

Public finance

Central, regional and local authorities

Trends in the second quarter of 1999

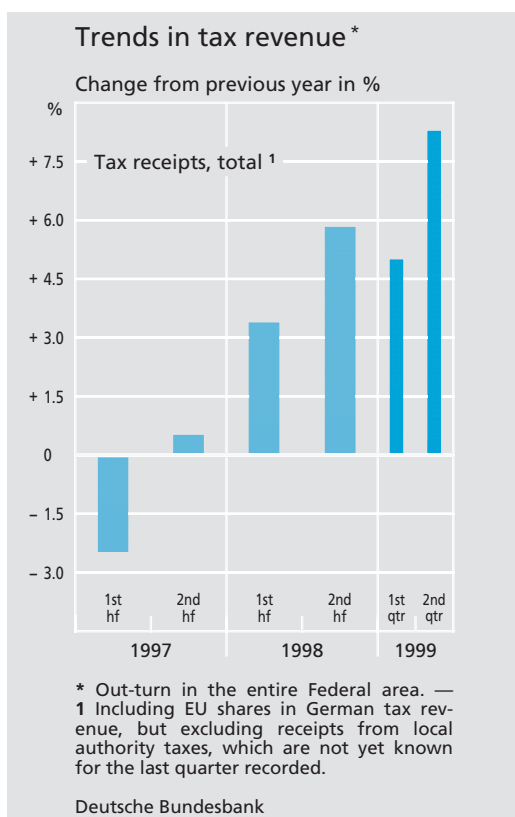
In the second quarter of 1999, the central and regional authorities (no results are available for the local authorities yet) showed a surplus of just under € 4½ billion or DM 8½ billion, compared with slightly more than DM 6 billion one year earlier. On the one hand, the size of the surplus was adversely affected by a decline in the Bundesbank profit transfer: although, at DM 16 billion, the amount paid to the Federal Government and the Redemption Fund for Inherited Liabilities was still large, it fell short of the preceding year's transfer by just under DM 8 billion. On the other hand, the second quarter surplus benefited from significantly larger tax receipts along with only a slight rise in expenditure. Thus the basic trend characterising the financial situation of the central, regional and local authorities in the second quarter of 1999 was positive.

Basic trends

In the second quarter, tax receipts¹ exceeded the corresponding level of 1998 by slightly more than 8%, increasing at an even more rapid pace than in the first few months of the year. One reason was the rise in energy tax that took effect on April 1. At the same time, the higher pay settlements this year began to have a stimulating effect on wage tax revenue. Moreover, the enhanced earnings situation of enterprises in the previous years led to an increase in profit-related tax returns.

Total taxes

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



Wage tax

In respect of taxes on income, wage tax yielded 3 ½ % more revenue than one year before whereas a year-on-year comparison of first-quarter receipts shows revenue to have stagnated in that period. The increase in revenue followed closely on the heels of a relatively steep rise in wage rates. At the same time, the raising of child benefit at the beginning of the year and the lightening of the tax burden especially for lower-income taxpayers continued to depress wage tax revenue.

Assessed income tax

Regarding assessed income tax, tax payments exceeded refunds by just under € 2 ½ billion or DM 4 ½ billion, whereas the latter had predominated (– DM ¼ billion) one year previously. The decisive factors tipping the balance were both higher tax prepayments and a considerable rise in final payments for earlier

years. The fact that the adverse impact which certain tax concessions had on revenue (especially those connected with the promotion of investment in eastern Germany) continues to diminish may have played a role, too.

Corporation tax

By contrast, receipts from corporation tax rose by a mere 3 %. Tax prepayments increased only moderately, a development that is probably related to the fact that enterprises' earnings situation has become less favourable. Still, enterprises stepped up their dividend payments markedly. For that reason, in the second quarter the non-assessed taxes on earnings – which basically include the investment income tax on dividends – raised slightly more than 1 ½ times as much revenue as one year before. At all events, the revenue from both taxes combined rose further by one-fifth.

Indirect taxes

In the second quarter, receipts from turnover tax increased by 4 ½ %, although it should be noted that the year-on-year result of this tax benefited only slightly from the increase in tax rates that came into effect on April 1, 1998. In conjunction with a moderate rise in consumer demand, the upwards trend shown by taxable investments – both in the government and housing sectors – had a positive effect on revenue. Receipts from mineral oil tax – the second most important indirect tax after turnover tax – rose by almost 6 %. This year's figure reflects for the first time the influence of the "ecological tax reform", which increased the tax on energy consumption as of April 1 in order to finance a cut in statutory non-wage labour costs. In addition to raising the tax rates for mineral oil, the first stage of

this reform introduced a tax on electricity, which yielded combined revenue for May and June amounting to not quite DM ½ billion.

*Federal
Government*

The deficit run up by the Federal Government in the second quarter amounted to just under € 3 billion or approximately DM 5½ billion, which was considerably less than in the same period last year (just under DM 15 billion). Tax receipts rose by almost 9%. Although other revenue sources shrunk, total revenue increased by 7½%. By contrast, expenditure was down slightly more than 1% from the previous year's level, although the additional funds procured by raising the energy tax were passed on to the pension insurance scheme. As a result, total payments to the pension insurance scheme for wage and salary earners went up by 7½%. The Federal budget profited primarily from a steep decline in transfers to the Redemption Fund for Inherited Liabilities. Expenditure relating to the labour market and on social benefits was lower than in the second quarter of 1998. Given the unusually large fluctuations in payment flows during the course of the current year, it would be wrong to draw conclusions concerning the year as a whole based on the greatly improved budget balance in the second quarter. At all events, current budgetary trends suggest that the deficit could turn out to be smaller than the DM 53½ billion envisaged in the budget plan.

Special funds

The position of the special funds – unlike that of the Federal budget – deteriorated sharply. This change had a considerable impact on the financial trends of the central, regional and local authorities in general. In the second

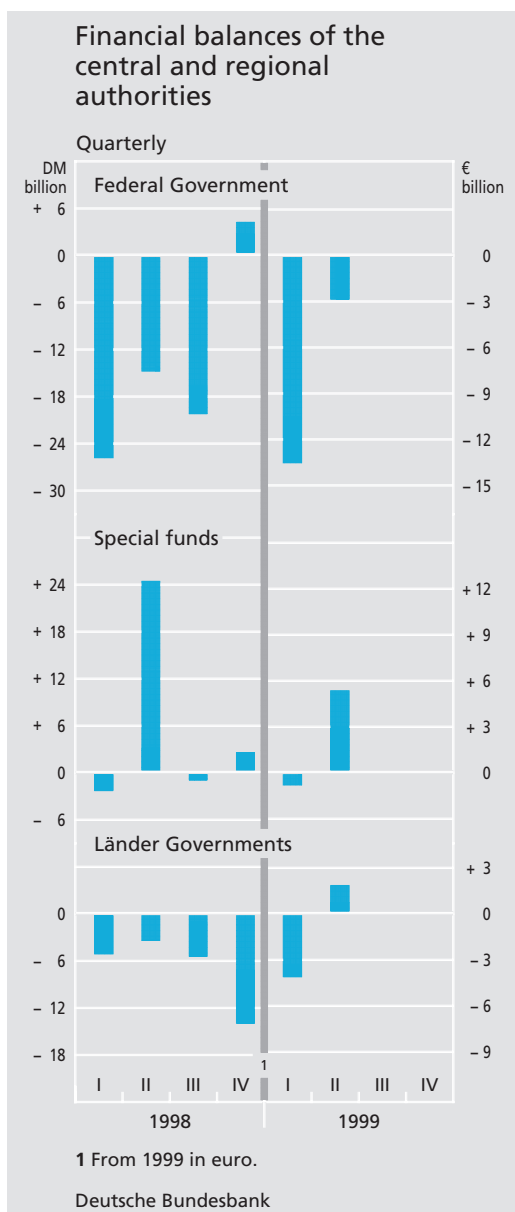
Trends in the revenue from major taxes

Type of tax	Revenue in			Change from previous year in %
	DM billion	€ billion		
	1st half-year			
	1998	1999	1999	
Wage tax	117.2	119.2	60.9	+ 1.7
Assessed income tax	- 0.9	4.2	2.2	.
Corporation tax	19.4	21.8	11.1	+ 12.5
Turnover tax	121.8	130.6	66.8	+ 7.2
of which: 2nd quarter				
Wage tax	58.9	60.8	31.1	+ 3.4
Assessed income tax	- 0.2	4.6	2.3	.
Corporation tax	10.4	10.8	5.5	+ 3.1
Turnover tax	62.2	65.0	33.2	+ 4.4

quarter, the special funds' surplus amounted to not quite € 5½ billion or DM 10½ billion, compared with DM 24½ billion one year before. This result reflects not only a substantial decrease in grants from the Federal budget but also a steep decline in the profits transferred by the Bundesbank to the Redemption Fund for Inherited Liabilities.

The position of the Länder Governments' budgets improved considerably in the second quarter. After having incurred a deficit of just under DM 3½ billion in the corresponding period of 1998, they rebounded with a surplus of almost € 2 billion or slightly over DM 3½ billion. Although other revenue increased only slightly, the Länder Governments profited from a sharp rise in tax revenue (slightly above 7½%). Total revenue grew by

*Länder
Governments*



almost 6%. By contrast, expenditure trailed somewhat behind the previous year's level. Still, expenditure on personnel increased rather sharply by more than 2½% after declining in the first few months of this year. The decisive factors here were pay raises of 3.1% for wage and salary earners in the public sector effective April and a one-off payment in the second quarter. Remaining expenditure

(which cannot yet be broken down) decreased on the year.

In the second quarter, the indebtedness of the central, regional and local authorities increased by € 3 billion (or DM 6 billion), which was substantially lower than in the first three months of 1999. In the period under review, their financing needs were offset above all by the Bundesbank's distribution of profits. Net borrowing was conducted through the sale of securities and money market borrowing, while loans against borrowers' notes were redeemed on balance. Among the various levels of government, the Federal Government raised € 3.2 billion net (or DM 6¼ billion), relying primarily on the sale of bonds and five-year special Federal bonds, and only secondarily on money market borrowing; at the same time it redeemed Treasury financing paper and loans against borrowers' notes. New borrowing by the Länder Governments amounted to € 1.8 billion (or DM 3½ billion). In addition to bank loans, the sale of Länder Treasury paper played a major role in the funding. The special funds, by contrast, reduced their indebtedness by € 2.3 billion (or DM 4½ billion), most of which was accounted for by the Redemption Fund for Inherited Liabilities. The latter raised funds from the sale of five-year special Federal bonds in connection with its joint issue of securities with the Federal Government; at the same time, it redeemed Treuhand notes and bank loans. On the whole the local authorities appear to have made scant use of the credit markets.

Indebtedness

Net borrowing in the market by the central, regional and local authorities

To end-1998: DM billion / from 1999: € billion

Period	Total	of which:		Memo items Acquisition of public debt in- struments by resi- dents out- side Ger- many
		Portfolio investment	Loans against borrowers' notes ¹	
1991 ²	+ 106.0	+ 71.3	+ 34.9	+ 50.9
1992	+ 102.6	+ 95.0	+ 8.1	+ 59.4
1993	+ 159.1	+ 120.3	+ 39.3	+ 109.1
1994 ³	+ 86.0	+ 45.6	+ 40.8	- 20.9
1995 ⁴	+ 97.7	+ 32.6	+ 81.4	+ 62.1
1996	+ 123.8	+ 65.2	+ 74.1	+ 57.3
1997	+ 95.5	+ 65.9	+ 39.9	+ 80.7
1998 ^p	+ 67.0	+ 53.6	+ 15.6	+ 69.6
of which:				
1st qtr	+ 31.3	+ 12.5	+ 18.8	+ 6.2
2nd qtr	+ 3.2	+ 12.7	- 9.6	- 1.3
1999				
1st qtr ^p	+ 12.6	+ 14.7	- 2.1	+ 2.4
2nd qtr ^{pe}	+ 3.1	+ 3.4	- 0.3	...

¹ Including cash advances and money market borrowing. — ² From 1991 including the east German Länder Governments and local authorities. Excluding Federal Railways debt assumed by the Federal Government. — ³ From 1994 including Federal Railways Fund. — ⁴ From 1995 including Redemption Fund for Inherited Liabilities.

Deutsche Bundesbank

1999 as a whole

Overall trends

Judging from the results available so far for this year, it is possible that the combined budget deficits incurred by the central, regional and local authorities will be smaller than the budgetary plan estimates despite relatively weak economic growth in 1999. Even so, deficits may be expected to exceed those of the previous year, when they totalled DM 57 billion. The main reason for this is that non-tax receipts will not match the exceptionally high level of the preceding year, primarily on account of the lower Bundesbank profit transfer and a decline in proceeds from the sale of assets.

Tax revenue

Tax revenue rose by 6.7 % in the first half-year, which is roughly one percentage point

higher than had been forecast in the last official tax estimate of May. As a result, budget appropriations may prove too modest. A reduction in tax concessions for investment in eastern Germany and considerable payments of tax arrears for corporate profits made in earlier years accounted for the higher revenue. In addition, tax receipts benefited from the relatively high pay settlements this year in both the private and public sectors; this boost in pay rates, however, not only results in higher wage tax revenue over the short term but also higher government expenditure on personnel.

Not least for this reason, expenditure may be expected to increase more steeply in 1999 than in the previous year, when the increase was measured at slightly under 2 %. A sharp rise in Federal grants to the pension insurance scheme and to the pension funds of successor enterprises to the Post Office have also made themselves felt in this context. At the same time, the central, regional and local authorities have profited from the price stability attained. Moreover, the interest rate level, which, when viewed from a longer-term perspective, has remained comparatively low, continues to ensure favourable refinancing terms. No threats in the form of additional expenditure are forthcoming from the labour market, not least owing to the generous appropriations for this year.

Outlook

Resolutions were passed in the Federal Cabinet on June 23 concerning the Federal budget for 2000 and medium-term financial

Expenditure

*Consolidation
as a fiscal policy
priority*

planning; with them the Federal Government began to shift, as it had previously announced it would, towards an urgently required consolidation policy. This development is significant not only for its successful attempt to economise over the short term but also for its unequivocal commitment to a medium-term financial policy that is in keeping with the guidelines laid down by the European Stability and Growth Pact; this policy is intended to place public finance on a course sustainable over the long term. It might also serve as an incitement at the European level to revive fiscal consolidation efforts that have been somewhat lacklustre of late.

*Structural gap
in the Federal
budget*

In addition to the deficits posted, the Federal budget suffers from a structural gap that has been concealed thus far primarily by the large proceeds stemming from privatisation. Without this additional revenue, which can be raised for a limited period only and thus can at best postpone the need for consolidation, net borrowing in the years 1998 and 1999 would have far exceeded the sum total of investment; this, in turn, is permitted only in exceptional circumstances, as laid down in Article 115 of the Constitution. In order to close this gap and to initiate a permanent decline in deficits besides, the Federal Government has approved a fiscal consolidation package that is designed to reduce the Federal budget deficit for the year 2000 by DM 30 billion. It envisages cuts in expenditure swelling, or revenue increasing, to almost DM 50 billion by 2003. All ministers are expected to carry their share of the programme burden in proportion to their contribution to total budget volume.

The consolidation package (which is presented in detail in the table on page 53) is impressive in its scope; still, when assessing its significance for fiscal policy, it is important to bear in mind that expenditure cuts have been calculated on the basis of debit estimates extrapolated from this year's budget. As a result, the size of the reductions also reflects assumptions concerning the tenability of the current status quo. Thus, besides certain revenue gains, the package includes reductions that would have had to have been made anyway. Moreover, it remains to be seen whether global cuts in expenditure not yet specified will reach the announced target of DM 5 billion. In addition, transfers to the statutory pension insurance scheme are to be reduced. Local authorities will also be subjected to additional fiscal hardship since certain cuts in social benefits will result in an increase in social assistance expenditure. At the same time, due attention should be given to the fact that Federal grants to other levels of government, along with social benefits, account for approximately 60% of total expenditure as it now stands, excluding interest payments not subject to change over the shorter term. It is impossible to economise on a comprehensive scale without taking into account these expenditure items. In addition, it should be noted that these economising measures will in some cases also provide relief for other levels of government. This is especially true of the projected ceilings on periodic pension adjustments in the next two years and on the adjustment of civil servants' salaries and pensions, the latter being limited to changes in the rate of inflation.

*Consolidation
package*

*Draft budget
for the year
2000*

The draft budget for the year 2000 has been shaped to a large extent by the measures proposed. Admittedly, the projected decrease in net borrowing by DM 4 billion vis-à-vis the deficit targeted for 1999 to DM 49 ½ billion is not large, considered for itself; still, it must be seen in conjunction with the fact that non-tax receipts are to be lowered by DM 20 billion to DM 40 billion, primarily through the reduced receipts resulting from the sale of assets. In this way, a considerable part of the structural gap that had previously been "invisible" will have been consolidated. Despite an expected rise of 4.4 % in tax receipts, total revenue will decline by 0.8 %. Estimated at slightly more than DM 478 billion, expenditure will be 1.5 % lower than in 1999.

*The Federal
Government's
medium-term
financial plan*

The medium-term financial plan, which was passed at the same time the draft budget was presented, stipulates a further decline in net borrowing by the Federal Government to slightly more than DM 30 billion in the year 2003. This figure acknowledges the loss in tax revenue that will result from subsequent stages of the income tax reform, which took effect at the beginning of this year, and the planned reform of corporate and family taxation.² Expenditure in 2001 and 2002 is expected to rise by 1.5 % each year, and by slightly more than 2 % in the year 2003 (assuming growth in nominal GDP of roughly 3 ½ % per year). In the period following that covered by its medium-term financial plan, the Federal Government will endeavour to

² Presumably, loss in government receipts will have reached the sum total of DM 30 billion in the year 2003, roughly half of which would be borne by the Federal Government.

**Main measures in the fiscal
consolidation package**

Measure	Budget relief in DM billion			
	2000	2001	2002	2003
Global cuts in expenditure not yet specified	5.00	5.80	6.44	6.87
Lowering of social security contributions for recipients of unemployment assistance ¹	4.50	4.40	4.40	4.30
Abolition of lump-sum housing allowances for recipients of social assistance	2.26	2.37	2.47	2.54
Cut in Federal grants to the pension insurance scheme	2.00	3.40	2.70	0.40
Savings in personnel expenditure	2.00	3.00	4.00	5.00
Additional effects of the reduced pension adjustment in 2000 and 2001 ²	1.80	4.50	5.10	5.50
Savings in defence services (excluding global cuts in expenditure not yet specified)	1.27	1.55	1.94	1.94
Discontinuation of unemployment assistance payments to persons not subject to social security contributions	1.00	1.30	1.30	1.30
Cut in grants to the Federal Office for Special Duties associated with Unification	0.92	–	0.15	–
Reduction of agricultural grants	0.86	1.06	1.23	1.43
Savings in structural adjustment measures for east German business enterprises	0.80	1.10	1.10	1.10
Cessation of financing of ERP equity capital aid programme	0.55	0.44	0.36	0.15
Lower spending on institutional and project promotion in the fields of education and research	0.53	0.53	0.80	1.11
Transfer of responsibility for financing student loans from the government to banks	0.50	0.45	0.40	0.35
Other measures	6.11	8.45	9.48	17.26
Total	30.08	38.35	41.89	49.25

¹ Contributions to the pension and nursing care insurance schemes are no longer calculated on the basis of 80 % of the recipient's last gross wages or salaries but instead on the amount of unemployment assistance received. — ² For example, the smaller adjustment of other social security benefits.

balance its budget. The other levels of government share this objective as a matter of policy. Thus, at the last meeting of the Financial Planning Council, the central, regional and local governments reaffirmed their commitment to reduce their deficits permanently in compliance with the objectives of the European Stability and Growth Pact, which mandates the pursuit of a balanced budget.

Gaining approval for cost-cutting decisions

Now that the savings schemes have been presented, fiscal policy makers are confronted with the task of defending the announced measures in the face of expected opposition both during the legislative process and in the course of implementing the budget. Experience indicates that this is only possible if the total volume of reductions is not compromised by concessions in individual areas that might encourage other groups affected by these economising measures to appeal to them on their behalf. Moreover, further consolidation measures must follow if the longer-term fiscal policy objective of balancing the budget, which has been set by the European Stability and Growth Pact, is to be realised as well.

Further reform measures

Some of the fiscal consolidation measures contained in the Federal budget are tied to more far-reaching projects. This is especially true of the pension insurance scheme. Here the pension adjustment is to be restricted, in conjunction with other measures, to the increase in the rate of inflation for the next two years, with the result that the relative pension level will have been permanently reduced. The planned reform of corporate taxation is also of considerable importance. According

to this plan, a further, concurrent broadening of the tax assessment basis for enterprises would reduce their standard tax rates to a level that is more internationally competitive. Since, however, this reform would not affect the tax rates for other income classes, the danger exists that a correspondingly strong bias in the tax rate system favouring retained corporate earnings would lead to misallocations in the capital markets. Increasingly, questions have also been raised concerning equality of taxation. Thus, over the medium term, this reform would increase the pressure to lower income tax rates across the board; this, however, would hardly be possible unless the tax assessment basis were to be broadened once again (this time beyond the corporate sphere) and expenditure was to be subjected to further and sustained consolidation efforts.

Social security funds

In the second quarter of 1999 the pension insurance scheme for wage and salary earners recorded a surplus of € 0.8 billion or DM 1 ½ billion; thus its financial position improved by DM 2 billion on the year. While receipts increased by 4 ½ %, expenditure rose by a mere 2 ½ %. Contribution receipts were only slightly more than 1 ½ % higher than one year before, primarily due to a lowering of the contribution rate from 20.3 % to 19.5 % effective April 1999.³ Since June, however, a new Federal grant financed by the increase in energy

Statutory pension insurance scheme

³ After adjustment for the lower contribution rate, the rate of increase amounted to 4 ½ %, which was chiefly attributable to negotiated wage adjustments.

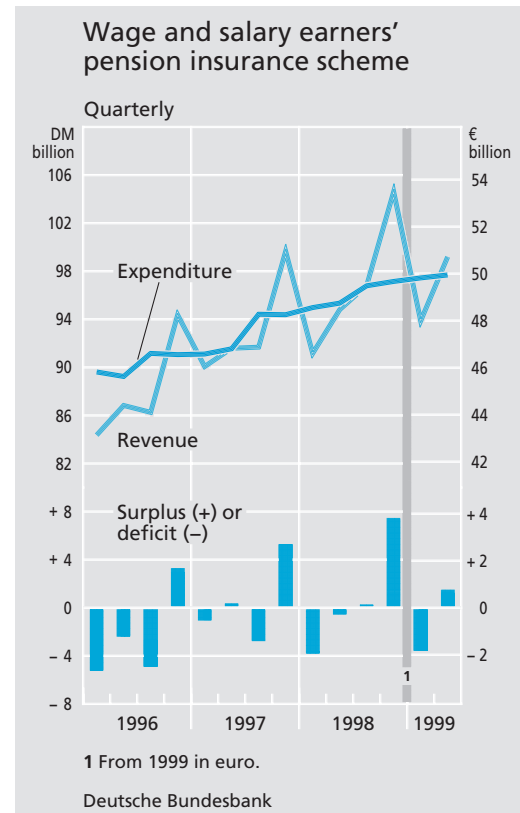
tax is being transferred from the Federal budget to the pension insurance scheme to cover periods of child rearing. Pension expenditure went up 2 ½ % in the second quarter, although the pension adjustment had been relatively small in mid-1998 and expenditure in the new Länder continued to be depressed by the reduction in replenishing amounts (i. e. those pension components that were only granted provisionally and are not governed by the pension legislation pertaining to unified Germany). These developments were, however, more than mitigated by a further rise in the number of pensions paid.

Prospects for 1999 ...

The surplus raised in 1999 as a whole will likely be substantially larger than that of the preceding year (DM 3 ½ billion). Although the pension adjustment of 1.34 % in the old Länder and of 2.79 % in the new Länder that took effect in July will lead to a sharper rise in pension expenditure than in the first half of 1999, the remuneration subject to compulsory insurance will clearly exceed that of the preceding year on account of the substantial wage and salary increases. The loss of revenue attributable to the lowering of the contribution rate is likely to be offset by additional funds deriving from the higher energy tax.

... and beyond

In future years, payments from the Federal budget are to be reduced as part of the Federal Government's consolidation package. Considerable loss of revenue will result primarily from the fact that the contributions paid for recipients of unemployment assistance are no longer to be calculated on the basis of 80 % of their last gross wages or salaries but rather in respect of current (and sig-



nificantly lower) wage substitutes. Projected constraints on pension adjustments are intended to fill the financing gap. The planned introduction of a minimum level of assistance depending on need and the reinstatement of occupational disability pension benefits will lead to increased expenditure, which is to be financed in part by funds stemming from the rise in energy tax; as a result, this tax can no longer entirely compensate for the effects of lowering the pension insurance contribution rate.

In the second quarter of 1999, the Federal Labour Office incurred a deficit of slightly more than € 1.4 billion or DM 2.8 billion, which was almost DM 1 billion smaller than one year before. Contributing factors were both a stronger inflow of revenue (+ 6 %) and a

Federal Labour
Office



moderate rise in expenditure (+ 2%). Contribution receipts were 4½% higher than in the corresponding period of the preceding year, primarily owing to larger pay settlements. On the expenditure side, the emphasis continued to shift from unemployment benefits to vocational assistance, a development that could be observed as early as mid-1998. Thus expenditure on unemployment benefits fell by 13% in keeping with the decline in the num-

ber of benefit recipients. In addition, the Federal Labour Office profited from the fact that since April 1999 the contribution rate for the pension insurance scheme had been 0.8 percentage points lower. By contrast, almost one-third more was spent on active labour market policy measures. This was reflected in a substantial increase in the assistance granted in the course of last year, which also helped to reduce the reported number of unemployed. Since the increase in this expenditure category will probably slacken significantly in the second half of 1999, the Federal Labour Office's financial situation will likely continue to improve. Presumably, then, it will not be necessary to make full use of the DM 11 billion grant earmarked in the Federal budget.

Although more recent data concerning the statutory health insurance funds are not available, there are signs suggesting deficit-building tendencies this year. Confirmation of this may be found in the fact that health insurance expenditure increased at a more rapid pace; in the first quarter the rise in expenditure amounted to 4½%, compared with slightly less than 1½% for 1998 as a whole. Accompanied by only weak growth in receipts, the deficit widened from DM 0.6 billion in 1998 to € 1.1 billion or approximately DM 2.2 billion in 1999. Even allowing for the more rapid growth in contribution receipts forecast for the remainder of this year, the continuing stability shown by the contribution rate over the last few years could be threatened.

Statutory health insurance funds

Outlook for the public sector as a whole

*Trends in the
national
accounts:
in 1999 ...*

While it is to be expected that the deficits of the central, regional and local authorities, as defined in the budgetary accounts for 1999, will continue to increase, the trend in the general government financial situation, as defined in the national accounts, is more favourable on balance (it is the latter which constitutes the relevant criterion for assessing compliance with the requirements of the European Stability and Growth Pact). Significantly, the national accounts treat the steep decline in proceeds from privatisation not as a decrease in revenue with deficit-widening effects but as an "exchange of assets". In addition, the overall trend reflects the rising surplus in the pension insurance scheme. As a result, the government deficit ratio, which had reached 2.0% last year, may be somewhere below that figure in 1999.

*... and over the
medium term*

Major advances in the reduction of deficits are to be expected in the next few years, provided that the economising measures envisaged are actually enacted. According to the medium-term benchmark figures which the Federal Government presented in the Finan-

cial Planning Council and which take into account these economising measures including the planned structural reforms, the government deficit ratio is expected to fall to 1 ½% next year and to 1% in 2001. In the year 2002 it would remain at approximately this level on account of the considerable tax cuts which have been approved but would decrease again in the following year to ½%. Even then, however, this figure would still be somewhat higher than the target value the Federal Government set with a view to balancing its budget but also to complying with the European Stability and Growth Pact. This scenario presupposes that total expenditure, as was acknowledged in the last session of the Financial Planning Council, does not increase by more than 2% per year. The government, proceeding from this assumption, has forecast that the debt ratio would fall below the 60% threshold for the first time in 2002 and would be 58 ½% in 2003. This forecast assumes a more rapid rate of consolidation than does the German stability programme presented at the beginning of this year; the latter predicted that in the years 2000 and 2001 the deficit ratio would still be 2% and 1 ½%, respectively.