

Public finances*

General government budget

Public finances are deteriorating dramatically in the current year. Whereas a balanced budget was achieved in 2008, supported by favourable economic conditions on an annual average, a deficit of just over 3% of GDP is now likely. This would exceed the ceiling laid down in the EC Treaty. Approximately one-half of this rise is due to the direct impact of the sharp cyclical downturn. However, this is still being moderated by the favourable macroeconomic growth pattern because gross wages and salaries as well as expenditure on private consumption, both of which are of particular significance for government revenue, are experiencing a far less unfavourable development than GDP, and growth in unemployment is likely to remain limited on an annual average. However, the decline in revenue from profit-related taxes is likely to be much greater than economic circumstances alone would imply. At approximately 1¼% of GDP, other factors, especially the fiscal stimulus packages, have also had a major impact. Government debt will shoot up to around €1¾ trillion, with financial market stabilisation measures already adopted but not recorded in the deficit also playing an important role in this respect.

Public finances deteriorating dramatically in 2009

Government revenue is falling markedly in 2009. In addition to the sharp cyclical downturn and the extraordinary drop in profit-

Revenue ratio rising despite a significant reduction in receipts

* 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 (predominantly budgetary) financial statistics.

related taxes,¹ the effect of substantial tax cuts is being felt. Changes to income tax rates and to the tax depreciation rules contained in the stimulus packages as well as the additional tax relief measures for enterprises adopted in July are especially important in this context. In the area of social contributions, the lower contribution rate to the Federal Employment Agency will be virtually offset by higher average annual rates to the health insurance fund and public long-term care insurance scheme. Despite a significant reduction in receipts on the whole, the revenue ratio will rise perceptibly due to the fact that the development of the economic structure is very favourable for public finances as GDP is declining even more sharply.

*Surge in
expenditure
ratio*

However, growth in the expenditure ratio is much stronger. This primarily reflects the impact of weak economic activity both through higher labour market-related expenditure and through the denominator effect of the fall in GDP. This alone accounts for about three-quarters of the expected increase of approximately 4 percentage points. Nevertheless, even after adjustment for cyclical effects, the expenditure ratio is still increasing considerably. The additional outlays arising from the fiscal stimulus packages alone are likely to come to around ½% of GDP in 2009, the largest areas of spending being the car scrapping incentive, the temporary expansion both of government investment and of active labour market policy measures and the one-off child bonus. In addition, spending on healthcare, old-age provision and personnel as well as the rise in child benefit have also contributed to the increase.

Public finances are likely to take another sharp turn for the worse next year. The debt ratio (forecast to exceed 75%) will mark a new historic high, while the deficit ratio will go up to around 5%. Although GDP is picking up again, the economic situation is likely to be an appreciable contributory factor because the growth structure – unlike in 2009 – is likely to be rather unfavourable for public finances. The rise in the deficit will, however, be ascribable mostly to structural factors. For instance, the exceptionally weak development in revenue from profit-related taxes, interpreted as a structural component, is likely to continue. Furthermore, extensive deficit-increasing measures are also having an impact. The new rules adopted in the coalition contract, due to come into effect at the beginning of 2010, alone could drive the deficit up by almost ½% of GDP.

*Deficit could
rise to around
5% of GDP in
2010*

The revenue ratio is likely to decline due to the forecast unfavourable growth structure, the continued negative growth effects in profit-related taxes and, above all, to sizeable cuts in tax and social contribution rates. These include the greater tax deductibility of insurance contributions and the renewed

*Development
of revenue ratio
predominantly
shaped by tax
cuts*

¹ Entrepreneurial and property income, which 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. It is therefore difficult to draw a distinction between cyclically-induced and other (structural) shortfalls. Pursuant to the standard cyclical adjustment procedure used in the European System of Central Banks, the development of the macroeconomic reference variable does not account for a considerable portion of the expected decline in revenue from this type of tax and it is therefore not included in the cyclical component calculated. Neither do the effects of legislative changes explain tax shortfalls to the extent expected. See also Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, pp 33-57.

adjustment to income tax rates adopted as part of the fiscal stimulus package of January 2009. By contrast, the additional tax relief measures now planned for enterprises and in connection with turnover tax will initially have rather a small impact in comparison. In the case of the social security funds, the intention to offset shortfalls in health insurance contributions with central government funds should ensure that health insurance institutions will, for the most part, not have to demand additional contributions in 2010.

Expenditure ratio is likely to increase slightly in 2010

By contrast, the expenditure ratio is likely to increase slightly although economic activity could have a dampening effect. Greater spending on healthcare and old-age provision is the prime cause. Although pensions are not likely to be raised in mid-2010, not least the effect of the rise in mid-2009, which was particularly high due to *ad hoc* interventions in the pension formula, will still be felt. The extent of the economic stimulus measures is also likely to augment. Although a number of temporary stimulus measures, such as the car scrapping incentive and the one-off child bonus, will have ceased to take effect, government investment is still likely to expand considerably because plans could only be implemented to a limited extent in 2009. Finally, sizeable extra spending, in particular an increase in child benefit, has been agreed for 2010 in the coalition contract.

Without consolidation measures, high deficits expected, in the medium term, too

Given the crisis and the associated high macroeconomic risks, it was justifiable for policymakers to launch extensive fiscal measures to stimulate the economy in addition to allowing the automatic stabilisers to take

effect and granting direct support to the financial markets. However, as only a relatively small amount of the deficit forecast for 2010 currently appears to be cyclical in nature, while a large part of the stimulus measures will probably prove permanent, large deficits and a rapidly rising debt ratio are likely to persist over the medium term unless the measures are properly counterfunded.

In almost all other EU countries, too, the European Commission's autumn forecast points to the prospect of very high deficit ratios and, in some cases, a veritable explosion in debt ratios. Such a development would not only entail fiscal and macroeconomic problems but would also pose a challenge for monetary policymakers. Markets might, for instance, form high inflation expectations on the perception that the budget situation is unsustainable in the long term. Not least to safeguard stability-oriented monetary policy from unsound fiscal policy, the EC Treaty and the Stability and Growth Pact stipulate minimum requirements of fiscal policy, which falls under national jurisdiction. Adjustment mechanisms have been envisaged should such requirements not be fulfilled. The Pact is sufficiently flexible to enable significant fiscal stabilisation in times of extraordinary crisis. However, the specific policy challenges arise where consolidation is necessary. As the past has shown, correcting excessive deficits using the agreed procedures has not always been plain sailing. Meanwhile, the European Commission has initiated an excessive deficit procedure against Germany and 12 of the 16 other euro-area countries (see box on pages 64 and 65). As economic pro-

Comprehensive consolidation required in almost all EU countries and ...

... also envisaged in EU budgetary rules

Excessive deficit procedure against 13 euro-area member states

In the EC Treaty, member states of the European Union committed themselves to avoiding excessive deficits. As a rule, the deficit and debt levels shall not exceed the reference values of 3% and 60% of GDP. The objective is to ensure sound public finances as a precondition for price stability and sustainable growth. Confidence in the long-term sustainability of public finances is particularly important in order to anchor inflation expectations at an appropriate level also in the medium and long term, and thus ease the task of monetary policy.

The European agreements also establish important minimum requirements for exiting stimulus measures and for the necessary consolidation. Pursuant to the Stability and Growth Pact, the reference value for the deficit ratio may be exceeded in the case of a severe economic downturn. However, even in such a situation, the deficit ratio may overshoot the 3% ceiling only temporarily and must remain close to the reference value. If the deficit ratio goes above 3% and the exemption clauses cannot be invoked, or if the debt ratio is higher than 60% and is not sufficiently diminishing, the Ecofin Council, at the recommendation of the European Commission, decides on the existence of an excessive deficit and puts forward recommendations for correction. The correction of an excessive deficit should normally be completed in the year following its identification. However, if there are special circumstances, this deadline may be extended, as a rule, by a year. As a benchmark, the structural deficit is to be reduced annually by at least 0.5% of GDP.

In April and July 2009, the Ecofin Council ruled that excessive deficits exist in a total of five euro-area countries. Greece, whose excessive deficit procedure is based on its overstepping of the reference value in 2007 – which it reported retroactively, was asked to correct its excessive deficit in 2010. Malta also ought to record a deficit of less than 3% of GDP in 2010. The correction deadlines for the other three countries, which likewise recorded excessive deficits in 2008, were extended in light of the size of the deficit and in the context of the extraordinary economic and financial crisis. Spain and France should comply with the 3% limit again by 2012 at the latest and Ireland by 2013. After six months, it has to be assessed whether the respective member state has taken effective action to meet the recommendations. If this is the case, but unexpected economic developments adversely affect public finances to a considerable extent, the Council can revise the recommendations, based on the Commission's advice. For this reason, on 11 November 2009, the Commission

recommended extending the deadline for Spain, France and Ireland by another year. By contrast, in the case of Greece, the government was found to be largely responsible for the sharp deterioration in the budgetary situation in 2009. The Commission therefore advised the Council to establish that no effective action had been taken. The next step would be to escalate the procedure and give notice to Greece. For Malta, the six-month period before the assessment of effective action is carried out comes to an end in January 2010.

At the same time as recommending revisions for the excessive deficit procedures that were initiated in spring 2009, the European Commission recommended that the Ecofin Council decide on the existence of an excessive deficit and put forward recommendations for correction for eight other euro-area countries. At the end of September, in their semi-annual notification as part of the European budgetary surveillance procedure, these countries had reported deficit ratios for 2009 that were well above the reference value and most of them also breached the debt criterion.¹ The European Commission recommends a correction deadline of 2013 for Germany, the Netherlands, Austria, Portugal, Slovakia and Slovenia, and a correction deadline of 2012 for Belgium and Italy.

In the Commission's opinion, Germany, the Netherlands and Austria can carry out their fiscal measures in 2010 as planned and do not have to start consolidation until 2011. If their structural balances improve by an annual average of ½% to ¾% of GDP between 2011 and 2013, these countries would be able to achieve the required correction on time. For Italy, Belgium and Slovenia, consolidation efforts on a similar scale are required, but they need to start in 2010. For the other countries, which should also start consolidation from 2010, the recommended improvements vary considerably. They range from an annual average of 1% of GDP for Slovakia, 1¼% for Portugal and France, 1¾% for Spain to 2% for Ireland.

By making a distinction with regard to the correction deadline and the extent of the annual consolidation, the Commission's intention is to propose structural adjustments that are deemed to be achievable while, at the same time, taking into account the varying risks for the sustainability of public finances as a result *inter alia* of differences in the debt levels. Against the backdrop of the extraordinary economic and financial crisis, which is leaving a distinct mark on general government budgets, and the fact that a year ago the Euro-

¹ See also Deutsche Bundesbank, Monthly Report, October 2009, p 10. — ² States the required average annual improvement in the structural deficit ratio as recommended by the Commission. — ³ In

the case of Malta, the assessment of effective action will be carried out after 7 January 2010. — ⁴ The Ecofin Council is expected to decide on the existence of excessive deficits and recommendations for cor-

Euro-area member states in the excessive deficit procedure

Country	Decision on the existence of an excessive deficit in	Deadline for correction	Start of consolidation	Annual consolidation requirement ² (as a percentage of GDP)	Budget balance as a percentage of GDP ⁵			Debt as a percentage of GDP ⁵		
					2009	2010	2011	2009	2010	2011
GR	April 2009	2010			-12.7	-12.2	-12.8	112.6	124.9	135.4
MT	July 2009	2010			-4.5	-4.4	-4.3	68.5	70.9	72.5
		Commission's proposal for new correction deadline								
ES	} April 2009	2013	2010	1¾	-11.2	-10.1	-9.3	54.3	66.3	74.0
FR		2013	2010	1¼	-8.3	-8.2	-7.7	76.1	82.5	87.6
IE		2014	2010	2	-12.5	-14.7	-14.7	65.8	82.9	96.2
	Procedure initiated ⁴ in	Commission's proposal for correction deadline								
BE	} October 2009	2012	2010	¾	-5.9	-5.8	-5.8	97.2	101.2	104.0
IT		2012	2010	½	-5.3	-5.3	-5.1	114.6	116.7	117.8
DE		2013	2011	½	-3.4	-5.0	-4.6	73.1	76.7	79.7
NL		2013	2011	¾	-4.7	-6.1	-5.6	59.8	65.6	69.7
AT		2013	2011	¾	-4.3	-5.5	-5.3	69.1	73.9	77.0
PT		2013	2010	1¼	-8.0	-8.0	-8.7	77.4	84.6	91.1
SI		2013	2010	¾	-6.3	-7.0	-6.9	35.1	42.8	48.2
SK		2013	2010	1	-6.3	-6.0	-5.5	34.6	39.2	42.7

pean committees themselves called for deficit-increasing measures to stabilise the economy, a correction deadline of more than one year is appropriate in many cases. However, the Commission's interpretation has severely stretched the flexibility of the Stability and Growth Pact. For Germany, as well as for other countries, a faster reduction of the high deficits and a reversal in the development of the debt ratio is desirable and possible. For some countries, the scale of consolidation recommended by the Commission is not or is barely above the minimum requirement of 0.5% of GDP per year, even though the deficit ratios clearly exceed the reference value. The mostly high and rapidly growing debt ratios also advocate more ambitious consolidation. It is now up to the Ecofin Council to decide on appropriate consolidation requirements and thus prevent damage to the fiscal framework – a cornerstone of monetary union. It is also vital that all member states respect the provisions relating to an excessive deficit procedure and take suitable measures so that they at least achieve the final improvements recommended.

The excessive deficit procedure should be relatively simple, transparent and focused on rapidly achieving the correction. The Commission's differentiation of the extent of annual

consolidation or the start date based on other indicators – such as current account balances – makes the procedure more complicated and intransparent. The attempt at macro-economic fine-tuning has a detrimental effect on accountability and weakens the binding force.

Against the backdrop of an economic recovery, rapid and sustained budgetary consolidation is in each member state's own best interests. For countries against which an excessive deficit procedure has been launched, deficit-increasing measures without counterfunding are a step in the wrong direction, however, and are generally incompatible with the regulations. It is now essential to achieve sound budgetary positions before the next downturn sets in. Some countries can thus also avoid the threat of risk premiums on interest rates, which would not only tighten the budgetary position but also impair economic development. Rapid and sustainable consolidation would not least boost confidence in the long-term sustainability of public finances and thus make a considerable contribution to anchoring stability-oriented inflation expectations. This would make it easier for monetary policymakers to ensure price stability at low interest rates.

rection on 2 December 2009. — 5 Source: European Commission, Autumn Forecast 2009.

spects stabilise, it will be vital to adopt a credible strategy to rapidly and rigorously correct the currently dramatic outlook for public finances in many countries.

Correction deadline recommended by Commission for Germany unambitious

The European Commission recommends that the Ecofin Council gives Germany until 2013 to correct its excessive deficit. According to this recommendation, Germany should not start the consolidation in 2010 but can implement the fiscal policy measures as planned. From 2011, the structural deficit is to be reduced by an annual average of 0.5% of GDP. Should economic or budgetary development be better than expected, consolidation is to be stepped up. With regard to the consolidation requirements, these recommendations lag behind central government's financial plan of the third quarter of 2009. This plan also envisaged implementing the deficit-increasing measures in 2010 that had been already agreed and not returning to the 3% ceiling until 2013. However, in the meantime, the fiscal balance for 2010 has been estimated to be 1% of GDP more favourable indicating that, if the previously planned consolidation path is pursued, the 3% limit could be met again as early as 2012. A more ambitious goal would also be desirable because the recommended scale of consolidation, which is already covered in part by the fact that temporary economic stimulus measures are now coming to an end, fulfils only the minimum requirements of the Pact and would merely extend the correction period unnecessarily.

Germany has a special responsibility for implementing the European fiscal rules, many

of which it initiated itself to ensure the stability of the euro. Additional deficit-raising measures in a country against which an excessive deficit procedure has already been launched are, as a rule, incompatible with the Pact, as they can be expected to require new borrowing. Moreover, the overall economic outlook has now brightened significantly, and, if the necessary fiscal consolidation is not tackled rapidly and rigorously, the next downturn could set in before a sound budgetary position has been re-established. Overall, further unfunded spending increases and tax cuts in 2010 are a problematic signal in this situation. They hamper and delay the necessary consolidation process, the compliance with international obligations as well as national debt rules. Furthermore, they are not appropriate from an economic perspective, especially as the bulk of the stimulus packages to date will take effect in 2010. It is vital that policymakers, in Germany in particular, do more than just pay lip service to European and national fiscal rules and set out a realistic prospect of consolidating public finances in the stability programme to be presented at the end of January.

Expansion of deficit by new spending increases and tax cuts gives problematic signal

Budgetary development of central, state and local government

Tax revenue

In the third quarter of 2009, tax revenue² was down sharply by 8% on the same quar-

Steep decline in tax revenue in Q3

² Including EU shares in German tax revenue, but excluding receipts from local government taxes, which are not yet known for the quarter under review.

*Large income
tax shortfalls*

ter in 2008 (see chart on this page and the table on page 68). This is attributable to the economic downturn and extensive tax relief measures. Income-related taxes felt the brunt of this (-16½%). Wage tax receipts (-5½%) declined as a result of lower – albeit only slightly when compared to GDP – gross wages and salaries. Moreover, at the start of the year, tax rates were lowered and the amounts deducted from cash receipts – child benefit and subsidies for supplementary private pension plans – rose. Massive shortfalls were recorded for profit-related taxes (-37½%). Receipts from corporation tax plummeted owing to lower advance payments for current profits and, on balance, higher refunds for 2008. Receipts from assessed income tax likewise decreased owing to the fall in profits, however, so far, they have been less severely affected. Added to this were revenue 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. Lower profit distributions also resulted in large declines in revenue from investment income tax. However, revenue from consumption-related taxes was at about the same level as in 2008 due to the relatively stable development of consumption.

*Revenue from
consumption-
related taxes
stable*

*Sharp drop in
revenue also
expected for
year as a whole*

According to the latest official tax estimate, a sharp drop in revenue is also expected for the year as a whole (including local government taxes, by -6½%) although the annual rate will be boosted by the relatively favourable results in the first quarter.³ The major factors behind the decline are shortfalls owing to the measures to support the economy,⁴ retroac-



tive corrections following the Federal Constitutional Court's ruling of December 2008 reinstating the standard travel allowance for commuters as well as the rise in child benefit,⁵ which, in total, amounted to €16½ billion. A massive drop in profit-related taxes is also expected (-17½% or €22 billion after adjustment for legislative changes), thus

³ The estimate is based on central government's current macroeconomic prognosis. It forecasts for 2009 a rate of change in real GDP of -5% (May: -6%) and in nominal GDP of -3.9% (May: -5.3%). In 2010, real growth is expected to be +1.2% (May: +0.5%) and nominal growth +1.6% (May: +1.2%).

⁴ Especially lowering the income tax rates, child bonus, easing depreciation facilities, extending actual taxation in the case of turnover tax, more lenient counterfinancing measures from the 2008 business tax reform.

⁵ In the government's financial statistics, increasing child benefit decreases the tax revenue as child benefit is deducted from wage tax revenue. However, in the national accounts, which are used as the basis for the analysis in the first section of this report, child benefit constitutes a gross item due to its transfer component and is booked as social expenditure.

Tax revenue

Type of tax	Q1 to Q3				Q3				Estimate for 2009 1, 2
	2008		2009		2008		2009		
	€ billion		Year-on-year change € billion	as %	€ billion		Year-on-year change € billion	as %	Year-on-year percentage change
Tax revenue, total 2	375.2	352.8	- 22.3	- 6.0	125.5	115.6	- 9.9	- 7.9	- 6.1
<i>of which</i>									
Wage tax	101.6	96.6	- 5.0	- 4.9	34.1	32.2	- 1.9	- 5.6	- 5.2
Profit-related taxes 3	60.2	45.4	- 14.8	- 24.6	18.1	11.3	- 6.7	- 37.3	- 25.0
Assessed income tax	22.9	18.8	- 4.1	- 17.9	8.9	6.7	- 2.1	- 24.2	- 17.9
Investment income tax 4	23.7	21.2	- 2.4	- 10.3	5.1	4.0	- 1.1	- 21.5	- 14.4
Corporation tax	13.6	5.3	- 8.3	- 60.9	4.1	0.6	- 3.5	- 85.5	- 59.9
Turnover taxes 5	130.5	130.9	+ 0.4	+ 0.3	44.3	44.4	+ 0.0	+ 0.1	+ 0.4
Energy tax	24.0	24.7	+ 0.7	+ 2.8	9.8	9.9	+ 0.1	+ 0.8	+ 0.0
Tobacco tax	9.5	9.4	- 0.0	- 0.4	3.6	3.5	- 0.2	- 4.1	+ 0.0

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 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.

Deutsche Bundesbank

reversing the best part of the extraordinary positive development over the past few years. Key tax variables, such as gross wages and salaries and, above all, private consumption, are developing much more favourably than nominal GDP, thus dampening the overall effect of the slowdown in economic activity on tax revenue. Fiscal drag is playing no role in the current year.⁶

Assuming there are no legislative changes, revenue is expected to fall by a further 2½% in 2010. The tax relief measures already agreed – which, on balance, will grow over time – such as shortfalls in the wake of raising special income tax allowances for contributions to health and long-term care insurance schemes in particular, will have an impact (overall €9½ billion). Added to this is the fact

that revenue from profit-related taxes will continue to fall as the slump in corporate earnings in 2009 is likely to take some time to feed through completely. 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.⁷ It should also be taken into account that the official tax estimate is based on the legislative *status quo*, hence the additional relief measures envisaged by the government

... and additional tax relief measures announced

Further clear decline in revenue expected in 2010 ...

⁶ Fiscal drag is usually positive on balance as the loss in real value for volume-based excise duties is overcompensated by the positive progressive effects for income tax. However, in 2009 the effects are reversed as the deflator for households' consumption expenditure and nominal average wages are expected to decrease slightly.

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

for 2010 are not yet included. Shortfalls arising as a result of raising child benefit and child tax allowance, adjusting corporate taxation and inheritance tax as well as giving preferential turnover tax treatment to the hotel trade are expected to be in the range of €6 billion in 2010 (0.2% of GDP or 1.2% of tax revenue) and amount to €8½ billion over a whole year.

Smaller revisions compared to May estimate

The forecasts for 2009 and 2010 have both been revised downwards by €½ billion compared with the last official tax estimate from May, if the effects of legislative changes adopted in the meantime and revisions to the central government estimate of tax shortfalls following the ruling of the European Court of Justice in the Meilicke case are factored out of the calculations.⁸ The upward revisions for consumption-related taxes are smaller than the downward revisions for income-related taxes. In comparison with the legislative *status quo* of the third quarter (ie including the tax relief measures for enterprises from July) and taking the additional tax cuts announced into consideration, the downward revision for 2010 amounts to €3 billion.

Future tax policy still unclear

In addition to measures to be implemented in the short term that are mentioned above, the coalition agreements contain further tax policy announcements. However, complex areas, such as the reform of corporate taxation and of local government funding, are yet to be clearly defined. Future decisions are also subject to a general financing proviso, which, given the goal *inter alia* of providing further relief of up to around €20 billion by adjusting income tax rates, should play a prominent

role in view of the European and national budgetary rules. Just which components the general reform of the tax system is to include thus remains to be seen. In order to make income taxation less complex, reducing the number of bands is not sufficient. Income taxation could be greatly simplified by reducing the number of tax subsidies and exceptions, although experience has shown that the challenge here will be pushing through actual measures against the will of current privileged stakeholders. However, so far, the more concrete plans indicate instead an extension of special cases, exemptions and preferential treatment. Ultimately, the intended tax reforms are to be analysed within the context of the overall tax and transfer system including the social security funds and with regard to intergenerational burden-sharing and the sustainability of public finances.

Central government budget

The central government budget recorded a deficit of €16 billion in the third quarter of 2009, which was €4½ billion higher than one year earlier. Despite the fact that revenue from motor vehicle tax (€2 billion) payable to central government since July was included for the first time, revenue decreased by almost 4% (€4 billion) due to a steep decline in tax receipts. Growth in expenditure of just over 2% (€2 billion) lagged somewhat behind

Marked rise in central government budget deficit in Q3

⁸ One particularly relevant legislative change is the introduction of tax relief for enterprises in July. Shortfalls as a result of the ruling in the Meilicke case have been pushed back another year as the European Court of Justice is first expected to issue another ruling in this case. This will result in considerable additional revenue, especially in 2010 (cumulated for 2009-2010: €3½ billion).



the compensation payments to state government for motor vehicle tax. However, account must be taken of the fact that one-off burdens as a result of recapitalising IKB Bank and granting state aid pursuant to a court ruling totalling almost €2½ billion had to be borne in the same period of 2008, thus obscuring additional expenditure elsewhere. Despite shifting the payout date for turnover tax resources to the Federal Employment Agency to the end of the year (resulting in relief of €2 billion a quarter for the first three quarters of 2009), transfers to the social security funds recorded additional costs of almost €1½ billion, predominantly due to higher payments for the statutory health insurance scheme. Moreover, investment increased by just short of €1 billion, half of which was for spending on roads. Expenditure on unemployment

benefit II was also almost €½ billion higher. By contrast, €1 billion less was paid for interest on debt – mainly as a result of issuing securities with premiums that are deducted from current year expenditure but are to be debited to budgets in the following years.

The second supplementary budget from the third quarter envisages net borrowing of over €49 billion for central government. At the end of the third quarter, the deficit amounts to €24½ billion. While the central government budget has recorded a surplus in the final quarter of the past few years, this year a significant deficit is expected, not least owing to falling tax receipts and changing the payment date for the regular grant to the Federal Employment Agency. However, it is becoming apparent that spending, especially on interest payments, calls on guarantees and on the loan to the health insurance fund to offset its revenue shortfalls in 2009, will be lower than forecast. Furthermore, according to the tax estimate, tax revenue is expected to be €3 billion higher. Overall, the deficit could therefore lag well behind the budgeted figure.

The draft Federal budget for 2010 proposed by the previous government in summer envisaged a large rise in net borrowing by €37 billion to €86 billion.⁹ However, the fact that the macroeconomic outlook has since brightened, substantially lightens the load on the Federal budget. Central government's payment to offset the Federal Employment Agency's deficit is likely to be much lower than previously estimated (€20 billion). The

High deficit for 2009 as a whole ...

... but development suggests results may be better than forecast

Despite a brighter outlook, exceptionally high deficit in 2010 even before planned measures

⁹ See Deutsche Bundesbank, Monthly Report, August 2009, pp 71-73.

moderate development in spending on interest payments and on calls on guarantees observed this year could also continue. According to the latest tax estimate, which, however, does not yet include the tax relief measures announced by the new government, revenue is also estimated as being €2 billion higher than previously forecast. The deficit could thus amount to around €75 billion.

Sizeable additional burdens owing to coalition agreements

However, recent coalition agreements show signs of causing considerable burdens. These agreements propose tax cuts and a rise in child benefit as well as additional expenditure, firstly, to stabilise health insurance contributions¹⁰ and, secondly, as a result of raising saving allowances for recipients of unemployment benefit II, of additional agricultural subsidies and in connection with education and research. Against this backdrop, the government currently seems to be assuming that the original deficit estimate contained in the draft budget for 2010 will not be significantly undershot. The borrowing limit as defined in the old Article 115 of the German Basic Law (*Grundgesetz*), which still applies, will thus be overshot by an extraordinarily large amount. According to a ruling of the Federal Constitutional Court from 1989, policymakers must justify why increased borrowing is necessary to avert a distortion of the macroeconomic equilibrium. As there is now an indication that growth is likely to be more favourable than originally forecast in the draft budget, additional debt-increasing measures no longer appear warranted. The Financial Planning Council voiced their opposition to

additional fiscal stimulus programmes as early as July.

Pursuant to the new debt rule,¹¹ structural net borrowing (ie adjusted for a cyclical component and for financial transactions) in the base year 2010, which the old government estimated to be 1.6% of GDP, is to be reduced in equal annual steps between 2011 and 2016 at least to the new ceiling of 0.35% of GDP. In the current medium-term financial plan up to 2013, the consolidation requirement is covered by global non-specific cost savings growing from €6½ billion in 2011 to €20 billion in 2013. The value for the cyclical component in the European Commission's autumn forecast calculated using the cyclical adjustment procedure specified as a guideline for the central government budget was substantially lower than in central government's original calculations, also in light of the fact that macroeconomic development is now more favourable. If new borrowing remains at the same level, the structural deficit would thus be significantly larger than assumed to date. Furthermore, owing to uncertainties surrounding estimations of the cyclically adjusted budgetary position, it would therefore seem wise to plan in a safety

Considerable consolidation requirement

¹⁰ According to the findings of a group of statutory health insurance estimators, spending by the health insurance institutions in 2010 is likely to exceed transfers from the health insurance fund by €7½ billion. Despite low inflation rates and a weak general income trend, this is nevertheless due to the continued sharp growth in expenditure. Cyclically-induced revenue shortfalls are thus only partly responsible for the gap in health insurance institutions' financing, which, strictly speaking, should be plugged by charging additional contributions.

¹¹ See Deutsche Bundesbank, Monthly Report, May 2009, pp 78-79.

margin below the new constitutional ceiling.¹²

*Strictly observe
new borrowing
limit*

Thus there is no discernible scope for unfunded, deficit-increasing measures. Instead, strict central government budget consolidation is necessary from 2011 onwards. Any unexpected budgetary improvements that might result from a more favourable economic development provide no additional fiscal scope under national and international fiscal rules and, not least in the light of past experience, should be used not to reduce revenues or increase spending but instead to curb new borrowing. It would be particularly worrying if policymakers were to use one-off measures in order to inflate the structural deficit in the base year 2010 with a view to gaining greater scope for new borrowing to fund planned additional spending in subsequent years by exploiting the fact that the prescribed debt reduction progression is benchmarked to the base-year level. According to the explanatory preamble, the transitional arrangement was introduced because the new provisions were not perceived to be achievable straightaway owing to the central government budget situation in the second quarter of 2009 and to measures adopted to overcome the severe recession. However, renewed deficit expansion is at odds with this and, from the very outset, is in danger of undermining the fundamental legislative intention of the new provisions, which is to effectively curb and curtail the ballooning growth in government debt.

Central government's off-budget entities recorded a deficit of just over €1 billion in the

third quarter compared with a surplus of €½ billion in the same period last year. This was mainly attributable to a deficit of just over €1½ billion recorded by the Investment and Redemption Fund, set up as part of the second economic stimulus package; the largest share coming again from the car scrapping incentive. The outflow of investment funds for central, state and local government projects intensified and amounted to €½ billion. By contrast, the Financial Market Stabilisation Fund recorded a slight surplus, predominantly due to proceeds from guarantees, for which again no funds had to be paid out and no further capital injections were necessary. At year end, the outflow of funds from off-budget entities is likely to accelerate and the overall deficit in 2009 could reach €20 billion.

*Off-budget
entities still
have deficits*

State government¹³

The state government budget situation continued to deteriorate markedly in the third quarter. The deficit amounted to €6 billion, after a surplus of €1½ billion in the same period last year. Revenue fell by 7%, with the steep decline in tax revenue (-13%) being partially curbed by significantly higher other revenue. The latter is associated with the transfer of receipts from motor vehicle tax to

*High deficit in
Q3 as a result
of steep decline
in tax revenue
and higher
expenditure*

¹² As the new constitutional borrowing limit may be overshot when drafting the budget only in exceptional circumstances (and must then be repaid as soon as possible), extensive consolidation requirements may arise in the short term if there is no safety margin, thus making it difficult to maintain a steady fiscal policy course. See J Kremer and D Stegarescu (2009), Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik, in Wirtschaftsdienst, Vol 89, pp 630 ff.

¹³ The development of local government finances in the second quarter was outlined in the short articles in the Bundesbank Monthly Report of October 2009. These are the most recent data available.

central government from July 2009. This caused state government tax revenue to fall whereas other revenue rose owing to the fixed amounts (just under €2½ billion per quarter) that central government paid to state government in way of compensation. Expenditure continued to record sharp growth (4½%), predominantly due to higher spending on personnel following the substantial wage adjustments in the second quarter and their extension to public sector employees with civil servant status as well as retired civil servants.

Dramatic rise in deficit expected for year as a whole and further deterioration in 2010

In the current year, the state government's budgetary position has deteriorated by a total of €26 billion compared with the same period in 2008 and the deficit already amounted to €19 billion at the end of September (of which €7 billion for the recapitalisation of BayernLB, which was allocated to the 2008 budgetary accounts). This figure is likely to shoot up further by year end. According to the budget estimates (plus the capital injection into BayernLB), the deficit could come close to matching the previous record of just over €30 billion in 2003, following a slight surplus last year. Whereas Mecklenburg-Vorpommern, Saxony and Thuringia reported surpluses or close-to-balance budgets for the first nine months, the financial position of most west German states deteriorated dramatically. Many of the draft budgets for 2010 presented to date foresee an overshooting of the old borrowing limit, which is still in place, as tax revenue continues to decline and net new borrowing rises. The latest tax estimate has not revised state government's tax revenue for 2010 compared with the May estimate

despite the assumptions of more favourable macroeconomic development. The estimate does not yet include the additional tax relief measures announced by the new government.

For the five heavily indebted states that are entitled to consolidation assistance from central government pursuant to the new Article 143 d of the German Basic Law, in particular Bremen and Saarland,¹⁴ reducing the structural deficit of 2010 in stages, which is laid down in section 2 of the Act granting consolidation assistance (*Konsolidierungshilfengesetz*) would be much more difficult if the extensive income tax relief measures announced for the subsequent years were to be implemented without counterfunding measures for all of Germany. These states thus also risk losing consolidation assistance. Even on the basis of the 2008 outturns, overall a number of states would be able to sustain a balanced budget from 2020 with no new borrowing only with extremely stringent expenditure discipline. The permanent tax relief measures adopted this year may now have exhausted the scope for further states. Given this situation, the Financial Planning Council stressed as early as July that a structurally balanced budget requires greater consolidation on both the revenue and expenditure side from 2011 onwards.

Announced tax relief measures without counterfunding hardly compatible with budgetary rules

¹⁴ The three other states – Berlin, Saxony-Anhalt and Schleswig-Holstein – have posted lower structural deficits; the consolidation need up until 2020 is therefore lower.

Social security funds¹⁵

Statutory pension insurance scheme

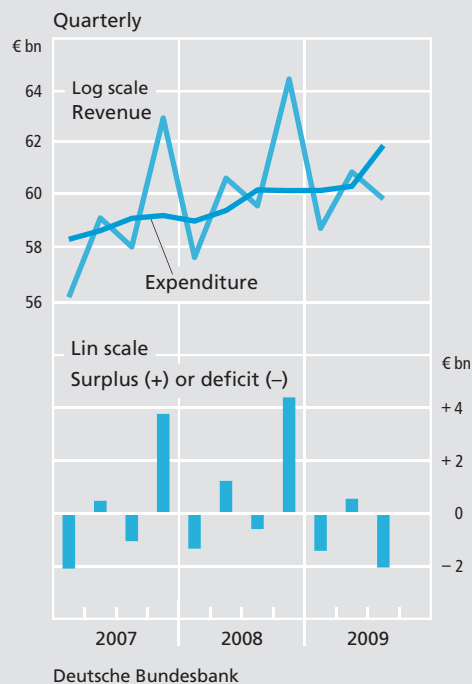
Weak revenue development masked by contributions for recipients of wage substitutes

The statutory pension insurance scheme recorded a deficit of just over €2 billion in the third quarter of 2009, which was €1½ billion higher than one year previously. Total revenue rose by just under ½%. Contribution receipts increased somewhat more strongly. However, this was due solely to contributions for recipients of wage substitutes, especially recipients of unemployment benefit I and II (+28%), as well as sickness benefit (+15%). By contrast, employees' compulsory contributions stagnated, even though contributions relating to short-time work are also booked in this item. The rise in unemployment is having a fairly muted effect on the income of statutory pension insurance institutions, particularly where unemployment benefit I is paid out.¹⁶ The growth in expenditure accelerated markedly to almost 3% following the sharp pension increase of 2.41% in western Germany and 3.38% in eastern Germany in July.

Still largely balanced result for 2009 as a whole, but deficit foreseeable in 2010

The cumulative deficit for 2009 amounted to €3 billion at the end of September. Owing to contributions from end-of-year bonus payments, especially Christmas bonuses, a considerable surplus of a similar size is expected in the last quarter of 2009. Statutory pension insurance institutions are therefore likely to record close-to-balance budgets in 2009. Although *per capita* earnings are likely to rise again, a weaker contribution trend is expected in 2010 because the level of employment will decline and a growing number of unemployed persons will stop receiving

Finances of the German statutory pension insurance scheme



unemployment benefit I once the maximum period of entitlement has been reached. Furthermore, even though average incomes are expected to decline in 2009, the pension guarantee that was approved in spring 2009 prevents a corresponding reduction in pension payment amounts in mid-2010. Overall, pension insurance schemes are therefore likely to post a substantial deficit in 2010.

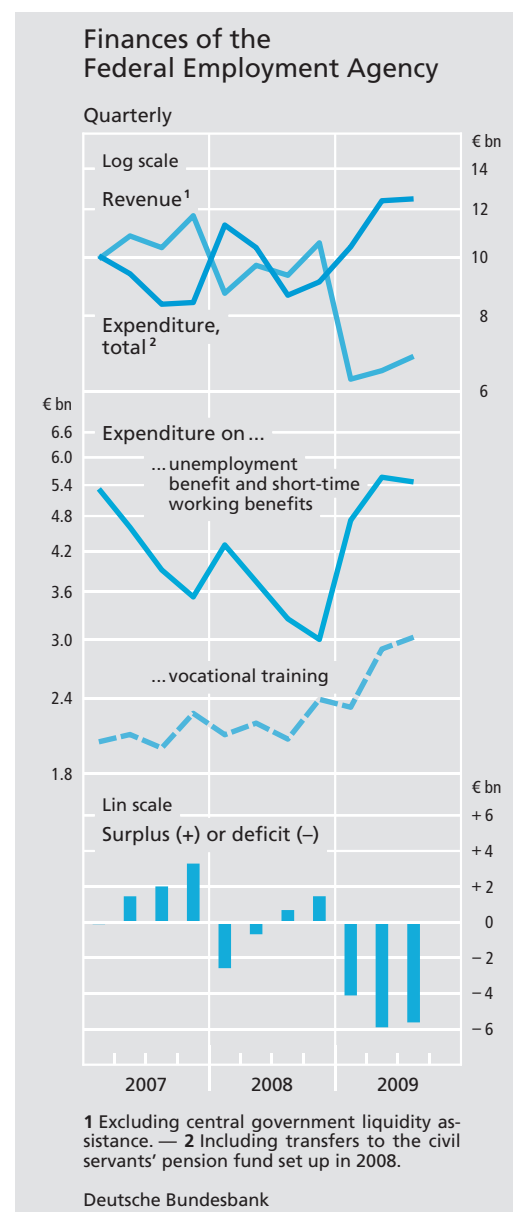
¹⁵ The financial development of the statutory health and public long-term care insurance schemes in the second quarter of 2009 was outlined in the short articles of the Monthly Report of September 2009. These are the most recent data available.

¹⁶ For each recipient of unemployment benefit I, the Federal Employment Agency transfers pension contributions on the basis of 80% of his/her previous gross remuneration. The same rule applies when calculating contributions for sickness benefit and short-time work. For unemployment benefit II, the assessment base decreases to a uniform €205 per month.

Federal Employment Agency

Financial situation obscured by negative special effects on the revenue side

The Federal Employment Agency recorded a deficit of €5½ billion in the third quarter of 2009, compared with a surplus of just over €½ billion a year earlier. This reflects, *inter alia*, the strong automatic stabilisation effect of the Federal Employment Agency. The fact that revenue fell by just over one-quarter is naturally predominantly due to other factors. For example, the contribution rate was once again cut by ½ percentage point to 2.8%. Furthermore, as of 2009, the Federal grant is no longer transferred in monthly instalments but, as a general rule, at the end of the year.¹⁷ After adjustment for these effects, the amount of revenue collected between July and September was 1% down on the year. Expenditure surged by 44%. Spending on unemployment benefit I increased by 37% or just over €1 billion in line with the rising number of recipients. Payments for short-time working benefits went up by €1 billion and vocational training costs (including refunds of social security contributions for short-time work made to employers, which are recorded here) rose by just under €1 billion. However, following its peak in July, expenditure on cyclical short-time working benefits is declining sharply again. Insolvency benefit payments were up by €½ billion on the year. In 2009, contributions envisaged for this purpose to be paid by employers were set in advance for the first time and, in view of the unexpectedly large increases in expenditure, the rate set was not sufficient. Consequently, contributions will be raised significantly in 2010, as they will have to cover both the loss



for 2009 and expenditure requirements for 2010, which are again expected to be high.¹⁸

The deficit of the Federal Employment Agency for the first nine months of 2009 came to €15½ billion. Despite rising unem-

Reserves not yet completely exhausted in 2009

¹⁷ However, in September €½ billion was received for the purpose of safeguarding liquidity.

¹⁸ The 2010 contribution rate for insolvency benefit payments will therefore be raised from 0.1% to 0.41% of the respective gross wages and salaries.

ployment, a substantial surplus is expected in the final quarter of 2009 because, firstly, contributions are usually higher at this time of year (in particular due to Christmas bonuses) and, secondly, the bulk of the regular Federal grant will be transferred. Overall, it is therefore likely that the Federal Employment Agency's reserves will not be completely depleted in 2009. However, this will happen in 2010, as unemployment is expected to increase significantly. The Federal Employment Agency will then have to rely on considerable financial assistance from central government.

Tax-financed subsidies for the Federal Employment Agency

According to the coalition agreement between the new governing parties, payments over and above the regular Federal grant should in future no longer be provided as repayable loans for liquidity assistance, but as grants. This reverses the last reform, which should have put an end to the previous prac-

tice of regularly providing the Federal Employment Agency with extensive funds from the Federal budget as needed. Since a contribution rate of currently 2.8%, following the recent cuts, and 3.0% from 2011, is not sufficient to structurally cover the Federal Employment Agency's expenditure, this would mean shifting the financial burden from contribution payers to the taxpayers of today and tomorrow. This would be appropriate if the regular Federal grant were smaller than the Federal Employment Agency's non-insurance-related benefits.¹⁹ However, as these are currently likely to be largely on a par, there is therefore a danger of permanently subsidising insurance-related benefits.

¹⁹ This includes above all the Federal Employment Agency's reintegration payment to central government to cover half of the costs of the reintegration and administration of unemployed persons receiving the basic welfare allowance.