

Public finances

General government budget

Public finances are currently developing much more favourably than had been anticipated in the original budget draft. This is largely due to the economic recovery, which is proving stronger than expected, and to the surprise growth in revenue from profit-related taxes, which are generally extremely volatile. The general government deficit amounted to 3.2% of GDP in 2005 but will fall well short of the 3% ceiling in 2006 thanks to the positive influences cited above. The current generally moderate expenditure patterns have also contributed to this decline. The debt ratio may remain at more or less the same level as in the previous year (67.9%). It is being curtailed by, among other things, the relatively sharp growth in nominal GDP, which may reach the highest level seen in the past decade.

*Deficit ratio
below 3% limit
for 2006*

A noticeable change in the general government revenue ratio is not likely to be observed this year. The tax ratio will grow significantly, particularly as a result of the extremely dynamic development of profit-related taxes. However, social contributions will increase only slightly due to the moderate growth in gross wages and salaries,¹ and non-tax revenue will actually decrease. This year there will be a further marked fall in the expenditure ratio. In addition to an easing in labour market spending resulting predominantly from positive macroeconomic develop-

*Generally
constant
revenue ratio
and decreasing
expenditure
ratio*

¹ Excluding the one-off receipts in connection with bringing forward the transfer deadline which cannot be posted as additional revenue in the national accounts as a result of the accruals principle of accounting.

ments,² other key factors curbing the ratio include the weak rise in spending on old-age provision, the further decrease in personnel expenditure, but also the relatively strong growth in nominal GDP.

Further clear decline in deficit ratio in 2007

The general government deficit is also expected to drop significantly in 2007. This is partly the result of the Federal Government's fiscal package which, when taken as a whole, will improve the financial situation by increasing taxes and social security contributions. Furthermore, the development in spending has so far been restrained, particularly in the areas of personnel, old-age provision and labour market. Macroeconomic wage developments, which are expected to remain relatively moderate, have slowed the growth in both government revenue as well as expenditure, causing the corresponding ratios to decrease because of the sharper increase in GDP. In 2007, this will be intensified by the effect of raising consumption taxes on nominal GDP. On the revenue side, these ratio-decreasing influences are offset by rises in taxes and social security contributions meaning that the revenue ratio could remain largely stable on balance. By contrast, the expenditure ratio will fall perceptibly.³

Increased consolidation in good times

Undershooting the 3% ceiling in 2006 is a positive development. However, the success of completing this first step of the journey must not detract from the need to continue reducing the deficit. Indeed, the debt ratio has merely stabilised at a very high level. This means that the significant level of structural consolidation of approximately 1% of GDP that central government reported to the EU

for 2007 is appropriate. This is true not only in light of European obligations but also given the requirements under national budgetary law. The current positive economic climate should be used to reduce structural deficits as quickly as possible. There is a common consensus that consolidation should be greater during good times. It would therefore be logical to intensify retrenchment efforts and to not repeat the mistake that has often been made in the past of using unexpected additional revenue for other purposes. It is important to resist the wide range of special interests. The experience in 2001 proved just how rapidly favourable economic conditions coupled with a boom in volatile profit-related taxes can turn and instead lead to extensive deficits, a racing debt ratio and a violation of budgetary ceilings if no sound underlying position has been achieved. Thus, central and the individual state governments should also aim to balance their budgets as soon as possible.

As regards the consolidation strategy, it would have been preferable to restrict expenditure further and to curtail tax privileges to a greater degree rather than to raise tax and contribution rates in connection with the measures to promote the economy in the short term. Stabilising the revenue ratio, which is structurally declining due to shifts away from highly "revenue-yielding" GDP components, by raising tax and contribution

Increases in tax and contribution rates problematical

² See Deutsche Bundesbank, The evolution of labour market-related expenditure, Monthly Report, September 2006, pp 59-83.

³ For a detailed explanation of the developments in the government revenue and expenditure ratio up to 2007, see Deutsche Bundesbank, Monthly Report, August 2006, pp 52-53.

rates poses problems. Although the revenue ratio may thus remain the same, this still entails additional distortions that may not be beneficial to the underlying economic conditions.

Budgetary development of central, state and local government⁴

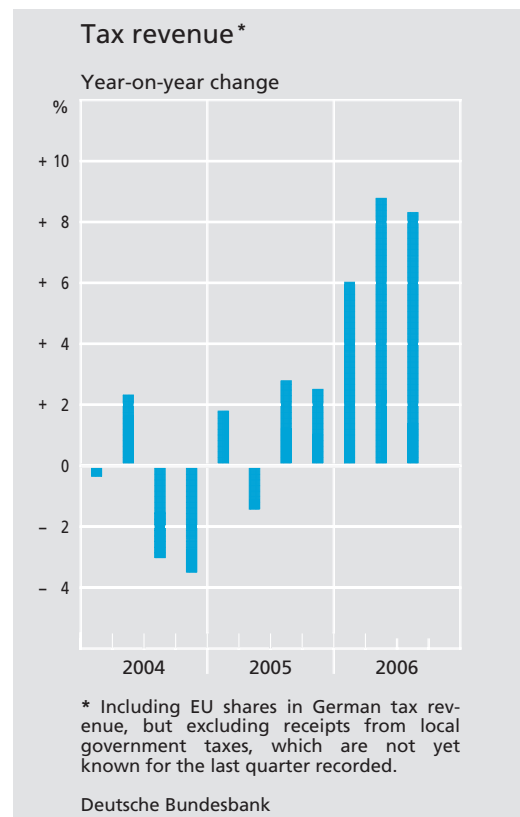
Tax revenue

Marked increase in tax revenue in third quarter

The third quarter saw a further sharp increase of 8½% (€8½ billion) in tax revenue⁵ on the year (for more information, see the table on page 54). Revenue from profit-related taxes in particular went up significantly (€5 billion) as did revenue from wage and turnover tax (together €3 billion). This clearly reflects the more favourable macroeconomic development. Another factor behind the increase in assessed taxes was that net payments for previous years were relatively small mainly due to lower employee refunds. Although revenue from energy tax⁶ also grew noticeably (almost 3%), after adjustment for a payment that was brought forward from the fourth to the third quarter, this revenue in fact decreased. Revenue from tobacco tax fell by 6½% despite the tax rise in September 2005. However, the figure for the previous year climbed owing to anticipatory effects.

Tax estimate for 2006 revised substantially upwards

According to the new official tax estimate, tax revenue (including receipts from local government taxes) is expected to rise by just over 7% for the whole of 2006. The tax ratio as defined in the government's financial statistics would therefore rise from 20.2% to



21.0%. Although the positive effects of progression and changes in legislation play their part, the increase in the ratio reflects above all the strong growth in profit-related taxes. Tax receipts as a whole are expected to be much higher (€19½ billion) than was last estimated in May. On the one hand, the macroeconomic reference variables grew more sharply than had been anticipated in the

⁴ The following report is based on the budgetary definition (as defined in the government's financial statistics).

⁵ Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the last quarter recorded.

⁶ Under the Act revising the taxation of energy products and amending the Electricity Tax Act (*Stromsteuergesetz*) of 12 July 2006, the Mineral Oil Tax Act (*Mineralölsteuergesetz*) was replaced by the Energy Tax Act (*Energiesteuergesetz*). The previous term "mineral oil tax" has been replaced by "energy tax".

Overall tax revenue and major individual taxes

Type of tax	Q1–Q3				Q3				Estimate for 2006 ³
	2005	2006	Year-on-year change		2005	2006	Year-on-year change		Year-on-year percentage change
	€ billion		in € bn	as a percentage	€ billion		in € bn	as a percentage	
Overall tax revenue ¹	294.4	317.3	+ 22.9	+ 7.8	101.8	110.3	+ 8.5	+ 8.3	+ 6.6
<i>of which</i>									
Wage tax	85.1	87.1	+ 2.0	+ 2.4	28.2	29.2	+ 1.1	+ 3.8	+ 2.6
Assessed income tax	3.7	10.0	+ 6.3	.	4.2	6.3	+ 2.1	+ 51.0	+ 75.6
Investment income tax ²	14.3	15.8	+ 1.6	+ 11.0	2.8	3.4	+ 0.5	+ 19.4	+ 9.8
Corporation tax	10.9	16.4	+ 5.5	+ 50.4	3.8	6.1	+ 2.3	+ 60.1	+ 41.7
Turnover tax	103.2	108.2	+ 5.0	+ 4.8	35.3	37.1	+ 1.8	+ 5.0	+ 4.6
Energy tax	24.1	24.3	+ 0.2	+ 0.6	9.8	10.0	+ 0.3	+ 2.8	- 1.0
Tobacco tax	10.1	10.1	+ 0.0	+ 0.3	4.0	3.7	- 0.3	- 6.4	- 0.5

¹ Including EU shares in German tax revenue, but excluding receipts from local government taxes, which are not yet known for the last quarter recorded. — ² Non-

assessed taxes on earnings and withholding tax on interest income. — ³ According to official tax estimate of November 2006, excluding local government taxes.

Deutsche Bundesbank

second quarter.⁷ In addition, to date the growth of cash receipts has been significantly stronger than had been expected given macroeconomic developments and changes in legislation. This holds particularly true for profit-related taxes for which the estimate was revised upwards by €13 billion. Revenue forecasts for wage tax (€2 billion) and turnover tax (€4 billion) were also increased considerably. Around the turn of the millennium, revenue from turnover tax grew at a much weaker rate than its assessment base (probably partly due to turnover tax evasion becoming more prevalent), however, the tide has now turned.

Tax revenue is expected to go up by 6% in 2007. The additional rise in the tax ratio to 21.7% is attributable to the effect of changes

in legislation, especially the increase in VAT. Compared with the May estimate, at €18½ billion (adjusted to account for recent amendments in tax legislation) similarly high additional revenue is expected in 2007 as in 2006. On the one hand, the revised forecasts of assessment bases for wage and turnover tax leads to greater upward adjustments. On the other hand, it is assumed that there will be a decline in momentum for profit-related taxes. Revenue from profit-related taxes is generally only loosely connected to the development of corporate and investment income, which is used as a macroeconomic reference variable – in the absence of better informa-

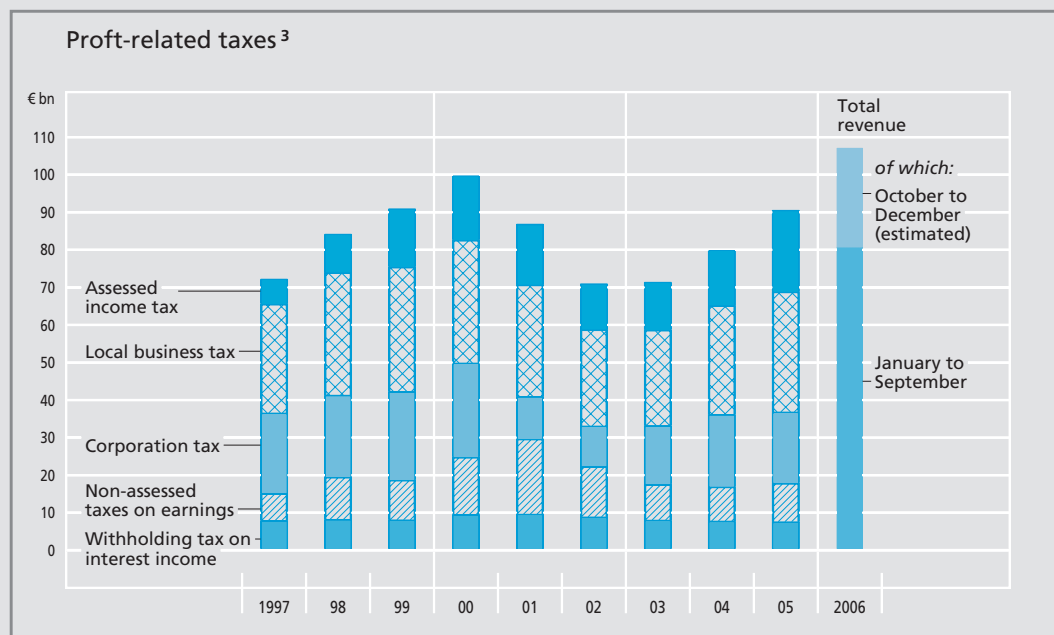
Stronger increase in revenue expected for 2007, too

⁷ Central Government projects overall nominal GDP growth of 2.9% for 2006 (May estimate: 2.0%) and 2.6% for 2007 (May estimate: 2.3%). Real GDP growth is now forecast at 2.3% (1.6%) and 1.4% (1.0%), respectively.

The development of profit-related taxes

Revenue from profit-related taxes is subject to sharp fluctuations. Even adjusted for the effects of legislative changes, it is far more volatile than entrepreneurial and investment income calculated as a residual in the national accounts, which is usually taken as the macroeconomic reference variable (see chart below).¹ First, systemic deviations between entrepreneurial and investment income and the actual tax assessment base exist, for instance because provisions are taken into account when determining the tax base. This may have contributed to the fact that in 2001 and 2002 the development of tax receipts after adjustment for legislative changes was far weaker than that of entrepreneurial and investment income.² Sharper fluctuations in revenue from assessed taxes also occur because in any one year advance tax payments are determined on the basis of estimated profits, with any deviations from the actual tax

liability only being settled in the following years. In particular when the advance payments are determined by past profit trends, a situation may arise in which large advance payments are accompanied by large back payments, for example, during periods of stronger growth in profits. This effect may be partly responsible for the current sharp growth. Finally, the extent and the duration of the effects of legislative changes are also difficult to estimate because of the above-mentioned uncertainties regarding the assessment base and the date on which they are reflected in the cash positions. Thus, for example, the additional tax receipts arising from the restriction of the facility to offset losses, which came into force in 2004, may have been underestimated. The problems mentioned impede not only the interpretation of past revenue trends but also the revenue forecast.



¹ The revenue fluctuations are recorded as cyclically-induced under the standard cyclical adjustment procedure only if they can be explained by the cyclical developments of the relevant underlying macroeconomic assessment base. Thus, other sharp temporary fluctuations affect the cyclically-adjusted deficit recorded under this procedure. See Deutsche Bundesbank, The development of public finances in Germany following qualification for European monetary

union, Monthly Report, April 2003, p 15. — ² In addition, various special factors in connection with the business tax reform, which came into force in 2001, also played a role, see Deutsche Bundesbank, Recent tax revenue trends, Monthly Report, December 2002 pp 15-36. — ³ As defined in the national accounts. Employee refunds deducted from assessed income tax revenue. Adjusted for the impact of changes in tax legislation in accordance with government estimates.

tion – and, moreover, this revenue is much more volatile. The margins of uncertainty are therefore especially large here (see also the comments on page 55) meaning that a cautious budget estimate is appropriate.

Central government budget

Higher deficit in third quarter owing to lower earnings on capital account

In the third quarter, central government recorded a deficit of €9 billion, which was twice as high as in the same period last year. The main reason for this was the 6% decrease in revenue (-€4 billion). Although tax revenue increased by 7% (just over €3½ billion), the decline in earnings on the capital account was greater (-€6½ billion). However, at €5 billion, loan repayments and the sale of participating interests continued to make a significant contribution to budget financing. In addition, the compensatory amount paid by the Federal Employment Agency and the motorway tolls for heavy goods vehicles – which were posted in a highly erratic way last year – were both €½ billion lower. By contrast, expenditure rose by 1% (just over €½ billion). In the case of interest, in particular, the discounts on the issuance of debt securities led to an increase of 7% (€1 billion). Expenditure in connection with the Hartz IV reform also went up by 5% (€½ billion). Although payments in connection with unemployment benefit II have recently been somewhat lower, integration benefits expanded noticeably. There was, however, a fall in grants to the pension insurance scheme. In 2005, these payments were brought forward to cover a liquidity shortfall.

By the end of September, central government had recorded a deficit of €29 billion. The 2006 Federal budget plan, which was not approved by the Bundestag until June, envisages €38½ billion for the entire year. In recent years, surpluses were regularly recorded in the final quarter. Revenue from asset realisations and repayments of liquidity assistance granted to the Federal Employment Agency during the year both played a role in this. By contrast, the deficit may increase somewhat before the end of this year as no such repayments are expected and indications have been made that only a minimal amount of revenue is to be achieved from the sale of participating interests. The budget outturn should still, however, be better than expected and fall below the previous year's figure of €31½ billion.

Budget development more favourable than planned

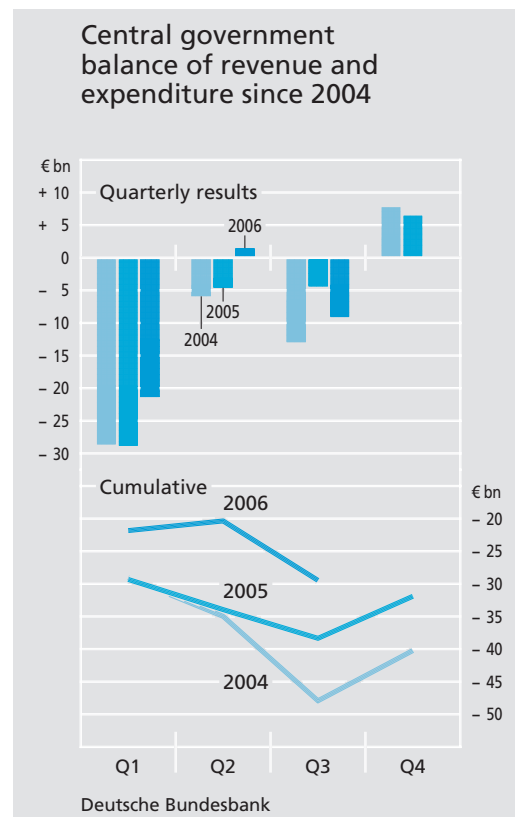
Following an adjustment meeting of the Budget Committee, the Federal budget deficit is to be reduced to just under €20 billion in 2007. With investment expenditure of €24 billion, the constitutional ceiling for new borrowing pursuant to Article 115 of the Basic Law of the Federal Republic of Germany (*Grundgesetz*) should be observed. However, in addition to extensive tax increases, this is also to be achieved by shifting burdens to other government budgets – in particular, the cut in contributions to the pension insurance scheme for recipients of unemployment benefit II. In the latest tax estimate, tax revenue is estimated at €6 billion higher than in this summer's draft budget. In addition to the reduction of €2½ billion in deficit, almost €2½ billion has been earmarked for central government's contribution – agreed with

In 2007, only formal compliance with borrowing limit is planned

state government – to accommodation costs for the recipients of unemployment benefit II. This figure is much higher than the amount envisaged in the summer budget draft. Just over €1 billion is needed to offset the compensatory amount paid by the Federal Employment Agency which is now lower than initially estimated. The Federal grant to statutory health insurance institutions has also been increased by €1 billion compared to the original budget draft to limit the increase in contribution rates. However, seeing as counterfinancing for this is planned in the budget, this measure should, on balance, not place a burden on central government. All in all, less than half of the additional tax revenue is to be used to achieve the necessary reduction in the Federal deficit. Although, according to the traditional interpretation, borrowing will fall below the limit defined in Article 115 of the Basic Law, relief of approximately €16 billion is planned through asset realisation, including the securitisation of Post Office pension fund claims (see the comments on the ERP special fund on page 58). In keeping with the intention behind an investment-oriented loan ceiling (golden rule), this revenue at least should be deducted from investment expenditure in the same way as depreciations. If the loan ceiling is adjusted in this way, a balanced budget is necessary. The structural overburdening of the budget is ongoing meaning that steps to consolidate are urgently needed.

State government budgets⁸

In the third quarter, the state government budgets recorded a deficit of €2 billion compared with €6½ billion in the third quarter of



2005. The substantial growth in revenue (+€8½%) is attributable to the continued favourable development of tax revenue. At ½%, the increase in expenditure was much more moderate. Personnel expenditure was 1% less than in the same quarter of 2005 owing to outsourcing, in particular of a large number of universities in North Rhine-Westphalia. However, other expenditure rose by 2% on the year as a result of this change in the method of funding universities. The budgets envisage a deficit of €23 billion for the year as a whole (actual deficit in 2005: €24 billion). According to the results of the latest tax estimate, which increased state government's revenue expectations by €7½

Sharp decrease in state government deficits in Q3 and ...

... clear undershooting of budget over entire year

⁸ The most recently published data on local government finances is analysed in the short articles in the Bundesbank Monthly Report of October 2006.

Capital revenue from the ERP Special Fund in the central government budget

The origins of the ERP Special Fund (*ERP Sondervermögen*) lie in the USA's European reconstruction programme after the Second World War (Marshall Plan), under which Germany received goods worth approximately US\$1½ billion. Recipients paid the invoices in Deutsche Mark to counterpart accounts held at the Deutsche Bundesbank. It was agreed in a treaty with the United States of America to deposit these financial resources in a special fund in order to use them to grant revolving loans to boost the economy. As a result of the debt relief granted in connection with this, Germany had to repay only US\$1 billion, an obligation that it fulfilled during the 1960s. Nevertheless, under the treaty, Germany has to obtain the approval of the United States of America before it makes any fundamental changes to the Special Fund.

At the end of 2005, the ERP Special Fund reported provisions of €1 billion, liabilities of €15 billion and assets of almost €29 billion. During final discussions about the 2007 Federal budget, the Federal Government evidently reached an agreement to restructure the ERP Special Fund. As well as transferring the capital base to the Reconstruction Loan Corporation (*Kreditanstalt für Wiederaufbau*), among other things equity in the amount of €2 billion is to be transferred to the central government budget. Compensatory measures are to be taken to prevent this resulting in a

restriction of lending capacity. In addition, it is understood that central government is intending to take on receivables and liabilities of €14½ billion.

Leaving aside any efficiency gains which may arise as a result of reorganising the ERP Special Fund, the plan should be viewed with a critical eye given the budgetary rules which restrict borrowing. This procedure is a prime example of how to circumvent existing budgetary rules.¹ The assumption of liabilities means that the level of central government debt rises without this being recorded as borrowing under budgetary law. However, the respective claims taken over are to be used specifically to finance the budget – probably in the form of asset disposals. This then bypasses the fundamental intention behind Article 115 of the Basic Law, ie to restrict debt. In view of the moderate gap between investment and net new borrowing, this ultimately means that it will be possible to finance current expenditure by debt assumption.²

The Federal Government is rightly committed to a comprehensive consolidation of the government budget. A timely reform to give renewed vigour to the rules restricting central government indebtedness could be a key component of the consolidation strategy. This also applies to state government whose budgetary regulations have also proven to be unsatisfactory.

¹ See Deutsche Bundesbank, Deficit-limiting budgetary rules and a national stability pact in Germany, Monthly Report, April 2005, pp 27–30. — ² By contrast, these trans-

actions do not have a direct effect on the Maastricht deficit because the realisation of financial assets is not recorded as revenue.

billion, the financial position is expected to be much more favourable. In the first three quarters of 2006, the deficit declined by €9 billion on the year. In addition, the absence of one-off burdens from the recapitalisation of enterprises in the final quarter of 2005 should mean that the year-on-year improvement is even better still.

Further consolidation efforts required

Before the results of the tax estimate were known, the state government budget plans envisaged that, compared with the target values for 2006, deficits would decline by approximately €4 billion to €19 billion. Even assuming the lowest results for 2006, the deficit should fall by this amount at the very least. Therefore, the target of reducing the deficit to below €10 billion is certainly realistic. Nevertheless, a number of state governments still have difficulties observing their constitutional borrowing limits. These limits have been overshot in Bremen, Saarland and Schleswig-Holstein. Some eastern German states, and Berlin in particular, may again fail to prove that they have used the special supplementary Federal grants for the reconstruction of eastern Germany for entirely appropriate purposes. Overall, there is still a clear need for budget consolidation as the objective of a balanced budget is anchored both in national and EU law. To avoid additional tax increases, it is essential to consistently limit expenditure.

Berlin ruling increases individual responsibility and ...

This is particularly true for state governments with a high budget deficit, such as Berlin. The Federal Constitutional Court rejected Berlin's application for a judicial review of constitutional law aimed at obtaining restructuring

aid. The judges stressed that all other possible consolidation measures must be tried before turning to this type of aid. Due to the high level of spending in Berlin compared to other state governments and to its potential for increasing revenue, it was found not to have fulfilled this requirement. This ruling significantly increases each state's responsibility for its own budget and lowers the problematic incentive associated with the federal principle of relying on the help of other public authorities rather than taking unpopular consolidation measures. In addition, a national procedure to monitor budgets would be necessary to recognise a potential budgetary crisis as early as possible and to initiate appropriate countermeasures. This could be implemented as part of the planned second phase of reforming the federal structure. The European budgetary surveillance procedure with its harmonised reporting and analysis of budgetary developments and budget planning could serve as a rough example. The Financial Planning Council could then assume a particularly important role with regard to evaluations and directives.⁹

... could be supplemented with fiscal monitoring system

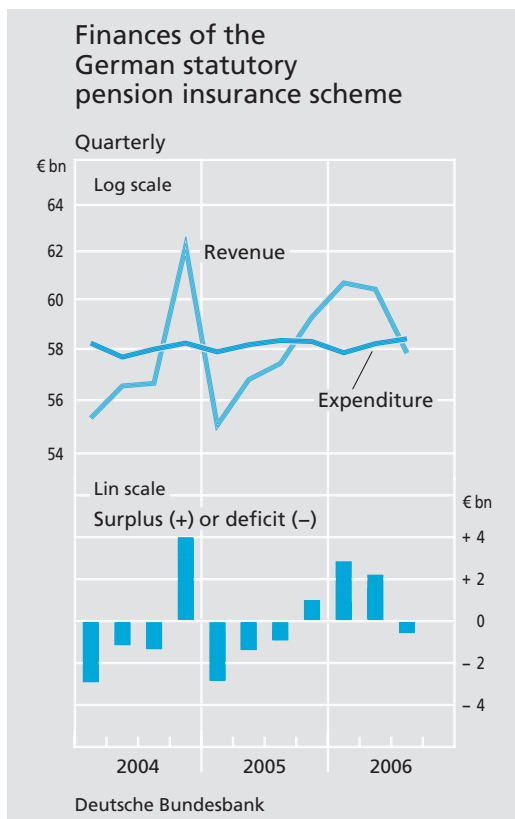
Social security funds

Statutory pension insurance scheme

In the third quarter, the statutory pension insurance scheme recorded a deficit for the first time this year (€½ billion). This was only marginally lower than the deficit recorded in the same period last year although in 2005 the

Deficit in third quarter reveals persisting severe structural problems

⁹ See Deutsche Bundesbank, State government finances in Germany, Monthly Report, July 2006, p 47.



deficit had been improved by bringing forward a Federal grant of €1 billion due to liquidity problems. In 2006, bringing forward the transfer deadline for contributions had led to an unusually high level of revenue up to July, however, the situation returned to normal in the following two months. The precarious financial situation within the statutory pension insurance scheme once again became evident despite the positive effects of favourable development of employment subject to social security contributions. After adjustment for the phase shifts¹⁰ brought about by the earlier transfer of contributions, revenue from contributions nevertheless increased by 2½% for August and September together. At 3½%, compulsory contributions grew at a much faster pace. By contrast, inflows for recipients of wage substitutes fell.

The overall growth in revenue was only just over ½% because the figure from the previous year had been pushed up by the earlier transfer of Federal funds. The increase in expenditure was only slight. Pensions were not put up mid year and the number of pensions rose only slightly.

In the first nine months of the year, the surplus of the pension insurance scheme amounted to almost €4½ billion. If there had been no special effect on the contribution side, however, there would have been a deficit of around €6 billion. A surplus is expected for the final quarter as a result of seasonal factors. Due to the fact that at the end of the year the reserves will clearly exceed the statutory minimum of 0.2 month's expenditure, the contribution rate for 2007 could have been set at a lower level than 19.9%. However, this would have meant that the reserves which were built up as a one-off this year would then be used up straight away and that the contribution rate would have to be raised even further for 2008.

Larger increase in 2007 smoothes development of contribution rate

The Act increasing the retirement age for the pension insurance scheme (*RV-Altersgrenzenanpassungsgesetz*) is to raise the statutory retirement age from 65 to 67 by the end of 2029. This takes account of increasing life expectancy and the associated continued expansion of the benefits granted under the pension insurance scheme and sends out clear signals to employees and employers

Rise in statutory retirement age with more concessions

¹⁰ The August contributions for 2006 refer to the wages and salaries subject to compulsory contributions that were paid in August. In the previous year the contributions related to August pay were, for the most part, not transferred until September.

that working lives need to be longer. However, favourable treatment of people who have paid contributions for 45 years¹¹ has cancelled out a considerable portion of the desired curbing of contribution rates. This regulation means that if the total amount of contributions paid and retirement age of insured persons are the same, one will receive a higher pension simply because the contributions were paid over a longer period of time. To ensure that the pension insurance scheme remains sound in spite of ever increasing life expectancy, it would be advantageous to forgo exemptions and to automatically link retirement age to life expectancy.

Outstanding pension cuts to be implemented

In previous years, a safeguard clause prevented pensions from being cut. Therefore, the reduction in the relative pension level that was passed by the government and considered necessary to stabilise the contribution rate did not take place. This also presents a problematic nominal rigidity. A modified safeguard clause is to halve pension increases from 2011 until the cuts which the government refrained from making have been made in full. By not rectifying the situation with sharper and more rapid measures, there is, however, a greater risk that in future economically weak phases, the statutorily fixed upper limit of 20% for the contribution rate will be overstepped before 2020.

Federal Employment Agency

Surplus again in third quarter

The Federal Employment Agency's surplus reached just over €2½ billion in the third quarter compared to less than €½ billion in the same period in the previous year. The key

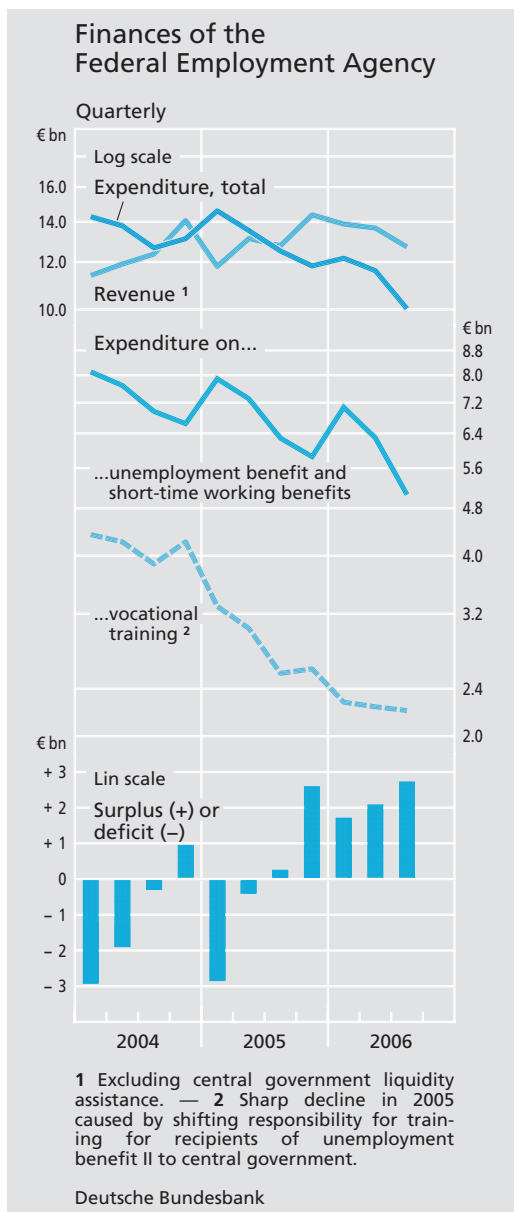
factor in this improvement is the economic recovery which results in lower spending but also higher revenue. Contribution receipts were almost 3% up on the year. Bringing forward the transfer deadlines played its part in this up to July. The underlying trend probably reached just over 1½%. However, overall revenue decreased by ½% as insolvency contributions and reimbursements of administrative costs were lower, although these were offset by declining corresponding items on the expenditure side. Spending on unemployment benefit I fell by 19%. A major factor here was the decrease of 9% in the number of unemployed persons. Although the decline in the number of people receiving unemployment benefits was probably less significant in absolute terms, as a percentage it is likely to have fallen much more sharply. This was also the case in the second quarter. The declining ratio of recipients¹² is not – as suggested by the year-on-year decrease of €½ billion in the compensatory amount – necessarily attributable to the switch from unemployment benefit I to unemployment benefit II but rather to the cyclically-induced decline in the number of short-term unemployed. Spending on active labour market policy was 13½% lower. However, no further savings were recorded compared with the previous quarter.

In the first nine months of the year, the surplus of the Federal Employment Agency amounted to €6½ billion. This is an improve-

Surplus over and above the amount expected for 2006 as a whole

¹¹ Periods spent caring for relatives and raising children are also counted alongside years in paid employment with compulsory contributions.

¹² Approximately 30% of persons registered as unemployed received unemployment benefit I in the third quarter.



ment of €9½ billion on the year. Approximately €3½ billion is likely to be attributable to bringing forward the transfer date for social security contributions. The large remaining amount is predominantly due to the economic recovery but also to the toning down of the active labour market policy. Over the course of the year, the surplus could exceed €10 billion. With this as a starting point and with the new central government grant fi-

nanced by VAT as well as further decreases in spending, the agency will also be able to cope with the large drop in contribution rates from 6.5% to 4.2% over the next – good – year. However, it should be carefully examined whether this contribution rate is compatible with a balanced budgetary position for the Federal Employment Agency in the medium-term in order to prevent a procyclical increase of contribution rates or the renewed need for larger Federal resources during future downturns assuming the level of benefits remains the same. Further expansion of the range of benefits granted by the Federal Employment Agency – such as extending the period for receiving unemployment benefit I for older claimants – would most likely step up the pressure on contribution rates and is therefore not a suitable method for promoting employment.¹³

Statutory health insurance scheme

The financial situation of the statutory health insurance scheme was mainly balanced until the middle of the year. In the second half of the year, a surplus is expected particularly owing to the typically high contributions receipts at the end of the year.¹⁴ Federal resources are to be reduced by €1½ billion to €2½ billion in 2007. Moreover, spending by health insurance institutions will be higher owing to the rise in VAT. These measures will mean a burden of €2½ billion for the statu-

Relatively favourable financial situation in 2006

13 See also Deutsche Bundesbank, The evolution of labour market-related expenditure, Monthly Report, September 2006, p 76.

14 The latest financial development of the statutory health and long-term care insurance schemes is analysed in greater detail in the short articles of the Monthly Report of September 2006.

Planned changes to healthcare regulation

In the draft Act to promote competition among statutory health insurance institutions (*GKV Wettbewerbsstärkungsgesetz*) the Federal Government has set out the details of its plans to amend health insurance law. The key elements include:

Introduction of a health fund from 1 January 2009

- The health fund is to be financed from income-based employee and employer contributions and tax resources whereby the employee's special contribution is to remain at 0.9% of his/her income subject to compulsory insurance contributions. Health insurance institutions are to receive risk-adjusted insurance premiums. The function of redistributing income between insured persons would shift from the health insurance institutions to the health fund.
- The contribution rate to the health insurance fund in 2009 is to be set in such a way that the revenue – together with the tax grant – is sufficient to finance total spending by the health insurance institutions. In the long-term, resources from the health fund are to cover on average at least 95% of expenditure by the health insurance institutions. The contribution rate will then be adjusted by Federal Government regulation.
- A grant of €1.5 billion from the 2008 Federal budget has been earmarked. This amount is to increase to €3 billion in 2009 and thereafter will increase at a rate that has yet to be defined. One of the main purposes of the grant is to finance the non-contributory co-insurance of children in the statutory scheme out of general taxation.
- If the resources from the fund are insufficient for individual health insurance institutions to cover their expenditure then they may demand an additional contribution of no more than 1% of income subject to compulsory insurance contributions from their members. Means testing can be avoided only if the contribution is less than €8 per month. Any excess payments can be refunded to members.

Private health insurance institutions obliged to offer a base tariff from 1 January 2008

- A base tariff should offer services similar to those under the statutory health insurance scheme at no more than the average maximum statutory contribution (currently just over €500 per month). This rate should be offered to all persons who are currently, or who were previously, privately insured. Persons who are voluntarily insured under the statutory scheme are to be granted a one-off right to join the private insurance scheme.
- If the person insured is not able to pay the base tariff premium, then this premium is to be halved. To ensure

that private health insurance institutions do not adopt a risk selection policy, they shall be obliged to set up a financial equalisation scheme.

- Ageing reserves which, in mathematical terms, are attributable to the base tariff are to be passed on if the person insured changes his/her insurance scheme. This applies to all persons privately insured.
- In the future, a change from statutory to private health insurance will be possible only if the individual's income is above the threshold for opting out of the statutory health insurance scheme (currently €47,250 per year) for three consecutive years. Currently, it is possible to change after only one year.

Other key regulations, some of which are due to come into force on 1 April 2007

- Extension of the benefits granted by statutory health insurance: treatments at health spas for older insured persons and for parents together with their children as well as recommended vaccinations are to become a mandatory service rather than an optional one.
- Resident doctors are to be remunerated according to fixed rather than variable service charges. In the future, contractual agreements will replace strict budgeting linked to the development of income subject to compulsory contributions. If the agreed volume of services is exceeded, then a retrogressive graduation of prices will come into effect.
- If individuals do not have regular medical check-ups, in the event that they become chronically ill their maximum own contribution rises from 1% to 2% of their household income.
- Spending on pharmaceuticals is to be limited by price negotiations between statutory insurance institutions, dispensing chemists and the pharmacy industry and by changing the current fixed-amount system to one based on maximum amounts. Special and, as a rule, expensive pharmaceuticals are to be financed by insurance institutions only after a second opinion has been obtained.
- Invoices issued by hospitals to insurance institutions for patients that were discharged after 31 December 2006 are to be reduced by 0.7% across the board.
- Instead of the current seven associations of the statutory health insurance scheme, in the future there is to be only one association at Federal level. Health insurance institutions are to be allowed to merge freely with each other and are to be subject to insolvency law.
- Health insurance institutions will be allowed to offer a choice of rates with different retained amounts.

tory health insurance institutions, which alone will force them to increase contribution rates (currently 14.3% on average) by 0.25 percentage point. Although, in exceptional cases, the deadline for clearing debts has been pushed back for one year until the end of 2008, the health insurance institutions as a whole should still strive for a surplus in 2007.

Health system reform will not prevent rise in contribution rates in 2007

The health reform introduced into the parliamentary legislative process in the form of the Act to promote competition among statutory health insurance institutions (*GKV Wettbewerbsstärkungsgesetz*) will not have any significant impact on the current upward pressure on contribution rates. The act that, according to plan, is to be implemented on 1 April 2007 will bring with it measures effective in the short-term (see overview on page 63) which should lead to financial relief of €1.4 billion in 2007 and €1.8 billion per year in the following years. However, it is questionable whether these savings will actually be achieved as they are mainly based on changing the regulations governing the relationship between service providers and health insurance institutions and the effect of these changes is difficult to gauge. Thus, overall, noticeable increases in contribution rates are likely in 2007.

From 1 January 2009, the financing system for statutory health insurance is to be changed. The health insurance fund is to be

raised from employer and employee contributions as well as from tax resources. The health insurance institutions receive risk-adjusted insurance premiums and are thereby organisationally freed from the responsibility for the redistribution of income. However, a further-reaching decoupling of financing for the statutory health insurance scheme from employment will be prevented by the fact that tight ceilings are envisaged for the flat-rate top-up contribution that individual institutions can charge if they run out of funds. This means that competition among health insurance institutions is likely to be intensified only to a limited degree. However, limiting the top-up contribution could increase the pressure to reduce spending because the standard contribution rate will be set by the Federal Government and the health insurance institutions will not have any other way of obtaining additional revenue. Of course such an effect assumes, with an eye to the contribution payers, that the institutions will refrain from calling for higher contribution rates. As a whole, in this area, which is characterised by a large number of particularly dynamic interest groups, the objective should still be to intensify competition and to promote the individual responsibility of those insured. It is also important to record the desired redistribution of income in a transparent way so that this can, if necessary, be financed in a comprehensive and regulated manner by tax resources.

Health fund creates clear organisational structure, however, makes practically no contribution to intensifying competition among health insurance institutions