

Public finances*

General government budget

Public finances in Germany developed more favourably in 2010 than had been anticipated at the height of the crisis. However, this should not mask the existence of substantial fiscal problems and the need for large-scale adjustment. According to initial data from the Federal Statistical Office, the general government deficit ratio rose to 3.5%, although the buoyant economy and positive one-off effects significantly eased the burden on public coffers (see box on pages 60 and 61). This rise was predominantly due to the considerable structural deterioration stemming from expansionary fiscal measures, but the assistance provided to financial institutions also drove up the deficit perceptibly. Furthermore, the debt ratio reached a new high at the end of 2010, estimated at well over 80%. The very sharp increase can be attributed mainly to the assumption of risk assets and liabilities by the government sector in connection with setting up resolution agencies for parts of Hypo Real Estate (HRE) and WestLB.

Further deterioration in public finances in 2010

The government revenue ratio fell by 1.4 percentage points to 43.1% in 2010. Fiscal measures were a major contributory factor in this decrease (particularly the greater tax deductibility of insurance contributions and the economic stimulus packages), while in the area of social security funds, shortfalls arising from the lower general contribution rate to

Drop in revenue ratio due to tax relief measures and unfavourable growth structure

* The analysis in the "General government budget" section is based on data contained in the national accounts and on the Maastricht ratios. The subsequent reporting on the budgets of the various levels of government and social security schemes is based on the budgetary figures as defined in the government's financial statistics (which are generally in line with the budgetary accounts).

The structural development of public finances in Germany – results of the disaggregated framework for 2010 –

According to provisional data from the Federal Statistical Office, the general government deficit in Germany (as defined in the national accounts) increased to 3.5% of gross domestic product (GDP) in 2010 after it had stood at 3.0% in the previous year. Using the disaggregated framework for analysing public finances,¹ it is possible, firstly, to estimate the role played by cyclical and specific temporary effects and, secondly, to identify other changes, referred to here as structural changes, in the revenue and expenditure ratios and their major determinants. The main results of this analysis for 2010 are presented below.²

The results show that, taken in isolation, favourable cyclical influences caused a decline in the deficit ratio of 0.4 percentage point. The effect is considerably lower than suggested by the strong increase in GDP, as important macroeconomic reference variables for government revenue (gross wages and salaries, private consumption) grew at a much weaker pace. In addition, clearly identifiable specific temporary effects (including the proceeds from the radio frequency auction and higher insolvency benefit contributions) reduced the deficit by 0.2 percentage point.³ Hence, the 2010 deficit – adjusted for these cyclical and specific temporary effects and in relation to trend-GDP – increased considerably by 1.1 percentage points.

While the unadjusted revenue ratio fell very markedly by 1.4 percentage points, the decline in the structural ratio (structural revenue in relation to trend-GDP) was more moderate (-0.7 per-

centage point). The determining factor for the weaker decline was that the short-term changes to the growth structure are not reflected in the structural ratio as it is geared towards longer-term assessment base trends. The trend growth rates of the macroeconomic reference variables that are particularly important for public finances even exceeded those of GDP, which had a slight ratio-boosting effect (positive decoupling of the assessment bases) of +0.2 percentage point. By contrast, legislative changes caused a sharp reduction in the ratio (-0.9 percentage point). This was mainly attributable to tax cuts (especially greater tax deductibility of insurance contributions, economic stimulus packages). Added to this was the lowering in the general contribution rate to the statutory health insurance scheme on 1 July 2009, the full annual effect of which was not felt until 2010.

The unadjusted expenditure ratio decreased by 0.9 percentage point in 2010, while the ratio of structural expenditure (to the more stable trend-GDP) increased by 0.5 percentage point. Public finances profited from a further slight decline in the interest expenditure ratio which was attributable to the very favourable financing conditions.⁴ The structural ratio of other expenditure (primary expenditure) went up by 0.6 percentage point. Social payments shot up owing to the further increase in child benefit as well as the relatively strong rise in expenditure on healthcare and old-age provision. In contrast to this, the decline in labour market expenditure as well as the expiration of the child bonus and

1 For an explanation, including of 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 The results are subject to amendment owing to revisions to the preliminary national account figures or revised estimates of the macroeconomic outlook. — 3 In relation to the level of deficit, these two factors contributed just under 0.3% of GDP in 2010. Financial effects in connec-

tion with support measures for financial institutions are not included in the specific temporary effects here. — 4 An exact quantification is still outstanding as the debt ratio for 2010 is not yet available. — 5 Adjusted for cyclical influences and specific temporary effects. In accordance with the EDP definition, ie including swaps and forward rate agreements in interest rate expenditure and the fiscal balance, or in accordance with ESA 95 (2010). — 6 Year-on-year change of the ratio to nominal GDP. — 7 Assessed income tax, corporation tax, local busi-

Structural development ⁵ as percentage of trend-GDP

Year-on-year change in percentage points

Item	2004	2005	2006	2007	2008	2009	2010
Unadjusted fiscal balance ⁶	0.3	0.5	1.7	1.9	-0.2	-3.2	-0.5
Cyclical component ⁶	-0.1	-0.2	0.7	0.4	0.4	-1.7	0.4
Temporary effects ⁶	0.0	0.1	-0.1	0.0	-0.2	0.3	0.2
Fiscal balance	0.3	0.6	1.1	1.5	-0.4	-1.7	-1.1
Interest payable	-0.1	0.0	0.1	0.0	-0.1	-0.2	-0.1
Owing to change in average interest rate	-0.3	-0.1	0.0	0.0	-0.1	-0.3	.
Owing to change in debt level	0.1	0.1	0.1	0.0	0.0	0.1	.
Primary balance	0.1	0.5	1.2	1.5	-0.5	-1.9	-1.3
Revenue	-1.1	0.1	0.8	0.7	0.0	-1.0	-0.7
Taxes and social contributions	-0.8	0.0	0.7	0.7	0.0	-0.9	-0.7
Fiscal drag	0.1	0.0	0.0	0.1	0.0	0.1	0.0
Decoupling of base from GDP	-0.2	-0.1	-0.1	-0.3	0.1	-0.2	0.2
Legislative changes	-0.5	-0.2	0.1	0.6	-0.6	-0.4	-0.9
Residual	-0.2	0.3	0.6	0.2	0.4	-0.5	0.0
of which: profit-related taxes ⁷	0.1	0.2	0.5	0.3	0.4	-0.6	0.1
Memo item: included in expenditure ⁸	-0.1	-0.2	-0.2	-0.1	-0.1	0.2	-0.1
Non-tax revenue ⁹	-0.3	0.1	0.1	0.0	0.0	0.0	0.0
Primary expenditure	-1.2	-0.4	-0.4	-0.8	0.5	0.9	0.6
Social payments ¹⁰	-0.7	-0.2	-0.1	-0.4	0.1	0.5	0.2
Subsidies	-0.1	-0.1	0.0	-0.1	0.0	0.1	0.0
Compensation of employees	-0.1	-0.2	-0.1	-0.2	0.0	0.1	0.0
Intermediate consumption	0.0	0.1	0.0	0.0	0.1	0.2	0.1
Gross fixed capital formation	-0.1	-0.1	0.1	0.0	0.1	0.1	0.0
Other expenditure ¹¹	-0.1	0.1	-0.2	-0.1	0.2	-0.1	0.2
Memo item							
Pension expenditure ¹²	-0.2	-0.2	-0.1	-0.3	-0.1	0.0	0.1
Healthcare expenditure ¹³	-0.4	0.1	0.1	0.1	0.2	0.3	0.1
Labour-market expenditure ¹⁴	-0.2	0.1	-0.1	-0.2	0.1	0.0	-0.1

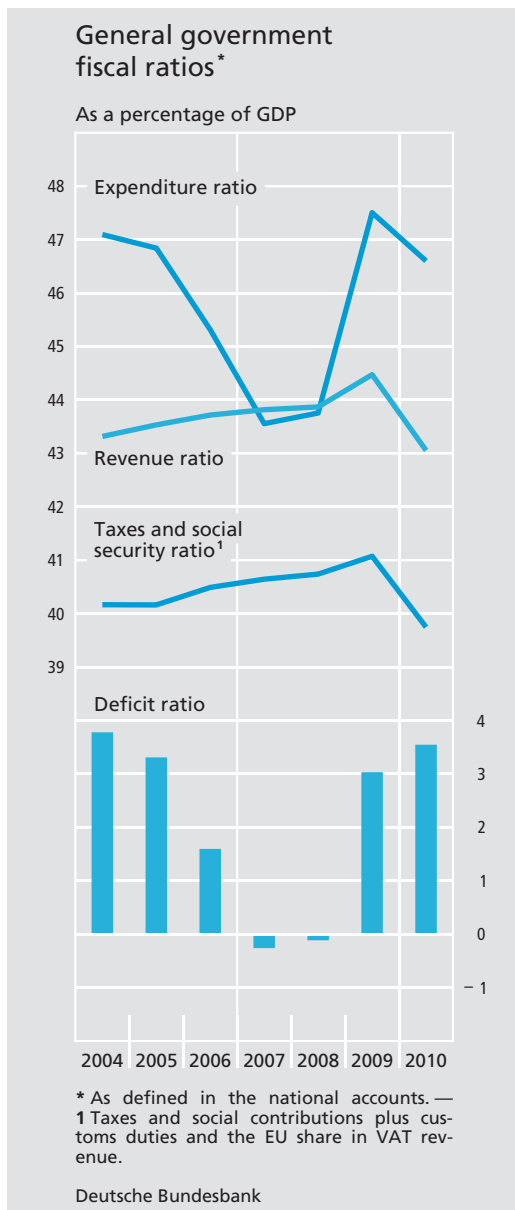
the car scrappage scheme, which was recorded in this item, had a dampening effect on the increase. In addition to social payments, the capital transfers in connection with the support of Hypo Real Estate were also partly responsible for the growth in the structural expenditure ratio.

Overall, it is apparent that there is a considerable structural deterioration in public finances, which has, however, been partly obscured by fa-

ness tax, investment income tax. — **8** Payments attributable to the general government sector, eg social contributions for public sector employees (estimated). — **9** Other current transfers receivable, sales and total capital revenue. — **10** Including other current transfers to households. — **11** Other current transfers payable to corporations and the rest of the world, other net acquisitions of non-financial assets and capital transfers. — **12** Spending by the statutory pension insurance scheme, on civil servants' pensions as well as payments by

avourable cyclical development and other temporary relief effects. The increase in the structural deficit is largely the result of extensive tax measures, relatively strong growth in expenditure on social benefits and financial market support measures.

the Post Office Pension Fund and the Federal Railways Fund. — **13** Spending by the statutory health insurance scheme and assistance towards civil servants' healthcare costs. — **14** Spending by the Federal Employment Agency (excluding the compensatory amount (up to 2007)/reintegration payment (from 2008)) paid to the Federal Government) and expenditure on unemployment assistance (up to 2004) or unemployment benefit II (from 2005) and on labour market reintegration measures.



the statutory health insurance scheme and additional revenue from raising insolvency benefit contributions largely cancelled each other out. The decline in the ratio is also attributable to the fact that gross wages and salaries and private consumption, both of which are important reference variables for revenue, grew at a much weaker pace than gross domestic product (GDP).

As a result of economic recovery, the government expenditure ratio dropped to 46.6% from 47.5%, after soaring by 3.7 percentage points in 2009. These fluctuations largely mirror the cyclical development of GDP in the ratio's denominator. The cyclically-adjusted expenditure ratio went up for the third year in a row. In particular, the effects of the further increase in child benefit, the relatively strong rise in spending on healthcare services and the higher capital transfers owing to support measures for HRE were felt in 2010. By contrast, the expiry of the car scrappage scheme and the child bonus, as well as the proceeds received in May from the auction of radio frequencies, all had an alleviating effect.¹

Expenditure ratio declined somewhat due to economic recovery

The deficit ratio could potentially drop towards 2% in 2011, provided (as is assumed here) the burdens arising from the financial market support measures decline and all levels of government initiate the corrections necessary, not least to comply with budgetary rules. Continued positive economic developments are likely to support a decline in the deficit. Furthermore, following two years of a very expansionary fiscal policy stance, fiscal measures are depressing the deficit on balance. Various economic stimuli – for example, in the area of active labour market policy or lowering the contribution rate to the unemployment insurance scheme – are being phased out. In addition, savings are to be

Improvement in 2011 due to economic development and muted spending growth

¹ In the government's national accounts, the purchase and sale of non-financial assets are netted out and recorded on the expenditure side. Thus the proceeds from the auction reduce expenditure (as was the case with the proceeds from the sales of UMTS mobile telephone licences in 2000), whereas in the government's financial statistics they increase revenue.

made in connection with the Federal Government's consolidation package from the summer of 2010. Furthermore, the contribution rate to the statutory health insurance scheme has been raised and the healthcare reform could dampen growth in expenditure. A continuation of the favourable labour market development could also contribute to a structural improvement.

Make use of more favourable economic development to reduce deficit at a faster pace

Despite the expected reduction in the deficit, fiscal policymakers still face a huge restructuring task, as is abundantly clear from central, state and local government budgets. The medium-term objective of a structurally close-to-balance budget is still a long way off. The debt ratio has exceeded the 60% reference value ever since 2002. It rose very sharply again during the crisis, even though it should be borne in mind that the rise is largely offset by an increase in financial assets in connection with financial market support measures. However, overall, the burden placed on future generations has increased significantly. Furthermore, during the financial and sovereign debt crisis, Germany assumed substantial risks from guarantees, which should by no means be disregarded. Against this backdrop, concessions in terms of the planned consolidation are not advisable. Instead, the better performance in terms of national and European budgetary rules should be used to implement budgetary consolidation as planned, taking advantage of the current very positive conditions to reduce deficits more quickly.

Confidence in the soundness of public finances remains extremely strained in several

euro-area countries. The corresponding risk premiums mean that these countries can only tap the capital market for funds at high interest rates or that they require financial assistance. Action will be required primarily from the stricken countries themselves to improve this situation on a sustainable basis by eliminating the root causes of the problem. They need to rapidly lower their government deficits, restructure their financial systems and implement comprehensive structural reforms to enhance economic growth. Financial assistance from other countries can at most buy time to allow the necessary adjustment processes to be spread over a longer period. As things currently stand, the euro rescue shield agreed in May 2010 would appear to provide a sufficient range of instruments.

Nonetheless, the possibility of adding new instruments to the rescue package, which runs to 2013, is currently being floated. One demand is that the European Financial Stability Facility (EFSF) should buy up government bonds of the affected countries on the secondary market. That would, however, absolve private sector creditors and national policymakers of even more of their responsibility and possibly result in the taxpayers in the financing countries having to shoulder more and potentially large-scale risks. Bond buybacks by the country itself using low-cost loans extended by the EFSF are being proposed, as is the idea that bonds acquired by the EFSF cheaply should be passed on to the debtor country below par. In economic terms, this would, like the reduction of the agreed interest rate conditions, involve an additional, intransparent intergovernmental transfer.

Affected countries must deal with causes of debt crisis themselves

Towards a European Stability Mechanism

In the context of the European Council meeting on 16-17 December 2010, the euro-area member states agreed to establish a permanent mechanism to safeguard the financial stability of the euro area as a whole. This future European Stability Mechanism (ESM) will replace the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), both of which are to remain in force until June 2013. In this context, the European Council decided to amend Article 136 of the Treaty on the Functioning of the European Union (TFEU) accordingly; as of 1 January 2013, a new, third paragraph is to be added with the following wording: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

Like the EFSF, the ESM is to be established on the basis of an intergovernmental agreement. All decision-making powers regarding assistance measures designed to safeguard the financial stability of the euro area as a whole therefore rest with the member states. The European Union will not undertake any further financial involvement of its own in this area and the EFSM, as an instrument established under Union law, will cease to exist in June 2013. Upon its introduction in May 2010, the EFSM was explicitly based on the derogation provided for in Article 122 (2) of the TFEU. In its conclusions of 16-17 December 2010, the European Council thus agreed that Article 122 (2) of the TFEU will no longer be needed for the purposes in question.

Article 136 of the TFEU was incorporated into primary Union law through the Treaty of Lisbon in December 2009 and forms part of a chapter on special provisions for member states whose currency is the euro. It allows these member states to coordinate their fiscal policy above and beyond the provisions of general EU law. Article 136 (1) and (2) of

the TFEU in its current wording also offers specific procedures for this purpose based in Union law. Conversely, the text of the planned amendment, which refers to the possibility of setting up the European Stability Mechanism, makes no provisions for any procedural rules. This can be explained by the clear commitment to an intergovernmentally established ESM in the conclusions of the European Council. Moreover, the decision in favour of the simplified procedure for revising the provisions of Part Three of the TFEU pursuant to Article 48 (6) of the Treaty on European Union (TEU) is also connected with the intergovernmental nature of the ESM. Such a simplified revision procedure may be applied only if competences already assigned to the European Union are not expanded as a result of the amendment and, accordingly, no new responsibilities are transferred to Union level. In this sense, the new Article 136 (3) of the TFEU merely confirms the existence of an option available to member states on account of their individual sovereignty to act within the framework of their financial autonomy.

The choice of wording for the revision and extension of Article 136 of the TFEU reflects some important decisions taken by the European Council with regard to the architecture of the future European Stability Mechanism. First, the wording stresses the need for there to be a risk to the stability of the euro area as a whole as opposed to turmoil that is restricted to one or a few member states. Second, the fact that the ESM is to be activated only when such action is indispensable emphasises that other possible solutions are to be given priority. The additional stipulation that the granting of any required financial assistance under the mechanism is to be made subject to stringent conditions enshrines in Union law the requisite strict conditionality attached to all such assistance.

Furthermore, the European Council's conclusions set out further key elements of the decision-making structure and design of the new mecha-

nism. For instance, they contain the explicit requirement that the mechanism be activated by mutual agreement of the euro-area member states. This represents a continuation of the EFSF rule that each country providing financial assistance has to agree to this action, thus ensuring that the individual member states retain decision-making authority over their own finances. The intergovernmental nature of the arrangement is also emphasised by the fact that EU member states whose currency is not the euro may participate in measures taken under the future mechanism on an *ad hoc* basis, as was the case with the Irish rescue package, which included bilateral loans from the United Kingdom, Sweden and Denmark.

Moreover, the European Council took on board the declarations in the statement made by the Eurogroup finance ministers on 28 November 2010 stipulating that the future ESM will be based on the current EFSF and will function according to the EFSF's rules. In this context, one particularly important aspect is the absence of joint and several liability for all exposures. Instead, liability corresponds to individual shares for which there are absolute size limits. In addition, the funds borrowed on the financial market are to be relayed to the financially distressed member state in the form of loans. As with the Greek assistance, the due interest is to be supplemented by processing costs and an appropriate margin. The credit conditions are elaborated by the European Commission – in this case acting on behalf of the member states – in liaison with the ECB and the IMF; in line with the requirement for strict conditionality, they contain an economic adjustment programme to which the member state receiving assistance commits.

The agreement concerning concrete modifications to the EFSF rules effective in October 2010 was likewise taken on board by the European Council. They are designed to provide for a case-by-case participation of private creditors in full compliance with IMF guidelines. Any provision of financial assi-

stance is preceded by a "debt sustainability analysis conducted by the European Commission and the IMF, in liaison with the ECB." Where this analysis concludes that the member state in question is solvent, private creditors are to be encouraged to maintain their exposure in line with IMF practices. However, if the completed debt sustainability analysis deems a country to be insolvent, ie over-indebted and carrying an unsustainable debt burden, the member state in question has to negotiate a comprehensive restructuring plan with its private sector creditors in line with IMF practices with a view to restoring debt sustainability. Only once debt sustainability has been achieved through these measures may the ESM provide liquidity assistance.

In order to facilitate the participation of private creditors, standardised and identical collective action clauses (CACs) will be included in the terms and conditions of all new euro-area sovereign bonds starting in June 2013. This will enable the creditors to pass a qualified majority decision agreeing a legally binding change to the terms of payment (standstill, extension of the maturity, interest rate cut and/or haircut) for all creditors. It will also prevent individual creditors from refusing to sign up to an agreement in the hope that they might secure more favourable conditions for themselves (the "free rider" problem). A further key change to the current EFSF rules is that the ESM loans are to be given preferred creditor status and are thus senior to all private creditors' claims and junior only to IMF loans. This clear signal to the markets is aimed at safeguarding public funds and thus ultimately protecting taxpayers in the countries providing assistance. By contrast, neither the current EFSF nor the European Council's conclusions with regard to the future ESM envisage capital accumulation at these institutions, the option to purchase government bonds on the secondary market or programmes which can be activated in advance of the onset of payment difficulties.

Prevention of sovereign debt crises needs to be improved

In order to be able to better prevent similar sovereign debt crises occurring in the future, distortions must be detected at an earlier stage and more decisive action taken to correct them. In addition to strengthening the Stability and Growth Pact, extending macroeconomic surveillance of serious distortions and improving the regulation and supervision of financial markets, the disciplining effect of the financial markets also plays an important role in this context. It is therefore essential that the incentives for creditors to adequately price risk, thereby ensuring a sound fiscal policy, are by no means reduced, but are instead increased in future.

Important cornerstones for crisis resolution mechanism already agreed

This is also an issue with the future European Stability Mechanism (ESM), which is to be set up lest intensified prevention measures prove insufficient. At the end of November 2010, the euro-area finance ministers established important cornerstones for the ESM, which the European Council confirmed in December (see also the box on pages 64 and 65). The ESM will accordingly be based on the EFSF in its current form. Financial assistance is permitted only if the stability of the euro-area as a whole is at risk and is to be conditional on a stringent economic and fiscal programme of adjustment. In the event of a liquidity crisis, private sector creditors are to be encouraged to maintain their exposure while, in the event of insolvency, private sector creditors and the respective debtor country must reach a comprehensive agreement on restoring debt sustainability as a condition for financial assistance. To protect the taxpayers in the countries providing assistance, ESM loans are to be given preferred creditor status and the

mechanism is to take the form of a bilateral agreement in which decisions regarding support measures are unanimously agreed by the countries providing assistance. At present, negotiations are ongoing with the objective of finalising the mechanism by March. Some of the proposals being discussed – for example involving secondary market purchases, extending joint liability (Eurobonds) or perceptibly lowering the interest charged on ESM loans – reduce incentives for sound fiscal policy and contravene important basic principles of the currency union such as subsidiarity, national fiscal responsibility and the no bail-out principle (see the box on pages 68 and 69).

Budgetary development of central, state and local government

Tax revenue

Tax revenue² went up by 1% in 2010 (see chart and table on pages 67 and 70). Shortfalls owing to substantial tax relief measures³ were more than offset by the positive influence of economic recovery. Revenue from income-related taxes fell slightly by ½%. The decline in wage tax (-5½%) owing to the tax relief measures and the increase in child

1% increase in tax revenue in 2010

Decline in income-related taxes on balance

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.

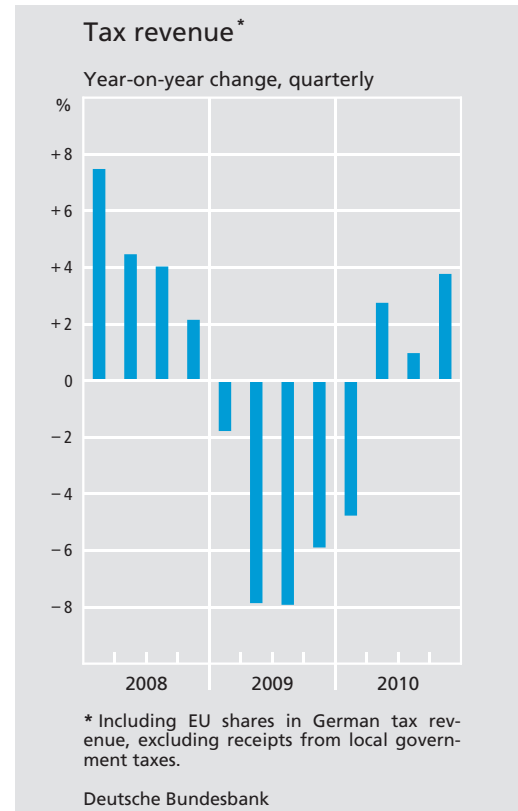
³ These notably include the greater tax deductibility of insurance contributions, the second stage of the reduction in income tax rates, preferential turnover tax treatment for the hotel trade, corporate taxation relief measures and the increase in child benefit. Unlike in the national accounts, in the government's financial statistics, child benefit payments are not recorded on the expenditure side, but are deducted from wage tax receipts.

benefit were set against a sharp rise in profit-related taxes of 11%. There was particularly strong growth in corporation tax receipts, which had been very low in 2009, with a further rise in advance payments, in particular. The underlying developments of assessed income tax were more stable during the crisis and the recovery started later and was more moderate. However, the rise in 2010 was strengthened by the fact that considerable revenue shortfalls in 2009 owing to tax refunds following the Federal Constitutional Court's ruling reinstating the standard travel allowance for commuters no longer have an impact and that grants to homebuyers, which are deducted from revenue, are being phased out. Revenue from investment income tax fell again, probably largely as a result of low interest rate levels, although non-assessed taxes on earnings from dividends rose again following a sharp drop in 2009. Receipts from consumption-related taxes went up by 1%, with turnover tax revenue increasing largely in line with private consumption, while income from specific excise taxes⁴ stagnated. Customs duties, shares in local business tax accruing to state and central government and real property transfer tax all recorded significantly higher revenue.

Perceptible rise in consumption-related taxes and other taxes

Marked rise in revenue expected in 2011

According to the latest official tax estimate from November 2010, revenue is expected to increase by just over 2½% (including local government taxes) in 2011, taking into account the forecast additional receipts from legislative changes passed since then.⁵ However, on balance, legislative changes in 2011 will have only a minor impact, as the increases in revenue mentioned above are set



against revenue shortfalls elsewhere.⁶ Overall, revenue growth will thus largely be determined by underlying economic developments.⁷ In its updated forecast from January, the Federal Government expects economic developments to be significantly more favourable than those used as a basis for the

⁴ This development is probably somewhat underestimated here owing to the booking of insurance tax cash flows being postponed beyond the turn of the year.

⁵ Including the introduction of the nuclear fuel tax and air traffic tax, as well as a reduction in the energy and electricity tax concessions by virtue of central government's consolidation package.

⁶ Above all deferred shortfalls due to greater tax deductibility of insurance contributions.

⁷ The Federal Government expects tax refunds in connection with the Meilicke case regarding the treatment of corporation tax paid abroad in the taxation of dividends under the tax imputation procedure that was abolished in 2001 to have a retarding effect. In this regard, shortfalls of around €3½ billion are included in the official tax estimate for 2011.

The debate on secondary market purchases by the future European Stability Mechanism

After the European Council established the cornerstones for the European Stability Mechanism (ESM) in December 2010, the concrete implementation details are currently being discussed with a view to a European Council decision in March. One proposal under consideration is for the future mechanism to allow secondary market purchases of government bonds of a country in distress. This includes the suggestion of sovereign debt buybacks financed via ESM loans. The main envisaged objectives are to involve private sector creditors in crisis resolution, stabilise bond prices, provide aid to countries requesting assistance, improve conditions for primary market issuance and to safeguard financial market stability.

However, if secondary market purchases were to be allowed, this would imply a move away from the principle agreed by the Eurogroup ministers on 28 November 2010 (and endorsed by the European Council in December) to base the functionality of the future ESM on the design of the EFSF from November 2010, as this instrument is not part of the EFSF. Moreover, the proposal appears questionable on economic grounds and its concrete implementation would raise serious problems *inter alia* regarding price-setting, purchase volume and transparency.

A fundamental misgiving is that the secondary market purchases under discussion would mean intervening in the market process and thus distorting prices and incentives. The creditors of the country in question would benefit from this arrangement as their exposure would be reduced and, as a result, the risks that they assumed previously would be transferred to the

countries providing assistance or to any other existing private sector creditors. If indirect or direct buybacks of debt of a country receiving assistance were allowed as well,¹ this would amount to a transfer to this country which would be all the higher, the lower the interest rate charged for the buyback loan.

As a rule, the only way to permanently lower the risk premium which the markets charge as compensation for default risk, and which largely determines interest rate levels and bond prices, is to improve expectations of the long-term sustainability of a country's public debt and thus also of its contracted debt servicing. The key prerequisite for gaining the trust of potential creditors is that the adjustment process, in the sense of a substantial improvement in the general government primary balance, is considered credible (for instance, because it is largely complete) and that the escalation of the country's indebtedness is halted and seems likely to be reversed in the near future.

Buybacks of bonds that are being traded below their face value would result in an *ad hoc* nominal reduction in the debt ratio of the country requiring assistance. However, the size of the reduction would be limited and the primary balance adjustment requirement would be eased only marginally. For instance, repurchasing 50% of an outstanding sovereign debt amounting to 150% of GDP at an average market price of the bonds of 80% of their face value would cut the debt ratio by a mere 15 percentage points in nominal terms.² This would probably reduce the medium-term consolidation requirement by less than 1% of GDP in many cases, which would be

¹ On the one hand, the country itself could buy back bonds directly and finance them using low-interest ESM loans. On the other hand, bonds purchased by the ESM at a low price could be passed on to the

debtor country, resulting in an ESM claim on the country concerned below the nominal value of the bonds. — ² The present value of the debt is reduced only if bond purchases are financed by loans at below

highly unlikely to dispel market doubts noticeably. Conversely, if assistance programmes were launched on a sufficiently large scale to reduce the distressed country's debt ratio significantly, market concerns would refocus on the associated huge burden incurred by the assisting countries. This danger is especially evident given that, in order to ensure equal treatment, such an arrangement would have to be granted to all countries experiencing serious payment difficulties. Furthermore, the (hidden) transfer associated with such buyback programmes would generally reduce incentives for recipient countries to pursue an appropriate fiscal policy. While states with an unsound budgetary policy could count on receiving assistance, countries with sound finances would be called on to provide financing.

Moreover, lower interest rates resulting from secondary market purchases are irrelevant for new borrowing by countries that are benefiting from an assistance programme because they are generally financed by means of ESM loans for the period considered necessary for stabilisation and are thus not reliant on capital market borrowing. For countries that are not benefiting from an assistance programme, secondary market purchases would contravene the principle that financial assistance may only be provided if the stability of the euro area as a whole is at risk and if a tough economic and fiscal policy adjustment programme is in place.

If secondary market purchases were to contribute to supporting the market price of sovereign bonds of the country requesting assistance, this would benefit bond sellers and might temporarily

reduce existing private sector creditors' write-downs. However, this kind of financial market support would be totally unfocused and thus costly. Furthermore, it cannot be ruled out that precisely those institutions that are especially vulnerable would choose not to reduce their bond portfolios even at a higher price so as to avoid the requisite need for write-downs, and so might not benefit at all. Moreover, this very broad form of financial market support would carry no conditions for financial institutions, with the result that they might ignore or underestimate the risk of their exposure *ex ante* and hence that market mechanisms would be weakened.

However, it is also possible that given the preferred status of ESM loans – which is a crucial requirement from the perspective of taxpayers in the countries providing assistance – secondary market purchases may actually trigger a fall in bond prices. This is because purchases would inflate the risks for any remaining private sector creditors of the country receiving assistance. This could heighten the pressure to sell and thus lower prices. If the remaining bonds do not have a wide float, then secondary market purchases could even jeopardise financial stability.

All in all, it appears doubtful whether the objectives set out by the European Council in December would be adequately taken into consideration if the ESM is given the opportunity of intervening directly or indirectly in the sovereign bond market of countries with solvency problems. In any case, this would contravene important basic principles of the currency union such as subsidiarity, national fiscal responsibility and the no bail-out rule.

market interest rates. In all other cases (assuming the maturity of the loan is the same), this merely constitutes swapping a bond with a high nominal value and a low interest coupon for a loan with a lower

nominal value and a higher interest rate, which in terms of present value is the same.

Tax revenue

Type of tax	Year as a whole				Estimate for 2010 as a whole 1, 2, 3	Q4			
	2009		2010			2009		2010	
	€ billion		Year-on-year change € billion as %			Year-on-year percentage change		Year-on-year change € billion as %	
Tax revenue, total ²	484.9	488.7	+ 3.9	+ 0.8	- 0.0	132.0	137.0	+ 5.0	+ 3.8
<i>of which</i>									
Wage tax	135.2	127.9	- 7.3	- 5.4	- 5.4	38.6	36.8	- 1.8	- 4.7
Profit-related taxes ⁴	58.5	64.9	+ 6.4	+ 10.9	+ 6.5	13.1	16.5	+ 3.3	+ 25.2
Assessed income tax	26.4	31.2	+ 4.7	+ 18.0	+ 17.7	7.6	8.0	+ 0.4	+ 5.8
Corporation tax	7.2	12.0	+ 4.9	+ 67.9	+ 41.6	1.8	4.7	+ 2.8	.
Investment income tax ⁵	24.9	21.7	- 3.2	- 12.9	- 15.6	3.7	3.8	+ 0.0	+ 1.3
Turnover taxes ⁶	177.0	180.0	+ 3.1	+ 1.7	+ 1.4	46.1	47.8	+ 1.7	+ 3.7
Energy tax	39.8	39.8	+ 0.0	+ 0.0	- 0.8	15.1	15.6	+ 0.5	+ 3.5
Tobacco tax	13.4	13.5	+ 0.1	+ 0.9	- 0.5	3.9	4.1	+ 0.2	+ 3.9

1 According to official tax estimate of November 2010. — 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes. — 3 Including (estimated) local government taxes, tax revenue was €17.8 billion above the November 2009 estimate, which was used as a basis for the 2010 Federal budget from March 2010. According to government estimates, had

legislative changes not been made in the meantime, the upward revision would have been €24.1 billion. — 4 Employee refunds, grants paid to home owners and investors deducted from revenue. — 5 Withholding tax on interest income and capital gains, non-assessed taxes on earnings. — 6 Turnover tax and import turnover tax.

Deutsche Bundesbank

tax estimate from last November, meaning that revenue could potentially rise by 3%.

Central government budget

2010 central government budget deficit considerably lower than planned after more favourable Q4 ...

Central government posted a deficit of €1½ billion in the fourth quarter, which was significantly more favourable than one year previously (-€10 billion). The recent deficit forecast for the year as a whole of around €50 billion was thus significantly undershot. The deficit amounted to €44½ billion and net borrowing was therefore just over €36 billion below the figure in the budget plan passed in March 2010. The improved result is largely due to additional tax revenue in the amount of €14½ billion, of which €4 billion alone was attributable to lower transfers to the EU budget. Furthermore, the one-off proceeds

from the radio frequency auction in May exceeded expectations by €4½ billion. On the expenditure side, labour-market-related payments were €10 billion below the figure forecast in the budget plans. In addition to a decrease of €7½ billion in the grant to offset the Federal Employment Agency's deficit, expenditure on the long-term unemployed was also below the level forecast. Furthermore, there were greater deviations from the estimated figures for interest expenditure (-€3½ billion) and calls on guarantees, with only just under half of the scope for authorisations of €2 billion being used.

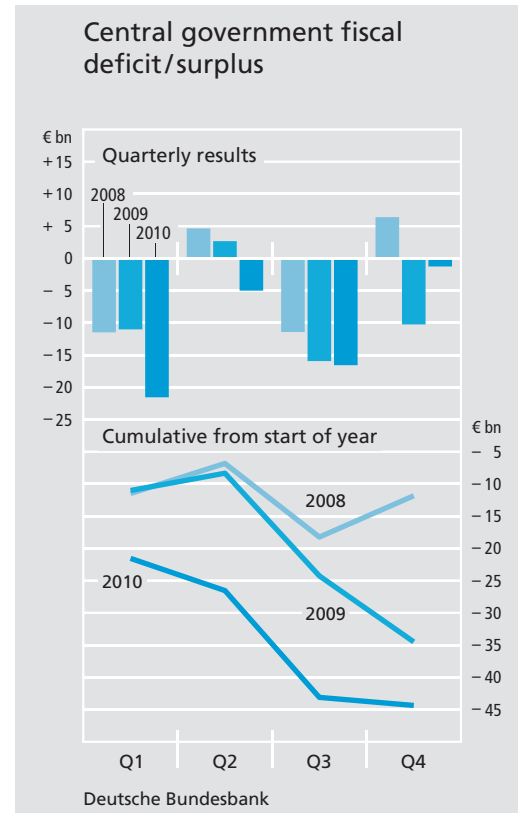
Despite the better-than-expected result, the deficit was once again significantly up on the year (+€10 billion). Including receipts from motor vehicle tax, which have been trans-

... but significantly up on the year again

ferred by state government since mid-2009, tax receipts increased by €2½ billion. In the case of other revenue, the drop-out of the one-off effect of using the Bundesbank's entire profits for 2009 to finance the budget⁸ was more than compensated for, above all by the proceeds from the radio frequency auction. Revenue increased by €5½ billion overall. However, expenditure increased at a significantly stronger pace, with payments to the health insurance fund and the Federal Employment Agency alone increasing by €8½ billion and €5½ billion, respectively. Refunds to state government to compensate for motor vehicle tax transfers were also up on the year (+€4½ billion). Against the backdrop of the ongoing exceptionally favourable financing possibilities for central government, at €5 billion, the marked reduction in interest expenditure since 2009 continued, despite rapid growth in debt.

2010 structural deficit starting point for borrowing limit up to 2015

On balance, net borrowing exceeded investment expenditure, ie the old constitutional borrowing limit, which was applied for the last time when drawing up the 2010 budget, by €18 billion. However, when the budget was adopted in March 2010, the overshooting of the borrowing limit was still justified by invoking the exemption clause that it served to avert a disruption of the macroeconomic equilibrium. The new borrowing limit, which applies from 2011 onwards, aims to limit central government borrowing to a significantly greater extent than the old rule. Taking the level of the structural deficit in 2010 as a starting point, the new rule stipulates that the upper limit for borrowing, after adjustment for cyclical effects and financial transac-



tions, is to be reduced in graduated steps to 0.35% of GDP from 2016 onwards. Given net borrowing of €44 billion in 2010, net income from the realisation of financial assets of €1 billion⁹ should be added to and the estimated cyclical component of around €7½ bil-

⁸ In 2009, the Bundesbank's profit amounted to €6½ billion. More than €3½ billion of this was transferred to the Redemption Fund for Inherited Liabilities, which paid the amount back to central government owing to a lack of outstanding debt instruments.

⁹ The Federal Ministry of Finance did not record financial transactions in the 2010 budget in line with the classification required for the debt brake. Thus both calls on guarantees and participating interests, under which income from assets is also booked, were recorded in their entirety as financial transactions.

lion¹⁰ subtracted from this figure. This would produce a structural deficit for 2010 of around €38 billion (or just under 1.6% of GDP), which ought to form the base value for the following years.¹¹ In order to comply with the provision of a gradual reduction up to 2016, the limit for structural new borrowing would then be around €33 billion in 2011 and approximately €29 billion in 2012.

Deficit limit in 2011 budget clearly undermines intention of debt brake ...

However, the 2011 budget was based on an upper limit derived from an outdated estimate from summer 2010, which is just over €12 billion higher. Keeping this inflated value, thereby creating additional scope for government borrowing during the rest of the transitional period too, would clearly violate the legislative intent of the debt brake, which is unambiguously documented. The planned reduction path should therefore be corrected, not least with regard to the 2012 draft budget to be drawn up this spring and the related financial plan up to 2015,¹² in order to ensure the necessary fiscal policy consistency in the period of consolidation up to 2016.

... but 2011 budget on track provided favourable base effects carried forward and no new burdens

The 2011 budget plan envisages net borrowing of €48½ billion. Compared with the actual value recorded for 2010, this still constitutes a rise in planned structural net borrowing of around €3 billion. Even the old borrowing limit based on investment expenditure, which was regarded as not strict enough, would still be overshot by €12 billion despite the rapid economic recovery and the fact that the previous exemption clause could no longer be invoked. However, if the outcome for 2010, which is much more favour-

able than previously forecast, particularly in the case of tax revenue and interest expenditure, is carried forward into 2011, a significant improvement in the result is expected, provided no deficit-boosting measures are taken in the short term. It would therefore be possible to achieve a structural deficit that also complies with the updated reduction path. Given that the deficit is still extremely high, the resolute reduction of structural net borrowing must remain a top priority. Any concessions in terms of the planned consolidation measures would be unacceptable before the prescribed target for 2016 is achieved. The new German budgetary rules are also being widely observed at an international level and the Federal Government is campaigning for similar rules to be implemented in other euro-area members states. This makes it all the more important for the provisions to be rigorously implemented at a national level.

The deficit of central government's off-budget entities fell by €14 billion to €7 billion

¹⁰ At EU level, the cyclical adjustment procedure was changed to a modified estimation method with effect from autumn 2010. Central government is likely to change its national budgetary rules accordingly. See also Deutsche Bundesbank, Requirements regarding the cyclical adjustment procedure under the new debt rule, Monthly Report, January 2011, pp 55-60. If the new cyclical adjustment procedure were to be used, the cyclically-induced budgetary burden would be somewhat greater.

¹¹ The debt limit is not tied to the deficit, but to net borrowing, which is regularly lower by the amount of coin seigniorage.

¹² See also Deutsche Bundesbank (2011), op cit, p 56. Possible differential amounts arising from an inflated scope for borrowing not being exhausted would be credited to the control account. These amounts would therefore not be available when drawing up a budget that complies with the constitutional requirements, but could be used to offset any future deviations from the budget plan that lead to the deficit limit being overshot. This would also ultimately result in an increased scope for new borrowing.

Off-budget entities record lower deficit for 2010 as a whole

in 2010. The Investment and Repayment Fund posted a deficit of €6 billion, as had been the case in 2009. While in 2009 expenditure on the car scrappage scheme was the main contributory factor, in 2010, at just over €4 billion, almost €3 billion more was spent on the investment programme for state and local government. However, only just over half of the total budget of €10 billion for investment under this programme was exhausted. Even if delays in the outflow of funds are taken into account, the investment programme triggered only a very moderate increase in output during the acute crisis.¹³ The majority of the stimulus impulses came during the recovery phase and therefore, from an economic policy perspective, appear to no longer be required. The Special Fund for Financial Market Stabilisation (SoFFin), whose guarantee and remaining loan authorisations were largely transferred to the Restructuring Fund (a new special fund) when the period of assistance expired at the end of 2010, recorded a deficit of €2½ billion in 2010. A marked decline in capital transfers to credit institutions resulted in a drop of €14 billion on the year. The extensive assumption of liability in connection with bad banks is not reflected in the cash deficit until there is an actual outflow of funds, meaning that the transfer of exposures to the resolution agencies of WestLB and HRE has not yet had an impact on the deficit. The planned liquidation of SoFFin, by distributing the remaining debt to central government and individual state governments, can only take place following the expiry of the respective assistance modules and the disposal of any participating interests acquired.

State government¹⁴

State government's core budgets recorded a deficit of €21½ billion in 2010, compared with €25½ billion one year previously. After adjustment for the exceptional burden arising from the recapitalisation of BayernLB in 2009, which no longer had an impact, this corresponds to a €3 billion deterioration in the fiscal balance. Nevertheless, the deficit result was considerably more favourable than the figure of €34½ billion estimated in the budget plans. Revenue rose by 2% overall vis-à-vis 2009. This was mainly attributable to both tax receipts, which – in addition to the compensation for the transfer of motor vehicle tax receipts to central government in mid-2009 – rose by 2%, and transfers from the Investment and Repayment Fund as part of the second economic stimulus package. Expenditure went up by ½%. If the exceptional burden in connection with BayernLB, which no longer had an impact, is removed from the calculation, expenditure would have risen by as much as 3%. The increase was due, not least, to developments in staff costs, which are particularly important for state government budgets, and other operating expenditure. However, seen in isolation, the measures taken by central government in the previous year to stabilise the economy also resulted in a knock-on increase in expenditure of around 1%.

High deficit for 2010 as a whole ...

¹³ There are accounting delays between output and the outflow of funds, but these are scarcely more than a few weeks and should therefore have barely any impact.

¹⁴ The development of local government finances in the third quarter was analysed in the short articles in the Bundesbank Monthly Report of January 2011. These are the most recent data available.

... and so far at best moderate improvement expected in 2011, ...

The state government budget plans, not all of which have been finalised, forecast a marked increase in the deficit for 2011 compared with the actual figure recorded for 2010. As the tax estimate from November 2010 – which was €8½ billion more favourable than the figure estimated in May 2010 – has not been taken into account completely, the total deficit should be considerably lower than the figure currently being forecast in the budget plans. However, it is not yet possible to foresee a significant improvement on the 2010 result, even if the further pick-up in economic developments is taken into account.

... even though decisive consolidation is necessary

The high deficits need to be reduced quickly. Carrying on invoking the exemption clause that borrowing serves to avert a disruption of the macroeconomic equilibrium, within the framework of the previous borrowing limits which still apply in most federal states, would seem extremely dubious given the favourable macroeconomic developments. Insofar as both central and state government switch to the new debt brake before 2020, it is essential that the related deficit reduction path is appropriately defined and firmly anchored. It should be borne in mind that the long transitional period was intended to be a concession only for individual federal states with particularly large structural fiscal imbalances. In light of this, some federal states that have reformed their budgetary rules have even completely done away with a further transitional period or have at least limited it to a few years.¹⁵ A rapid return to sound budgets is absolutely essential, particularly for those

federal states confronted with high pension claims.

Social security funds¹⁶

Statutory pension insurance scheme

The statutory pension insurance scheme posted a surplus of just over €1½ billion in 2010. The financial result was thus significantly better than both the slight surplus recorded in 2009 and the deficit of just over €3½ billion forecast one year previously. This more favourable development is almost solely due to higher contribution receipts owing to positive macroeconomic developments. Overall, revenue increased by just over 2% and expenditure rose by 1½%. The statutory pension insurance scheme's reserves were topped up to €18½ billion or 1.1 of monthly expenditure.

2010 financial result much better than expected

In 2010, contribution receipts were up by just over 2% on the year. At almost 2½%, the increase in employees' compulsory contributions was somewhat sharper, with growth during the course of the year accelerating to just over 3% in the final quarter. By contrast, contributions for recipients of unemployment benefits were down by 5½% on the year. Central government grants increased by

Perceptible growth in contribution receipts and central government grants

¹⁵ Such strict borrowing limits are already being applied in Baden-Württemberg, Bavaria, Saxony and Thuringia (since 2011); Saxony-Anhalt and Hamburg have also only envisaged short transitional periods of up to 2013 at most.

¹⁶ The financial development of the statutory health and public long-term care insurance schemes in the third quarter of 2010 was analysed in the short articles of the Monthly Reports of December 2010 and January 2011. These are the most recent data available.

2½% overall. This was attributable, in particular, to the continuation of the general central government grant in line with the perceptible wage rise in 2008.

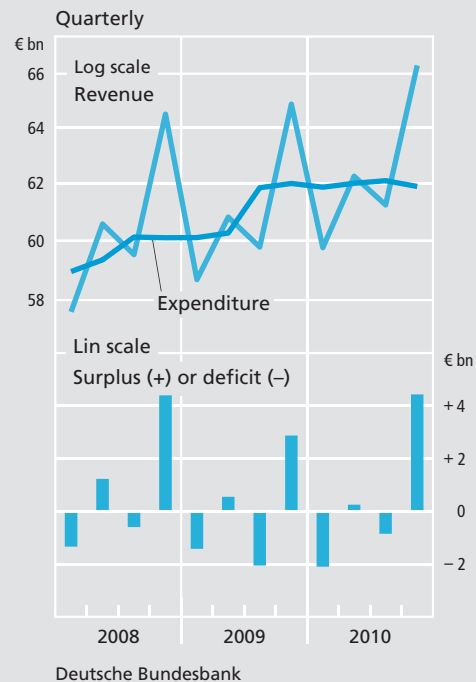
Moderate rise in expenditure following pension adjustment waiver

Spending on pensions rose by just over 1½% in 2010. The growth rate of 3% in the first half of the year, despite a relatively weak increase in the number of pensions, still reflects the high mid-2009 pension increase. By contrast, following the waiver of the pension adjustment of 1 July 2010, there was only a slight rise of less than ½%. The pension insurance scheme's spending on health insurance contributions for pensioners even fell slightly because the general contribution rate to the health insurance institutions was cut from 15.5% to 14.9% in mid-2009.

Financial deterioration in 2011 despite favourable conditions

In 2011, the financial situation of the statutory pension insurance scheme could deteriorate somewhat. The contribution trend can be expected to be even more positive than one year previously. Furthermore, pension expenditure is likely to grow at a slower pace because the mid-2011 pension adjustment will be lower than the high mid-2009 increase (which also affected the first half of 2010).¹⁷ However, all of this will be set against revenue shortfalls of just over €2 billion owing to central government's consolidation package. In particular, central government will no longer transfer any contributions on behalf of recipients of unemployment benefit II. However, the knock-on effect of a reduction in pension expenditure will not be felt until later. In addition, this is likely to result in additional spending on pensions for persons with a reduced earning capacity.¹⁸

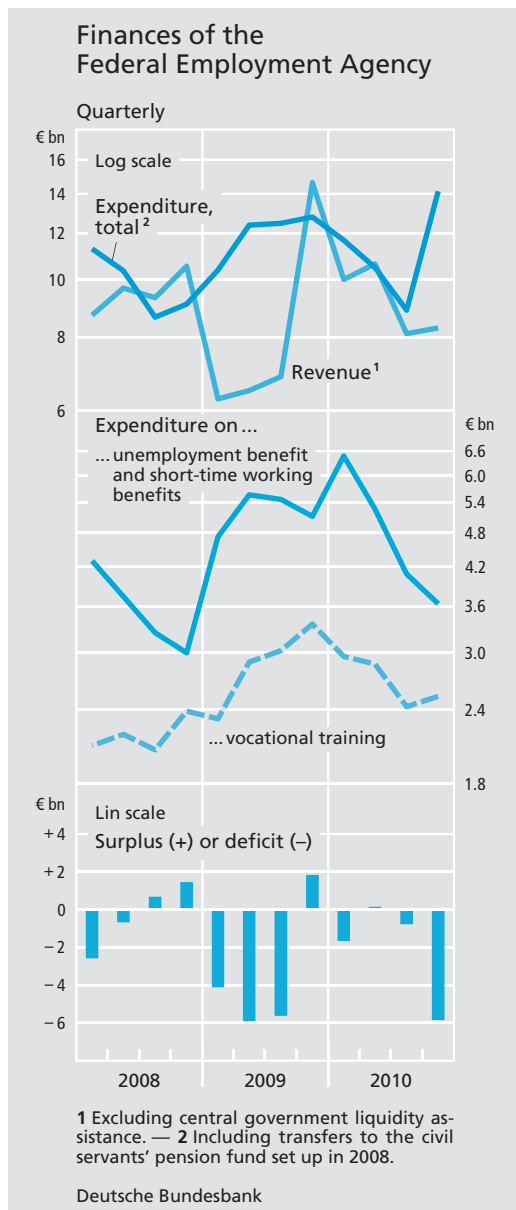
Finances of the German statutory pension insurance scheme



Furthermore, higher expenditure on the basic allowance for elderly persons can be expected in future. Nevertheless, overall, there will thus be a greater concentration of transfer benefits on persons in need.

¹⁷ Pensions were raised on 1 July 2009 – by 2.41% in western Germany and 3.38% in eastern Germany. The discretionary suspension of the “Riester reform steps”, which have a dampening effect on the pension increase, was, of course, a contributory factor here. By contrast, the “Riester reform steps” will result in the mid-2011 pension adjustment being just over 0.6 percentage point lower. Furthermore, for the first time, those pension cuts that were in principle deemed necessary according to the formula but waived owing to the safeguard clause will be clawed back by halving the calculated pension increase.

¹⁸ Under current law, the number of years for which a person has received unemployment benefit II reduces their pension entitlement based on benefits. In future, these years with particularly low contributions will no longer reduce the underlying average earnings, as they will only be taken into account as non-contributory periods.



Federal Employment Agency

Significant financial improvement in 2010 despite high deficit

The Federal Employment Agency recorded a deficit of just over €8 billion in 2010. Just under €3 billion of this could be offset by drawing upon reserves. Central government assistance was required to cover the remaining just over €5 billion. On an exceptional basis, in 2010 this assistance took the form of a non-repayable grant. Overall, there was a

marked improvement in the Federal Employment Agency's financial situation compared with the previous year's deficit of almost €14 billion. Nevertheless, the deficit was very high, despite the unemployment rate reaching its lowest level since German reunification. The Federal Employment Agency's pension fund, which finances the pensions of its civil servants, recorded a surplus of just under €½ billion and its reserves amounted to almost €4 billion at the end of 2010.¹⁹ In consolidated terms, the deficit was therefore somewhat lower.

The Federal Employment Agency's revenue went up by 8% in 2010. The main reason for this was not the regular contribution receipts, which nevertheless increased by 2½%, but revenue from insolvency benefit contributions, which more than quadrupled after the contribution rate was raised from 0.1% to 0.41%. Furthermore, both the rule-based central government grant, which is linked to the development of turnover tax receipts, and central government administration cost reimbursements exceeded the previous year's figures, at times significantly.

Considerable additional revenue, particularly due to higher insolvency benefit contributions

By contrast, expenditure declined by almost 6%. In absolute terms, unemployment benefit (-4%), short-time working benefits (-20%), insolvency benefit payments (-54%) and active labour market policy measures (-7%, including refunds of social contributions for

Lower expenditure across the board

¹⁹ Contributions calculated in actuarial terms are deducted for civil servants employed by the Federal Employment Agency. The pension fund's resources (including the one-off transfers of €2½ billion in 2008) should suffice to completely cover the remaining pension payments now that civil servant status is no longer awarded.

short-time work which are recorded here) contributed to the decline in more or less equal measure. Overall, this reflects the positive economic developments.

*2011 deficit
could be lower
than forecast*

In its budget plan, the Federal Employment Agency expects a deficit of €5½ billion for 2011. Although the contribution rate to the Federal Employment Agency has been raised from 2.8% to 3.0%, the contribution rate for insolvency benefit payments, which is also linked to the wage sum, has been temporarily lowered from 0.41% to 0%. In 2010, receipts from insolvency benefit contributions exceeded payments by just over €2 billion,

thereby more than offsetting the €1 billion shortfall from 2009.²⁰ Overall, in light of the current macroeconomic projections, the planned deficit appears to be pessimistic, especially since in its Annual Economic Report the Federal Government is now expecting more favourable developments with regard to both wages and employment.

²⁰ Separate calculations are made for insolvency benefit payments and contributions charged. The contribution rate for a given year is to be set so that estimated revenue covers forecast expenditure, taking into account previous surpluses and deficits. An excess of €1¼ billion is thus calculated for the end of 2010, while expenditure of just under €1 billion is estimated in the 2011 budget plan.