

## Public finance

### Central, regional and local authorities

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#### Trends in the fourth quarter of 1997

According to the data available so far, the financial situation of the central, regional and local authorities improved considerably in the final quarter of 1997 compared with the same period in 1996 after the cumulative deficit in the first nine months of last year – at DM 70 ½ billion – had more or less matched the comparable figure in the corresponding period of 1996. The trend in tax revenue towards the end of 1997 was not quite as unfavourable as it had been previously, while the growth in other revenue appears to have been quite strong, mainly owing to sizeable asset disposals. A further factor was the continuing determination of public authorities to curb spending as much as possible.

*Overall situation*

Although the overall trend in tax revenue remained relatively weak at the end of 1997, the trends relating to certain tax categories brightened perceptibly. All in all, tax receipts<sup>1</sup> in the fourth quarter of 1997 were 1¼% greater than in the same period of the previous year, after failing to reach the corresponding 1996 level in the first three quarters.

*Taxes as a whole*

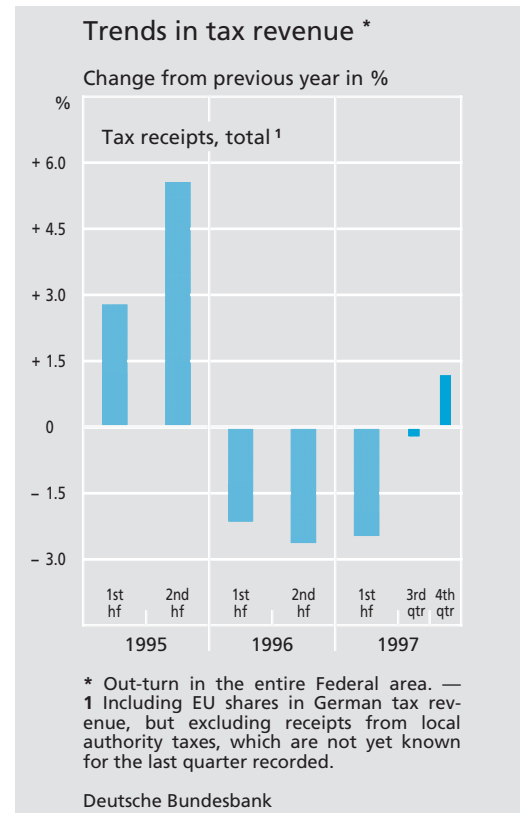
The decline in tax revenue came to an end in the latter stages of the period under review thanks to a remarkably favourable out-turn in respect of assessed taxes. Thus receipts from assessed income tax rose by 12% in the fourth quarter, while corporation tax yielded

*Assessed taxes*

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<sup>1</sup> Including EU shares in German tax revenue, but excluding receipts from local authority taxes, which are not yet known.

as much as 42% more than in the same period of 1996. This buoyant growth was due to various factors. For one thing, the comparison over 12 months was favourably affected by the fact that at the end of 1996 the level of prepayments of both taxes had been fairly low – apparently not least because many individuals and enterprises had taken advantage of the special 50% depreciation allowance for investment in eastern Germany (before these rates were substantially curtailed at the turn of 1996-7). For another thing, the prepayments made by many firms at the end of 1997 seem to have been distinctly larger than at the end of 1996 on account of their improved profitability. An additional factor was that larger final tax payments for earlier years were likewise received in the wake of a favourable profit position.



*Wage tax*

By contrast, the amount received from wage tax was again below the previous year's level (-1 ¼%). The trend in wage tax continued to be affected by the raising of child benefit at the beginning of 1997, which reduced the yield from this tax. Even after eliminating this tax-reducing factor, however, wage tax receipts were merely on a par with the 1996 figure. The sluggish revenue trend continued to reflect the decline in the number of employed persons, which was accompanied by only a small increase in average earnings – resulting *inter alia* from the lower Christmas bonus payments in many industries.

*Turnover tax*

The trend in the revenue from turnover tax, too, was again unfavourable; following a slight rise in the preceding months, the amount raised in the fourth quarter barely in-

creased at all. This stagnation was due primarily to weak domestic demand; the yield from turnover tax was depressed by the level of private consumption and by lower investment in the residential construction sector and in the public sector, which in both cases is subject to tax.

The more favourable financial result recorded by the central, regional and local authorities in the final months of last year was predominantly attributable to the Federal Government. The Federal Government's financial position showed a deficit of just over DM 4 billion in the fourth quarter, whereas 12 months previously the deficit had stood at minus DM 23 billion. The spending figure fell by just over 6 ½% compared with the fourth quarter of 1996; this was partly due to the fact that the

*Federal fiscal balance*

Federal Labour Office refunded previously paid grants, whereas in the fourth quarter of 1996 the Federal Government had made payments amounting to DM 1¾ billion. Receipts were 8% greater than in the same period of 1996. Although tax receipts went up by only 3½%, other revenue climbed by a total of two-thirds, owing *inter alia* to higher privatisation proceeds.

Länder  
Governments

It is likely that the deficit recorded by the Länder Governments in the fourth quarter of 1997 roughly matched the total of DM 21 billion which they had run up during the same period of 1996. Although the Länder Governments' spending, by virtue of their resolute retrenchment policy, almost certainly did not exceed the previous year's level, the trend in their revenue likewise remained weak, mainly owing to the level of tax receipts which, notwithstanding a revival towards the end of the period under review, was still disappointing. No figures are available on the out-turn of the local authorities in the last quarter of 1997.

Net borrowing

New public sector borrowing between October and December 1997 totalled DM 23½ billion; this was fairly low if one considers that borrowing usually reaches its peak in the final months of the year. In the first three quarters of 1997 public authorities had borrowed DM 73½ billion net. In the fourth quarter the Federal Government repaid money market loans amounting to DM 11½ billion. By contrast, the level of capital market debt incurred by the central, regional and local authorities grew by DM 35 billion; three-fifths of this sum took the form of loans from

Trend in the revenue from major taxes

Type of tax	Revenue in DM billion		Change from previous year in %
	1996	1997	
	Full year		
Wage tax	251.3	248.7	- 1.0
Assessed income tax	11.6	5.8	- 50.4
Corporation tax	29.5	33.3	+ 12.9
Turnover tax	237.2	240.9	+ 1.6
	of which: fourth quarter		
Wage tax	76.1	75.1	- 1.3
Assessed income tax	4.6	5.1	+ 12.0
Corporation tax	7.4	10.5	+ 41.7
Turnover tax	62.7	62.9	+ 0.3

banks against borrowers' notes, with the remainder being raised by sales of securities.

Net borrowing by the Federal Government came to only DM 3½ billion in the final quarter of 1997; this low overall volume masked considerable changes in the individual segments, however. As the Federal Government was obliged to refinance the aforementioned redemption of money market loans in the capital market, its funding from that quarter amounted to a sizeable DM 15 billion. Specifically, the Federal Government sold large amounts of bonds (DM 16½ billion net) and Federal Treasury notes (just under DM 5½ billion net), whereas the amount of five-year special Federal bonds outstanding decreased by DM 10 billion net as a result of substantial scheduled redemptions. At the same time,

the Federal Government had recourse to loans against borrowers' notes to the extent of just under DM 3 billion. The principal borrowers in the fourth quarter were the Länder Governments, which tend to have particularly large borrowing requirements in the last few months of the year. Their new borrowing of DM 18½ billion focused on the raising of loans against borrowers' notes. The net borrowing of the local authorities was likewise fairly high, at an estimated DM 3½ billion. Of the special funds, the "German Unity" Fund and the Federal Railways Fund redeemed just over DM 1½ billion and just under DM 1 billion, respectively, whereas the Redemption Fund for Inherited Liabilities borrowed DM ½ billion net.

#### Provisional out-turn for the year 1997

##### *Overall result*

Last year the central, regional and local authorities made progress in the field of consolidation. Their deficit (as measured in the budgetary accounts), which had amounted to just over DM 120 billion in 1996, fell by around DM 20 billion in 1997 according to the figures available to date. An improvement was also achieved by the social security funds, which recorded a surplus after closing the previous year with a deficit of DM 13 billion. The two main factors responsible for this were the sharp increase in the pension insurance contribution rate and the cost-saving measures, particularly in the health sector.

##### *Tax revenue remains low*

It was the persistently low level of tax revenue, above all, that prevented the public sector deficits from being reduced even more. Tax revenue in 1997 came to DM 796

billion<sup>2</sup>, which was ½% lower than the previous year's result. The tax estimate of November 1996, on which the budget plans were largely based, was undershot by DM 35 billion. These shortfalls can be explained to some extent by macroeconomic factors. For example, employment developed far more unfavourably than had been expected in November 1996, and this considerably depressed wage tax receipts. The amount raised from this tax decreased by 1%, partly as a result of the increase in child benefit; but even after allowing for this factor, wage tax receipts grew by only 1½%. Furthermore, the sluggish domestic demand led to lower revenue from value added tax.

But more important than the macroeconomic influences and the temporary losses due to the abolition of wealth tax were the aforementioned structural factors which led to an erosion of the tax base. The most graphic example of this was the trend in assessed income tax, in which rebates to wage tax payers further curtailed receipts; the revenue from this tax fell by one-half to only DM 5¾ billion. Corporation tax receipts were likewise below original expectations, even though they did grow by 13% in 1997 as a result of the higher corporate profits.

The public authorities sought to counter the surprisingly large tax shortfalls by further tightening their retrenchment policy on the expenditure side. Thus in implementing their budgets, the Federal Government and many Länder Governments introduced freezes on

*Tighter  
retrenchment  
policy*

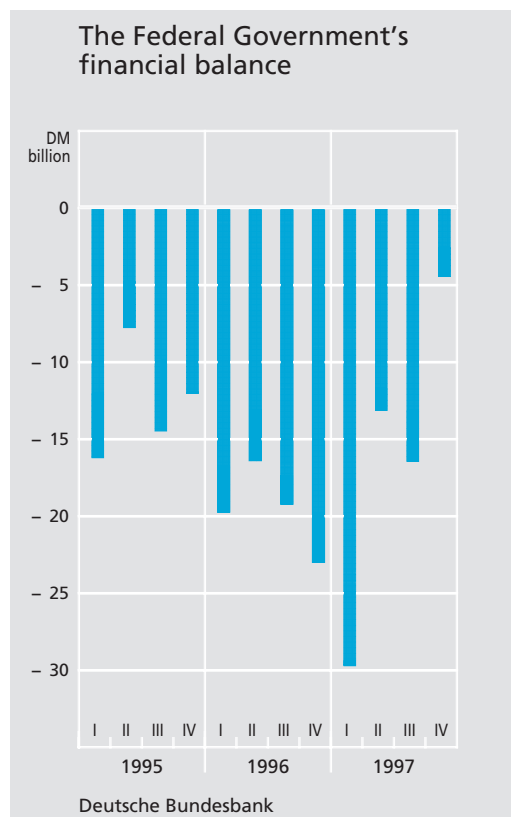
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<sup>2</sup> According to the provisional result, which includes an estimate for the local authority taxes.

expenditure not tied to statutory obligations. According to the data available at present, the overall spending volume in 1997 did not exceed that of 1996. Little more was spent than in the previous year on either government consumption (i.e. expenditure on personnel and operating expenses) or current transfers. While interest paid grew by an estimated 2% to 3%, this rise was quite moderate given the fact that debt had been expanded by 6½% in 1996. The central, regional and local authorities were helped in this instance by the persistently low interest rate level, which enabled them to refinance expiring debt at far lower rates. The biggest impact achieved by the retrenchment policy came in the field of expenditure on tangible fixed assets. This item of expenditure, which is fairly easy to influence, was reduced for the fifth year in a row; however, this development is not consistent with the requirement of a "qualitative consolidation".

*Federal  
financial  
position*

The Federal Government envisaged a deficit of DM 53½ billion in its budget plan for 1997, representing an improvement of DM 25 billion on the 1996 result. But the additional burdens (compared with the budgeted figures) which had already become apparent in the first few months of 1997 and the associated extra borrowing requirements necessitated a supplementary budget. Following radical changes to the draft proposed in July 1997, the final version of this supplementary budget was adopted by the Bundestag at the end of November together with the budget for 1998. This supplementary budget set the expected deficit DM 17½ billion higher at DM 71 billion. Shortfalls of DM 15 billion re-



sulting from the two revisions of the tax estimate and additional labour-market-related spending of DM 17 billion produced an extra fiscal gap of no less than DM 32 billion vis-à-vis the original budget plan; however, this figure was partly offset by a cut of DM 6 billion in the transfers to the Redemption Fund for Inherited Liabilities, additional savings likewise amounting to DM 6 billion and an increase of just over DM 2 billion in revenue from other sources.

In the event, the deficit sustained in 1997 was DM 63½ billion, which was DM 7 billion smaller than the amount envisaged in the supplementary budget and DM 15 billion less than the 1996 deficit. Whereas the decline of just over 2% in tax revenue roughly matched the revised expectations, other revenue ex-

ceeded the budgeted amounts by DM 3 billion. The principal reason for this was the repayment – not included in the 1997 budget – of development grants to the aviation industry. The forecast spending totals were undershot by around DM 3 billion net, thanks mainly to the Federal Labour Office, which required DM 2½ billion less than expected. On balance, spending in 1997 was just over 2 % lower than in 1996.

*Länder  
Governments*

The deficits incurred by the Länder Governments were not as large as in 1996 (DM 46 billion) but nevertheless substantially exceeded the original projection of DM 32 billion. The fiscal position of the Länder Governments, like that of the Federal Government, was depressed by large tax shortfalls which amounted to DM 16 billion compared with the tax estimate of November 1996 on which the original budget plans were largely based. A major factor was the losses which were caused by the abolition of the wealth tax and which, contrary to the original expectations, were not offset by correspondingly greater amounts from inheritance tax and from the land and buildings transfer tax. The Länder Governments were unable to close the resulting additional gap completely despite intensified cost-saving efforts and sales of assets. Nevertheless, they succeeded in limiting the increase in total expenditure to approximately 1%. However, this was achieved in part by cutting grants to local authorities.

*Local  
authorities*

To date only the results for the first three quarters of 1997 are available for the local authorities; during that period their deficit rose by DM ½ billion from its level at the end

of the first nine months of 1996 to DM 5½ billion. The main reason for this was that receipts – largely as a result of the reduction in grants from the Länder Governments – fell more than 3½ % short of the previous year's level.<sup>3</sup> On the other hand, expenditure was also reduced by almost 3½ %. This owed something both to lower investment costs and to the enlargement of the range of services provided under the statutory nursing insurance scheme from mid-1996, which eased the cost burden on local authorities arising from social assistance benefits. As the latter factor became less and less significant in the second half of 1997 for the 12-month comparison, the trend in the local authorities' deficits probably worsened towards the end of the year. Hence the combined municipal deficit, which had amounted to DM 6½ billion in 1996, presumably increased last year.

*Special funds*

The special funds customarily end the year with a considerable surplus, especially as the Redemption Fund for Inherited Liabilities and the "German Unity" Fund pay off debt on balance. But in 1997 this surplus was probably smaller than in the previous year (DM 12 billion). The principal reason for this was the aforementioned reduction in the Federal transfers to the Redemption Fund for Inherited Liabilities, although this was offset to some extent by exceptional income which accrued to that special fund from payments received in respect of claims of east German banks that had previously been written off.

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<sup>3</sup> Some municipal services continue to be provided by independent associations or enterprises. This reduces both local authorities' revenue (especially fees and charges) and their spending (in particular, staff costs, operating expenses and investment).

The ERP Special Fund, which likewise plays a fairly substantial role in the overall fiscal position of the special funds, probably ended 1997 with a small deficit, primarily as a result of increased lending, after recording a surplus of DM 1 billion in the previous year.

### Budget plans for 1998

#### *Tax estimate*

The budget plans of the central, regional and local authorities for the current year are aimed at further reducing the deficits. This task is being made harder by the fact that the sluggish trend in tax revenue looks set to persist. Although nominal GDP is expected to grow by 4½%, the "Tax Estimates Committee" forecast at its meeting in November that tax revenue would rise by only 2½%. That tax estimate did not take account of the fact that the standard rate of value added tax is to be raised from 15% to 16% from the beginning of April 1998. The extra revenue, which for 1998 is put at around DM 9½ billion and in the full year 1999 is likely to yield DM 15½ billion, is to be used to finance an additional Federal grant to the statutory pension insurance scheme so as to obviate the need to raise the pension insurance contribution rate this year.

Even after taking into account the increase in value added tax, which will more than offset the tax reductions through the lowering of the solidarity surcharge by 2 percentage points and the further rise in the basic personal tax allowance, tax revenue will presumably grow by no more than approximately 3½% and hence more slowly than nominal GDP. One reason for this is that exports,

which are not subject to turnover tax, are likely to remain the principal generator of economic growth. Another reason is that the intensive utilisation of tax allowances will continue to limit the amount of tax raised, a tendency that is especially noticeable in the field of assessed taxes. Just how adversely the disappointing tax out-turns are affecting the budget plans for 1998 is shown by the fact that the central, regional and local authorities are having to accommodate shortfalls amounting to DM 22½ billion compared with the tax estimate which was made in May and on which the first budget drafts were largely based, despite virtually identical growth assumptions and before taking account of the changes in tax law; this corresponds to roughly one-fifth of the deficits which they recorded last year.

In view of these lower receipts, the budget plans of the public authorities once again include curbs on the growth of expenditure. On balance, public expenditure is to exceed the 1997 level by only 2%; it should be borne in mind in this context that interest payments are likely to rise quite sharply as a result of the heavy new borrowing last year. Whereas government consumption and transfers are set to grow – albeit by a small margin – expenditure on tangible fixed assets is again to be reduced.

#### *Spending plans*

The 1998 Federal budget, which came into force on schedule at the beginning of the year, foresees a deficit of DM 56½ billion, which is DM 7 billion lower than the fiscal gap recorded at the end of 1997. This decline is attributable to the exceptionally large pri-

#### *Federal budget*

atisation proceeds which are planned and which, at DM 32 billion, are DM 24 billion above the actual amount yielded in 1997. Consequently, the Federal Government's overall revenue is forecast to grow by just under 6% even though almost no growth is expected in tax receipts – mainly because of the lowering of the solidarity surcharge by 2 percentage points. A rise of 3% is envisaged on the expenditure side compared with last year's actual out-turn – which was lower than the projected figure. The Federal budget takes no account of the "rechannelling" of funds into the statutory pension insurance scheme, which was agreed by the German Parliament in December. These measures will increase both tax receipts and the grants to the pension insurance scheme by around DM 9½ billion; the projected deficit remains unchanged.

*Länder  
Governments'  
budget plans*

Most of the Länder Governments' budget plans for 1998 have now been adopted. They provide for a significant reduction in the deficits to around DM 30 billion. This is to be achieved, in particular, by a rigorous retrenchment policy restricting the growth in spending to only 1% over the target figure for 1997. A key element of this policy is that the transfers to local authorities are to fall below last year's level. The rise in staff costs, which account for a substantial portion of the Länder Governments' budgets, is to be limited to just over 1%. On the other hand, an increase of around 5½% is envisaged for interest payments. On the income side, it is assumed that tax receipts will grow by 2½% compared with last year's budgeted figure. As in 1997, the Länder Governments are at-

tempting to procure additional financial resources through increased privatisation, although this can provide relief only in the short term. Whether the Länder Governments manage to reduce the deficits as planned depends not only on the uncertainties associated with the tax estimate but above all on whether the moderate pay policy pursued in the public sector last year is continued.

The only data available so far on the budget plans of the local authorities are those contained in the annual survey of their central associations. These figures point to a slight deterioration in the financial position of the local authorities. The expected decrease in the transfers from the Länder Governments, which play a major role in municipal budgets, will depress revenue. Despite a rise of about 4% in tax receipts, therefore, virtually no growth is expected in income as a whole. Expenditure is to grow a little following last year's decrease. An important consideration in this context is that no additional savings can be expected on social assistance payments through the introduction of the second phase of the statutory nursing insurance scheme. Expenditure on tangible fixed assets is to be curbed once more although the size of the cut – at 4% – is to be somewhat lower than in 1997.

*Outlook for  
local authority  
finances*

### **Social security funds**

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In the fourth quarter the wage and salary earners' pension insurance scheme generated a large surplus through contributions by vir-



*Wage and salary earners' pension insurance scheme in the fourth quarter...*

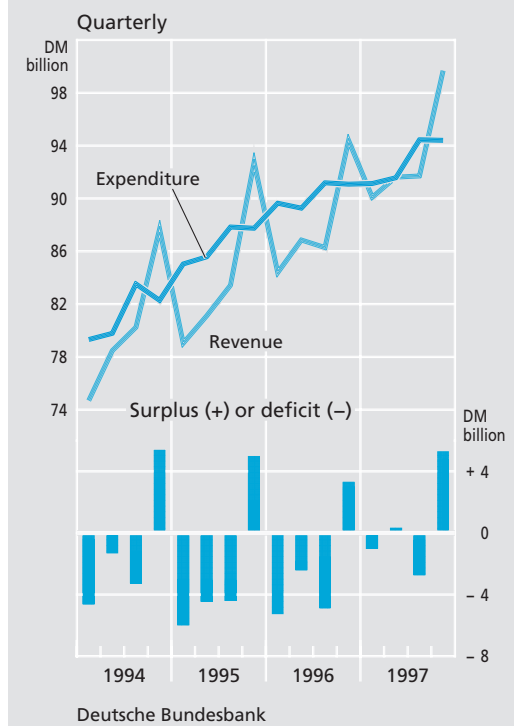
tue of the exceptional payments that are concentrated at the end of the year; at almost DM 5½ billion, it was around DM 2 billion higher than the surplus recorded in the final quarter of 1996. This was mainly attributable to the raising of the contribution rate from 19.2 % to 20.3 % at the beginning of 1997, as a result of which receipts from compulsory contributions grew by just over 5 %. Without that increase in the contribution rate, receipts would have fallen slightly, mainly as a result of the unfavourable employment trend. With payments from the Federal Government also rising steeply, total receipts went up by just over 5½ %.

Spending climbed by a little over 3½ % in the fourth quarter. Pension payments went up by 4 %, i.e. much faster than the general increment awarded in the middle of the year (1.65 % in western Germany and 5.55 % in eastern Germany<sup>4</sup>). The chief factor fuelling expenditure was the further increase in the number of pensions. By contrast, the cost burden borne by the pension insurance institutions was eased by the statutory restrictions in respect of rehabilitation measures; spending on this item in the last three months of 1997 was one-quarter below the previous year's level.

*... and in 1997 as a whole*

The financial position of the pension insurance scheme in 1997 as a whole improved considerably thanks to the consolidation measures taken, especially the sharp increase in the contribution rate. The year ended with a surplus of DM 1½ billion, compared with a deficit of DM 9 billion in the previous year. A much higher surplus would have been

### Wage and salary earners' pension insurance scheme



needed, however, to replenish the fluctuation reserves to the statutory minimum level of one month's expenditure. Two factors prevented that goal from being achieved: firstly, the disappointing employment trend led to substantial contribution shortfalls and, secondly, the Federal Insurance Office for Salaried Employees did not sell off assets on the scale intended.

A large surplus must be generated this year, too, if the fluctuation reserves are to be brought up to the statutorily prescribed minimum. That would have necessitated a further increase to 21% in the pension insurance

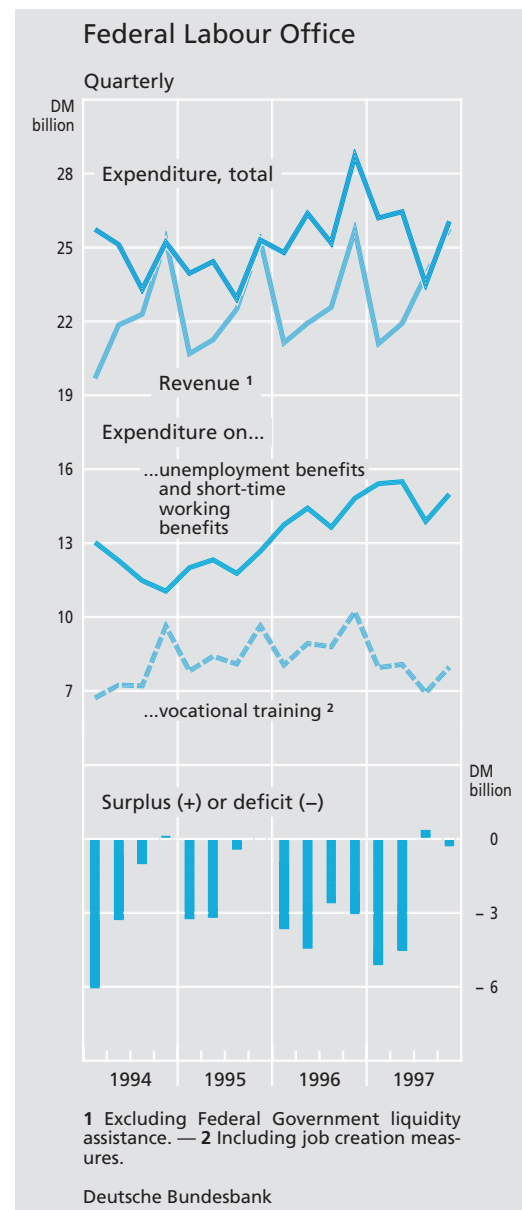
*Outlook for 1998*

<sup>4</sup> However, the further reduction in the "topping-up" amounts, pursuant to the Pension Insurance Transference Act, led to a smaller increase in the pension amounts paid on average in eastern Germany.

contribution rate payable on wages and salaries. Given the extra burdens that this would have entailed for both employers and employees, who had already been heavily burdened by earlier substantial increases in the contribution rate, an alternative method of financing was chosen – as mentioned above. Thus instead of an increase in the contribution rate, the standard rate of value added tax is to be raised from 15% to 16% on April 1, and the resulting extra income is to be used to provide an additional Federal grant to the pension insurance fund. Originally, this “rechannelling” of funds was not meant to come into force until the start of 1999 – together with the benefit restrictions introduced by the pension reform; but it was brought forward so as to avoid the need to raise the contribution rate. By contrast, the other measures (essentially a slower rate of increase in pension payments and restrictions on disability pensions) are to be introduced as originally scheduled. Those elements of the reform package relating to improvements in recognising child-rearing years for pension purposes will come into effect six months earlier, as originally planned, in mid-1998.

*Federal Labour Office in the fourth quarter...*

The financial balance of the Federal Labour Office in the fourth quarter of last year was virtually in equilibrium following a deficit of DM 3 billion a year before. The main reason for this was that expenditure was more than 9% down on the previous year's level. Spending on vocational training (including job creation schemes) actually dropped by just over one-fifth; the restrictions on benefits introduced by the reform of the Work Promotion Act also had an impact in this context. Ex-



penditure on unemployment benefits grew fairly moderately, at just over 1½%; a decline of 5½% in the west was accompanied, however, by rise of almost one-fifth in the east. The moderate overall increase in the cost of unemployment benefits resulted primarily from the fact that the period of entitlement to unemployment benefits has expired for many people who have been jobless for quite a long time. This is indicated by the fact that

unemployment assistance, which is paid direct out of the Federal budget, used up 18 % more financial resources in the fourth quarter than 12 months earlier. The income of the Federal Labour Office between October and December roughly matched that in the same quarter of 1996. While receipts from contributions grew a little more strongly than before, at slightly more than 1½ %, other revenue fell steeply.

*... and in 1997  
as a whole*

In 1997 as a whole the deficit run up by the Federal Labour Office, which has to be funded from the Federal budget, came to just under DM 10 billion. This was DM 4 billion less than the corresponding 1996 figure even though the number of unemployed grew sharply. Costs were held down, however, by the restrictions on benefits introduced in 1997, as a result of which spending on vocational training fell 14 % below the very high level reached in 1996. On the other hand, expenditure on unemployment benefits climbed by 6½ % in 1997, although the initially very steep rate of increase tailed off considerably in the course of the year. All in all, the Federal

Labour Office's volume of spending declined by a little more than 2½ % against 1996 while its income grew by just under 1½ %, partly on account of the sale of claims in respect of loans.

The 1998 budget plan of the Federal Labour Office foresees a deficit of just over DM 14 billion, which is DM 4½ billion higher than last year's actual deficit. This is based on the assumption that the annual average number of unemployed, at 4.4 million, will remain more or less the same as in 1997; but that presupposes a change in the trend on the labour market in the course of the year. The amounts earmarked for unemployment benefits are some 2 % above the volume actually paid in 1997, and an even bigger increase is envisaged for spending on vocational training. Total planned expenditure is to rise by 5½ % compared with last year's actual total, whereas revenue is to go up by not quite 1½ %. In contrast to previous years, the Federal Labour Office's budget plan for 1998 appears to take adequate account of labour-market-related risks.

*Budget plans  
for 1998*