Public finances*

General government budget

Significant improvement in public finances in 2011

Despite the easing of cyclical strains, the deficit ratio in Germany rose significantly (to 4.3%[1]) again last year. This year, however, it is likely to fall substantially to around 1%. This is due in no small part to the ongoing economic recovery, and – despite the economic slowdown likely at the end of the year – the cyclical component is expected even to enter positive territory. Moreover, in 2011 the extensive capital transfers to financial institutions that were seen in 2010 (1.4% of gross domestic product (GDP)) will probably largely cease to be a factor. Finally, consolidation measures and the phasing out of parts of the economic stimulus programmes will also contribute to this improvement. The forecast deficit, coupled with relatively strong nominal GDP growth, will help to bring the debt ratio down markedly. Overall, the ratio could fall from its high last year to 81.1% according to government plans, although this is subject to considerable uncertainty, not least due to the sovereign debt crisis.[2]

Rising revenue ratio and …

The government revenue ratio is likely to increase notably in 2011. Following sizeable

* 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 In spring, the recorded deficit ratio for 2010 still stood at 3.3%. The upward revision is chiefly attributable to higher capital transfers being booked in connection with the founding of the FMS Wertmanagement "bad bank" as a result of new information coming to light.
2 In 2010, the debt ratio stood at 83.2% This figure includes debt in connection with support measures for financial institutions of 12½% of GDP since 2008. This contrasts for the most part with financial assets, which are, however, especially prone to risk.

Decisions of the European Council and the Euro Summit of 26 and 27 October 2011

On 21 July 2011, the euro-area heads of state or government and the EU institutions agreed on extensive measures to curtail the renewed intensification of the sovereign debt crisis.[1] In particular, the set of tools available to the European Financial Stability Facility (EFSF) was extended to include precautionary credit lines, allow loans to recapitalise financial institutions to also be granted to non-programme euro-area countries, and to provide the option of intervening in the secondary market for government bonds. Furthermore, the leaders announced a second assistance programme for Greece and expressed their intention to achieve the voluntary involvement of private creditors in tackling Greece's budgetary problems. Finally, the interest rates on assistance loans to Greece, Ireland and Portugal were cut significantly and their maturities were extended. The expansion of the set of tools available to the EFSF as well as the previously agreed increase in the EFSF's effective lending capacity to €440 billion were ratified by the last member states in October.

However, the decisions did not result in a lasting stabilisation of the financial markets. Instead, despite interventions by the Eurosystem, Spanish and, above all, Italian long-term government bond yields, for example, rapidly increased again. This was predominantly due to doubts about the fiscal consolidation paths of some euro-area countries regarded as problematic, a loss of confidence within the European banking sector and a deterioration in the macroeconomic outlook. These factors mutually reinforced one another.[2] In light of this, on 26 and 27 October the European Council and the Euro Summit once again took decisions aimed at alleviating the current crisis.

Based on these decisions, the European financial system is to be strengthened by means of higher capital requirements and government guarantees on longer-term bank liabilities. At the same time, it is to be ensured that the credit flow to the real economy is not unduly restricted. From July 2012 onwards, large, internationally active financial institutions in the EU must temporarily build up a higher core tier 1 capital ratio amounting to at least 9% after each institution has marked its holdings of EEA government bonds to market. Government guarantees are intended to facilitate access to longer-term funding. These measures could help increase financial institutions' resilience to shocks. However, to protect the taxpayer and minimise distortions to competition in the financial sector, any government funds that may be required should only be granted subject to suitable conditions being imposed on the respective financial institutions, in return for corresponding rights to participate in decisions, and in line with state aid rules.

It is important that, as envisaged, capital requirements are met as far as possible using private sources of capital, which may also include the conversion of debt to equity instruments and constraints regarding the distribution of dividends and the granting of bonus payments. Support from national governments is only justified if this cannot be achieved in sufficient measure, and the EFSF can only issue special-purpose loans to euro-area countries if support from national governments is likewise unavailable to the extent necessary. If the EFSF were to provide direct financial assistance to credit institutions, this would upset the balance between national responsibility for banking supervision and liability and is therefore not envisaged.

With regard to government guarantees for bank debt securities, it should be ensured that the institutions have sufficient equity. The envisaged coordination at EU level regarding access criteria and conditions may help to minimise distortions to competition within Europe. The guarantees should be suitably recompensed and scaled back within a foreseeable timeframe. The EFSF support measures must not result in the necessary restructuring measures in the banking systems concerned being bypassed.

The effective lending capacity of the EFSF is once again to be significantly increased (on a scale of up to €1 trillion according to the EFSF) by means of two leverage models designed to mobilise additional private capital. In the first model, private investors buying new government bonds would be offered credit enhancement providing insurance up to a certain percentage (which has yet to be specified) against the risk of losses in the event of a haircut. In the second model, public sector entities pay subordinated capital into special purpose vehicles (SPVs). Unlike the first model, the SPV option also allows interventions in the secondary market for government bonds and the involvement of other public financiers, such as the IMF or its shareholders. In both cases, the leverage effect and the potential loss distribution depend on the specific features of the models (which have yet to be decided) and the evolving assessment of market participants. Neither variant envisages the participation of the Eurosystem in the leverage. Both the proposal for the EFSF to be refinanced via the central bank and the idea of providing foreign reserve assets as collateral, which has subsequently been discussed, would be at odds with the ban on the monetary financing of governments. With regard to the details of the leverage models, which have yet to be finalised, the risk of loss for the EFSF, and consequently

1 See Deutsche Bundesbank, Decisions taken by the heads of state or government of the euro area and the institutions of the European Union on 21 July 2011, Monthly Report, August 2011, pp 62-65. — 2 See also pp 37-47 in this report and Deutsche Bundesbank, Financial

for the taxpayers of the guaranteeing countries, would be limited if in both models the EFSF first grants loans to the beneficiary member state and the latter then, as a next step, uses these funds to provide credit enhancement (model 1) or hedge the subordinate tranche of the SPV's financing (model 2). This provision is also included in the EFSF framework agreement, which envisages loans to member states only. As a general rule, complex leverage models reduce transparency, thus making it difficult to monitor the assistance tools. Although the leverage does not result in an increase in Germany's total liability, it does bring increased risk in the form of a greater loss if guarantees are exercised.

The reorganisation of the EFSF in the wake of the decisions taken in July has resulted in a marked overall increase in the communitisation of liability risks. The incentives for sound fiscal policy are being reduced, above all in conjunction with the near-elimination of interest rate premiums on assistance loans and the expansion of support options with potentially greatly diminished conditionality, and this is not being counterbalanced by granting additional rights at a central level to intervene in national budgetary policy.

The euro-area heads of state or government want private holders of Greek government bonds to take a voluntary haircut on their claims. To this end, a bond exchange is to be carried out at the beginning of 2012. With a nominal discount of 50% of the nominal value, the contribution of the private sector is to be considerably greater than initially announced in July. The euro-area countries will contribute up to €30 billion to the credit enhancement for the exchanged bonds. On this basis, it was announced that public funds of up to €100 billion until 2014 would be provided for a new adjustment programme. The new programme is to be agreed by the end of 2011 and is also to include a recapitalisation of Greek banks. In principle, the involvement of private creditors in a restructuring of sovereign debt is an important component of the regulatory framework for monetary union. However, such a process also entails risks. In particular, it is essential to ensure that it does not give rise to the expectation that failure to meet prescribed consolidation targets will ultimately result in debt relief, lower consolidation requirements and additional assistance from other countries, allowing the country concerned to scale back its own efforts. Otherwise, this would additionally reduce incentives to achieve sound public finances and further erode capital market confidence.

Furthermore, the euro-area member states were called upon to enshrine the provision of a structurally balanced budget in their constitutions, or the legal equivalent thereof, by the end of 2012 and to draw up their budget plans on the basis of independent growth forecasts. This could be a significant step forward. However, the effectiveness of such rules hinges on the details, which can, for example, produce loopholes.[3] Ultimately, it is crucial that the rules are implemented stringently and effectively and that there is confidence that the respective countries' political majorities also actually feel bound to the new rules.

Italy was called upon to carry out structural reforms, including privatisation, deregulation, labour market reforms and increasing the statutory retirement age. Close monitoring of these measures by the European Commission was announced.[4]

Finally, it was agreed to further develop the institutional framework of European monetary union. The Commission and the Council have been given powers to examine and adopt an opinion on national draft budgets before they are passed by the respective national parliaments. The institutions at euro-area level are to be considerably expanded (including semi-annual Euro Summits chaired by a president). Furthermore, a working group has been commissioned to identify steps to strengthen economic convergence in the euro area, improve fiscal discipline and deepen economic union. For this purpose, the possibility of making limited changes to the Treaty on the Functioning of the European Union is to be considered, too.

Overall, it remains unclear what a coherent regulatory framework for monetary union will look like going forward. A fundamental decision must be taken on whether to strengthen the existing framework, with national fiscal sovereignty and the application of some Community rules with a no-bail-out rule, or whether to create a fiscal decision-making structure where a central level has ultimate powers to intervene in national budget sovereignty. The route currently being taken of partially expanding joint liability, and thus concurrently reducing the incentive for countries to achieve sound public finances on their own, without at the same time significantly strengthening the right to intervene in national budgets is yielding an increasingly inconsistent framework for monetary union. This is increasing the risk of unsound public finances, and the potential for conflict with a stability-oriented monetary policy is likewise growing significantly.

Stability Review 2011. — **3** See Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40. — **4** Shortly afterwards, it was decided that the IMF would also play a role in this monitoring.

cuts in tax and social contribution rates between 2008 and 2010, additional revenue is resulting in particular from higher contribution rates to the statutory health insurance scheme and to the Federal Employment Agency as well as from tax hikes under central government's consolidation package. Moreover, on the whole – as in previous upturns – tax revenue (adjusted for the impact of legislative changes) is developing much more favourably than its macroeconomic reference variables.

... falling expenditure ratio

The expenditure ratio is likely to decline significantly. A year-on-year cyclical improvement is causing the ratio to fall chiefly via higher GDP in the denominator. In addition, the extensive capital transfers to safeguard financial institutions recorded last year will probably largely cease to be a factor. The partial phasing out of temporary macroeconomic support measures from 2009 and 2010 and, not least, the subdued development of expenditure as a result of a structural fall in unemployment figures as well as the dampening effect of the pension adjustment formula are also playing a part in the decline.

Deficit ratio virtually unchanged in 2012

As things stand, the deficit ratio is likely to remain virtually unchanged in 2012. The effect of cyclical developments could be neutral on the whole, not least because the expected economic slowdown is predominantly attributable to external causes and thus has less of an impact on cyclically sensitive domestic factors that have greater weight for public finances. Only a slight structural improvement is on the cards, partly because the originally announced consolidation path has now been relaxed. As is the case this year, temporary economic stimulus measures – in particular investment programmes, which for the most part have an especially long time lag – will continue to be phased out. The muted development of structural pension and labour market expenditure may also continue.

Despite favourable developments, consolidation still needed

The decline in the general government deficit in 2011 is partly due to the social security funds, which are currently especially benefiting from dynamic wage and employment developments and are recording high surpluses on balance. Central, state and local government, on the other hand, are still posting considerable structural deficits, and the need for consolidation remains substantial, not least given the borrowing requirements in the reformed budgetary rules.[3] It is also becoming apparent that the debt ratio will still be well above the reference value of 60% for many years to come, even if the sovereign debt crisis does not escalate further. A rapid reduction of the debt ratio is warranted. This would additionally help to avert the danger of Germany also being affected by a loss of confidence in the sustainability of its public finances if additional strains arise. The burden of demographic change is soon likely to become much heavier, which, without effective adjustments – many of which have yet to be set out in detail – would inflate the debt ratio. For 2011 and, in particular, for subsequent years, an escalation of the sovereign debt crisis and a stronger-than-expected eco-

3 See also Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40.

nomic downturn would entail considerable risks.

Not appropriate to weaken course given positive forecast revisions or …

Against this backdrop, structural deficit reduction should take priority. However, the fact that several aspects of the original consolidation course have been weakened – as happened recently with the decisions taken by the coalition committee at the beginning of November – suggests that a different course has been embarked upon. In particular, the series of upward revisions of forecast tax revenue in the wake of the economic upswing have encouraged policymakers to delay eliminating the structural budget imbalance. It would be better to use the windfall gains instead to reduce the deficit faster and to achieve the medium-term objective of a structurally (close-to-) balance budget earlier. The planned income tax cuts will slow down the attainment of this objective if there is no counterfinancing of these cuts, for instance by abolishing tax breaks or reducing growth in expenditure.[4] The expansion of the benefits provided under the public long-term care insurance scheme will initially be covered by a higher contribution rate from 2013 onwards; however, this paves the way for a faster rise in burdens in the medium term.

… in order to stimulate demand

Delaying consolidation to actively stimulate demand – as international bodies in particular are proposing – is not appropriate either given the limited economic slowdown in Germany indicated by the baseline scenario in most current macroeconomic forecasts. Here, the automatic stabilisers are sufficient to absorb shocks. The impact of German fiscal policy on other countries via the demand channel is very limited anyway, as indicated by an IMF study.[5] It should also be noted that because of its lower structural deficit, the fiscal policy stance required in Germany for rapid consolidation does not have to be as restrictive as in many other countries.

Bring about sustainable reversal in debt trend now

The virtually unchecked growth in the debt ratio since the 1970s highlights the continuous erosion of fiscal policymakers' radius of action that has ensued from their habitual tendency to keep putting off budgetary consolidation until later. The reforms of the national budgetary rules and of the European Stability and Growth Pact are intended precisely to avoid making this mistake in the future. However, this will succeed only if the requirements are implemented rigorously – which has not happened in the past.

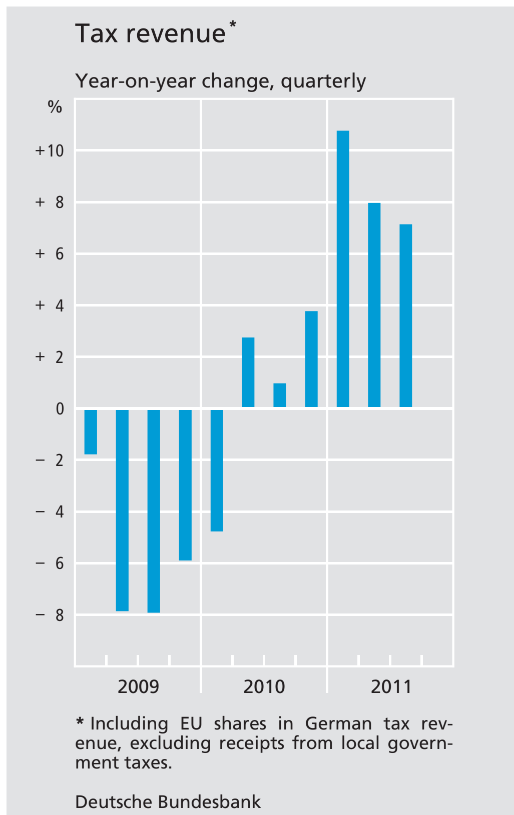
Budgetary development of central, state and local government

Tax revenue

Sharp rise in tax revenue in Q3

Tax revenue[6] was up by 7% on the year in the third quarter (see the chart and table on pages 68 and 69). Although the year-on-year rate was again somewhat below the level recorded in the previous quarter, the pace of growth remained strong. Revenue from income-related taxes rose sharply by just over

4 See for example the recommendations in German Council of Economic Experts, Verantwortung für Europa wahrnehmen, Annual Report 2011/2012, p 19f (in German only).
5 See IMF, Germany – Staff Report for the 2011 Article IV Consultation, June 2011, p 15.
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.



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

Deutsche Bundesbank

10½%. The increase in wage tax receipts was chiefly attributable to the positive pay and employment trends but to a lesser extent also to lower deductions (child benefit and subsidies for supplementary private pension plans). Revenue from profit-related taxes went up by just under 12% due, on balance, to a strong rise in corporation tax. Receipts from consumption-related taxes grew by 3½%, with turnover tax revenue developing largely in line with its macroeconomic reference variables. Overall, revenue from the new air traffic tax and the nuclear fuel tax also contributed notably to growth in revenue.[7]

Strong growth also expected for year as a whole

According to the latest official tax estimate, tax receipts for 2011 as a whole are expected to rise by 7½% (including local government taxes).[8] This growth reflects economic developments as well as – to a much lesser extent – fiscal drag[9] and legislative changes. In the case of the latter, additional tax revenue (especially from nuclear fuel tax, air traffic tax and tobacco tax as well as from subsidy cuts for electricity and energy tax) and lower expenditure on homebuyers grants – which are being phased out – contrast with revenue shortfalls in other areas (in particular, deferred shortfalls due to greater tax deductibility of insurance contributions). In addition, as in previous upturns, revenue growth is much stronger than implied by figures for economic developments, the effects of progressive taxation and legislative changes.

Clear rise expected in future, too

Slower but still significant revenue growth of 3½% is anticipated for 2012. Although aggregate growth is forecast to weaken, the macroeconomic figures relevant to tax revenue are expected to see solid growth. The impact of legislative changes is again projected to be slightly positive (in particular, the phasing out of homebuyers grants and the waning impact of depreciation allowances under the first economic stimulus package). In the medium term (from 2013 to 2016), an-

7 Court orders have decreed that nuclear fuel tax paid to date has to be refunded in some cases. A decision regarding the lawfulness of this tax is, however, still outstanding.
8 This estimate is based on central government's current macroeconomic forecast. In 2011, real GDP growth is expected to be +2.9% and nominal growth +3.8% (May 2011: +2.6% and +3.5% respectively). Growth for 2012 is forecast to be +1.0% and +2.4% respectively (May 2011: +1.8% and +3.5% respectively). In the medium term, nominal growth of around 3% per year is forecast (as was also the case in May).
9 In this context, this term comprises the positive revenue effect of the progressive structure of the income tax schedule as well as the nominal dampening effect as a result of the extensive price inelasticity of specific excise duties.

Tax revenue

Type of tax	Q1 to Q3				Q3				Estimate for 2011[1,2]
	2010	2011			2010	2011			Year-on-year percentage change
	€ billion		Year-on-year change € billion	as %	€ billion		Year-on-year change € billion	as %	
Tax revenue, total [2]	351.7	381.9	+ 30.2	+ 8.6	116.7	125.0	+ 8.3	+ 7.1	+ 7.5
of which									
Wage tax	91.1	100.2	+ 9.1	+ 9.9	30.4	33.6	+ 3.1	+ 10.3	+ 9.6
Profit-related taxes [3]	48.5	55.2	+ 6.7	+ 13.8	12.4	13.8	+ 1.5	+ 11.8	+ 11.2
Assessed income tax	23.2	23.2	+ 0.1	+ 0.3	7.3	7.1	– 0.2	– 2.8	+ 0.7
Corporation tax	7.4	9.7	+ 2.4	+ 32.0	1.6	3.0	+ 1.4	+ 90.7	+ 23.1
Investment income tax [4]	17.9	22.2	+ 4.3	+ 23.8	3.5	3.7	+ 0.2	+ 6.7	+ 19.8
Turnover taxes [5]	132.2	140.6	+ 8.4	+ 6.4	45.0	47.2	+ 2.2	+ 4.8	+ 5.7
Energy tax	24.2	24.5	+ 0.3	+ 1.3	10.2	10.1	– 0.1	– 1.1	+ 1.0
Tobacco tax	9.4	9.6	+ 0.2	+ 2.3	3.6	3.4	– 0.2	– 5.3	+ 2.5

1 According to official tax estimate of November 2011. — **2** Including EU shares in German tax revenue, excluding receipts from local government taxes. — **3** Employee refunds, homebuyers grant and investment grant 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

nual revenue growth is also expected to be 3½% on average, with legislative changes playing a negligible role. The tax ratio (as defined in the government's financial statistics) is projected to increase to 23.0% by 2016 (2010: 21.4%). Fiscal drag accounts for approximately ½ percentage point, or €15 billion, of this rise. Overall, it should be borne in mind that the baseline scenario used in the Federal Government's macroeconomic forecast and hence in the official tax estimate assumes that no further downside risks as a result of the sovereign debt crisis will materialise, which entails considerable uncertainty.

Declining additional revenue vis-à-vis earlier expectations

Compared with May 2011, the macroeconomic assumptions underlying the tax estimate are, on the whole, more favourable for 2011 but somewhat less favourable thereafter. Legislative changes made in the intermittent period are resulting in (limited) shortfalls compared with the last forecast. Especially in 2011 but also in 2012, there is, moreover, a positive impact from the fact that tax refunds in connection with a court ruling are now assumed to be much lower than before.[10] In total, expectations now exceed the May estimate by €16 billion (½% of GDP) for 2011, €7½ billion for 2012 and between €4½ billion and €6 billion for the period from 2013 to 2015. Compared with the autumn 2010 forecast, which forms the basis for the cen-

10 The Federal Government previously expected tax refunds 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) of just over €3½ billion for 2011 and just under €1½ billion for 2012. Now that the European Court of Justice has issued a new ruling on additional details concerning this case, total shortfalls of €½ billion have been assumed for 2012 and 2013 combined.

tral government budget and partly also for state government budgets for 2011, the increase is much higher, totalling €34 billion for 2011 and €29 billion for 2012 (1½% and 1% of GDP respectively).

Central government budget

Marked improvement in fiscal balance in Q3

Central government recorded a deficit of €12 billion in the third quarter of 2011 compared with a deficit of €16½ billion one year previously. Revenue rose sharply by 9% (€6 billion). Tax receipts continued to grow significantly by 7½% (€4½ billion). Expenditure went up by 2% (€1½ billion). On balance, this increase was predominantly attributable to the fact that interest expenditure was €3 billion higher, ultimately because of a distorted figure from the previous year.[11] As a result, the improvement in the fiscal balance in the third quarter is significantly understated. Among the other expenditure items, outlays on unemployment benefit II in particular fell by €1 billion, partly because of the abolition of pension insurance contributions on behalf of benefit recipients, which reduced the receipts of the statutory pension insurance scheme accordingly. Transfers to the social security funds were also down (-€½ billion) given lower needs-based payments to the Federal Employment Agency.

Lower-than-budgeted deficit for year as a whole

Central government therefore recorded a cumulated deficit of €28 billion at the end of the third quarter of 2011 compared with a deficit of €43 billion one year previously. While the actual deficit in 2010 totalled €44½ billion, as things stand it appears entirely possible to keep net borrowing for the year as a whole below €25 billion (budget target: €49 billion) provided that tax revenue continues to develop favourably, as expected. Compared with the budgeted amount, the new official tax estimate forecasts additional revenue of €17½ billion, and expenditure looks likely to ease by a total of almost €10 billion, especially on labour market-related costs (for loans to offset the Federal Employment Agency's deficit and for unemployment benefit II, in particular) and interest costs. Consequently, the value for the structural deficit to be calculated by central government at budget outturn under the debt brake will probably be around €20 billion below the deficit ceiling used to date for 2011. However, this undershooting is largely due to the fact that the deficit ceiling, which is to sink gradually up to 2016, has so far not been adjusted to the much more favourable result for 2010. As a result, budgetary leeway that is at odds with the intention of the debt brake is still being recorded.[12]

After latest adjustments, 2012 budget envisages increase in deficit …

Following the Budget Committee's adjustment meeting, the 2012 central government budget now envisages net borrowing of €26 billion, which represents a marked rebound on the actual level that is emerging for 2011. Compared with the Federal Cabinet decision in July, new borrowing has been cut by only €1 billion despite tax rate rises put forward in

11 Interest expenditure of this amount for the interest due date at the beginning of July 2010 has apparently been recorded in the cash statistics as an outflow in June.
12 For a more in-depth explanation and critique, see Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40.

On the cyclical adjustment procedure under the German central government's new debt rule

The new debt rule for Germany's central government budget relates to structural net borrowing. The procedure to determine the cyclical component of the budget deficit therefore plays an important role. The cyclical component depends largely on the estimated output gap, which is defined as the deviation of GDP from potential output.[1] According to the Act implementing Article 115 of Germany's Basic Law, potential output, which cannot be observed, must be estimated in line with the procedure applied under the European Stability and Growth Pact (EU procedure).

The current design of the procedure under national budgetary rules entails problems with the sensitivity of the estimation results, which are in clear evidence at the current end.[2] While Germany's central government reports an output gap of -0.7% of GDP for 2011 based on the EU procedure, calculations conducted by the European Commission yield a figure of 0% of GDP.[3] As the estimates are made using only slightly different expectations regarding the macroeconomic outlook, a uniform estimation procedure could be expected to yield very similar results. However, the fact that they differ bears testimony to the options that the current EU procedure allows in terms of modelling and setting parameters.

Under the debt brake, there is a risk that the symmetry of the cyclical components will be lost – possibly because loopholes are exploited – and that, over time, deficits will therefore systematically be wrongly excused as being the result of cyclical factors. That would run counter to the intention of the debt brake. Such concerns were already expressed back when the new procedure was first applied. The current range of estimation results now confirms that such a complex and opaque procedure that is difficult to verify is not really suited to application under a debt rule.

The alternative would be a return to the version of the EU procedure that was used in the autumn of 2010 to draw up the 2011 central government budget and, at the time, was obviously seen to be in line with legal requirements. The necessary smoothing of the time series was effected using only the comparatively transparent Hodrick-Prescott filter.

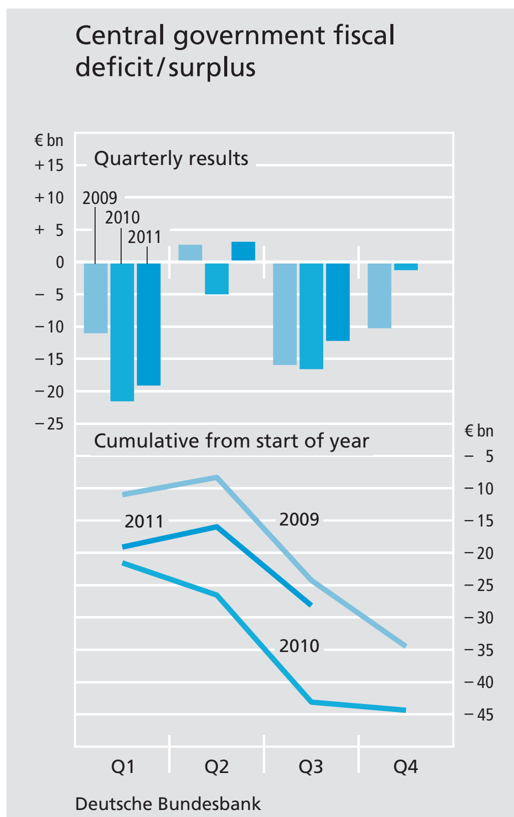
Irrespective of the procedure selected, the calculations must be transparent and verifiable. All information needed for control purposes must be provided in full, in user-friendly form and in a timely manner. It is therefore very welcome that the central government already provides comprehensive material at an early stage. However, additional steps in this direction are necessary to ensure complete verifiability and user-friendly application.[4]

Moreover, especially in connection with budgetary rules, a certain procedural stability appears very important, particularly to allow for oversight by parliament and the public. This is difficult to square with discretionary modelling or frequent other methodological *ad hoc* interventions. Any interventions that are nonetheless made should be documented and explained. For more substantial changes, comparative calculations should be used to show the significance for assessment of the structural budget situation. The transparency this creates would ultimately be a precondition for the desirable continuous oversight of budgetary policy by the public.

The symmetry of the cyclical components in real time, on which the respective budgets are based, can, moreover, also be verified retroactively. If this reveals a significant negative cyclical component on average across one cycle, which has resulted in a trend increase in debt over time, this should be corrected going forward – in line with the constitutional intention.

1 For more on issues relating to the application of cyclical adjustment in the context of the German central government's debt rule, see Deutsche Bundesbank, Requirements regarding the cyclical adjustment procedure under the new debt rule, Monthly Report, January 2011, pp 55-60, and Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40. — **2** See also German Bundestag, Budget Committee, committee printed paper 2946 of the 17th electoral term and Deutsche Bundesbank (January 2011), loc sit, pp 57-59. — **3** See Federal Ministry of Economics and Technology, www.bmwi.de/BMWi/Redaktion/PDF/G/gesamtwirtschaftliches-produktionspotenzial-herbstprojektion-2011, published on 20 October 2011, and European Commission, www.circa.europa.eu/Public/irc/ecfin/outgaps/library, published on 10 November 2011. As part of the Joint Economic Forecast, the research institutions involved use the same procedure to estimate capacity overutilisation, of +1%, given similar expectations of macroeconomic developments, see Project Group Joint Economic Forecast, Adverse Effects on the German Economy from the European Debt Crisis, Joint Economic Forecast Autumn 2011, p 6, published on 13 October 2011. — **4** Almost all of the necessary data are already available on the websites of the Federal Ministry of Finance and the Federal Ministry of Economics and Technology. However, the program codes used by the government are not yet disclosed. This relates both to the production function itself and the approaches used to smooth the unemployment rate and total factor productivity. Moreover, documentation and an explanation of methodological changes have not yet been released.

Deutsche Bundesbank



the latest tax estimate (€2 billion)[13] and the estimated fall of €1½ billion in interest expenditure. Plans to relieve pressure on the budget on balance by effecting asset realisations of €4½ billion and the fact that the Federal Government has estimated a more negative cyclical effect (-€5½ billion) in view of weaker growth expectations (for more information on calculating cyclical components, see page 71) put the structural deficit at €25½ billion. Despite the planned pause in consolidation, the debt brake ceiling used to date by the Federal Government would thus be undershot by €14½ billion.

… and clear move away from agreed consolidation measures

The 2012 central government budget represents a clear departure from the consolidation measures decided in June 2010. In addition to the foregone revenue that a financial transaction tax could have supplied, lower receipts from the nuclear fuel tax following the closure of a number of nuclear reactors, the transfer of proceeds from the sale of CO_2 emission permits to the Energy and Climate Fund, shortfalls resulting from the 2011 Tax Simplification Act and a €1 billion supplementary expenditure item for surplus personnel in the administration of the Federal Armed Forces, it has now been decided that cutbacks in special payments for public sector employees with civil servant status and retired civil servants should also be reversed and that investment in transport infrastructure should be increased. Including the gradual assumption of the costs of the basic allowance to ease the strain on local government, the total departure from the consolidation measures agreed for 2012 already amounts to around €8 billion (the total volume originally planned was €19 billion). This delay in consolidation comes at a time when the economic conditions continue to be rather favourable (according to the baseline scenario in the current macroeconomic forecasts) and when the demographic burdens are still relatively limited. Policymakers are thus putting off the essential task of adjusting fiscal policy to the debt brake's increasingly strict borrowing limits, running the risk of ultimately having to implement these adjustments in a much tougher environment.

13 In this estimate, central government is expected to receive an extra €2½ billion in revenue overall compared with the estimate from May 2011. However, the summer draft budget already contained an additional €2 billion vis-à-vis the May estimate to offset shortfalls as a result of legislative changes, which at that time were only in the planning phase but most of which have now been taken into account in the tax estimate. The upward correction stated in the article results from this sum plus additional planned tax relief measures of €½ billion.

Off-budget entities record deficit in Q3, but surplus likely for year as a whole

Central government's off-budget entities recorded a deficit of €4 billion in the third quarter of 2011 compared with just over €1 billion in the same period last year. SoFFin posted a deficit of €2½ billion chiefly due to a capital injection for HRE's resolution agency – which is also ascribed to the government sector – compared with a surplus from guarantee fees of €½ billion one year previously. As in the third quarter of 2010, there was a net outflow of €1½ billion from the Investment and Repayment Fund set up in the spring of 2009 to overcome the economic crisis. Investment by state and local government generated expenditure of €1 billion. In total, there is still almost €2 billion (of an original €10 billion) available until the end of the year for this purpose alone. For the year as a whole, central government's off-budget entities are expected to record a surplus of more than €5 billion, compared with a deficit of €7 billion in 2010. In addition to the high cash surplus that SoFFin can be expected to record if no further support measures are agreed,[14] the transfers booked to the pension reserves, the Restructuring Fund's income from the new bank levy as well as inflows to the special fund "Provision for final payments for inflation-indexed Federal securities" booked as interest expenditure for both central government and for the purposes of the Maastricht deficit will make a particular contribution to this surplus.

State government[15]

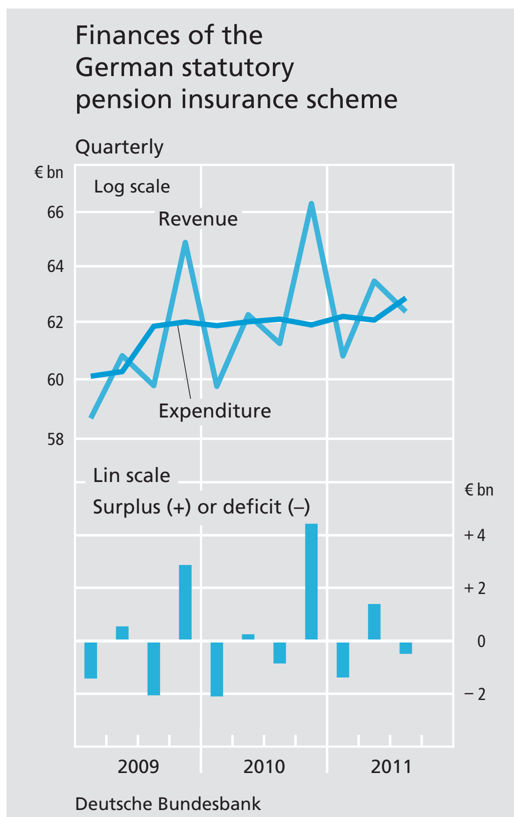
Improvement continues in Q3

State government budgets continued to improve in the third quarter. The deficit of state government's core budgets fell by €2½ billion to €3 billion compared with the same period one year previously. Revenue rose sharply by 7½% (€5 billion). In addition to tax revenue (+6½%, or €3 billion), receipts from other levels of government recorded especially strong growth (+11½%, or €2 billion), partly as a result of the €½ billion in consolidation assistance granted to the five federal states entitled to such funds. Although growth in spending was slower than that in revenue, it was still considerable (+3½%, or €2½ billion). In addition to the sharp rise in current transfers to local government (+6½%, or €1 billion), the development of personnel expenditure (+3½%, or €1 billion) following the rise in negotiated pay rates in spring and the – in some cases delayed – extension to public sector employees with civil servant status and retired civil servants were a key factor.

Sharp deficit reduction in 2011 as a whole

The latest tax estimate forecasts further additional revenue for state government (€6½ billion) for 2011 compared with the May estimate, putting year-on-year growth in revenue at €13½ billion (6½%). Given this situation, despite higher personnel expenditure and transfers to local government, and contrary to the budget plans, the deficit is likely to fall sharply for the year as a whole (2010: €21 billion). Nevertheless, some federal states for which the Stability Council has not de-

14 Write-downs on the assets of resolution agencies due to debt forgiveness are not recorded in the financial statistics. As a rule, they are included in the Maastricht deficit provided that no decreases in value were already priced in when the assets were allocated to the government sector.
15 The development of local government finances in the second quarter of 2011 was analysed in greater detail in the short articles in the Bundesbank's October 2011 Monthly Report. These are the most recent data available.



clared impending budgetary hardship are still posting sizeable financial deficits. It seems all the more important to use the relatively favourable macroeconomic conditions (according to the baseline scenario in the current forecasts) for consolidation measures. Defining more ambitious, binding consolidation paths for the period before the new debt rule comes into force (in 2020 at the latest) could help this process.[16] Tax cuts without counter-financing would inflate the need for consolidation accordingly and increase the threat to the constitutional requirement of a balanced budget in states with high starting deficits.

Fiscal surveillance by Stability Council

At its next meeting on 1 December, the Stability Council will focus in particular on the current stability reports for 2011 as well as the five-year restructuring programmes to be agreed for the four federal states for which it declared impending budgetary hardship in May 2011 (Berlin, Bremen, Saarland and Schleswig-Holstein). In this context, it seems essential for the restructuring programmes to lay the ground for a rapid and sustainable reduction of structural borrowing. For this purpose, it would be helpful to clearly set out the details of sufficiently extensive consolidation measures that will be effective over a number of years, and to enshrine in law a commitment to make appropriate corrections if benchmarks are missed. To improve the transparency and comparability of the budgetary circumstances of the individual governments, it would also be desirable to expand the regular reporting requirements and to establish a closer connection between the key figures to be reported and the applicable borrowing limits.[17]

Social security funds[18]

Statutory pension insurance scheme

Lower deficit than one year previously

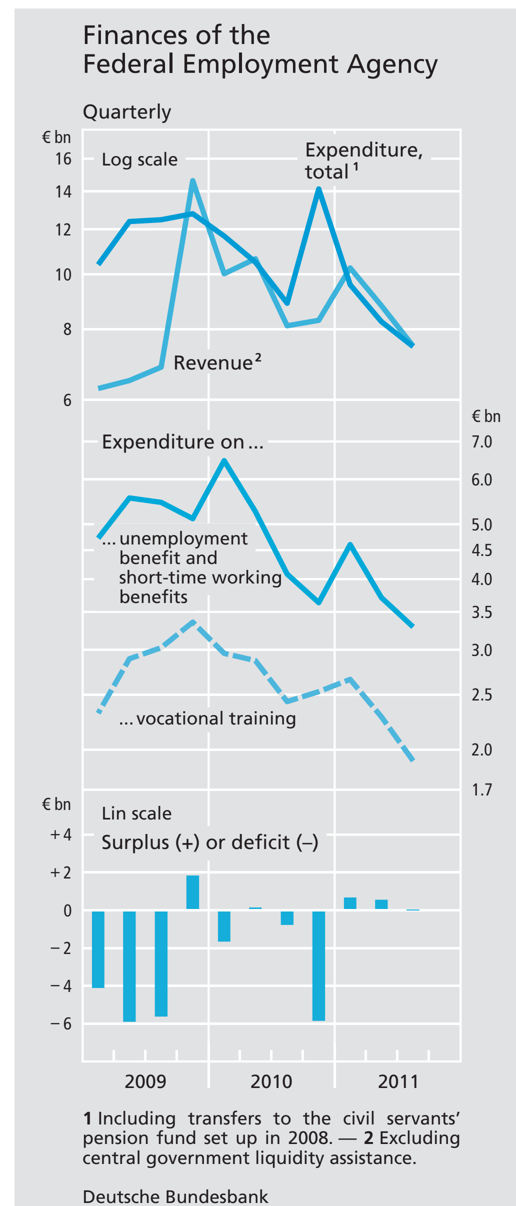
The statutory pension insurance scheme recorded a deficit of €½ billion in the third quarter of 2011. However, one year previously the deficit still amounted to €1 billion. Contribution receipts increased by a total of

16 For more details, see Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40.
17 For more details on the information contained in this section, see Deutsche Bundesbank, The role of the Stability Council, Monthly Report, October 2011, pp 20-23.
18 The financial development of the statutory health and public long-term care insurance schemes in the second quarter of 2011 was analysed in the short articles of the September Monthly Report. These are the most recent data available.

2½% in the third quarter. Employees' compulsory contributions rose more strongly (by almost 4%) owing to the favourable employment and pay trends. By contrast, contributions for recipients of unemployment benefits fell by almost 45%. This was due in particular to the fact that since the beginning of 2011 pension contributions have no longer been paid on behalf of recipients of unemployment benefit II. However, revenue growth was also dampened by the stagnation on balance of transfers from the central government budget. Following the previous freeze in pension adjustments, pension payments climbed at a slightly faster pace again owing to the increase of almost 1% in mid-2011. Nevertheless, the rise was still moderate as the number of pensions grew only very marginally and the number of new pensions was relatively low on average, probably due partly to a sharper increase in pensions for persons with a reduced earning capacity, which are lower on average. At almost 5%, the contributions that the pension insurance scheme has to pay to the health insurance scheme on behalf of pensioners grew at a much sharper rate owing to the rise in the latter scheme's contribution rate.

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

Temporary easing in financial situation before demographic burdens rise

The statutory pension insurance scheme is expected to record a clear surplus for 2011 as a whole. Even if economic activity slows somewhat, a surplus is again likely in 2012. As the reserves held at the end of 2012 will probably exceed the threshold of 1.5 times the scheme's monthly expenditure if the contribution rate remains unchanged, the contribution rate has to be cut. As the post-war baby boomers increasingly enter retirement from 2015 at the latest, the financial situation of the statutory pension insurance scheme will lastingly deteriorate and the contribution rate will be subject to constant upward pressure. The current positive financial situation is thus only of a temporary nature and offers no scope for a permanent expansion of benefits.

Federal Employment Agency

Financial improvement understated due to special effect

In the third quarter, the Federal Employment Agency recorded a virtually balanced budget compared with a deficit of close to €1 billion in the same period last year. However, the year-on-year comparison is still distorted by the time lags affecting payment flows between central government and the Federal Employment Agency. As just over €½ billion less in central government funds were paid out in advance from July to September 2011, the actual financial improvement is likely to be greater. In unadjusted terms, however, revenue was 8% and expenditure 16% lower than one year previously. The sharp rise in employees' contributions (+12½%) is predominantly attributable to the contribution rate being raised from 2.8% to 3.0%. However, even after adjustment for this effect, contributions grew by almost 5%. This additional revenue was fully offset by shortfalls resulting from the absence of insolvency benefit contributions in 2011. The decline in total revenue in the third quarter is thus almost entirely due to lower advance payments from central government. The decline in expenditure is mainly the result of lower payments for unemployment benefits (-14%) and for active labour market policy (-21%).

Federal Employment Agency structurally underfinanced

For 2011 as a whole, the Federal Employment Agency's financial situation will be far more favourable than the deficit of €5½ billion in the budget plan. A central government loan, which is still likely to be required, will probably be repaid for the most part next year thanks to surpluses. However, the contribution rate of 3.0% is likely to be too low to fund expenditure over the economic cycle in the long run, in particular owing to the planned halving of the VAT-financed grants from central government.[19]

19 See Deutsche Bundesbank, Sustainable contribution rate for the Federal Employment Agency, Monthly Report, August 2011, pp 76-77.