

Public finances

General government budget

The public finance situation in Germany improved perceptibly in 2007. For the first time since German reunification, the general government budget (as defined in the national accounts)¹ should be balanced after a deficit of 1.6% of GDP was run up last year. Although the favourable course of economic development has also had its part to play in this decrease, it is attributable in large measure to structural improvements, in particular the increase in VAT and the continued moderate development of expenditure. The debt ratio, which declined only slightly to 67.5% in 2006, is falling significantly in 2007. Nevertheless, the 60% ceiling stipulated by the EC Treaty will continue to be overshot by a considerable amount.

Close to balance government budget expected in 2007

Despite increases in taxes and social security contributions, the general government revenue ratio will increase only slightly. Legislative changes which came into force at the start of the year have, on balance, led to considerable increases in receipts. Additional revenue, especially from the 3 percentage point rise in the standard rate of VAT and of insurance tax and the higher contribution rates to the statutory pension insurance and health insurance schemes, are more than compensating for the shortfalls resulting from the 2.3 percentage point cut in the contribution rate to the Federal Employment Agency. In addition, profit-related taxes are this year again likely to grow much more strongly than would have been expected based on the

Revenue ratio rising at best marginally despite tax and social contribution hikes

¹ Excluding extraordinary proceeds from UMTS licences in 2000.

changes in legislation and the sharp growth in entrepreneurial and investment income, which is used as an indicator for the tax assessment base. In contrast to these revenue improvements, major macroeconomic reference variables for government revenue, such as gross wages and salaries but above all pre-tax private consumption, are increasing more slowly than nominal GDP, which is expanding faster as a result of the price effect of the higher excise taxes. This is offset only partly by the continued favourable development of entrepreneurial and property income. Finally, non-tax revenue is expected to stagnate in absolute terms.

Moderate spending growth and favourable economic development reducing expenditure ratio

Although the growth of government spending has accelerated somewhat compared with last year, it is likewise well below the pronounced rise in nominal GDP, which means that the expenditure ratio could fall by around 1½ percentage points. This sharp fall is partly related to the positive cyclical momentum which, as well as having a lowering effect via the ratio's denominator, also reduces labour market-related expenditure. Furthermore, the expenditure ratio has also fallen considerably in structural terms. Overall wage developments, which have been moderate to date, are not only having a dampening effect on the growth of government revenue but are also substantially curbing government expenditure – without being associated with any active fiscal consolidation measures. Thus many social benefits, such as pensions and unemployment benefit I, are pegged to the preceding growth in *per capita* earnings. Wage increases in the public sector are similarly connected to developments in the pri-

vate sector, and in fact the recent barely rising negotiated rates of pay are likely to curb this growth even more. In addition, legislative measures, such as the shortening of the maximum period of entitlement to unemployment benefit I, which was decided in 2003, the cuts in social contributions for recipients of unemployment benefit II and the abolition of the grant to new homebuyers, are also contributing to the subdued expenditure growth.² By contrast, government investment is being stepped up significantly.

The budgetary situation of general government is likely to worsen in 2008. Thereby, the ongoing positive cyclical influence anticipated on the basis of current expectations will partially mask the underlying deterioration. This will be attributable *inter alia* to the trend in profit-related taxes, the revenue from which will be curtailed considerably, first by shortfalls owing to the business tax reform that will enter into force in 2008 and, second, by the fact that in 2007 the recent surge in profit-related tax receipts might have reached a level which is well above average. Consequently, the latest official tax estimate forecasts a weak development of revenue from profit-related taxes not only as a result of the tax cuts. In addition, the turbulence on the financial markets is also likely to lead to tax revenue shortfalls, although these cannot be reliably estimated at the moment. Social contributions will also develop comparatively

Cyclically adjusted fiscal balance set to worsen in 2008

² However, the cut in pension insurance contribution payments on behalf of recipients of unemployment benefit II reduces the social security funds' contribution receipts by the same amount and thus initially results merely in a contraction of the general government balance sheet.

weakly owing to the planned sharp cut in the Federal Employment Agency's contribution rate. Overall, the general government revenue ratio could therefore decrease significantly. However, the expenditure ratio will also decline – albeit to a lesser extent – as pension and labour-market expenditure, in particular, is expanding at a slower rate than nominal GDP. Expenditure will nonetheless increase at a much faster pace than in previous years.

*Favourable
budgetary
development ...*

Public finances have recently developed extremely favourably. This makes it possible to attain a balanced budget this year, also in structural terms.³ This means that a key objective of the Stability and Growth Pact, which the Federal Government had not planned to achieve until 2010, can already be attained in 2007. If this target is also met in the coming years or if a structural budgetary surplus is generated, then the debt ratio could be brought below the reference value of 60% within a reasonable period of time. The resulting relative easing of the debt service burden would provide a cushion for coping with the likely expansion of expenditure ensuing, in particular, from the ageing of the population. Structural surpluses would make an important contribution to this as well as additionally easing the burden on younger and future generations.

*... should not
be endangered
by deficit-
increasing
measures*

The outlook for 2008 shows that expenditure growth has to continue to be tightly curbed to ensure that the budgetary consolidation achieved so far is not endangered and to create scope to possibly reduce taxes and social contributions. It must be remembered that

achieving a structurally balanced budget during a cyclical upturn means surpluses in unadjusted terms. However, the unadjusted position – and, even more so, the structural position – is expected to deteriorate in 2008. Furthermore, current fiscal policy discussions are, for the most part, characterised by calls for deficit-increasing measures. Given the danger that the surge in revenue from profit-related taxes that has been observed so far will not continue indefinitely and that the turbulence on the financial markets is generating additional risks for government budgets, any straying from the consolidation course would be problematic.

Budgetary development of central, state and local government⁴

Tax revenue

The third quarter of 2007 saw a further sharp increase of 9½% (€10½ billion) in tax revenue⁵ on the year (for more information, see the table on page 64). This was due to the 15% increase in turnover tax receipts as a result of the VAT hike at the start of the year and to the 8½% increase in revenue from income tax in the wake of the buoyant macro-

*Further sharp
rise in tax
revenue in Q3*

³ "Structural", in the sense of the European budgetary surveillance procedure, means a budget position that has been adjusted for cyclical influences and temporary measures. With regard to the German budget position in 2007, it should be noted that the extremely erratic development of revenue from profit-related taxes is currently likely to be at an abnormally high level, which is a factor that cannot be fully allowed for in this adjustment.

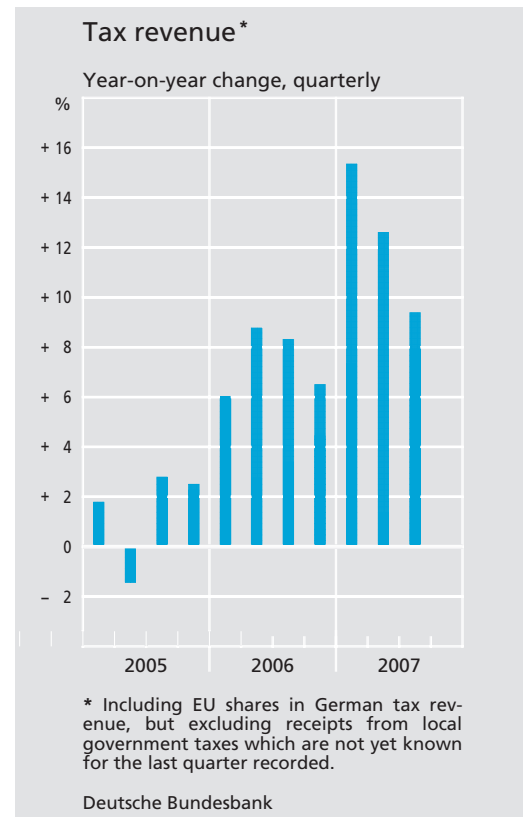
⁴ The following analysis is based on the budgetary figures as defined in the government's financial statistics.

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.

economic momentum. The rise in wage tax (+7½%) was due to the perceptible growth of gross wages and salaries and also to the effects of tax progression. Furthermore, deductions from cash receipts in the form of child benefit decreased, while the restriction of tax allowances claimable by commuters boosted revenue.⁶ Receipts from profit-related taxes also increased sharply (+10%), although the pace of growth slowed compared with the first half of the year. This deceleration resulted chiefly from the fact that in the first six months of 2007 revenue was lifted significantly by smaller deductions for grants to homebuyers, which are being phased out, and lower rebates to employees.

Tax estimate for 2007 raised

The latest official tax estimate predicts a sharp rise in tax revenue for the year as a whole (including local government taxes, +10½%) and an increase in the tax ratio (as defined in the government's financial statistics) of 1.2 percentage point to 22.2%. This reflects above all the higher tax rates for turnover tax and insurance tax as well as the sharp rise in taxes on income and earnings. Revenue expectations have been revised upwards by €4½ billion since the last official tax estimate in May. Part of the upward revision results from the development of the economy as a whole, which is now assessed more positively.⁷ The greater part, however, is attributable to growth in profit-related taxes, which is even larger than expected and cannot be explained by the increase in the macroeconomic reference variables (entrepreneurial and investment income) and the estimated effect of legislative changes.



For 2008 total revenue is expected to increase by 3% and the tax ratio to decrease to 22.1%. The legislative changes due in 2008 will reduce revenue on balance. A certain counterswing to the extreme growth in profit-related taxes over the previous years is also anticipated, although no serious negative effects from the financial market turbulence were assumed. On the other hand, the effect of income tax progression owing to comparatively strong growth in average gross wages

Expectations for 2008 not unfavourable ...

⁶ Cases are currently pending at the Federal Constitutional Court questioning the constitutionality of the revised rules for the standard travel allowance for commuters, which came into effect in 2007, so that, for the time being, these tax-free allowances can again be continually claimed.

⁷ The Federal Government now estimates nominal GDP growth for 2007 at 4.4% (May estimate: 4.0%) and real GDP growth at 2.4% (2.3%). However, lower growth is now expected for 2008: nominal 3.5% (3.7%) and real 2.0% (2.4%).

Tax revenue

Type of tax	Q1–Q3				Q3				Estimate for 2007 1
	2006		2007		2006		2007		
	€ billion		Year-on-year change in € billion	as %	€ billion		Year-on-year change in € billion	as %	Year-on-year change as %
Tax revenue, total 2	317.3	356.5	+ 39.1	+ 12.3	110.3	120.6	+ 10.4	+ 9.4	+ 11.0
<i>of which</i>									
Wage tax	87.1	94.1	+ 7.0	+ 8.1	29.2	31.4	+ 2.2	+ 7.5	+ 8.1
Profit-related taxes 3	42.3	53.7	+ 11.4	+ 26.9	15.7	17.3	+ 1.6	+ 10.2	+ 20.8
<i>of which</i>									
Assessed income tax	10.0	16.3	+ 6.3	+ 62.9	6.3	7.3	+ 1.0	+ 16.5	+ 43.2
Investment income taxes 4	15.8	20.1	+ 4.3	+ 27.0	3.4	4.5	+ 1.1	+ 32.0	+ 26.0
Corporation tax	16.4	17.2	+ 0.8	+ 4.8	6.1	5.6	- 0.5	- 8.4	- 0.8
Turnover taxes 5	108.2	125.7	+ 17.5	+ 16.2	37.1	42.6	+ 5.6	+ 15.0	+ 15.9
Energy tax	24.3	23.7	- 0.6	- 2.4	10.0	9.9	- 0.1	- 1.4	- 1.4
Tobacco tax	10.1	10.2	+ 0.1	+ 0.6	3.7	3.8	+ 0.1	+ 2.0	- 0.3

1 According to November 2007 official tax estimate. — 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes which are not yet known for the last quarter recorded. — 3 Employee

rebates and grants paid to home owners and investors deducted from revenue. — 4 Non-assessed taxes on earnings and withholding tax on interest income. — 5 Turnover tax and import turnover tax.

Deutsche Bundesbank

and salaries *per se* will lead to a higher tax ratio. All in all, the expectations have not been significantly revised compared with the May estimate. But the financial effects of the business tax reform, which is to come into effect in 2008 and which was not adopted until after the May estimate,⁸ have been included for the first time, and the Federal Government predicts that this will lead to revenue losses of €6½ billion. The Federal Government is also expecting that tax revenue losses following the ruling of the European Court of Justice in the Meilicke⁹ case will now no longer occur chiefly in 2008 – as forecast in May – but in 2009. Excluding the impact of legislative changes which have since been adopted and excluding any adjustments resulting from the Meilicke case, the projections for 2008 have been revised upwards by €4 billion com-

pared with the May estimate, especially because of the higher baseline level in 2007.

However, the forecast for 2008 is subject to major estimation risks due to the uncertainty concerning the future development of profit-related taxes. These taxes are likely to have exceeded their normal medium-term level as a result of the very steep growth that they have recorded in the recent past, meaning that a counterswing is to be expected, although the scale and timing of this can only be guessed. Furthermore, it is very difficult to gauge the financial implications of the busi-

... but subject to major uncertainty

⁸ For information on the business tax reform, see Deutsche Bundesbank, Monthly Report, February 2007, p 62 ff.

⁹ This case relates to a claim to retroactively include foreign corporation tax payments when taxing shareholders' dividends under the corporation tax imputation system, which was abolished in 2001.

ness tax reform and of the recent financial market turmoil.

Central government budget

Only moderate fall in deficit in Q3

In the third quarter, central government's deficit decreased only slightly compared with the same quarter in 2006 to €8½ billion. At 5½% or €3½ billion, the increase in revenue was somewhat more moderate than in the previous quarters. The continued strong growth in tax receipts (+11% or €6 billion) was dampened perceptibly by the sharp decline in proceeds from asset realisations (-€2 billion) and the fall in the compensatory amount paid by the Federal Employment Agency (-€½ billion). At the same time, expenditure rose again significantly (+4%). Transfers to the social security funds increased by €2 billion, in particular as a result of the VAT-financed grant to the Federal Employment Agency, which was introduced in 2007. In addition, interest payments were also €1 billion higher on the year, not least owing to significantly higher interest rates for short-term debt instruments and the assumption of the debts of the ERP Special Fund in the middle of the year. Investment grants – in particular to the German railways (Deutsche Bahn) – were almost €1 billion higher than in the third quarter of 2006. On the other hand, expenditure on the basic allowance for job seekers sank by almost €1 billion. This was chiefly attributable to the cut in contributions paid to the statutory pension insurance scheme on behalf of recipients of unemployment benefit II and the positive development on the labour market.

The favourable development of tax revenue has since been taken into account in a supplementary Federal budget for 2007. Projections have been revised upwards by a total of €11 billion. The main reason for the supplementary budget, however, is to finance a new special fund for extending childcare into which central government intends to pay over €2 billion to contribute to corresponding investment by state and local government.¹⁰ As the expenditure was not contained in the main budget and is not to be booked in future budgets either, it was necessary to secure authorisation by means of a supplementary budget. At the same time, proceeds from asset realisations have now been revised downwards substantially. At €14½ billion, central government's deficit for 2007 should be over €5 billion lower than predicted in the original budget. Overall, part of the revenue windfalls will be used to increase expenditure. Setting up off-budget special funds and shifting asset realisations back and forth (in part by involving other government-controlled entities) makes it more difficult to analyse the underlying budgetary development and diminishes the reliability of the usual budgetary figures.¹¹

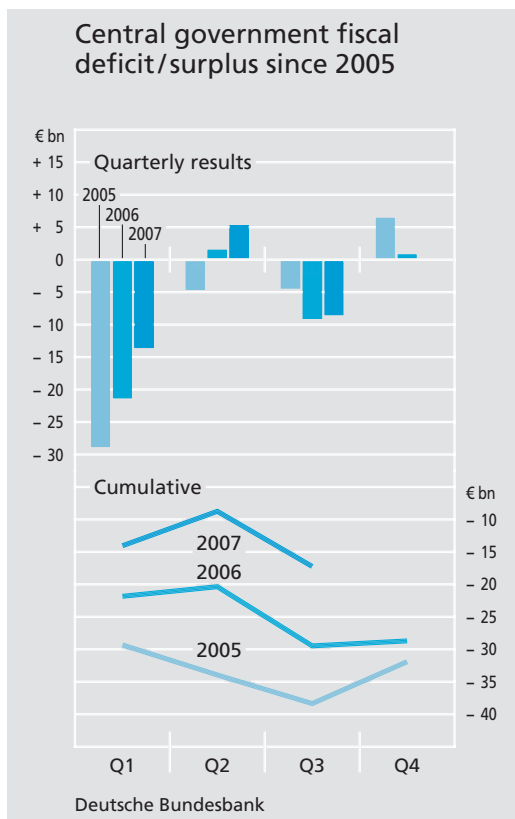
Supplementary budget only envisages a slight decrease in net borrowing

Following the Budget Committee's adjustment meeting, new net borrowing by central government is planned to be reduced to €12 billion in 2008. Hence the additional revenue of €1 billion according to the latest tax esti-

Hardly any progress towards consolidation planned in 2008

¹⁰ See also Deutsche Bundesbank, Trends in local government finances since 2000, Monthly Report, July 2007, p 40.

¹¹ For more on the issue of enhancing transparency, see Deutsche Bundesbank, Reform of German budgetary rules, Monthly Report, October 2007, p 47 ff.



mate will be reflected in an improvement of the deficit. However, the Committee recently also resolved to increase expenditure, which is to be offset by marginally downsizing the appropriations, in particular, for interest payments and grants to the statutory pension insurance scheme. As well as the revenue shortfalls from the business tax reform, the budget will be strained, in particular, by the fact that the Post Office pension fund has since used up the funds generated by securitisation activities and so central government will have to finance practically the entire spending on benefits of €6 billion from 2008¹² – in 2007 only €½ billion was earmarked for this purpose. Furthermore, higher turnover tax-financed grants to the Federal Employment Agency and greater total expenditure on parental benefits and child-

raising benefit, which is being phased out, have each led to extra costs of €1 billion vis-à-vis the targeted figure for 2007. These factors were cited as major reasons why the targeted figure for expenditure for 2008 exceeds the projections from the 2007 supplementary budget by 4%. Other major factors are increased interest expenditure resulting from a rise in interest rates, in particular for short-term maturities, and from assuming the debt of the ERP Special Fund, and additional expenditure on important political projects such as development aid and external and internal security. This extra spending obscures cost savings compared with 2007, for example due to the dropout of expenditure on expanding childcare and to lower payments for retired rail staff civil servants, war victims' welfare benefits and the all-day school programme. If the budget plans are adjusted for proceeds from asset realisations, which, at €12½ billion, are to be almost doubled in 2008, and other one-off proceeds in order to identify the underlying development, the deficit declines at best by a very limited amount between the current and the coming year. With the deficit still at an overall high level, the 2008 Federal budget is not in line with the intention of the principle agreed at European level to accelerate the reduction of deficits in economically favourable times.

¹² While the central government budget was relieved by securitisation in the period from 2005 to 2007, it is now having to do without the associated incoming payments amounting to €1½ billion per year. Ultimately this has the same effect as outright borrowing. This is also how the transaction was recorded in the national accounts.

State government¹³

*State govern-
ment surplus
in Q3 ...*

The positive trend in state government finances continued in the third quarter. After a deficit of €2 billion last year, state governments recorded a surplus of €2 billion this time round. This was attributable to a considerable further increase in revenue (+8%) – in particular tax receipts – along with a comparatively slow rate of expenditure growth (+1%). Transfers to local government are also likely to have increased sharply as a result of the positive trend in tax receipts.

*... and probably
also for the
year as a whole
amid big
differences for
individual states*

The favourable development of tax revenue, which the Working Group on Tax Estimates has recently predicted will rise by a further €2½ billion vis-à-vis its May forecast, and a moderate increase in expenditure indicate that the state government budgets will record a surplus for the year as a whole, too. They will thus conclude the year significantly better than predicted in the budget plans, which currently still forecast an overall deficit of €11 billion. The budget plans for 2008, which have so far only been slightly adjusted for recent developments, anticipate a deficit of €8 billion. However, with considerable revenue losses from the business tax reform and an expected accelerated increase in personnel expenditure, the outturn for 2008 is likely to be less favourable than in 2007, but better than current predictions.¹⁴ A number of states are still a long way from attaining a balanced budget. For example, the budget plans most recently reported for 2008 by Saarland and Bremen, but also by Rhineland-Palatinate, show no appreciable decline in their net borrowing, which is still at a relative-

ly high level, while Schleswig-Holstein even reports that it expects its net borrowing to increase again. Yet it was agreed, notably in the European Stability and Growth Pact, that economically favourable times should be used to accelerate the reduction of deficits. In this respect, too, a tightening of debt incurrence regulations in the state government constitutions needs to be discussed in the second phase of the reform of the federal structure.¹⁵

Social security funds¹⁶

Statutory pension insurance scheme

In the third quarter of 2007, the statutory pension insurance fund recorded a deficit of €1 billion, which was almost twice as high as in the same period last year. Although the contribution rate was raised from 19.5% to 19.9% at the beginning of the year and the employment and pay trends had a positive impact on the financing of the statutory pension insurance scheme, employees' compulsory contributions increased by only 1½%. However, the outturn in the third quarter of

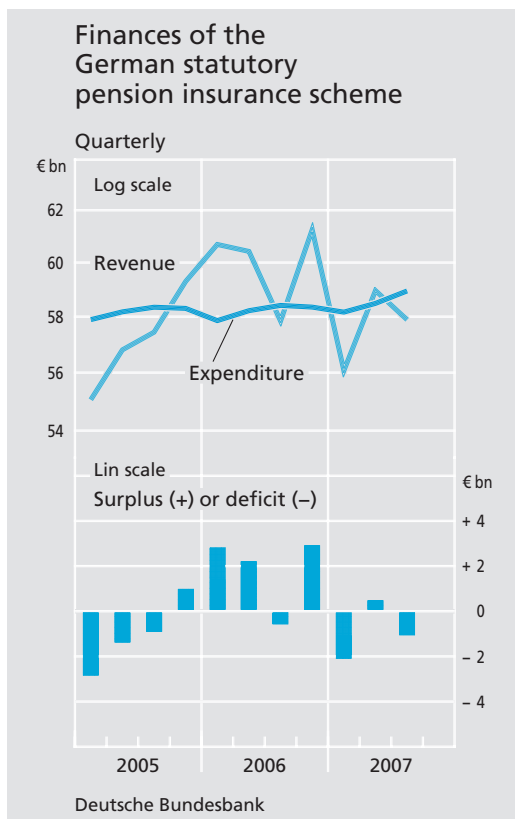
*Stagnating
revenue and
slight increase
in expenditure
in Q3*

¹³ The most recently published data on local government finances are analysed in the short articles in the Bundesbank Monthly Report of October 2007.

¹⁴ According to the latest tax estimate, revenue is expected to be €½ billion lower than in the May forecast. However, the losses arising from the business tax reform of approximately €2½ billion, which have now been included in the estimate for the first time, are already contained in the budget plans for most state governments.

¹⁵ See also Deutsche Bundesbank, October 2007, loc cit, p 58 ff.

¹⁶ The financial development of the statutory health and long-term care insurance schemes in the second quarter of 2007 was analysed in the short articles of the Monthly Report of September 2007. These are the most recent data available.



2006 benefited from the fact that one-off additional revenue was received up to and including July in connection with the earlier transfer deadline for social security contributions.¹⁷ Pension contributions made on behalf of recipients of unemployment benefit I and II actually plummeted (-39%). This was due to a significant decrease in the number of recipients of unemployment benefit I. Another contributory factor was that the contribution for each recipient of unemployment benefit II was almost halved – this should lighten the load on the Federal budget by approximately €2 billion over the full year. On balance, the revenue generated by the statutory pension insurance scheme has hardly changed on the year despite a small rise in the Federal grant. Expenditure in the third quarter rose at a rate of almost 1%. This was due to a mid-year

adjustment to pensions by 0.54% across the board. Total pension expenditure increased by ¾%. In addition, significant extra spending on health insurance for pensioners was incurred amounting to almost 6½%, which was due to sharp increases in the contribution rates of the statutory health insurance institutions.

By the end of the year, the deficit of over €2½ billion that has accumulated so far should be converted to a surplus. Overall, contributions are tending to increase at a more rapid pace than pension expenditure owing to the favourable development of gross wages and salaries. This development is likely to continue in 2008, even though the adjustment of pensions on 1 July 2008 is likely to be larger than in 2007. In the medium-term, too, the financial outlook of the statutory pension insurance scheme is likely to remain positive based on present-day expectations. However, this is likely to change at the beginning of the next decade with the retirement of the baby-boom generation born in the post-war years, which will push up the number of pensioners, particularly in relation to contribution payers.

Favourable medium-term outlook with continued positive labour market development

Federal Employment Agency

In the third quarter of 2007, the Federal Employment Agency recorded a surplus of €2 billion, which was over €½ billion smaller than in the same period of 2006. Although

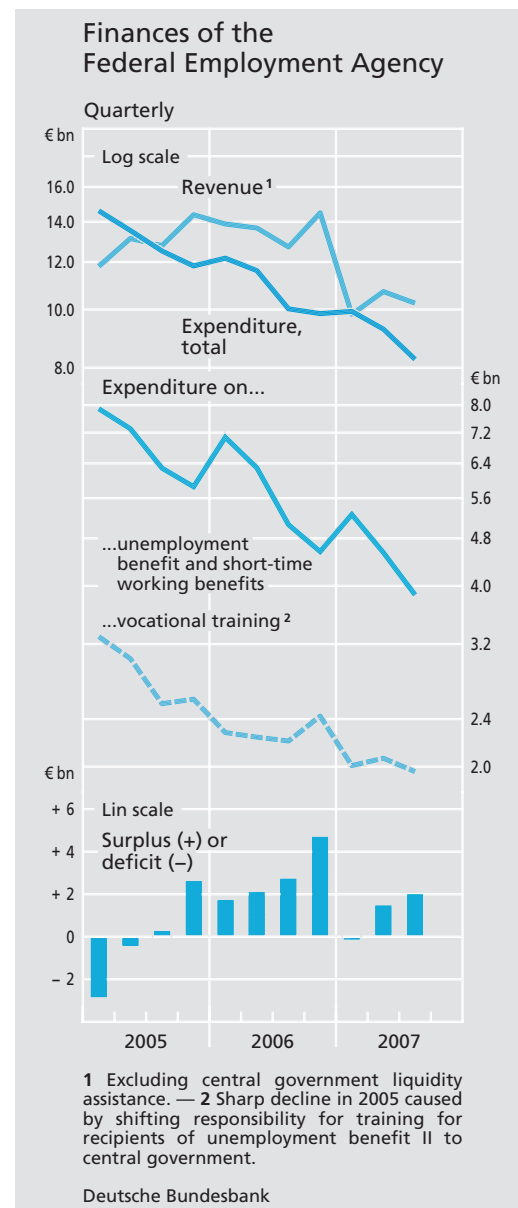
Surplus in Q3 despite clear fall in revenue

¹⁷ In August and September, for which an unbiased comparison with 2006 is possible, revenue from employees' compulsory contributions rose by over 4½%. A good 2 percentage points of this, however, was due to the rise in contribution rates.

expenditure was cut by 17%, revenue decreased at a faster rate (19½%). On the revenue side, the lowering of the contribution rate from 6.5% to 4.2% led to much lower inflows. Furthermore, in this scheme, too, there was a continuing negative baseline effect owing to the one-off revenue windfalls resulting from the advancement of the transfer deadlines, which were recorded up to July 2006. Overall, revenue from contributions was 35% down on the year. However, adjusted for the reduced contribution rate, this would have resulted in an increase of just over ½% as a result of the positive trends in employment and pay.¹⁸ In total, the decline in revenue was muted, mainly because the rule-based Federal grant of just over €1½ billion per quarter has been paid since the beginning of this year.

Sharp fall in spending due to favourable labour market development

On the expenditure side, spending on unemployment benefit I, in particular, again fell drastically, albeit at a gradually declining rate (-24%). This is mainly due to the sustained favourable labour market development but also to the shortening of the maximum eligibility period for claiming this benefit to 12 months in general and 18 months for those over the age of 55. The number of unemployed fell by 15½% on the year and the number of recipients of unemployment benefit I for whom the Federal Employment Agency is responsible declined at an even faster rate of over 23%. The Federal Employment Agency's expenditure on active labour market policy measures also decreased (-11%). The compensatory amount due to be paid to central government in the third quarter was only about half as much as one year previously.



This is consistent with the observation that the labour market recovery is increasingly reducing the number of long-term unemployed.

In the first three quarters of the year, the surplus of the Federal Employment Agency

High surplus expected again for 2007 as a whole

¹⁸ An unbiased comparison with last year is possible only for August and September. This resulted in 3½% growth in adjusted revenue from contributions.

Extension of the period of entitlement to unemployment benefit I

Until the mid-1980s, the period of entitlement to insurance-related unemployment benefit (now known as unemployment benefit I) was not differentiated according to the recipient's age. Depending on how long the person had been insured beforehand (in 1984 at least three years), unemployment benefit was paid for a maximum of one year. It was not until 1 January 1985 that older unemployed persons were given preferential treatment with the introduction of a progressively extended entitlement period. Most recently, those over the age of 57 could claim unemployment benefit I for up to 32 months.

In addition, claiming unemployment benefit I was made easier (unemployed persons could receive unemployment benefit I upon reaching 58 years of age without being available for work) and unemployed persons were allowed to draw an early pension (until 1996 without actuarial deductions) from the age of 60. Furthermore, claiming a disability pension was made easier if the individual concerned was thought to no longer have a chance of finding employment. Up to 1995, the total annual number of people taking up a retirement pension due to unemployment increased to almost 300,000 claimants. Only after that did the figure gradually decline, doubtless partly on account of the actuarial deductions in cases of early retirement. However, this decline was limited by the government-assisted partial retirement scheme introduced in 1996 as a new instrument promoting early retirement.

The Act to Reform the Labour Market, which was passed in 2003, reduced the standard period of entitlement to unemployment benefit I to 12 months. However, for unemployed persons aged 55 or more the period of entitlement was extended to 18 months. The revised rules apply to individuals who became unemployed after 31 January 2006. Consequently, an easing of the financial burden of the Federal Employment Agency was not expected until 2007. A permanent reduction in the Federal Employment Agency's financial burden of €4 billion per year was quantified in the 2003 draft law, which was based on a more pessimistic forecast of labour market developments. However, this is accompanied by sizeable, albeit appreciably smaller, additional spending on the welfare-related unemployment benefit II.

The government coalition parties have now decided to partially revoke the shortening of the entitlement period. Thus persons aged 50 and over are to be paid unemployment benefit I for 15 instead of 12 months and persons aged 58 and over for 24 instead of 18 months. Statistics from the Institute for Employment Research (*Institut für Arbeitsmarkt- und Berufsforschung*) on the breakdown of recipients of unemployment benefit I and of the expenditure generated by them according to age and payment duration allow the fiscal costs of implementing this proposal to be gauged. Based on the current legal situation, the average number of recipients of unemployment benefit I in 2005 and 2006, when the effects of shortening the period of entitlement were not yet felt directly, would have amounted not to 1.59 million but rather only 1.45 million. By contrast, under the proposed extension of entitlement, the number of recipients would have come to 1.50 million.

¹ With regard to the 2005 and 2006 average, firstly the different economic situations have to be taken into account. Secondly, for 2006, certain "foreshadowing effects" of the shortened period of eligibility to unemployment benefit I cannot be ruled out. At the end of 2006 barely 2% of unemployment benefit I recipients had been claiming the benefit for more than 12 months. At the beginning of

It can be inferred from this that, based on 2005 and 2006 data,¹ extending the period of entitlement to unemployment benefit I would cause initial additional expenditure of around €¼ billion a year compared with the legislative *status quo*. This includes social security contributions paid to the statutory pension, health and long-term care insurance schemes on behalf of unemployed persons. If the period of entitlement to unemployment benefit I is extended, the Federal Employment Agency will also have financial responsibility for active labour market policy measures for a longer period of time. On the other hand, savings can be expected as a result of the required longer insurance qualification period before claiming. Overall, gross additional expenditure could come to around €1 billion or just over 0.1 percentage point of the contribution rate. This will be accompanied by additional revenue from contributions made on behalf of unemployment benefit I recipients to the other statutory social security schemes.

During the current year the labour market situation has continued to improve considerably, due to the favourable macroeconomic situation and also, not least, as a result of the labour market reforms. Therefore, it is likely that the costs of extending the period of entitlement to unemployment benefit I will initially be lower. However, extending the length of time that the benefit is granted will partly reverse an important part of the reforms.

As regards the financial implications for general government, lower central government expenditure on unemployment benefit II and the other benefits that fall within the basic allowance for job seekers may be expected. However, this is likely to be significantly less than the additional expenditure arising from extending the period of entitlement to unemployment benefit I, *inter alia* because the preconditions for receiving unemployment benefit II are that the individual has no claims to maintenance from family members or partners and no assets.

All in all, it is quite conceivable that extending the period of entitlement to unemployment benefit I will lower the number of older persons in employment by reducing the incentive to search for a job and raising the temptation on the part of both employees and employers to resort to the instrument of early retirement. International studies show that a longer period of drawing on wage substitutes is more likely to reduce the chances of finding employment (again).² Ultimately, policymakers need to make a fundamental decision concerning the extent of unemployment insurance cover, the financing of which should be secured. It would be wrong, however, to reckon with a continuation of the current cyclically induced positive financial situation of the Federal Employment Agency. As significantly higher costs are to be expected in economic downturns, this would make a procyclical rise in contributions more likely. The revised rules that have been agreed also further dilute the risk insurance nature of the statutory unemployment insurance scheme. However, it seems questionable whether, especially in view of the demographic changes, the rough realisation of an implicit savings contract within a pay-as-you-go social security scheme is preferable to private provision for periods of unemployment.

2006 the figure was still 16%. — ² See A Bassanini and R Duval, *The Determinants of Unemployment Across OECD Countries: Reassessing the Role of Policies and Institutions*, OECD Economic Studies No 42, 2006/1 or also R Lalive, *How Do Extended Benefits Affect Unemployment Duration? A Regression Discontinuity Approach*, *Journal of Econometrics* (2007), doi: 10.1016/j.jeconom.2007.05.013.

amounted to almost €3½ billion. However, the fourth quarter usually sees particularly high revenue from contributions and low expenditure on unemployment benefit. It is therefore possible that the surplus will have doubled by the end of the year. The reserves of approximately €11 billion that were accumulated by the end of 2006 are likely to increase accordingly. €2.5 billion of these reserves is to be earmarked for a civil servant pension fund.¹⁹ This amount is therefore no longer available to offset cyclical fluctuations in income and expenditure. A further share of the financial reserves is required to absorb fluctuations in liquidity that arise during the course of the year.²⁰ The reserves available to prevent increases in contribution rates in future downturns are correspondingly lower.

Financial outlook clouded by discretionary interventions

Despite relatively favourable macroeconomic perspectives, the financial outlook for the Federal Employment Agency is clouded because its budget is threatened by considerable burdens resulting from discretionary interventions. For example, the compensatory amount payable to central government, which is likely to total almost €2 billion this year, is to be replaced by a reintegration payment that is likely to be more than twice as high. With this payment the Federal Employment Agency will assume half of the costs of reintegration measures and of the administrative expenses related to unemployment benefit II. Moreover, central government is also no longer paying contributions for persons raising children, who will thus be compulsorily in-

sured without having to pay contributions in the future. Ultimately, this means that the statutory unemployment insurance scheme will take on responsibility for activities that are not consistent with the insurance purpose but nevertheless have to be financed by the contribution payers. Furthermore, the contribution rate is to be reduced to 3.3% (and thus well below the amount of 3.9% envisaged hitherto) while benefits are concurrently expanded. In particular, the maximum period of eligibility for the receipt of unemployment benefit I is to be extended for older persons. This will lead to considerable additional costs that might mushroom even higher if recipients adapt their behaviour and make only half-hearted efforts to find a new job (see box on page 70). All in all, there are indications for the scenario – which has often prevailed in the past – that taxes and social security contributions are lowered and expenditure raised during an economic upturn. It is to be feared that this may happen on a scale which cannot be sustained in the long term, which would make the need for procyclical countermeasures in the next downturn inevitable.

¹⁹ This is intended to fully cover the existing pension claims of Federal Employment Agency civil servants. Future claims will be financed on an accruals basis by means of contributions to the pension fund calculated using actuarial methods. In return, the ongoing pension payments from the Federal Employment Agency's budget will cease.

²⁰ Spending on benefits is typically particularly high during the winter quarter at the beginning of the year, whereas receipts tend to be weak. However, this situation usually reverses itself by the end of the year. The monthly deficits run up at the beginning of the year can therefore usually be offset only by subsequent surpluses generated during the later part of the year.