Public finances*

General government budget

Decline in deficit and debt ratios in 2011

The general government deficit ratio declined significantly from 4.3% in 2010 to 1.0% last year. The deficit thus fell back below the 3% threshold two years before the deadline set under the excessive deficit procedure. The favourable economic developments were one important factor in this development. As in previous upturns, growth in tax revenue was perceptibly stronger than that in the macroeconomic reference variables which were positively affected by the business cycle. In addition, very large capital transfers to support financial institutions (which amounted to just under 1½% of gross domestic product (GDP) in 2010) were almost entirely absent in 2011, and the structural deficit also declined over and above that (see also the box on pages 56 to 57 for more information on developments in 2011). However, the debt ratio was probably still above 80% at the end of 2011, although it is likely to have fallen below the record level recorded at the end of 2010 (83.2%).[1] While the deficit pushed up the debt ratio, this was far outweighed by the strong impact of nominal GDP growth in the opposite direction. In addition, risk assets – and the associated liabilities – held at state "bad banks" and capital assistance were scaled back. These factors more than offset the debt growth caused by increased financial assistance for euro-area countries.

Revenue ratio rose significantly

The general government revenue ratio rose significantly to 44.6% (2010: 43.6%). Higher taxes and social contributions, such as the increase in contribution rates to the statutory health insurance scheme and the Federal Employment Agency and the discretionary tax hikes arising from the central government consolidation package that was agreed in 2010, were particularly important factors in this development. The very dynamic growth in tax revenue during the upturn had an impact too, and non-tax revenue also rose more rapidly than GDP. In particular, interest income from financial market support measures increased considerably, although this was accompanied by higher interest expenditure on the liabilities assumed in that context.

Decreasing expenditure ratio due to both cyclical and structural factors

The expenditure ratio fell sharply to 45.6% (2010: 47.9%). The favourable cyclical developments chiefly lowered the ratio via increased GDP in the denominator. In the area of fiscal measures, the aforementioned absence of support measures for the financial sector was the main factor contributing to the decline. Other factors included the structural fall in unemployment and the fact that pension payments rose only moderately, which dampened expenditure.

Barely any change in deficit on the cards for 2012

Assuming a limited economic slowdown and barring any major additional burdens from the financial and sovereign debt crisis, the deficit ratio should remain virtually unchanged this year. A fairly small cyclical fiscal burden would be roughly neutralised by a slight structural improvement. The substantial incremental consolidation originally announced will be interrupted in 2012. However, various economic support measures brought in during the 2008-2009 crisis (such as depreciation allowances and investment programmes, which were implemented with long time lags in some cases) are being discontinued this year, and structurally lower unemployment figures and muted spending on pensions could continue to dampen social payments. While the ground for reducing the debt ratio has essentially been laid, assistance for euro-area countries and

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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 budgetary figures as defined in the government's financial statistics (which are generally in line with the budgetary accounts).
1 The ratio stood at 81.8% at the end of the third quarter of 2011.

The structural development of public finances in Germany – results of the disaggregated framework for 2011

According to provisional data from the Federal Statistical Office, the general government deficit in Germany (as defined in the national accounts) fell significantly to 1.0% of gross domestic product (GDP) in 2011, after standing at 4.3% in 2010. Using the "disaggregated framework" for analysing public finances[1], it is possible, firstly, to estimate the role played by cyclical and specific temporary effects and, secondly, to identify other changes, referred to here as structural, in the revenue and expenditure ratios and their major determinants. The main results of this analysis for 2011 are presented below[2].

The results show that favourable cyclical influences caused a decline of just over 0.8 percentage point in the deficit ratio. By contrast, clearly identifiable specific temporary effects, including the fact that both the proceeds from the 2010 radio frequency auction and the high insolvency benefit contributions in the same year were now absent, as well as tax shortfalls linked to a court ruling in 2011 on the taxation of dividends among affiliated enterprises,[3] led to a deterioration of just under 0.4 percentage point in the fiscal balance. As a result, the (structural) deficit ratio, adjusted for both cyclical effects and these specific temporary effects and in relation to trend GDP, decreased considerably by 2.7 percentage points in 2011.

The unadjusted revenue ratio climbed 1.0 percentage point, while the structural ratio showed an even stronger increase of 1.4 percentage points. Growth in non-tax revenue (+0.4 percentage point) contributed to this rise, which was influenced by factors such as the assumption of risky assets (and liabilities) by government "bad banks" and the clear increase in the resulting interest income (and interest expenditure of a similar volume). Furthermore, the macroeconomic variables particularly relevant to government revenue showed faster trend growth than GDP (positive decoupling of the revenue base). This had the effect of raising the ratio by 0.2 percentage point. Legislative changes also contributed to the increasing ratio (+0.3 percentage point). The rise in social contribution rates (to the statutory health insurance scheme and the Federal Employment Agency) and (net) tax increases, most notably those aimed at consolidating the central government budget (especially air traffic tax, nuclear fuel tax and subsidy cuts for energy taxes) were important factors in this development. In addition, the structural revenue ratio grew by 0.4 percentage point (residual). This is largely attributable to the growth in revenue from profit-related taxes, which was stronger than can be explained by the development of entrepreneurial and property income (which serves as the macroeconomic reference variable) and the estimated impact of legislative changes. Positive residuals such as these have been observed during upturns in the past and are generally related to the fact that the modelled temporal distribution does not fully reflect the complex pattern of advance tax payments and net backpayments, while the statistical reference variable does not adequately capture fluctuations in the actual tax base.

The unadjusted expenditure ratio decreased significantly by 2.2 percentage points in 2011, while the structural ratio declined much less steeply (-1.3 percentage points), primarily as a

1 For a more detailed description of the framework, including the standardised method of determining the cyclical component used in the European System of Central Banks, see Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pages 61-76.
2 These results are subject to subsequent amendments arising from revisions to the preliminary national account figures or to estimates of the macroeconomic outlook.
3 In this analysis, the impact of support measures for financial institutes on the deficit is not included among the specific temporary effects.

Structural development*

Year-on-year change in percentage points

Item	2005	2006	2007	2008	2009	2010	2011
Unadjusted fiscal balance[1]	0.4	1.7	1.9	– 0.3	– 3.2	– 1.1	3.2
Cyclical component[1]	– 0.2	0.7	0.5	0.4	– 1.6	0.2	0.8
Temporary effects[1]	0.1	– 0.1	0.0	– 0.2	0.3	0.2	– 0.4
Fiscal balance	0.5	1.1	1.4	– 0.5	– 1.6	– 1.5	2.7
Interest payable	– 0.1	0.1	0.0	– 0.1	– 0.2	– 0.1	0.3
Owing to change in average interest rate	– 0.1	0.0	0.1	– 0.1	– 0.3	– 0.4	.
Owing to change in debt level	0.1	0.1	0.0	0.0	0.1	0.3	.
Primary balance	0.5	1.1	1.4	– 0.5	– 1.9	– 1.7	3.0
Revenue	0.1	0.8	0.8	0.3	– 0.9	– 0.4	1.4
Taxes and social contributions	– 0.1	0.6	0.7	0.2	– 0.9	– 0.5	1.0
Fiscal drag	0.0	0.0	0.1	0.0	0.1	0.0	0.0
Decoupling of base from GDP	– 0.1	– 0.1	– 0.3	0.2	– 0.2	0.2	0.2
Legislative changes	– 0.2	0.2	0.7	– 0.6	– 0.3	– 0.8	0.3
Residual	0.2	0.5	0.2	0.6	– 0.6	0.1	0.4
of which: profit-related taxes[2]	0.1	0.4	0.2	0.5	– 0.6	0.3	0.3
Non-tax revenue[3]	0.2	0.1	0.1	0.1	0.0	0.0	0.4
Primary expenditure	– 0.4	– 0.4	– 0.6	0.8	1.0	1.2	– 1.6
Social payments[4]	– 0.2	– 0.2	– 0.4	0.3	0.5	– 0.1	– 0.3
Subsidies	– 0.1	0.0	– 0.1	0.0	0.1	0.0	– 0.1
Compensation of employees	– 0.2	– 0.1	– 0.2	0.0	0.1	0.1	0.1
Intermediate consumption	0.1	0.1	0.0	0.2	0.2	0.1	0.1
Gross fixed capital formation	– 0.1	0.1	0.1	0.1	0.1	– 0.1	0.0
Other expenditure[5]	0.1	– 0.3	– 0.1	0.2	– 0.1	1.2	– 1.4
Memo item							
Pension expenditure[6]	– 0.1	– 0.1	– 0.3	0.0	0.0	0.0	– 0.1
Healthcare expenditure[7]	0.1	0.1	0.1	0.2	0.3	0.1	0.0
Labour-market expenditure[8]	0.1	– 0.1	– 0.2	0.1	0.0	– 0.2	– 0.3

* Adjusted for cyclical influences and specific temporary effects. In accordance with EDP definition, ie includes swaps and forward rate agreements in interest rate expenditure and the fiscal balance; figures for 2011 in accordance with ESA 95. **1** Year-on-year change in the ratio to nominal GDP. **2** Assessed income tax, corporation tax, local business tax, investment income tax. **3** Other current transfers receivable, sales and total capital revenue. **4** Including other current transfers to households. **5** Other current transfers payable to corporations and the rest of the world, other net acquisitions of non-financial assets and capital transfers. **6** Spending by the statutory pension insurance scheme, on civil servants' pensions as well as payments by the Post Office Pension Fund and the Federal Railways Fund. **7** Spending by the statutory health insurance scheme and assistance towards civil servants' healthcare costs. **8** Spending by the Federal Employment Agency (excluding the compensatory amount (up to 2007)/reintegration payment (from 2008) paid to the central government) and central government expenditure on unemployment benefit II and on labour market reintegration measures.

result of the less pronounced increase in nominal trend GDP. The interest expenditure ratio rose perceptibly,[4] not least owing to the aforementioned balance sheet extension, and the structural ratio of other expenditure (primary expenditure) thus fell somewhat more sharply (-1.6 percentage points). On balance, this was almost exclusively due to the near-absence of capital transfers to support financial institutions in 2011 (just under 1½% of GDP in 2010). Social payments also made a noticeable contribution, chiefly as a result of the structural fall in unemployment figures. Another factor was the decline in expenditure caused by temporary economic stimulus measures being phased out. By contrast, as in the preceding years, rises in employee compensation and intermediate goods increased the structural ratio slightly.

Overall, the significant reduction in the high deficit in 2011 was mainly the result of positive cyclical developments, an additional boom in profit-related taxes and the discontinuation of extensive financial market support measures. Various increases in taxes and social contributions and the slower growth in social benefits had a much lesser but still noticeable impact.

4 The determinants of the change in the interest expenditure ratio are not shown for last year because the debt level at end-2011 is not yet available.

possibly also German financial institutions will increase debt[2], meaning that the ratio may even grow again.

Consolidation still needed despite favourable developments

The general government deficit developed very favourably in 2011. However, this should not blind us to the fact that the outcome was well short of the medium-term objective of a structurally close-to-balance general government budget. The relatively good general government budget situation was due, not least, to the surplus posted by the social security funds. Nonetheless, the institutional setting means that this surplus is merely temporary. By contrast, some state and local government budgets are still very strained. It is also becoming apparent that the debt ratio will remain well above the reference value of 60% for many years to come, even assuming that the sovereign debt crisis does not escalate any further and demographic problems are addressed in a manner which does not increase the debt ratio.

Achieve structurally balanced budget promptly

Against this backdrop, it is important not to delay further consolidation, but rather to rapidly achieve a structurally balanced budget at all levels of government. The economic outlook also does not justify any relaxation of consolidation efforts, besides which the automatic stabilisers would take effect should the economy weaken significantly (which does not currently appear likely). Calls from some quarters for Germany to loosen its fiscal policy stance in order to stimulate economic activity in other euro-area countries often overlook the fact that the impact of German fiscal policy on demand elsewhere in Europe is very limited,[3] meaning that this strategy would probably be doomed to failure. Aside from that, much less consolidation is needed in Germany to achieve a structurally balanced budget than in most of its partner countries in Europe.

Strict compliance with budgetary rules

Particularly in view of the recent European agreements on tightening national fiscal rules (see pages 60 to 63), fiscal policymakers in Germany must set an example in implementing national rules. Not least for that reason, both central government and the federal states should promptly cut their deficits and also aim to build in safety margins vis-à-vis the ceilings specified in the budgetary rules. The hesitant or less than rigorous implementation seen in some cases illustrates the continuing conflict between current consolidation needs and the political desire for expansionary fiscal policy in the short term. Fiscal policymakers in Germany should both manage national budgets responsibly and strive to ensure at the European level that budgetary objectives truly are more than non-binding recommendations in future – not least in order to limit the risks to German public finances. Sound public finances are vital to maintaining governments' room for manoeuvre, and credible steps in this direction are needed to overcome the current crisis of confidence.

Budgetary development of central, state and local government

Tax revenue

Buoyant tax revenue growth in 2011

At almost 8%, tax revenue[4] grew very buoyantly in 2011 (see chart and table on pages 64 and 65), and was thus €2 billion higher than expected by the Working Group on Tax Estimates in November. The rise in revenue from income-related taxes was above average, at 10½%.

Strong growth in income-related taxes

The increase in wage tax receipts (+9½%) was bolstered by the fall in deductions for child benefit and subsidies for supplementary private pension plans, but would still have been around 6½% without these effects. Growth in revenue from profit-related taxes

2 In particular, the possibility of the government sector assuming further assets and liabilities in connection with the liquidation of WestLB is being discussed. The precautionary reactivation of SoFFin has created the option of supporting financial institutions in new cases of distress. However, specific cases where this facility might be used are not under discussion at present.
3 See IMF, Germany – Staff Report for the 2011 Article IV Consultation, June 2011, p 15.
4 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.

was particularly strong (+13½%). Corporation tax income continued to rise very sharply following on from the previous year's strong growth.[5] Receipts from investment income tax also climbed steeply. While revenue from non-assessed taxes on earnings (especially on dividends) rose significantly, receipts from withholding tax on interest income and capital gains declined. Developments in assessed income tax were less volatile and revenue grew relatively moderately, by 2½%; without the falling deductions arising from the homebuyers grant and from refunds to employees, it would actually have decreased. Revenue from consumption-related taxes also rose significantly by just over 5%, with growth in receipts from excise duties growing almost as strongly as those from turnover tax, mainly as a result of tax hikes affecting excise duties.

Clear rise in receipts from consumption-related taxes

Marked rise in revenue expected for 2012, too

The latest official tax estimate in November 2011 expected revenue (including local government taxes) to rise by 3½% this year, with robust growth forecast for the especially high revenue-yielding macroeconomic reference variables. In the updated macroeconomic forecast published by central government in January, the relevant economic developments appear only slightly less favourable. The impact of legislative changes and extraordinary effects on tax receipts is likely to be slightly positive on balance, especially owing to the expiry of both the homebuyers grant and depreciation allowances brought in under the economic stimulus package that was adopted at the end of 2008.

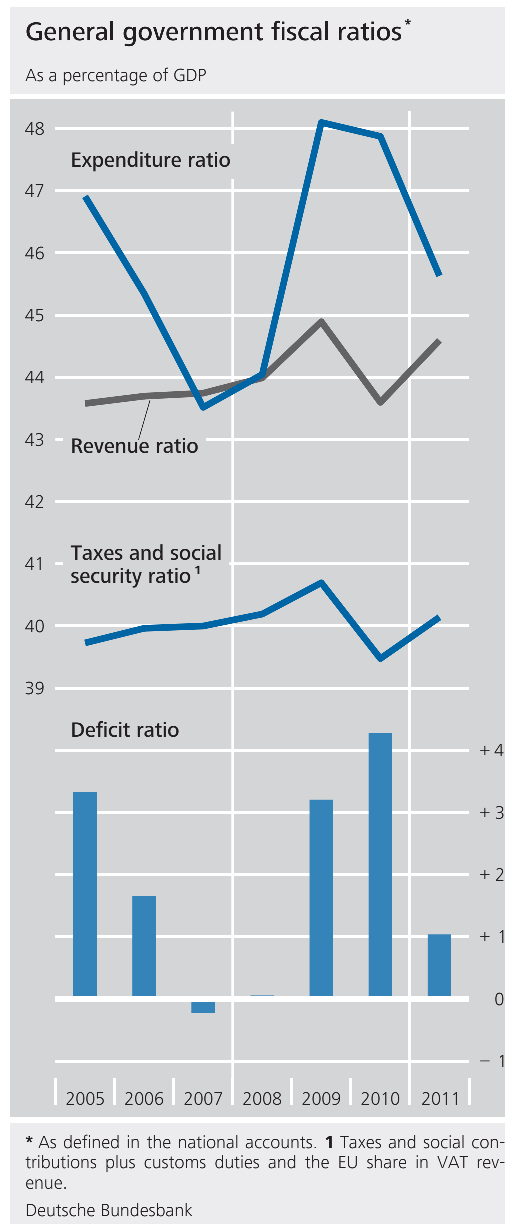
Central government budget

Deficit in central government budget fell substantially in 2011

Central government posted a deficit of €17½ billion for 2011, which was €27 billion lower than that recorded for 2010. This was partly thanks to a sharp rise in revenue (6½%, or €19 billion). Even stronger growth in tax revenue contrasted with a decline in other receipts, notably owing to the absence of the one-off effect amounting to €4½ billion from the auction of radio frequencies in 2010. Expenditure fell by 2½% (€7½ billion). Alongside the absence of the payment to offset the Federal Employment Agency's deficit, another important factor in this decline was the fall in expenditure on unemployment benefit II, although this was mainly due to pension contributions on behalf of recipients of this benefit having been discontinued.

General government fiscal ratios*

As a percentage of GDP



* As defined in the national accounts. **1** Taxes and social contributions plus customs duties and the EU share in VAT revenue.

Deutsche Bundesbank

On balance, the deficit only came to just over a third of the figure estimated in the November

5 The development of the individual taxes is distorted by a one-off sizeable refund of corporation tax coupled with additional revenue of the same amount for non-assessed taxes on earnings.

The fiscal compact and the European Stability Mechanism

Since the onset of the sovereign debt crisis, the euro area has not only taken measures aimed at alleviating acute problems but has also been overhauling its fiscal framework. The regulatory framework enshrined in the Treaty on the Functioning of the European Union, featuring national fiscal responsibility and the no bail-out rule, is to remain unchanged. Recently, for example, the proposal made in connection with Greece of intervening in a country's budgetary autonomy was clearly rejected. However, in order to more firmly curb future risks to financial stability, measures to prevent imminent defaults in a euro-area country are to be improved and – should this prove insufficient in individual cases – the elimination of obstructions is to be made easier.

With a view to enhancing crisis prevention, the Stability and Growth Pact itself was modified with effect from the end of 2011. Beyond the fiscal domain, the Euro Plus Pact and the macroeconomic imbalances procedure have been agreed.[1] Moreover, extensive changes are being made in the field of financial market regulation and supervision. In light of ongoing tensions in the financial markets, the heads of state or government of the euro-area countries additionally agreed at the beginning of December 2011 to "move towards a stronger economic union" and announced a fiscal compact. This declaration resulted in an intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which was finalised on 30 January 2012 and includes the fiscal compact. It is to enter into force on 1 January 2013 provided at least 12 of the contracting parties have ratified it by then. Alongside the euro-area countries, the other EU member states, with the exception of the United Kingdom and the Czech Republic, have also signed the treaty and plan to ratify it. Furthermore, with regard to improving crisis resolution, a treaty establishing a permanent European Stability Mechanism (ESM) was adopted.

Fiscal compact

A key component of the fiscal compact is the stipulation that general government budgets must be at least close to balance in structural terms.[2] Although the Stability and Growth Pact includes very similar requirements, under the terms of the fiscal compact they are to be hardcoded into national legislation (preferably into the constitution). Moreover, the pact envisages an automatic correction mechanism that is triggered if targets are missed by a wide margin, for which the Commission will propose uniform principles at a later date. The Commission will also oversee the transposition of the budgetary rules into national legislation ("debt brake"). If it finds fault with the transposition process, one or several of the contracting parties will bring a case before the European Court of Justice (ECJ). The contracting parties can also file a case independently of the Commission's report if they consider implementation to be inadequate.[3]

1 See Deutsche Bundesbank, European Council decisions on the prevention and resolution of future sovereign debt crises, Monthly Report, April 2011 pp 53-58.
2 The structural deficit must not exceed 0.5% of GDP. If a country's debt ratio is significantly below the 60% ceiling and the risks for the long-term sustainability of public finances are considered to be low, the structural deficit may amount to a maximum of 1% of GDP. Temporary deviations from the provisions are permitted only in exceptional circumstances (natural disasters, severe recessions).
3 The decision of the ECJ will be binding. The next step in the event of non-compliance would be to bring another case before the court. The ECJ can then impose a fine of up to 0.1% of national GDP.

The objectives underlying the fiscal compact are welcome. If placing the fiscal rules on a firmer legislative footing means that compliance with a structurally at least close-to-balance budget becomes the norm, this would be an important contribution to ensuring the sustainability of public finances, and could create confidence.

However, much hinges, *inter alia,* on the details awaiting clarification at supranational level by proposals from the Commission. Furthermore, the corresponding detailed provisions must be formulated in such a way that the ECJ can make a clear assessment regarding the adequacy of the transposition into national legislation. These common principles concern, firstly, the adjustment paths. Thus there is a need to define the pace at which existing structural deficits are to be reduced, and, consequently, the deadline for achieving the budgetary objective. In so doing, it is essential that a sufficiently ambitious path is set. The standard rule envisaged in the Stability and Growth Pact requiring a structural improvement of 0.5% of GDP on an annual average appears inadequate, at least for member states with serious public finance problems. Furthermore, (equal) annual consolidation steps should be stipulated to thwart the danger of backloading the consolidation efforts to the very last years of the adjustment period. This temptation to backslide has often been observed in the past, with the result that the adjustment burden may be seen as excessive in the final years and so prompt appeals to postpone the correction deadline.

A second key need is to specify the basic features of the automatic correction mechanism that is triggered if targets are missed. Stipulating rules for the repayment of debt resulting from overshooting the deficit limit – as have been introduced with the German debt brake – would constitute a significant step forward vis-à-vis the existing fiscal rules at European level.

However, the success of the planned budgetary rules ultimately depends on their implementation and application in the national context. Both the general public and the national (constitutional) courts are likely to have an important role to play in this respect as long as the appeal procedures in the member states are not narrowly constrained. Moreover, a high degree of transparency is essential when it comes to implementing the rules. However, as in the case of the Stability and Growth Pact, this still cannot rule out the risk of numerous exceptions ultimately being tolerated.

In addition to provisions on national budgetary rules, the fiscal compact also contains a stronger automatic sanctions mechanism in connection with the European excessive deficit procedure. Thus the Council members with voting rights pledge to follow the proposals or recommendations of the Commission in an excessive deficit procedure unless a qualified majority opposes this (what is known as a reverse qualified majority). This is to be welcomed and should also apply unequivocally to the debt criterion. This makes it more likely that the Commission's position will prevail and could make the procedure less prone to fears that corresponding measures could also be passed against the voting parties themselves. However, budgetary discipline will only be promoted if the Commission also actually makes fiscal soundness a priority and demands more stringent compliance with the common budgetary rules than in the past.

Yet aside from its potential to reinforce fiscal rules, the fiscal compact in no way introduces a "fiscal union". Outside the Stability

and Growth Pact, the European authorities are to be given no supranational right to intervene in national fiscal policy. This would not even be the case if the agreed national rules were not properly applied in practice. The fiscal compact does not, consequently, justify any extensive joint liability (eg Eurobonds). Otherwise, there would be an even greater mismatch between liability and control than is already the case, and the framework of monetary union would become increasingly inconsistent.

European Stability Mechanism

In order to overcome the crisis, it was agreed to set up a permanent mechanism, the European Stability Mechanism (ESM), which is scheduled to come into force in mid-2012 and is to replace the European Financial Stability Facility (EFSF) in the medium term.[4] The ESM's maximum lending capacity (counting funds for primary and secondary market purchases) is to amount to €500 billion, including financial assistance provided by the EFSF. However, it has been announced that this figure will be reassessed in March. The ESM will have a total subscribed capital of €700 billion, €80 billion of which is to be paid up in instalments over, in principle, a period of five years. Advance or additional payments might be required in order to support the ESM's rating or offset any losses.

In addition to bond-financed assistance loans, the ESM – as is already the case for the EFSF – can also issue precautionary credit lines, grant loans to refinance financial institutions to non-programme countries and make primary and secondary market purchases. Furthermore, in principle, the effective lending capacity can be increased by means of leveraging. The ESM's financing and administrative costs are to be covered by the interest on the assistance loans. In addition, an appropriate margin is to be factored into the calculation. In line with the terms and conditions for EFSF loans to Ireland and Portugal, which have since been eased, it appears, however, that no interest rate premiums will be charged as a general rule. In accordance with the practice of the International Monetary Fund (IMF), involvement of private creditors is envisaged, should this prove necessary in order to restore the sustainability of public finances. From 1 January 2013 onwards, all new government bond issues of ESM member states (with a maturity of more than one year) are accordingly to include a collective action clause to facilitate restructuring. ESM loans will be junior only to IMF loans; they will be senior to the loans of all other creditors. From 1 March 2013, the transposition of the fiscal compact's provisions into national legislation will be a prerequisite for receiving assistance from the ESM.

Important decisions, particularly regarding the amount of ESM capital and its maximum assistance volume, the granting of financial assistance and the conditions thereof, as well as the range of instruments available to the ESM, are to be made by the representatives of the member states within the respective ESM board[5] "by mutual agreement". However, in emergencies, where the Commission and the ECB jointly conclude that the financial stability of the euro area will otherwise be at risk, a qualified majority of 85% of the capital will suffice (which nevertheless still implies a veto right for Germany).

4 The ESM treaty will enter into force as soon as member states representing 90% of the capital commitments have ratified it.
5 Each ESM member state sends its finance minister as its representative to sit on the Board of Governors. Further delegates from the countries form the Board of Directors.

The ESM can help to contain risks to financial stability in the euro area. However, it weakens the no bail-out rule that applies generally throughout the euro area. Moreover, any assistance mechanism has the potential to reduce the incentives for sound public finances and the effectiveness of the preventive rules. It is therefore crucial that, on the one hand, the granting of assistance is subject to strict conditionality and that non-compliance is penalised. On the other hand, the assistance loans should only be granted with appreciable interest rate premiums. The IMF, for example, on which the European assistance mechanisms are in part explicitly modelled, envisages premiums totalling around 300 to 400 basis points. Waiving an interest rate premium would mean largely abandoning an important incentive to avoid tapping the assistance mechanism, or to at least rapidly return to the capital market. Countries providing assistance which themselves have budgetary problems might end up paying higher interest rates than the countries receiving assistance. It would prove difficult to rigorously implement the EU budgetary rules, up to and including the imposition of sanctions if the rules are breached, if a country that has forfeited access to the capital market following blatant breaches of the rules receives support from the ESM at heavily subsidised interest rates.

Looking at the extended set of instruments that the ESM has assumed from the EFSF, the authorisation of secondary market purchases, in particular, is not promising.[6] The envisaged preferred creditor status for ESM loans, which protects the taxpayers in the countries providing support, is to be welcomed.[7] It is important that measures are taken to ensure that this status is not undermined by primary and secondary market purchases. The EFSF leverage models, which might also be transferred to the ESM, are at odds with the principle of preferred creditor status, as they effectively amount to junior status. With regard to parliamentary control and broad public acceptance, it is important that the assistance mechanisms are transparent and verifiable.

Given the recent ruling of the Federal Constitutional Court on assistance for Greece and the euro rescue shield, calling for parliamentary control, it would seem problematic for the Board of Governors of the ESM to be able to change important elements such as the set of instruments, the capital and the maximum lending volume, possibly even autonomously. As in the case of the EFSF, the German Bundestag can secure rights to participate in such decisions in the ratification process. Guidelines for the instruments and conditions of the ESM can also be decided in this context.

6 For more information, see Deutsche Bundesbank, The debate on secondary market purchases by the future European Stability Mechanism, Monthly Report, February 2011, pp 68-69.
7 By contrast, the EFSF generally has no preferred creditor status.

Tax revenue*

Year-on-year change, quarterly

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

Result also considerably better than in budget plan

2010 budget plan (€49 billion). Tax revenue exceeded the estimates very clearly by €19 billion, and expenditure was €9½ billion lower. The largest single deviation from the estimates resulted from the fact that the loan to offset the Federal Employment Agency's deficit (€5½ billion) was not required. However, the estimates were also significantly undershot for interest expenditure (by €2½ billion), payments for unemployment benefit II (by €1 billion) and calls on guarantees (by €1 billion).

Large amount credited to control account but borrowing limit set too high

The structural deficit, which is of key importance to the debt brake, was also lower in 2011 than expected in the budget plan (€41½ billion). According to the available data, it amounted to €20 billion on balance, far below the constitutional limit of €45½ billion in the budget plan (see also pages 66 to 67). If the data remain unchanged, this amount will be credited to the control account at the beginning of March.[6] However, if the rules for calculating the starting value for the borrowing limit during the transitional period are applied more stringently, the limit was undershot by much less (€10 billion).

The 2012 central government budget plan envisages a clear rise of €9 billion in the deficit compared with the actual figure for 2011, resulting in an estimated deficit of €26½ billion for 2012. The structural deficit would also increase appreciably (to €25½ billion) based on the figures in the budget plan. However, some of the estimates are fairly cautious from today's perspective, even based on the somewhat less favourable macroeconomic developments assumed in the Annual Economic Report published at the beginning of 2012. For example, the fact that transfers to the EU budget – which are deducted from tax revenue – are estimated to increase by one quarter (€5 billion) vis-à-vis the actual figure for 2011 means that revenue could turn out to be higher than assumed in the 2012 budget plan. The plan also provides for a rise of €4 billion in interest expenditure, which appears highly unlikely in view of the favourable financing conditions. If there are no calls on guarantees for loans to Greece, appropriations for guarantees will probably act as a buffer, along with estimates in connection with long-term unemployment. All in all, the renewed growth in the deficit could therefore remain limited. However, the intended steady reduction in the structural deficit during the transitional period to ensure that the future limit of 0.35% of GDP will be met in 2016 does not look likely at present. A large number of the measures that were adopted under the June 2010 consolidation package have since been dropped.[7]

2012 budget plan shows clear rise in deficit, but estimates cautious

Supplementary budget needed to bring forward capital transfer to ESM

Even before the 2012 Budget Act had come into force, it was announced that a supplementary budget would be passed to provide funds for the European Stability Mechanism (ESM), which is to be set up earlier than planned. If the regular first annual tranche of the €4½ billion capital transfer were brought forward, this could probably be funded from the existing borrowing authorisation, but a supplementary budget is needed for the spending authorisation. According to a provisional decision by Eurostat, the capital transfer could be classified as

6 For a critical assessment of this, see Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40.
7 See Deutsche Bundesbank, Public finances, Monthly Report, November 2011, pp 63-76.

Tax revenue

Type of tax	Year as a whole				Estimate for 2011 as a whole 1, 2, 3	Q4			
	2010	2011			Year-on-year change	2010	2011		
	€ billion		Year-on-year change € billion	as %	as %	€ billion		Year-on-year change € billion	as %
Tax revenue, total[2]	488.7	527.3	+ 38.5	+ 7.9	+ 7.5	137.0	145.4	+ 8.4	+ 6.1
of which									
Wage tax	127.9	139.7	+ 11.8	+ 9.3	+ 9.6	36.8	39.5	+ 2.8	+ 7.6
Profit-related taxes[4]	64.9	73.8	+ 8.9	+ 13.7	+ 11.2	16.5	18.6	+ 2.2	+ 13.2
Assessed income tax	31.2	32.0	+ 0.8	+ 2.6	+ 0.7	8.0	8.8	+ 0.7	+ 9.2
Corporation tax	12.0	15.6	+ 3.6	+ 29.8	+ 23.1	4.7	5.9	+ 1.2	+ 26.4
Investment income tax[5]	21.7	26.2	+ 4.5	+ 20.6	+ 19.8	3.8	4.0	+ 0.2	+ 5.3
Turnover taxes[6]	180.0	190.0	+ 10.0	+ 5.5	+ 5.7	47.8	49.4	+ 1.6	+ 3.3
Energy tax	39.8	40.0	+ 0.2	+ 0.5	+ 1.0	15.6	15.5	− 0.1	− 0.7
Tobacco tax	13.5	14.4	+ 0.9	+ 6.8	+ 2.5	4.1	4.8	+ 0.7	+ 17.3

1 According to official tax estimate of November 2011. **2** Including EU shares in German tax revenue, but excluding receipts from local government taxes. **3** Including (estimated) local government taxes, tax revenue was €35.6 billion above the November 2010 estimate, which formed the basis for the 2011 central government budget plan at the end of 2010. According to government estimates, had legislative changes not been made in the meantime, the upward revision would have been €33.7 billion. **4** Employee refunds, homebuyers grant and investment grant deducted from revenue. **5** Withholding tax on interest income and capital gains, non-assessed taxes on earnings. **6** Turnover tax and import turnover tax.
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a financial transaction. If it were booked as such, it would have no impact on the structural deficit, which influences the borrowing limit. Nonetheless, the extensive international assistance measures harbour substantial risks for the central government budget, which must be taken into account through cautious budgetary planning, especially with a view to ensuring sustainable public finances in the long term.

Return to consolidation needed in decision on benchmark figures for financial planning

The forthcoming decision in March on the benchmark figures for the 2013 central government budget and for the financial plan up to 2016 needs to mark a return to the path of structural deficit reduction that has been interrupted this year. The medium-term financial plan drawn up in summer 2011 already contained substantial risks. More details are needed on the consolidation planned from 2013 onwards using €2 billion in revenue from a financial transactions tax, as well as on the estimated savings in defence spending and the budgetary relief to be provided by better job mediation for the long-term unemployed. Furthermore, the substantial global expenditure savings of €5 billion per year planned from 2014 onwards still need to be translated into concrete, sustainable consolidation measures, and both the newly planned income tax cuts and the childcare supplement need reliable counterfinancing from 2013 onwards. Otherwise, there is a danger of these factors largely eroding the vitally important safety margin vis-à-vis the borrowing limit which was achieved in 2011. If that were to happen, negative surprises regarding developments in the structural deficit, eg following an economic downturn, would require immediate and potentially procyclical consolidation measures.

Clear surplus in off-budget entities

Central government's off-budget entities posted a surplus of €7 billion in 2011, after recording a deficit of the same size one year previously. This was ultimately due to Commerzbank's substantial repayment of capital contributions to SoFFin, which consequently re-

Debt brake: safety margin vis-à-vis strict borrowing limit

The debt brake limits the increase in central government debt at both the planning and the budget execution stage. To this end, a control account was introduced to which the (positive or negative) difference between actual structural borrowing and the constitutional limit is booked. If debt on the account exceeds a certain threshold, which the implementation act fixes at 1% of GDP, corrective measures are, as a general rule, needed to reduce it.[1]

The preliminary outturn for the 2011 central government budget shows net borrowing of €17.3 billion. After adjustment for financial transactions and cyclical effects,[2] structural borrowing works out at €20 billion.

From 2016 onwards, the constitutional limit for structural borrowing will be 0.35% of GDP. For the transitional period beginning in 2011, structural borrowing in 2010 is the starting value on which the reduction of the limit in even steps is based. The German central government uses its June 2010 estimate of 2.2% of GDP (€53.2 billion) as the starting value for the limit.[3] The limit for 2011 was therefore set at 1.9% of GDP (€45½ billion). The difference between this limit and the actual figure means that the control account will be credited with 1% of GDP (€25½ billion).[4] For the current year, the deficit is again well below the threshold defined by the government despite the planned consolidation pause, and under current plans a large sum would be credited to the control account again in the 2012 budget year. In view of the debt brake's purpose of tightly restricting growth in debt during budgetary planning and execution, it still appears to make sense not to use the "ski jump effect" to book extensive credit to the control account. This is because, in the opposite case of the borrowing limit being exceeded during budget execution, the buffer on the control account would permanently allow higher debt levels, as the general redemption principle would be waived for this amount, contrary to the debt brake's intention.

In addition, one important characteristic of the new debt brake is revealed when looking at unexpected budgetary and economic developments. For instance, of the €19 billion by which tax revenue in 2011 exceeded the estimated figure,[5] only just over €3 billion is reported as being due to cyclical factors even though the overall difference in GDP growth was attributed to cyclical factors. Ultimately, only a small percentage of the additional revenue was therefore filtered out.

Conversely, when developments are less favourable than planned – such as during the first half of the last decade – a large percentage of tax shortfalls vis-à-vis the budget plans is generally likely to be treated not as cyclical, but rather as increasing the structural deficit. In an ongoing budget, residual borrowing authorisations or a supplementary budget, which allows the regular constitutional limit to be exceeded by 3% of tax

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1 There is no ceiling for credit balances.
2 On balance, net disposals of -€1.9 billion were recorded for financial transactions, which raises the structural deficit. When the budget was adopted, the cyclical component had been expected to make a negative impact of -€2.5 billion. As GDP growth turned out to be higher than expected at that time, the cyclical component must be adjusted before a booking can be made to the control account. Specifically, the economic growth not foreseen in the budget plan, which is, under the rules of the implementation regulation, classified in full as cyclical, formally accounts for budgetary relief of just over €3 billion, which means a positive cyclical effect of just under €1 billion (product of nominal growth differential (+0.8 percentage point), the corresponding sensitivity of the central government budget (0.16) and nominal GDP).
3 By contrast, the actual structural deficit (which is not reported officially) was only 1.4% of GDP in 2010 (€34 billion).
4 If the limit were linked to the deficit actually recorded in 2010, however, the figure would be just €10 billion. The "ski jump effect" brought about by the artificially high starting point for the limit up to 2015 is discussed in greater detail in Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 26-28.
5 Of the additional revenue just under €5 billion are, on balance, the result of lower payments to the EU, the fact that tax refunds expected in connection with the Meilicke case did not occur and legal changes made in the meantime, which leaves an adjusted difference of €14 billion.

revenue (currently €7½ billion), could be used. If this leeway to exceed the general borrowing limit were to prove insufficient, an exemption clause would have to be used or a short-term consolidation package enacted.

When passing the next regular budget, any remaining financing gap would then have to be closed, however, and the constitutional borrowing limit would have to be strictly met if the exemption clause could (no longer) be used. Netting with a control account balance is possible only when the limit is breached during the execution of a budget.[6] Past experience shows that the necessary consolidation can be considerable and will probably tend to be procyclical.[7] Against this backdrop, we would urgently recommend maintaining a clear safety margin vis-à-vis the regular constitutional borrowing limit. It would be advisable to resume the consolidation steps agreed in June 2010 and at least to plan to maintain the margin vis-à-vis the limit scheduled for 2012 and thus to aim for a structural surplus from 2016 onwards. The very high debt ratio and the future strains as a result of demographics mean that the reduction in government debt that this would entail (provided there are no negative surprises) appears appropriate.

6 However, it would be possible to deliberately run down the credit balance in the event of distorted budget estimates.
7 See Deutsche Bundesbank, Reform of German budgetary rules, Monthly Report, October 2007, pp 47-68 and J Kremer and D Stegarescu, Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik, Wirtschaftsdienst, 9/2009, pp 630-636.

corded a cash surplus of €10½ billion. The precautionary special fund for repaying inflation-indexed central government debt instruments, the pension reserves and the post office pension fund all posted surpluses – as did the new Restructuring Fund as a result of its income from the bank levy. By contrast, the Investment and Repayment Fund (IRF), which was set up in 2009 to combat the economic crisis, recorded a deficit of €7½ billion because of final drawdowns.

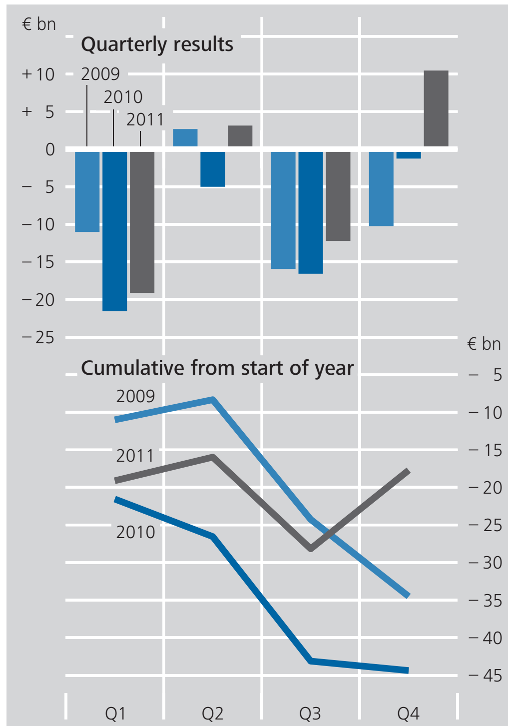
Substantial borrowing authorisations for off-budget entities in 2012

There is a great deal of uncertainty surrounding developments in central government's off-budget entities in 2012. Following the expiry of the IRF's measures and in view of the surpluses that will probably be recorded by the special funds and reserves formed to provide for subsequent budgetary burdens, another positive budget balance would seem likely. However, an act reinstating the Financial Market Stabilisation Fund (SoFFin) has now been passed, authorising the fund to take new assistance measures to stabilise financial institutions up to the end of 2012 and supplement them later if necessary. In addition, the restrictions on existing borrowing authorisations were lifted and their volume was increased by €20 billion. Although no new applications for assistance are foreseeable at present, the German government is thus taking precautions in case the sovereign debt crisis worsens, as agreed by the European Council in December 2011.

New borrowing authorisation for SoFFin problematic for debt brake

However, this new borrowing authorisation for a special fund, which ultimately has no time limit, is a problematic "foreign body" in the context of the debt brake. The statement of legislative intent accompanying the act introducing the debt brake stresses that special funds with their own borrowing authorisation are not compatible with the debt brake. For this reason, this legislation permits the use of special funds' borrowing authorisations that were already in existence at the end of 2010, but evidently does not allow new authorisations. In the past, bor-

Central government fiscal deficit / surplus



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rowing via off-budget entities has noticeably contributed to the accumulation of government debt; ultimately, this complicates the task of ensuring transparent adherence to the rules and effective monitoring by both the public and parliament. The new borrowing authorisation for SoFFin threatens to set a precedent which would rob the structural borrowing limit (0.35% of GDP from 2016 onwards) – which was intended as a cast-iron rule – of some of its binding effect, as it allows the overall limit for the central government budget (including the special funds) to be overshot ex ante without invoking the exemption clause. While we welcome the fact that actual borrowing above the limit must be subsequently repaid regardless of the balance on the control account, the temporal disconnect between borrowing authorisations and their repayment plans weakens the key incentive established in the constitutional rules governing the exemption clause, which envisage that the decision on a repayment plan should be taken at the same time as that regarding the exceptional borrowing authorisation itself. It would therefore have been advisable to include a necessary additional borrowing authorisation in the central government budget rather than borrowing via off-budget entities.[8] Going forward, it will be important – not least in view of the fiscal compact recently adopted at the European level – to ensure that national debt rules are applied stringently and transparently and to refrain from opening up or using any scope for circumvention.

State government[9]

Clear decline in deficit in 2011

With a deficit of €9½ billion in 2011, the federal states' finances were in appreciably better shape than planned (€23½ billion) and than a year earlier (€21½ billion). The main reason for the clear year-on-year improvement was the sharp increase of 7½% in revenue, with tax receipts also rising by 7½% (€14 billion), while expenditure grew markedly but at a slower pace (+2½%). Ongoing payments to local governments rose by 5½%, reflecting not only an increase in funds transferred from central government but also larger payments in the tax-revenue-sharing arrangement with local government, which is essentially based on developments in tax receipts. Personnel expenditure – a major component of state government spending – was up by 2½% on the year, mainly because of the increase in negotiated pay rates agreed in the spring and its extension to employees with civil servant status and retired civil servants.

Plans for 2012 show ongoing need for consolidation

The available budget plans for 2012 envisage an improvement vis-à-vis the target figures for 2011. Compared with the significantly better budget outcome for 2011, however, they imply renewed growth of over €15 billion in the deficit. None-

8 See also the Bundesbank's statement at the hearing of the Budget Committee on 23 January 2012 at www.bundestag.de.
9 The development of local government finances in the third quarter of 2011 was analysed in greater detail in the short articles in the Bundesbank's January 2012 Monthly Report. These are the most recent data available.

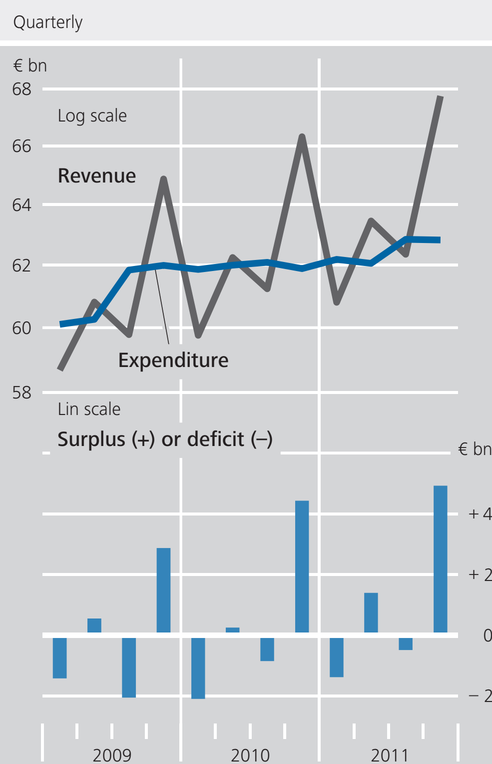
theless, the improvements during budget execution in 2011, which are only partly taken into account in the estimates, mean that the 2012 budget outcome could likewise be better than expected. Given that economic conditions are at least near-normal, the borrowing plans presented by some federal states point to an ongoing, substantial need for consolidation, which is not confined to those states that have agreed restructuring programmes with the Stability Council. Reducing structural deficits remains an important task in almost all federal states.

Restructuring programmes lack sufficient detail in many cases

The restructuring programmes for the federal states in budgetary hardship (Berlin, Bremen, Saarland and Schleswig-Holstein) presented at the Stability Council's[10] latest meeting in December 2011 envisage declining deficits for the years from 2012 to 2016. Like the plan for central government, these programmes do not allow safety margins vis-à-vis the overly high deficit limits, contrary to the administrative agreements (to receive consolidation assistance) signed in spring 2011.[11] Bremen's margin will, *de facto,* be fully eroded, and in Saarland the need for action to curb the deficit is even set to increase towards the end of the programme period. The planned deficit reduction crucially depends on the marked growth in tax receipts expected up to 2015 and extrapolated for 2016 in the November 2011 tax estimate. By contrast, some of the planned spending cuts are left rather abstract. The programme for Bremen even states that the process of drawing up the budget has not yet progressed far enough to name the specific measures that are required. Given that the Constitutional Court of Bremen ruled in August 2011 that Bremen was in extreme budgetary hardship – a status which, according to the Federal Constitutional Court's ruling on Berlin in 2006, can actually only be declared once all possibilities for easing the budgetary situation have been exhausted – it remains to be seen whether the necessary savings can really be made.

Finances of the German statutory pension insurance scheme

Quarterly



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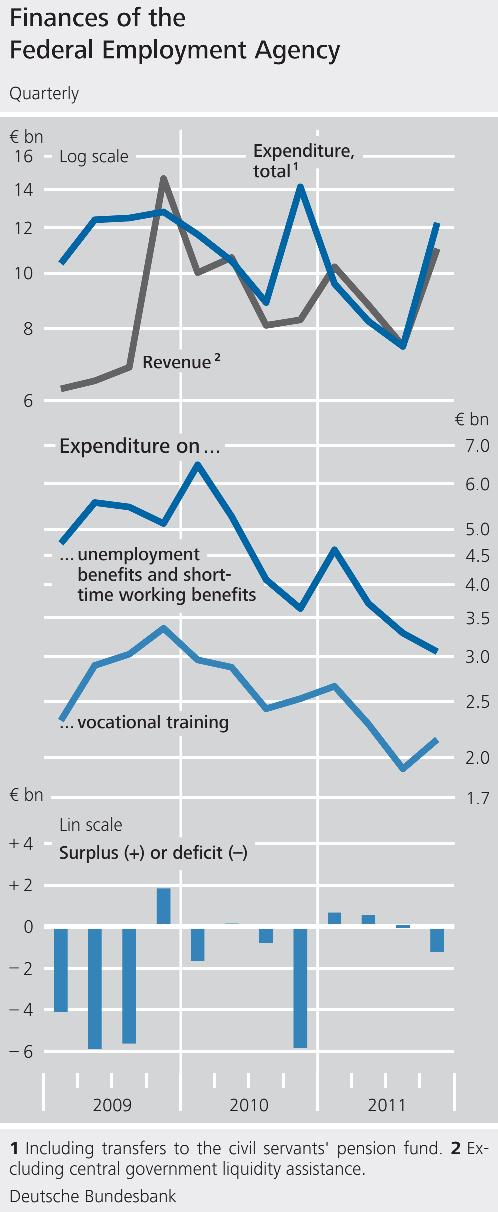
Social security funds[12]

Statutory pension insurance scheme

Surplus more than double that of previous year

According to provisional figures, the statutory pension insurance scheme posted a surplus of €4½ billion in 2011, which was more than double that recorded one year previously. Growth of 2% in revenue was partly offset by a rise of just under 1% in expenditure. The scheme's reserves thus swelled to €24 billion, or 1.4 times its monthly expenditure. Assuming that the labour market remains robust and wage growth

10 See Deutsche Bundesbank, The role of the Stability Council, Monthly Report, October 2011, pp 20-23.
11 See Deutsche Bundesbank, German states receiving consolidation aid – initial deficit reduction requirements not very ambitious, Monthly Report, May 2011, pp 70-71.
12 The financial development of the statutory health and public long-term care insurance schemes in the third quarter of 2011 was analysed in detail in the short articles of the Bundesbank's December 2011 Monthly Report. These are the most recent data available.



1 Including transfers to the civil servants' pension fund. 2 Excluding central government liquidity assistance.
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is stable, on this basis – and given an unchanged contribution rate – the threshold value of 1.5 times the scheme's monthly expenditure would be overshot at the end of 2012. To prevent this from happening, the contribution rate was lowered from 19.9% to 19.6% on 1 January 2012.

Cyclical growth in contributions dominates revenue developments

Revenue from contributions grew by more than 2½% in total. At just over 4%, the increase in employees' compulsory contributions was much sharper owing to the favourable employment and wage developments. By contrast, contributions on behalf of recipients of unemployment benefit I and basic social welfare allowances contracted by two-fifths. This development was influenced by the declining number of unemployment benefit I recipients, and even more strongly by the fact that pension contributions on behalf of recipients of unemployment benefit II were discontinued at the beginning of 2011. All in all, central government grants were down slightly on the year because they had been largely extrapolated on the basis of (negative) wage growth in 2009.

Expenditure developments moderate overall

Pension payments, the largest component on the expenditure side, increased moderately, by less than ½%. This was mainly due to low adjustments[13] overall and to the near-stagnation in the number of pensions paid out. By contrast, the fact that the general contribution rate to the statutory health insurance scheme had been raised from 14.9% to 15.5% at the beginning of 2011 drove up expenditure. The contribution payments[14] made by the pension insurance scheme to the statutory health insurance scheme thus rose by just over 4½%.

Deterioration in finances owing to contribution rate cut

In 2012, the statutory pension insurance scheme's finances will deteriorate as a result of the 0.3 percentage point cut in the contribution rate. Furthermore, a much sharper pension increase can be expected in mid-2012, essentially because of the wage growth recorded in 2011. In addition, the sustainability factor will increase the adjustment, as the rise in employment – combined with only marginal growth in the number of pensions – has driven down the relevant pensioner ratios. However, the adjustment will be dampened by another "Riester reform step" and, in particular, by the need to make up for pension cuts that were previously waived.[15] Macroeconomic developments will be crucial in determining whether the contribu-

13 Pensions were not increased in mid-2010 and were raised by 0.99% in mid-2011.
14 The statutory pension insurance scheme pays half of the general contribution to the health insurance scheme less the special contribution of 0.9%, just as employers do for their employees.
15 The accumulated need for such compensation currently amounts to 2.85% in western Germany and 1.43% in eastern Germany. It will be reduced by cutting calculated pension increases by no more than one half.

tion rate will be cut again in 2013. Fundamentally, however, pressure to raise the contribution rate will re-emerge when the post-war "baby boomers" start to retire around the middle of this decade.

Federal Employment Agency

Balanced budget thanks to favourable labour market developments

The Federal Employment Agency posted an almost balanced budget for 2011, after recording a deficit of just over €8 billion in 2010. Although revenue growth, at 1½%, was not particularly strong, expenditure fell by 17½%.[16]

Strong growth in contribution receipts …

Growth in the Federal Employment Agency's contribution receipts was particularly strong in 2011 (12½%), as the contribution rate had been raised from 2.8% to 3.0% at the beginning of the year. The favourable employment and wage developments also made an important contribution to the sharp rise in revenue. However, contributions for insolvency benefit payments were cancelled for 2011 following a particularly high contribution rate of 0.41% in 2010. Total contributions therefore did not exceed the previous year's level. While the regular central government grant had been raised only slightly, a special payment of €½ billion from central government contributed to the appreciable improvement in revenue.[17]

… but insolvency benefit contributions cancelled

Sharp decline in spending thanks to favourable labour market developments

Expenditure on unemployment benefit I declined sharply by 17%. Spending on short-time working benefits fell by as much as two-thirds and nearly returned to its pre-crisis level. Outlays on active labour market policy likewise decreased by 17% (including refunds of social contributions for short-time work). Overall, the Federal Employment Agency thus benefited significantly from the very favourable labour market conditions.

Surplus could be larger than estimated in budget plan

In its budget plan, the Federal Employment Agency expects a slight surplus of €½ billion for 2012. This estimate assumes that unemployment will continue to decline on average over 2012 and employment will see another slight increase. It also includes the first scheduled cut of just under €1 billion in the rule-based central government grant. As things stand, the labour market developments could turn out to be more favourable. In addition, the expenditure appropriations for active labour market policy measures could be overly high, as has often been the case in the past. All in all, a larger surplus could be attainable for the Federal Employment Agency this year.

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16 The Federal Employment Agency's pension fund, which receives contributions from the Federal Employment Agency and pays the pensions of its civil servants, again recorded a surplus of just under €½ billion and its reserves thus amounted to just over €3½ billion.

17 At the end of 2011, central government transferred just under €½ billion to compensate for the fact that the Federal Employment Agency had paid pension insurance contributions on behalf of employees in the entry or educational area of recognised workshops for disabled persons over a period of four years. Section 179 of the Social Security Code VI specifies that central government shall no longer refund these contributions from 2012 onwards.