

Public finances*

General government budget

Clear fall in deficit in 2012, but ...

Public finances in Germany present a mixed picture in 2012. On the one hand, the deficit ratio will fall further (from 0.8% in 2011), and it may be possible to balance the general government budget. On the other hand, the debt ratio is expected to once again rise perceptibly from its already very high level of 80.5% in 2011. The cyclical situation has had no major impact on the decline in the deficit, but rather has provided relief for government budgets on a similar scale to 2011. Although growth in gross domestic product (GDP) will probably be below its trend, on an annual average the economic slowdown is not reflected in the macroeconomic aggregates that are especially relevant for public finances. The favourable labour market figures and the stable rise in wages will, in particular, also contribute to a large surplus in the social security funds. The improvement in the budgetary position in structural terms is primarily due to strong growth in profit-related taxes above and beyond the calculated impact of the business cycle and legislative changes, the expiry of the stimulus programmes introduced during the 2008-09 crisis, relief provided by low interest rates and a moderate overall expenditure trend. The rebound in the debt ratio stems from the increasing assistance provided to contain the euro-area debt crisis and from the liquidation of the public regional bank WestLB.¹ According to the Maastricht report submitted in the autumn, the Federal Government expects the debt ratio to stand at around 82% at the end of 2012.

... debt ratio will probably rise again

Revenue ratio rising, expenditure ratio virtually stagnating

A distinct rise in the revenue ratio is likely for 2012. This is due, first, to the dynamic growth in profit-related taxes mentioned above. Second, the rise reflects the favourable growth structure for government revenue. In particular, gross wages and salaries are still increasing at a faster pace than GDP. The expenditure ratio could virtually stagnate. Low interest costs, the

fact that pension increases are still muted overall, the further fall in labour market expenditure and the decline in government investment following the expiry of the 2008-09 economic stimulus packages could compensate for burdens elsewhere (eg transfers following the liquidation of WestLB).

In 2013, the general government deficit is likely to rise again as a result of the economic slowdown currently expected; the cyclical component, which was still favourable in 2012, could be eroded.² In addition, various opposing trends are likely to more or less balance each other out. On the one hand, the statutory pension contribution rate will be lowered significantly in light of the considerable overshooting of the pension reserve ceiling. Furthermore, a degree of fiscal policy loosening will continue to be provided by new budgetary burdens which are not counterfinanced – in particular the abolition of the surgery visit charge. On the other hand, the ongoing subdued growth in social welfare and interest expenditure is likely to relieve the budget, and no new capital transfers to support the financial market are currently planned. The debt ratio could fall if no new measures which push up the debt level are

2013: deficit set to worsen, debt ratio to improve

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

¹ Unlike the EFSF liabilities, the liabilities of the ESM, which was set up in October 2012, are not assigned to the countries providing assistance. Provided the assistance loans are settled via the ESM and any debts due are serviced, the loans are therefore not reflected in the German debt level. By contrast, capital transfers to the ESM increase the respective national debt level. Following the liquidation of WestLB, debts and risky assets were transferred to an enterprise attributable to the government sector, thereby pushing up the level of general government gross debt.

² There are considerable risks with regard to macroeconomic developments and the European debt crisis. The comments are based on the assumption that the macroeconomic slowdown will be only temporary.

taken to support German financial institutions or to contain the European debt crisis.

Government entities need to consolidate further

Of late the government deficit in Germany has unexpectedly developed very positively, and is low by international standards. However, despite favourable underlying conditions,³ the structural general government budget gap is unlikely to have been closed fully. Furthermore, the high temporary surpluses of the social security funds, *inter alia*, conceal – in some cases sizeable – deficits at central government level as well as within many state⁴ and local governments. The cut in transfers to the social security funds provides relief for the central government budget, but means *per se* that the social security funds will have to increase their contribution rates or reduce benefits in the medium term. From a regulatory perspective, it would be better to generally link central government grants to clearly defined non-insurance-related expenditure.⁵ Such a transparent linkage would place the finances of the social security funds on a more solid footing. Furthermore, it would put an end to fiscal policymakers' habit of using the social security funds as a budgetary stopgap. It would also create a clearer relationship between social contributions and social benefits.

Use favourable conditions for more rapid consolidation

Particularly in view of the high debt ratio and foreseeable demographic adjustment burdens, government finances should be consolidated swiftly and comprehensively. There is a danger that the favourable underlying conditions which have prevailed hitherto have not been, and will not be, utilised sufficiently to this end. Although Germany has complied with the provisions of the national debt brake and the excessive deficit procedure (which has now been terminated), these were set on the basis of considerably more pessimistic expectations. The positive shocks, especially with regard to tax receipts and interest expenditure, have been used in part to dilute the moderate consolidation course originally announced, which has prevented swifter reduction of central and state government deficits.

The gloomier economic situation in the euro area has led to demands in some quarters for Germany to pursue a more expansionary fiscal policy. However, in the context of current forecasts, this does not appear justified, particularly as normal macroeconomic fluctuations are cushioned at the time they occur by the automatic stabilisers. By contrast, an asymmetric policy approach has often been pursued in the past. Consolidation was postponed in favourable economic constellations, but fiscal policy was rapidly loosened whenever a downturn loomed. Consequently, consolidation targets were regularly met in the medium-term plans, but more rarely achieved in reality, and ultimately the rise in the debt ratio was not prevented. Furthermore, it cannot be assumed that a more expansionary German fiscal policy would provide a distinct economic boost to the European countries most affected by the debt crisis. Budgetary consolidation should have priority for all levels of government, so that Germany can remain an anchor of stability in the European debt crisis.

Policy loosening inappropriate

The permanent deficit limits for central and state government set by the national debt brakes should be complied with swiftly. To ensure that the new, stricter constitutional rules are adhered to, it would also be advisable as a general principle to stipulate clear and binding

Advisable to rapidly lower high debt ratio

³ Using its cyclical adjustment method, the Federal Government – like the European Commission – forecasts a slight cyclically induced deficit for 2012. However, this corresponds to a marginal position within the spectrum of current estimation results, as the IMF, the Joint Economic Forecast and the German Council of Economic Experts, based on current estimates of potential output, all project cyclically induced surpluses. The method applied here, which, in contrast to the procedure used by the Federal Government, is based on the key macroeconomic budget variables, likewise shows a cyclically induced surplus for 2012. Given the stable development of the key budget variables, this also seems more plausible.

⁴ See also Deutsche Bundesbank, The development of state government finances in Germany since 2005, Monthly Report, October 2012, p 29ff.

⁵ Although no clear-cut dividing line can be drawn between insurance-related and non-insurance-related benefits, clearly defining which benefits are to be financed out of general tax revenue would mean that financial transactions between central government and the social security funds could be more transparently structured and better protected from ad hoc intervention.

The conclusions of the European Council at its meeting on 18-19 October 2012

At its meeting on 18-19 October 2012, the European Council discussed changes to the framework of the European monetary union, focusing mainly on the plans to create a banking union. The council concluded that the EU's legislative bodies should agree on a legal framework for the single supervisory mechanism for euro-area banks by the end of 2012. However, it will take longer to decide on the details of the framework and implement it in practice. Some matters remained undecided, including the question of when to allow the European Stability Mechanism (ESM) to recapitalise financial institutions directly.

All in all, a banking union may be a useful addition to the existing framework of the monetary union, particularly if it includes a single supervisory mechanism, a single recovery and resolution mechanism and a recovery fund which is essentially funded by the banks themselves but can be topped up by the ESM if urgently required. It could provide a more harmonised structure for the supervision of banks – and, where necessary, their recovery or resolution – and these new mechanisms could reduce the tendency towards overly tentative financial regulation and supervision at national level. One of the aims of the new framework under discussion is to create a more level playing field for credit institutions and allow better control of cross-border contagion, thus counteracting uncertainty and nascent crises at an early stage. A banking union in this form could also help to stave off unhealthy developments in national fiscal and economic policy, notably overindebted public or private sector entities.

Yet it is important to strike a balance between liability and control. Above all, it is crucial to make sure that mutualised liability for sovereign debt is not brought in through the back door by providing European-level fiscal protection against risks stemming from the banking sector, thus circumventing the no-bailout clause. To prevent this from occurring, several prerequisites need to be fulfilled.

First, the reforms must fundamentally ensure that, if a bank runs into serious difficulties, its owners and creditors are the first to foot the bill. In addition to minimum requirements for capital and hybrid capital which ensure that banks are sufficiently resilient, an effective resolution regime is needed in order to reduce the likelihood of tax funds being used for bank bailouts.

Second, the risks to financial stability which may arise from unsound public finances have to be curtailed. To achieve this, there need to be regulatory measures in place to reduce the concentration of risk exposures to individual governments on bank balance sheets, eg via appropriate risk weighting and by preventing excessive credit concentration. This will give banks a stronger incentive, right from the outset, both to ensure that interest rates – including those on government debt – adequately reflect the risks involved and to avoid taking on excessive risk, as they would otherwise face higher funding costs.

However, the ongoing financial and sovereign debt crisis has shown that these two lines of attack will not suffice on their own. It is therefore important to ensure that the banking union confers powers of interven-

tion on the central level which can override some of the budgetary sovereignty of any member state committing sustained and serious violations of the fiscal rules (or of the conditions attached to assistance programmes), making it less likely that sovereign debt will reach dangerous levels.

Yet unsound public finances are not the only potential risk to banks' solvency; significant growth in loans that are vulnerable to default would also pose a threat. This kind of increase can occur, for example, when real estate bubbles burst or recessions hit – events which may partly be due to misguided national economic policies. It would therefore make sense, particularly if some of the associated costs are mutualised, to ensure that the work of national and European authorities is adequately coordinated, including in the field of macroprudential supervision.

It currently seems likely that the ECB will be assigned responsibility for the single supervisory mechanism for euro-area banks. The possibility of conflicts of interest with the ECB's primary objective of safeguarding price stability must be permanently ruled out, and it is therefore imperative to maintain a strict separation between monetary policy and banking supervision. If the banking union is to succeed in easing the burden on the single monetary policy, the new framework must ensure that problems relating to excessive debt are solved by politicians; they are not the central bank's responsibility.

A banking union, if designed in the right way, may play an important part in achieving a stability-oriented monetary union. As a means of overcoming the current crisis, however, it is wholly insufficient, as the control elements at the European level need to be strengthened before liability is ex-

panded. In particular, the member states themselves should bear any losses arising from past risks which arose on their watch.

In addition to achieving a political consensus on the timeframe for introducing banking supervision at European level, the European Council also called upon legislators to adopt the "two-pack" proposals on measures to improve budgetary surveillance in the euro-area countries by the end of 2012. This matter is still under negotiation.

The European Council acknowledged the interim report presented by its president on changes to the framework of European economic and monetary union, which proposes an increase in economic and fiscal policy integration. Among other measures, it suggests creating a separate euro-area budget, primarily as a means of strengthening the countercyclical effect of fiscal policy. However, it is not immediately apparent whether this step is actually necessary in view of the regulations that are already in place. The existing budgetary rules essentially envisage that the automatic stabilisers should be allowed to take effect, and this should be easily possible in future provided that the sound budgetary and economic policies aspired to at present are implemented. At all events, decision makers would need to ensure that this does not create a window for incurring debt at euro-area level, thus circumventing national deficit limits and ultimately causing a build-up of structural debt by introducing, in essence, a kind of Eurobond.

safety margins below the borrowing limits, thereby taking account of the high degree of uncertainty involved in estimating the structural budget position. Given the experience gained during the present debt crisis and the looming demographic burdens, it would make sound sense to adopt a more ambitious policy with a view to reducing the debt ratio faster from its current very high level.

Budgetary development of central, state and local government

Tax revenue

Sharp rise in tax revenue in Q3

Tax revenue⁶ was up by 8% on the year in the third quarter of 2012 (see chart and table on pages 65 and 66). This was a faster rate of revenue growth than in the first half of 2012, though it was due in part to temporary exceptional factors. In the first three quarters taken together, revenue rose by 5½%. Receipts from income-related taxes, in particular, developed dynamically in the third quarter, jumping by just under 15½%. The sharp rise in wage tax receipts was primarily due to the favourable developments in pay and employment trends, which were amplified by back payments in connection with public-sector wage increases. But net revenue was additionally boosted by lower deduction amounts (child benefit and subsidies for supplementary private pension plans). Receipts from profit-related taxes expanded robustly. However, this partly reflects special developments such as an offset of the corresponding revenue shortfalls from the previous quarter caused by a change in the procedure for deducting withholding tax on dividends. Receipts from consumption-related taxes increased by just under 3%, with turnover tax revenue recording somewhat stronger growth (just over 4%).

Clear revenue growth for year as a whole

According to the latest official tax estimate, tax receipts for 2012 as a whole are expected to rise by 5% (including local government taxes).⁷



The macroeconomic variables that are particularly relevant to revenue (gross wages and salaries, private consumption) have recorded stable growth to date, and both fiscal drag⁸ and legislative changes⁹ have also produced additional revenue. However, as a result of favourable intra-year cash developments, revenue is expected to record significantly higher growth than would be expected based on the above factors alone.

Weaker growth is forecast for 2013 (+2½%). Although the increase in the macroeconomic assessment bases is expected to be more favourable than in 2012, the currently high revenue level has not been carried forward in full, and perceptible tax refunds are expected in connection with the ruling of the European

Weaker growth in 2013, followed by significant rise in medium term

⁶ Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.

⁷ This estimate is based on the Federal Government's current macroeconomic projection. For 2012, real GDP growth is expected to be 0.8% and nominal growth 2.4% (May: +0.7% and +2.3%, respectively). Growth for 2013 is forecast to be 1.0% and 2.8%, respectively (May: +1.6% and +3.2%, respectively). In the medium term, nominal annual growth of around 3% is still forecast.

⁸ In this context, this term comprises the (positive) revenue effect of the progressive structure of the income tax schedule as well as the (negative) impact of the extensive price inelasticity of specific excise duties.

⁹ In particular, the phasing out of depreciation allowances under the first economic stimulus package and of grants to homebuyers.

Tax revenue

Type of tax	Q1 to Q3				Estimate for 2012 ^{1,2}	Q3			
	2011		2012			2011		2012	
	€ billion		Year-on-year change € billion	as %	Year-on-year change as %	€ billion		Year-on-year change € billion	as %
Tax revenue, total ²	381.9	403.4	+ 21.5	+ 5.6	+ 5.0	125.0	135.2	+ 10.1	+ 8.1
<i>of which</i>									
Wage tax	100.2	106.8	+ 6.6	+ 6.6	+ 6.5	33.6	36.6	+ 3.0	+ 8.9
Profit-related taxes ³	55.2	64.4	+ 9.2	+ 16.8	+ 12.8	13.8	18.3	+ 4.4	+ 32.0
Assessed income tax	23.2	27.3	+ 4.1	+ 17.7	+ 15.0	7.1	8.9	+ 1.8	+ 24.8
Corporation tax	9.7	13.0	+ 3.3	+ 33.6	+ 17.9	3.0	2.5	- 0.5	- 16.4
Investment income tax ⁴	22.2	24.1	+ 1.9	+ 8.4	+ 7.0	3.7	6.9	+ 3.2	+ 85.6
Turnover taxes ⁵	140.6	144.7	+ 4.1	+ 2.9	+ 2.9	47.2	49.1	+ 2.0	+ 4.2
Energy tax	24.5	24.1	- 0.4	- 1.6	- 0.3	10.1	10.0	- 0.0	- 0.4
Tobacco tax	9.6	9.5	- 0.1	- 1.5	- 0.6	3.4	3.6	+ 0.2	+ 5.6

1 According to official tax estimate of October 2012. 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes. 3 Employee refunds, homebuyers' grant and investment grant deducted from revenue. 4 Withholding tax on interest income and capital gains, non-assessed taxes on earnings. 5 Turnover tax and import turnover tax.

Deutsche Bundesbank

Court of Justice on the taxation of dividends paid to foreign corporates. In the medium term (between 2014 and 2017), the forecast average growth of 3½% per year primarily reflects the underlying macroeconomic assumptions. The tax ratio (as defined in the government's financial statistics) is projected to increase to 23.1% by the end of the forecast period (2011: 22.1%). Fiscal drag accounts for approximately ½ percentage point, or around €16 billion, of this rise. Furthermore, the growth profile will boost the ratio slightly.

*Forecast risks:
tax cuts and
economic
developments*

When interpreting the figures, it should be borne in mind that the estimate is based on the legislative *status quo* and that (albeit limited) tax cuts are planned on balance (*inter alia* the lowering of income tax rates in 2013-14). Furthermore, the Federal Government's macroeconomic projection and, consequently, the official tax estimate assume only a slight weakening of economic momentum at the current

end. There is a great deal of uncertainty in this respect, particularly because of the debt crisis.

The estimates for intra-year cash developments in 2012 were revised upwards again vis-à-vis previous forecasts. Subsequently, the overall less favourable macroeconomic assumptions are given increasing weight, and the high level of revenue recorded in 2012 is not carried over in full to 2013. Compared with the May 2012 estimate, which was used as a basis for central government's budgetary and financial planning of summer 2012, legislative changes are now forecast to depress revenue in 2013, though this is chiefly attributable to a revaluation of the financial impact of the aforementioned court ruling.¹⁰ After adjustment for legislative changes made in the intervening period, the revision to the estimate for 2012 amounts to +€5½ billion. For the planning period 2013

*Upward revision
in 2012, but
slight reduction
in medium term*

¹⁰ The expected financial impact has since been further adjusted.

to 2016, the adjustments fall to +€1½ billion and then -€1 billion.

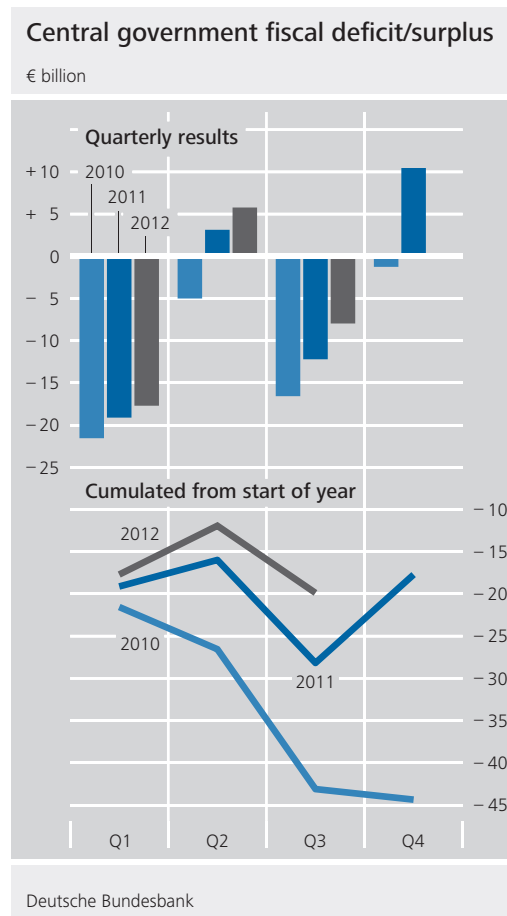
Central government budget

Improvement continued in Q3

The improvement in central government's finances continued in the third quarter. The deficit fell significantly on the year (by €4 billion to €8 billion). This was mainly attributable to strong growth in revenue (6%, or €4½ billion) as a result of the very positive developments in tax receipts (+7½%, or €5 billion). At the same time, expenditure went up only moderately (½%, or €½ billion). The decline in interest expenditure (-€½ billion) continued and transfers to the social security funds (especially to the Federal Employment Agency and the health insurance fund), spending on the long-term unemployed and investment expenditure were also down by similar amounts on the year. However, these developments were offset, above all, by significantly higher personnel costs (+6½%, or €½ billion) – primarily due to the retroactive adoption of the pay increase negotiated in March for employees with civil servant status and retired civil servants – and transfers to the east German states (€1 billion). In the first three quarters taken together, the deficit fell by just over €8 billion to €20 billion.

Second 2012 supplementary budget reduces net borrowing and ...

At the end of September, the Federal Government presented a draft second supplementary budget for 2012, which has since been revised in the Budget Committee's adjustment meeting. The supplementary budget enables the obligations contained in the European growth package regarding the capital increase for the European Investment Bank (German share: €1½ billion) to be met and also contains spending authorisations to permit the implementation of the agreements reached by central and state government at the end of June 2012 in connection with the European Fiscal Compact. In particular, the special fund for the expansion of childcare facilities is to be topped up by €½ billion. Furthermore, a commitment appropriation is envisaged to ensure that central gov-



ernment's planned assumption of a share in the forthcoming transfer of funds to the Berlin-Brandenburg Airport (€½ billion) complies with the budgetary rules. Finally, the additional revenue forecast in the latest tax estimate (€4 billion vis-à-vis the May estimate, of which €1 billion is attributable to lower transfers to the EU) and interest savings were taken into account at the adjustment meeting. Overall, this should reduce net borrowing in 2012 from €32 billion under the first supplementary budget to €28 billion. In 2011, net borrowing totalled €17½ billion.

The supplementary budget also records a more favourable figure for the structural deficit, which is the key benchmark for the debt brake. The structural deficit came to €20½ billion in 2011, and a figure of €15½ billion is estimated for 2012. Given the favourable development during the first three quarters of 2012, from the current perspective the deficit could turn out to be somewhat lower still. The underlying struc-

... structural deficit

tural deficit ceiling (€39½ billion, or 1.6% of GDP) would then be even more clearly under-shot.

Current plans contain limited need for adjustment

A notable feature of the budgetary and financial planning for the coming years is that, while the May tax estimate for 2013 to 2015 has largely been confirmed, central government's tax receipts at the end of the financial planning period are estimated to be €2½ billion lower (as a result of higher transfers to the EU). Second, at the start of November, the coalition committee approved new budgetary burdens (in particular, additional investment in transport infrastructure and tax-funded pension top-ups for low earners). However, the consequent need to adjust central government's plans to take account of this has been reduced in the short term, not least as a result of a decrease in transfers to the statutory health insurance scheme.

Permanent deficit ceiling already attainable in 2013

Following the adjustment meeting, the current budget plans for 2013 forecast net borrowing of €17 billion, which is €1½ billion lower than the figure recorded in the draft budget. The Budget Committee revised the estimates for privatisation proceeds (€1 billion), tax revenue (€1 billion) and investment (€½ billion) upwards slightly vis-à-vis the Federal Government's draft figures. Even taking into account the latest coalition agreements, with a structural deficit of €9 billion, the plans foresee that the permanent upper limit for structural net borrowing of 0.35% of GDP from 2016 will already be met in 2013.

Balanced structural budget announced for 2014 feasible

At the coalition meeting, it was also agreed to balance central government's budget (in structural terms) in 2014 – two years earlier than envisaged in the current plans. The very positive development of central government's finances in recent years has stemmed primarily from sizeable and unexpected additional tax revenue and lower interest expenditure. These positive influences have more than offset the continuous weakening of the originally planned consolidation path. In order to meet the new

target, despite the additional expenditure resulting from the coalition agreements, the reduction in the central government grant to the health insurance fund – which was originally only intended for 2013 and was increased by €½ billion to €2½ billion at the adjustment meeting – is to be repeated at least in 2014. Furthermore, it appears that regular transfers from the German development bank KfW are envisaged from 2014 onwards, although the details remain unclear. Finally, the full impact of the budgetary burden caused by the new child-care supplement will not be felt until 2015 owing to the postponement of its introduction. On the basis of the underlying assumptions, the goal of achieving a structurally balanced budget in 2014 appears feasible in principle. However, over and above the danger of a deliberate further relaxation of the consolidation path, the objective is additionally subject to substantial risks in connection with macroeconomic developments and the debt crisis.

The first definitive booking to the debt brake's control account was made on 1 September 2012. Any overshooting or undershooting of the constitutional borrowing limit incurred when implementing the budget for the individual years has to be recorded via the control account.¹¹ Net borrowing in 2011 (€17.3 billion) undershot the maximum level permitted (€42.5 billion) by €25.2 billion. Although the structural trend was indeed favourable, this large undershoot was primarily due to the inflated figure chosen as the 2010 starting value from which the borrowing limit is to be progressively lowered.¹² A similarly sized positive difference is expected for 2012. According to the Federal

Growing "credit balance" on debt brake's control account foreseeable

¹¹ In the year following the budgetary year in question, a provisional figure for the deviation from the borrowing limit is calculated on 1 March and a final figure is determined on 1 September. The maximum permissible level of borrowing is ascertained by multiplying the maximum permissible percentage of GDP (from 2016: 0.35%) by the GDP for the year preceding the year in which the budget was drawn up. Financial transactions and a cyclical component are then added to this figure.

¹² See Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, p 26ff.

Government, these “credit balances” are merely virtual and will not be used to create additional scope for borrowing in future years.¹³ The credit on the control account may indeed not be used *ex ante* in a draft budget to allow the borrowing limit to be exceeded. However, a large buffer is currently being created for deviations at the budget implementation stage which could ultimately give rise to optimistic budget estimates. Given that special provisions apply to bookings to the control account during the transitional period, it would make sense to delete the credit balance accumulated during this time in 2016. Such a proposal is currently under consideration in the parliamentary consultation process and is worth adopting.

Off-budget entities record marked improvement in Q3, and surplus likely for 2012

Central government’s off-budget entities posted a surplus of €1½ billion in the third quarter of 2012. Their finances thus improved significantly, increasing by €5½ billion on the year. This is attributable, first, to the €1 billion surplus recorded by SoFFin as a result of the state of North Rhine-Westphalia (as co-owner) repaying a silent participation in WestLB. In 2011, SoFFin had posted a deficit owing to a capital injection (€2 billion) into HRE’s resolution agency. In light of the continued uncertainty, it was recently agreed, as a precaution, to extend SoFFin’s temporary authorisation to implement new stabilisation measures to the end of 2014. Second, as in the final quarter of 2011, the restructuring fund received €½ billion from the bank levy. Other central government off-budget entities, such as the civil servants’ pension reserve, generally also recorded slight surpluses. The Investment and Repayment Fund – whose financing measures expired at the end of 2011 – finished the quarter with a virtually balanced budget, having recorded net outflows of €1½ billion one year previously. For the year as a whole, the surplus posted by central government’s off-budget entities is likely to be around half as high as in 2011 (€6 billion). Excluding financial transactions, which notably included a sizeable repayment to SoFFin in 2011, the off-budget entities would record a significant improvement in their finances.

State government¹⁴

State government’s core budget deficit fell to €1½ billion in the third quarter of 2012 (compared with €3 billion one year earlier). Revenue rose by 6% (€4 billion) overall, chiefly as a result of stronger growth in tax receipts (+9%). Expenditure increased perceptibly (by 3½%, or €2½ billion). In addition to the state of North Rhine-Westphalia’s capital repayment to SoFFin in connection with the resolution of WestLB, higher personnel costs and general grants to local government also contributed to this increase. By contrast, real investment and interest expenditure decreased.

Lower deficit in Q3 due to stronger tax revenue growth

Following the relatively favourable interim result, a deficit of €9½ billion is expected for 2012 as a whole, which is lower than the figure recorded for 2011. The target figure of €15½ billion would thus be considerably undershot. By the end of September, half of the federal states – including all the east German states and Berlin – had posted a surplus. By contrast, particularly high *per capita* deficits were recorded by the states of Saarland and Bremen, which are receiving consolidation assistance, as well as Rhineland-Palatinate, North Rhine-Westphalia (also owing to the special factor mentioned above), Hamburg and Hesse. Compared with the May tax estimate, the latest estimate envisages additional state government tax revenue of €2½ billion in 2012. By contrast, the new estimate envisages extra receipts of only €½ billion in 2013. The welcome decline in the deficit to date has largely been achieved through the unexpected positive developments in tax revenue. However, from 2013 onwards, growth in tax receipts is forecast to be markedly lower than in 2011 and 2012. Despite the marked fall in the deficit, state government as a whole still has a long way to go to achieve a

Smaller deficit expected for 2012 as a whole, but big consolidation need in some states

¹³ For further information and for details on the calculation, see Federal Ministry of Finance, Monatsbericht, October 2012.

¹⁴ The development of local government finances in the second quarter of 2012 was analysed in greater detail in the short articles in the Bundesbank’s October 2012 Monthly Report. These are the most recent data available.

structurally balanced budget. Individual states still need to achieve sizeable consolidation before 2020.¹⁵

Stability Council finds no new budgetary emergencies and calls for further restructuring measures

Given the positive developments, at its sixth meeting on 24 October 2012, in the context of its regular ratio-based budgetary surveillance using the stability reports from central and state government, the Stability Council found no indications of further looming budgetary emergencies – over and above those federal states that are already subject to a restructuring procedure. The restructuring reports submitted by Berlin, Bremen, Saarland and Schleswig-Holstein were given a largely positive assessment, although the improvement was chiefly attributed to the unexpected favourable developments in tax receipts. In the case of Bremen and Saarland, it was found that further structural measures are required and the potential for consolidation has not yet been exhausted. Yet no specific provisions are attached to these findings, and no sanctions are envisaged even if the federal states do deviate from the agreed consolidation paths.

■ Social security funds¹⁶

Statutory pension insurance scheme

Slight deterioration owing to accelerated expenditure growth

In the third quarter of 2012, the deficit of the statutory pension insurance scheme, at just over €½ billion, was somewhat higher than the figure recorded one year previously. Contribution receipts rose by only 2½% as a result of the contribution rate being cut from 19.9% to 19.6% at the beginning of 2012 (+4% after adjustment). Central government transfers also recorded relatively weak growth, as they are linked in part to the current contribution rate. Consequently, overall revenue rose by just over 2%. At almost 2½%, expenditure rose at a faster pace than revenue for the first time since mid-2010. Growth in expenditure mirrored the stronger mid-2012 pension increase (+2.18% in

western Germany and +2.26% in eastern Germany).

During the first three quarters of 2012, the finances of the statutory pension insurance scheme developed more favourably overall than in the corresponding period of 2011. The surplus for 2012 as a whole is also expected to be somewhat higher than the figure posted for 2011 (just over €4½ billion). By the end of 2012, the accumulated reserves will thus clearly exceed the threshold of 1.5 times the scheme's monthly expenditure. In line with the statutory provisions, the 2013 contribution rate must thus be lowered to a level (18.9%) that ensures that – taking into account the forecast financial developments – the reserves are scaled back and no longer overshoot the ceiling. A sharp turnaround in the finances of the statutory pension insurance scheme is thus expected and a marked deficit is on the cards. The potential for lowering the contribution rate is limited by the fact that the general central government grant for 2013 will be reduced on an *ad hoc* basis by €1 billion, which is roughly equivalent to 0.1 percentage point of the contribution rate. Furthermore, central government transfers will be lower as they will be automatically adjusted in line with the fall in the contribution rate. Expenditure is expected to continue to record rather moderate growth because the mid-2013 pension increase is likely to be relatively low, especially in western Germany, owing to

Contribution rate cut to reduce reserves

¹⁵ See also Deutsche Bundesbank (2012), *op cit*, p 36ff.

¹⁶ The financial development of the statutory health and public long-term care insurance schemes in the second quarter of 2012 was discussed in the short article in the September 2012 Monthly Report. These are the most recent data available.

particularities in the pension adjustment formula.¹⁷

Recent coalition decisions on tax-funded pension top-ups

The recent decisions of the governing coalition still envisage topping up the pensions of low earners so that they exceed the basic allowance. Furthermore, it is planned to no longer fully offset supplementary private pension provision against the transfer entitlement. The higher pensions are to be financed out of tax revenue. In contrast to previous proposals for pension top-ups, this would not impair the insurance equivalence principle of pension entitlements being linked to contributions paid. It is not yet clear which of the various forms of supplementary private pension plans will no longer be included in the calculation of basic allowance claims. Whereas the basic allowance for the elderly was specifically set up to prevent poverty in old age, the granting of pension top-ups for low earners is intended to make employment subject to social security contributions and private pension plans more attractive. However, the advantages should be weighed up against the negative impact of the financing burden, particularly given the demographic burdens that already exist.

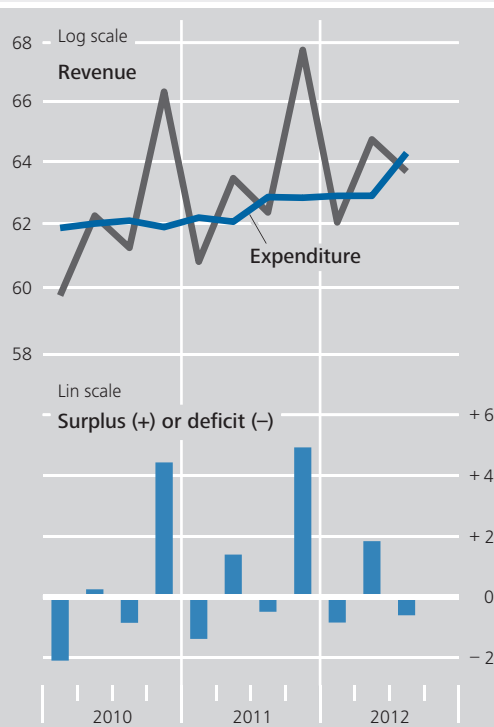
Federal Employment Agency

More favourable result masked by financial transactions with central government

In the third quarter of 2012, the Federal Employment Agency recorded an almost balanced budget. Its finances thus deteriorated slightly vis-à-vis the figure posted one year previously. However, the year-on-year comparison is distorted by sharp intra-year fluctuations in the financial transactions with the central government budget. Central government provided less liquidity assistance and the Federal Employment Agency's reintegration payment to central government was higher than in 2011. After adjustment for these effects, the Federal Employment Agency's finances improved by just over €½ billion in year-on-year terms. Overall, after adjustment, revenue rose by almost 4%, while expenditure decreased by 4½%. Contribution receipts were up by almost 5% on the

Finances of the German statutory pension insurance scheme

€ billion, quarterly



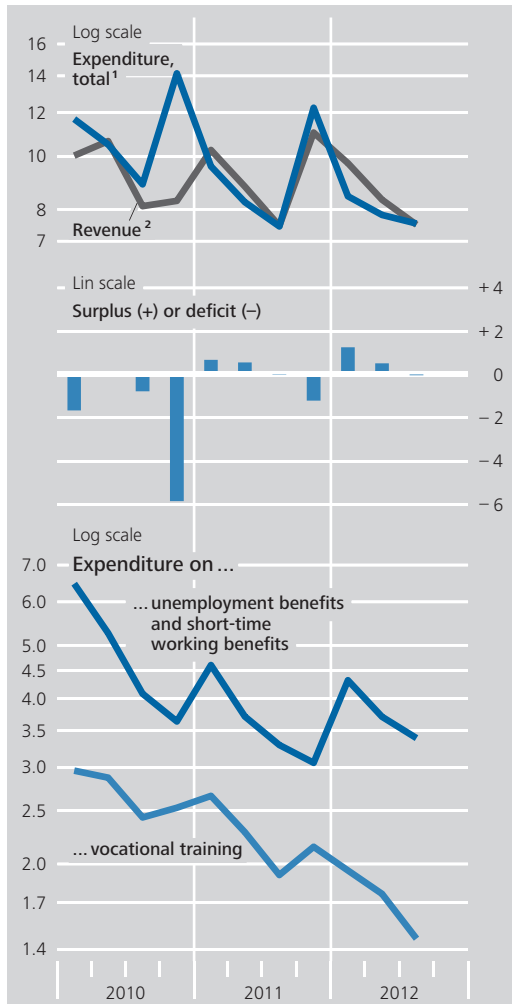
Deutsche Bundesbank

year, although the growth rates are gradually declining. By contrast, central government's administration cost reimbursements for unemployment welfare benefit (II) recipients

¹⁷ The sustainability factor, which enables the change in the ratio of standard pensioners to average contribution payers (pensioner ratio) to be taken into account when calculating the pension increase, is likely to have a particularly strong dampening effect on the pension increase in 2013 because the number of contribution payers was much higher in 2011 than in 2012. This is due to the fact that the number of average contribution payers is calculated by dividing the actual contribution receipts by the pension contributions payable on the provisional level of average income. The provisional level of average income in a given year is, in turn, calculated by carrying forward the value for the year preceding the previous year on the basis of the growth rate for the year preceding the previous year multiplied by two. Because average income actually fell in 2009, the above calculations result in very low average income for 2011, but a very high number of contribution payers. Consequently, the sustainability factor inflated the 2012 pension increase. These excessive increases will largely be counterbalanced by the sizeable dampening effect expected in 2013. The fact that the adjustments are also influenced by other factors, such as clawback decreases to compensate for cuts waived in previous years or deviations between total gross wages and salaries and income subject to compulsory contributions, makes it more difficult to interpret the findings.

Finances of the Federal Employment Agency

€ billion, quarterly



¹ Including transfers to the civil servants' pension fund. ² Excluding central government liquidity assistance.
 Deutsche Bundesbank

– who are steadily declining in number – were lower. The further sharp decline in expenditure (in adjusted terms) is due almost entirely to the cuts in spending on active labour market policy. By contrast, expenditure on unemployment insurance benefit (I) in the third quarter of 2012

was up on the year for the first time since the start of 2010.

For 2012 as a whole, a marked surplus of around €2 billion is forecast. The figure recorded in the Federal Employment Agency's budget plan, which envisaged a surplus of only €½ billion, will thus be exceeded. However, a significant deterioration in the financial situation is likely in 2013, as considerably more is expected to be spent on unemployment insurance benefit and it is unlikely that further significant cuts in spending on active labour market policy will be made. Furthermore, the Federal Employment Agency loses out overall from the abolition of the turnover tax-financed central government grant¹⁸ and the simultaneous discontinuation of the reintegration payment to central government. All in all, with a contribution rate of 3.0%, in the long run the Federal Employment Agency's receipts are likely to barely cover its expenditure over the economic cycle. Central government loans to offset the Federal Employment Agency's deficit are recorded as financial transactions in central government's budget and are therefore not counted towards the constitutional borrowing limit. In the absence of clear repayment rules, the Federal Employment Agency could potentially accumulate liabilities over and above the limit imposed by the debt brake without needing to raise its contribution rate or directly cut benefits.

Surplus for year as a whole, but gloomy outlook

¹⁸ The abolition of the central government grant means that all remaining "non-insurance-related benefits" of the Federal Employment Agency (eg the children's allowance as part of the unemployment benefit replacement rate or the age-determined maximum period of entitlement to unemployment benefit) will be financed by wage-related contributions.