

Public finance

Central, regional and local authorities

Trends since the beginning of the year

In the first quarter of 1999 the central and regional authorities (no results are available for the local authorities yet) recorded a deficit of approximately € 18 billion (about DM 36 billion). This represents a slight deterioration compared with the first three months of 1998. Revenue grew by 2 ½ %, which was rather sluggish given the abundant tax receipts. The increase in spending, which does not include the new pay settlement in the public sector, amounted to 3 %.

Basic trends

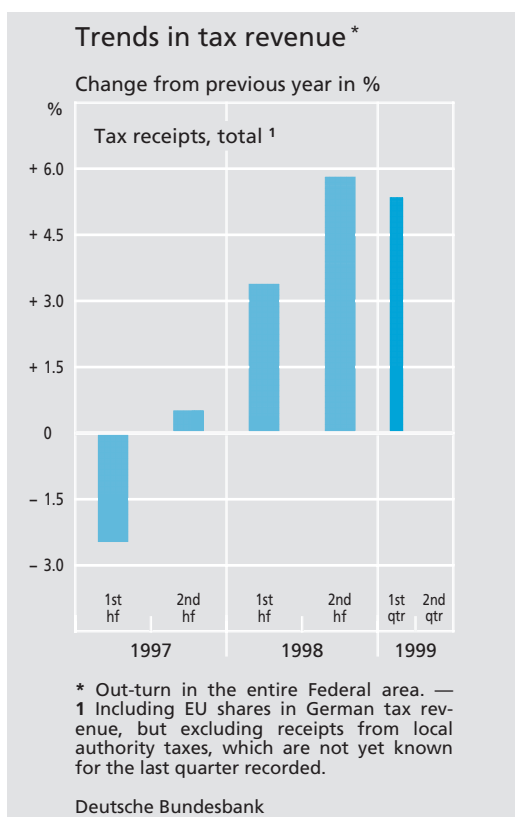
The strong growth in tax receipts, which has been observed since the spring of 1998, continued at the beginning of the year. Tax revenue¹ in the first quarter was 5.4 % higher than in the corresponding period of last year, although at the beginning of the year some tax relief measures came into effect. In the first quarter this ongoing favourable trend was driven firstly by the significant improvement in corporate profitability during the past few years, which for quite some time now has been reflected by a strong rise in receipts from profit-related taxes. Secondly, the increase in turnover tax, which entered into force on April 1, 1998, continued to affect the year-on-year result.

Overall taxes

It was largely attributable to the latter factor that turnover tax, which rose by 10.2 %, was the mainstay of revenue growth. This trend

Turnover tax

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



was further supported by a comparatively favourable development in the assessment basis compared with the first quarter of 1998. Among other things, the mild weather conditions at the beginning of the year resulted in higher construction turnover (which is subject to taxation).

Wage tax

In respect of taxes on income, revenue from wage tax in the first quarter merely equalled the level in the corresponding period of last year, whereas in 1998 it had increased by approximately 4%. This reflected, for the first time, the raising of child benefit at the beginning of the year and the changes in the income tax scale, which included a higher tax-free allowance and a lower starting rate. Moreover, payments of child benefit temporarily depressed wage tax revenue by a

margin that exceeded the effect of the actual increase in this benefit.²

Regarding assessed income tax, receipts were again a little less than the value of the out-payments financed by that tax, as a result of which the out-turn improved only slightly compared with the first quarter of 1998. However, this is principally attributable to the sharp increase in payments of the allowance for the purchase of owner-occupied dwellings, which replaced the previous tax allowance under section 10e of the Income Tax Act³ in 1996 and is mostly disbursed in March. Another year's beneficiaries have contributed to swelling the cost of this promotion scheme (which is granted for a period of eight years). If this revenue-reducing factor is disregarded, the out-turn of assessed income tax improved significantly compared with the first three months of 1998.

Assessed
income tax

In the first quarter of 1999 corporation tax yielded nearly a quarter more than a year ago. This remarkably steep growth in revenue was attributable to higher payments for past years in which sizeable profits were recorded. By contrast, tax prepayments by enterprises apparently increased only moderately. This may be a first sign of a less favourable momentum in export business.

Corporation tax

2 Although, since the start of the year, the labour exchanges have been exclusively responsible for paying out child benefit (except for recipients working in the public sector), sizeable payments by employers (amounting to DM 3 ¾ billion) also had an impact in the first quarter. In part they related to wage and salary payments for December.

3 The old tax allowance for home buyers was largely taken into account in the wage tax deduction procedure and has thus reduced wage tax receipts rather than revenue from assessed income tax.

*Federal
Government*

The deficit run up by the Federal Government in the first quarter, at € 13½ billion or approximately DM 26½ billion, more or less matched the level of last year. Both expenditure and receipts grew by just over 2%. All in all, the trend so far seems to be largely in line with the Federal Government's budget plan. However, in the course of the year considerable fluctuations are likely in the payment flows due not least to irregular income from the disposal of participating interests. This has also affected the result for the first quarter.

Special funds

In the first three months of the current year the Federal Government's special funds ran a deficit of just under € 1 billion (just over DM 1½ billion), which was virtually the same out-turn as in the corresponding period of 1998. Whereas the financial position of the ERP Special Fund and the Federal Railways Fund was more positive, the deficits of the Redemption Fund for Inherited Liabilities, the "German Unity" Fund and the Equalisation Fund for Safeguarding the Use of Coal increased somewhat.

*Länder
Governments*

The first-quarter deficit of the Länder Governments amounted to just under € 4 billion or approximately DM 7½ billion, compared with just over DM 5 billion a year ago. This less favourable result was partly due to the fact that spending increased rather rapidly by just under 3%. Expenditure on personnel, however, was lower than in the same period of last year, although it should be noted that the result for the first quarter of 1999 does not yet reflect the public sector pay settlement, which has a major impact on the budgets of

Trend in the revenue from major taxes

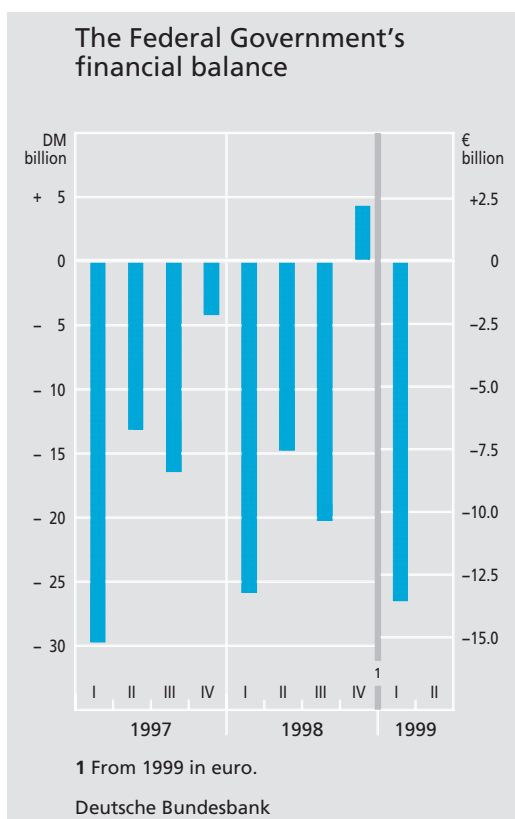
Type of tax	Revenue in			Change from previous year in %
	DM billion		€ billion	
	1st quarter			
	1998	1999	1999	
Wage tax	58.4	58.4	29.8	+ 0.0
Assessed income tax	- 0.7	- 0.3	- 0.2	.
Corporation tax	8.9	11.0	5.6	+ 23.5
Turnover tax	59.5	65.6	33.5	+ 10.2

Deutsche Bundesbank

the Länder Governments. Total revenue only grew by just over ½%, although tax receipts, which rose by more than 5%, were very abundant.

In the first quarter the combined indebtedness of the central and regional authorities (no information is available on the local authorities yet) grew by € 12½ billion. Net borrowing was largely focused on short-term credits. The money market was drawn on to the tune of just over € 8 billion, whereas recourse to the capital market, at a little over € 4 billion (net), was comparatively low. Of the various levels of government, the Federal Government was the only one to increase its liabilities (by € 16½ billion), mainly stepping up its money market and bonded debt. In the case of the Länder Governments and the spe-

Indebtedness



cial funds, by contrast, redemptions outweighed new borrowing, resulting in a reduction of their overall debt level by almost € 1 billion and € 3 billion, respectively.

Outlook for 1999 as a whole

In the current year as a whole the central, regional and local authorities will, in all probability, run a higher combined budget deficit than in 1998 (DM 57 billion). Although the Federal Government's deficit is expected to decrease slightly and the deficit of the Länder Governments will probably not exceed last year's figure, the surplus generated by the special funds will fall sharply. In addition, the fiscal balance of the local authorities will probably deteriorate, too, following their surprisingly favourable result in 1998.

*Less favourable
budgetary
trend likely*

The revenue of the central, regional and local authorities is expected to grow less strongly than in 1998 (just over 5 ½ %) owing to a significant decline in non-tax receipts. One major factor is that the profit transferred by the Bundesbank in 1999 in respect of the 1998 financial year was DM 8 billion lower than the amount transferred in 1998. In addition, the proceeds of asset disposals will probably not quite reach the exceptionally high level attained last year. On the other hand, tax receipts are expected to expand substantially.

*Subdued
revenue trend*

According to the new official forecast prepared recently, tax receipts are expected to grow by 5.3% in the current year. Compared with the comparable estimate made in the autumn of last year – i. e. notably adjusted for the first stage of the income tax reform and the "ecological tax reform", which had not been taken into account at that time – the expectations for 1999 have improved by just under DM 3 ½ billion, after last year the earlier forecast was already exceeded by nearly DM 5 billion. Although a slightly lower economic growth is now assumed⁴, this will be offset to some extent by several structural factors. The higher wage settlements, for example, are expected to result in a greater increase in wage tax receipts than was anticipated in the earlier forecast, while the potential adverse effects on economic development will largely only later be reflected in a reduction in tax revenue. Moreover, the expect-

Tax estimate

⁴ The latest assumptions made by the Federal Government with respect to both nominal and real GDP (around 3% and 1 ½ %) are ½ percentage point below the expectations made in the autumn.

ations regarding turnover tax will hardly be affected by the slower rate of economic growth, as that will mainly depress exports and corporate capital formation, which are not subject to that tax. In addition, the erosion of the assessment basis for assessed taxes associated with the promotion of the east German Länder is continuing to abate and the impact of the comprehensive special dividend distributions from former revenue reserves ("EK 50" corporate tax relief measure), which reduced the growth of corporation tax receipts in 1998, no longer applies.

It is mainly owing to these structural factors and the expected additional receipts of DM 7 billion resulting from the changes in tax legislation which have now come into force that the forecast increase in tax receipts significantly exceeds nominal economic growth. As defined in the financial statistics, the overall tax ratio will increase accordingly by ½ percentage point to 22.7 %, after already having risen last year for the first time in a long while.

*Accelerated
increase in
expenditure*

Despite the continuing low interest rate level and the level of price stability that has been reached, the growth of expenditure of the central, regional and local authorities is expected to accelerate in 1999 and to exceed the rate of 2 % recommended by the Financial Planning Council. The latest public sector pay settlement, which was considerably higher than in recent years, and increased transfers by the Federal Government to the statutory pension insurance scheme and the pension funds of the successor enterprises to the

Post Office will make themselves felt in this context.

The Federal budget for the current year, which has now been approved by the Bundestag, foresees a deficit of DM 53.6 billion (approximately € 27½ billion), following a deficit of DM 56.5 billion in 1998. In the course of the parliamentary deliberations the former budget estimate⁵ was reduced by DM 2.7 billion. Budgeted expenditure has been cut by DM 2.3 billion net, even after taking into account additional costs associated with the Kosovo conflict totalling DM 750 million. As things stand today, it is likely that the overall budget estimates will be kept to.

*Federal
Government*

With respect to revenue, the latest tax estimate for the current year paints a somewhat more favourable picture (partly because of lower transfers to the EU) than the November forecast on which the budget was based. This new forecast anticipates an increase in the Federal Government's tax receipts by approximately 9 %. This sharp increase is largely attributable to the raising of energy tax (as of April 1 of the current year) and value added tax (from April 1, 1998). Both measures serve to finance the increase in Federal grants to the statutory pension insurance scheme. On the revenue side, the budgeted extensive sales of financial assets (approximately DM 27 billion) provide for a flexible element with great weight. The bulk of these planned proceeds is accounted for by the disposal of Federal shares in Telekom AG to the Reconstruct-

*Slight
improvement
signalled by
new tax
estimate*

⁵ For more details see: Deutsche Bundesbank, Monthly Report, February 1999, pages 44 ff.

tion Loan Corporation (*Kreditanstalt für Wiederaufbau – KfW*). In the event of a favourable budgetary development, part of these proceeds could be postponed until next year.

Budget estimates on the expenditure side appropriate

Furthermore, no major budgetary risks are currently discernible overall on the expenditure side, unless the burdens associated with the Kosovo conflict increase significantly in the further course of the year. All in all, labour-market-related expenditure seems to have been estimated generously. This item reflects a considerable expansion of active labour market policy measures. Following the partial assumption of the debt of the Redemption Fund for Inherited Liabilities, the Federal Railways Fund and the Equalisation Fund for Safeguarding the Use of Coal, interest expenditure, which accounts for nearly 17% of the total volume of spending, makes up the second largest item after social security expenditure. In view of the continuing low interest rate level, which is favourable not only for funding new borrowing but also for refinancing maturing debt instruments at low credit costs, the estimate contained in the Federal budget appears to be appropriate.

Financial situation of the special funds to deteriorate significantly

The financial situation of the special funds will deteriorate considerably in the current year. The aggregate surplus, which last year amounted to nearly DM 24 billion, will probably decrease by about two-thirds this year. On the one hand, this is due to the lower Bundesbank profit. On the other hand, in 1998 the Redemption Fund for Inherited Liabilities received transfers from the Federal Government for debt repayment to the tune of around DM 7 billion. Since the Federal

Government, along with other bodies, is assuming the special funds' debt in 1999, these grants will no longer be forthcoming.

The budget plans of the Länder Governments provide for a deficit of approximately DM 29 billion (just under € 15 billion) for the current year, which roughly matches the provisional out-turn for 1998. On the expenditure side an increase of 1.5% against the out-turn for 1998 has been envisaged. However, in view of the substantial burden compared with previous years on the labour-intensive budgets of the Länder Governments that will ensue from this year's public sector pay settlements and the raising of the contribution rate to the supplementary pension fund for public sector wage and salary earners, an even sharper increase is likely. On the revenue side, however, the favourable trend in tax receipts is expected to continue. The growth in total revenue, which, at 1.3%, has been estimated rather modestly, might be exceeded, even though the Länder Governments have included lower proceeds from asset disposals in their budget plans than last year. All in all, from the present vantage point it is unlikely that there will be any major deviations from the estimated deficits.

Länder Governments

At the level of the local authorities, a more unfavourable result is to be expected for the current year, following last year's surprisingly positive financial balance (i. e. a surplus of just under DM 5 billion). According to an estimate by the Association of German Municipalities, the local authorities will even record a deficit. This estimate expects expenditure to rise by approximately 1½%, following a slight de-

Local authorities

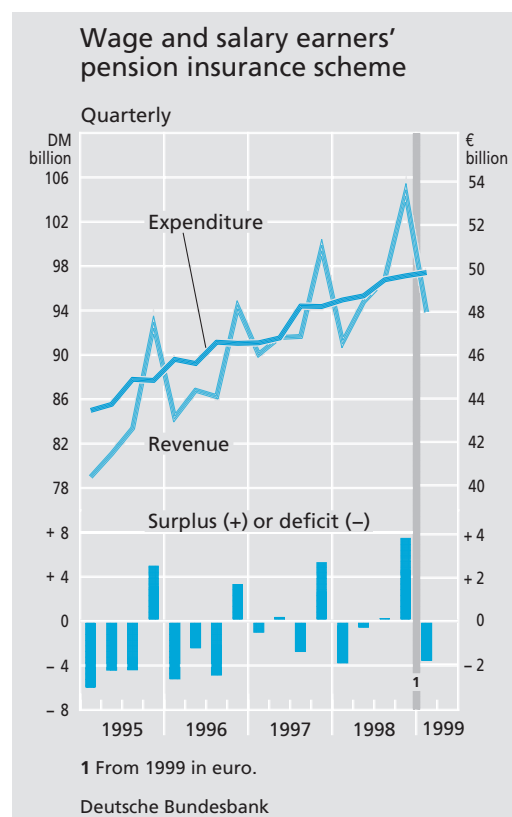
cline last year. It foresees that capital formation will probably decrease further, however. On the revenue side, the estimate forecasts a decrease of approximately 1½%, the main reasons being the declining proceeds from asset disposals and the high one-off payment of tax arrears last year.

Social security funds

Statutory pension insurance scheme

In the first quarter of 1999 the deficit of the statutory pension insurance scheme amounted to € 1¾ billion or approximately DM 3½ billion; it was thus slightly lower than in the same period last year. The additional Federal grant, which has been paid since April 1, 1998 and which has been funded by a concurrent increase in value added tax, had a positive effect on the revenue side. Contribution receipts, by contrast, were somewhat lower than a year ago. Slightly increasing compulsory contributions contrasted with decreasing contributions in respect of wage substitutes as a consequence of the year-on-year fall in unemployment. Overall revenue grew by 3%. Expenditure rose less sharply by just over 2½%. Pension payments went up by nearly 3%, although the pension adjustment of mid-1998 was relatively small (0.44% in western Germany and 0.89% in eastern Germany). However, the number of pensioners increased further, particularly in western Germany.

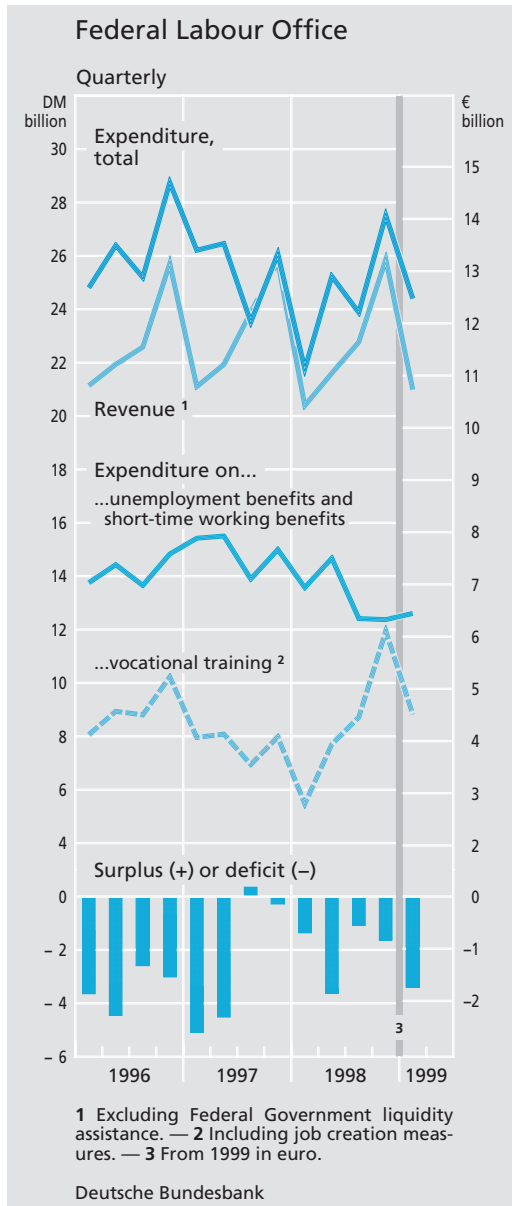
On the one hand, pension costs are likely to increase even more sharply in the further course of the year, following the larger pension adjustment of 1.34% in the old Länder



and 2.79% in the new Länder⁶ in mid-1999. On the other hand, the higher wage settlements are likely to result in a more favourable trend in contribution receipts. Although the new legal provisions are giving rise to considerable shifts in the pattern of financial flows, they will not have any major effect on the net overall result. In this respect the lowering of the contribution rate from 20.3% to 19.5% as of April 1, 1999 and its funding through additional transfers from the Federal budget are the most important factors.

From the present perspective, a higher surplus is to be expected than last year (DM 3½ billion). Yet it will presumably again not suffice to replenish the fluctuation reserve to its

⁶ The east German gross standard pension will thus reach 87% of the west German level.



statutory minimum level of one month's expenditure, especially as the sale of the housing company of the Federal Insurance Office for Salaried Employees, which was included in the calculation of the contribution rate for 1999 and which has been planned since 1997, will probably not be realised in the current year.

In the first quarter of 1999 the Federal Labour Office recorded a deficit of € 1¼ billion or approximately DM 3½ billion, which was DM 2 billion higher than in the same period of 1998. The main reason for this is that spending on active labour market policy measures rose by three-fifths over twelve months. This rise owed little to the Federal Government's immediate employment creation programme "100,000 Jobs for Young People". Although at the end of March approximately 62,500 young people were already participating in such a measure, only a small proportion of the DM 2 billion earmarked for this purpose has actually been disbursed so far. In contrast to the high additional costs associated with measures to promote employment, expenditure on unemployment benefit decreased by 7%. Whereas in the old Länder this was accompanied by a fall in unemployment, a major role was probably also played in the new Länder by the increase in long-term unemployment, with the associated switching from unemployment benefit to unemployment assistance. In addition, the decline in spending on unemployment benefits is considerably understated by the fact that in January 1998 expenditure had been particularly low as a consequence of a change in the payment rhythm. Overall, the Federal Labour Office's expenditure rose by 12%, whereas its revenue grew by less than 3%.

Federal Labour
Office

In the further course of the year the deterioration observed in the first quarter is not expected to continue to the same extent. Disregarding the change in the payment rhythm introduced in January 1998, which distorts the year-on-year comparison, the recent pay

round is likely to result in more sharply growing contribution receipts. Furthermore, the high 12-month growth rates in active labour market policy spending are unlikely to be sustained because the corresponding expenditure was expanded substantially in the course of 1998 from a comparatively low starting level. The grant of DM 11 billion to the Federal Labour Office envisaged in the Federal budget will therefore probably prove to be sufficient.

Overall outlook for the public sector budgets

Higher deficit in 1999 as defined in the financial statistics ...

As defined in the financial statistics, which record revenue and expenditure flows as per the budget accounts, a growth is expected in 1999 in the overall deficit, which in 1998 amounted to just under DM 53 billion. The growth is largely attributable to the decline in receipts from sales of assets and to the lower Bundesbank profit. In addition, expenditure is expected to grow distinctly faster than last year.

... but deficit ratio virtually unchanged as defined in the national accounts

As defined in the national accounts, the current trend in public finance is more favourable. As financial transactions which merely represent a shift within government financial assets are recorded in the national accounts as not affecting the deficit,⁷ the sharp decline of such revenue is not reflected in the national accounts balance. As things stand today, it is to be expected that the government deficit ratio, as defined in the Maastricht Treaty, will hardly change, following a decline by 0.7 percentage point in each of the two previous

years leading to a deficit of 2.0% in 1998. The fact that the reduction of the overall deficits is faltering is not so much a result of the more unfavourable macroeconomic growth perspectives. As mentioned, the tax receipts of the overall public sector are actually being supported to some extent in the short term by the pattern of economic development. It is rather the accelerated growth in expenditure that is detrimental to the public finance position.

Thus, the government spending and levy ratios, which have fallen since 1996, will presumably rise in the current year, *inter alia* owing to the small increase in nominal GDP. In addition, the government debt ratio is likely to rise again. In 1998, it had decreased slightly for the first time, although at 61.1% it still exceeded the limit laid down in the Maastricht Treaty. Between 1990 and 1997 it had increased dramatically, mainly because of the burdens resulting from German unification.

Rising government spending and levy ratios

The stability programme presented by the Federal Government in January envisages a reduction in the deficit ratio to 1% by the year 2002. However, the medium-term prospects of public finance have deteriorated significantly compared with the previous medium-term financial plans. The latest medium-term tax estimate, for example, anticipating a nominal rate of economic growth, which at 3¾% per year, is assumed by the new Federal Government to be ½ per-

Medium-term prospects still uncertain

⁷ Thus the proceeds of privatisations, the granting of loans and a large part of the extraordinary Bundesbank profit do not affect the fiscal balance.

centage point lower than the figure envisaged a year ago, foresees growing shortfalls in tax revenue as compared with the May 1998 estimate (adjusted for changes in tax legislation). In addition, the Tax Relief Act, which came into force in the current year, will result in considerable tax shortfalls, particularly in 2002, which have not been taken into account in the medium-term financial plans to date. Moreover, further decisions concerning key areas of tax legislation and social security are still awaited. According to the ruling of the Federal Constitutional Court, costs associated with child-rearing and child-care must attract far greater tax relief. In addition, a reform of corporate taxation is in the pipeline aimed principally at reducing the tax ratios, which are high by international standards. Finally, fundamental adjustments will have to be made both in the statutory pension insurance scheme and in the statutory

health insurance scheme in order to avoid a further rise in contribution rates.

The way these fiscal policy reforms is framed is of great significance for Germany's future economic development. It is essential to ensure greater planning certainty both for enterprises and for employees, with respect to the basic conditions provided by the government, and to improve the conditions for production. In addition, efforts must be made to achieve a more balanced inter-generational burden sharing. In order to be able to cope with the budgetary burdens associated with these reforms, it is essential to reduce the government spending ratio in the medium term. This is the only way to bring about the required reduction in the levy ratio while, at the same time, ensuring a sustainable consolidation of public finance which must also take account of the future demographic burdens.