Public finances*

General government budget

Public finances improving in 2011

Both the crisis-ridden year 2009 and the high-growth year 2010 witnessed an expansionary fiscal policy, large general government deficits and debt ratios soaring to new historical record levels. A marked improvement is now on the cards, however, as long as budgetary consolidation is implemented as planned and new burdens arising from the financial and sovereign debt crisis remain within narrow bounds. The deficit ratio could consequently fall below 2% in 2011, after it rose to 3.3% in 2010. This notably mirrors a clear structural improvement, although the ongoing cyclical recovery, which is more than compensating for the dropout of positive one-off effects (especially proceeds from the auction of radio frequencies) that were recorded in 2010, is also making an important contribution. All other things being equal, a lower deficit coupled with relatively high nominal GDP growth should bring the debt ratio down from its record 2010 level (83.2%).[1] However, the European support programmes for other euro-area countries will create additional debt, and uncertainty in connection with support measures for German financial institutions remains high.

* The analysis in the "General government budget" section is based on data contained in the national accounts and on the Maastricht ratios. The subsequent reporting on the budgets of the various levels of government and social security schemes is based on the budgetary figures as defined in the government's financial statistics (which are generally in line with the budgetary accounts).
1 This figure includes debt in connection with support measures for financial institutions since 2008 of 13½% of GDP. Although this is largely offset by financial assets, the related risks are high. The same is true for government guarantees in connection with the financial and sovereign debt crisis.

Almost no change in revenue ratio

There is only little scope for change in the government revenue ratio in 2011. Growth in revenue as a result of raising the contribution rates to the statutory health insurance scheme and the Federal Employment Agency and of various increases in taxes and social contributions, especially as part of central government's consolidation package, will largely be offset in particular by a decline in the contribution rate for insolvency benefit payments as well as tax shortfalls following the lagged effects of earlier relief measures (especially greater tax deductibility of insurance contributions).

Expenditure ratio declining due to sharp GDP growth and falling transfers to financial institutions

The expenditure ratio is expected to decline significantly. Favourable economic conditions are causing the ratio to fall chiefly via an increase in GDP in the denominator. In addition, no further major asset transfers to support financial institutions are on the horizon (in 2010, this item amounted to ½% of GDP). Moreover, labour market expenditure is falling not only owing to cyclical factors but also to a structural decrease in unemployment figures, the expiry of spending increases in the wake of the economic crisis and to savings as part of central government's consolidation package.

Further improvement in 2012 due to muted spending developments

Current plans envisage a further decline in the deficit in 2012. From today's perspective, cyclical and one-off effects will be of only minor importance. The revenue ratio is expected to remain largely unchanged whereas the expenditure ratio is forecast to decline again. Muted developments in pension expenditure and a continued slight decline in labour market expenditure in structural terms, too, will be instrumental in this context. In addition, government investment is expected to decrease as the investment measures from the economic stimulus packages – which have an especially large time lag – will then have come to an end and consolidation requirements at local government level will still be considerable.

Federal Government envisages structurally balanced general government budget by 2015

The Federal Government presented its updated stability programme on 13 April 2011, outlining the adjustment path towards achieving a structurally balanced general government budget in 2015. The figures are based on the macroeconomic forecast from January 2011 and on an extrapolation of tax revenue that the Federal Government has adjusted in accordance with this forecast. On 14 April 2011, the Federal Government published an updated forecast of key macroeconomic data, which – on the whole – is somewhat more favourable. The expected average developments of those variables relevant for public finances (especially gross wages and salaries, nominal private consumption and the labour market) for the period from 2011 to 2015 appear rather cautious, not least given the updated forecast data. According to the programme, the deficit ratio will fall to 2½% in 2011 and then continue to decrease gradually in the years thereafter until it reaches ½% in 2015. The consolidation measures agreed by Federal Government in summer 2010 were included in the calculations in an only slightly amended form, even though some details of these measures have yet to be specified.

Key data of the Federal Government's updated stability programme

Item	2010	2011	2012	2013	2014	2015
Real GDP growth (as %)						
Stability programme April 2011	3.6	2.3	1.8	1 ½	1½	1½
Stability programme January 2010	1.4	2	2	2	–	–
General government fiscal balance (as % of GDP)						
Stability programme April 2011	– 3.3	– 2 ½	– 1 ½	– 1	– ½	– ½
Stability programme January 2010	– 5 ½	– 4 ½	– 3 ½	– 3	–	–
Structural fiscal balance (as % of GDP)						
Stability programme April 2011	– 2	– 2	– 1	– 1	– ½	– 0
Stability programme January 2010	– 4 ½	– 4	– 3	– 2 ½	–	–
Debt level (as % of GDP)						
Stability programme April 2011	83.2	82	81	79 ½	77 ½	75 ½
Stability programme January 2010	76 ½	79 ½	81	82	–	–

Source: Federal Ministry of Finance.

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Achieve structurally balanced budget promptly

In a welcome development, the unexpectedly favourable macroeconomic setting is – as stipulated in the excessive deficit procedure initiated against Germany – to be used to achieve a lower deficit path rather than to dilute the fiscal policy course. The deadline set by the Ecofin Council in December 2009 – which was, even then, excessively long – to bring the deficit below the 3% ceiling by 2013 will be reached ahead of schedule (for information on the development of public finances in the euro area, see the box on pages 22 and 23). By contrast, progress along the adjustment path towards the medium-term objective is likely to be slower than specified in the preventive arm of the European Stability and Growth Pact.[2] This is regrettable, not least given efforts at EU level to give this part of the Pact, in particular, greater binding force.[3] Overall, it is now crucial that the more favourable conjuncture is not seen as an opportunity to relax the consolidation course before the medium-term objective is achieved. Remaining on track is essential given the worryingly high levels of government debt. This is warranted even more by the currently benign macroeconomic situation. Moreover, the time window for

2 The figures in the government's plans have been rounded, thus rendering them less transparent on the whole. The preventive arm of the Pact stipulates that the structural deficit ratio should generally be reduced by 0.5 percentage point, and at an accelerated pace in "good times", until the medium-term objective is achieved. However, the stability programme foresees a structural improvement of only 1½ percentage points in total for the four years from 2011 to 2014.
3 For more information on pending EU reforms in the area of public finances, see Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011, pp 53-58.

making adequate fiscal allowance for the imminent demographic burdens ensuing from an ageing population is rapidly narrowing.[4] In addition, the new national budgetary rules generally stipulate a budgetary position that is (close-to-) balanced as a binding ceiling and not a target value for new borrowing. It is therefore highly advisable to leave a sufficient margin of safety below the constitutional ceilings in "good times".[5]

Budgetary development of central, state and local government

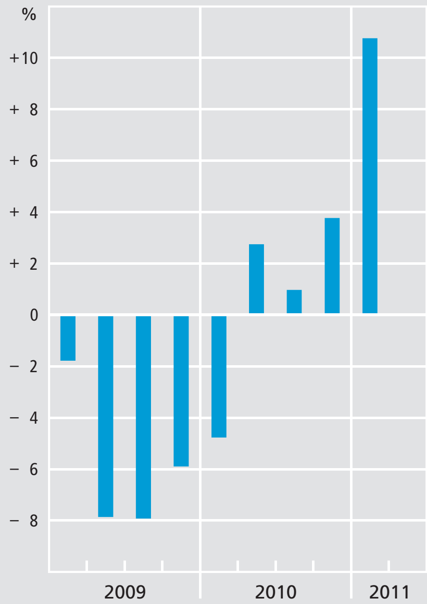
Tax revenue

Sharp rise in tax revenue in Q1

Tax revenue[6] increased in the first quarter of 2011 by almost 11% compared with the same quarter in 2010 (see the adjacent chart and the table on page 64). The sharp rise is predominantly due to favourable economic developments but also to positive special factors. Revenue from income-related taxes went up by 11½%. Strong growth in wage tax primarily reflects the positive trend in pay. On top of this there was a slight decline in deduction amounts (child benefit, subsidies for supplementary private pension plans). Revenue from profit-related taxes rose by 20% in total.[7] After a very low level in 2010 as a result of the crisis, corporation tax recorded considerable additional receipts. Furthermore, the grant to homebuyers, which is deducted from the assessed income tax revenue total and is mainly paid out in March, has been gradually phased out since 2006. At over 9½%, revenue from consumption-related taxes also rose sharply. However, the strong growth in turnover tax is likely to overstate underlying growth. The previous year's level was very low and intra-year developments in this item are generally very vola-

Tax revenue*

Year-on-year change, quarterly



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

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4 See Deutsche Bundesbank, Demographic change and the long-term sustainability of public finances in Germany, Monthly Report, July 2009, pp 29-44.
5 See Deutsche Bundesbank, Reform of German budgetary rules, Monthly Report, October 2007, pp 47-68; Deutsche Bundesbank, The reform of the borrowing limits for central and state government, Monthly Report, May 2009, pp 78-79; J Kremer and D Stegarescu (2009), Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik, Wirtschaftsdienst, Vol 89/9, pp 630 ff (available in German only) as well as J Kremer and K Wendorff (2010), Für eine stetige Finanzpolitik: Konjunkturbereinigung und Berücksichtigung von Schätzfehlern, in: C Kastrop, G Meister-Scheufelen and M Sudhof (eds), Die neuen Schuldenregeln im Grundgesetz, 2010, pp 416-431 (available in German only).
6 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.
7 It should be noted that the development of the individual taxes is distorted by a one-off sizeable refund of corporation tax coupled with additional revenue of the same amount for non-assessed taxes on earnings.

Tax revenue

Type of tax	Q1 2010	Q1 2011		Estimate for 2011 1, 2
	€ billion		Year-on-year percentage change	Year-on-year percentage change
Tax revenue, total 2	111.2	123.1	+ 10.8	+ 4.4
of which				
Wage tax	30.3	32.5	+ 7.3	+ 5.1
Profit-related taxes 3	14.9	17.9	+ 20.0	+ 2.3
Assessed income tax	6.2	6.8	+ 9.7	– 9.6
Corporation tax	2.0	2.5	+ 27.4	+ 11.8
Investment income tax 4	6.8	8.6	+ 27.3	+ 14.0
Turnover taxes 5	42.9	47.4	+ 10.5	+ 4.1
Energy tax	4.4	4.5	+ 0.3	+ 0.5
Tobacco tax	2.5	2.9	+ 17.5	– 0.4

1 According to official tax estimate of May 2011. — **2** Including EU shares in German tax revenue, excluding receipts from local government taxes. — **3** Employee refunds, grants paid to homebuyers and investors deducted from revenue. — **4** Withholding tax on interest income and capital gains, non-assessed taxes on earnings. — **5** Turnover tax and import turnover tax.

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tile. There was also a clear increase in revenue from other excise duties, which was particularly attributable to the deferred booking of insurance tax cash flows and to frontloading effects for tobacco tax prior to the rate rise in May.

Clear rise in receipts expected in 2011

According to the latest official tax estimate, tax receipts for 2011 as a whole are expected to rise by 4½% (including local government taxes).[8] This growth primarily reflects favourable macroeconomic developments but also a rebound from 2010's muted level. As far as legislative changes are concerned, the effects of various tax increases (in particular, nuclear fuel tax, air traffic tax, tobacco tax and a reduction in the electricity and energy tax concessions) as well as the phasing out of grants to homebuyers outweigh revenue shortfalls in other areas (in particular, deferred shortfalls due to greater tax deductibility of insurance contributions). Growth is curbed by the fact that sizeable tax refunds in connection with court rulings have been included in the calculations.[9]

Clear rise expected in future, too

A faster pace of growth in revenue of 5½% is expected for 2012. The improvement in relevant key macroeconomic figures is set to continue, the effect of legislative changes is again expected to be positive (in particular, the phasing out of grants to homebuyers and of depreciation allowances as part of the first economic stimulus package) and the abovementioned tax refunds are set to expire for the most part. For the medium-term planning period up to 2015, an average annual increase of just over 3½% is forecast, with legislative changes and special factors not expected to play a significant role. The tax ratio (as defined in the government's financial statistics) is projected to increase from 21.2% in 2010 to 22.3% in 2015. Fiscal drag is to contribute around ½ percentage point or €11½ billion to this rise if account is taken of both the positive revenue effect of the progressive structure of the income tax schedule and the below-average development owing to the ex-

8 The estimate is based on the Federal Government's current macroeconomic forecast, which foresees real GDP growth of 2.6% and nominal GDP growth of 3.5% for 2011 (November 2010: 1.8% and 3.0%, respectively). Growth for 2012 is forecast to be 1.8% and 3.5%, respectively (November 2010: nominal GDP growth: 2.8%). In the medium term (up to 2015), nominal growth is assumed to be 3.0% per year.
9 The Federal Government expects shortfalls, in particular, in connection with the Meilicke case (recognition of corporation tax paid abroad in the taxation of dividends under the tax imputation procedure that was abolished in 2001). These have been estimated at just over €3½ billion for 2011 and just under €1½ billion for 2012.

tensive price inelasticity of specific excise duties.

Additional revenue vis-à-vis earlier expectations

Compared with the latest medium-term tax estimate from spring 2010, the underlying macroeconomic assumptions have improved considerably and expectations have been revised upwards also vis-à-vis last autumn. Furthermore, legislative changes – in particular, in connection with central government's consolidation package – have been resolved in the intermittent period and these are expected to generate additional revenue of €3 billion to €4 billion per year on balance from 2011 onwards. These two factors account for the bulk of the upward revisions to the tax estimate from May 2010 and a good part of the corrections to the tax estimate from November 2010. Compared with the May 2010 estimate, revenue for 2010 was €20½ billion (¾% of GDP) higher. Corrections for the individual years are forecast to continue to rise and the estimate for 2014 is €49 billion (1¾% of GDP) above the figures from last May. In comparison with the autumn 2010 forecast, additional revenue of €5 billion in 2010[10] is expected to increase to €21½ billion in 2012.

Central government budget

Decline in deficit at start of year ...

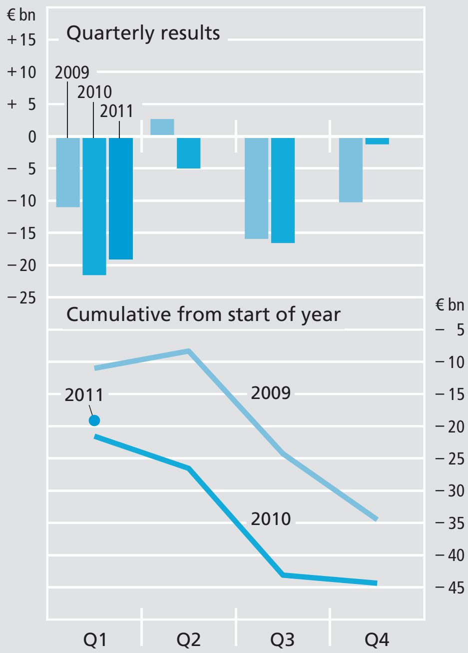
In the first quarter of 2011, the central government deficit fell by €2½ billion on the year to €19 billion. Revenue was 7% up on the year (€4½ billion) with tax receipts rising by a very sharp 11½% (€6 billion). However, non-tax revenue contracted mainly as a result of the Bundesbank's lower profit distribution. Spending grew by 2½% (€2 billion). The largest single contribution came from €1 billion higher payments to the Federal Employment Agency, which was running a deficit and was no longer able to use reserves as it had done, in part, at the beginning of 2010. But payments to the post office pension fund were also much higher than one year previously. By contrast, expenditure on unemployment benefit II, in particular, declined mainly owing to the abolition of pension contributions on behalf of recipients of unemployment benefit II.

... expected to continue and enable clear undershooting of budget target

The decline in the deficit is set to continue as 2011 progresses, although the €4½ billion windfall from the auction of radio frequencies in May 2010 will drop out. Overall, there is likely to be a clear undershooting of the forecast deficit of just over €48½ billion. The latest tax estimate projects that tax revenue will be €8 billion higher than budgeted. Furthermore, better-than-anticipated developments on the labour market imply lower expenditure to offset the Federal Employment Agency's deficit and on benefits for the long-term unemployed amounting to a total of around €5 billion. Expenditure on interest and calls on guarantees is also likely to be perceptibly lower than forecast, thus enabling revenue shortfalls of almost €1 billion from the Bundesbank's profit to be more than offset. All in all, it should be possible to cut the deficit from €44½ billion in 2010 to around €30 billion in 2011.

10 The revision for 2010 is mainly attributable to the fact that revenue from – the generally very volatile – profit-related taxes was unexpectedly high in the final quarter of 2010.

Central government fiscal deficit/surplus



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Benchmark figures from March for the 2012 budget ...

To improve compliance with the rules on the debt brake, the Federal Government has made fundamental changes to the process of drawing up budgets. Up to now, individual ministries have submitted their budget plans every spring and these were then altered in subsequent negotiations to ensure that they adhered as closely as possible to fiscal targets. In mid-March 2011, for the first time, the Federal Government set out benchmark figures for the budget – based on the macroeconomic forecast in its January Annual Economic Report – clearly affirming the expenditure ceilings for individual ministries, which have to be substantiated in time for the cabinet decision on the 2012 budget and medium-term financial plan up to 2015 scheduled for the beginning of July.

... show clear decline in structural deficit is expected

Now that current forecasts estimate tax revenue to be much higher than in the summer 2010 financial plan, new borrowing is to be limited to €31½ billion in 2012 compared with €40 billion in previous budget planning. As this improvement is expected to continue in subsequent years, net borrowing for 2014 has now been put at €15½ billion. This figure is then only expected to drop slightly to €13½ billion in 2015. The projected development of the structural deficit, which is key for the debt brake, can only be approximated as no information is available on the financial transactions to be deducted. However, the imputed net effect is likely to be small. The cyclical components are assumed to have a slight negative impact on the budget, even in 2015.[11] Overall, the framework data show a clear decline in the structural deficit. By the end of 2015, borrowing would then be close to the constitutional limit of 0.35% of GDP to be applied from 2016 onwards.

As things currently stand, benchmark figures unambitious

Overall, the target benchmark figures seem achievable and, if the volume of consolidation announced is implemented rigorously and macroeconomic expectations continue to improve, should be notably undershot. The updated tax estimate forecasts additional income for the period from 2012 to 2015 of between €4½ billion and €6½ billion per year compared with previous estimates. However, particularly given the lack of international agreement so far on a financial market tax, it

11 For a detailed critique of the method used, see Deutsche Bundesbank, Requirements regarding the cyclical adjustment procedure under the new debt rule, Monthly Report, January 2011, pp 55-60. The underlying cyclical adjustment procedure was also largely criticised at a hearing of the Budget Committee of the German Bundestag on 21 March 2011, see www.bundestag.de.

is doubtful whether the financial market tax revenue of €2 billion forecast by the Federal Government for the years from 2012 will be generated. Furthermore, the global savings of almost €5 billion included in the latest financial plan for 2014 have not yet been removed but rather carried over to 2015. Consequently, there is still a substantial need for clarification.[12]

Plan a clear safety margin below borrowing limit

The new constitutional debt brake is a much stricter deficit ceiling than previous arrangements. It is thus essential to plan a larger safety margin between the deficit target and the maximum amount permitted to ensure that if GDP develops unexpectedly unfavourably or if other negative shocks occur, it is not necessary to take additional consolidation measures that have a procyclical impact.[13]

Set ceiling for deficit reduction path appropriately

However, such a safety margin should not be set by using a questionable interpretation of the rule to extend the ceiling. Yet precisely this situation seems to be on the cards, as – contrary to the intention of the debt brake – an outdated and significantly overstated estimate of the structural deficit from 2010 is being used in current plans as the starting value to determine the ceiling for the path to reduce the structural deficit between 2011 and 2016. This enlarges the scope for borrowing by a cumulated amount of approximately €50 billion.[14] Even if the scope is not fully utilised at the current end, this could still potentially increase debt because, as a rule, this amount is then credited to the control account and can be used in budget execution in the coming years to compensate for unexpected deficits. Instead it would be appropriate to base the ceilings for the deficit reduction path on the actual 2010 deficit. The deficits in the government's benchmark figures are close to the values calculated in this way. Not least the favourable macroeconomic conditions should be used to more rapidly comply with the provisions of the debt brake which come into effect from 2016, and to set up a desirable safety margin below the constitutional limits as early as possible. Experience has shown that in good times the course embarked upon is generally not ambitious enough and that this makes compliance with the rules thereafter difficult. Given the tougher borrowing limit, it is essential that every effort is taken to avoid making this mistake.

Avoid transferring burdens and thus circumventing the debt brake

Financial transactions should also be considered in a consistent manner in connection with the debt brake. This can be demonstrated using the example of the financial relations with the Federal Employment Agency. For instance, the reforms of unemployment benefit II prescribed by the Federal Constitutional Court stipulate a gradual transfer of the annual costs of currently around €4 bil-

12 After the German government had decided on its benchmark figures for the 2012 budget, agreement was reached at EU level that €4½ billion is to be paid as capital to the ESM each year from 2013 to 2017. This will increase net borrowing and the deficit as defined in the government's financial statistics. However, as far as both the deficit as defined in the national accounts and central government's constitutional debt ceiling (which is based on this deficit) are concerned, it is irrelevant as the transfer is recorded as a financial transaction and is therefore not to be included in the debt brake. Should shortfalls arise as a result, the burdens would have to be included in the debt brake.
13 See also the literature cited in footnote 5.
14 For more information, see the statement by the Bundesbank at a hearing of the Budget Committee on 21 March 2011 at www.bundestag.de. The Federal Court of Auditors is also calling for the ceiling for the period up to 2016 to be linked to the actual deficit level in 2010.

lion for the basic allowance for elderly persons and people with reduced earning capacity, which have so far been paid by local government, to central government. To fund this, the VAT-financed grants to the Federal Employment Agency, which were introduced in 2007, are to be effectively halved by 2014, which will take a toll on the Federal Employment Agency's structural financial situation. If this results in deficits for the Federal Employment Agency, then an examination should be launched into whether corresponding compensation payments by central government, which are factored into the budget as loans and are subsequently classified as a financial transaction and thus not included in the debt rule, actually still have the character of a financial transaction in the sense of whether the structure thereof is of a profitable financial asset. Their present form of an unlimited and non-interest-bearing loan – coupled with extensive cuts of regular grants – is already a sign that they exhibit elements of a transfer, thus indicating that it appears appropriate to count them towards the exploitation of the debt limit. In any case, it should be guaranteed that any future debt relief or assumption is generally classified as expenditure, thus lowering the scope for borrowing elsewhere.

Off-budget entities record deficit at start of year, but clear surplus on the horizon for 2011 as a whole

Central government's off-budget entities recorded a deficit of €1 billion in the first quarter of 2011 compared with a deficit of €1½ billion in the same period last year. After the formal end of the assistance period, the Financial Market Stabilisation Fund (SoFFin) recorded a slight surplus from fees for continuing guarantees. At the start of 2010, it had a deficit of €1½ billion. The Investment and Repayment Fund (IRF), which was set up in 2009 to combat the economic crisis and is, in particular, to finance government investment commenced by the end of 2010, recorded a deficit of €1½ billion in the first quarter of 2011 (2010 Q1: €½ billion). This rise in the deficit is attributable to higher drawdowns of funds for investment by state and local government as well as to the absence of a transfer from the Bundesbank's profit to repay debt as the profit did not exceed the amount reserved for the central government budget, which was lowered to €3 billion for 2011. For 2010 as a whole, the off-budget entities posted a deficit of €7½ billion. In 2011, above all the repayment of SoFFin capital injections in the amount of around €10 billion, which has already begun, is likely to be much higher than the outstanding IRF drawdowns. As things currently stand, the off-budget entities are expected to post a significant surplus.[15]

State government[16]

Further decline in deficit in 2011 Q1, ...

The deficit of state government's core budgets halved in the first quarter of 2011, compared with the same period one year previously, falling from just over €7 billion to €3½ billion. This improvement is due to a strong rise in revenue of 9% (€5½ billion), chiefly driven by sharp growth in tax revenue (+9½%). Inflows from the IRF increased at an even faster pace. At 2½% (just over €1½ bil-

15 This does not include transactions by the resolution agencies.
16 The development of local government finances in the final quarter of 2010 was analysed in greater detail in the short articles in the Bundesbank's April 2011 Monthly Report. These are the most recent data available.

lion), the rise in expenditure was much weaker. While growth in personnel expenditure remained relatively subdued (+1½%) prior to the recent pay rises, other operating expenditure (+3%) and, in particular, overall investment expenditure (+7%) grew at much stronger rates.

... but no significant improvement expected for 2011 as a whole

Despite favourable economic developments and corresponding additional tax revenue, the full-year situation is not expected to improve greatly on 2010. This is because, after a good start to the year, tax revenue is expected to grow at a slower pace during the rest of the year and burdens are forecast owing to increased spending, for example on other operating expenditure, to the latest pay settlement, which comes into force in the spring and, in many federal states, also applies to both public sector employees with civil servant status and retired civil servants, as well as to transfers to local government. The budget plans, some of which had not yet been finalised in the first quarter, forecast a €4 billion rise in the deficit vis-à-vis the actual level provisionally recorded for 2010[17] to €26½ billion. However, if the additional revenue from the latest tax estimate (roughly €6 billion compared to the November 2010 level, which has been used in the calculations for the most part) is factored in, the results should be much more favourable and there could even be a slight improvement on the past year. Counter to the very favourable macroeconomic developments, a number of federal states, including North Rhine-Westphalia – despite the constitutional court's ruling on the supplementary budget for 2010[18] – plan to overshoot the regular borrowing limit to avert a disruption of the macroeconomic equilibrium.

Ensure that deficit is reduced resolutely

In addition to the recipients of consolidation aid (see the box on pages 70 and 71), it would also be appropriate for the other federal states to use the currently very favourable macroeconomic developments to reduce high deficits rapidly and promptly implement the new debt rules. Provisions to this effect should be enshrined in state government constitutions – and not only in state budgetary rules[19] – and be combined with binding minimum adjustment paths that aim at rapid budgetary consolidation.

Social security funds[20]

Statutory pension insurance scheme

Lower deficit in Q1

The German statutory pension insurance scheme recorded a deficit of almost €1½ billion in the first quarter of 2011. However, compared with the same period last year (-€2

17 Once the constitutional court's ruling on the supplementary budget of North Rhine-Westphalia for 2010 has been implemented, the value is likely to be lowered by €1½ billion.
18 For more information, see Deutsche Bundesbank, Implications of the ruling on the supplementary budget of North Rhine-Westphalia for 2010, Monthly Report, April 2011, pp 10-11.
19 For example, in the coalition agreement of the new majority parliamentary groups in Baden-Württemberg there is mention of the provisions set forth in the German constitution but not of the strict debt brake stipulated in the state budgetary rules. The debt brake makes provisions for repaying loans taken up during the crisis and prevents the accumulation of more debt before 2020 to avoid inflicting additional burdens on future taxpayers.
20 The financial development of the statutory health and public long-term care insurance schemes in the final quarter of 2010 was discussed in the short articles of the March 2011 Monthly Report. These are the most recent data available.

German states receiving consolidation aid – initial deficit reduction requirements not very ambitious

During the consultations on the introduction of the national debt brake, some states had already indicated before the outbreak of the financial crisis that they would find it particularly difficult to balance their budgets from 2020 without taking on new debt. Article 143d of the German constitution (*Grundgesetz*) laid the foundation for the five highly indebted states of Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein to receive consolidation aid during the transitional period from 2011 up to and including 2019. The total annual amount of €800 million – of which €300 million is for Bremen, €260 million for Saarland and €80 million each for the other three recipient states – will be financed by central and state government (including the recipient states) in equal measure; the contributions of the individual states will be deducted from turnover tax revenue. In principle, this money will only be paid if the recipient states comply with the consolidation requirements to be specified in the respective administrative agreements.

Following a long negotiation process, these administrative agreements were signed by mid-April, thereby enabling payments to be made, as planned, from mid-2011 onwards. The upper bounds for structural borrowing, which will decline in equal annual steps until the structural budget deficits are completely eliminated by 2020, have been set individually for Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein. They are based on the fiscal balance of the state's core budget and of the off-budget entities with borrowing authorisations, after adjustment for financial transactions and cyclical influences as well as for outstanding settlements from the various stages of the state government revenue-sharing scheme, from 2010. As is the case for central government, the cyclical adjustment procedure is based on the method used in the EU budgetary surveillance procedure.

However, the starting structural deficit value was not calculated on the basis of actual tax revenue but on outdated state government data (the respective 2010 tax estimates). As a one-off, the additional tax revenue of state government as a whole (€7½ billion, or 2½% of total expenditure) vis-à-vis these tax estimates is classified in its entirety as cyclically induced for 2010, thus resulting in a substantially higher starting structural deficit value. By contrast, when drawing up the budget for subsequent years, this amount of additional revenue is largely classified as structural, thereby providing considerable short-term relief from the pressure to consolidate. There is therefore a danger – as in the case of the strategic starting level definition at central government level [1] – of a particularly favourable period for reducing the deficit going largely unused and severe cuts – ultimately unavoidable – being deferred. It would be extremely worrying, especially in such a setting, if the Stability Council, which has the power to sanction any failure to meet deficit reduction targets by withholding consolidation aid, were to exculpate any overstepping of the respective deficit limits by making allowances for state-specific special factors or exceptional circumstances.

The additional room for manoeuvre secured by using the tax estimates from May 2010 rather than the actual values for 2010 becomes particularly clear when considering the example of the state of Berlin. According to the cash statistics, a deficit of €1.4 billion is recorded for the reference year 2010. The first item to be subtracted from this figure is financial transactions, such as loans granted, which placed a burden of just over €0.15 billion net on the budget and reduced the starting structural deficit value accordingly. Furthermore, the cyclical impact on the budget must be deducted. Using the European cyclical adjustment procedure and the data as of February 2011, the Federal Ministry of Finance estimated an output gap for Germany for 2010 of -1.8% of potential output. [2] For Berlin's

1 For information on the central government issue, see Deutsche Bundesbank, Public finances, Monthly Report, February 2011, p 71 f. — **2** See Federal Ministry of Finance, Die Ermittlung der Konjunkturkomponente des Bundes im Rahmen der neuen Schuldenregel, Monthly Report, February 2011, p 69 (available in German only).

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budget, this corresponds to a cyclical burden of roughly €0.4 billion, which further reduces the starting structural deficit value. This is offset by burdens arising from the time lag of one quarter in the settlement of various stages of the state government revenue-sharing scheme in the amount of €0.25 billion, which are based on Berlin's particularly favourable tax revenue situation at the end of 2010. Thus, overall, a starting structural deficit value of roughly €1.1 billion is obtained. In order to comply with the consolidation requirement to receive aid – a reduction in the structural deficit ceiling of one-tenth of the respective starting value – this ceiling would have to be lowered by just over €0.1 billion in each of the subsequent years up to 2020. This would result in a structural deficit ceiling for 2011 of €1 billion.

By contrast, in accordance with the administrative agreement, on the basis of Berlin's tax estimates from May 2010, a starting structural deficit value of €2 billion results in an upper limit of €1.8 billion for 2011, thereby producing additional room for manoeuvre of €0.8 billion. With reference to the minimum requirements, Berlin could even postpone its consolidation efforts for several years and enlarge the structural deficit vis-à-vis 2010 by €0.7 billion. Yet the current extremely favourable macroeconomic developments mean that it would actually be advisable to rapidly implement the necessary consolidation measures. Otherwise, there is a risk of these measures having to be implemented in a significantly more difficult macroeconomic setting. Furthermore, higher deficits would result in additional debts and, consequently, higher interest burdens – and high interest burdens, in particular, have been identified as one of the main causes of the budgetary problems. Decisive action should be taken at the current end to prevent this.

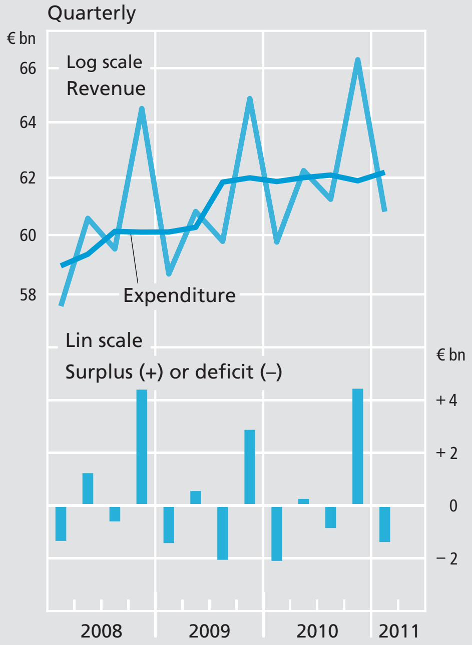
According to rough calculations, using figures from the May 2010 tax estimates results in less serious distortions for the other states. This is probably chiefly due to the fact that the figures used were based more closely on those in the tax estimate. For the future, the decision to use the income calculated in a state's regionalised official tax estimate as an upper limit for projected revenue when monitoring compliance with the consolidation requirements seems adequate. However, the example of Berlin clearly demonstrates that including safety margins when calculating the starting deficits – for example, by referring to an outdated tax revenue estimate – is at odds with the intention of the consolidation requirements enshrined in the German constitution and should therefore be reconsidered.

Moreover, it appears inappropriate to include one-off effects or special factors that apply for a very limited period of time in the calculation of the starting point for a deficit reduction path for a whole decade. This evidently concerns Saarland in particular, which – in addition to larger short-term burdens arising from special funds set up to stabilise the economy – has, for example, provided additional funds for several years in advance to a university. This clearly undermines the basic concept of a 2010 reference deficit.

Overall, during its introduction phase, the implementation of the new debt brake lacks stringency in key areas and, in this respect, runs contrary to the intention of the rule. The phenomenon, which has been observed time and time again in the past, of putting off the necessary consolidation measures to the future, has resurfaced. This is all the more concerning given the currently very favourable conditions. It is essential that an ambitious approach to reduce deficits is adopted, particularly in the highly indebted states, in order to firmly curb the interest burden and have a realistic chance of complying with the provisions enshrined in the German constitution from 2020 onwards.

Finances of the German statutory pension insurance scheme

Quarterly



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billion), the financial situation has improved. At just over 1½%, revenue growth was much weaker than in the preceding quarters; yet, at ½%, growth in expenditure was even slower. At just over 4%, employees' compulsory contributions increased sharply. However, this was offset by a fall of over one-third in contribution receipts on behalf of the unemployed – owing not only to the improved labour market situation but also to a large extent to central government cutting pension contributions on behalf of recipients of unemployment benefit II as part of its consolidation package. Overall, contribution receipts rose by 2½%. By contrast, central government grants were not up on the previous year because they were calculated on the basis of, *inter alia*, the slightly negative growth in wages and salaries in 2009. Pension expenditure in the first quarter hardly changed on the year. This was due to the waiver of the pension adjustment in mid-2010 and to a persistently very weak rise in the number of pensions. However, contributions by the pension insurance scheme to the statutory health insurance scheme on behalf of pensioners shot up following a rise in the general contribution rate at the beginning of the year from 14.9% to 15.5%.

Surplus possible in 2011

Contrary to original expectations, it is now looking likely that the statutory pension insurance scheme will be able to post a surplus again for 2011 as a whole. Pensions will be raised by 0.99% on 1 July 2011. This means that the calculated increase has been halved to make up for some of the financial effects of waiving pension cuts in recent years. While the reserves are likely to rise, the upper intervention threshold of 1.5 of monthly expenditure – the overshooting of which is to be prevented by lowering the contribution rate – will not yet have been reached. This is also unlikely to happen in 2012. However, should the positive macroeconomic developments continue, the contribution rate would need to be lowered in 2013. It is now essential to implement all of the agreed pension adjustment rules rigorously and not – as was often the case in the past – to increase spending at will without duly considering foreseeable demographic burdens.

Federal Employment Agency

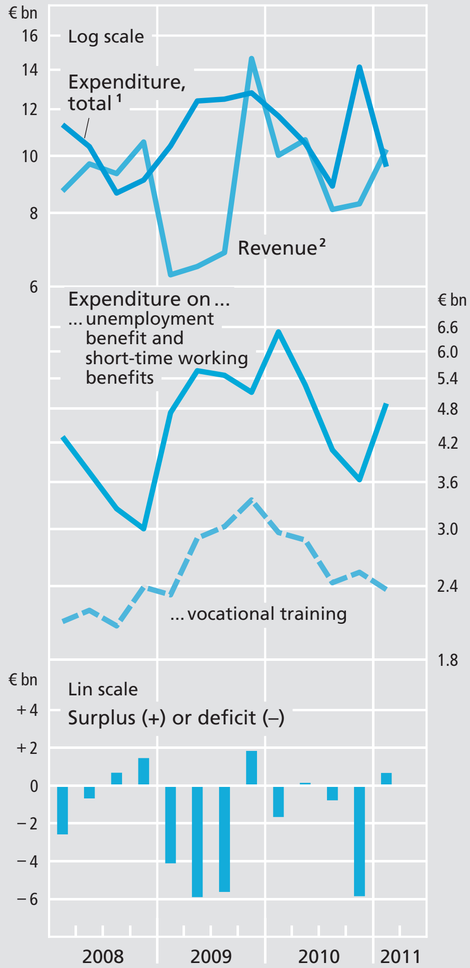
Surplus thanks to positive economic developments

The Federal Employment Agency recorded a surplus of over €½ billion in the first quarter of 2011, compared with a deficit of just over

€1½ billion one year previously. Whereas revenue rose by just under 2½%, expenditure fell by 18%. The extremely favourable economic developments left their mark on the Federal Employment Agency's financial position. Employees' insurance contributions rose – *inter alia* as a result of raising the contribution rate from 2.8% to 3.0% – by 12½% (adjusted for the increase in the contribution rate: +5%). However, this was offset by the absence of receipts from insolvency benefit contributions after the contribution rate was cut from 0.41% to 0.0%. The regular grant from central government, which is calculated on the basis of turnover tax revenue, was 4% higher than one year previously. However, this is also due to the fact that a payment was made earlier than last year. An increase of just over 1% is forecast for 2011 as a whole. The sharp decline on the expenditure side is split almost equally between lower payments for unemployment benefit (-19%) and reduced spending on short-time working benefits (-67%). Expenditure on active labour market policy measures declined by 20%. Excluding the refunds of social security contributions for short-time working made to employers – which were still sizeable in 2010 in the wake of the recession – that fall into this category, expenditure on this item fell by 11½%.

Finances of the
Federal Employment Agency

Quarterly



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

Deutsche Bundesbank

Loan to offset deficit likely to be much lower than forecast

The central government loan to offset the deficit of almost €5½ billion included in the Federal Employment Agency's budget plan seems to be far too high, especially since the underlying central government projections of wage and employment trends from autumn 2010 now seem rather pessimistic. Assuming the macroeconomic upturn continues, the coming years should see a further easing in the financial situation and it should be possible to repay part of this year's loan as early as next year. In the longer term, however, with a contribution rate of 3.0%, the Federal Employment Agency seems to be clearly underfinanced, especially if central government cuts its regular grant to the Federal Employment Agency, which was introduced in 2007 when the standard rate of VAT was raised from 16% to 19%, by around €4 billion as planned. This would create the risk of the Federal Employment Agency accumulating debt on behalf of central government if the payments from central government earmarked for offsetting the deficit were to be classified as a loan and thus excluded from the definition stipulated by the new debt brake.