Public finances*

General government budget

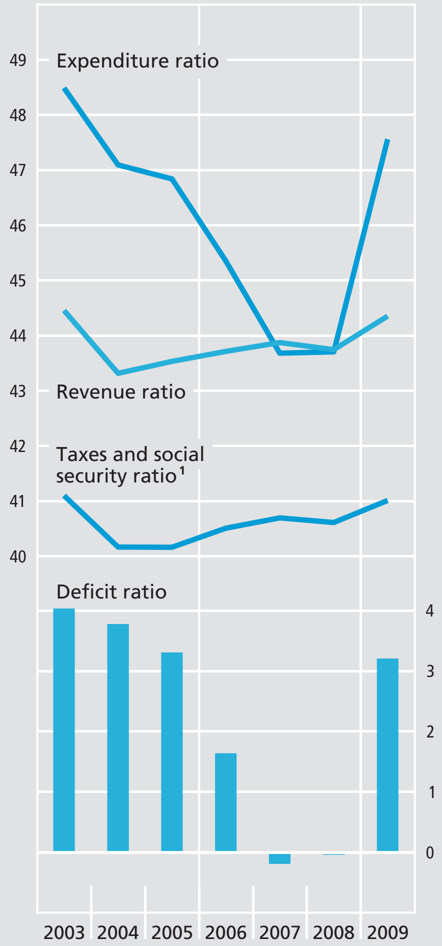
General government deficit for 2009 slightly above 3% mark

Following two years of a virtually balanced government budget, 2009 saw the return to a high deficit. According to provisional data from the Federal Statistical Office, the deficit ratio amounted to 3.2% and thus exceeded the European reference value. Cyclical factors accounted for not quite half of the dramatic deterioration vis-à-vis the previous year. In this context, the negative cyclical impact was still significantly mitigated by the fact that the macroeconomic profile was favourable for public finances. Gross wages and salaries as well as private consumption, both of which are of particular importance for government revenue, experienced a far more stable development than gross domestic product (GDP) and growth in unemployment also remained limited. The plunge in revenue from profit-related taxes from exceptionally high levels (see box on pages 66 and 67) contributed to the sharp rise in the deficit after adjustment for direct cyclical and temporary effects. Even more significant, however, were the deficit-increasing measures, with cuts in tax and social contribution rates and higher spending in connection with the fiscal stimulus packages accounting for the largest share, whereas support measures for the financial sector were

* The "General government budget" section starts with an analysis based on data contained in the national accounts and on the Maastricht ratios. 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.

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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reflected in the national accounts deficit to a limited extent only.[1]

Revenue down considerably

Government revenue fell by just over 2% in 2009. The economic slowdown coupled with plummeting profit-related taxes[2] and extensive tax cuts contributed to the 4½% decline in tax revenue. Changes to income tax rates and to the tax depreciation rules contained in the fiscal stimulus packages as well as the additional tax relief measures for enterprises adopted in summer 2009 are especially important in this context. By contrast, revenue from social contributions increased slightly as the lower contribution rate to the Federal Employment Agency was virtually offset by higher average annual rates to the health insurance fund as well as to the public long-term care insurance scheme, and cyclically induced shortfalls were alleviated by contributions paid on behalf of the unemployed by the Federal Employment Agency and central government. The general government revenue ratio rose perceptibly to 44.4% as revenue decreased less sharply than nominal GDP because the development of the economic structure was favourable for public finances.

Expenditure significantly increased due to government measures and cyclical impact

At 5%, government spending in 2009 grew at a pace not seen since the early 1990s. Measures such as the car scrappage scheme, expansion of public investment, increases in

1 Support measures for HRE in particular were recorded as increasing the deficit if participating interests were not acquired at prevailing market rates. According to SoFFin's annual accounts, interest expenditure was offset by substantially higher income predominantly from fees for guarantees issued. In total, capital injections to credit institutions recorded as not affecting the deficit amounted to just over 1% of GDP. From the extensive guarantees of 7% of GDP, there have so far been no deficit-increasing calls on guarantees.
2 Entrepreneurial and property income, which, for the sake of simplicity, is normally used as a macroeconomic reference variable for revenue from profit-related taxes, provides only a rough approximation of the actual tax assessment base. Thus only an approximate distinction can be drawn between cyclically induced and other (structural) developments. Pursuant to the standard cyclical adjustment procedure used in the European System of Central Banks, a considerable portion of the expected decline in revenue from this type of tax in 2009 can be attributed to neither the development of the macroeconomic reference variable (and is thus not cyclically induced) nor legislative changes. For a seminal contribution, see Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, pp 33-57.

child benefit and additional expenditure on healthcare alone are likely to have accounted for approximately one half of this increase. Moreover, labour-market-related expenditure also rose significantly, primarily due to economic circumstances. The expenditure ratio was up by almost four percentage points to 47.6% due to the sharp decline in GDP.

Deficit to continue to rise substantially in 2010

The deficit ratio is likely to continue to rise substantially in 2010 and could reach as much as 5%. Based on current analysis, the cyclical component of the deficit is again likely to increase slightly even though GDP is expected to expand perceptibly, as the overall growth profile will probably be fairly unfavourable for public finances. The rise in the deficit will nonetheless be primarily structural in nature. Extensive deficit-increasing measures are once again taking their toll. On the revenue side, these include the extended tax deductibility of contributions to the health and long-term care insurance schemes and various measures adopted to support the economy (notably, the renewed adjustment to income tax rates, tax relief measures for corporate taxation, new tax allowances for turnover tax as well as the lower contribution rate to the health insurance fund on an annual average). On balance, spending will rise owing to measures such as a further increase in child benefit and growing investment. Moreover, healthcare expenditure, in particular, is likely to continue to soar.

Ecofin Council recommendations to correct excessive deficit not very challenging

In December 2009, the Ecofin Council adjudged Germany to have an excessive deficit and called on the German government to bring the deficit ratio back below the 3% ceiling by 2013 at the latest. In order to achieve this, Germany is to reduce its structural deficit by an average of 0.5% of GDP a year starting from 2011, with consolidation to be accelerated should economic and budgetary developments be better than expected. The Council demanded no consolidation for 2010, instead recommending fiscal measures be implemented as planned. In light of the macroeconomic outlook, these recommendations are not very challenging and, at best, constitute minimalist requirements as measured by the intention of the Stability and Growth Pact.[3]

Consolidation planned in stability programme just meets requirements

The updated stability programme that the German government presented on 9 February just complies with these requirements. The programme is based on a 1.4% increase in real GDP for 2010 whereas a somewhat optimistic figure of +2% per annum has been estimated for the period from 2011 to 2013. The deficit ratio is expected to rise to 5½% in 2010, in particular due to a further expansion in discretionary budgetary burdens.[4] From 2011, the ratio is to be reduced by not quite one percentage point a year with the aim of just undershooting the 3% ceiling in 2013. Budgetary burdens arising from further tax cuts envisaged in the coalition agreement have not been factored into these projections. From 2011, the structural deficit is to be cut by an annual average of just over ½% of GDP. Given the high deficits and the fact that the debt ratio will still continue to rise in

3 See also Deutsche Bundesbank, Monthly Report, November 2009, pp 63-66.
4 Unlike in the ESCB procedure, the EU procedure does not report an increase in cyclically induced budgetary burdens for 2010.

The structural development of public finances – results of the disaggregated framework for 2009

The general government budgetary position in Germany deteriorated sharply in 2009. According to provisional data from the Federal Statistical Office, the general government deficit (as defined in the national accounts) amounted to 3.2% of GDP, after the budget had been balanced in 2008. Using the disaggregated framework for analysing public finances,[1] it is possible, firstly, to estimate the role played by cyclical and specific temporary effects and, secondly, to identify other changes, referred to here as structural changes, in the revenue and expenditure ratios and their major determinants. The main results of this analysis for 2009 are presented below.[2]

Just less than half of the very sharp deterioration in the unadjusted deficit ratio can be attributed to direct cyclical influences. Applying the standard adjustment procedure used within the European System of Central Banks, there was a negative impact from the change in the cyclical component of 1.3 percentage points (pp), which would have been significantly higher had it not been for the fact that the profile of macroeconomic development was extremely favourable for public finances. Clearly identifiable specific temporary effects reduced the increase in the deficit by 0.2 pp as the tax refunds which resulted from the Federal Constitutional Court's ruling reinstating the commuting allowance were already recorded in the national accounts in 2008 and thus reduced revenue in that year instead of in 2009. In addition, last year Germany received a one-off repayment from the EU budget for the years 2007 and 2008 owing to the implementation of the Own Resources Decision of 2007.[3] The (structural) fiscal balance adjusted for these cyclical and specific temporary effects consequently deteriorated sharply by 2.1 pp in relation to trend-GDP.

While the unadjusted revenue ratio increased by 0.7 pp, the structural revenue decreased markedly by 1.1 pp of nominal trend-GDP. The more favourable development in the unadjusted ratio reflected the fact that those macroeconomic reference variables that are of particular importance for government revenue, such as gross wages and salaries and private consumption, were hurt far less by the economic downturn than was overall GDP. This revenue-boosting change in the pattern of economic activity is not reflected in the structural revenue ratio as it is geared to longer-term trends in the macroeconomic reference variables. The negative structural decoupling of the macroeconomic reference variables from the development of GDP thus continued to slightly depress the revenue ratio (-0.2 pp). While the trend for entrepreneurial and investment income remained above trend-GDP, this was more than offset by the comparatively low trend-growth of gross wages and salaries and private consumption. Legislative changes caused a noticeable reduction in the structural revenue ratio (-0.4 pp). This was caused by the further lowering of the contribution rate of the Federal Employment Agency from 3.3% to 2.8%, cuts in taxes and social contribution rates agreed as part of the stimulus packages and the tax relief measures for enterprises adopted in summer 2009. The higher average annual contribution rates to the statutory health and long-term care insurance schemes had a lesser impact in comparison. By contrast, the structural ratio was increased slightly by the positive fiscal drag (+0.1 pp) owing to income tax progression accompanied by slightly positive trend-growth in *per capita* wages.

The decline experienced in the structural revenue ratio in 2009 can only be partially explained by the three factors mentioned above (fiscal drag, the structural decoupling of the macroeconomic reference variables from GDP and legislative changes). The part remaining unexplained in the standardised procedure (residual) came to a total of -0.6 pp. This is largely attributable to the fall in revenue from profit-related taxes, which was faster than can be explained by 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 is connected with the fact that the fall in corporate earnings was more quickly reflected in revenue (in particular via the rapid adjustment of advance payments of assessed taxes and lower investment income tax payments on dividends) than assumed according to the average relationships upon which the disaggregated approach is based. Overall, much of the extraordinary surge in revenue from profit-related taxes over the past years to a distinctly above-average level now seems to have been cancelled out.

1 For a more detailed description, including of the standardised method of determining the cyclical component, 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** Expenditure associated with the support measures for financial institutions (0.2 pp) is not included in the specific temporary effects here and, moreover, also occurred on a similar scale in 2008, meaning that the year-on-year change was minimal. — **4** Adjusted for cyclical influences and specific 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 (2009). — **5** Year-on-year change of the ratio to nominal GDP in percentage points. — **6** Assessed income tax, corporation tax, local busi-

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Structural development [4] as percentage of trend-GDP

Year-on-year change in percentage points

Item	2003	2004	2005	2006	2007	2008	2009	Total 2003-2009
Unadjusted fiscal balance[5]	– 0.4	0.3	0.5	1.7	1.8	– 0.2	– 3.2	0.5
Cyclical component[5]	– 0.4	– 0.1	– 0.2	0.8	0.5	0.5	– 1.3	– 0.3
Temporary effects[5]	0.0	0.0	0.1	– 0.1	0.0	– 0.2	0.2	0.1
Fiscal balance	0.1	0.3	0.6	1.0	1.3	– 0.5	– 2.1	0.7
Interest payable	0.0	– 0.1	0.0	0.1	0.0	– 0.1	– 0.2	– 0.4
Owing to change in average interest rate[pe]	– 0.1	– 0.3	– 0.1	0.0	0.0	– 0.1	– 0.3	– 0.8
Owing to change in debt level[pe]	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.4
Primary balance	0.1	0.1	0.5	1.1	1.3	– 0.6	– 2.3	0.4
Revenue	– 0.3	– 1.1	0.1	0.8	0.7	0.1	– 1.1	– 0.8
Taxes and social contributions	– 0.2	– 0.8	– 0.1	0.7	0.7	0.1	– 1.0	– 0.5
Fiscal drag	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.5
Decoupling of base from GDP	– 0.3	– 0.2	– 0.1	– 0.1	– 0.2	0.1	– 0.2	– 0.8
Legislative changes	0.4	– 0.5	– 0.2	0.1	0.7	– 0.5	– 0.4	– 0.4
Residual	– 0.4	– 0.2	0.2	0.6	0.1	0.4	– 0.6	0.3
of which: profit-related taxes[6]	– 0.1	0.1	0.2	0.5	0.3	0.4	– 0.5	0.9
Memo item: included in expenditure[7]	0.0	– 0.1	– 0.2	– 0.1	– 0.1	0.0	0.1	– 0.3
Non-tax revenue[8]	– 0.1	– 0.3	0.1	0.1	0.0	0.0	– 0.1	– 0.3
Primary expenditure	– 0.4	– 1.3	– 0.4	– 0.3	– 0.6	0.6	1.2	– 1.1
Social payments[9]	– 0.1	– 0.8	– 0.3	0.0	– 0.3	0.2	0.7	– 0.6
Subsidies	– 0.1	– 0.1	– 0.1	0.0	0.0	0.0	0.2	– 0.2
Compensation of employees	– 0.2	– 0.1	– 0.2	– 0.2	– 0.2	0.0	0.1	– 0.7
Intermediate consumption	0.0	0.0	0.1	0.1	0.0	0.1	0.2	0.4
Gross fixed capital formation	– 0.1	– 0.1	– 0.1	0.1	0.0	0.1	0.1	– 0.1
Other expenditure[10]	0.1	– 0.1	0.1	– 0.2	– 0.1	0.2	0.0	0.0
Memo item								
Pension expenditure[11]	0.0	– 0.2	– 0.2	– 0.1	– 0.3	– 0.1	0.0	– 0.8
Healthcare expenditure[12]	– 0.1	– 0.4	0.1	0.1	0.1	0.2	0.3	0.2
Labour-market expenditure[13]	– 0.1	– 0.2	0.0	0.0	– 0.1	0.1	0.2	– 0.1

While the unadjusted expenditure ratio increased dramatically by 3.9 pp in 2009, the ratio of structural expenditure to the more stable nominal trend-GDP increased by just 1.0 pp. General government profited from a renewed decline in the interest expenditure ratio which was attributable to the very favourable (re)financing conditions. Conversely, the structural ratio of other expenditure (primary expenditure) increased somewhat more sharply (+1.2 pp). It was chiefly driven by higher spending on social benefits (primarily healthcare expenditure, child benefit and the car scrappage incentive, which was booked under other current transfers to households). But public intermediate consumption, subsidies and investments, which were expanded as part of the economic stimulus measures, also played a significant role.

Overall, it is apparent that half of the very sharp deterioration in the fiscal balance in relation to GDP, amounting to 3.2 pp in net terms, is attributable to the effects of the automatic stabilisers, temporary effects and the normalisation of profit-related taxes. The significant additional deterioration on both the revenue and expenditure sides is largely the result of discretionary fiscal policy measures (in particular the two economic stimulus packages).

ness tax, investment income tax. — **7** Payments attributable to the general government sector, eg social contributions for public sector employees (estimated). — **8** Other current transfers receivable, sales and total capital revenue. — **9** Including other current transfers to households. — **10** Other current transfers payable to corporations and the rest of the world, other net acquisitions of non-financial assets and capital transfers. — **11** Spending by the statutory pension insurance scheme, on civil servant pensions and payments by the post office pension fund. — **12** Spending by the statutory health insurance scheme and assistance towards civil servants' healthcare costs. — **13** Spending by the Federal Employment Agency (excluding the compensatory amount (up to 2007)/reintegration payment (from 2008) 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.

Key data of the Federal Government's updated stability programme

As a percentage

Item	2008	2009	2010	2011	2012	2013
Real GDP growth						
Stability programme January 2010	1.3	– 5.0	1.4	2	2	2
Stability programme January 2009	1.3	– 2¼	1¼	1¼	1¼	–
General government fiscal balance (as % of GDP)						
Stability programme January 2010	0.0	– 3.2	– 5½	– 4½	– 3½	– 3
Stability programme January 2009	– 0.1	– 3	– 4	– 3	– 2½	–
Structural fiscal balance (as % of GDP)						
Stability programme January 2010	– 1	– 1½	– 4½	– 4	– 3	– 2½
Stability programme January 2009	– 1	– 2	– 3	– 2	– 2	–
Debt ratio						
Stability programme January 2010	65.9	72½	76½	79½	81	82
Stability programme January 2009	65½	68½	70½	71½	72½	–

Source: Federal Ministry of Finance.

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2013, greater efforts would have been desirable. Furthermore, contrary to the basic function of the stability programmes as a component of the EU budgetary surveillance procedure, the funding of this improvement is still pending as concrete measures for cutting the deficit will not be set out before central government's draft budget for 2011 and medium-term financial plan up to 2014.

Budgetary development of central, state and local government

Tax revenue

Steep decline in tax revenue in 2009

In 2009, tax revenue[5] recorded a marked fall of 6% (see chart on page 69 and table on page 70), however, it was thus around €1 billion higher than forecast in the latest official tax estimate from November 2009. This decline in revenue is mainly attributable to the economic downturn, fiscal policy measures[6] as well as tax refunds following the Federal Constitutional Court's ruling reinstating the standard travel allowance for commuters, which are recorded in the cash receipts for 2009.

Large income tax shortfalls

Revenue from income-related taxes fell very sharply (-12%). Wage tax receipts declined by just over 4½%. This is partly due to

5 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.
6 These notably include lowering the income tax rates, easing depreciation facilities, extending actual taxation in the case of turnover tax, more lenient counterfinancing measures from the 2008 business tax reform, reinstating the previous, more generous standard travel allowance for commuters as well as the child bonus and the increase in child benefit which are recorded as reducing revenue in the cash receipts.

the fact that gross wages and salaries decreased overall and progression had an additional revenue-reducing effect owing to lower per capita wages. Moreover, tax rates were lowered and the payments deducted from cash receipts were raised (one-off child bonus, increase in child benefit and subsidies for supplementary private pension plans). Massive short-falls were recorded for profit-related taxes (-25½%). Receipts from corporation tax plummeted mainly owing to lower advance payments for current profits and, on balance, higher repayments for 2008. The effects of considerable shortfalls as a result of tax refunds following the Federal Constitutional Court's ruling reinstating the standard travel allowance for commuters, and of tax cuts were felt in assessed income tax. By contrast, smaller deductions for grants to homebuyers, which are being phased out, boosted revenue. Lower profit distributions resulted in large decreases in revenue from investment income tax. Given the relatively stable development of consumption, however, revenue from consumption-related taxes rose slightly by just under ½%.

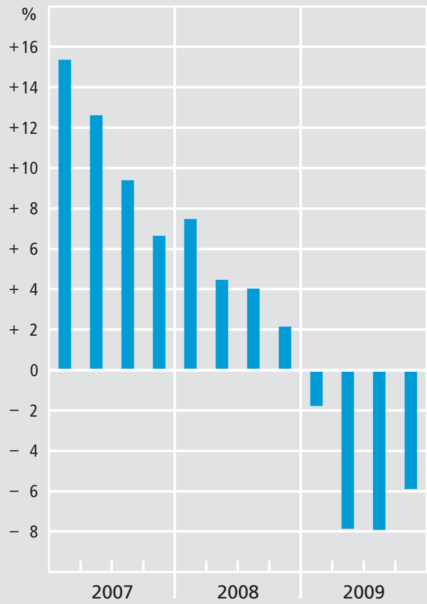
Revenue from consumption-related taxes stable

Further marked decline in revenue expected in 2010

On the basis of the November tax estimate, a further decline in revenue (including local government taxes) of 3½% is expected in 2010 if shortfalls of €6 billion (1% of 2009 tax revenue) due to tax relief measures agreed in December 2009 are additionally factored in (especially the increase in child benefit and in child tax allowance, preferential turnover tax treatment for the hotel trade as well as relief measures for corporate and inheritance tax). Measures that had been previously adopted – in particular the extended

Tax revenue*

Year-on-year change, quarterly



* Including EU shares in German tax revenue, but excluding receipts from local government taxes.

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tax allowances for insurance contributions and the fiscal stimulus packages – resulted in considerable net shortfalls. Added to this is the fact that receipts from profit-related taxes are likely to continue to fall as the slump in corporate earnings associated with the economic downturn partly takes some time to feed through to revenue. Furthermore, the macroeconomic reference variables for wage tax and consumption-related taxes are also expected to develop poorly. All in all, however, forecasting uncertainty is currently very high, primarily owing to the unsettled economic outlook, estimation problems with regard to extremely volatile revenue from profit-related taxes[7] and the fact that the

7 See also Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, pp 33-57.

Tax revenue

Type of tax	Year as a whole 2008 € billion	2009 € billion	2009 Year-on-year change € billion	as %	Estimate for 2009 as a whole 1, 2, 3 Year-on-year percentage change	Q4 2008 € billion	2009 € billion	2009 Year-on-year change € billion	as %
Tax revenue, total 2	515.5	484.9	– 30.6	– 5.9	– 6.1	140.3	132.0	– 8.3	– 5.9
of which									
Wage tax	141.9	135.2	– 6.7	– 4.7	– 5.2	40.3	38.6	– 1.8	– 4.4
Profit-related taxes 4	78.6	58.5	– 20.1	– 25.5	– 25.0	18.4	13.1	– 5.2	– 28.5
Assessed income tax	32.7	26.4	– 6.3	– 19.1	– 17.9	9.7	7.6	– 2.2	– 22.1
Corporation tax	15.9	7.2	– 8.7	– 54.8	– 59.9	2.2	1.8	– 0.4	– 17.6
Investment income tax 5	30.0	24.9	– 5.1	– 17.0	– 14.4	6.4	3.7	– 2.7	– 41.9
Turnover taxes 6	176.0	177.0	+ 1.0	+ 0.6	+ 0.4	45.5	46.1	+ 0.6	+ 1.4
Energy tax	39.2	39.8	+ 0.6	+ 1.5	+ 0.0	15.2	15.1	– 0.1	– 0.7
Tobacco tax	13.6	13.4	– 0.2	– 1.5	+ 0.0	4.1	3.9	– 0.2	– 4.1

1 According to official tax estimate of November 2009. — **2** Including EU shares in German tax revenue, but excluding receipts from local government taxes. — **3** Including (estimated) local government taxes, tax revenue was €46.8 billion below the November 2008 estimate, which was used as a basis for the original 2009 Federal budget from the end of 2008. According to government estimates, €18.8 billion of this shortfall is attributable to additional legislative changes. — **4** Employee refunds, grants paid to home owners and investors deducted from revenue. — **5** Withholding tax on interest income and capital gains, non-assessed taxes on earnings. — **6** Turnover tax and import turnover tax.

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financial impact of extensive legislative changes is, at times, difficult to quantify.

Central government budget

2009 central government budget with much smaller deficit than planned, ...

The central government budget recorded a deficit of €34½ billion in 2009. Net borrowing was thus €15 billion below the level envisaged in the second supplementary budget from July 2009. The main factors behind the better-than-anticipated results were the almost €4 billion improvement in tax receipts, partly driven by smaller transfers to the EU budget, and much lower spending (€11 billion in total). The loan to the health insurance fund, forecast to be €4 billion, was not taken up and, owing to the low level of interest rates and the issue of debt instruments with considerable premiums, interest expenditure was lower than estimated. Calls on guarantees and benefits for the long-term unemployed were also below budget.

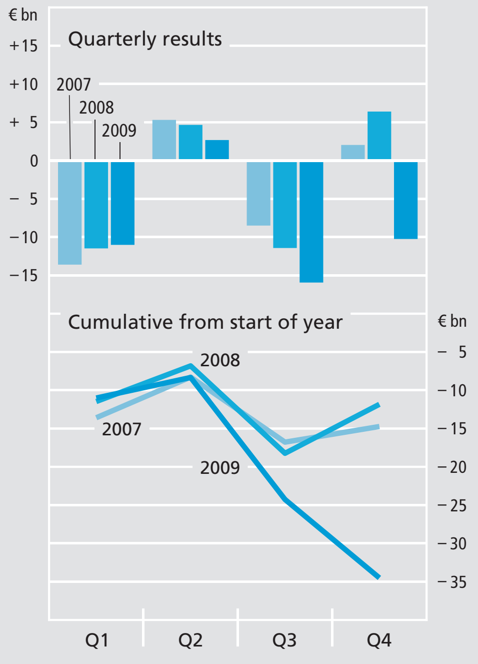
... however, up sharply on 2008 and borrowing limit overshot

Nevertheless, the deficit was up sharply on the year by €23 billion. After adjustment for the transfer of motor vehicle tax to central government, tax revenue was down by just over €12 billion; however, on balance, more than half of this drop was attributable to new tax relief measures. Proceeds from asset realisations fell by €4 billion, although, this was largely offset by the one-off use of the Bundesbank's entire profits to finance the budget. Growth in expenditure was recorded in particular for grants to the statutory health insurance scheme and investment. But other operating expenditure, benefits for the long-term unemployed and personnel expenditure also rose markedly. By contrast, interest expenditure recorded a decline of €2 billion. On balance, net borrowing exceeded investment expenditure by €7 billion. When drawing up the supplementary budgets, the overstepping of the constitutional borrowing limit was justified by invoking the exemption clause that it serves to avert a disruption of the macroeconomic equilibrium.

Despite improvement in macroeconomic environment, 2010 draft budget contains exceptionally high deficit

The new government presented a revised draft budget for 2010 in mid-December 2009. Although the macroeconomic environment has improved significantly compared with expectations in June, forecast net new borrowing was revised down by barely €½ billion to just short of €86 billion. While lower estimates of expenditure to offset the Federal Employment Agency's deficit, less funds earmarked for benefits for the long-term unemployed and interest payments, as well as additional tax revenue forecast in the latest official tax estimate will amount to total relief of €10 billion, this will be virtually offset by the goal of strengthening cyclical growth forces primarily by means of the Act to Accelerate Growth (*Wachstumsbeschleunigungsgesetz*), an additional one-off grant to the health insurance fund as well as additional spending on education and promoting agriculture. The fact that the macroeconomic outlook has brightened perceptibly in the meantime indicates that there is no real need for additional stimuli and that the associated growth effects are likely to remain limited. All in all, from today's perspective, the deficit in 2010 is nevertheless likely to be substantially lower than forecast. For instance, in the Federal Government's Annual Economic Report

Central government fiscal deficit/surplus



from January, labour market development is expected to be much more favourable, which should give rise to cost savings, notably for expenditure to offset the Federal Employment Agency's deficit but also for benefits for the long-term unemployed. Furthermore, interest, not least with a discount of €2 billion, appears to be estimated extremely cautiously, especially as the latest topping up of 30-year Federal bonds alone yielded a premium of almost €½ billion.

Strictly apply new borrowing limit

The (structural) deficit for 2010, ie adjusted for cyclical effects and financial transactions, constitutes the starting point for the gradual reduction of the constitutional borrowing limit to 0.35% of GDP by 2016. The 2010 budget is therefore of particular importance (see box on pages 72 and 73). As a rule, the

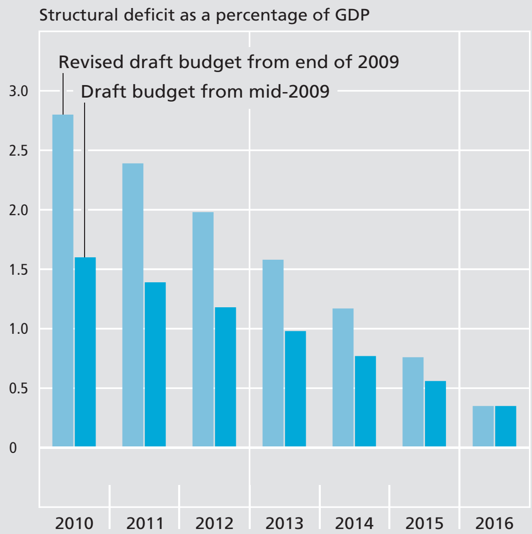
Federal budget for 2010 and scope for borrowing up to 2016

In 2009, following approval from both houses of parliament (Bundestag and Bundesrat), a new constitutional debt rule for central and state government was inserted into the German Basic Law (*Grundgesetz*). From 2016 onwards, central government's "structural" net borrowing (ie total borrowing adjusted for cyclical effects and financial transactions) may generally not exceed 0.35% of GDP. During the transitional period from 2011 to 2015, the limit for structural new borrowing will decrease to this figure in equal steps, starting from the level in the base year 2010.[1]

Structural deficit sharply revised in draft Federal budget for 2010

Hence the higher the debt ratio at the start of the mandatory reduction path, the greater the overall scope for borrowing during the transitional period (see chart below). The key significance of this starting value can be seen by comparing the draft budget for 2010 from mid-2009 with the revised draft budget for 2010 from December 2009. The revised draft budget, presented by the new German government in December, put the structural budget deficit at €68½ billion (2.8% of GDP). This figure was arrived at by deducting €16½ billion for cyclical effects and €1 billion for net acquisitions of financial assets from the total deficit of €86 billion. In mid-2009, by contrast, a similar-sized overall deficit estimate was reduced by €26 billion for the cyclical component and €21 billion for financial asset acquisitions, resulting in an estimated structural deficit of €39½ billion (1.6% of GDP). At almost €60 billion altogether or around €10 billion per year, the deviation from the future constitutional borrowing limit of 0.35% of GDP, which is to be reduced through consolidation, is almost twice as large under the current draft budget as it was in the initial calculation. However, this also means that, particularly during the first few years of the transitional period, the maximum annual structural deficit could be set significantly higher and still comply with the rule.

Scope for borrowing up to 2016 based on central government structural deficit for 2010



Just over €5 billion of the revisions vis-à-vis the mid-2009 draft budget can be attributed to measures adopted under the Act to Accelerate Growth (*Wachstumsbeschleunigungsgesetz*) and additional spending on education, long-term unemployment and agriculture. Furthermore, the size of the estimated negative cyclical influence was considerably reduced. Another major revision concerned the conversion of a loan to the Federal Employment Agency into a grant (totalling €16 billion). In the mid-2009 draft budget, this loan to the Federal Employment Agency was categorised as an acquisition of financial assets and consequently deducted from the total deficit when calculating the structural deficit.[2] In addition, an extra €4 billion of central government funds is now to be transferred to the health insurance fund, pushing total transfers up to €20 billion. Pursuant to the draft Social Security Stabilisation Act (*Sozialversicherungs-Stabilisierungsgesetz*), these payments are

1 Section 9 (2) of the Act Implementing Article 115 of the German Basic Law, based on Article 143d of the same law. For more information on the new rules, see Deutsche Bundesbank, The reform of the borrowing limits for central and state government, Monthly Report, May 2009, pp 78-79. — **2** Under the new budgetary rule – in line with European provisions – financial transactions, above all loans, are not assigned to the structural deficit component. — **3** Amounting to five-sixths of the one-off structural burden in 2011, decreasing further in equal stages in

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intended to offset cyclically induced revenue shortfalls and crisis-induced additional expenditure on the part of the Federal Employment Agency which it cannot cover with its own funds.

Success of new rule depends on strict application

The underlying objective of the new debt rule is to reverse the upward trend in the debt ratio, which has been evident for many years, and to counter the perpetually observed tendency to put off the consolidation of public finances, though generally acknowledged as being necessary, to some unspecified future date. In order to enhance the credibility of the new rule, it is crucial that from the very start it is implemented in line with the intended objective and, in particular, that no attempts are made to circumvent the rule's provisions and hence its underlying objective. In this respect, the decision to reject the idea of transferring the debt to off-budget entities before the rule came into force, as was discussed last autumn, is consistent with the underlying objective. Another problematic option would be to base the mandatory path to reduce borrowing during the transitional period on a pessimistic budget estimate for 2010 (see comments on pages 74 and 75) and to not adjust it in the light of more favourable expectations or actual figures. This would create unjustifiable additional scope for borrowing. Measures which have only a one-off impact on the 2010 budget but are viewed as structural under the new debt rule (such as the components of the one-off grant to the Federal Employment Agency which are not classed as cyclical) will also increase the scope for borrowing during the transitional period.[3] In accordance with the spirit of the transitional arrangements, none of these options should be exploited when drawing up the Federal budget for 2011 or the medium-term financial plan.

There is therefore a need to resist the temptation to artificially inflate the borrowing limit in order to formally create scope for temporary unfunded tax cuts or expenditure increases in the short term or to defer a sizeable part of the required consolidation to the next legislative period. While the size of the overall structural adjustment to be achieved by 2016 would remain unchanged, the introduction of further deficit-increasing measures would enlarge the adjustment requirement and the postponement of consolidation would necessitate managing the necessary adjustment – as well as the additional interest burden – within a much shorter period of time. Both scenarios would seriously endanger the new debt rule's long-term prospects of success as minimal compliance with the limit without allowing for unforeseen budgetary burdens would entail the risk of having to take extensive and timely consolidation measures in future downturns, thus destabilising overall economic development.[4]

The new debt rule, which was adopted during the last legislative period with a broad political consensus, is of key significance both in a national and international context. Its strict application could reverse the current trend of ever increasing debt ratios and thus provide a better basis for addressing the looming demographic burdens in Germany. Furthermore, credible budgetary rules, especially when the financial situation is tense, are an important safeguard for gaining and maintaining the confidence of the general public and the capital markets in sustainable public finances and thus facilitate, in particular, a stability-oriented monetary policy in the euro area. The new German budgetary rule was expressly welcomed by international organisations. Other countries, some of which have even higher deficits, seem willing to introduce similar national rules, not least in order to limit the danger of incurring sovereign risk premiums on the capital markets. Central government's pending fiscal policy decisions therefore take on crucial significance both in view of the intention underlying the new constitutional rule and in light of international developments. Ensuring the success of the new debt rule will be one of the foremost tasks of fiscal policy.

the years up to 2015. — 4 See also Deutsche Bundesbank, The reform of the borrowing limits for central and state government, Monthly Report, May 2009, pp 78-79 and J Kremer and D Stegarescu (2009), Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik, in Wirtschaftsdienst, Vol 89/9, pp 630 ff.

scope for borrowing up to 2015 is greater, the larger the reference deficit in the base year 2010. Inflating the reference deficit with a view to gaining a greater scope for borrowing during the transitional period would clearly undermine the intention of the legislation. Should a sizeable part of the required consolidation be deferred to the next legislative period or even enlarged as a result of additional measures, the success of the new debt rules would ultimately be endangered. The very purpose of these rules is to prevent the structural consolidation of public finances, which is generally acknowledged as being necessary, being put off to some unspecified future date and to reverse the upward trend in the debt ratio, which has been evident for many years. Against this backdrop, when drawing up the central government budget for 2011 and the medium-term financial plan, the reference deficit in 2010 should be based on a realistic assessment of current budgetary developments and temporary charges (such as the one-off conversion of the loan to the Federal Employment Agency into a grant) should not be misused in order to artificially increase the future scope for borrowing.

On balance, off-budget entities recorded sizeable deficit for 2009

At just over €20 billion, the deficit of central government's off-budget entities more than tripled in 2009. This was chiefly attributable to the Special Fund for Financial Market Stabilisation (SoFFin), which was set up in the fourth quarter of 2008. Although no funds were paid out for guarantees or purchasing impaired securities, further outflows of funds, in particular, to top up banks' capital, led to a deficit of just under €17 billion. The Investment and Repayment Fund, set up to manage spending relating to the second economic stimulus package, reported a deficit of €6 billion largely resulting from the car scrappage scheme. Of the €10 billion for investment grants to state government, only just under €1½ billion had an impact, not the intended minimum of €5 billion. By contrast, the Post Office Pension Fund again recorded a surplus of just over €½ billion in 2009. The newly created special fund to build up reserves for final payments of inflation-indexed Federal Government debt instruments is likely to have recorded an even larger surplus of €1½ billion. This should provide for the increase in repayment amounts due to past inflation.

State government[8]

Deficit already high for 2009 as a whole ...

After a surplus of just over €½ billion in 2008, state government recorded a high deficit of €25½ billion for 2009 as a whole. Excluding the additional burden from the second stage of the capital injection into the Landesbank BayernLB of €7 billion, which was allocated to the 2008 budgetary accounts but did not affect cash receipts until 2009, the deficit amounted to €18½ billion.[9] The forecast state government deficit was thus still undershot by €4 billion. Owing to the fall in tax revenue, receipts declined by 5½%. By contrast, at just over 2½%, expenditure – adjusted for both stages of the aforementioned recapitalisation – increased relatively sharply.

8 The development of local government finances in the third quarter of 2009 was outlined in the short articles in the Bundesbank Monthly Report of January 2010. These are the most recent data available.
9 Furthermore, Hamburg, Schleswig-Holstein and Baden-Württemberg injected a total of €5 billion of capital into their Landesbanken in 2009, however, off budget.

Not least the impact of the distinct rise in the compensation of employees and pension payments in the wake of the spring 2009 pay agreement was felt here. Budgetary burdens arising from co-financing the investment programme initiated by central government as part of the second economic stimulus package appear, to date, to have had only a minor role to play.

... and expected to climb even further in 2010

According to the official tax estimate from November excluding shortfalls owing to the Act to Accelerate Growth, tax revenue is expected to again decline markedly in 2010. Pursuant to budget plans available to date, the tax-revenue-sharing schemes with local government are likely to offer limited relief only. On the expenditure side, no sizeable relief has been budgeted for on balance, not least owing to growing personnel expenditure, meaning that the fiscal deficit is again likely to rise substantially. In order to come close to a structurally balanced budget by 2020, as stipulated in the German Basic Law's new debt rule, extensive consolidation measures are required for the most part. The fact that the old borrowing limit enshrined in the state government constitutions, which is still in place, is forecast to be overshot, in some cases, for a number of years, ultimately indicates that structural deficits are likely to be exceptionally high and will require decisive, swift countermeasures. However, even those state governments that have already imposed stricter borrowing limits in their budgetary regulations and that are plugging current deficits with reserves or by taking out temporary loans, have to take into account the new financial outlook sooner or later.

Social security funds[10]

Statutory pension insurance scheme

Despite marked deterioration on 2009, balanced result

The statutory pension insurance scheme recorded a virtually balanced result for 2009, compared with a surplus of €3¾ billion one year previously. Total revenue rose by just under 1%. Employees' compulsory contributions went up by ¼%, even though gross wages and salaries fell slightly on balance. However, contributions relating to periods of not working as part of short-time working schemes are also recorded under this item. In addition, the statutory pension insurance scheme's funds were stabilised in particular by contributions for recipients of unemployment benefit I. Transfers from the central government budget increased by just under 1½%.

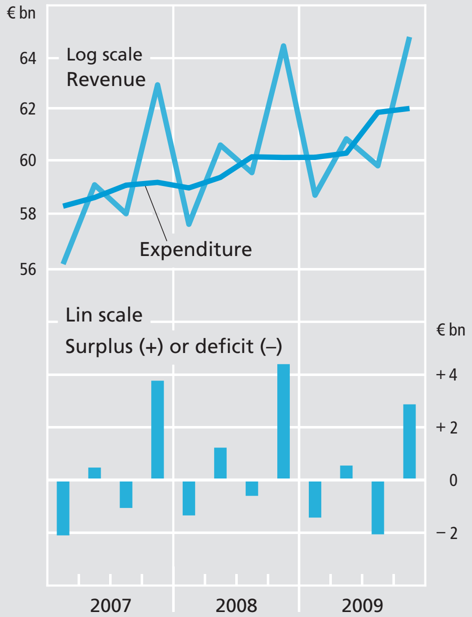
Accelerated growth in expenditure due to high mid-2009 pension increase

Spending by the statutory pension insurance scheme went up by 2½% in 2009. The sharp mid-year pension increase (+2.41% in western Germany and +3.38% in eastern Germany, compared with +1.1% in both in mid-2008) made a decisive contribution to this. Pension expenditure rose by just over 2%, which was broadly in line with the average annual increase. At 2½%, the rise in spending on health insurance contributions to be paid by the pension insurance scheme was only slightly higher than the increase in pension expenditure, despite the fact that the contribution rate to the statutory health in-

10 The financial development of the statutory health and public long-term care insurance schemes in the third quarter of 2009 was analysed in the short articles of the Monthly Report of December 2009. These are the most recent data available.

Finances of the German statutory pension insurance scheme

Quarterly



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surance scheme was higher on an annual average. This is probably because many pensioners are members of health insurance institutions that charged above-average contribution rates up to the end of 2008 meaning that the increase was then lower for them. Expenditure on rehabilitation measures, in particular, rose at a sharper rate (+9%).

2010 deficit also attributable to extended pension guarantee

In the final quarter of 2009, the Federal Government expected the statutory pension insurance scheme to record a deficit of €3¾ billion in 2010. As the underlying macroeconomic assumptions in the Old-age Provision Report[11] seem rather pessimistic from today's standpoint, the financing of the statutory pension insurance scheme may develop more favourably. However, a deficit is still likely. This is due in part to the fact that following the extension of the safeguard clause, pensions will not be cut in mid-2010 despite a probable fall in average earnings in 2009. To finance the resulting higher (relative) pension level, the contribution rate does not need to be raised initially as there are still reserves that can be drawn on. As pension cuts waived in the past owing to the safeguard clause are also to be clawed back in the coming years by halving the pension increases due at those times, no more than minor rises are to be expected for the foreseeable future if current legislation is applied.

Federal Employment Agency

High deficit in 2009

The Federal Employment Agency recorded a deficit of almost €14 billion in 2009, compared with an operating surplus of €1½ billion a year earlier (ie excluding the one-off payment of €2.5 billion to the pension fund set up in 2008[12]). This financial deterioration primarily reflects the automatic stabilisation effect of the Federal Employment Agency. However, the labour market was comparatively robust during the economic crisis. Revenue declined by a total of 10½% on the year. The main factor behind this was the lowering of the contribution rate from 3.3% to 2.8% at the beginning of 2009. Had the contribution rate remained the same, revenue

Decline in revenue mainly brought about by lowering contribution rate

11 In the 2009 Old-age Provision Report (Bundestags-Drucksache 17/52 of 20 November 2009), the Federal Government expected gross wages and salaries per employee to rise by 0.7% and the number of employees to decline by 2.0% in 2010. In its Annual Economic Report, it now expects per capita earnings to increase by 0.9% and employment to decline by 1.1%.
12 By contrast, the pension fund posted a small surplus of just under €½ billion in 2009. Building up reserves by means of ongoing transfers from the Federal Employment Agency continued to outweigh spending, especially on civil servant pensions.

would have only fallen slightly by just under ½%.

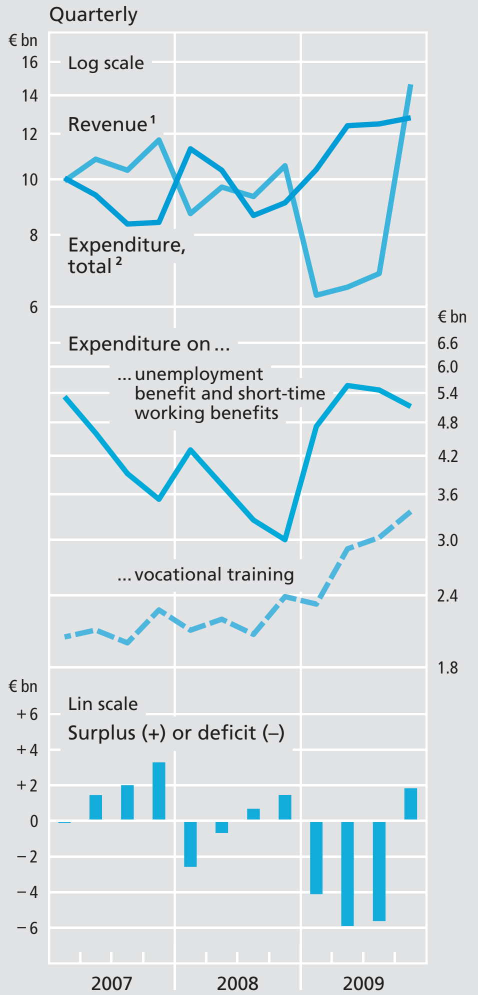
Growth in expenditure due to crisis

Again adjusted for the one-off transfers to the pension fund in 2008, expenditure by the Federal Employment Agency rose by 30%, or €11 billion. At almost €17½ billion, close to €3½ billion more was spent on unemployment benefit I. Payments for short-time working benefits increased from just under €½ billion to just over €3½ billion, and expenditure on active labour market policy measures (including refunds of social contributions for short-time work made to employers, which are recorded here) was up by almost €3 billion. Insolvency benefit payments rose to more than two-and-a-half times their prior year amount owing to the crisis, and a revenue gap of approximately €1 billion, which is to be plugged in 2010, arose from the insolvency benefit contributions, which were set in advance for the first time.[13]

2010 deficit likely to be lower than forecast

The Federal Employment Agency's reserves were depleted to just under €3 billion by the end of 2009. The Federal Employment Agency's 2010 budget plan envisages a deficit of almost €18 billion. However, this is based on macroeconomic projections from October 2009, which, in particular, foresaw an increase in the number of unemployed persons to 4.1 million. In its Annual Economic Report, the Federal Government is currently expecting a much smaller increase to 3.7 million. This should mean that the Federal Employment Agency's deficit, while still at a high level, is markedly lower in 2010.

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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Contribution rate not sufficient to structurally cover expenditure

This year, on a one-off basis, central government's payments to the Federal Employment Agency to offset the deficit are to take the form of a non-repayable grant rather than a loan. This ultimately constitutes tax financing of insurance benefits. As the current contribution rate of 2.8% (3.0% from 2011), to-

13 For this purpose, the contribution rate for insolvency benefit payments was raised from 0.1% to 0.41% of the respective gross wages and salaries.

gether with other revenue, is not sufficient to structurally cover the Federal Employment Agency's expenditure, benefits either have to be cut permanently or the contribution rate has to be raised. Otherwise, the Federal Employment Agency will remain dependent on extensive central government funds to balance its budget even in normal economic times.