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**MTEF in Germany**  
**Medium-term Financial Planning in the**  
**Federal Republic of Germany**

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**PRESENTERS**



# Medium-term Financial Planning in the Federal Republic Germany

by  
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## 1. Introduction

This paper provides an overview of the federal government's medium-term financial planning in the Federal Republic of Germany.

Part A describes the historical development of medium-term financial planning since the 1969 budget reform as well as the need for and the objectives of such financial planning. The basic features of the content and of the planning period are outlined. Part B shows in detail which parties offer advice and help shape the medium-term financial planning and sketches the planning procedure. Part C takes as a specific example the current budget preparation procedure to demonstrate how financial planning can be realised in the same cycle.

## 2. Principles of medium-term financial planning

### A. Historical development

The 1969 budget reform set up a mandatory, standardised framework for the budget law of central and regional government. For one thing, the budget provisions in the Basic Law of the Federal Republic of Germany (Sections 109 to 115) were revised. For another, the Law on Budget Principles was passed. The Law on Budget Principles contains the common principles which the federal government and the Länder must follow in managing their budgets. The Law on Budget Principles provides the substructure upon which is built both the Federal Budget Code of the German federal government, and the Land budget codes of all the federal States (Länder) of the Federal Republic of Germany.

The principal innovations introduced by the budget reform in conjunction with the Law to Promote Economic Stability and Growth (StWG), which had already entered into force in 1967, were the following:

- In their budget management, the Federation and the Länder are enjoined to take account of the requirements of macroeconomic equilibrium (stable prices, a high level of employment, and external balance accompanied by steady and adequate economic growth) (Article 109 (2) GG).
- Revenue from borrowing may not exceed the total expenditure for investment provided for in the budget estimates (Article 115 GG). Exceptions to this rule are permissible only to remedy a serious and sustained disturbance of macroeconomic equilibrium.
- The Federation and the Länder each base their respective budget management on a financial plan covering a five-year period (Section 50 of the Law on Budget Principles - HGrG).
- A financial planning council chaired by the Federal Ministry of Finance (FMF) was set up to submit recommendations for co-ordinating the financial plans of

the Federation, the Länder, the communes and associations of communes (Section 51 HGrG).

- In order to ensure that the budgets of the federal government, the Länder and the local authorities can be judged by uniform criteria, a standardised budget system was developed with the following characteristics:
  - system of classification by object: a three-tiered list; revenue and expenditure are classified by **categories** (for example tax revenue, staff expenditure, interest payments and investment expenditure)
  - system of classification by function: a three-tiered list; expenditure and revenue are classified according to **tasks of public administration** (e.g. defence, environmental protection and conservation, health)

Since this reform, adopting an approach geared to the medium term has become a matter of course in all sectors of budget and fiscal policy. As employed by the FMF, the financial plan has become a useful tool for fending off excessive demands on the budget. The obligation to draw up a financial plan each year reinforces awareness within the federal government of the need for fiscal discipline and responsible budget policy and helps to ensure a balanced fiscal policy. In this way any need for fiscal policy action can be identified at an early stage.

Though financial planning is a valuable instrument, it cannot guarantee the implementation of a sound fiscal policy.

## **B. The need for medium-term financial planning**

Medium-term financial planning is necessary in order to be able

- to take account of likely developments in public finance in the medium term when making the decisions incorporated in the yearly budget;
- to identify at an early stage the financial impact of new measures, reform projects, statutes and the like;
- to assess in good time the scope available for fiscal policy action in future years;
- to identify in good time undesirable fiscal policy trends with longer-term impact and to counter them at an early stage.

## **C. Object of financial planning and planning period**

"Financial planning" is taken to mean the actual process of planning, whilst the "financial plan" is the outcome of this process.

Financial planning is detailed:

Financial planning comprises the detailed planning by budget title of **all** individual revenue and expenditure positions included in the budget in the planning period, that is, not just aggregate figures for total revenue and expenditure. Currently these comprise about 1,100 revenue titles and about 5,300 expenditure titles, grouped in chapters and departmental budgets.

Financial planning is comprehensive:

It includes expenditure which can already definitely be earmarked, and provision for risks which loom in the medium-term planning period. Sound financial planning includes reserves as well.

Financial planning has a macroeconomic orientation:

It is based on the medium-term projection of aggregate economic development produced by the federal government in April of each year. From this, calculations can be made in particular of labour market expenditure on the spending side and of tax revenue on the receipts side. In addition, for revenue planning the figures produced by the Working Party on Tax Estimates are also consulted. This working party consists of experts from the federal and Land governments as well as independent experts.

The financial plan is not a fixed five-year plan of the type used in planned economies, rather, it is a rolling plan:

Each time the budget is prepared, the federal government's financial planning is also brought up to date by the Federal Ministry of Finance and rolled forward by one year. In concrete terms this means that at the same time as preparation of the 2005 federal budget is now getting underway, work is also starting on converting the currently valid 2003-2007 financial plan into the 2004-2008 financial plan.

The planning period covers five years:

- the current fiscal year (now: 2004)
- the draft budget for the next fiscal year (now: 2005)
- three more genuine planning years (now: 2006-2008)

A five-year period has shown itself to be most practicable. A longer planning period would involve too many uncertainties.

For comparison purposes, the published financial plan ought to be drawn up according to the same system as the budget. In the German financial plan as published, expenditure is presented in about 40 categories put together in accordance with functional considerations. However, all medium-term planning data on roughly 5,300 expenditure and some 1,100 revenue titles in the budget are available within the administration.

The financial plan is a government plan. It is negotiated and revised title by title with the ministries. Then it is summarised into main categories and submitted to the legislative bodies together with the government's draft federal budget for the next fiscal year. There is no need for the financial plan to be adopted by the legislature (unlike the budget). It is submitted to parliament for information only.

## **2. Participants and procedures in the medium-term financial planning of the German federal government**

### **A. Participants**

The federal government's medium-term financial planning is under the overall control of the Budget Directorate-General of the Federal Ministry of Finance. All relevant information is brought together in the Policy Division for the Federal Budget. In order to identify undesirable trends at an early stage and react appropriately, the financial planning is continuously being updated within the government. But only once a year - in the course of the budget preparation for the next calendar year - is a new financial plan drawn up and presented to the legislative bodies.

The relevant divisions in the Budget Directorate-General are responsible for individual departmental sections and chapters of the budget. Early in the year they start

re-evaluating the individual budget titles and estimating the risks connected with them. Later in the budget preparation procedure they will have to negotiate their estimates at working level with the departments for which they are responsible.

### ***Financial Planning Council***

The necessary co-ordination of the budgets and financial plans of the different levels of government is undertaken in the Financial Planning Council. This is a co-ordinating body at ministerial level with the FMF in the lead, comprising in particular the finance ministers of the Länder and representatives of the associations of communes. Representatives of the Deutsche Bundesbank may participate in the consultations. The Financial Planning Council meets twice a year (spring / autumn). These meetings strive to reach agreement on future spending policy, which can also find expression in agreements on expenditure ceilings.

### ***Working Party on Tax Estimates***

Estimates of future revenue are based on the estimates (spring / autumn) drawn up by the "Working Party on Tax Estimates", meeting each year in May. This body includes representatives of all the financial and economic experts in Germany:

- Federal Ministry of Finance
- Finance Ministries of the Länder
- Six leading economic research institutes
- Federal Statistical Office
- Deutsche Bundesbank
- Board of Experts for the Assessment of General Economic Trends
- Federal Union of Central Associations of Local Authorities

## **B. Procedure**

At the start of the calendar year, which is also the start of the budget preparation year, the financial plan is updated based on the actual figures of the fiscal year which has just ended. As the new budget is prepared, the individual revenue and expenditure titles must be re-evaluated. At the same time, during this process account is also taken of the risks and of any changes in the law. In this way it is then possible to roll the individual titles forward for another three years and to evaluate them on this basis.

Once a first compilation has been made, the financial plan is first analysed internally by the Federal Ministry of Finance in order to identify any need for action in areas in which particularly strong increases or undesirably high expenditure are expected. This information may be input into the development of the policy guidelines of the federal government.

At issue in the budget negotiations between the Federal Ministry of Finance and the departments are the budget estimates for the coming fiscal year and also simultaneously the financial plan. Thus the planned figures for next fiscal years are debated within the government between the Federal Ministry of Finance and the other federal ministries. The results of this process of consultation result in a further adjustment of the financial plan.

It is essential for expenditure and revenue to be brought into line with the aggregate productive capacity of the national economy. To this end, planning must be based on a medium-term projection of key macroeconomic data, which can enable a forecast to be made in particular of tax revenue and expenditure for the labour market.

In the German system of financial planning, a forecast of aggregate economic development is made for the first two years of the planning period, taking account of discernible trends in economic activity. The medium-term projection of the envisaged development of the economy in the last three years of the planning period deliberately makes no allowance for fluctuations in the level of economic activity.

Based on this macroeconomic projection, the Working Party on Tax Estimates produces a forecast of tax revenues in the financial planning period.

### **C. Links between the medium-term financial planning of the federal government and of the Länder**

All Länder and communes in the Federal Republic of Germany are obliged to draw up a financial plan.

In a country consisting of a federation of states, the fiscal policies pursued by the different levels of government must be co-ordinated in the interest of achieving the envisaged development of the economy as a whole. To this end, the financial planning data of all levels must be combined in an aggregate public-sector budget. This means that the budgets and financial plans of public authorities must be comparable and must in particular employ a standardised system of budget classification.

As a member of European monetary union, the Federal Republic of Germany must fulfil certain criteria concerning the general government deficit (no more than 3% of gross domestic product) and the total amount of public-sector indebtedness (no more than 60% of gross domestic product).

Since in Germany the Länder and the federal government are autonomous and independent of each other in their fiscal administration (Article 109 Basic Law), they need to reach mutual agreement on their spending policies if the "Maastricht criteria" are to be fulfilled. For this reason the Law on Budget Principles had added to it the new Section 51 a, which sets up the so-called "national stability pact".

This development has lent increased importance to the Financial Planning Council, as this has become the body in which the budgetary developments of the federal government and of the Länder are discussed and in which recommendations for the observance of fiscal discipline are drawn up. Spending policies are discussed twice a year in the meetings of the Financial Planning Council, and - if possible - agreement is reached.

The comparability of the data is based on the arrangement of the budget system, a standard which is equally binding for the federal government and the Länder; it formed part of the 1969 budget reform and is laid out in the Law on Budget Principles.

## **3. Medium-term financial planning in the budget preparation procedure**

In view of the close links between the budget and the financial plan it is expedient for the latter to be drawn up at the same time as the yearly budget. The financial plan then serves a year later as starting-point and guideline for preparing the new draft budget and the new financial plan.

### **A. Introduction**

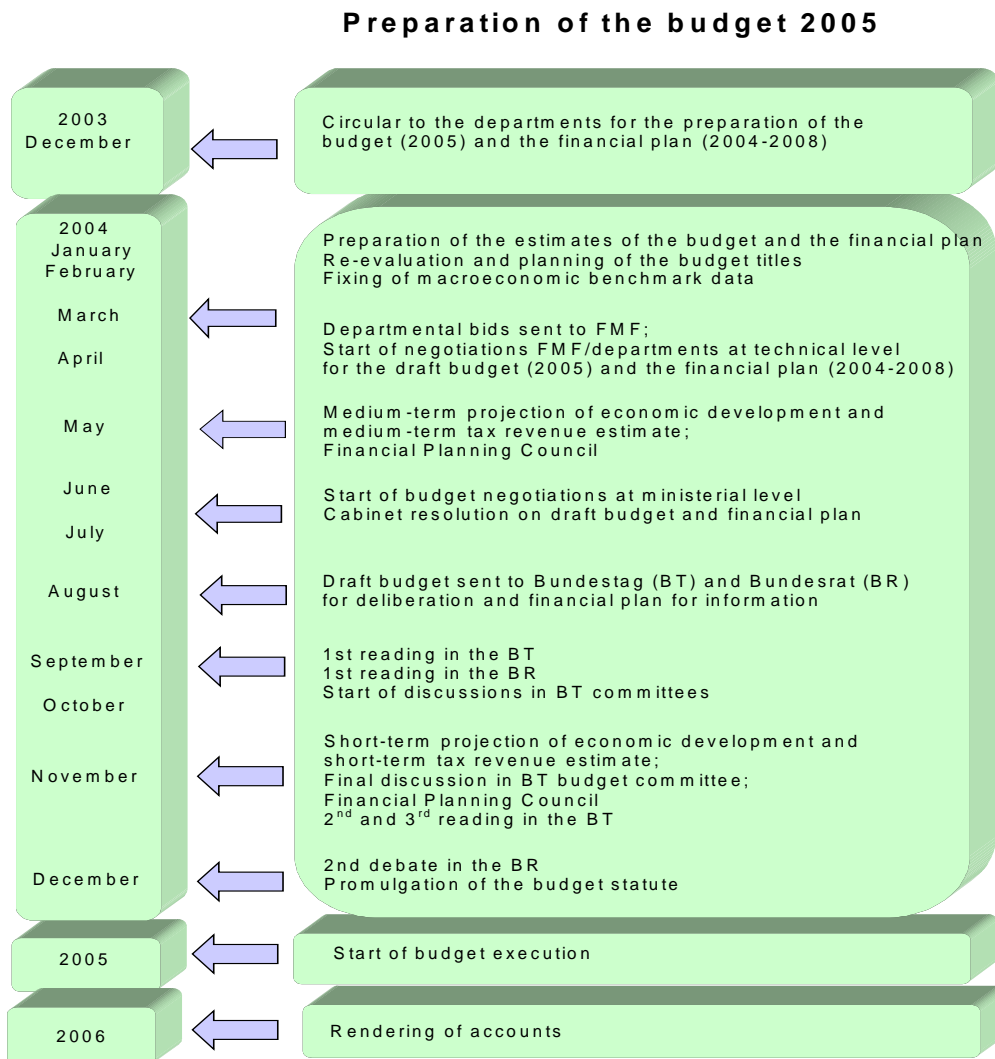
The Federal Ministry of Finance (FMF) is responsible for the budget preparation procedure. The procedure begins one year before passage of the budget law with a circular to all government departments to submit their bids / estimates to the FMF.

In accordance with the arrangement of the budget system, as set forth in the Federal Budget Code (BHO), the budget is subdivided into departmental budgets, chapters and titles. The departmental budgets contain the funds appropriated for the ministries. They are subdivided into chapters for the ministry, general appropriations, subordinate authorities etc. Each chapter is subdivided into titles, which are the smallest subdivisions in the budget.

At present the federal budget comprises approximately 1,100 revenue titles and 5,300 expenditure titles, grouped together in chapters and departmental budgets. These titles are subject to ex-ante control in medium-term financial planning and in the budget preparation procedure. After the close of the fiscal year, they are audited by the Federal Court of Audit (FCA) to see if they were managed effectively.

## B. Schedule

The budget preparation procedure may be seen from the following diagram:



### **C. Issued and negotiation of the medium-term financial plan**

After the circular on the preparation of the budget has been sent to the departments, the preparations for the medium-term financial planning begin in the FMF. This includes a stocktaking of the finished titles of the fiscal year which has just come to an end and the forecast of future expenditure based on the individual titles. The tax estimate of the previous autumn as well as discussions of the Financial Planning Council form the first foundation for the macroeconomic benchmark data.

The bids / estimate of government departments are submitted to the FMF in the spring and are checked against the principles of need, conformity with regulations and economy.

These principles also guide the negotiations which follow at working level with the departments on the draft budget and the financial plan. The divisions assigned to examine the titles ("twinned" divisions) are independent of the departments and are subordinated through the Budget Directorate-General to the executive level of the FMF (Finance Minister and State Secretaries).

Any issues that cannot be settled at this level are the subject of further negotiations at directorate or ministerial level. This process is aimed not only at bringing together the positions of the FMF and of the departments. At the same time, the macroeconomic benchmark data must be reconciled with the detailed, title by title planning in the draft budget and with the financial plan. This is an iterative process in which each and every individual title is negotiated between the FMF and the department concerned and rolled forward for the financial planning period, so that within the administration medium-term planning data is available for all the expenditure and revenue titles. The law - the Federal Budget Code - requires that a realistic estimate be made for every budget title, so the key data of the starting position may have to be corrected. In this process, more recent data is provided by the macroeconomic projection in April and the latest tax estimate in May.

After having been adopted by the cabinet (June), the draft budget is submitted to the Bundestag and the Bundesrat for consultation. In addition to the draft budget, the federal government's financial plan (scope and nature of expected revenue and expenditure over a five-year period; Section 9 StWG) is also presented. However, the Bundestag and the Bundesrat merely take notice of the financial plan.

At this point in the budget preparation procedure, the medium-term financial planning has been completed. The parliamentary procedure concerns only the draft budget for the coming fiscal year.

### **D. Consideration of the draft budget in the Bundestag**

After the first parliamentary reading in the Bundestag, the draft budget is referred to the Budget Committee of the Bundestag, which takes charge of the subsequent deliberations.

The Budget Committee scrutinises all the estimates and, where necessary, submits proposals for amendment. The decisions of the Budget Committee are prepared by a number of committee members. The rapporteurs / co-rapporteurs of the Budget Committee discuss the draft budget with representatives of the supreme federal authorities concerned and of the FMF and the Federal Court of Audit (FCA). Proposals submitted by the rapporteurs form the basis of deliberations in the Budget Committee and are adopted in most instances. A detailed debate is generally held in the Budget Committee if the rapporteurs and co-rapporteurs are unable to reach agreement on specific points or if an issue is of such fundamental significance as to require to be dealt with by the Budget Committee itself.

The comments of the specialised committees and of the Bundesrat are taken up in the deliberations of the Budget Committee. Issues that cannot be finally disposed of when the departmental budgets are considered by the Budget Committee are shelved until the so-called "settlement" session. This is usually held in November, and marks the conclusion of the Budget Committee's deliberations on the draft budget. The FMF submits documentation for decisions to be taken in the settlement sessions combining all the deferred issues and other matters on which it considers a decision necessary (the so-called settlement items).

This is followed by the second and third readings of the budget law in parliament, during which minor amendments are made, and the final debate in the Bundesrat.

#### **4. Conclusion**

Medium-term financial planning in the Federal Republic of Germany has proved to be an effective instrument in the quest for a stable fiscal policy.

It is based essentially on the fact that each of the approximately 6,400 revenue and expenditure titles are re-evaluated at the start of the budget preparation procedure and planned for the next four years, taking into account the expected risks. At the same time the Federal Ministry of Finance evaluates the overall economic situation of the country on the basis of the macroeconomic data. In this way the German federal government gains an exact picture which is determined by the macroeconomic climate and which also takes detailed account of future revenue and expenditure.

On the one hand the analysis of these data makes it possible to identify any fiscal policy action which needs to be taken by the government. On the other hand from the negotiation of the financial plan with the departments in the budget preparation procedure there emerges a target specification on the expenditure ceilings for the coming years. The financial plan forms the basis for the budget preparation and facilitates the budget negotiations in the following years.