

Public finances

General government budget

The German public finance situation will continue to pick up perceptibly in the course of 2007. Following the unexpectedly sharp fall in the general government deficit ratio to 1.7% in 2006, a further drop to less than 1% is expected this year. While this is partly due to the favourable economic environment, the structural deficit ratio (ie adjusted for cyclical and temporary effects) will also experience a noticeable decline. The main factors behind this are the Federal Government's fiscal measures – above all the VAT rise – aimed at increasing revenue and the expected continuation of the moderate expenditure growth observed in the past. With this favourable budgetary development, the debt ratio, which remained unchanged at 67.9% in 2006, will go down for the first time since 2001. Nevertheless, the 60% ceiling stipulated by the EC Treaty is likely to be overshoot again by a considerable amount.

Noticeable improvement in the general government fiscal position in 2007

The development of the general government revenue ratio in 2007 is being shaped by two opposing influences. On the one hand, legislative changes which came into force at the start of the year have, on the whole, led to considerable increases in revenue. Additional revenue, especially from the 3 percentage point rise in the standard rate of VAT and the higher contribution rates to the statutory pension insurance and health insurance schemes, are more than compensating for the shortfalls resulting from the 2.3 percentage point cut in the contribution rate to the Federal Employment Agency. On the other hand, major macroeconomic reference vari-

Revenue ratio could decline slightly despite increases in taxes and social security contributions

ables for government revenue, such as gross wages and salaries but also pre-tax private consumption, are expected to increase far more slowly than nominal GDP, which will experience stronger growth as a result of the price effect from higher excise taxes. This will be offset only partly by the ongoing favourable pattern in entrepreneurial and property income, which is used as the macroeconomic reference variable for profit-related taxes. All in all, as things currently stand and in view of a further dampening in the pattern of energy tax receipts and a decline in other revenue, a slight fall in the revenue ratio can be expected.

Growth in expenditure much smaller than GDP growth

The increase in government expenditure is still well behind the pronounced rise in (nominal) GDP, which means that the expenditure ratio is falling more sharply. This is partly related to the very positive economic trend, which is leading to a perceptible decline in labour-market-related spending.¹ What is more, moderate wage developments are having a dampening effect not only on the government revenue trend but also on the expenditure trend – without being associated with any active fiscal policy consolidation measures. For example, many social benefits such as pensions and unemployment benefit are being strongly influenced by recent growth in per capita income, and the increases in wages in the public sector are also connected to developments in the private sector. What is more, the pension adjustment in mid-2007 will be curtailed by the correction factors incorporated in the pension formula. Together with the low number of new pension recipients – due not least to the fact

that the section of the population now reaching retirement age was born in years with relatively low birth rates – the trend in expenditure on old-age provision is contributing significantly to the decline in the government expenditure ratio. This is also true for personnel expenditure by general government, which may even fall in absolute terms given further staff cuts and another round of very moderate wage developments. In addition to the favourable trend in the economy as a whole, legislative measures, such as the shortening of the maximum period of entitlement to unemployment benefit I and the reduction in social contributions paid on behalf of recipients of unemployment benefit II, are another factor depressing labour-market spending.² Finally, capital transfers can also be expected to contribute to consolidation primarily because grants to homebuyers are gradually being phased out.

Even though not currently envisaged in government plans, the deficit ratio could fall again slightly in the coming year provided there are no additional cuts in taxes and social security contributions or increases in expenditure. This is because, as things currently stand, the economic outlook is set to remain positive. The structural deficit ratio, however,

Slight cyclical fall in deficit possible in 2008

¹ During a cyclical upswing, strong nominal GDP growth, in particular, generally leads to a significant decline in the expenditure ratio via its impact on the denominator. By contrast, cyclical developments usually have only a mild impact on the revenue ratio because the cyclical fluctuations in taxes and social security contributions (in the numerator) tend to follow largely the same pattern as those of GDP.

² However, on its own, the cut in pension insurance contribution payments on behalf of recipients of unemployment benefit II reduces the social security funds' contribution receipts by the same degree and, in turn, depresses the government revenue ratio.

is likely to remain largely unchanged (and to be higher than the ratio before adjustment for cyclical effects). Tax revenue shortfalls related to the planned business tax reform could be offset by restrained growth in spending on pensions, the labour market and, possibly, personnel and also by further cuts in capital transfers.

However, further consolidation still needed ...

The favourable developments in government budgets at the current time should not, however, be used as a pretext for relaxing efforts to achieve a radical consolidation of public finances. The situation at the start of the millennium has clearly shown how – when a structurally balanced budgetary position has not yet been achieved – the combined effects of an economic downturn, insufficiently counterfinanced tax cuts and sharp falls in the very volatile revenue from profit-related taxes can quickly lead to excessive deficits, which take years to correct. To attain and maintain a structurally balanced budget it is necessary to achieve clear surpluses during economic boom periods. This means that cyclical surges in revenue and drops in expenditure should not be used to finance tax cuts or greater spending. Otherwise a procyclical fiscal policy will arise, which will have to actively respond countercyclically during the automatic deterioration in the budgets in an economic downturn, thereby strengthening cyclical fluctuations. A structurally balanced budget has a decisive role to play in rapidly reducing the government debt ratio, which is currently at its highest level in the history of the Federal Republic of Germany. A lower debt ratio would also mean less pressure on the budget from interest payments, which

would make it easier to cope with the prospective expenditure growth resulting from an ageing population.

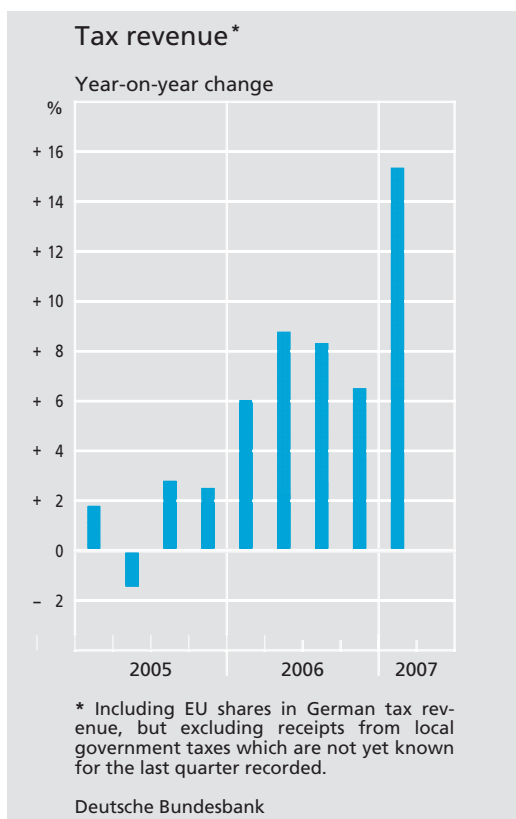
The EC Treaty and the Stability and Growth Pact take into account these considerations. Countries whose debt ratio exceeds the 60% reference value are obliged to bring it down under the upper limit at a rapid pace. Moreover, member states which have not achieved their medium-term budgetary objective are required to reduce their structural deficit annually by 0.5% of GDP. Consolidation efforts are to be intensified when economic activity is robust whereas, during a slump, non-achievement of the reference value is tolerated.³ What is more, a study is currently underway to examine how future demographically induced expenditure rises, in particular for pensions, should be taken into account when determining an appropriate medium-term budgetary objective. It may well be that, in Germany's case, the objective of a structurally balanced budget will be deemed insufficiently ambitious.

... and required under European fiscal framework

Even if Germany is released from the excessive deficit procedure – as proposed by the European Commission – it will still not have fulfilled all the requirements of the Stability and Growth Pact by any means. According to the European Commission's spring forecast, the 2006 structural deficit ratio was 1.5% and this is the authoritative value for the European budgetary surveillance procedure, clearly demonstrating that there is still a long way to go before a structurally balanced

Essential to achieve a structurally balanced budget by 2009 at the latest

³ See Fiscal developments in the euro area, pp 18-19.



budget is achieved. The Commission has forecast an improvement of 0.7 percentage point in the structural deficit ratio for 2007, which may be regarded as adequate even in the favourable economic climate. However, as it is assumed that this climate will persist, a further significant improvement ought to be achieved in 2008 to eliminate most of the structural deficit by then. To achieve this, the revenue shortfalls resulting from the business tax reform will need to be counterfinanced elsewhere. The general government objective of a structurally balanced budget should be achieved by 2009 at the latest.

Budgetary development of central, state and local government⁴

Tax revenue

In the first quarter of 2007, tax receipts⁵ were up by 15½% on the year. In addition to the increases in tax rates mentioned above, another major factor was the favourable macroeconomic trend. Wage tax yielded 8½% or €2½ billion more than in the first quarter of 2006. This reflects the reduction in child benefit as well as the favourable developments in the labour market thanks in part to the mild winter. Profit-related taxes, which are by nature very volatile, once again saw far greater growth with an increase of just over €4½ billion (+55½%). Additional revenue from assessed income tax was especially high, with receipts also affected by the phasing-out of the grant to home buyers which is booked against this tax. The increase in revenue from withholding tax (+€1 billion) most likely reflects the cut in the savers' tax-free allowance and, not least, the rise in interest rates. In the first quarter, turnover tax yielded an extra 17% or just over €6 billion more even though the full impact of the rise in the standard rate of VAT from 16% to 19% is not likely to have been felt until March owing to the transfer deadlines. The standard rate of insurance tax had also been increased at the start of the year and receipts grew by one-fifth.

Sharp increase in tax revenue in 2007 Q1

⁴ The following reporting is based on the financial statistics.

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

Higher revenue expectations for 2007

The latest official tax estimate from May also predicts a sharp rise of 9½% in receipts for the year as a whole (including local government taxes) and a perceptible rise in the tax ratio (as defined in the government's financial statistics) of 1 percentage point to 22.3%. This is primarily a reflection of the rise in the standard rate of VAT but also of the expected sharp growth in income tax receipts. Revenue expectations have been revised upwards by €20 billion since the last tax estimate in November 2006. This revision takes into account not only the much more favourable assessment of the macroeconomic trend,⁶ but also the stronger than expected growth of tax receipts, especially profit-related taxes.

Outlook for 2008 not unfavourable

It is forecast that tax revenue will increase by 4% in 2008. However, this does not take into account the impact of the business tax reform which has yet to be adopted by parliament. The ruling coalition's draft bill, parts of which are currently undergoing revision, envisages revenue shortfalls of approximately €6½ billion for 2008. Gross revenue losses totalling €19½ billion are set against counterfinancing measures with a volume of €12½ billion. Furthermore, additional revenue arising from the retransfer of tax-relevant profits to Germany – initially estimated at just over €½ billion – has also been factored into the calculation. If the envisaged shortfalls from the business tax reform are incorporated into the estimate, this results in a rise of just over 2½% in tax revenue for 2008, which would be slightly less than the increase in nominal GDP.

Between 2009 and 2011, tax receipts are predicted to grow by an annual average of

Overall tax revenue and major individual taxes

Type of tax	Q1		Year-on-year percentage change	Estimate for 2007 1
	2006	2007		
	€ billion			
Overall tax revenue 2	95.9	110.6	+ 15.4	+ 10.1
<i>of which</i>				
Wage tax	28.1	30.5	+ 8.4	+ 7.1
Assessed income tax	- 2.1	0.8	.	+ 26.1
Investment income tax 3	5.4	7.0	+ 28.6	+ 11.7
Corporation tax	5.2	5.4	+ 4.8	+ 3.1
Turnover tax	35.9	42.0	+ 17.2	+ 17.7
Energy tax	4.5	4.5	+ 1.3	+ 0.2
Tobacco tax	2.8	2.9	+ 4.6	+ 0.8

1 According to official tax estimate of May 2007, excluding local government taxes. — 2 Including EU shares in German tax revenue, but excluding receipts from local government taxes, which are not yet known for the quarter recorded. — 3 Non-assessed taxes on earnings and withholding tax on interest income.

Deutsche Bundesbank

3½%. Thus, revenue will be significantly higher than predicted in the preceding medium-term forecast from May 2006, which the Federal Government used in its last medium-term plan of July 2006. The reasons for this are the more favourable macroeconomic development and the fact that medium-term revenue from profit-related taxes is now estimated to be far higher. Taking into account all the legislative changes which have since been adopted by parliament and the revenue shortfalls envisaged as a result of the business tax reform, revenue in 2009 is now expected to be €47 billion or 2% of GDP higher than predicted in the tax

Substantial additional revenue expected in the medium term

⁶ The Federal Government is predicting nominal GDP growth of 4% for 2007 as a whole (compared with the November forecast of 2.6%). Real growth is now forecast at 2.3% (compared with 1.4%).

estimate from May 2006. If the Federal Government's medium-term objective from 2006 of a general government deficit ratio of 1½% in 2009 is adjusted to take account of this additional revenue alone, a fiscal surplus should be a possibility then. However, given, in particular, the high degree of uncertainty surrounding the medium-term macroeconomic outlook and the impact of the significant changes in tax legislation as well as the high volatility – especially in profit-related taxes – that can be explained only partly by macroeconomic developments, the tax forecast for the coming years involves considerable risks.

Central government budget

In the first quarter of 2007, central government recorded a deficit of €13½ billion, which was a sizeable €7½ billion down on the same period of last year. While receipts rose by 15½%, expenditure growth was modest at ½%. A major factor in the positive revenue trend was another sharp rise in tax receipts of just over €8½ billion (+20%). However, after large debt repayments from abroad had been recorded in the first quarter of 2006, net non-tax revenue declined slightly.⁷ On the expenditure side, additional spending, in particular due to higher payments to the Federal Employment Agency (+€1 billion) as a result of the new VAT-financed grant, were offset almost entirely by lower expenditure on the basic allowance for job seekers. The decline in spending on unemployment benefit II noticeably exceeded the scale of the cut in pension insurance contributions transferred on behalf of recipients

of unemployment benefit II that came into effect at the start of the year.⁸

The budgetary development in 2007 as whole should be more favourable than foreseen in the plan. The latest tax estimate expects central government tax receipts to increase by €26½ billion (+11%) on the year, which is €10 billion more than the budgeted figure. It should therefore be possible to stay well below the envisaged deficit of almost €20 billion. However, the end result will depend in no small part on receipts from asset realisations, which are open to influence. In view of the favourable trend, some of the relief measures foreseen in the budget plan and amounting to just over €15 billion⁹ – from privatisation proceeds and other asset realisations (including the liquidation of Post Office pension fund reserves) – could be held back to bridge possible budget deficits which may occur in the future.

More positive development in year as a whole thanks to additional tax revenue, ...

Significant reduction in central government budget deficit in 2007 Q1

⁷ The Bundesbank's profit was up again on the year by almost €1½ billion to just over €4 billion. However, only slightly more than €½ billion was recorded as additional revenue in the central government budget as profit in excess of €3½ billion is transferred directly to the Redemption Fund for Inherited Liabilities for debt repayment.

⁸ While the number of persons receiving unemployment benefit II rose again by ½%, expenditure on this benefit fell by 5% even without the reduced social security contributions. Lower expenditure per recipient may be due to higher income from employment, which is indicated by the significant decline in the number of recipients registered as unemployed (-10½%).

⁹ The short-term realisation of receivables from the ERP Special Fund to finance the current budget is one particularly problematic element as the corresponding assumption of Special Fund debt by central government is not planned to be booked as borrowing. See also: Deutsche Bundesbank, Monthly Report, November 2006, p 58 and The Federal Court of Auditors, Report to the "ERP economic plans" subcommittee of the German Bundestag Committee on Economics and Technology, 12 April 2007, available only in German.

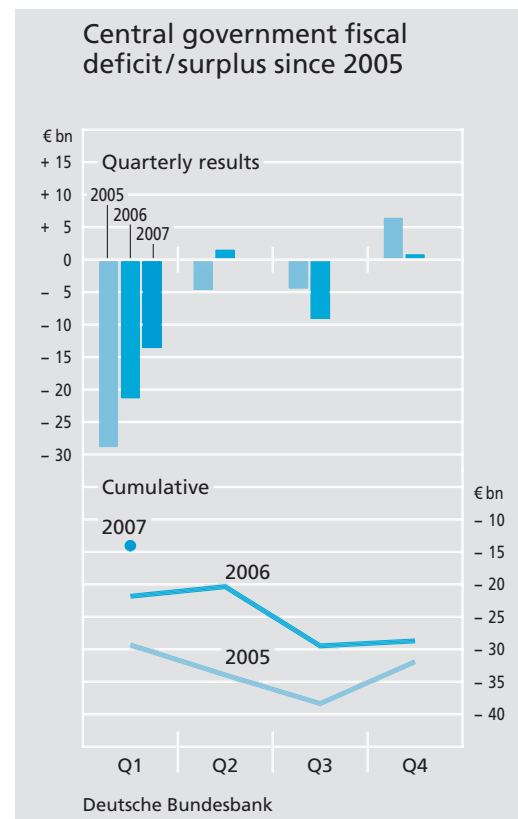
... but structural consolidation still necessary

Despite the fact that fiscal developments are significantly more favourable than been predicted, it is likely that central government will, at best, only just manage to stay within the regular borrowing limits in 2007 without recourse to asset realisations – which produce only one-off sizeable fiscal windfalls – and will still be a long way from a sustainably balanced budget. With regard to the central government budget in particular, it therefore seems imperative that the favourable macroeconomic trend be used to achieve a further reduction in the budget deficit after adjustment for asset realisations. This not only means forgoing extra spending financed from cyclically-induced additional revenue; it also calls for further structural consolidation, especially as tax revenue shortfalls can be expected next year in connection with the planned business tax reform and increasing grants to the statutory health insurance scheme have already been agreed for the following years.

State government budgets¹⁰

Sharp decline in state government deficit in 2007 Q1

In the first quarter of 2007, the combined state government deficit amounted to €3 billion, which was a further sharp decline of almost €4½ billion on the year. Revenue rose again (+11%) thanks to strong growth in tax receipts. While expenditure was also noticeably up on the year, at just over 3% the rise was, however, much more moderate. As personnel expenditure increased only slightly, higher transfers to local government under the tax sharing arrangements are likely to have played a role in the increased expenditure. Construction investment also rose sharply (+10½%).



If the favourable trend in tax revenue, in particular, continues, state government could record a close-to-balance budget position for 2007 as a whole despite the fact that current plans still envisage a deficit of €15½ billion. According to the latest tax estimate, following a deficit of just under €10 billion in 2006, tax revenue is expected to go up by €16½ billion on the year, while the budget plans envisage an increase in expenditure of only €6 billion. However, the financial situation in the individual federal states remains very heterogeneous. While a number of states managed to achieve a balanced budget in 2006, Berlin, Bremen, Saarland and Schleswig-Holstein, in particular, but also North Rhine-Westphalia

In 2007 as a whole, close-to-balance state government budgets possible ...

... although financial situation varies across states

¹⁰ The most recently published data on local government finances are analysed in the short articles in the Bundesbank Monthly Report of April 2007.

and Rhineland-Palatinate still showed considerable consolidation needs. There were also incidences of misappropriation of Solidarity Pact funds in a number of east German states. Nevertheless, if the favourable developments in the economy continue, most federal states should be able to achieve a balanced budget before 2010. It goes without saying that, given the objective of a structurally balanced budget, state government also needs to achieve surpluses when the economic climate is, as expected, favourable.

Constitutional breach by North Rhine-Westphalian 2005 supplementary budget remains without consequences ...

In a recently pronounced judgment, the Constitutional Court for the Federal State of North Rhine-Westphalia found that the second 2005 supplementary budget was in breach of the state constitution because the net new borrowing which it envisaged exceeded total investment (by €1½ billion) without stating sufficient grounds. The judges expressly rejected the defence of an alleged “objective impossibility” of observing the borrowing limit, which the state parliament had claimed was based on legal obligations over which it no longer had any influence. The newly elected government had claimed that its predecessor’s budget estimates had required major adjustment while, at the same time, the short-term savings potential had been exhausted. Even if the judgement does not have any direct consequences as the budget concerned has already been closed and, since the start of 2007, North Rhine-Westphalia has no longer had recourse to this clause, this is the first time that the defence of a supposed “objective impossibility”, which is also invoked by other federal states, has been deemed inadmissible by a court.

The fact that the constitutional breach has not led to the imposition by the court of consolidation conditions – meaning that there is practically no deterrent effect – underlines the need in the forthcoming second stage of the federal structure reform to strengthen the binding impact of the borrowing limits and the possibility of sanctions, and to introduce fast-track procedures for examining lawfulness.

... and emphasises the need to reform central and state government budget law

Social security funds¹¹

Statutory pension insurance scheme

The German statutory pension insurance scheme recorded a deficit of more than €2 billion in the first quarter of the year. By contrast, in the same quarter of 2006 a surplus of €3 billion was recorded. The main reason for this was the sharp 7½% drop in receipts. This in turn was largely due to the fact that the impact of the particularly high one-off windfalls in the first quarter of 2006 owing to earlier transfer deadlines for social contributions has now dropped out of the statistics. What is more, contributions for recipients of unemployment benefit II were practically halved at the start of the year, leading to revenue shortfalls of more than 1%. On the other hand, the rise in the contribution rate from 19.5% to 19.9% on 1 January 2007 led to a substantial rise in revenue from contribu-

Deficit in 2007 Q1 despite sharp rise in contribution rate

¹¹ An analysis of the budgetary development of the statutory health insurance and public long-term care insurance schemes can be found in the short articles in the Bundesbank Monthly Report of March 2007; a more extensive analysis of the long-term care insurance scheme is published in the Monthly Report of April 2007.

tions of just over 2% when viewed in isolation.

Moderate expenditure growth

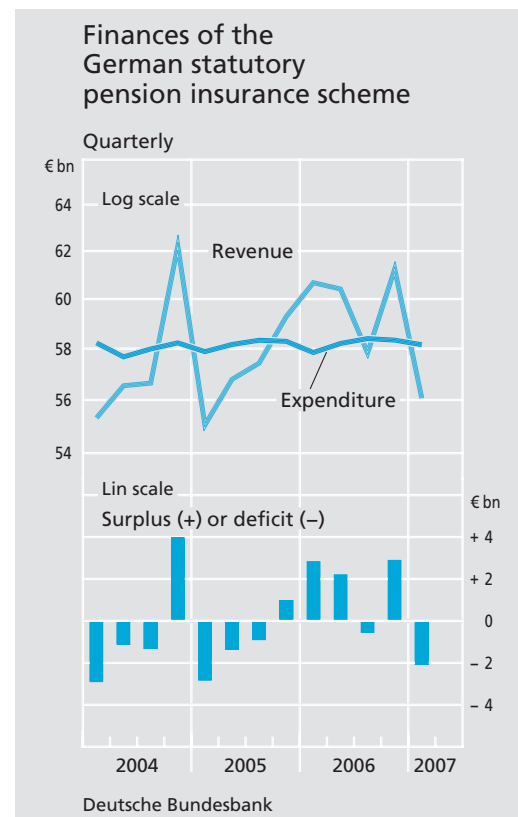
There was only minor growth on the expenditure side. Despite the fact that pension payments were not increased in mid-2006, pension expenditure rose by ½%, largely as a result of a slight increase in the number of persons receiving a pension. An increase of 1% in spending on health insurance contributions for pensioners also played a role. The sharp rise in contribution rates by many statutory health insurance institutions at the start of the year has not yet made itself felt, however. Owing to a time lag stipulated by law, the increases in the contribution rates will entail additional expenditure for the pension insurance scheme only from the second quarter of the year onwards.

Accelerated pace of expenditure growth to be expected in remainder of 2007

In the course of 2007, expenditure will grow at an accelerated pace. One reason for this, besides the increase in health insurance contributions, is that pensions are to go up on July 1 (by 0.54%) for the first time since 2003. In addition to the more favourable pay trend last year, the perceptible rise in employment will also play a role here via the pensioner quotient in the sustainability factor – (after a certain time lag, the initial cyclical improvement in revenue will lead to increased expenditure in the coming years). All in all, the statutory pension insurance scheme could close with a largely balanced budget in 2007.

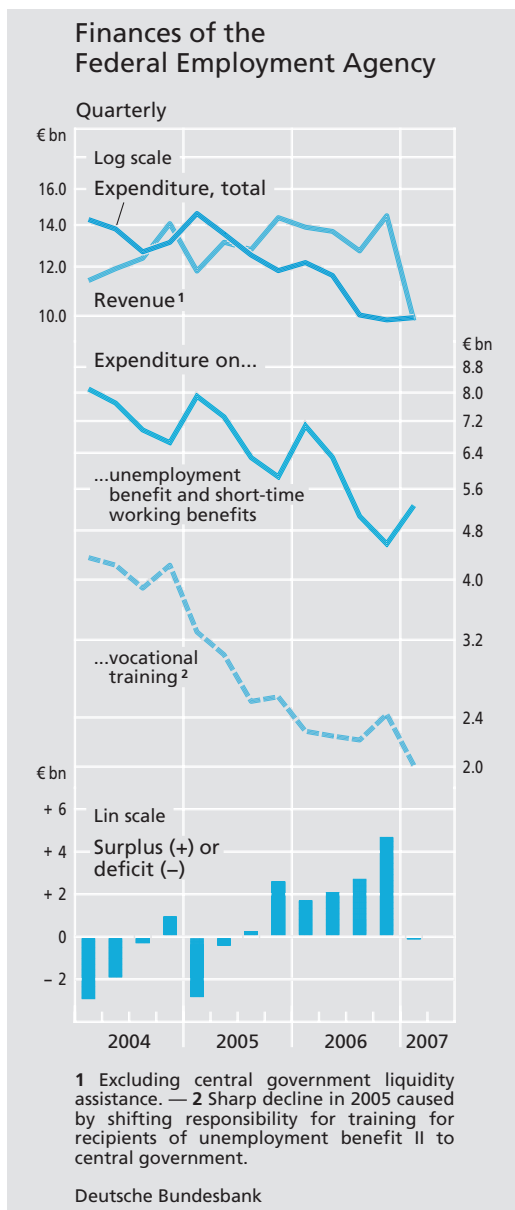
Federal Employment Agency

The Federal Employment Agency recorded a practically balanced result in the first quarter



of 2007, having achieved a surplus of just over €1½ billion in the same period of 2006. However, only a very limited comparison between these results is possible. In the first quarter of 2006 substantial one-off revenue windfalls were recorded because the transfer deadlines for social contributions were brought forward. The resulting fall in contribution revenue at the start of this year was exacerbated by significant revenue losses as a result of the cut in the contribution rate from 6.5% to 4.2% (-€4 billion), which was offset only to a small extent by the new (VAT-financed) Federal grant (€1½ billion). All in all, this meant that revenue was 29½% down on the year. However, spending also went down by 18½%.

Balanced result in 2007 Q1 hardly comparable with previous year



Decline in unemployment means lower expenditure on wage substitutes

The ongoing decline in unemployment was responsible for the accelerated fall in spending by the Federal Employment Agency. In the first quarter of the year, spending on unemployment benefit I was 27% down on the year. This was due mainly to the fall in the number of recipients as the payment amount per recipient barely changed. The number of unemployed persons fell less sharply by 16½%, which meant that the proportion of

recipients of unemployment benefit I in total unemployment went down again. One of the reasons for this is probably that individuals entitled to unemployment benefit, ie the relatively short-term unemployed, currently have comparatively good chances of finding a new job. However, another factor is that the entitlement period to unemployment benefit I was shortened to 12 months (or 18 months for persons aged 55 or over) in February and the resulting effect is now beginning to be felt. In the first quarter of the year, spending on active labour market policy measures was down by 12%. There was a particularly sharp drop in expenditure on one-person business start-up grants and bridging payments, which were replaced by a single start-up grant in August 2006. The compensatory amount¹² paid to central government was down by more than one-third on the year.

The budget plan envisaged a negative fiscal balance of just over €2 billion for the Federal Employment Agency in 2007, which was based on the assumption of a 4.5% contribution rate. The actual rate, which is 0.3 percentage point less, entails further revenue losses of more than €2 billion. The resulting deficit of almost €4½ billion predicted in the revised budget plans is, however, outdated given the now much more favourable assessment of the macroeconomic trend. In addition to lower expenditure on wage substitutes, another factor is that the compensa-

Surplus also expected in 2007

¹² The compensatory amount is calculated according to the number of unemployed persons in the previous quarter transferring to unemployment benefit II within three months of the expiry of their entitlement to unemployment benefit I, multiplied by the average annual cost of an income-support household as defined in the Second Book of the Social Security Code (just over €10,000).

tory amount payable to central government was significantly overestimated at €4 billion. If the favourable economic trend continues, a surplus can be expected for 2007 as a whole, albeit a significantly smaller one than that of just over €11 billion in 2006.

*Debate about
the use
of reserves*

The further cut in the contribution rate currently under discussion in the light of the favourable economic climate at present could necessitate a corresponding rise in less favourable economic phases. As the Federal Employment Agency's budget reacts on the revenue side and even more so on the expenditure side to fluctuations in the macro-economic rate of capacity utilisation, appropriately high reserves are needed to stabilise the contribution rate across the economic cycle. For this reason, careful examination is

necessary to establish whether a cut in the contribution rate would, in the long term, be in keeping with sustainable financing of the statutory unemployment insurance scheme. The current discussion about using the statutory unemployment insurance scheme to provide relief for the Federal budget – for example, via a cut in the new rule-based Federal grant or, indirectly, via higher health insurance contributions for recipients of unemployment benefit I – shows that a transparent and logical distinction between tax-financed and contribution-financed benefits is essential. If there were a systematic separation of insurance and income redistribution tasks as well as a clear documentation of non-insurance-related benefits, this would help to avoid the sometimes arbitrary shifting of financing responsibilities.