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Germany's austerity package and the federal budget

Growth-compatible

— **Germany has presented a four-year consolidation package to reduce its structural deficit and bring cumulative budget relief of over EUR 80 bn (65% via spending cuts and 35% via revenue increases).**

— **Spending cuts (above all in the labour and social security budgets) will make up the lion's share of the package, whereas tax hikes and subsidy reductions will play a smaller part. Taken together, the spending cuts and revenue increases foreseen for next year will amount to less than 0.5% of GDP. Moreover, the budgets for key growth areas such as education and research will remain unchanged.**

— **The package will put larger burdens on airlines, energy utilities, banks and energy-intensive producers, with the proposals still needing to be detailed in draft legislation by the responsible ministries.**

— **The government's legislative proposals – presumably in the shape of a budget accompanying law – will not be tabled until autumn at the earliest, with the Bundestag probably also not voting on them until the budget debate. The cabinet's recently adopted draft budget for 2011 and financial planning no doubt already at least specify the totals for revenue increases and expenditure cuts.**

The components of the consolidation package

On June 7 the German government presented the key points of a budget consolidation package which foresees total relief of about EUR 82 bn in the next four years.

Some 65% of the four-year package will consist of spending cuts, and 35% of revenue increases (mainly from new taxes). The spending cuts will largely focus on the labour and social security budgets. For example, expenditure for social security benefits is to be reduced by trimming mandatory state benefits and subsidies and by interpreting social security legislation more narrowly. Moreover, the government plans to save money by raising the efficiency of (state) job placement procedures. In addition, the so-called parenting benefit is to be cut, affecting family policy. Overall, the savings in the social security and labour budgets will amount to about 37% of the total package.

About 28% of the budget relief (including the expected drop in interest payments) is to come from the administration, for example in the form of job redundancies. The government also hopes that spending can be reduced via the planned reform of the armed forces.

Revenues are to be hiked by putting a larger burden on the corporate sector (about 35% of the total package). For example, the banking sector is to bear some of the costs caused by the financial-market crisis. In addition, tax privileges for energy-intensive companies are to be scaled back, and all passengers who take off from a German airport will have to pay an air travel levy. Moreover, taxes on the nuclear power industry will be raised and the preferential treatment of tax authorities in insolvency procedures is to be reintroduced. The accumulated revenues from these measures are to total almost EUR 29 bn by 2014.

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Consolidation package – an overview

EUR bn

	2011	2012	2013	2014
Cuts in the social security budget	**3.0**	**7.0**	**9.4**	**10.9**
of which:				
Cuts in mandatory benefits and top-ups	4.4	6.4	7.3	7.3
More efficient job placement			1.5	3.0
Cuts in family benefits	0.6	0.6	0.6	0.6
Other	-2.0	0.0	1.5	3.0
Administrative savings, armed forces reform, saved interest	**2.9**	**4.4**	**7.6**	**7.9**
Burdens on companies	**5.3**	**7.8**	**7.8**	**7.8**
of which:				
Cuts in energy tax breaks	1.0	1.5	1.5	1.5
Ari travel levy	1.0	1.0	1.0	1.0
Nuclear power tax	2.3	2.3	2.3	2.3
Railway dividends	0.5	0.5	0.5	0.5
Levy on financial insitutions		2.0	2.0	2.0
Preferential treatment of tax authorities in insolvencies	0.5	0.5	0.5	0.5
Total	**11.2**	**19.1**	**24.7**	**26.6**

Sources: BMF, DB Research 1

Key areas not included in the package

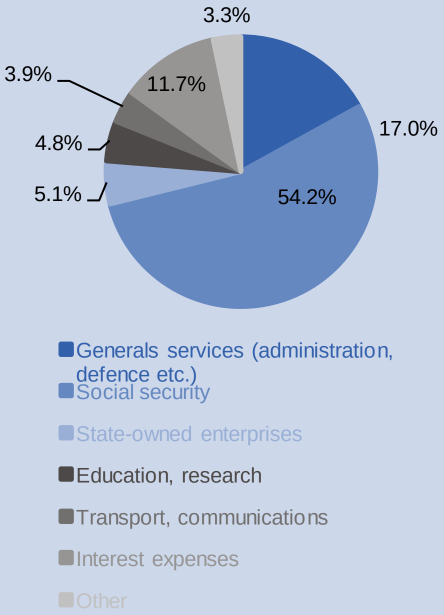
Cuts justified from a political and an economic standpoint

In principle, the cuts are going into the right direction. Seeing that more than half of the federal government's total expenditure goes to social security (1990: 30%), cuts in this area are quite appropriate. The package of individual measures can be justified from both a political and an economic standpoint. The political argument applies to the reduction of the parenting benefit for Hartz IV recipients, for example. This is fitting, since the parenting benefit is one that falls under family policy and demographic developments but not social policy, as it is meant to raise the incentive for working parents to have children. The abolishment of certain top-up benefits for jobless people makes economic sense, as this step makes it more attractive to find a job. Higher employment will both reduce government spending and strengthen domestic demand.

Consolidation package does not address reform of health insurance or long-term care

No major or necessary reforms of healthcare or long-term-care insurance are linked with the consolidation package, though, nor is there even any prospect of the same. Thorough reforms of both social security branches are still wanting. None of this will be changed by the ruling coalition's recent adoption – after tough negotiations – of resolutions on key points to reform the health insurance system either. While it ought to be possible to eliminate the over EUR 11 bn deficit looming in 2011, little is going to change on two basic problems of the status quo. Firstly, contributions to the system are increasing only slowly because of the moderate rise in wage income. Secondly, and this is the more important point, outlays on healthcare are continuing to skyrocket. The hike in the contribution rate (from 14.9% to 15.5% of gross income) and the scope for add-on fees will do little to change this, but at over EUR 6 bn these factors account for the lion's share of the volume. Merely EUR 3 bn is to be funded via spending cuts (moreover, the current tax subsidy of over EUR 13 bn will be hiked by EUR 2 bn.) For the first time, though, there will at least be an attempt to decouple contributions from wages in part and thus from wage costs since, for one thing, the employer's portion of the contribution is to be frozen

Federal goverment spending by tasks
Planned shares, 2010



Sources: BMF, DBResearch 2

at 7.3% and, for another, the flat-rate add-on fee which health insurers may levy will no longer have an income-related cap. A social equalisation facility, for whose technical implementation employers will be responsible, is meant to avoid hardships. The goal of decoupling contributions from wages is to give the health insurers more financial autonomy and intensify competition.

Besides healthcare and long-term care, the pension system will also remain untouched, even though key elements of the thorough pension reform introduced between 2002 and 2007 were reversed to some extent during the past two years, not least due to the economic crisis. These include a demographic factor that took account of a downturn in pension contributions and benefits (i.e. the sustainability factor) and the pension guarantee extended in 2009. Contrary to the system, the latter completely decoupled pensions from income growth, since wage cuts no longer result in lower pensions (the cuts have to be compensated at a later date via smaller increments in pension increases – which is a tinderbox politically.) The bill will have to be footed by employees and employers (since the federal subsidy for the statutory pension system continues to be geared to wage development).

Considerable uncertainty about the volume of potential social security savings

Many question marks hang over the projected volume of the expenditure cuts. For example, it is uncertain whether cuts in mandatory benefits and the introduction of more leeway in the decisions about discretionary benefits will indeed result in reducing the federal government's and the labour-market administration's expenditure by up to EUR 5 bn p.a. In any case, the social courts are likely to see their workload increase.

Risk of social security expense being shifted from one budget to another

If the social security system is not thoroughly overhauled, some measures might simply shift expenses from one budget to another, depending on the economic development. The abolishment of subsidies for pension contributions for Hartz IV recipients (EUR 1.8 bn p.a.) is a good example. This measure will initially result in deficits in the pension system. These deficits will have to be financed by the pension system, i.e. either by hiking contributions (a step which is almost impossible) or by using its provisions (sustainability reserve). If the labour market situation deteriorates (a development which is rather improbable at the moment) the provisions will shrink and the deficit will ultimately have to be included in the federal budget. In the long run, the municipalities will have to spend more, as people who have been unemployed for longer periods of time (Hartz IV recipients) will have lower pension entitlements. This will trigger higher social-security benefits later on (for example for housing or basic pension benefits).

Extent of the burden on corporates still unclear

Direct and indirect impact on financial industry

The additional burden on companies of up to almost EUR 8 bn p.a. might have considerable implications, depending on how it is structured. Plans to introduce an international tax on financial transactions that would have hit the banking sector have ultimately failed after the G20 meeting in Toronto. At the European level, however, such a tax is still on the agenda. The bank levy is now to go into a separate restructuring fund and not into the general budget. A reintroduction of the preferential treatment of tax authorities in case of insolvency might hit the banks' interests as well. Claims of the remaining creditors – usually banks – would be reduced, and it might even become more difficult to save and restructure insolvent companies. If a company becomes insolvent, all creditors – suppliers, customers and employees as well as health insurers and the Federal Labour Agency – usually have to waive a large share of their claims in order to ensure that the company can continue its business on a sounder basis. Industrial and merchant companies in particular may have accumulated huge tax debts in times of crisis. As a result, most creditors might find it even more attractive than today to hedge their loans by pledges or other collateral.

Heavier burden on nuclear power industry

Other measures summarised under the keywords "subsidy cuts" and "having the companies bear part of the burden" are not very concrete either. Concerning the taxation of nuclear energy producers, the federal government has not made clear in either the budget draft or the financial planning until 2014 whether electricity suppliers will have to pay the new tax only if the running time of nuclear power plants is extended or whether the tax will be levied additionally to skim off profits. The government's statements are still contradictory. The fact that the new tax is expected to be levied from 2011 to 2014 suggests that it is intended to boost revenues further in addition to the extra revenues stemming from a possible lengthening of the power plants' running time. From an economic vantage point, it is interesting to ask who will ultimately have to shoulder the new tax. We believe that it will have to be borne by the power companies in full. While the new tax will increase nuclear power production costs, it will not have an effect on the volume of electricity production, as production costs of nuclear power plants are among the lowest. The point of intersection between the supply and demand curves will therefore remain unchanged, so more expensive fossil-fuelled (marginal) power plants will continue to determine prices. What is unclear as well is whether the Bundesrat (the second chamber of the German parliament) will have to agree to an extension of the nuclear power plants' lives. Whether running times are extended at all may well depend on this procedural issue. Various studies have produced differing assessments. Overall, the worst-case scenario for the energy companies would be one in which the new nuclear power tax is introduced and the old running time regulation remains in place.

Air travel: Levy <u>and</u> emissions trading?

The planned air travel levy for all passengers who take off from German airports is to remain in place until air travel is included in EU emissions trading (from 2012). In order to obtain the intended revenues (EUR 1 bn) the average ticket price will have to be increased by a low two-digit euro amount. A ministerial draft foresees a levy of EUR 13 per ticket for flights up to 2,500 km, and EUR 26 for flights over 2,500 km. For most business and many private travellers, this price increase would not be prohibitive. Nevertheless, all else being equal, demand for air travel would decline from some groups of customers (for example low-income families). Moreover, travellers who live near the German borders might prefer airports abroad that are not subject to the levy. This raises issues of competition policy. These two effects might reduce the receipts from the levy. Once all European air travel is included in the EU emissions trading system, the shifting effects described above will be prevented, provided that the national air travel levy is abolished at the same time. The government plans to obtain the targeted revenues of EUR 1 bn p.a. in 2013 and 2014 via CO_2 emission certificates, "if necessary". This wording leaves considerable room for interpretation and may mean that both instruments may be used, at least in 2012.

Attempt to minimise rent-seeking effects of exceptional tax breaks for energy-intensive companies

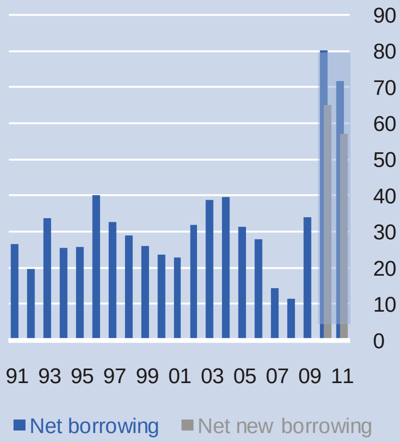
The review of exceptional energy tax breaks (about EUR 7 bn p.a., for example reduced electricity tax rates for chemicals, aluminium and steel producers) for industry or certain energy-intensive industrial processes might weigh on the international competitiveness of certain energy-intensive sectors, depending on how it is implemented. Above all, the government wants to reduce rent-seeking, which may occur if, for example, service providers outsource the maintenance of heating and cooling systems to separate associated companies which then benefit from the subsidies, as they are officially registered as industrial companies. Whether reducing rent-seeking is sufficient to obtain the envisaged receipts (EUR 1.5 bn) is doubtful. We will not know more until a detailed draft law is presented. Those who criticise the exceptional tax breaks also believe that the system introduced to smooth peak burdens should be abolished. Under this mechanism, industry may claim to have tax payments reimbursed if the burden from the eco-tax exceeds the relief from the reduction of employer contributions to the pension system (about EUR 2 bn out of 7 bn).

Volume and structure of consolidation package reflect balanced growth policy

The consolidation package pursues two goals at the same time. First, it aims to meet the rules of the EU Stability and Growth Pact, i.e. to reduce the fiscal deficit to less than 3% of GDP (the European Commission has said this must be the case by 2013 at the latest). Second, the new debt brake is to be complied with; this brake will enter into force from 2011. It permits a structural federal budget deficit of 0.35% of GDP from 2016. The structural deficit will have to be reduced steadily from 2011 in order to drop below 0.35% of GDP by 2016.

Previously, the federal government expected net borrowing of about EUR 80 bn in 2010. Thanks to persistently robust growth, however, tax receipts are higher and labour-market spending lower than expected, so the government now forecasts new debt of "only" about EUR 65 bn. The overall deficit is therefore likely to be closer to 4.5% of GDP than 5% this year. However, the consolidation package already takes this development into account. Estimates of the structural deficit are also no longer as high now as they were at the end of last year (about EUR 53 bn).

Net federal borrowing
EUR bn



Sources: BMF, DB Research 3

Still, net borrowing of EUR 65 bn this year (and EUR 57 bn next year) is a peak. Net borrowing will be up 50% from its former peak reached in 1996. While the savings required by the debt brake have declined somewhat as things stand today, they are still considerable – especially when the challenges of the demographic development are factored in.

A close look at the figures shows that claims from the US in particular (but also from some European partners) contending that the package would throttle the German economy, or even the international economy, are exaggerated. In fact, net savings are on the moderate side. In 2011, expenditure will be cut by some EUR 6 bn in comparison to 2010, i.e. roughly 1.9% of total federal government spending or 0.25% of GDP. At the same time the burden on business will be increased by about EUR 5.3 bn. Taken together, this is equivalent to less than 0.5% of GDP. In 2014, net savings of about EUR 17 bn and revenue increases of about

EUR 8 bn are foreseen, totalling (including interest payment savings) almost EUR 27 bn compared to the 2010 budget. In view of the recent, considerable increase in the government share in the economy, these savings are moderate. The dampening effect on growth should be minor, particularly since interest payments would rise considerably in the medium term if no austerity efforts were made. This, in turn, would weigh on investment and consumption. Moreover, surveys confirm that Germans tend to have a lower propensity to consume if they anticipate higher taxes and contributions on account of an increase in government debt.

Concrete decisions in autumn

No concrete decisions until autumn

The ministries have to draft the necessary legislation under the programme by the end of July so that the cabinet can adopt the measures in mid-August. The cabinet decision on the budget for 2011 was resolved recently. At least the totals for expenditure cuts and revenue increases have already been specified (however, the cabinet draft will not be sent to the Bundestag (the first chamber of parliament) until mid-August). Then, the consolidation package will go through the legislative procedure in parliament. This means that it will probably not be adopted by the Bundestag and the Bundesrat until autumn at the earliest. However, the measures of the package that are to enter into force by 2011 will need to be detailed at the time of the budget decision for 2011 at the latest, i.e. in December 2010.

Only a fraction of consolidation measures likely to require Bundesrat approval

In compiling the consolidation package the government obviously tried to avoid the involvement of the Bundesrat – much to the anger of the opposition, but in anticipation of the election result in North Rhine-Westphalia. In that federal state, the newly formed SPD-led minority coalition government of the SPD and the Greens has resulted in the federal government coalition’s losing its Bundesrat majority. At the moment, at least the federal government believes that only a fraction of the package (less than EUR 0.5 bn p.a. or less than 3% of the total volume) will need Bundesrat approval. However, much will depend on the concrete measures detailed in the laws. By 2014, i.e. after the end of the current parliament, an additional EUR 5.6 bn of savings will be necessary to comply with the debt brake. So far, however, these savings are only included as global amounts in the financial planning and will need to be detailed later on.

In terms of political economy, a highly comprehensive package makes most sense

In terms of political economy, the preferred option is a comprehensive package which abolishes as many exceptions and special regulations as possible at the same time. This increases the chance that any disadvantages an economic agent may suffer are compensated by advantages from another measure. Similarly, this raises the degree of political acceptance and feasibility. The credibility of political goals and the politicians who pursue them can also be boosted by cutting funding for favourite projects in order to show that there is no alternative to austerity.

Tax discussion to continue

Several debt reduction measures had been discussed ahead of the consolidation package. These included not only a more comprehensive dismantling of subsidies or tax breaks but also tax increases (for example of the top marginal tax rate or the property tax rate). Not many of these measures made it into the consolidation package. However, recent studies have shown that there are still many subsidies that could be trimmed – the tax breaks alone amount to about EUR 50 bn p.a. These include doubtful VAT exceptions – for example, income from the reduced VAT rate is estimated at about EUR 20 bn. Reviews of these rules and a reform of the municipalities' finances, which would cover a number of taxes, are on the coalition's agenda or have already been started with the introduction of reform committees. In the longer run, the intention to reduce the burden on medium income earners makes sense, too.

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