Public Finances*

General government budget

Small surplus in 2012 amid favourable conditions

The underyling situation for public finances in Germany remained favourable in 2012. The particularly good financing conditions were complemented by relatively high employment and low unemployment as well as ongoing strong momentum in profit-related taxes. Against this background, general government posted a small budget surplus for the first time since 2007. A breakdown of the overall result shows that a still marked deficit run up by central and state governments was eclipsed by a surplus generated by the social security funds. Overall, the fiscal balance stood at +0.1% of gross domestic product (GDP), compared with -0.8% in 2011. The cyclical impact on the fiscal balance in 2012 remained roughly as positive as in 2011 because key macroeconomic aggregates for public finances (gross wages and salaries, unemployment) were barely affected by the considerable slowdown in GDP growth.[1] The structural balance thus improved by around 1% of GDP compared with 2011 (for more detailed information see the box on pages 60 and 61). Nonetheless, a structural deficit – albeit a small one – remains in terms of the level.[2]

Rising revenue ratio, falling expenditure ratio

The revenue ratio rose distinctly from 44.5% in 2011 to 45.1% in 2012. This was primarily due to the favourable growth structure and the momentum in profit-related taxes. The expenditure ratio fell from 45.3% to 45.0%. This decline was primarily attributable to the moderate annualised pension increase, lower labour market spending, the phasing-out of the 2009 stimulus programme and low interest rates. Conversely, the relatively moderate GDP growth in the denominator tended to lessen the reduction of the debt ratio.

Support measures probably pushed up debt ratio in 2012

The final debt ratio figure for 2012 is not yet available. At the end of the third quarter, it had risen to 81.7% and is likely to have remained at around that level at year-end (2011: 80.5%). The increase can be attributed to the support measures in the euro area (EFSF loans, ESM capital injections), which totalled around €45 billion.[3] In general, the measures taken since 2008 to stabilise the euro area and to support German financial institutions have considerably inflated the general government debt ratio. Although these support measures were accompanied in most cases by the acquisition of financial assets, their intrinsic value is subject to considerable uncertainty.

2013: fiscal balance set to worsen, debt ratio to improve

As things stand at the moment, the general government surplus looks set to revert to a deficit in the current year that could amount to ½% of GDP. The slowdown in economic activity can be expected to erode the positive cyclical influence from 2012, thereby revealing the existing structural deficit. No major changes in the structural deficit are apparent in 2013 vis-à-vis 2012. On the one hand, the pension contribution rate has been lowered in order to bring the reserves back down below the maximum permissible level. Additionally, the moderate loosening of fiscal policy is being continued by way of new budgetary burdens that are not

* 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 For the cyclical adjustment method, see Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pp 61-76.
2 By contrast, the Federal Government perceives a slightly negative cyclical influence for 2012. But in view of the development of the relevant macroeconomic aggregates, in particular, it seems more plausible to assume that cyclical factors provided marked relief for the central government budget.
3 By contrast, the rise in the debt ratio was slowed by the small budget surplus and nominal GDP growth of 2% (in the ratio's denominator). Furthermore, various financial transactions occurred last year concerning, inter alia, resolution agencies assigned to the general government sector (accelerated portfolio reduction, on the one hand, and the further assumption of liabilities and claims in the wake of resolving the public regional bank WestLB, on the other). However, the overall results are not yet available.

The structural development of public finances in Germany – results of the disaggregated framework for 2012

According to provisional data from the Federal Statistical Office, Germany's general government deficit (as defined in the national accounts) was completely eliminated in 2012. Following a deficit in 2011 of 0.8% of gross domestic product (GDP), a slight surplus of 0.1% of GDP was achieved. Using the "disaggregated framework" for analysing public finances,[1] it is possible, first, to estimate the role played by cyclical and specific temporary effects. Second, other changes, referred to here as structural, in the revenue and expenditure ratios and their major determinants can be identified. The main results of this analysis for 2012 are presented below.[2]

The results show that cyclical developments played no role in the decline in the deficit ratio. At first glance, the relatively weak rate of GDP growth suggests a negative influence; however, key macroeconomic reference variables for revenue (primarily gross wages and salaries) developed far more stably. Clearly identifiable specific temporary effects were also insignificant.[3] As a result, the structural deficit ratio, adjusted for both cyclical effects and specific temporary effects and set in relation to nominal trend GDP, decreased by 0.9 percentage point in 2012. However, it was not completely eliminated and still stood at just under ½%.

The unadjusted revenue ratio climbed by 0.5 percentage point, whereas the structural ratio rose only slightly, by 0.2 percentage point. Non-tax revenue caused a 0.2 percentage point decline in the structural ratio – owing in part to the Bundesbank's lower profit distribution. The trends of the macroeconomic categories particularly relevant to government revenue virtually tracked trend growth of nominal GDP, and the middle-term growth structure was thus neutral in terms of the structural ratio. Legislative changes reduced the ratio slightly (-0.1 percentage point), primarily due to the lowering of the pension contribution rate. By contrast, fiscal drag increased the ratio by around the same amount. Leaving aside the factors mentioned, the structural revenue ratio grew by 0.4 percentage point (residual). This is largely attributable to the fact that, as in 2011, revenue from profit-related taxes grew faster 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. Consequently, the plunge in revenue from profit-related taxes ascribed to this residual in the recession year of 2009 was more than made good in the following years up to 2012. Fluctuating residuals such as these have also been observed in the past and are particularly related to the fact that the modelled lag structures do not fully reflect the complex pattern of advance tax payments and net backpayments, while the reference variable does not adequately capture the volatility of the actual tax base.

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, pp 61-76.
2 These results are subject to amendments arising from revisions to the national account figures or to estimates of the macroeconomic outlook.
3 In this analysis, the impact of support measures for financial institutions on the deficit is not included among the specific temporary effects.

Structural development*

Year-on-year change in percentage points

Item	2006	2007	2008	2009	2010	2011	2012
Unadjusted fiscal balance[1]	1.7	1.9	− 0.3	− 3.0	− 1.1	3.4	0.9
Cyclical component[1]	0.7	0.5	0.3	− 1.5	0.3	0.9	0.0
Temporary effects[1]	− 0.1	0.0	− 0.2	0.2	0.2	− 0.2	0.0
Fiscal balance	1.1	1.4	− 0.5	− 1.5	− 1.6	2.6	0.9
Interest payable	0.1	0.0	− 0.1	− 0.2	− 0.1	0.1	− 0.1
Owing to change in average interest rate	0.0	0.1	− 0.1	− 0.3	− 0.3	− 0.1	
Owing to change in debt level	0.1	0.0	0.0	0.1	0.2	0.2	
Primary balance	1.2	1.4	− 0.5	− 1.8	− 1.7	2.7	0.7
Revenue	0.8	0.8	0.3	− 0.8	− 0.5	1.2	0.2
Taxes and social contributions	0.7	0.7	0.2	− 0.9	− 0.5	0.9	0.4
Fiscal drag	0.0	0.1	0.0	0.1	0.0	0.0	0.1
Decoupling of base from GDP	− 0.1	− 0.3	0.2	− 0.1	0.2	0.3	0.0
Legislative changes	0.2	0.7	− 0.6	− 0.3	− 0.7	0.2	− 0.1
Residual	0.5	0.2	0.6	− 0.6	− 0.1	0.3	0.4
of which: profit-related taxes[2]	0.4	0.2	0.5	− 0.6	0.2	0.3	0.3
Non-tax revenue[3]	0.1	0.1	0.1	0.1	0.1	0.3	− 0.2
Primary expenditure	− 0.4	− 0.6	0.8	1.0	1.2	− 1.5	− 0.5
Social payments[4]	− 0.2	− 0.4	0.3	0.6	− 0.1	− 0.2	− 0.2
Subsidies	0.0	− 0.1	0.0	0.1	0.0	− 0.1	− 0.1
Compensation of employees	− 0.1	− 0.2	0.0	0.2	0.0	0.0	− 0.1
Intermediate consumption	0.1	0.0	0.3	0.2	0.1	0.1	0.0
Gross fixed capital formation	0.1	0.1	0.1	0.1	0.0	0.0	− 0.2
Other expenditure[5]	− 0.3	− 0.1	0.2	− 0.1	1.3	− 1.4	0.1
Memo item							
Pension expenditure[6]	− 0.1	− 0.3	0.0	0.0	0.0	− 0.1	− 0.2
Healthcare expenditure[7]	0.1	0.1	0.2	0.3	0.0	0.1	0.1
Labour-market expenditure[8]	− 0.1	− 0.2	0.1	0.0	− 0.2	− 0.3	− 0.2

* Adjusted for cyclical influences and specific temporary effects. Year-on-year change in the ratio to nominal trend GDP. Maastricht definition, ie including swaps and forward rate agreements in interest expenditure and the fiscal balance. **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 payable. **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 central government) and central government expenditure on unemployment benefit II and on labour market reintegration measures.

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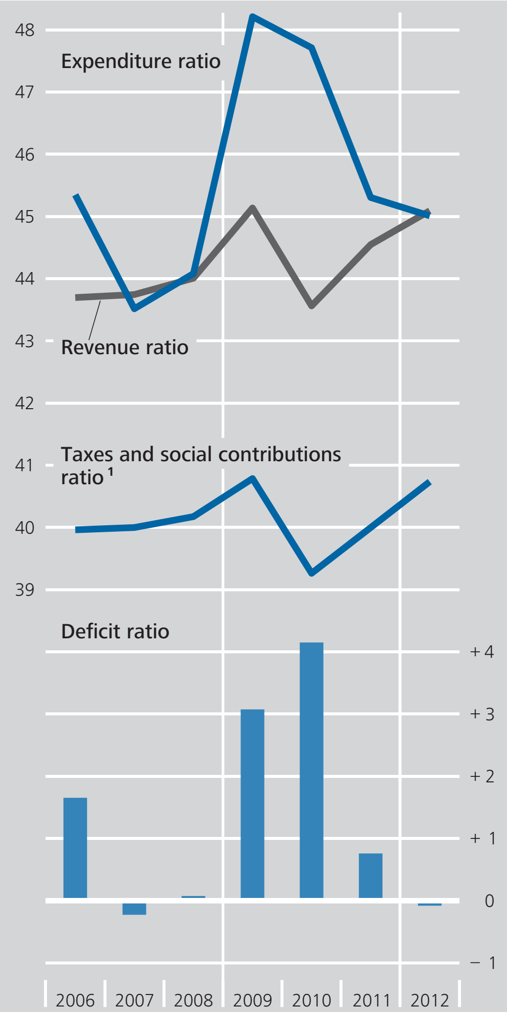
The unadjusted expenditure ratio dropped by 0.3 percentage point in 2012, while the structural ratio showed an even stronger decrease of 0.6 percentage point. The interest expenditure ratio declined given the favourable financing conditions.[4] The structural ratio of primary expenditure fell by 0.5 percentage point. Social spending made a noticeable contribution to the decline owing to a continuing structural drop in labour market-related spending and moderately increasing pension payments. Another factor pushing down expenditure was the phasing-out of economic stimulus measures related to the financial and economic crisis of 2008-09. These factors therefore considerably outweighed the capital transfers from the government to the banking sector posted in connection with the liquidation of the public regional bank WestLB.

Overall, the analysis reveals that the further reduction of the deficit in the past year owes much to the surge in profit-related taxes. Other major factors were the subdued rise in social spending and the expiry of temporary economic stimulus measures. By contrast, cyclical developments, which had a largely neutral impact on public finances, did not play a role.

4 The determinants of the change in the interest expenditure ratio are not shown because the debt ratio for 2012 is not yet available.

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.

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counterfinanced (such as the abolition of the surgery visit charge). On the other hand, there are various alleviating factors, such as the continuing beneficial financing conditions, which facilitate a favourable rollover of longer-dated debt instruments, in particular. By contrast, the debt ratio is likely to decline if – as expected – the budget deficit turns out to be small compared with nominal GDP growth and, in contrast to last year, the redemption of liabilities at public resolution agencies outweighs any new burdens associated with stabilising the euro area and supporting German financial institutions.[4]

Government budgets should be consolidated quickly and safety margins built in

Thanks to the unexpectedly buoyant underlying conditions for public finances in Germany, the government deficit has been eliminated much sooner than was initially expected in the light of the financial and economic crisis in 2008-09. Consequently, Germany's budget situation is favourable by international standards. Given Germany's high debt ratio and foreseeable demographic burdens, however, it is nonetheless important for it to swiftly plug the remaining structural gaps in its central, state and local government budgets, especially as the present surpluses of the social security funds will not last. In particular, the long transitional periods until Germany's reformed budget rules kick in should be taken advantage of, at most, only by those state governments that face extraordinary budgetary imbalances which it is virtually impossible to rectify in the short term.[5] In these instances, ambitious binding minimum steps for deficit reduction should be stipulated. The fiscal expansion that some commentators are demanding of Germany does not appear to be appropriate. The automatic stabilisers already cushion the cyclical fluctuations in the German economy to a sufficient degree; moreover, any additional measures to stimulate domestic demand would have only a very limited impact on the European countries affected by adjustment recessions. All levels of government should therefore rigorously focus their efforts on achieving sound public finances. Furthermore, clear safety margins below the permanent constitutional borrowing limits should be factored in to account for the high degree of uncertainty involved in estimating the structural budget position and to avoid the danger of subsequently having to pursue a procyclical budgetary policy.

4 This assessment is based, in particular, on the fundamental assumptions that the slowdown in macroeconomic momentum will be short-lived and that the euro-area debt crisis will not escalate further.
5 For a differentiated analysis, see also Deutsche Bundesbank, The development of state government finances in Germany since 2005, Monthly Report, October 2012, p 29ff.

Decisions of the Ecofin Council and the European Council on 13-14 December 2012

In the run-up to the European Council meeting on 13-14 December 2012, expectations were raised of far-reaching decisions aimed at advancing towards a more closely integrated European Economic and Monetary Union. In preparation for the summit, the President of the European Council, in collaboration with the Presidents of the European Commission, the Eurogroup and the European Central Bank, submitted a report setting out a draft timetable of progressive steps towards deeper integration of the Economic and Monetary Union in the areas of banking, budgetary policy and economic policy as well as in terms of democratic legitimacy and accountability.[1] The European Commission and the European Parliament also set down their ideas on the way forward.[2] Prior to all this, some calm had been restored to the capital markets – in particular following the announcement that the Eurosystem was prepared to take sweeping measures if necessary, measures which implied not least a redistribution of private and sovereign solvency risk. In this context, the agreements presented by the European Council were very vague and more specific details are required. At the end of the day, apart from the plans for a banking union, no other steps towards more far-reaching integration were agreed. This means there is currently only partial clarity as to how the various *ad hoc* crisis management measures are to be brought together into a consistent framework of liability and control in the Economic and Monetary Union.

The day before the European Council meeting, the Economic and Financial Affairs Council (Ecofin) agreed on the principal features of the banking union. The main focus was on the Single Supervisory Mechanism. Under this mechanism, the ECB will be responsible in principle for the supervision of all credit institutions, though, notwithstanding the ECB's authority to set guidelines, certain supervisory powers for institutions of lesser size will fall to participating member states.[3] The national supervisory authorities will retain their original competencies only on the margins. Furthermore, the ECB's supervisory function and its monetary policy mandate are to be separated. This will mean that the members of the Supervisory Board appointed by the ECB can have no responsibilities directly connected with monetary policy. In addition, a mediation panel is to be established to resolve differences of opinion between the Supervisory Board and the ECB Governing Council. However, EU legal requirements mean that the ECB Governing Council would have to have the last word on banking supervisory decisions as a matter of principle. Thus, under prevailing EU primary law, a systematic separation of monetary policy and banking supervision is not possible.

1 See Herman Van Rompuy, Towards a genuine Economic and Monetary Union, 5 December 2012. This report was the product of a lengthy process of discussion and negotiation. See also, inter alia, Deutsche Bundesbank, The European Council and Euro Area Summit statements of 28 and 29 June 2012 regarding the stabilisation of the euro area, Monthly Report, August 2012, pp 59-61, and Deutsche Bundesbank, The conclusions of the European Council at its meeting on 18-19 October 2012, Monthly Report, November 2012, pp 63-64.
2 See European Commission, A blueprint for a deep and genuine economic and monetary union: Launching a European Debate, 30 November 2012, and European Parliament, Towards a genuine Economic and Monetary Union, 20 November 2012.
3 See Article 5 (5) (a) and (c) of the Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions of 14 December 2012.

The ECB is to assume its supervisory role on 1 March 2014 (or 12 months after the regulation comes into force, if this does not happen by 1 March 2013 as intended). However, the ECB is to have immediate supervisory powers over credit institutions for which this is deemed by the European Stability Mechanism (ESM) to be a condition of direct recapitalisation. The operational framework for this kind of direct recapitalisation of banks by the ESM is to be put in place in the first half of 2013 – also involving a definition of what constitute distressed legacy assets on a bank's balance sheet. This is another condition, in addition to the Single Supervisory Mechanism, for direct recapitalisation of banks by the ESM.

The European Council stressed the importance, too, of new European bank capital requirements (Capital Requirements Directive IV and Capital Requirements Regulation) in the creation of a single rule book for the regulation of banks, and called for swift agreement on these rules. Furthermore, the proposals for the Recovery and Resolution Directive and the Deposit Guarantee Schemes Directive are to be passed by June 2013 and then rapidly transposed into national law.

With regard to public finances and economic policy, prospective measures and a timetable covering a number of aspects are scheduled to be submitted to the European Council in June 2013: between now and then, major economic policy reforms are to be discussed and, where necessary, coordinated among the member states. This period is also to be used to examine the feasibility and operation of contracts for competitiveness and growth agreed mutually between member states and the relevant EU bodies. These contracts would be a binding requirement for all member states in the monetary union, while other member states could also opt to enter into such contracts. More work is required on the question of providing support through "solidarity mechanisms" for the efforts of member states that have signed such legal agreements for competitiveness and growth.

In addition, the European Council set out a general objective of ensuring democratic legitimacy and accountability at the level at which decisions are made and implemented. According to the Council, each new step in the direction of increased control of economic policy needs to go hand in hand with moves towards enhanced legitimacy and accountability. In the Council's view, steps towards further integration of budgetary and economic policy mean that member states have to ensure their parliaments are properly involved, while deeper integration of policymaking and increasing concentration of powers also need to be matched by an appropriate role for the European Parliament. Furthermore, the Council wishes to see closer collaboration between national chambers and the European Parliament.

Overall, the plans put forward leave many questions unanswered, and in many respects the practical details remain unclear. More far-reaching steps towards closer integration of fiscal and economic policy, and in particular, a partial relocation of budgetary sovereignty from national to European level, which were initially on the table, now appear unlikely.

Sustainable reduction of debt ratio is key

The reformed national and European budgetary rules provide a more robust foundation for achieving sound public finances. The fact that Germany has managed to comply with these rules so far is to be welcomed. The ultimate objective of achieving a structurally balanced general government budget is increasingly being used in the public debate as a benchmark for evaluating budgetary policy. However, the favourable figures and the positive shocks have been used as an opportunity to relax the policy course, which in turn has delayed the consolidation of public finances. In view of the rules' binding effect, it is crucial that in future these are not open to arbitrary interpretation for the purpose of creating short-term budgetary leeway at the expense of later budgets.[6] The draft law on implementing the Fiscal Compact envisages the Stability Council as the national overseer for ensuring compliance with European and national rules. The Council, which predominantly comprises the finance ministers of central government and the state governments, should critically appraise ongoing developments with a view to protecting the goals of the debt break from any attempts to veer off course.[7] The real test for fiscal policy will ultimately be whether the rising trend shown by the debt ratio is lastingly reversed and whether the rules are rigorously implemented also in less favourable circumstances.

Budgetary development of central, state and local government

Tax revenue

Clear rise in tax revenue in 2012

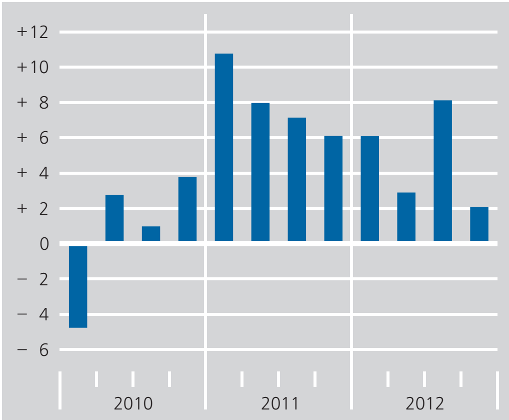
Although tax revenue[8] rose considerably by 4½% in 2012 (see the chart on this page and the table on page 66), it was still €2 billion below the October forecast of the Working Party on Tax Revenue Forecasting. Receipts from income-related taxes climbed by an above-average 8½%. Although the considerable increase in wage tax receipts (+6½%) was bolstered by stagnating deductions for child benefit, it was mainly attributable to the buoyant wage trend. It was additionally boosted by the progressive taxation schedule. Revenue from profit-related taxes continued to rise sharply (+12%). Despite slower growth in corporation tax receipts, following a strong increase in 2011, the associated rise remained high. By contrast, revenue from assessed income tax rose more sharply last year following low growth in 2011. The development in assessed income tax is also being boosted by currently declining net deductions (due primarily to the phasing-out of the homebuyer's grant and barely rising employee refunds). Income from non-assessed taxes on earnings (particularly withholding tax on dividends) increased considerably again, not least owing to special factors. In view of the low interest rates, receipts from withholding tax on interest income and capital gains increased only moderately. Revenue from consumption-related taxes rose

Above-average growth in income-related taxes

Moderate rise in receipts from consumption-related taxes

Tax revenue*

Year-on-year percentage change, quarterly



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

6 See also Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-39.
7 Up to now, the Council has focused on identifying impending budgetary emergencies. However, the indicators and thresholds chosen are ultimately only partially suitable for this purpose, thus raising doubts as to the suitability of this committee of ministers for taking early warning measures. See Deutsche Bundesbank (2011), op cit, pp 20-23.
8 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.

Tax revenue

Type of tax	Year as a whole 2011 € billion	2012 € billion	2012 Year-on-year change € billion	2012 Year-on-year change as %	Estimate for 2012 as a whole [1,2,3] Year-on-year change as %	Q4 2011 € billion	Q4 2012 € billion	Q4 2012 Year-on-year change € billion	Q4 2012 Year-on-year change as %
Tax revenue, total[2]	527.3	551.8	+ 24.5	+ 4.7	+ 5.0	145.4	148.4	+ 3.0	+ 2.1
of which									
Wage tax	139.7	149.1	+ 9.3	+ 6.7	+ 6.5	39.5	42.2	+ 2.7	+ 6.8
Profit-related taxes[4]	73.8	82.5	+ 8.7	+ 11.8	+ 12.8	18.6	18.1	− 0.5	− 2.9
Assessed income tax	32.0	37.3	+ 5.3	+ 16.5	+ 15.0	8.8	9.9	+ 1.2	+ 13.2
Corporation tax	15.6	16.9	+ 1.3	+ 8.3	+ 17.9	5.9	3.9	− 2.0	− 33.4
Investment income tax[5]	26.2	28.3	+ 2.1	+ 8.2	+ 7.0	4.0	4.2	+ 0.3	+ 6.9
Turnover taxes[6]	190.0	194.6	+ 4.6	+ 2.4	+ 2.9	49.4	49.9	+ 0.5	+ 1.1
Energy tax	40.0	39.3	− 0.7	− 1.8	− 0.3	15.5	15.2	− 0.3	− 2.2
Tobacco tax	14.4	14.1	− 0.3	− 1.9	− 0.6	4.8	4.7	− 0.1	− 2.6

1 According to official tax estimate of October 2012. 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes. 3 Including (estimated) local government taxes, tax revenue was €8.3 billion above the November 2011 estimate, which was used as a basis for the 2012 Federal budget at the end of 2011. According to government estimates, had legislative changes not been made in the meantime, the upward revision would have been €10.2 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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by 1½% overall. The stronger increase in turnover tax receipts is broadly in line with the development in private consumption.

Further marked revenue growth expected in 2013

According to the latest official tax estimate, revenue (including receipts from local government taxes) is expected to rise by 2½% this year, as robust growth is forecast for those macroeconomic reference variables that are particularly relevant for government revenue. The updated macroeconomic forecast published by the Federal Government in January paints a somewhat less favourable picture overall. Over and above the negative baseline effect, this would result *per se* in a slight downward revision.[9] On the other hand, the tax refunds due in connection with the European Court of Justice's ruling on the taxation of dividends paid to foreign corporates are now not expected to be disbursed in part until 2014. On balance, legislative changes, including new regulations which have been passed in the meantime, are likely to have a mostly neutral impact on the development of tax revenue in 2013.

Central government budget

Deficit increased again by ESM and EIB capital contributions in 2012 Q4

In particular, large payments to the European Stability Mechanism (ESM) and the European Investment Bank (EIB) totalling €10½ billion contributed to central government's €3 billion budget deficit in the fourth quarter of 2012, following a surplus of €10½ billion twelve months earlier. According to the preliminary outturn, the deficit for 2012 as a whole amounted to almost €23 billion. This equates

9 In its 2013 Annual Economic Report, the Federal Government expects nominal GDP in the current year to increase by 2.3% (October 2012: 2.8%). However, the growth structure – in particular, the development of gross wages and salaries and nominal private consumption – is also significant for the tax forecast. Gross wages and salaries are now expected to rise by 2.7% (October 2012: 2.8%) while nominal private consumption is now estimated to grow at a rate of 2.3% (previously 3.0%).

to an increase of €5 billion compared with 2011. Although tax receipts were up by 3% (€8 billion),[10] other income fell by €3 billion overall – not least due to the Bundesbank's lower profit distribution. Expenditure rose by €10 billion in the wake of the capital contributions to the ESM and the EIB. The renewed significant decline in interest costs (€2½ billion) was offset not least by higher transfers to state government and to the Fund for the Expansion of Childcare Facilities, which was set up in 2007.

Marked relief vis-à-vis supplementary budget from November

The deficit was €5½ billion lower than in the second supplementary budget of November 2012. This was primarily due to the €2½ billion reduction in transfers and grants (half of which was attributable to long-term unemployment benefits). Additionally, interest expenses, personnel costs and calls on guarantees undershot the budget estimates by a total of €2 billion. Supplementary budgetary relief was provided on the income side by higher-than-estimated EU payments.

Structural deficit also much lower than expected

At €8 billion (0.3% of GDP), structural net borrowing in the core budget, as calculated in accordance with the provisions of the debt brake, likewise fell considerably short of the most recent forecast of €15½ billion.[11] In formal terms, central government is thus already adhering to the permanent constitutional ceiling for structural borrowing (0.35% of GDP), which is not due to come into effect until 2016. Yet this is based on the simplified cyclical adjustment procedure for the budget outturn envisaged in the debt brake provisions, under which estimated potential output is not updated. Whereas a considerable negative cyclical effect was thus calculated, a comprehensive re-estimate on the basis of the Annual Economic Report 2013 would probably indicate a cyclically induced burden of only €½ billion. This would make the structural deficit €6½ billion (0.3% of GDP) higher.

The results of the simplified cyclical adjustment will be used as the basis for calculating the provisional booking to the control account on 1 March 2013. This means that in view of the high permissible borrowing limit during the transitional period, which central government continues to use, another extremely large credit balance of €31½ billion will be recorded in addition to the existing accounting surplus of €25 billion for 2011.[12] The announced cancellation by the end of 2015 of these large virtual credit balances on the control account, which have largely arisen from a very lax interpretation of the rules for calculating the deficit reduction path, is a welcome move.

Envisaged cancellation of large credit balances on control account welcome

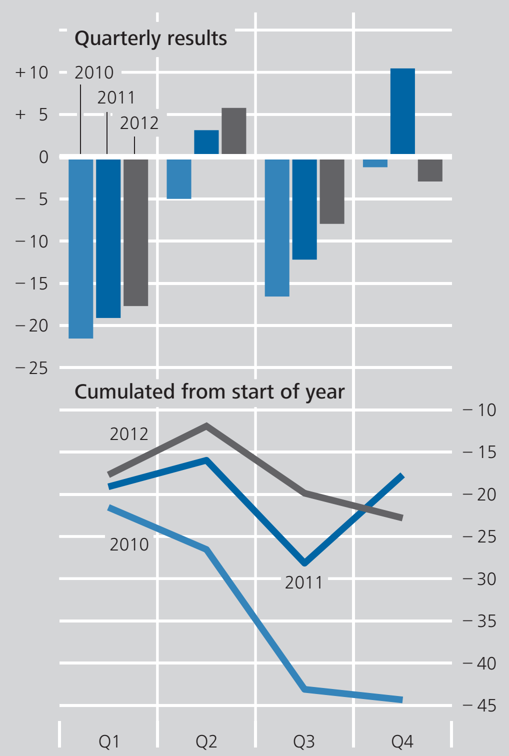
2013 budget shows fall in deficit …

With a target deficit of €17½ billion, the 2013 central government budget points to a considerable reduction of €5½ billion compared with the actual figure for 2012. On the revenue side, tax receipts are projected to grow by €4½ billion. On the expenditure side, the budget envisages net relief amounting to €4 billion from cutting grants to the social insurance schemes (in particular to the health insurance fund and the Federal Employment Agency).[13] Savings totalling €2 billion are to be yielded by the investment plan through the dropout of the one-off capital increases to the EIB and the top-up contribution to the Fund for the Expansion of Childcare Facilities. However, a further transfer of €8½ billion to the ESM is envisaged. On the other hand, the budget appropriations of central government contain additional costs related to debt incurrence (including calls on guarantees).

10 In spite of a rise of €2 billion in transfers to the EU budget, which are deducted from tax revenue.
11 Net borrowing of €22½ billion was adjusted by €7½ billion for burdens arising from financial transactions (including the payments to the ESM and the EIB) and by €7 billion for a negative cyclical effect.
12 For a critical assessment, see Deutsche Bundesbank (2011), op cit, p 28. In the case of a target-oriented interpretation of the provisions, the limit would still have been undershot significantly by over €10 billion in 2012.
13 Alongside cuts in payments to the health insurance fund and the statutory pension insurance scheme, central government's financial relations with the Federal Employment Agency have also been altered. The planned abolition of the turnover tax-financed grant to the Agency has been adjusted for the elimination of the Agency's reintegration payment to central government.

Central government fiscal deficit/surplus

€ billion



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… and outturn may be slightly better than planned, …

At the moment it seems likely that some improvements from the 2012 budget outturn may continue and so have an alleviating effect on the 2013 draft budget. Thus, interest payments, which notably contain a budgeted net increase of €2½ billion from premium charges, could turn out to be lower than planned given ongoing favourable funding conditions. Personnel costs and calls on guarantees might likewise be lower than expected. However, the Bundesbank's projected profit distribution of €1½ billion is subject to uncertainty, and the additional aid to Greece of just over €½ billion agreed at the end of November is also not included in the budget. But all in all, there could be a marginal improvement compared with the budget plan.

… but further consolidation strongly recommended

The central government deficit could fall again significantly in 2013 on the year. Moreover, given the expected deterioration in the overall economic setting, the structural deficit might improve even more, irrespective of the somewhat reduced burden from financial transactions.[14] A major consideration, however, is the considerable uncertainty surrounding the further evolution of the euro-area crisis, which arises from potential burdens in the wake of new assistance measures and from the opportunities and risks concerning the macroeconomic environment. Moreover, a distinct increase in expenditure could ensue if central government's exceptionally favourable refinancing conditions cease. Overall, therefore, the Federal Government would be well advised to step up its fiscal consolidation efforts going forward. Ultimately, the establishment of a broad safety margin below the permanent ceiling for structural borrowing of 0.35% of GDP is the best assurance that, in future, short-term consolidation measures that have a procyclical effect will not have to be taken in the event that the hitherto favourable budgetary development suddenly worsens.

Fiscal benchmark figures for structurally balanced budget should be underpinned by consolidation measures

In this context, the decision taken by the coalition committee in November 2012 to bring forward the planned achievement of a structurally balanced budget at central government level from 2016 to 2014 is to be welcomed. Based on the fiscal plan drawn up in summer 2012, this means that €5½ billion would have to be consolidated in the upcoming fiscal benchmark figures. If the revenue planned at that time for 2014 from the financial transaction tax (€2 billion) – which is to be introduced as a concerted measure within the European Union – is deferred anew, this shortfall will have to be additionally offset. Although further savings on interest expenditure seem likely in the short term, the government would be ill advised to waive genuine consolidation measures and to rely on the hope that the currently extremely

14 This is suggested by an updated complete cyclical adjustment based on the most recent data available. However, if the simplified cyclical adjustment procedure (pursuant to the provisions of the debt brake) is used for 2012 and a detailed calculation procedure for 2013 at the time the budget was drafted, the 2013 central government budget shows no reduction in the structural deficit since the cyclical burden, despite the anticipated subdued growth of GDP, is estimated to be lower than the figure calculated for 2012 using the simplified procedure owing to the revision of potential output.

favourable financing conditions will continue indefinitely. With regard to funding the social security schemes, it would be better to clearly and openly define which are non-insurance-related benefits and to then ensure that these are dependably financed out of the central government budget. It routinely appears as if such transfers are made on a rather arbitrary basis depending on the government's cash flow situation at a given time, thus infringing the insurance principle of equivalence between contributions and benefits.

Overall surplus in off-budget entities despite slight deficit at year-end

According to information from the Federal Ministry of Finance, central government's off-budget entities (ie specifically excluding resolution agencies, for which no information is available) show a deficit of €1 billion for the fourth quarter of 2012 compared with €2 billion in 2011. This improvement is primarily due to the cessation of funding measures by the Investment and Repayment Fund and to the €½ billion top-up transfer from central government resources to the Fund for the Expansion of Childcare Facilities set up in 2007. On the other hand, the Financial Market Stabilisation Fund (SoFFin) had to transfer €2 billion to offset losses of the resolution agency dealing with Hypo Real Estate's legacy debt. Overall, a surplus of € 2½ billion was recorded in 2012, compared with €6 billion one year previously. The decline is largely attributable to the large capital repayment made by Commerzbank to SoFFin in 2011, which outweighed the (investment) funding measures of the Investment and Repayment Fund at the time.[15] Another surplus can be expected in 2013, predominantly owing to the ongoing accumulation of provisions for future civil servant pension payments. SoFFin's financial market stabilisation measures have been further extended beyond 2012 and will now be available until the end of 2014, but there are currently no signs of banks seeking recourse to them. A definite burden, by contrast, will ensue from the forthcoming repayment of an inflation-linked five-year Federal note (Bobl), for which reserves will be released.

State government budgets[16]

2012: fall in deficit on back of strong tax revenue growth

The positive trend in the state government budgets did not continue into the fourth quarter of 2012. Nonetheless, the core budget deficit for the year as a whole fell to €5½ billion, compared with €9½ billion in 2011, and was considerably lower than the planned shortfall (€15 billion). Revenue rose by 2½%, mainly as a result of sharply rising tax receipts (+6% or €12½ billion). This was partly offset by a fall in transfers received (just over €3 billion) following the phasing-out of the Investment and Repayment Fund. Overall expenditure increased by just over 1%. Higher payments, in particular for personnel (+2½% or €2½ billion) and operating expenditure (+2% or €½ billion), outweighed the sharp decline in investment (-9% or €3 billion) as the Investment and Repayment Fund was phased out.

Big differences between states, and gloomier outlook for 2013

Irrespective of the deficit reduction for state government as a whole, there are still big differences in the budgetary position of individual states. While surpluses were posted once again by Bavaria, Mecklenburg-West Pomerania and Saxony and now additionally by Berlin, Thuringia and, to a lesser extent, Baden-Württemberg and Saxony-Anhalt, not only Bremen and Saarland, which are receiving consolidation assistance, but also Hamburg, Rhineland-Palatinate, Hesse and North Rhine-Westphalia are still showing large *per capita* deficits, despite the favourable macroeconomic setting. A combined deficit of just over €12 billion is budgeted for the current year, with those states that already posted large deficits last year planning to expand their new borrowing considerably. In view of the expected slower growth of tax rev-

15 The national accounts figures indicate a considerable improvement in the fiscal balance of the off-budget entities for 2012. The difference between this result and the outturn shown in the financial statistics is largely due to the fact that Commerzbank's repayment was booked as a financial transaction in the national accounts with no impact on the deficit.
16 The development of local government finances in the third quarter of 2012 was analysed in the short articles in the Bundesbank's January 2013 Monthly Report. These are the most recent data available.

enue and rise in personnel costs, operating expenditure and transfers to local government, the budgetary situation of state government might deteriorate somewhat on the year.

Debt rules need to be quickly tightened to ensure balanced budget plus risk buffer

To underpin the general prohibition of new borrowing from 2020, as now enshrined in Germany's Basic Law, it is essential that this is also implemented in each federal state's legislation. The focus should be on swiftly reducing existing structural deficits and building up safety margins. It would, however, be problematic if – as was often the case in the past – the necessary consolidation measures were deferred and then declared to be non-attainable at the end of the transitional period. It is thus, for example, a worrying sign that Baden-Württemberg has recently relaxed its debt brake provisions, which to date are merely contained in the state budget law, and has significantly protracted its consolidation timeline. North Rhine-Westphalia, being the most populous German state, is of critical importance in this regard. It has so far made no adjustments to the state budgetary rules and has announced only very limited steps towards reducing its deficit. The state is even having problems meeting the old, comparatively lax constitutional provisions that are currently still in place. For example, the 2011 budget – despite including extensive additional tax revenue – contained net borrowing appropriations totalling €5 billion, thus exceeding the constitutional borrowing ceiling (capped at the amount of self-financed investment) by €1½ billion.[17] This budget is currently being examined by the state's constitutional court. While new borrowing under the 2013 budget, according to the current draft from autumn 2012, will be slightly (€½ billion) below the constitutional ceiling, this includes not only asset realisations but also unspecified general revenue and saving appropriations amounting to €1 billion which still have to be generated. As before, the borrowing limit has been artificially raised by €½ billion by including investment projects that are financed out of central government grants. In its ruling on the 2010 supplementary budget, the constitutional court stipulated that debt growth, in line with the requirements of macroeconomic equilibrium, should be held sufficiently below the defined borrowing ceiling to allow policymakers a certain amount of operational flexibility. Equally, the extremely strained financial situation of many local governments in North Rhine-Westphalia indicates a substantial need for correction.

Rising transfers under state government financial equalisation scheme

In addition to the implementation of the new debt rules, a reform of the Federal financial equalisation scheme is assuming increasing importance, also – but not solely – because the existing arrangements will expire at the end of 2019. The volume of the financial equalisation scheme among the federal states (narrowly defined) rose by €½ billion to €8 billion in 2012, with only three states being net contributors. The financial positions of the individual states still vary greatly and are equalised up front to a certain extent through a similarly extensive *ex ante* redistribution of turnover tax receipts. Bearing in mind that a fundamental disparity in tax revenue collection across the federal states reflects not only comparative differences in each region's economic strength but also associated differences in regional price levels, capping the extent of the equalisation of financial capacities would appear warranted. New revenue-sharing arrangements should also take account not least of the economic disincentives of such transfers; they could also introduce greater legislative autonomy for the individual states to define regional tax rates.[18]

17 See Deutsche Bundesbank, Implications of the ruling on the supplementary budget of North Rhine-Westphalia for 2010, Monthly Report, April 2011, pp 10-11.
18 See also Deutsche Bundesbank (2012), op cit, p 49

Social security funds[19]

Statutory pension insurance scheme

Higher-than-expected surplus in 2012 owing to robust contribution receipts

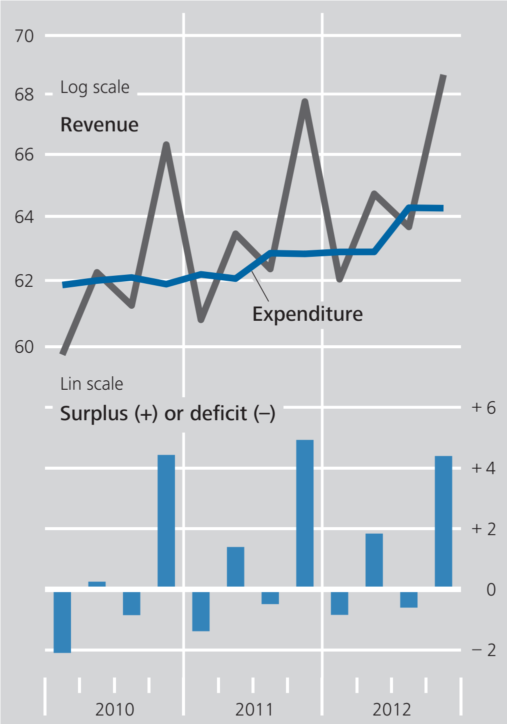
The statutory pension insurance scheme, as usual, posted a surplus in the fourth quarter of 2012 which, at almost €4½ billion, was a little lower than in the same period of 2011. The overall surplus for 2012 of nearly €5 billion was nonetheless slightly greater than the 2011 figure owing to the better performance in the first half of the year. The reserves exceeded the threshold of 1.5 times the scheme's monthly expenditure by almost €3½ billion, which was largely attributable to contribution receipts being higher than had been expected when the contribution rate for 2012 was set. Although the contribution rate was lowered from 19.9% to 19.6% as of 1 January 2012, contribution receipts rose by just over 2% (by 3½% when adjusted for the contribution rate cut.) Total revenue went up by just under 2%. Spending on pensions, too, rose by almost 2%, with the annualised pension increase averaging just over 1½%.[20] The number of current pensions also increased slightly.

Reserves to be depleted through contribution rate cut in 2013

The contribution rate for the current year has been lowered to 18.9%, and the Federal Government forecasts a deficit of just over €2 billion in its annual pension insurance report. This will reduce reserves to around 1.5 times the (rising) average monthly expenditure incurred by the statutory pension insurance scheme. The low contribution rate means that the statutory pension insurance scheme is likely to post deficits for the next few years. The contribution rate will have to be raised again if there is a risk that the reserve floor of 0.2 times the scheme's monthly expenditure may be undershot, which is likely to happen in the second half of this decade. Thus, the low contribution rate is only temporary and should not be seen as a sign of permanent easing in the financial situation. This also means that there is no structural financial leeway for increasing benefits. On the contrary, that would necessitate raising the contribution rate or introducing savings in general pension benefits or in other areas in the foreseeable future.

Finances of the German statutory pension insurance scheme

€ billion, quarterly



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Federal Employment Agency

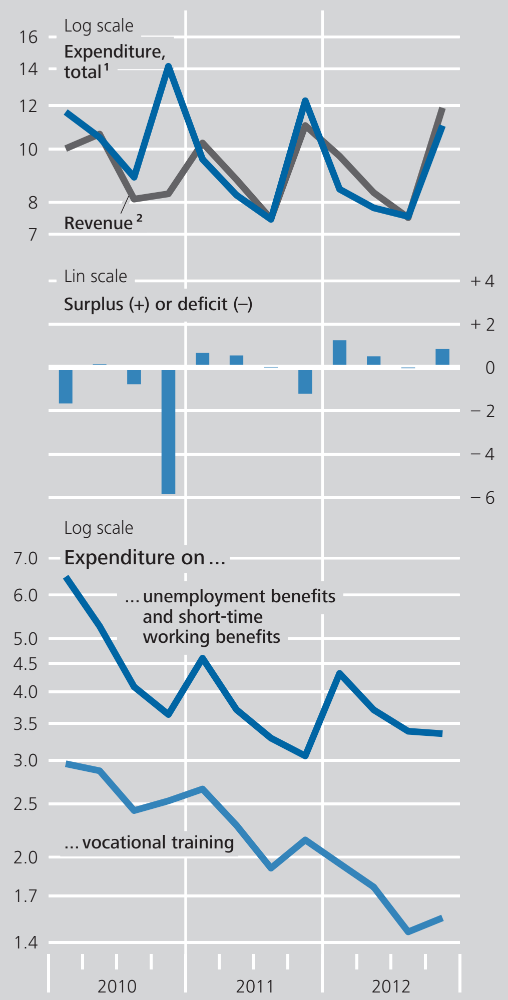
Improvement in 2012 largely due to savings in active labour market policy measures

The Federal Employment Agency recorded a surplus of just under €1 billion in the fourth quarter of 2012. This implies that the Agency will post a surplus of €2½ billion for 2012 as a whole, compared with a virtually balanced result one year previously. The financial improvement is largely attributable to lower spending on active labour market policy measures and

19 The financial development of the statutory health and public long-term care insurance schemes in the third quarter of 2012 was discussed in the short article in the December 2012 Monthly Report. These are the most recent data available.
20 Although the pension adjustment in mid-2012 was relatively substantial (2.18% in western Germany and 2.26% in eastern Germany), the smaller increase in mid-2011 (0.99%) had a dampening effect in a year-on-year comparison.

Finances of the Federal Employment Agency

€ billion, quarterly



1 Including transfers to the civil servants' pension fund. **2** Excluding central government liquidity assistance.
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on the short-time working allowance as well as, but to a lesser extent, to higher contribution receipts owing to the favourable employment and wage trends over the course of the year. At the same time, expenditure on unemployment benefits remained virtually unchanged compared with 2011. The decline in the (incoming) central government grant and (outgoing) reintegration payment had practically no impact on the outturn on balance.

Financial deterioration budgeted for 2013

In its budget plan, the Federal Employment Agency projects a deficit of just over €1 billion for 2013.[21] This financial deterioration is primarily attributable to the abolition of the central government grant, which was introduced in 2007 and updated in line with the growth of turnover tax revenue. The concurrent cessation of the Federal Employment Agency's reintegration payment to central government does not fully offset this financial shortfall. Moreover, when the budget is implemented, spending on active labour market policy measures might rise significantly by just over €1½ billion compared with the outturn for 2012. However, this negates the experience of the past few years, so that the expenditure appropriations might actually be undershot. All in all, the actual outturn could turn out to be better than the target figures, as was the case over the past few years.

21 Including transfers to the insolvency benefit reserves (€¼ billion). Revenue (insolvency benefit contributions) and expenditure related to insolvency benefits are recorded separately from the general reserve and the Federal Employment Agency's budget to ensure that cumulated surpluses or deficits from previous years are taken into account when calculating the contribution rate.