year-on-year percentage change	Estimate for 2009 1, 2 Year-on-year percentage change
	2008	2009		
	€ billion			
Tax revenue, total <sup>2</sup>	118.8	116.7	- 1.8	- 5.8
<i>of which</i>				
Wage tax	32.8	34.0	+ 3.6	- 4.2
Profit-related taxes <sup>3</sup>	16.9	16.0	- 4.9	-23.1
Assessed income tax	3.7	3.0	-19.0	-30.1
Investment income tax <sup>4</sup>	8.5	8.7	+ 2.3	-11.2
Corporation tax	4.7	4.4	- 6.9	-31.2
Turnover taxes <sup>5</sup>	44.3	43.1	- 2.7	+ 0.3
Energy tax	4.7	4.8	+ 2.3	- 2.9
Tobacco tax	2.5	2.4	- 7.1	- 1.4

1 According to official tax estimate of May 2009. — 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes, which are not yet known for the quarter recorded. — 3 Employee refunds, grants paid to home owners and investors deducted from revenue. — 4 Withholding tax on interest income and capital gains, non-assessed taxes on earnings. — 5 Turnover tax and import turnover tax.

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most part, these corrections are a result of lower macroeconomic benchmarks. The need for revision arose primarily only in recent months (revision for 2009 compared with November 2008 forecast: -€28½ billion). In addition to the forecasting errors, tax cuts made in the meantime have also caused considerable revenue shortfalls. Compared with the estimate from May 2008, these amount to €28 billion for 2012, which is also due to the fact that not all measures to stimulate the economy are of limited duration but may become a persistent burden on government budgets.

### Central government budget

At €11 billion, central government's deficit in the first quarter was slightly down on the

year. Tax revenue as well as the reintegration payment received from the Federal Employment Agency – on the basis of the settled accounts for 2008 – declined slightly. However, central government received exceptional funds of almost €3 billion from the Redemption Fund for Inherited Liabilities as the share of the Bundesbank's profit transferred to this special fund was no longer used by it to redeem maturing debts.<sup>7</sup> Net spending growth was still relatively weak, not least thanks to markedly lower interest expenditure. Premiums from the issuance of securities, which are deducted from the interest cost, a sharp fall in short-term borrowing rates and a later coupon date for new five-year Federal notes (Bobs) all played a role in this.

*Deficit down slightly in Q1 thanks to Bundesbank's profit*

The supplementary budget adopted by central government in February already identified a sharp rise in the full-year deficit from €12 billion in 2008 to €37 billion. In the meantime, the assumptions for the likely course of macroeconomic development have worsened substantially and now indicate that this forecast will be considerably overshoot, despite the fact that one-off proceeds from the Bundesbank's profit have eased budgetary strains. According to the latest tax estimate, current estimates fall short by €7½ billion. Furthermore, there will also be additional expenditure of billions of euro vis-à-vis the supplementary budget for liquidity assistance to the health insurance fund and quite probably also for unemployment benefit II because the

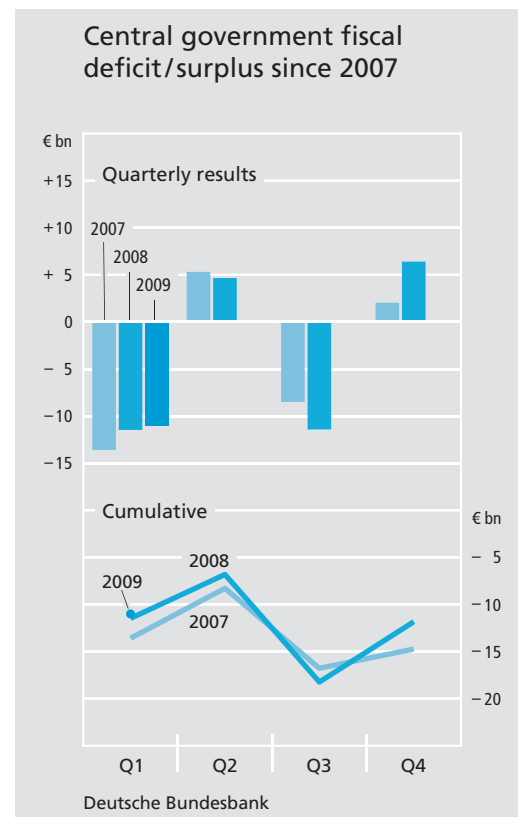
*Full-year deficit far above target, additional supplementary budget necessary*

<sup>7</sup> From 2010, the Bundesbank's profit distributions that exceed legally stipulated thresholds will generally be transferred to the Investment and Repayment Fund which has been set up for measures resolved in the second economic stimulus package.

budget as yet makes hardly any provision for a growing number of recipients. The Federal Employment Agency is likely to require temporary liquidity assistance in the course of 2009 which will not affect the final outturn and for which the budget already contains an appropriation authorisation of €7 billion. Since central government's extensive residual borrowing authorisations carried forward from the years up to and including 2007 have now expired, a further supplementary budget will be necessary to cover the increased borrowing requirements.

*Further steep rise in central government deficit in 2010*

It is already foreseeable that central government's deficit will continue to increase drastically in 2010; as things currently stand, it could amount to up to €90 billion. Tax revenue will continue to fall significantly. Moreover, there will be no repetition of the one-off proceeds from the Bundesbank's profit distribution. Furthermore, expenditure on unemployment benefit II is expected to rise significantly owing to the deteriorating labour market situation. Payments to offset the Federal Employment Agency's deficit once its financial reserves have been used up are likely to present an even greater strain. The borrowing limit laid down in Article 115 of the German Basic Law may again be overshoot on the grounds of averting a disruption of the macroeconomic equilibrium. The new debt rules that are currently being planned (see the box on pages 78 and 79) provide extended scope for borrowing in exceptional circumstances such as the current situation. The extensive cyclically adjusted deficit for 2010 is to be gradually reduced, however, in the transitional phase from 2011 to 2016. The large



payment to offset the Federal Employment Agency's deficit should be strictly an exception, as insurance benefits should, as a matter of principle, be financed from contributions. As soon as the macroeconomic situation stabilises, appreciable additional consolidation efforts will nonetheless be required to achieve the stipulated budgetary targets. Thus on this count, too, there is currently no scope for any further structural relief measures.

Although the financial situation of central government's non-core budget entities at the beginning of 2009 was almost balanced, large deficits look likely to accrue during the remainder of the year. The Investment and Repayment Fund set up as part of the second economic stimulus package is likely to have a borrowing requirement in the order of

*High full-year deficits for non-core budget entities*

## The reform of the borrowing limits for central and state government

The Federal Reform Commission II, established in December 2006, agreed on reforms in March 2009 which have now been presented as draft laws in both houses of parliament (Bundestag and Bundesrat) and are to be adopted before the summer recess. The main focus is on reforming the constitutional borrowing limits, which were last adjusted at the end of the 1960s and have failed to sufficiently curb the increase in central and state government debt over the past few decades. This failure was due, among other things, to the fact that net borrowing was capped at the level of budgeted investment expenditure rather than the actual (sometimes lower) level. In addition, the borrowing ceiling was not adjusted for the consumption of fixed capital, asset disposals or for investment expenditure which does not augment government assets. Furthermore, significant exceptions for the special funds (non-core government budgets) and for averting a disruption of the macroeconomic equilibrium as well as a lack of adjustment mechanisms during more buoyant economic phases, have persistently impaired the effectiveness of the borrowing limit. Against this backdrop, in its ruling given in July 2007 on the constitutionality of the 2004 Federal budget, the Federal Constitutional Court urged that the borrowing ceiling be revised, not least in order to safeguard fiscal policymakers' future radius of action by limiting debt service burdens.<sup>1</sup>

The guiding principle of the planned reform is to incorporate the basic elements of the European Stability and Growth Pact into national constitutional law. The pact stipulates government budget positions which are close to balance or in surplus over the medium term in order to ensure fiscal sustainability. On this basis, net annual central government borrowing is to be generally restricted to a maximum of 0.35% of gross domestic product (GDP). At least new borrowing authorisations appear to be prohibited for the special funds and, in principle, new borrowing will not be permitted in state government budgets.<sup>2</sup> No individual

constitutional borrowing limit for local government and the social security funds is to be set in the German Basic Law. The preamble to the legislation justifies this on the grounds that central and state government are responsible for ensuring that European fiscal standards are met by those government entities, too.

As at EU level, the automatic stabilisers are to be allowed to take effect, and cyclically induced budgetary deteriorations and improvements will not be restricted by the aforementioned borrowing limit. The purpose of this symmetric approach is to ensure that surpluses during upswings compensate for deficits during downturns. Additional borrowing is possible in exceptional circumstances (eg natural disasters or the current extreme financial market and economic crisis). The obligation – above and beyond the European rules – to repay such debts within an appropriate period of time (possibly still to be stipulated more precisely) should ensure that this option is exercised only in cases of genuine hardship and will not lead to a sustained rise in debt over time. Moreover, the reform stipulates that, within the framework of supplementary budgets, the cyclically adjusted borrowing limit may be exceeded by up to 3% of the budgeted tax revenue if an unexpectedly unfavourable development (eg in tax receipts) emerges during the year. However, this gap must be closed in the following fiscal year unless recourse is made to the exemption clause. To prevent systematic infringements of the borrowing limit during budget implementation, discrepancies between the actual figures and the borrowing limit are to be recorded on a "control account" with a maximum credit facility of 1.5% of GDP. If the debt recorded there exceeds a threshold of 1% of GDP, it must be reduced in opportune cyclical conditions.

Under these new fiscal rules, the task of estimating the cyclically adjusted budgetary position assumes key importance. In this respect, however, there is signifi-

<sup>1</sup> See Federal Constitutional Court (Bundesverfassungsgericht), 2 BvF of 9 July 2007, sections 133-135. — <sup>2</sup> To enable those federal states with particular budget difficulties, too, to commit to this objective, the other members of the German federation agreed to grant annual aid of €0.8 billion from 2011 to 2019 which, however, the recipient states will not receive unless their existing deficits are actually

eliminated. — <sup>3</sup> Alternatively, it would be conceivable to allow adjustment over an extended period of time. In the event of generally unforeseen tax shortfalls, for example, a transitional period of three years could be allowed in which the borrowing limit could be progressively exceeded by the amount of the shortfall. In order to ensure



cant estimation uncertainty. For example, under the cyclical adjustment procedures used in the EU surveillance of budgetary positions, the very substantial and sometimes seemingly erratic fluctuations in revenue from profit-related taxes are classified as being cyclically induced only in some cases. Furthermore, if there are unforeseen macroeconomic developments, trend growth and thus also the level of potential output are often revised, which in turn leads to revisions of the cyclically adjusted fiscal balance. Consequently, if there were an unexpectedly unfavourable development, central and local government budgets might fairly quickly face substantial and, in many cases, procyclical consolidation requirements. This would be particularly true if – as in the past under the old borrowing rule – the cyclically adjusted scope for incurring debt were to be largely exhausted on a regular basis at the time the budget is drawn up. By contrast, automatic stabilisation of economic activity through public finances is able to take full effect if the aim of maintaining an adequate safety margin below the borrowing limit – which requires, at the least, that the cyclically adjusted scope for incurring debt is not utilised – is set and is generally also achieved.<sup>3</sup> Enshrining this in the legislation implementing the central government borrowing limit might be an option worth considering.

In line with the European fiscal framework, financial transactions will be disregarded when calculating the deficit and the borrowing limit. The privatisation proceeds and loan repayments often used in the past to plug budgetary gaps can therefore no longer be employed as a means of keeping to the borrowing limit. However, attempts could be made to exploit the leeway on the expenditure side. For example, payments to enterprises or other institutions could be recorded in the budget as loans or capital injections even where no associated market-based returns may be expected. Under the European fiscal framework, such payments are usually reclassified as capital transfers and thus

have a negative impact on the fiscal balance, as do non-cash debt relief and debt assumption. For the planned new budgetary rules, too, a comparable procedure for such transactions – including them when calculating the distance from the borrowing limit – would also be appropriate in order to ensure compatibility with the EU regulations as expressly stipulated in the constitutional text.

The new rules, which enter into force as early as 2011, will only be fully applicable following a relatively extensive transitional phase during which the existing structural deficits – which partly result from the measures taken to combat the current crisis – must be reduced in stages. The central government budget may exceed the new limit up to and including 2015. However, the necessary consolidation is to commence in 2011 and will be implemented in even stages. Given the particularly pressing need for consolidation mainly in Bremen and Saarland, a longer period of adjustment up to and including 2019 was agreed for the federal states. It is particularly important that the constitutional limits in the Basic Law are adhered to equally in all federal states and are implemented stringently to prevent their fiscal positions from differing so widely in future and to ensure that the budgets of all federal states are sustainable in the long term.<sup>4</sup>

Overall, the reform and its objectives are to be thoroughly welcomed, especially given the current sharp rise in budget deficits. By anchoring the commitments made in the European Stability and Growth Pact more firmly in national law, this key pillar of monetary union will be strengthened and a major step towards sustainable public finances will be taken. If the rules are applied consistently, the debt-to-GDP ratio will fall and an ensuing significant decline in interest expenditure relative to total government spending will provide relief for future generations and help to ease the burdens resulting from demographic developments.

that the longer-term effect of this rule on the debt level is neutral, the adjustment rules would need to be designed to operate symmetrically and infringements of the borrowing limit booked to the "control account". See Deutsche Bundesbank, Reform of German budgetary rules, Monthly Report, October 2007, pp 48-68 and J Kremer und

D Stegarescu (2008), Eine strenge und mittelfristig stabilisierende Haushaltsregel, in Wirtschaftsdienst, Vol 88, pp 181 ff — 4 For information on the need for such implementation, see Deutsche Bundesbank, Can Bremen, Saarland and Schleswig-Holstein also balance their budgets? Monthly Report, June 2008, pp 10-11.

€10 billion as a result of the car scrapping incentive, which has since been topped up to €5 billion, and also outflows connected with investment programmes. Furthermore, the capital injections announced to date by the government stabilisation fund SoFFin alone have generated borrowing requirements in excess of €15 billion.<sup>8</sup>

### State government<sup>9</sup>

*Clear rise in deficit at start of year mainly due to bank recapitalisations*

In the first quarter, state government reported a deficit of just under €10½ billion, after €½ billion a year earlier. Revenue fell by 3½% owing to declining tax receipts and the drop-out of windfall gains from asset realisations in Berlin. Expenditure increased by just under 11%. This can be attributed primarily to the second tranche of recapitalisation for the Bavarian Landesbank Bayern LB (€7 billion) which, although included in the 2008 supplementary budget, did not affect cash flows until the first quarter of 2009.

*Growing strains as year progresses*

A severe worsening of state government finances is expected for 2009 as a whole compared with 2008. Additional personnel expenditure totalling €3 billion will result from the pay settlement for salaried staff concluded in March and its probable extension to public sector employees with civil servant status as well as retired civil servants in all states. According to the latest tax estimate, shortfalls of €17 billion are expected compared with the last estimate from November, which would mean a decrease of €13½ billion on 2008. Further bank recapitalisations are apparently to be conducted outside of the core budgets. Thus Hamburg and Schleswig-

Hostein have set up an agency mandated to raise €3 billion on the capital market and transfer this to HSH Nordbank. Measures to recapitalise Baden Württemberg's Landesbank LBBW are likewise to be taken by an entity that is not integrated in the state government budget accounts. Pursuant to the debt brake enshrined in Baden-Württemberg's state budgetary rules, the incurrence of new debt would otherwise only have been permissible in narrowly defined extraordinary circumstances. State governments' budgets, which appear to make allowance for barely half of the tax revenue shortfalls that have become evident since the November estimate, envisage a deficit of €17 billion in 2009. If the recapitalisations of the state banks (Landesbanken) that have either been formally spun off from the core budget or allocated to the 2008 budgetary accounts are factored into the deficit, then it may even surpass the highest level recorded so far (€30 billion in 2003). Given the growing volume of tax revenue shortfalls, no significant decline in this deficit can be expected for 2010 even assuming that no further capital injections into state banks will be necessary. State governments, therefore, will likewise have to take extensive consolidation measures as soon as the macroeconomic situation stabilises.

<sup>8</sup> In its outlook for the year, the German Finance Agency envisaged financial requirements of no less than €60 billion for SoFFin.

<sup>9</sup> The development of local government finances was analysed in greater detail in the short articles in the Bundesbank Monthly Report of April 2009.

## Social security funds<sup>10</sup>

### Statutory pension insurance scheme

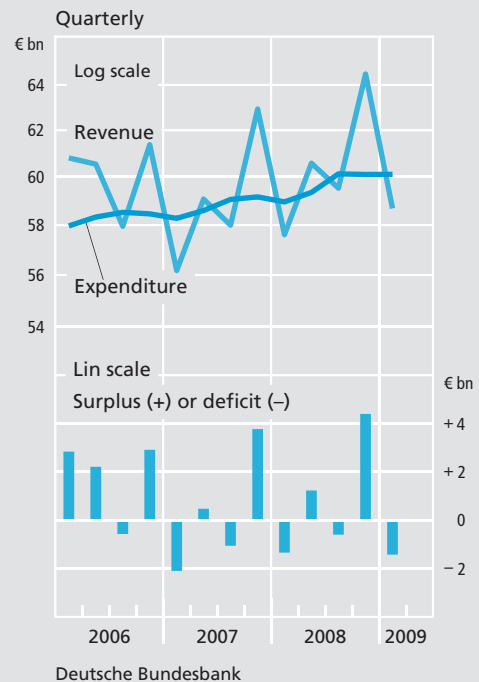
*Deficit in Q1, revenue still stable at 2008 level*

The statutory pension insurance scheme recorded a deficit of €1½ billion in the first quarter of 2009, which was barely larger than in the first three months of last year. While both total revenue and employees' compulsory contributions generated 2% more than in the first quarter of 2008, this represents a noticeable slowing in the pace of growth compared with previous quarters. Expenditure, too, rose by 2%. Pension payments played a key role in this. They increased by 1½% on the back of the 1.1% rise in pensions on 1 July 2008 and a rise of just under ½% in the number of pensions. Substantial spending increases ensued from the rise in contribution rates to the statutory health insurance institutions in respect of contributions attributable to the statutory pension insurance scheme and from rehabilitation measures.

*Financial deterioration due to macro-economic slowdown this year...*

The statutory pension insurance scheme could conclude the year with a deficit. One reason for this is that pensions will be raised comparatively sharply, by 2.41% in western Germany and 3.38%<sup>11</sup> in eastern Germany, as from 1 July 2009. This reflects the marked growth in wages and salaries in 2008. Another important element is the suspension of the "Riester factor" in the pension adjustment formula, which is designed to curb pension increases by the amount set aside by employees for supplementary private pension provision. Moreover, the positive overall employment situation in 2008 helped to lower

### Finances of the German statutory pension insurance scheme



the pensioner ratio, which allowed for a higher pension adjustment due to the correspondingly reduced sustainability factor. The planned cut in the contribution rate to the health insurance fund in mid-2009 to 14.9% will generate some financial relief in the second half of the year.

<sup>10</sup> The financial development of the statutory health and public long-term care insurance schemes in the final quarter of 2008 was analysed in the short articles of the Monthly Report of March and April 2009. These are the most recent data available.

<sup>11</sup> Pensions will be increased by a larger margin in eastern Germany because earnings data there in the past few years have been revised upwards. The justification for this was that adjustments which were essentially too low in previous years should now be compensated for by a more generous adjustment. However, downward adjustments have been very limited in eastern Germany because safeguard clauses both prevented any pension cuts and (in 2007 and 2008) ensured that adjustments in eastern Germany matched those in western Germany.



... and in coming years

Next year, the macroeconomic slowdown is likely to have a larger negative effect on the labour market and weaken the revenue base for the statutory pension insurance scheme. Due to the fact that dampening factors are to be used again in the pension adjustment formula, this would not lead to a rise in pensions even if *per capita* earnings were to increase slightly in 2009. Pension cuts as a result of falling *per capita* earnings are to be generally

prevented by law. This *ad hoc* intervention will increase the risk of permanently higher burdens on contribution payers unless previously waived pension cuts are later offset by larger adjustment curbs. Overall, it cannot be ruled out that if contribution rates remain unchanged at 19.9%, the lower intervention threshold for the pension reserves of 0.2 of monthly expenditure may be undershot in 2011. As things currently stand, the putative lowering of the contribution rate, which has been factored into the projections to date, no longer appears likely.

#### Federal Employment Agency

In the first quarter of 2009, the Federal Employment Agency recorded a deficit of €4 billion, whereas one year previously, in terms of the operating result (ie excluding the one-off transfers to the Agency's dedicated civil servant pension reserves), the shortfall had amounted to only €1 billion. Revenue plummeted by 28% which, however, was largely due to the fact that, as from 2009, the Federal grant is no longer paid in equal monthly instalments but instead in one lump sum at the end of the year. Furthermore, the contribution rate was cut again from 3.3% to 2.8% at the beginning of the year. Expenditure of the Federal Employment Agency formally recorded a total decrease of 8%. In operating terms, however, ie excluding the one-off transfer to the civil servant pension reserve fund last year, it actually went up by 7%. It should also be noted that the reintegration payment to be paid to central government was particularly low because at the beginning of the year it was offset against ex-

*Financial situation already much worse at start of 2009*

cess payments from last year. While, at 3%, expenditure on unemployment benefit showed a relatively moderate increase, growth in short-time working benefits<sup>12</sup> (which almost tripled) and in active labour market policy measures (+11%) had a far greater impact.

*Extremely  
negative  
financial  
outlook  
in downturn...*

The Federal Employment Agency's supplementary budget foresees a full-year deficit of nearly €11 billion. However, this is still based on the more favourable macroeconomic assumptions from central government's Annual Economic Report. The economic outlook has since deteriorated, and this will have a particularly severe effect on the Federal Employment Agency's finances because not only is expenditure on wage substitutes and other benefits increasing at a faster pace but its contribution receipts are already contracting.<sup>13</sup> Therefore, in 2009, the Federal Employment Agency's deficit is likely to distinctly exceed the target figure. Over the year as a whole, the reserves should be sufficient to cover the deficit. However, during the year, liquidity shortages are to be expected because contributions from Christmas bonus payments and, above all, the Federal grant will not be received until the end of the year.

Liquidity assistance from central government is envisaged for this purpose.

The expected further rise in unemployment will not only completely exhaust the Federal Employment Agency's reserves in the coming year but will also give rise to a high deficit to be covered by central government. Hence while a contribution rate of approximately 3% just about sufficed to finance the very low number of recipients of unemployment benefit in 2008, it is too low to cover the Federal Employment Agency's structural expenditure over the entire business cycle. The planned contribution rate of 3% from 2011 onwards can therefore only be maintained if high Federal transfers are made regularly from tax revenue or if the Federal Employment Agency significantly reduces its range of benefits.

*... may  
necessitate  
higher Federal  
grants next year*

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<sup>12</sup> Short-time working benefits payable for cyclical, seasonal and restructuring reasons are paid retrospectively, ie expenditure in the first quarter reflects growth in short-time working from December 2008 to February 2009.

<sup>13</sup> By contrast, the statutory pension, statutory health and public long-term care insurance schemes receive contributions for unemployed recipients of wage substitutes (generally based on 80% of previous gross remuneration), meaning that initially they are not as greatly affected by a fall in unemployment.