Public finances*

General government budget

Decline in deficit in 2011 …

Following a sharp deterioration in German public finances over the past two years, a marked decline in the deficit ratio is expected in 2011.[1] The Federal Government's recent estimate of 1½% appears realistic, provided the financial crisis and the sovereign debt crisis do not cause any major new strains. The buoyant macroeconomic development is considerably facilitating the task of deficit reduction. Given that production capacity utilisation has returned to more or less normal levels, the deficit ratio (after adjustment for cyclical influences) will probably also be around 1½%. All other things being equal, the lower deficit, coupled with relatively high nominal growth in the gross domestic product (GDP), should *per se* bring the debt ratio down considerably from its record 2010 level of 83.2%.[2] However, there is uncertainty in particular in connection with aid programmes for euro-area countries and support measures for German financial institutions.

… especially due to falling expenditure ratio

The government revenue ratio is likely to increase somewhat in 2011. Following sizeable cuts in tax and social contribution rates between 2008 and 2010, legislative changes are expected to result in additional revenue on bal-

* 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, a deficit ratio of 3.3% was announced for 2010. This figure is expected to be revised upwards somewhat in September.
2 This figure includes debt in connection with support measures for financial institutions of 13½% of GDP since 2008. This is largely offset by financial assets, which are, however, prone to risk.

ance in 2011. By contrast, the expenditure ratio is likely to fall significantly. This is predominantly attributable to favourable economic developments, which are chiefly reflected in the increase in GDP in the denominator. Furthermore, according to the latest information, capital transfers to support financial institutions could be dropped for the most part.

Decline in deficit could continue in 2012, but to a lesser extent

From the current perspective, the deficit is expected to contract further in 2012, albeit at a slower pace. Although the Federal Government has now watered down its consolidation plans from the summer of 2010, *inter alia* by virtue of the new energy strategy, in the absence of additional deficit-increasing measures, the expenditure ratio is nevertheless likely to fall, while the revenue ratio could remain virtually unchanged. Economic developments will probably play only a minor role in this context. Of greater importance is the fact that the current regulations mute pension growth and labour market expenditure is expected to decline once again in structural terms. Furthermore, the temporary economic stimuli (above all the investment programmes, which have an especially large time lag) will continue to be phased out.

Rapidly achieve balanced budget in good times

The relatively favourable developments and lower deficits than in previous years should not, however, be allowed to mask the fact that fiscal consolidation is far from complete. Even in the economic upturn the deficit will still be substantial. Moreover, the debt ratio is very high, and demographic trends will soon place an additional strain on public coffers. The sovereign debt crisis has made it abundantly clear that political leeway requires sound public finances. Therefore, the medium-term objective of a close-to-balance structural budget ought to be achieved rapidly and, given a favourable overall economic setting, a surplus should also be recorded. Cuts in tax and social contribution rates are not appropriate at this juncture unless they are fully funded by counterfinancing measures. They would delay the consolidation of central and state government budgets required under the national debt brake, and the opportunity for consolidation provided by the currently favourable conditions might be missed. It is imperative that Germany quickly reduces its deficit, not least in light of the requirements of the Stability and Growth Pact and the objective of better safeguarding the euro area in the future by means of stricter budgetary rules.[3]

Budgetary development of central, state and local government

Tax revenue

Sharp rise in tax revenue in Q2

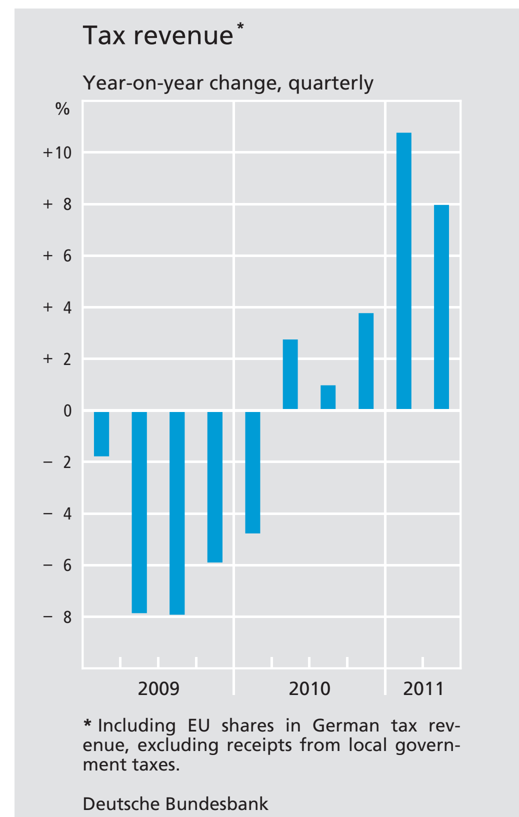
Tax revenue[4] was up by 8% on the year in the second quarter (see the chart and table on pages 61 and 66). The pace of growth was thus somewhat weaker than in the first quarter, but was nevertheless still strong. Revenue from income-related taxes rose by 11½%. The

3 The preventive arm of the Pact stipulates that, once the 3% limit is undershot, the structural deficit ratio should generally be reduced by ½ percentage point, and at an accelerated pace in "good times", until the medium-term budgetary objective is achieved. It is therefore linked to improvements in the structural deficit and not (as, for example, in the stability programme) to the planned deficit level.
4 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.

increase in wage tax receipts, which – before deducting child benefit and subsidies for supplementary private pension plans – was, however, somewhat lower than recorded in the cash flows, is likely to mainly reflect the positive pay and employment trends. Revenue from profit-related taxes went up by 10½%, chiefly as a result of the sharp growth in non-assessed taxes on earnings (especially investment income tax on dividends). Revenue from consumption-related taxes also rose (by just under 4½%). Growth in turnover tax receipts was largely in line with the macroeconomic reference variables. The reduction in the electricity and energy tax concessions as well as the new air traffic tax, in particular, also resulted in additional revenue.

Marked growth also expected for year as a whole

According to the official tax estimate from May, tax receipts for 2011 as a whole are expected to rise by 4½% (including local government taxes). This growth above all reflects underlying macroeconomic developments. Furthermore, profit-related taxes are likely to experience a rebound from 2010's muted level and legislative changes to result in additional revenue on balance (in particular, nuclear fuel tax, air traffic tax, tobacco tax and a reduction in the electricity and energy tax concessions). Since economic growth is currently expected to be higher,[5] and tax refunds in connection with the ruling on the Meilicke case[6] to be lower, revenue is now forecast to rise much more sharply, although growth will probably weaken during the course of the year.



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

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"Cold progression", ie the rise in income tax revenue due to a combination of inflation and the progressive rate of tax, also produces additional revenue. However, usually little attention is paid to the fact that, on the other hand, inflation reduces the real consumption tax burden as special excise duties (eg energy tax) are generally linked to quantity. Taking these opposing effects into account, if tax conditions remain unchanged, additional tax revenue resulting from cold progression is likely to amount to an extra €1½ billion each year between 2011 and 2013. If the impact on income

Cold progression only compensated for via counter-financing

5 The estimate was based on the Federal Government's macroeconomic forecast from April that predicted an increase in real GDP of 2.6% for 2011. At the current end, growth is expected to be around 3%.
6 The case concerns the recognition of corporation tax paid abroad in the taxation of dividends under the tax imputation procedure that was abolished in 2001. The Federal Government has estimated the associated shortfalls at just over €3½ billion for 2011 and just under €1½ billion for 2012. However, not least following the ruling of the European Court of Justice (of 30 June 2011; file number C-262/09) a delay and lower repayments seem plausible.

Decisions taken by the heads of state or government of the euro area and the institutions of the European Union on 21 July 2011

The founding principle of the euro area was to leave the responsibility for fiscal policy in the hands of each individual member state. However, at the same time, the need to safeguard joint monetary policy and other member states from the potentially unsound fiscal policies of individual countries was recognised. If fiscal policy were to be too expansionary on the whole, monetary policy would be forced to pursue a more restrictive path to maintain price stability. With regard to the sustainability of fiscal policy, if sovereign debt is high, there are greater incentives to exert pressure on the Eurosystem to ease monetary policy or to monetise sovereign debt in order to reduce the real burden of a high debt level by means of low interest rates or high inflation. Monetary policy should be protected first and foremost by the disciplining function of the financial markets and by regulations for national fiscal policies enshrined at European level. As an incentive to establish sound budgetary policy, it was codified in the Maastricht Treaty that neither the Community nor the member states may be liable for or assume the debt of another member state. The consequences of unsound fiscal policy, for example in the form of rising financing costs due to risk premiums on interest rates, were meant to be concentrated on the member state in question and not shared between other countries in the currency union as would be the case with joint liability or a transfer union. Furthermore, the Treaty and the supplementary Stability and Growth Pact set out regulations on national fiscal policy and, in particular, ceilings for the government deficit and debt ratios.

The fact that the current sovereign debt crisis was able to take hold in a number of euro-area countries despite these regulations is due to a number of reasons, the importance of which can differ greatly for each country affected. One key reason is that in many cases the fiscal regulations were not appropriately implemented, neither in the run-up to the financial crisis nor in the ensuing sharp economic downturn. In the case of Greece, this was aggravated by the fact that the statistics were severely lacking and, for many years, the public finance situation was presented in a considerably more favourable light than was actually the case. Furthermore, the underlying structural problems in a number of economies and their potential effects on financial markets and public finances were underestimated. In addition, financial investors' assessment of government budgets was evidently too optimistic and after a decade with only very low risk premiums on euro-area government bonds, the risk of rising interest rates appears to no longer have served as a sufficient deterrent.

Given the intensification of the sovereign debt crisis, at first Greece and then – as part of newly established rescue funds at euro-area and EU

1 See Deutsche Bundesbank, The assumption of guarantees in connection with a European Stabilisation Mechanism, Monthly Report, May 2010, pp 12-13; and Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2011, pp 22-23. — **2** In particular, the use of reverse majority under the Stability and Growth Pact and individual points regarding the procedure for macroeconomic imbalances are still contentious issues. — **3** For more information on the main features of the changes already agreed in March, see Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April

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level – Ireland and Portugal were granted financial assistance with the participation of the IMF. This financial assistance was tied to compliance with fiscal and economic policy conditions. While interest rates were fixed at well below market level, they were still noticeably higher than financing costs for member states with very high credit ratings.[1] From an economic perspective, given the threat for the stability of European monetary union, the assistance funds set up to ensure short-term stabilisation and the aid programmes with their strict fiscal and economic policy conditionality were by and large justifiable, even if the future incentives for sound public finances were weakened.

To at least partially compensate for this, changes to the framework of monetary union were drawn up in parallel with the aim of being able to better prevent future sovereign debt crises. However, no changes were made to the fundamental framework of monetary union. On the contrary, the no bail-out principle, member states' national responsibility for their own fiscal policy as well as investors' individual responsibility for their investment decisions remain constituent components of monetary union. Regarding prevention, planned measures mainly include modifications to the Stability and Growth Pact, the introduction of a procedure for macroeconomic imbalances and the "Euro Plus Pact" (EPP).[2] Although the proposed enhancement of prevention is a welcome development in principle, the approach appears to be too cautious, particularly with regard to the Stability and Growth Pact. In addition, the establishment of a European Stability Mechanism (ESM) was resolved to improve the handling of future sovereign debt crises – should they occur despite better prevention measures being in place – even after the European Financial Stability Facility (EFSF) has been wound up in mid-2013.[3]

At the beginning of July, uncertainty heightened on the financial markets and, *inter alia,* interest rates for the government bonds of some larger euro-area countries (including Italy and Spain[4]) rose. Against this background, decisions taken by the heads of state or government of the euro area and the institutions of the European Union on 21 July 2011 have after only a short interval (and even before the ratification process has begun in the countries in question) once again changed key areas of the proposed reforms. Moreover, assistance for Greece has been expanded significantly by announcing an additional €109 billion aid programme, which is to run until the end of 2014. A voluntary contribution by the private sector has also been proposed to plug Greece's financing gap. Furthermore, the maturity of future EFSF aid loans to Greece, Portugal and Ireland was extended to 15 to 30 years, and, in particular, the EFSF will largely refrain from adding an interest rate premium to its cost

2011, pp 53-58. — **4** In 1997, the year relevant for joining monetary union, government interest expenditure in Italy still amounted to 9.3% of gross domestic product (GDP) but dropped sharply to 4.5% by 2010 (Spain 1997: 4.7% and 2010: 1.9% of GDP). Although the observed increase in yields – had it persisted for a longer period of time – would have caused a gradual rise in additional expenditure, in the short term on no account would it have given rise to unsustainable fiscal burdens that would have necessitated immediate rescue measures. These countries should instead rapidly take credible measures to rebuild market confidence. For Spain, for example, even in the case of

Decisions taken by the heads of state or government of the euro area and the institutions of the European Union on 21 July 2011 (cont'd)

of funding for current programme countries. Lastly, it was resolved to appreciably extend the set of instruments available to the EFSF and the ESM without specifying any concrete details. They are to be able to intervene on a precautionary basis, allowed to provide loans also to governments of non-programme countries for recapitalising financial institutions, and have the option of buying government bonds in secondary markets.[5] However, the previously planned extension of Article 136 of the Treaty on the Functioning of the European Union to legally protect the ESM is not to be changed meaning that, in principle, the ESM is to be activated only as a measure of last resort to avert an immediate risk to the stability of the euro area as a whole, and financial assistance must be subject to strict conditionality.

The latest resolutions are another big step towards joint liability and weakening the disciplining function of capital markets, without noticeably increasing the influence and control over individual national fiscal policies as a *quid pro quo*. A fundamental drawback is that the new credit conditions considerably reduce the incentives for countries with an aid programme to make fiscal and economic reforms to enable as rapid a return as possible to sounder public finances and the capital market. If these conditions are also adopted for future aid programmes (or even for the ESM), this would perpetuate this problem of weakened incentives and encourage countries to apply for an aid programme. Secondary market purchases are an additional disincentive for appropriate fiscal policy.[6] While states with an unsound budgetary policy could count on receiving assistance, countries with sound finances would be increasingly called on to provide financing. This raises the question as to how, for example, an improved sanction mechanism in the Stability and Growth Pact is to prevent unsound national fiscal policies if, assuming the rules continue to be breached, protection from the capital market is ultimately granted at extremely beneficial conditions that are even much more favourable than those for some countries providing assistance. If the bonds of countries without aid programmes are purchased on the secondary market, it is not clear how countries can be strictly bound to consolidation and reform conditions and how this can be brought into line with the requirement of granting aid only as a measure of last resort to avert a risk to the stability of the euro area as a whole. These prerequisites likewise have to apply to any preventive programme. In any case, important basic principles, such as subsidiarity, national fiscal responsibility and the no bail-out rule – and thus also the disciplining function of the capital markets – will again be considerably weakened.

Greece has been granted an additional aid programme that is to secure funding for the govern-

a temporary sharp rise in interest rates, the interest expenditure ratio is likely to remain below the euro-area average in 2012 and, in Italy, this ratio is likely to be far lower than at the time it joined monetary union. — **5** Any future interventions on the secondary market by the EFSF and the ESM differ from bond purchases by the Eurosystem *inter alia* in that they are to be resolved – if necessary, following authorisation by parliament – unanimously by governments, under the no bail-

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ment during an adjustment period, which is now significantly longer. One key condition here should continue to be that the fiscal and economic policy adjustment measures originally agreed are actually implemented in full. To ensure that the conditionality for aid remains credible, an appropriate response to missed targets is not for the requirements of the aid programme to be watered down but for the programme country in question to rectify the matter. It must continue to be stressed that aid is granted only if the programme is implemented (conditionality). This also means that any interest cost savings as a result of more favourable credit conditions than envisaged in the original plan should be used for additional deficit reduction and not as compensation for any missed expenditure or revenue targets. The involvement of private creditors envisaged for Greece is voluntary and, overall, not without advantage for them (see also the comments on pages 68-71). The pledge by heads of state or government to provide Greek banks with sufficient collateral for funding and, if necessary, mobilise funds for recapitalisation is welcome. Supporting financial institutions that are no longer solvent – in adherence with European competition law – is without a doubt a task for fiscal policymakers. Also in this case, it is important to heed the separation of monetary from fiscal policy in line with the provisions stipulated in the Treaty. Monetary policymakers have no authorisation to redistribute such risks or burdens among the taxpayers of various euro-area countries.

Overall, there is a risk that the resolutions of 21 July will increasingly erode the originally agreed institutional framework of monetary union. While fiscal policy will continue to be determined by democratically elected parliaments at national level, the resultant risks and burdens will increasingly be borne by the Community in general and financially strong countries in particular, without this being offset by any much further reaching powers of intervention. There is currently nothing on the political agenda that would establish a joint European fiscal policy or a political union that would democratically empower a central entity to exert some control over national budgetary policies. This means there is a danger that the euro-area countries' propensity to incur debt may increase even further, and the pressure on the euro-area's single monetary policy to adopt an accommodating stance may grow. Unless and until a fundamental change of regime occurs involving an extensive surrender of national fiscal sovereignty, it is imperative that the no bail-out rule still enshrined in the treaties and the associated disciplining function of capital markets for national fiscal policies are not fatally weakened but strengthened.

out principle specified in the EU Treaty will generally be implemented only as a last resort to avert a risk to the financial market stability of the euro area as a whole and are to be made under a programme with appropriate conditionality. — **6** See Deutsche Bundesbank, The debate on secondary market purchases by the future European Stability Mechanism, Monthly Report, February 2011, pp 68-69.

Tax revenue

Type of tax	H1 2010 € billion	H1 2011 € billion	H1 Year-on-year change € billion	H1 Year-on-year change as %	Q2 2010 € billion	Q2 2011 € billion	Q2 Year-on-year change € billion	Q2 Year-on-year change as %	Estimate for 2011 [1, 2] Year-on-year percentage change
Tax revenue, total [2]	235.0	256.9	+ 21.8	+ 9.3	123.9	133.7	+ 9.9	+ 8.0	+ 4.4
of which									
Wage tax	60.7	66.6	+ 5.9	+ 9.8	30.4	34.1	+ 3.7	+ 12.1	+ 5.1
Profit-related taxes [3]	36.1	41.3	+ 5.2	+ 14.5	21.2	23.5	+ 2.3	+ 10.6	+ 2.3
Assessed income tax	15.8	16.1	+ 0.3	+ 1.8	9.7	9.4	– 0.3	– 3.3	– 9.6
Corporation tax	5.8	6.7	+ 0.9	+ 15.9	3.8	4.2	+ 0.4	+ 10.1	+ 11.8
Investment income tax [4]	14.5	18.5	+ 4.0	+ 27.9	7.7	9.9	+ 2.2	+ 28.4	+ 14.0
Turnover taxes [5]	87.2	93.5	+ 6.2	+ 7.2	44.3	46.1	+ 1.7	+ 3.9	+ 4.1
Energy tax	14.0	14.5	+ 0.4	+ 3.0	9.6	10.0	+ 0.4	+ 4.2	+ 0.5
Tobacco tax	5.8	6.2	+ 0.4	+ 7.0	3.3	3.3	– 0.0	– 0.8	– 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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tax is viewed in isolation, it is around twice as high. With regard to the discussion on reducing tax rates to compensate for this increase in the tax burden, in light of the still strained budgetary situation, it is essential that any tax cut is counterfinanced, so as to ensure that the original consolidation path is not watered down further and the success of the consolidation measures is not jeopardised.

Central government budget

Marked improvement in fiscal balance in Q2

Central government recorded a surplus of €3 billion in the second quarter of 2011 compared with a deficit of €5 billion one year previously. Revenue rose by 1½% (€1 billion). Tax receipts continued to increase sharply (7½%, or €5 billion). By contrast, other revenue was affected by the absence of the one-off effect of €4½ billion from the auction of radio frequencies that had been recorded one year previously. Conversely, higher inflows from business activities owing to the new railway dividends of €½ billion were far less significant. At almost 9% (-€7 billion), expenditure declined sharply. The most important contributory factors were payments to the social security funds (-€3 billion, which on balance was almost entirely due to lower transfers to the Federal Employment Agency) and interest expenditure (just over -€2½ billion). In the case of the latter, on the one hand, the previous year's figure was significantly overstated due to an advanced outflow and, on the other hand, there was additional expenditure due to discounts when issuing new securities. However, even without these special effects, the debt service burden is likely to have declined again somewhat. Fur-

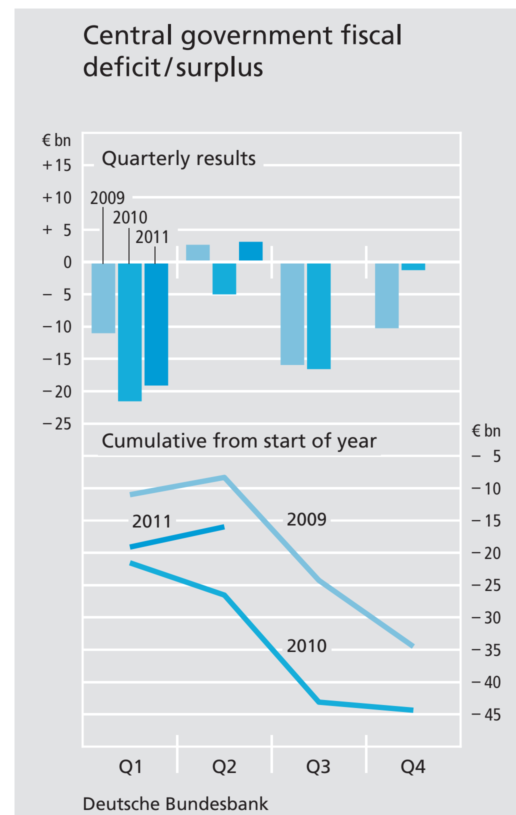
thermore, spending on unemployment benefit II fell by just over €½ billion – not least owing to central government cutting pension contributions on behalf of recipients of unemployment benefit II. By contrast, further relief as a result of favourable labour market developments is likely to have been masked by the subsequent payment of the increased amounts owing to higher standard rates with retroactive effect from the beginning of the year.

Lower-than-expected deficit for year as a whole

Central government has further lowered its estimate for new borrowing in 2011 to around €30 billion (budget plan: €48½ billion). Given that macroeconomic developments are now forecast to be even more favourable, the burdens arising from the Meilicke ruling are smaller than estimated and the transfers to the EU budget are lower, the additional income of €8 billion forecast on the basis of the tax estimate from May is once again likely to be significantly exceeded. Furthermore, if the number of unemployed persons continues to fall and the financing conditions for central government are favourable, expenditure will probably remain well below the estimates, meaning that an even greater undershooting of the planned deficit appears possible.

Considerable additional burdens despite new top-down procedure for drawing up 2012 budget

When drawing up the draft Federal budget for 2012, the Federal Government used a top-down procedure for the first time. The benchmark figures from mid-March set out budgets for the individual government departments. Thereafter, if the rules are resolutely implemented, adjustments may only be made in response to the effects of unexpectedly favourable or unfavourable macroeconomic developments. In this respect, only the revised revenue



expectations in the wake of the May tax estimate and higher loan repayments from the Federal Employment Agency would have been regarded as positive and, by contrast, the upward revisions to interest costs would have been considered negative. However, in connection with the new energy strategy, the decision was also taken to permanently shut down older nuclear reactors and bear the ensuing nuclear fuel tax shortfalls, as well as to transfer the proceeds from CO_2 emissions certificates, which have so far gone to the Federal budget, to the Energy and Climate Fund. Along with additional expenditure resulting from the surplus of personnel in the Federal Armed Forces and the income foregone from the financial transaction tax, the additional burdens in the draft budget from July amount to almost €5 billion vis-à-vis the benchmark

Proposal for an effective private sector involvement for bond issues from mid-2013 onwards

The fundamental importance of sound public finances within the euro area to ensuring an independent and stability-oriented monetary policy is abundantly clear at present. Where there is a lack of direct, centralised powers to intervene in national budgets, fiscal-policy rules as well as, in particular, the disciplining effect of the financial markets on national fiscal policies play a key role (see box on pages 62-65). If investors believe that the servicing of government bonds may become jeopardised by unsound fiscal policy, then they have cause to demand higher interest ex ante. The possibility of rising interest rates strengthens the financial incentives to pursue a more ambitious budgetary policy. They are likely to have a far greater effect than reprimands and recommendations from European institutions. For this disciplining effect via the capital markets to remain intact, however, investors actually have to believe that they will bear potential losses. If, on the other hand, they expect government rescue funds, say, to relieve them of any losses, this incentive to pursue sound budgetary policies will be lost.

For this reason, the Treaty on the Functioning of the European Union (TFEU) bans governments from assuming liability for the debts of other states ("no bail-out" clause). In the event of the imminent insolvency of one state, however, a trade-off can occur between the liability of private investors and the safeguarding of financial stability. This prompted the European Council to propose, in March 2011, a supplement to the TEFU whereby a stability mechanism may be established and financial aid given under strict conditionality in order to ensure the stability of the euro area as a whole. If a country is no longer in a position to service its debts despite massive consolidation and reform efforts (or if the state fails to undertake the necessary efforts and violates the conditions), the creditors must, as a general principle, nevertheless continue to assume that their claims will not be met in full.

On 21 July 2011, the European Council resolved that the substantial expansion of government assistance for Greece is to be linked to the participation of private creditors of that country. This is essentially in keeping with the European agreements; however, the concrete framework conditions have ultimately made effective implementation almost impossible in this particular case. First, a sizeable part of Greek sovereign debt is already held by public creditors, above all because maturing debt securities have for some time now been passed to the countries providing assistance. Private creditors have thus been able to reduce their liability risks. Second, there was the danger that a moderate, yet enforced waiver of claims – which was also a topic of debate prior to the summit meeting – would have jeopardised euro-area financial stability without getting to the root of Greece's problems. In the end, the

1 Particularly in the case of bonds with long residual maturities, creditors probably stand to gain a financial advantage by swapping given the guarantee linked to the swap. Although the possibility of extending the scope of the swap to include bond maturities after

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idea of involving private creditors on a mandatory basis was rejected. Moreover, it was agreed that extensive government guarantees would be furnished as collateral for voluntarily swapped bonds. The form that private sector involvement will ultimately take has not yet been decided. However, it can probably be expected that the overall package will impose very strict limits on the contribution made by private creditors,[1] and, above all, that there will be a further transfer of risk to the countries providing assistance.

In view of the severe problems that have become evident with regard to implementing private sector involvement, it will be important in future to make it as effective, ie as goal-oriented, as possible. On the one hand, the potential trade-off between financial market stability and the assumption of liability by private creditors ought to be reduced by strengthening financial market stability – over and above what is planned or already implemented – by suitable measures in the regulation and supervision of financial markets. Moreover, the EMU rules need to be adjusted in a way that prevents private creditors from offloading their liability after just a short period of time at the expense of aid-providing countries' taxpayers the moment a euro-area member state appears to be on the verge of difficulties. This objective is likely to be achieved only to a very limited extent under the provisions contained in the draft European Stability Mechanism (ESM) treaty on private sector involvement and the planned collective action clauses (CACs), which from July 2013 onwards are to be included in the terms and conditions of all new euro-area government bonds with a maturity of more than one year. The draft ESM treaty does envisage initiatives by the member state receiving assistance in the event of liquidity risks, the aim being to encourage the most important private investors to hold on to their exposure; however, there are doubts as to whether such negotiations would be very successful, since private investors in particular will have little interest in extended maturities.

A pragmatic and fairly simple approach towards achieving an effective private sector involvement would be to extend the terms of bonds issued by euro-area member states.[2] In this way, the terms of all newly issued euro-area government bonds could include not only the already planned CACs but also a standard trigger clause concerning the bond's maturity. Such a clause would stipulate that the regular maturity (eg five or ten years) of each bond would be automatically extended by three years (to a total of eight or thirteen years) as soon as the ESM grants financial assistance to the country in question. During this extended maturity, the bond would continue to be subject to the agreed bond terms. Three years could be an appropriate (fixed) period, because a large part of the necessary re-

2020 is evidently under discussion, it does not appear to be inevitable under the present circumstances, not least given Greece's access to capital. — **2** See AA Weber, J Ulbrich and K Wendorff, Finanzmarktstabilität sichern, Investorenverantwortung stärken, Steuerzahler scho-

Proposal for an effective private sector involvement for bond issues from mid-2013 onwards (cont'd)

form and consolidation efforts by the country concerned would have to be carried out by the end of that period. A trigger clause that is firmly anchored in the bond terms would offer an array of important benefits.

Should it become apparent only in the course of the first three years of the period of assistance that a restructuring of sovereign debt is unavoidable, considerable risks would not have to be concentrated on a much smaller group of private creditors or transferred to the taxpayers of the countries providing assistance. One key advantage for countries providing assistance, moreover, is that the need for support within the framework of the assistance programmes would be dramatically reduced; "only" the current deficits (interest payments and primary deficits) would need to be refinanced. These would probably make up by far the smaller part of the overall funding requirement – for instance, more than two-thirds of the loans to Greece under the first aid package were used to refinance maturing bonds. The maturity extension clause could thus very sharply reduce the volume required by the assistance fund. In the event of a crisis, the maturity extension clause would improve the maturity structure of the debt of countries receiving assistance. At the same time, particularly if a country unexpectedly suffers financial distress through no fault of its own (and therefore previously had relatively favourable financing conditions), the interest payments on the extended bonds would probably be fairly low. In addition, these countries would have planning certainty with regard to interest payments for the duration of the extended maturity.

The inclusion of a maturity extension clause would do more to enhance financial market stability than an ESM programme without this additional measure. The European Council has agreed to accord ESM loans preferred creditor status, analogous to IMF conditionality. This preferred creditor status is crucial as a means of protecting taxpayers in the countries providing assistance and ought to be non-negotiable in the future. However, without an automatic extension of maturities, this status could on the whole also have some undesirable implications for financial stability. For instance, creditors of short-term bonds would get off largely risk-free, whereas creditors of longer-dated paper might have to participate in any unavoidable future restructuring. These investors would then have to bear heavier losses than if there had been no assistance programme: their claims would be subordinated to those of the IMF and the ESM, and in the event of restructuring they would have to take the entire haircut. The greater the share of preferred debt, which itself largely stems from the financing of maturing paper, the larger the haircut. This could put additional downward pressure on the prices of long-dated instruments.

nen. Ein Vorschlag zur Stärkung des Europäischen Stabilitätsmechanismus durch die geeignete Ausgestaltung künftiger Anleihekonditionen, Frankfurter Allgemeine Zeitung, 3 March 2011 (English translation available at http://www.bundesbank.de/presse/presse_aktuell.

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Secondary market purchases, which should also be rejected for other fundamental reasons, would exacerbate this development further.

By contrast, incorporating a maturity-extending trigger clause into the terms of government bonds would mean that, notwithstanding the length of the residual maturity, all private creditors of the bonds of the country in question would face a similar default risk. This would spread any price losses across more shoulders, making them easier to cope with. In addition, it would ensure that financial investors continue to bear responsibility for their investment decision and that liability is not passed on to the taxpayer in the event of a crisis. Unlike moratoriums for which there are no ex ante provisions, the explicit inclusion of a maturity clause in bond terms would mitigate contagion effects. Thus, there would be no failure to comply (default) on the part of the debtor, since the procedure would have been laid down ex ante in the bond terms. Moreover, where a maturity extension is already provided for in the terms, the direct impact on credit default swap contracts and automatic rating downgrades should remain within limits – and hardly differ from what it would be if ESM loans were granted without an automatic extension clause. Thus, changeover problems associated with amending the bond terms are also likely to be limited, since the bond terms will be fundamentally changed in any case given the firm plans to include CACs.

Sovereign debtors may, as a general principle, incur higher costs from investors factoring in the specific risk of a maturity extension when they purchase government bonds subject to such conditionality. However, with the increasing likelihood of an application for ESM assistance being made and granted during the regular maturity, the interest rate expected when the bonds are issued would, at most, come close to the interest rates of bonds which have a maturity running three years longer from the outset. Countries with a good credit rating would probably hardly see any increase in interest rates. The interest rate spread would also remain limited for countries with a poorer credit rating and a higher probability of EMS utilisation. The European Council has in any case already agreed that more emphasis be put on medium and long-term debt. However, the yield curve is usually relatively flat in this maturity segment, meaning that a potentially longer maturity would carry no more than a relatively benign premium. The interest payments could even be lower on the whole if the proposed bond conditionality reduces the likelihood of a transfer to overindebted countries, and if a more effective disciplining of the markets throughout the euro area leads to a more stability-oriented fiscal policy.

en.php). A differently structured option to extend foreign currency debt is proposed by WH Buiter and AC Sibert (1999), UDROP: a contribution to the new international financial architecture, International Finance 2 (2), pp 227-247.

figures. This has not been compensated for by means of new consolidation measures. Rather, these effects were accounted for on a one-off basis with a discretionary supplement (with regard to compliance with the debt brake, this is treated as entirely structural) on tax revenue (€2 billion compared with the May tax estimate) as well as higher forecast proceeds from asset realisations.

Mostly cautious estimates in 2012 draft budget …

Overall, the 2012 draft budget passed by the Federal Cabinet foresees net borrowing of €27.2 billion. Compared with the actual result for 2011 expected by the Federal Government, this amounts to only a small decrease. The improved economic situation and higher (net) proceeds from sales of financial assets even produce an increase in the structural deficit. However, the estimates appear to be rather cautious. Although the discretionary supplement on the tax estimate result poses procedural problems (as it permits the creation of budgetary leeway when needed in the short term), as things currently stand, it is justified in objective terms and even higher additional revenue appears plausible. On the expenditure side, it is likely that above all estimates for interest and for long-term unemployment have been calculated cautiously. Overall, it seems that a significantly lower deficit can be achieved.

… and departure from 2010 consolidation programme

Despite these more favourable developments, the draft budget constitutes a clear departure from the volume of consolidation agreed in June 2010, which the impact of the very favourable economic developments only masks. The burdens vis-à-vis the benchmark figures plus the shortfalls owing to the planned 2011 Tax Simplification Act (overall amounting to €5½ billion), which were already included in the calculation of these figures, are considerably delaying deficit reduction.

Implementation of debt brake at odds with intention

This easing of fiscal policy during the upturn is facilitated by problematic room for manoeuvre having been created when implementing the debt brake. For example, the starting value for the structural deficit limit, which was set in spring last year and is to be reduced gradually by 2016, has still not been adjusted for the considerably more favourable actual result for 2010. This produces additional scope for borrowing in 2012 of up to approximately €15 billion, as the upper limit was set at €40 billion rather than just over €25 billion. According to the draft budget, the structural deficit will amount to €29½ billion (although, given the rather cautious budgetary estimates, the stricter limit also appears within reach). If the room for manoeuvre created by not adjusting the upper limit were to be exhausted, the currently favourable setting for far-reaching budgetary consolidation would go unused.

Problematic cyclical adjustment procedure

In this connection, a further cause for concern is the fact that despite the forecast good capacity utilisation for 2012, a cyclically induced burden for the Federal budget of €3 billion is still estimated and the scope for new borrowing will be increased accordingly. The cyclical adjustment procedure based on the modified EU approach therefore appears unsuitable for the debt brake, also particularly given its design weakness. It is therefore advisable to revert back to the procedure used last year, which is considerably more straightforward.

Medium-term financial plan and permissible net borrowing of central government under the debt rule

€ billion

Item	Actual 2010	Target 2011	Draft 2012	Financial plan 2013	2014	2015
Expenditure [1]	303.6	305.8	306.0	311.5	309.9	315.0
of which Investment [2]	26.1	26.9	26.4	25.3	25.1	24.9
Revenue [1, 3]	259.6	257.4	278.9	286.6	291.2	300.3
of which Tax revenue [1]	226.2	229.2	247.4	256.4	265.8	275.7
Net borrowing	44.0	48.4	27.2	24.9	18.7	14.7
plus cyclical component [4]	– 12.3	– 2.5	– 2.8	– 2.2	– 1.3	– 0.0
plus balance of financial transactions [5]	0.9	– 5.0	4.8	0.6	– 4.3	– 5.2
Structural net borrowing	32.6	40.9	29.2	23.3	13.1	9.5
as a percentage of GDP [6]	1.4	1.7	1.2	0.9	0.5	0.3
Memo item						
Structural net borrowing [7]						
Upper limit according to Federal Ministry of Finance	53.2	45.6	39.8	33.1	26.0	18.2
Upper limit if actual 2010 result is reduced in equal steps	32.6	28.6	25.6	22.1	18.4	14.3

1 After deducting supplementary central government grants, shares in energy tax revenue, compensation as part of the 2009 motor vehicle tax reform and consolidation assistance from 2011 onwards, which are all remitted to state government. 2014 and 2015 including global savings of €4.8 billion each year from the "package for the future". — **2** Excluding loans to the Federal Employment Agency and participating interests in ESM. — **3** Including proceeds from coin seigniorage. — **4** For 2010, current estimate of the Federal Ministry of Finance. For 2011, in accordance with budget plan. For 2012 to 2015, current estimate of the Federal Ministry of Finance (date: spring forecast 2011, see Federal Ministry of Finance, Monthly Report, May 2011, p 132 (complete report available in German only)). — **5** For 2010, in accordance with cash statistics data. — **6** Nominal GDP in the year preceding the drafting of the budget; for 2010, GDP in 2009 (date: spring forecast 2011). — **7** Central government does not record an actual result for structural net borrowing for the base year 2010. The deficit reduction path from 2011 onwards (upper limits), which was laid down in 2010, is based on last year's forecast of the starting structural deficit value of 2.2% of GDP in 2010 and stipulates a reduction of 0.3% of GDP each year.

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Inclusion of financial transactions

By contrast, in the case of financial transactions, attempts are being made to produce a more appropriate economic definition, which would, for example, treat transfers to multilateral development banks in the amount of almost €1 billion as transfers rather than as participating interests, under which they have been recorded to date. However, interest-free loans without a fixed redemption date that are granted to the Federal Employment Agency are to continue to be classified as financial transactions and thus not fall under the debt brake.

Financial plan up to 2015 records marked structural deficit reduction, but also contains sizeable risks

The financial plan envisages a further gradual reduction in net borrowing to €14½ billion by 2015. Assuming normal capacity utilisation and high burdens stemming from financial transactions – particularly from the capital transfer to the ESM – this would mean that the limit for structural new borrowing of 0.35% of GDP, which applies from 2016 onwards, would already be complied with in 2015. However, the plan entails substantial risks. For example, the calculation includes income of €2 billion per year from 2013 onwards stemming from a financial transaction tax that has not yet been specified. Furthermore, global savings of €5 billion are planned for both 2014 and 2015, but they have yet to be finalised. Moreover, the government assumes that defence expenditure will be reduced by just over €1 billion by 2015, despite rising pay levels. In addition, given annual real GDP growth of just over 1½%, it is assumed that the output gap will not be closed until 2015. However, in the past, visible optimism with regard to the growth trend has often resulted in the financial plan

goals being abandoned owing to comparatively weaker economic developments. Since the debt brake is intended to prevent an accumulation of debt in the future, it is imperative that a margin of safety is set below the deficit ceiling so as to avoid procyclical consolidation in the case of unwelcome surprises.

Central government's off-budget entities record high surplus

Central government's off-budget entities recorded a surplus of €12½ billion in the second quarter compared with a deficit of €2½ billion in the same period last year. This was mainly due to the repayment to SoFFin of the capital assistance granted during the financial crisis. The Investment and Repayment Fund still has around €3 billion of funds that can be requested for investment purposes during the remainder of the year, well after the end of the economic slump. For the year as a whole, the off-budget entities could record a surplus of around €5 billion, compared with a deficit of €7 billion in 2010.

State government[7]

Surplus in Q2

The financial situation of state government continued to improve in the second quarter. Following a deficit of €½ billion one year previously, the core budgets posted a surplus of €1½ billion. The main reason for this was a further sharp increase in revenue of just under 8½% (€5½ billion). Tax revenue alone went up by almost €4 billion (+8%). At the same time, expenditure grew at a similarly strong pace (just under 5½%, or €3½ billion), which is attributable not least to €1½ billion higher current transfers to local government. In addition, personnel costs likewise rose at an accelerated pace owing to the recent pay agreement, which also broadly applies to both public sector employees with civil servant status and retired civil servants (+3%).

Improvement expected for year as a whole, …

A decline in the deficit is also expected for the year as a whole, although growth in tax revenue is likely to weaken during the remainder of the year and spending on personnel and other operating expenditure as well as transfers to local government will probably continue to increase significantly. By contrast, a total deficit of just over €23½ billion is still assumed in the budget plans, following an actual result of €21½ billion in 2010.

… although overshooting of regular borrowing limits planned

The fact that many federal states plan to overshoot the regular borrowing limits by invoking the exemption clause that it serves to avert a disruption of the macroeconomic equilibrium, despite the exceptionally favourable economic developments, is extremely problematic. The notion that it is impossible to comply with the debt brake owing to extreme budgetary hardship, as in the case of Bremen, is even less comprehensible. It was only in spring 2011 that recipients of consolidation aid undertook to reduce their structural new borrowing to zero by 2020. Given the moderate growth in tax revenue which can be assumed up until then, in order to achieve this, extensive reduction opportunities must be included in the budget and adopted in any restructuring programme to be agreed. This would make it unlikely for there to be an extreme situation of budgetary hardship in which all revenue leeway has al-

7 The development of local government finances in the first quarter of 2011 was analysed in greater detail in the short article in the Bundesbank Monthly Report of July 2011. These are the most recent data available.

ready been made use of and all possible expenditure cuts have already been implemented.

Sluggish implementation of the new debt rules

To date, the implementation of the new debt rules has been hesitant. Alongside Schleswig-Holstein, Rhineland-Palatinate and Hesse, Mecklenburg-West Pomerania has now also implemented the debt brake of the Basic Law (*Grundgesetz*) in its state government constitution. However, like in the other three federal states, it appears that the more precise arrangements remain largely open. In the other federal states there are at most regulations in the budgetary laws that can – as is evidently also currently planned in Baden-Württemberg – be adjusted as and when necessary. The fact that some federal states have even assumed additional budgetary burdens, despite the reduction in new borrowing that is to be achieved by 2020, and are postponing necessary consolidation measures, should also be viewed critically. Given this general climate and the considerable need for consolidation in some federal states, tax cuts that are not counterfinanced would also be problematic from the perspective of state government in the coming years.

Stability Council determines imminent budgetary hardship in four federal states receiving consolidation aid

At its meeting in May, the Stability Council – the successor to the Financial Planning Council of central and state government – determined, as expected, that in four of the five federal states with a fundamental entitlement to consolidation aid (Bremen, Saarland, Schleswig-Holstein and Berlin) there is also a threat of budgetary hardship.[8] Consequently, these federal states must additionally present five-year restructuring programmes that contain concrete measures – at least for the subsequent budget – for the gradual reduction of net borrowing. The federal states concerned and the Stability Council intend to agree on these at the next meeting in November. Owing to the inflated starting level for the deficit reduction paths,[9] particular attention should be paid to making sure that, in accordance with section 5 of the Stability Council Act (*Stabilitätsratsgesetz*), measures are implemented to ensure the calculated deficit reduction steps, rather than the distorted levels, are fulfilled in their entirety, insofar as this cannot be achieved by means of purely structural relief from the tax estimate. Otherwise, there is a risk of more or less passing up the currently favourable macroeconomic setting for far-reaching budgetary consolidation. It would also seem advisable to set concrete sanctions in case deviations are made from the respective programmes.

Social security funds[10]

Statutory pension insurance scheme

Higher surplus in Q2

The statutory pension insurance scheme recorded a surplus of almost €1½ billion in the second quarter, which was just over €1 billion higher than one year previously. While revenue

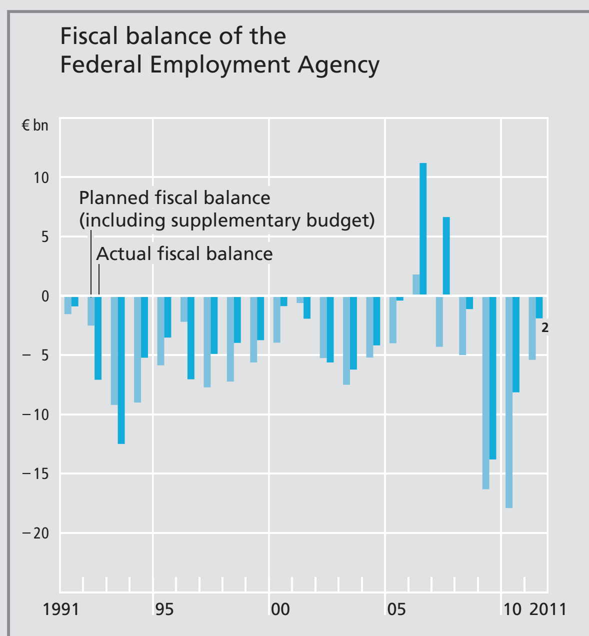
8 See press release on the third meeting of the Stability Council on 23 May 2011 at www.stabilitaetsrat.de (available in German only).
9 See Deutsche Bundesbank, German states receiving consolidation aid – initial deficit reduction requirements not very ambitious, Monthly Report, May 2011, pp 70-71.
10 The financial development of the statutory health and public long-term care insurance schemes in the first quarter of 2011 was analysed in the short articles of the Monthly Reports of June and July. These are the most recent data available.

Sustainable contribution rate for the Federal Employment Agency

The Federal Employment Agency's main source of funding comes from insurance contributions. Last year, such contributions accounted for approximately three-fifths of its revenue. The second largest source of revenue was the rule-based central government grant, which covered roughly €8 billion, or just over 17%, of expenditure in 2010.[1] Economic justification for regular tax grants can be derived from the concept of "non-insurance-related benefits" that are not to be financed solely by contribution payers. Although a universal definition of these benefits is not possible, there is much to suggest that they are likely to be more or less covered by current central government funds. In addition, in 2010 the Federal Employment Agency recorded income from insolvency benefit contributions, refunds of administrative costs for support for the long-term unemployed, taking recourse to remaining reserves and from an extraordinary central government grant to offset losses.

The contribution rate to the Federal Employment Agency was raised from 4.3% to 6.5% at the start of the 1990s, following German reunification, where it remained until

Fiscal balance of the Federal Employment Agency



it was cut to 4.2% in 2007 and 3.3% in 2008 and 2009. The rate was subsequently lowered to 2.8% as part of the economic stimulus programme. The rate has stayed put at 3.0% since the beginning of 2011. In the past, the respective contribution rate was usually not sufficient for the Federal Employment Agency to be able to cover its expenditure with own funds. For instance, in 2010 a rate of 3.8% would have been required to do so.[3] Up to 2006, the annual deficit was offset by central government grants. Since 2007, funds from central government to offset the deficit have been granted solely in the form of non-interest-bearing loans that are to be repaid in years when a surplus is recorded. However, this rule was broken in 2010 when the deficit of €5.2 billion, which could no longer be covered by reserves, was offset by a non-repayable central government grant.

With the aid of a sustainable contribution rate, it should be possible to balance out the Federal Employment Agency's revenue and expenditure over the economic cycle without having to make procyclical adjustments to the contribution rate or take recourse to additional structural central government grants. In 2011, when production capacities can hardly be regarded as underutilised, the Federal Employment Agency is expecting a deficit of just under €2 billion and just short of 850,000 recipients of unemployment benefits.[4] To ensure a balanced budget, the contribution rate should have been set a quarter of a percentage point higher.

The contribution rate required in the long term hinges on the average number of recipients of unemployment benefits. If the following assumptions are made

– the central government grant is halved as planned (-€4 billion)

– expenditure on active labour policy measures is lowered by roughly €2 billion compared with 2010

– the promotion of partial retirement, which currently amounts to just over €1 billion, comes to an end (in accordance with the laws applicable at that time)

1 The central government grant was introduced in 2007 when the standard rate of VAT was raised from 16% to 19% and it corresponds to the (extrapolated) revenue from 1 percentage point of the standard rate of VAT. — **2** Current estimate of deficit by the Federal Employment Agency. — **3** Had the contribution rate been 3.8% instead of 2.8%, this would have meant additional income of just over €8 billion which would have covered the deficit. — **4** The number of recipients of unemployment benefits is usually somewhat below the number of

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– the reintegration payment is reduced by around €1 billion compared with 2011 to approximately €4 billion per year

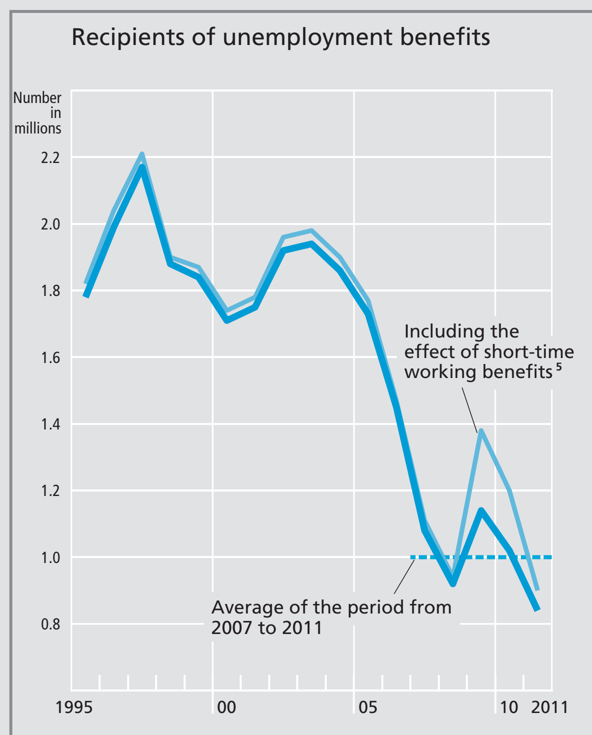
– there is no repetition of the crisis-related extension of short-time working benefits

then a contribution rate of 3.4% would be required based on the forecast number of recipients of unemployment benefits in 2011. Conversely, with the current contribution rate of 3.0%, benefits could be financed for only just short of 700,000 recipients, meaning that the number of recipients would have to be permanently cut on average over an economic cycle by a further 15% on current values.

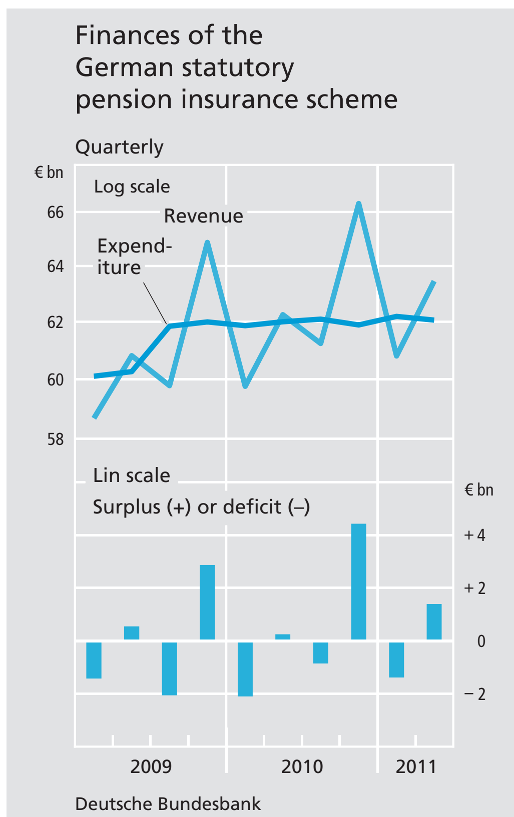
By contrast, on an annual average, the number of recipients of benefits observed between 1995 and 2005 amounted to almost 1.9 million. Admittedly a rather sharp decline has been observed since then, which is probably chiefly due to labour market reforms over the course of the past decade. Nevertheless, even if the average for the period from 2007 to 2011 were to continue, there would still be around one million recipients of unemployment benefits. Under the assumptions stated above, this would necessitate a contribution rate of 3.7%. If the payment of short-term working benefits were to be extended again in future downturns, an additional 100,000 recipients of unemployment benefits would have to be financed.

Overall, under the aforementioned conditions, the current contribution rate of 3.0% can only be considered sufficient if the present positive labour market situation continues to improve and a further drop in the number of recipients of unemployment benefits forms the basis for a new long-term average. This appears unlikely (see also the comments on p 53). It is more realistic that a further lowering of the contribution rate to the Federal Employment Agency would – at best – be financially manageable only in the very short term, with a continuation of positive economic developments and no reduction of the central government grant.

In the long term, it is safe to assume that even with a contribution rate of 3.0%, the Federal Employment Agency will be structurally underfinanced. Furthermore, halving the rule-based central government grant by 2015 means that under-coverage of the Federal Employment Agency's "non-insurance-related benefits" is inevitable. In the future, action will have to be taken. On the one hand, changes could be made to the benefits – above all to the level and period of entitlement. Alternatively, either the contribution rate would have to be increased or central government funds would have to be raised again. However, if the contribution rate remains unchanged, it is unlikely that the Federal Employment Agency would be able to repay a central government loan. In such a scenario, not booking a grant as a grant but as a repayable loan, which is not included in the calculation of central government's deficit, would cause problems for central government's debt brake.



unemployed persons in the category SGB III. The number of short-term unemployed persons who are not entitled to unemployment benefits (eg directly after a period of training) is usually higher than the number of recipients of unemployment benefits who are not registered as unemployed (eg due to illness). — **5** After converting expenditure on short-time working benefits into recipients of unemployment benefits.



rose by nearly 2%, expenditure largely stagnated. Contribution receipts rose by close to 3% in total. At almost 5%, employees' compulsory contributions rose even more strongly owing to the favourable employment and pay trends, while contributions on behalf of recipients of unemployment transfers fell by 42%. Just over 22% less was transferred on behalf of recipients of unemployment benefit, and 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 muted by the fact that transfers from the Federal budget were, in accordance with the rules, extrapolated in line with wage and salary developments two years previously (2009) and therefore stagnated. Pension payments even fell slightly in the second quarter, as pensions were not increased mid-2010, the number of pensions hardly increased and, furthermore, discontinued pensions were on average higher than new pensions. By contrast, the contributions that the pension insurance scheme has to pay to the health insurance scheme on behalf of pensioners increased by just over 4% owing to the rise in the general contribution rate.

Surplus in 2011 and contribution rate cuts in the years thereafter

It is now looking more and more likely that the statutory pension insurance scheme will record a marked surplus for 2011 as a whole because, following the balanced result for the first half of the year, a surplus is expected in the second half of the year particularly owing to contributions paid on Christmas bonuses. However, it should also be taken into account that pensions were raised by 0.99% on 1 July 2011. If the favourable economic developments continue in 2012, from today's perspective it can no longer be ruled out that in November reserves in excess of the intervention threshold of 1.5 of monthly expenditure will be forecast for the end of 2012, provided the contribution rate remains unchanged. If this is the case, the contribution rate would be lowered on 1 January 2012. A further cut in the contribution rate at the beginning of 2013 appears possible. However, in the years thereafter, the ratio of the number of contribution payers to pensioners can be expected to deteriorate for demographic reasons, making continual contribution rate rises appear likely, although they will be dampened by the deceleration in pension increases and the gradual rise in the statutory retirement age to 67 years.

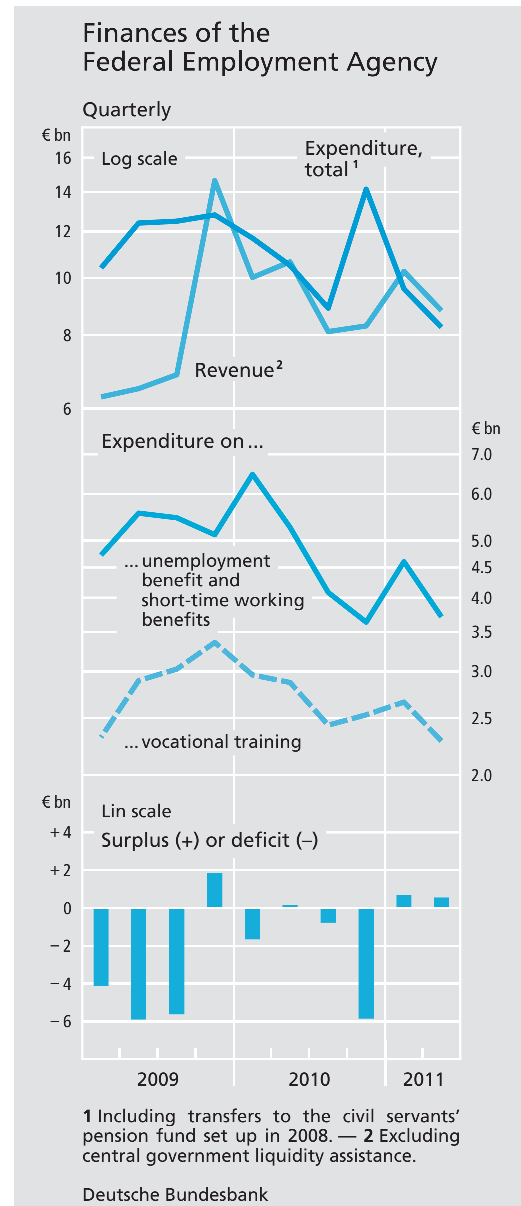
Federal Employment Agency

Financial improvement understated by special effect

The Federal Employment Agency recorded a surplus of just over €½ billion in the second quarter of 2011, compared with a virtually balanced budget one year previously. As from April to June of the previous year more central government funds were transferred in advance, the financial improvement is understated by €2 billion. Overall, revenue fell by 17½%. Yet expenditure fell even more sharply (-21½%). On the revenue side, on the one hand there was a considerable increase in employees' contributions (+13½%). The contribution rate was raised from 2.8% to 3.0% at the beginning of the year and even after adjustment contribution receipts increased by 6%. On the other hand, revenue from insolvency benefit contributions is absent in 2011. Both effects more or less balance each other out. However, central government payments fell by a half owing, among other things, to the above-mentioned shifting of the payment date. The renewed sharp decline on the expenditure side was attributable to lower payments for unemployment benefits (-21%), for short-time working benefits (-73%) and for active labour market policy measures (including refunds of social contributions for short-time work, which are recorded here: -8%). The expenditure of the Federal Employment Agency thus responded to the favourable labour market developments.

Despite lower-than-expected deficit, Federal Employment Agency structurally underfinanced

The central government loan to offset the deficit of almost €5½ billion estimated in the Federal Employment Agency's budget plan is likely to be much higher than required. The Federal Employment Agency itself calculated mid-2011 that only just under €2 billion is still needed. If the favourable macroeconomic developments continue, it would appear feasible for the central government loan to be completely repaid as early as next year. Nevertheless, in the longer term, the Federal Employment Agency is likely to be significantly underfinanced with a contribution rate of 3.0% (see comments on pages 76-77).



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

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