Public finances*

General government budget

Limited decline in deficit in 2012, but …

Germany's public finances are likely to record a mixed performance this year.[1] After falling to 1% last year, the deficit ratio could decline further in 2012 to around ½%, which would be low by international standards. By contrast, the debt ratio is likely to rise from the very high level recorded last year (81.2%). The cyclical impact on the deficit is expected to be more or less neutral. The revenue ratio could increase. The main reason for this is the favourable growth structure for government revenue, ie the macroeconomic reference variables that are particularly important for public finances (gross wages and salaries, nominal private consumption) will probably grow at a faster pace than nominal gross domestic product (GDP). Revenue shortfalls as a result of legislative changes, particularly lowering the contribution rate to the statutory pension insurance scheme, will have only a partial countervailing effect. A slight decline in the expenditure ratio may be anticipated. For one thing, the pension increase was limited on an annual average and, for another, unemployment is likely to fall slightly on the year. In addition, exceptionally good refinancing conditions are holding down interest expenditure. Furthermore, the stimulus programmes introduced during the 2008-09 crisis have now been phased out.

… debt ratio will probably rise again

The debt ratio has increased sharply since 2008, particularly owing to the support measures for German financial institutions, and the assistance provided to help contain the euro-area debt crisis has also been pushing up the debt level since 2010. Additional distinct burdens will accumulate in the course of the current year. Thus the liquidation of the regional public bank WestLB will once again transfer liabilities (and risky assets) to the government sector. In addition, the agreed loans from the European Financial Stability Facility (EFSF) to Ireland, Greece, Portugal and Spain as well as capital injections to the European Stability Mechanism (ESM) could, on their own, further increase the debt level by more than 2% of GDP.[2] The above-mentioned factors outweigh the downward trend in the debt ratio that had begun to emerge, which is due to the low deficit ratio relative to nominal GDP growth and the redemptions envisaged in connection with the "bad banks".

Unchanged deficit and declining debt ratio in 2013

Germany's general government deficit will barely change next year. Divergent developments look set to cancel each other out. On the one hand, the statutory pension contribution rate will probably be significantly lowered to meet the upper reserve limit. Moreover, fiscal policy will be loosened further by new budgetary burdens which are not permanently counterfinanced, such as the planned income

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* 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 figures as defined in the government's financial statistics (which are generally in line with the budget accounts).

1 There are risks not least in connection with the European debt crisis. The comments below are based on the assumption that any deteriorations will remain within narrow bounds.

2 The scale of this debt effect is uncertain, particularly with regard to the establishment of the ESM and the assistance for Spain. Furthermore, Cyprus has also applied for a support programme, although its impact on the German debt level would be very limited. The Federal Constitutional Court is currently reviewing constitutional challenges and petitions in the court proceedings against the Act concerning the Treaty on the Establishment of the ESM of 2 February 2012, which are linked to applications for a temporary injunction against the Act being signed onto the statute book. A summary judgment is to be made on 12 September 2012. Given the size of the German capital share, the ESM treaty can enter into force only if it is ratified by Germany. The impact of the assistance provided to Spain in 2012 on the debt level depends, first, on how much of it is drawn down by the end of year, which cannot be predicted. Second, it is expressly envisaged that the assistance programme will be transferred to the ESM. Because the EFSF merely acts as a "vehicle" through which the guarantor countries can implement the support measures, its liabilities are assigned to these countries in line with their share of liability, which has a bearing on the debt level. However, there are no plans to apply a similar procedure for recording the ESM's liabilities, as it is to be classified as an autonomous international entity.

tax cuts or the introduction of a childcare supplement. On the other hand, the continued muted growth in social and interest expenditure is likely to relieve the budget. The debt ratio, by contrast, could start to dip, as described above, if, over and above the aforementioned measures, no additional measures which push up the debt level are taken to provide support for German financial institutions or to contain the European debt crisis.

Excessive deficit procedure against Germany closed, compliance with medium-term objective in 2012 recommended

As the deficit ratio was significantly below the 3% threshold in 2011, in June the Council of the European Union decided to close the excessive deficit procedure against Germany, which had been initiated at the end of 2009. This and the now historically low general government deficit are welcome developments. With regards to the European fiscal targets, in the context of country-specific recommendations under the EU semester, Germany was particularly called upon to achieve the "medium-term budgetary objective" of a structural deficit ratio of at most 0.5% of GDP in 2012.[3]

Further deficits despite favourable macroeconomic setting

The macroeconomic setting for Germany's public finances is currently very favourable on the whole. Nevertheless, many state and local governments are still running deficits, some of them sizeable. This is partly masked by high but temporary surpluses in the social security funds. The very high debt ratio, which has risen almost without interruption since the 1970s, reflects past failures to consolidate public finances. In view of the foreseeable future budget burdens stemming from demographic developments, and the substantial risks to public finances – not least as a result of the debt crisis[4] – policymakers should make use of the current favourable conditions in order to resolutely consolidate. Overall, loosening fiscal policy through new budgetary burdens which are not counterfinanced on a sustainable basis therefore appears inappropriate. Moreover, international calls for *inter alia* Germany to switch to an expansionary fiscal policy are thus problematic. Confidence in German public finances is a key anchor of stability in the current crisis, but it cannot be taken for granted. Furthermore, a more expansionary budgetary policy in Germany is in any case likely to generate very little direct economic impetus for the peripheral countries.

Ambitious fiscal policy desirable

All in all, an ambitious fiscal policy stance is desirable. The automatic stabilisers will cushion the impact of any risks that might materialise. The aim should be to swiftly comply with the permanent consolidation requirements enshrined in the national debt brakes for central and state government. Furthermore, appreciable and binding safety margins below the national borrowing limits should be introduced as a general principle. Given the high estimation uncertainty regarding the state and development of structural budgets, such buffers that can absorb the impact of negative shocks are a key condition for being able to pursue a stable, target-oriented fiscal policy. This would allow the debt ratio to be rapidly lowered, which would yield an extra benefit in view of its current very high level.

Budgetary development of central, state and local government

Tax revenue

Weaker rise in tax revenue in Q2

Tax revenue[5] was up by 3% on the year in the second quarter (see chart and table on pages 61 and 62). The pace of growth was thus somewhat weaker than in the first quarter, although this was probably partly due to temporary special factors affecting profit-related taxes. Revenue from income-related taxes went up by 4%. Wage tax receipts once again recorded

3 See Council of the European Union, Council recommendation on the National Reform Programme 2012 of Germany and delivering a Council opinion on the Stability Programme of Germany, 2012-2016, Brussels, 10 July 2012.
4 For more information on the European Council's and the Euro Area Summit's statements of 28 and 29 June 2012 on the stabilisation of the euro area, see the box on pp 59-61.
5 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.

The European Council and Euro Area Summit statements of 28 and 29 June 2012 regarding the stabilisation of the euro area

On 29 June 2012, the European Council reached its conclusions on the future structure of the EMU's institutional framework. These include a general agreement to develop – by the end of 2012 – possibilities for closer cooperation in fiscal and economic policy and to strengthen the democratic legitimacy of such cooperation. In the Euro Area Summit statement, the heads of state or government of the euro-area countries called, in particular, for the establishment of a single supervisory mechanism for financial institutions, involving the ECB. It is emphasised that this would be a necessary condition for permitting the planned European Stability Mechanism (ESM)[1] to provide financial assistance not just to governments but also directly to banks. The European Commission intends to present legislative proposals on a single European supervisory mechanism shortly. The statement further affirms that the European Financial Stability Facility (EFSF) and the ESM will use their instruments in a flexible and efficient manner in order to stabilise the markets for countries that are respecting their commitments under the various European procedures (including rules laid down in the Stability and Growth Pact and the Macroeconomic Imbalance Procedure). In future, the ECB is to be more involved in conducting EFSF/ESM market operations. Furthermore, the statement stresses that the financial support to be provided to Spain by the EFSF for recapitalisation of its banking system will not gain seniority status after its pending transfer to the ESM (as envisaged for such transfers in preamble 13 of the ESM Treaty). Finally, the European Council has decided on a "Compact for Growth and Jobs" to allow, for instance, the lending capacities of the European Investment Bank (EIB) to be extended and the Structural Fund resources from the EU budget to be used to promote economic growth more broadly.

Single supervisory mechanism for banks

A more centralised system of banking supervision can essentially help to better factor in cross-border effects arising, for example, from banking groups that operate in several countries, and may facilitate the uniform implementation of harmonised regulations without taking national interests into account. A standardised EU-wide approach would be desirable in principle, potentially with an opt-out for non-euro-area member states. In the long term, all banks should be covered by the new single supervisory mechanism so as to prevent regulatory arbitrage. However, giving the ECB extensive responsibilities in banking supervision entails the risk of coming into conflict with the primary objective of monetary policy, namely to safeguard price stability. Moreover, the decisions of a supranational banking supervisor, which may be far-reaching in some cases and could ultimately also affect national fiscal policy, basically require democratic legitimacy and control. This holds true regardless of the institution responsible.

1 The ESM Treaty will enter into force only when countries representing 90% of the capital commitments have ratified it. This will not be achieved without Germany, where ratification of the Treaty has been suspended until the Federal Constitutional Court (Bundesverfassungsgericht) announces its summary judgment on the constitutionality of the legislation to ratify the ESM Treaty and of the ESM Financing Act (ESM-Finanzierungsgesetz) on 12 September 2012.

Using the ESM to recapitalise banks directly can reduce the interdependencies between the creditworthiness of banks and sovereign states, as is essentially desired. However, this simultaneously leads to risks being redistributed among the member states. To maintain a balance between liability and control, this would necessitate – depending on the specific structure chosen – the introduction of adequate powers of intervention in fiscal and economic policy, as well as their rigorous execution. It would therefore make sense for the EMU countries to assume joint liability (via the ESM) only for those risks which arise after the single supervisory mechanism has been set up. Nevertheless, shared responsibility for banking supervision should not entail granting insolvent banks financial support on a permanent basis, not least to limit the risks for the taxpayers in the member states. Instead, such banks should be promptly restructured, possibly recapitalised and/or liquidated in an orderly manner.

The interconnections between banks and governments will not be completely severed by introducing joint liability for distressed banks. In order to limit the risks to financial institutions arising from high levels of public sector debt, the framework for banking supervision and regulation also needs to be adjusted in terms of its treatment of government bonds. For example, capital requirement ratios could be laid down commensurate with risk or large exposures could be limited accordingly. This would more heavily restrict banks' exposure to individual governments. It would be essential – especially if individual countries are facing difficult financing conditions – to ensure that the interconnections between banks and governments do not increase excessively, thereby transferring substantial sovereign solvency risks to other member states by the back door of granting financial support to the banking sector. A single European supervisory mechanism could constitute an important step towards a more stable institutional framework for the single market. However, it would not be an appropriate solution – at least in the short and medium term – to the current European sovereign debt and banking crisis.

Financial assistance programme requirements

Interest rate premiums on emergency loans as well as strict economic and fiscal policy conditions are key to ensuring that a country receiving financial assistance still has an incentive to correct undesirable developments quickly and to regain access to the capital markets without delay. From this perspective, the tendency to water down conditionality is a matter for concern – say by basically making the financial assistance provided under an EFSF/ESM programme subject only to the rules that have to be adhered to anyway under the upstream fiscal and macroeconomic correction mechanisms.

Secondary market purchases

The reference in the Euro Area Summit statement to the ECB's agreeing "to serve as an agent to EFSF/ESM in conducting market operations in an effective and efficient manner" indicates the ECB's involvement as a service provider. On 2 August 2012, the ECB Governing Council then announced that it would buy government bonds on the secondary market in conjunction with the EFSF and ESM programmes on a potentially sizeable scale. Secondary market bond purchases are also possible within the framework of EFSF and ESM programmes themselves. Outright purchases by the Eurosystem might massively expand the volume of funds provided under assistance programmes. Risks to taxpayers arising from EFSF and ESM secondary market purchases are essentially not much different from risks arising from Eurosystem purchases (see also the comments concerning the ECB Governing Council's decisions on pages 22 and 26).

Compact for Growth and Jobs

In the Compact for Growth and Jobs, the EU governments affirm their commitment to the European single market. This initiative is to be welcomed, as structural reforms in member states, the further dismantling of barriers to competition at EU level and the reduction of excessive bureaucratic procedures can boost potential growth in the EU. Furthermore, the EIB's lending capacity is to be strengthened by €60 billion by increasing its paid-in capital by €10 billion (of which Germany accounts for €1.6 billion). To generate the desired additional macroeconomic stimuli, free-rider absorption effects should be minimised. Furthermore, the EIB is requested to launch "project bonds" which, as a supplement to private funds, are to help kick-start additional infrastructure projects worth €4½ billion. It is important in this connection to ensure that governments have sufficient administrative capacities to select and control the projects. Overall, care must be taken to ensure that such new subsidisation instruments do not mask the level of national government debt or evade the EU budget prohibition on debt-financing. Finally, Structural Fund resources are to be reallocated to combating youth unemployment and subsidising small and medium-sized enterprises. In this case, too, much effort will need to be directed at ensuring that public resources are used efficiently – not least in the light of past experience.

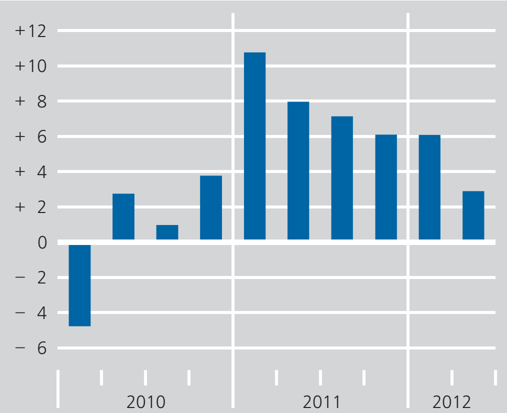
significant growth, which mainly reflects the positive pay and employment trends. Receipts from profit-related taxes increased by 1% overall. Revenue from corporation tax and assessed income tax continued to expand dynamically, although this development was more or less cancelled out by a decline in receipts from non-assessed taxes on earnings. However, this decrease appears to be linked to a change in the procedure for deducting withholding tax on dividends, which has resulted in delays in incoming payments. Revenue from consumption-related taxes went up by just over ½%. Although receipts from turnover tax grew at a somewhat weaker pace than their macroeconomic reference variables, significant intra-year fluctuations in turnover tax revenue[6] are perfectly normal.

Considerable growth expected for year as a whole

According to the official tax estimate from May, tax receipts for 2012 as a whole are expected to rise by 4% (including local government taxes). This growth reflects above all the anticipated positive developments in the macroeco-

Tax revenue*

Year-on-year percentage change, quarterly



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

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6 Fluctuations in revenue may stem in particular from the at times large refunds or back payments that are due in cases where advance payments made during the course of the year deviate from the final amount of tax payable.

Tax revenue

Type of tax	H1				Estimate for 2012[1,2]	Q2			
	2011	2012				2011	2012		
	€ billion		Year-on-year change € billion	Year-on-year change as %	Year-on-year change as %	€ billion		Year-on-year change € billion	Year-on-year change as %
Tax revenue, total[2]	256.9	268.2	+ 11.4	+ 4.4	+ 4.0	133.7	137.6	+ 3.9	+ 2.9
of which									
Wage tax	66.6	70.3	+ 3.6	+ 5.5	+ 5.5	34.1	36.1	+ 2.0	+ 5.9
Profit-related taxes[3]	41.3	46.1	+ 4.8	+ 11.7	+ 6.6	23.5	23.7	+ 0.2	+ 0.9
Assessed income tax	16.1	18.5	+ 2.3	+ 14.5	+ 8.5	9.4	10.0	+ 0.6	+ 6.9
Corporation tax	6.7	10.5	+ 3.8	+ 56.2	+ 17.1	4.2	5.0	+ 0.8	+ 18.5
Investment income tax[4]	18.5	17.2	− 1.3	− 7.0	− 1.9	9.9	8.7	− 1.2	− 12.3
Turnover taxes[5]	93.5	95.6	+ 2.1	+ 2.2	+ 3.3	46.1	46.6	+ 0.5	+ 1.1
Energy tax	14.5	14.1	− 0.3	− 2.4	− 0.2	10.0	9.7	− 0.3	− 2.9
Tobacco tax	6.2	5.9	− 0.3	− 5.5	− 1.5	3.3	3.5	+ 0.3	+ 7.6

1 According to official tax estimate of May 2012. **2** Including EU shares in German tax revenue, but 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.
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nomic reference variables. Fiscal drag[7] and legislative changes (particularly the expiry of the homebuyers' grant and more generous depreciation allowances) are also likely to produce additional revenue on balance.

Central government budget

Marked rise in surplus in Q2

In the second quarter, at €6 billion, central government's budget surplus was €2½ billion higher than one year previously. Revenue rose by 2% (€1½ billion). Growth in tax revenue (1%, or €½ billion) was dampened by higher transfers of €1 billion to the EU budget. Expenditure fell by 2% (-€1½ billion). In particular, relief was provided by the €1 billion decline in interest expenditure, primarily owing to discounts when issuing new securities. Transfers to the social security funds were also €1 billion down on the year. This was mainly due to the Federal Employment Agency's lower liquidity requirements and the planned reduction in payments to the health insurance fund. Furthermore, spending in connection with long-term unemployment fell by €½ billion in the light of the buoyant labour market.

Supplementary budget despite relief …

In June, a supplementary budget for 2012 was passed in connection with having to fund the first contributions to the ESM in the amount of €8½ billion. The net borrowing appropriation was reduced by €2½ billion to €32.1 billion compared with the draft supplementary budget. This reduction more or less corresponds to the additional revenue expected in the May tax estimate.[8]

7 In this context, this term denotes the balance of the revenue effects stemming from the progressive structure of the income tax schedule (positive) and the fact that specific excise duties are largely inelastic to price changes (negative).
8 Additional relief, such as the further reduction in interest expenditure, has been cancelled out in particular by the marked wage increases for central government employees that have come into effect in the meantime.

… alongside structural deficit increase compared with 2011, …

Despite the high level of employment and a fairly normal level of capacity utilisation, the German government anticipates a marked cyclical burden on the central government budget in 2012. This amounts to €4 billion according to the new estimate of potential output in the government's spring forecast. With net borrowing due to financial transactions[9] amounting to €5 billion, primarily owing to the ESM contributions, structural borrowing totals €23 billion. This is quite a sharp rise compared with the current reference figure for 2011 of €19 billion (for more information on the method of calculating the structural deficits, see the box on pages 64 and 65).

… but lower-than-estimated deficit plausible

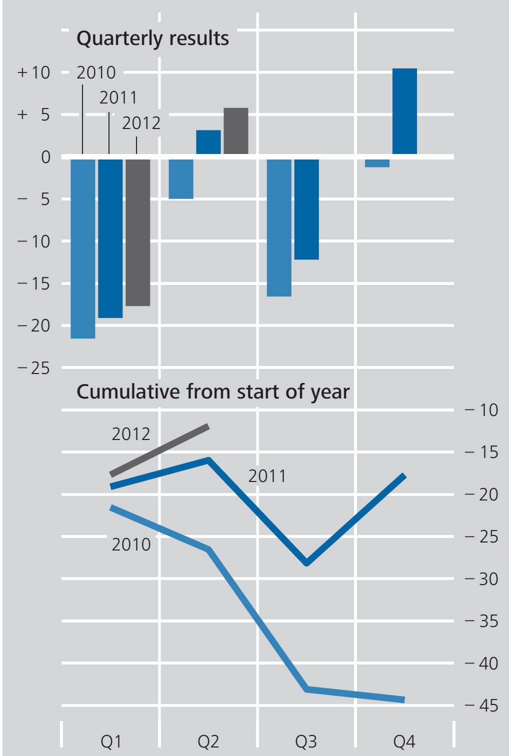
The higher structural deficit projected in the June supplementary budget is partly due to a departure from the original consolidation path decided in the summer of 2010. However, it also reflects the fact that some of the appropriations are cautious from today's perspective. As in previous years, it seems likely that above all interest expenditure and labour-market-related burdens could remain below budget estimates. The fact that in mid-2012 central government's total deficit was €4 billion down on the year also indicates that, in the absence of unexpected burdens, a markedly better-than-expected result will probably be recorded once again. On the basis of the above calculation, a further reduction in the structural deficit therefore seems possible.

Benchmark figures for 2013 budget plan not fully binding

In accordance with the top-down procedure for drawing up budgets, which was introduced in 2011, central government's 2013 draft federal budget from the end of June is based on the benchmark figures approved by the Federal Cabinet in March. In the draft, the budgeted amount for new borrowing was reduced by €1 billion to €18.8 billion. Extra tax revenue of €3½ billion and lower debt servicing costs were counterbalanced in particular by a €4½ billion higher capital transfer to the ESM. However, personnel expenditure estimates were also adjusted for the impact of the recent pay increases. The new budget procedure could be made more binding if any deficit-increasing measures or extraordinary effects that are adopted after the benchmark figures are agreed, and which are not exempted as being attributable to a higher cyclical burden or to an acquisition of financial assets with recoverable value, were to be mandatorily offset by savings.

Central government fiscal deficit/surplus

€ bn



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2013 draft budget shows marked fall in deficit …

Compared with the target figure in the 2012 supplementary budget, the draft budget for 2013 envisages a significant reduction in net borrowing in the amount of €13½ billion. Much of this is allocated to higher revenue, including a €7½ billion increase in tax receipts. Additional spending of €1½ billion from the first stage of the scheduled lowering of income tax rates is planned to be largely counterbal-

9 Financial transactions are understood to comprise revenue from sales of participating interests, loan repayments and borrowing in the public sector as well as expenditure on acquisitions of participating interests, loans granted and debt repayments in the public sector.

Calculating structural deficits in the central government budget – some technical comments

Under the debt brake, structural net borrowing is the key number in the central government budget as the borrowing limit laid down in Article 115 of the German Basic Law is based on this variable. To calculate this variable, net borrowing (deficit less coin seigniorage) is adjusted to take account of both cyclical factors and the balance resulting from the acquisition and realisation of financial assets (financial transactions).

The respective values can change significantly during the time that elapses between budget drafting and outturn. For instance, the actual figure for net borrowing regularly deviates from the target values. The same applies to financial transactions; in addition, some of the activities recorded under this heading may be reclassified later.[1] The estimated influence of cyclical factors may also be significantly revised even after the end of the respective year, eg if ongoing macroeconomic developments differ from previous assumptions or the (unobservable) potential growth path for gross domestic product (GDP) is adjusted owing to changes to the estimation methodology.[2]

The implementation regulation concerning the central government debt brake (Article 115 Regulation) stipulates that the cyclical impact on the central government budget has to be calculated differently for budget drafting, on the one hand, and for supplementary budgets and budget close-out, on the other. When drawing up the budget, the cyclical effect is to be determined using the available macroeconomic data and forecasts of central government, based on a current estimate of potential output. But when drawing up a supplementary budget

Deriving different variables of central government's structural net borrowing

€ bn

	2011 Actual	2012 Supplementary budget
1) Net borrowing	17½	32
2) Cyclical component in the Budget Act	– 2½	– 6
3) Cyclical component after budget implementation (simplified procedure)	1	
4) Cyclical component according to spring projection 2012 (complete re-estimate)	– 1	– 4
5) Financial transactions according to respective definition of the budget year	2	– 5
6) Financial transactions according to the definition for 2012	3	– 5
7) Currently reported structural borrowing under respective budgetary rules [7) = 1) + 5) + (3) or 2))]	20	21
8) Comparable structural borrowing [8) = 1) + 4) + 6)]	19	23

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or closing the books, the rules provide for a greatly simplified calculation approach. It is simply assumed that any deviation of nominal GDP growth from the original expectations which have since been presumed or observed is solely the result of cyclical factors. The estimate of potential output is not

1 For example, capital injections granted to multilateral development banks are no longer booked as financial transactions, as they were in 2011, but instead as capital transfers, thus increasing structural net borrowing. Calls on and repayments of guarantees to other countries were apparently reclassified even in the course of budget implementation: when the 2011 budget was being drawn up, the items were still categorised as financial transactions, but when the books were closed this was no longer the case.
2 The cyclical adjustment methodology used for determining the cyclical component under the new budgetary rule was amended with effect from the second quarter of 2011 due to the adoption of a change made by the EU, meaning that, for this reason alone, the respective figures from 2012 onwards are not fully comparable with those from previous years.

updated. By contrast, in the course of a full cyclical adjustment recalculation the deviation to a large extent induces a revision of the potential output figure as well.[3] The simplified approach therefore means that higher-than-forecast GDP growth in the year in question results in less budgetary leeway than in the case of a complete re-estimate, whereas lower growth expands the policy radius.

Overall, it is evident that recourse to different calculation methods for determining the structural deficits is warranted, depending on the analytical goal. The actual structural development should be analysed without regard to the procedural rules that apply to the different phases of the budgetary cycle. Hence, for each year under observation, a cylical adjustment should be initiated on the basis of the currently valid estimate of potential GDP, and financial transactions should be deducted using a uniform definition. Conversely, when gauging the extent to which budgetary developments comply with the procedural rules for the debt brake and calculating what values are to be recorded on the control account, the simplified cyclical adjustment procedure has to be used along with the currently valid definition of financial transactions for the respective budget.

3 The German Basic Law stipulates that cyclical factors are to be taken into account over time in a symmetric fashion in order to prevent an additional systematic rise in debt. This gives rise to the need for the procedure for estimating potential output to ensure a symmetric balance between upswing and downswing phases. Ultimately, this means that whenever a downward revision of GDP is not just temporary, the growth path of potential GDP as a whole is revised downwards, and vice versa.

anced, *inter alia* by the estimated income from a tax repatriation agreement with Switzerland, although the Bundesrat has so far blocked the agreement. A marked decline in expenditure is the other factor contributing to the projected deficit reduction. Given the ongoing very favourable financing conditions, interest expenditure is expected to fall by €2½ billion. Even more is to be saved by cutting transfers to the social security funds. In the light of the health insurance fund’s accrued surpluses, payments to it will be reduced by €2 billion on a one-off basis. Furthermore, it is planned to discontinue the regular central government transfer to the Federal Employment Agency (which is financed through turnover tax) and, in return, to abolish the Federal Employment Agency’s welfare administration payment to central government. This, too, will produce a €2 billion saving for the central government budget in 2013. An additionally envisaged discretionary cut of €1 billion in payments to the statutory pension insurance scheme will largely be offset by the budgeted year-on-year increase for this item. By contrast, the childcare supplement – a new social payment which is planned to be introduced in 2013 – is expected to generate a limited burden of just under €½ billion during its first year.

… and complies with 0.35% structural borrowing limit, but debt crisis risks remain

The draft budget for 2013 envisages a distinct improvement in structural terms, too. Structural net borrowing is forecast to decline by €14 billion compared with the recalculated deficit target of €23 billion for 2012 (which, as explained above, has been adjusted for the new estimate of potential output from spring 2012), down to €9 billion. The presumed negative cyclical impact amounts to €3½ billion and net burdens from financial transactions to €6 billion. Central government is therefore already set to comply with the ceiling of 0.35% of GDP, which will be compulsory from 2016 onwards, in 2013. Many of the budget appropriations appear rather cautious from today’s perspective. As in recent years, transfers to the EU budget could be lower than projected. On the expenditure side, it is likely that above all the costs of interest payments and long-term unemployment have once again been overstated. By contrast, the budget figures do not yet include additional central government expenditure, particularly on extending day care for small children and with regard to assuming a total share of €1 billion of the costs for the basic allowance for the elderly and disabled, as decided under the agreement between central and state government on implementing the fiscal compact. There are risks, too, in association with the Bundesbank's estimated profit transfer of €1½ billion. Nevertheless, for 2013 as a whole – as in recent years – a lower-than-estimated deficit (of around €15 billion, compared with the figure of €18.8 billion in the draft budget) appears quite feasible provided there is not a further marked loosening of fiscal policy. However, this favourable outlook is based on the assumption of ongoing marked macroeconomic growth, very low interest rates and the absence of burdens from guarantees in connection with the euro-area debt crisis.

But continuing departure from 2010 consolidation programme

The budgeted decline in the deficit should not hide the fact that the clear departure from the June 2010 consolidation programme which started in 2012 is set to continue. Revenue totalling €2 billion from the financial transactions tax, which was initially planned to be introduced in 2012, is not evident for 2013 either. The savings of around €2 billion each for the German armed forces and long-term unemployment, as envisaged for 2013 under the 2010 consolidation programme, are not apparent in the plans. The favourable budgetary developments since 2010, which are projected to continue in the budget plans, are largely due to additional tax revenue on the back of the German economy's robust development, as well as to sizeable cost relief relating to debt servicing. This entails considerable risks and means that the planned abandonment of sustainable general government consolidation measures, combined with a lowering of income tax rates and new (social) expenditure burdens for a central government budget that traditionally records a deficit, should be viewed in an even more critical light.

Fiscal plan targets slight structural surplus in 2016 but reduces safety margin

The medium-term fiscal plan up to 2016 envisages a gradual reduction in net borrowing, culminating in its complete elimination by the end of the planning period. If capacity utilisation remains normal and the net acquisition of financial assets is moderate, this amounts to a slight structural surplus in the final year. Although interest expenditure is forecast to increase significantly in keeping with prudent accounting, the annual income of €2 billion from a financial transactions tax as well as the planned reduction in defence expenditure, which are both assumed from 2014 onwards, appear to entail risks. Furthermore, it would seem appropriate for the central government budget to contain measures to counterfinance its significant assumption of the costs of local government integration measures for disabled persons, as announced in connection with the fiscal compact. Moreover, the fiscal plan is based on the assumption that real GDP will increase by 1½% each year until 2016 and thus somewhat faster than the imputed potential growth rate. On the basis of a posited (but questionable) perceptible underutilisation at the current end, the output gap will thus supposedly not be closed until 2016 (for more information, see the box on cross-country evidence regarding bias in real-time cyclical adjustment on pages 68 to 70). This recalls the planning pattern of past fiscal plans whose goals often had to be abandoned owing to downward revisions to growth estimates. As the debt brake places a strict limit on structural borrowing, the planned reduction in the safety margin to around €10 billion in 2016 appears risky, particularly given the high level of uncertainty.

Surplus for off-budget entities

Central government's off-budget entities recorded a surplus of €1½ billion in the second quarter, compared with €12½ billion one year previously owing to banks' repayment of capital assistance to the Financial Market Stabilisa-

Central government's medium-term financial planning from 2012 to 2016 and structural net borrowing under the debt brake

€ billion

Item	Actual 2010	Actual 2011	Target 2012[1]	Draft 2013	Fiscal plan 2014	2015	2016
Expenditure[2]	303.6	296.2	312.7	302.2	302.9	303.3	309.9
of which Investment[3]	26.1	25.4	27.0	25.6	25.4	25.2	24.9
Revenue[2, 4]	259.6	278.9	280.6	283.4	289.8	298.6	309.9
of which Tax revenue[2]	226.2	248.1	252.2	259.8	269.1	277.3	288.5
Net borrowing	44.0	17.3	32.1	18.8	13.1	4.7	–
plus cyclical component[5]	– 12.3	0.8	– 5.9	– 3.7	– 2.8	– 1.4	0.0
plus balance of financial transactions[6]	0.8	2.0	– 4.9	– 6.1	– 4.7	– 0.5	– 0.8
Structural net borrowing	32.5	20.1	21.3	9.0	5.6	2.8	– 0.8
as a percentage of GDP[7]	1.4	0.8	0.9	0.4	0.2	0.1	– 0.0
Memo item Structural net borrowing[8] Upper limit according to Federal Ministry of Finance	53.2	45.6	39.4	33.0	25.5	17.9	9.8

1 Including supplementary central government budget for 2012. **2** After deducting supplementary central government grants, shares in energy tax revenue, compensation under the 2009 motor vehicle tax reform and consolidation assistance from 2011 onwards, which are all remitted to state government. **3** Excluding participating interests in the ESM. **4** Including proceeds from coin seigniorage. **5** Figure for 2010 is taken from central government's 2011 spring forecast. Figure for 2011 is taken from the budgetary accounts. Figure for 2012 as stated in the supplementary budget. For 2013 to 2016, as stated in central government's 2012 spring forecast. **6** As defined for the respective fiscal year. **7** Nominal GDP in the year preceding the drafting of the budget (data as at 2012 spring forecast). **8** Central government did not record an actual result for structural net borrowing for the base year 2010. The deficit reduction path from 2011 to 2015 is based on the June 2010 estimate of the starting structural deficit value for 2010 (2.2% of GDP) and a reduction of 0.31% of GDP per year.

Deutsche Bundesbank

tion Fund (SoFFin). As in 2011, the precautionary fund for final payments for inflation-indexed Federal securities recorded a distinct surplus. In the case of the civil servants' pension reserves, too, income continued to distinctly outweigh expenditure. For the year as a whole, the overall off-budget surplus will probably be significantly below the figure of €6 billion recorded one year previously. However, under the Maastricht deficit definition – which disregards reductions of equity holdings – it should improve considerably. This is mainly due to the non-recurrence of the marked outflows from the Investment and Repayment Fund, which expired at the end of 2011.

State government[10]

Despite slightly higher surplus in Q2, full-year fall in deficit uncertain

State government's core budgets recorded a surplus of €2 billion in the second quarter of 2012 compared with €1½ billion one year before. Although tax revenue rose by 3½%, total revenue stagnated, primarily due to a drop in investment income following the end of central government's stimulus programme, which had been introduced in 2009. On the expenditure side, the reduction in corresponding spending on fixed asset formation and investment transfers to local government lowered the overall level of outpayments somewhat on balance (-½%). The May tax estimate suggests that revenue will grow at a weaker pace during the remainder of 2012. At the same time, state government faces increased spending pressures owing not least to personnel costs, current transfers to local government and a capital injection in connection with the liquidation of the public regional bank WestLB. This will probably hinder a marked decline in the deficit.

10 The development of local government finances in the first quarter of 2012 was analysed in greater detail in the short article in the Bundesbank Monthly Report of July 2012. These are the most recent data available.

Some evidence on biased cyclical adjustment within fiscal rules

Problem

Under the forthcoming European fiscal compact, most EU member states are committed to implementing national fiscal rules concerning cyclically adjusted general government budget balances in line with the Stability and Growth Pact. The basic assumption is that the ups and downs of the economic cycle are largely symmetrical in the longer term, meaning that there is neither a prevalence of weak or strong phases nor any resultant lasting effects on the debt ratio. Although this is essentially a useful benchmark, cyclical effects cannot be observed directly and are not uniquely measurable. They must therefore be estimated using the information available at the time following a procedure deemed adequate.

In the specific cyclical adjustment procedures which are used in the context of the Stability and Growth Pact and the German central government's fiscal rule, the cyclical component of the general government budget balance is the product of the macroeconomic output gap and the average responsiveness of the state budget to this gap (budget sensitivity). The latter thus gauges the impact of cyclical fluctuations in gross domestic product (GDP) on the budget balance and is usually assumed to be time-invariant.[1] The output gap is defined as the deviation of GDP from the estimated potential output and thus serves as a measure of the economy's cyclical position.[2]

The German debt brake and the Stability and Growth Pact basically aim to keep the debt ratio at a sustainable level whilst also using the automatic stabilising effect of temporary cyclically induced fluctuations in the budget balance ("automatic stabilisers"). If a long-run increase in the debt ratio caused by cyclical components is to be prevented, surpluses and deficits that have been classified as cyclically induced have to balance over time. Under the given method, this means that negative and positive output gaps which are used to calculate the cyclical components must neutralise over time. If this does not already apply for the output gaps estimated in real time,[3] the rule should contain a corrective mechanism which prevents debt from accumulating. The existing literature suggests that output gap estimates at the current end are subject to considerable uncertainty and are often revised significantly at a later stage.[4]

Results of an empirical study

When investigating the risk of a potential structural build-up of debt due to systematically biased estimations, it is of some interest to observe the extent to which these have occurred in the past. A recent empir-

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1 Both the European Commission and the German government use the results of the following study for this purpose: N Girouard and C André (2005), Measuring cyclically-adjusted budget balances for OECD countries, OECD Economics Department Working Paper No 434.
2 For a representation of the requirements for cyclical adjustment procedures used in the context of budgetary rules and an assessment of the procedures used by the European Union and the German government, see also Deutsche Bundesbank, Requirements regarding the cyclical adjustment procedure under the new debt rule, Monthly Report, January 2011, pp 55-60 and Deutsche Bundesbank, On the cyclical adjustment procedure under the German central government's new debt rule, Monthly Report, November 2011, p 71.
3 For the German government's fiscal rule the real-time estimate produced in autumn 2012 is relevant to the planned adoption of the 2013 budget in the Bundestag. The assessment of compliance with the rule is then based on the summer 2014 estimate. To assess compliance with the rule, a simplified estimation procedure is applied from the start of the budget year, see comments on pp 64-65. The following comments are of a general nature, however, and do not refer directly to the German rule.
4 See, for example, A Orphanides and S van Norden (2002), The unreliability of output-gap estimates in real time, Review of Economics and Statistics, 84, pp 569-583 or M Marcellino and A Musso (2011), The reliability of real-time estimates of the euro area output gap, Economic Modelling, 28, pp 1842-1856.

ical study[5] therefore analyses the bias in cyclical components that would have materialised since the mid-1990s had they been calculated using real-time estimates of the output gap by the OECD, European Commission or IMF. The data set for the respective institution covers 12 to 15 EU member states over a period of 10 to 16 years.[6] These real-time data are compared with the respective institution's estimate from autumn 2011.

The unbiasedness of the real-time output gaps is tested using the following regression model:

$$rev^{gap}_{it} = \alpha_i + \varepsilon_{it}$$

where $rev^{gap}_{it} = gap^{final}_{it} - gap^{real\text{-}time}_{it}$ denotes the revision to the output gap between the final estimation in autumn 2011 (gap^{final}_{it}) and the real-time vintage ($gap^{real\text{-}time}_{it}$). i denotes the countries and t the years. Based on this simple regression, the unbiasedness of the real-time estimates can be checked using a Wald or F-test with the null hypothesis that the country-specific constants α_i are jointly not significantly different from zero. Positive α_i indicate that the real-time output gaps were systematically smaller (ie showed less favourable economic conditions) than the autumn 2011 estimates, which are used as a benchmark in this study. This would imply that real-time estimates of the cyclical component were largely too unfavourable and that too much of the deficit was thus interpreted as cyclical (negative bias). Finally, ε_{it} denotes an error term. The table on page 70 presents the results of the estimation model for the OECD data, for which the largest data set is available. Results for the four real-time vintages, spring t-1, autumn t-1, spring t and autumn t, are listed in the columns.

The tests for unbiasedness are rejected for all four real-time vintages, as seen in the results of the Wald tests. The estimates for the country-specific constants are almost entirely positive, which means that real-time estimates of economic conditions were systematically too unfavourable in real time.[7] In other words, cyclically adjusted deficits based on these estimates would be too low. Most of the country-specific constants are also individually significantly different from zero. The magnitude of the bias is considerable: on an unweighted average across the entire cross-section of countries, the real-time output gap, depending on the vintage, is 0.9 to 1.3 percentage points below the value calculated last autumn. EU and IMF real-time data show a similar bias.

The real-time bias in the cyclical components can then easily be derived based on the bias in the output gaps and using the budget sensitivities applied under the Stability and Growth Pact and the German government's fiscal rule. The unweighted cross-country average of the real-time bias in cyclical components is around -½% of GDP per year; if these data had been used for a national fiscal rule, the annual scope for borrowing would thus have been around ½% of GDP too high compared with the autumn 2011 estimates.

The estimation results reflect the period 1996 to 2011 and are not necessarily representative for the future. They are, however, not a peculiarity of the severe economic crisis in 2008-2009 and the preceding boom period, as a restriction of the data set shows. Moreover, further empirical evidence from the described study and find-

5 See G Kempkes (2012), Cyclical adjustment in fiscal rules: some evidence on real-time bias for EU-15 countries, Bundesbank Discussion Paper No 15/2012.
6 The countries and years covered in the data sets differ slightly among the three institutions. OECD: Germany, France, Italy, Spain, Greece, Ireland, Austria, the Netherlands, Belgium Finland, Sweden, Portugal, the UK, Denmark, 1996-2011. European Commission: countries as for OECD plus Luxembourg, 2002-2011. IMF: countries as for OECD but without Greece and Denmark, 2000-2011.
7 Negative coefficients are estimated for only five of the 56 country-specific constants. Only two of these are statistically significant, namely the coefficients estimated for Greece on the basis of the real-time vintages for year t–1. However, the current high estimation uncertainty with regard to Greece's potential output must be taken into consideration here.

Test for unbiasedness of real-time output gaps[1]

Endogenous variable rev^{gap}_{it}: revision of estimated output gap between autumn 2011 and spring t-1 (column 1), autumn t-1 (column 2), spring t (column 3) and autumn t (column 4)

Item	rev^{gap}_{it} spring t-1 (1)	rev^{gap}_{it} autumn t-1 (2)	rev^{gap}_{it} spring t (3)	rev^{gap}_{it} autumn t (4)
Germany	0.69	0.69	0.92	0.64
	(0.61)	(0.46)	(0.27)***	(0.31)**
France	0.65	0.98	1.03	1.04
	(0.48)	(0.37)***	(0.30)***	(0.28)***
Italy	2.06	2.1	2.39	1.85
	(0.48)***	(0.37)***	(0.30)***	(0.39)***
Spain	1.61	1.65	1.98	1.51
	(0.36)***	(0.19)***	(0.26)***	(0.30)***
Ireland	1.32	2.01	2.06	1.34
	(0.73)*	(0.61)***	(0.59)***	(0.67)**
Austria	0.86	1	1.01	0.78
	(0.55)	(0.40)**	(0.28)***	(0.34)**
Netherlands	1.37	1.51	1.56	1.14
	(0.67)**	(0.44)***	(0.34)***	(0.39)***
Belgium	1.28	1.43	1.51	1.11
	(0.58)**	(0.50)***	(0.34)***	(0.39)***
Finland	– 0.36	0.17	0.29	0.29
	(0.73)	(0.75)	(0.34)	(0.31)
Sweden	0.79	0.69	0.97	0.78
	(0.76)	(0.54)	(0.46)**	(0.39)**
Portugal	2.38	2.4	2.78	2.17
	(0.45)***	(0.36)***	(0.30)***	(0.36)***
United Kingdom	0.96	0.98	1.04	0.88
	(0.45)**	(0.45)**	(0.39)***	(0.36)**
Denmark	0.28	0.66	0.93	0.96
	(0.61)	(0.52)	(0.33)***	(0.28)***
Greece	– 1.19	– 1.25	– 0.66	– 0.51
	(0.55)**	(0.58)**	(0.44)	(0.48)
N	196	210	210	224
Wald test, H0: $\alpha_i = 0$	1,279.3***	8,729.5***	1,360.6***	100.4***
Constant in a pooled model	0.91	1.08	1.3	1.06
	(0.45)***	(0.28)***	(0.18)***	(0.17)***

1 Standard errors (in parentheses) are robust in the presence of autocorrelation, heteroscedasticity and contemporaneous cross-country correlation. * Significant at the 10% level, ** significant at the 5% level, *** significant at the 1% level.

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ings from the literature suggest that other standard cyclical adjustment methods also lead to biased real-time estimates.

Conclusions

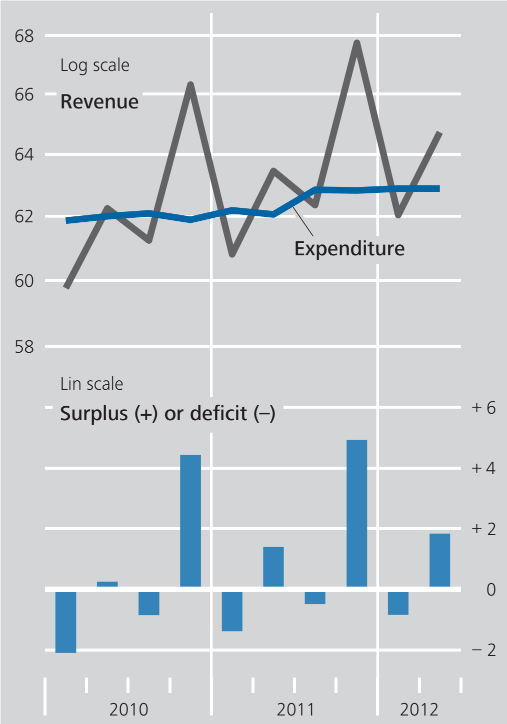
The results of the empirical study highlight the risk that fiscal rules which refer to cyclically adjusted budget balances may systematically fail to achieve the desired debt limitation on account of a regular overestimation of potential output (ie an overestimation of cyclical strains) at the current end. To ensure that this does not regularly lead to overly high borrowing compared to the respective national fiscal rule's deficit limit, assessments of compliance with the rule should not be based solely on the cyclically adjusted budget balance estimated in real time, as is usual in Germany and the EU. Instead, possible biases in the real-time cyclical components should be taken into account. A first step could be to keep a record of each cyclical component used to assess compliance with the rule. If after approximately one full economic cycle (eg eight to ten years) the cyclical components do not turn out to be roughly balanced on average, the borrowing limit for the subsequent period could be raised or lowered accordingly. Such a correction mechanism would be relatively easy to implement and would automatically become less important if estimation methods were improved.

Stability Council confirms consolidation compliance of aided states in 2011

The Stability Council determined at its meeting in May that the five federal states receiving consolidation assistance complied with the deficit reduction requirements for the 2011 fiscal year. Some of the federal states even achieved sizeable safety margins below the upper limits for structural deficits. However, the respective requirements are based on overstated total structural deficits in the 2010 reference year, which, in particular, did not take account of additional structural tax revenue which was already known about. In order to catch up with the other federal states as required, it is also crucial that the aided states take action to reduce the margin by which their structural deficit exceeds the average value for all the federal states. If the states receiving consolidation assistance are not obligated to reduce this deficit overhang at a faster pace, there is a danger that they may further postpone the permanent benefit cuts or even tax hikes needed in the foreseeable future to comply with the debt brake in the medium term, and that they will then also have to implement these measures in a less favourable macroeconomic setting.

Finances of the German statutory pension insurance scheme

€ bn, quarterly



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Social security funds[11]

Statutory pension insurance scheme

Higher surplus despite lowering of contribution rate

The statutory pension insurance scheme recorded a surplus of almost €2 billion in the second quarter, which was €½ billion higher than at the same time last year. At 2%, revenue continued to increase at a stronger pace than expenditure (just under 1½%). Contribution receipts rose by almost 2½% on the year.[12] By contrast, payments from the central government budget increased by only just over 1%, not least as a result of the cut in the contribution rate.

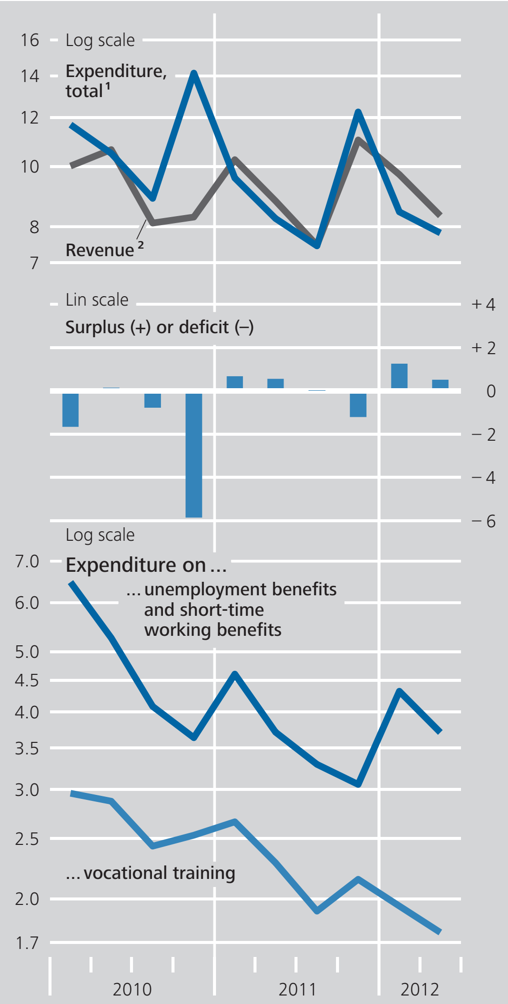
Low mid-2011 pension increase still impacting on expenditure

In the second quarter, spending on pensions was up by just over 1% on the year. This resulted from the mid-2011 adjustment (+0.99%), a slight increase in the number of current pension payments and a decline in the average payment amount after adjustment for the pension increase. On 1 July 2012, pensions were raised by 2.18% in western Germany and 2.26% in eastern Germany. This was mainly driven by the relatively robust developments in gross wages and salaries in 2011 as well as the exceptionally strong adjustment-boosting effect of the stability factor,[13] though the rise was dampened by a clawback of pension cuts waived in previous years.

11 The financial development of the public long-term care and statutory health insurance schemes in the first quarter of 2012 was analysed in the short articles of the Monthly Reports of June and July. These are the most recent data available.
12 After adjustment for the lowering of the contribution rate from 19.9% to 19.6% on 1 January 2012, revenue from contributions increased by almost 4%.
13 The reduction in the pensioner-contributor ratio responsible for this is not solely due to the very robust employment situation and the merely moderate increase in the number of pensioners. Another significant factor is that the number of "standardised contributors" is calculated using (outdated) provisional average wages. This factor will markedly reduce the pension increase in 2013.

Finances of the Federal Employment Agency

€ bn, quarterly



1 Including transfers to the civil servants' pension fund. **2** Excluding central government liquidity assistance.
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After renewed high surplus for 2012 as a whole, …

A somewhat steeper rise in expenditure can thus be expected during the second half of the year owing to the pension adjustment. But income is likely to increase just as strongly as in the first six months. Following the improvement in the first half of the year, the surplus for 2012 as a whole could be somewhat higher than the figure recorded in 2011 (just over €4½ billion).

… cut in contribution rate to below 19% in 2013 conceivable

Depending on the assessment of further financial developments in 2013 and even taking into account the planned €1 billion cut in the general central government grant, a rule-induced cut in the contribution rate to below 19.0% (the level that was most recently calculated by the official estimators) cannot be ruled out.

Temporary favourable financial situation does not justify permanent benefit rises

In the light of the demographic changes, which are set to have an increasingly stronger financial impact from the middle of the current decade onwards, the 2013 contribution rate will suffice for a time only. It is likely that the reserves will be depleted in the near future and that distinctly higher contribution rates will soon be required. Benefit increases, such as the mooted top-up for very low pensions or higher pensions for persons with reduced earning capacity, will thus have to be financed by even higher taxes or contributions in the long term.

Federal Employment Agency

Financial situation better in Q2

The Federal Employment Agency recorded a surplus of €½ billion in the second quarter of 2012, as it had done one year previously. However, the Agency received just over €½ billion less in central government liquidity grants, so that after adjustment for financial transactions with the central government budget, there was once again a marked improvement in the result. On the revenue side, this was helped by the ongoing significant growth in contributions (+4%). On the expenditure side, spending on active labour market policy was once again reduced by a round one-fifth. By contrast, expenditure on unemployment benefit barely fell. Insolvency benefit payments, in particular, recorded strong growth. Overall, the Federal Employment Agency's revenue decreased by almost 5½%, while its expenditure fell by just over 5%.

Financial improvement also expected for 2012 as a whole

In the first half of 2012, the Federal Employment Agency's surplus was €½ billion higher than the figure recorded one year previously, and its finances for the year as a whole are also expected to improve. Contribution receipts are forecast to record further strong growth in the wake of the relatively high wage agreements from spring 2012. Moreover, despite the cut of almost €1 billion for the year as a whole, in a year-on-year comparison, more funds are expected to flow from the central government budget in the second half of the year as a result of the significantly lower payments so far this year. The decline in outlays on job promotion schemes is likely to continue. However, spending on unemployment benefit, which is influenced by the short-term employment trend, is set to pick up again. In June, the number of recipients of unemployment benefit started to increase. Nevertheless, overall it can be assumed that the surplus of €½ billion for the year as a whole – as forecast by the Federal Employment Agency in its budget plan – will be exceeded.