

## Public finance

### Central, regional and local authorities

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#### Current developments

In the first quarter of 2001, the central and regional authorities (the figures for the local authorities are not yet known) recorded a deficit of € 17 ½ billion compared with € 16 ½ billion in the corresponding period of last year. While receipts rose by just under 2 % altogether, expenditure increased by 2 ½ %. In the further course of the year these rates of increase are likely to slow markedly on both the revenue and the expenditure side.

*Underlying trends*

This year the deficits of the government sector, which increased already last year (to € 34 billion) are set to expand further. This is due mainly to the revenue shortfalls connected with the tax reform which will lead to a substantial worsening of the financial balances of the Länder Governments and local authorities. The Federal Government will offset its lost receipts to a greater extent by selling off assets, which will enable it to again reduce its deficit slightly. The off-budget special funds will close the year with a much better fiscal balance than in 2000 as the portion of the Bundesbank profit allocated to the Redemption Fund for Inherited Liabilities for debt repayment is € 4 ½ billion higher than last year.

The tax receipts<sup>1</sup> of the central, regional and local authorities in the first three months of this year were a little above (+ ¼ %) the corresponding figure in the first quarter of 2000.

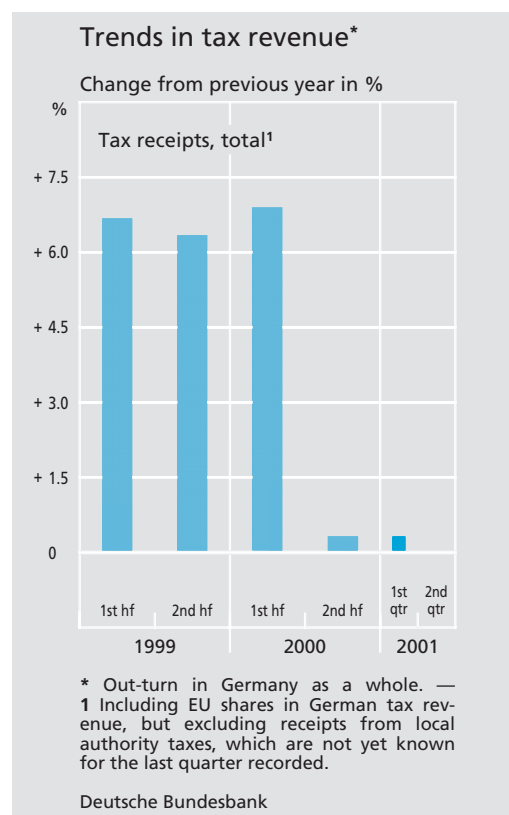
*Tax receipts in the first quarter of 2001...*

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

The effects of the comprehensive tax relief measures which came into force at the start of this year with the first stage of the "Tax Reform 2000" were partly masked by special factors. Moreover, the tax reform – which comprises a lowering of income tax rates and a reform of business taxation which, on balance, will likewise cut tax payments to some extent<sup>2</sup> – did not yet have a full impact on the revenue trend during the first quarter.

Of the income taxes, wage tax yielded 1¾% more than in the same period of last year. This is presumably attributable to the fact that a substantial amount of special payments were shifted from the end of 2000 to the start of 2001 in order to benefit from the lower tax rates applying from January 1. In addition, the tax rate reductions introduced by the reform package began to depress the volume of receipts only from February onwards. Although the outturn of assessed taxes deteriorated considerably compared with the first three months of 2000, this was caused only partly by the receipts lost in the wake of the tax reform. In the case of assessed income tax the outpayments outweighed the corresponding repayments – to an even greater extent than at the same time last year. However, this was mainly due to the increase in the government supplement to home buyers, which is mostly paid in March. This category of receipts was also depressed, in particular, by lower payments in respect of past years. By contrast, smaller prepayments by virtue of the tax reform had hardly any impact because part of the adjustment of these payments to the new tax legislation in the wake of the past year's assessment will not occur until later in the year.



With respect to corporation tax revenue, too, only a small part of the sharp decline in receipts by almost three-quarters (to just over € 1½ billion) was due to adjustments of prepayments in connection with the tax reform. In this case the fall resulted principally from an exceptionally large rise in profit distributions, although this, too, was connected with the tax reform.<sup>3</sup> Consequently, receipts from non-assessed taxes on earnings amounted to € 6½ billion, which was two-and-a-half times as much as a year earlier.<sup>4</sup>

<sup>2</sup> For a detailed account of the tax reform see Deutsche Bundesbank, Monthly Report, August 2000, pages 54 ff.

<sup>3</sup> For the distribution effects triggered by the reform of business taxation see Deutsche Bundesbank, Monthly Report, November 2000, page 52.

<sup>4</sup> Receipts from the tax on interest income in the first quarter also rose sharply by almost two-fifths because the halving of savers' tax allowance which came into force in 2000 affected the year-on-year comparison for the last time at the beginning of this year.

### Trends in the revenue from major taxes

| Type of tax         | Revenue<br>in € billion |       | Change<br>from<br>pre-<br>vious<br>year<br>in % |
|---------------------|-------------------------|-------|---|
|                     | 1 <sup>st</sup> quarter |       |   |
|                     | 2001                    | 2000  |   |
| Wage tax            | 31.2                    | 30.7  | + 1.7   |
| Assessed income tax | - 2.3                   | - 0.2 | .   |
| Corporation tax     | 1.7                     | 6.2   | -73.1   |
| Turnover tax        | 35.1                    | 35.5  | - 1.2   |

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As regards indirect taxes, revenue from turnover tax was just over 1 % lower than in the same period of last year. It was also dampened by the further decline in taxable investment in the house-building sector. By contrast, receipts from mineral oil tax were almost 23 % higher than in the first quarter of 2000. Only a small part of this was attributable to the further increases in the tax rates applying to petrol which came into force with the third stage of the "ecological tax reform" at the beginning of the year. Around two-thirds of the total increase in receipts from this tax in the first quarter was due to payment held back from the fourth quarter of 2000.

As the revenue losses caused by the tax reform will have a growing impact during the

remainder of the year, tax revenue for 2001 as a whole is likely to fall well short of the out-turn in 2000. According to the recent forecast of the "Tax Estimates" working group, tax revenue in 2001 will probably be 2½ % smaller than last year. Given an expected growth of nominal GDP by approximately 3½ %, the overall tax ratio (as shown in the government financial statistics) is set to fall by 1¼ percentage points compared with 2000 to 21.7 %.

Lower receipts must also be reckoned with in comparison with last autumn's forecast after actual tax revenue for last year already dropped below the expectations at that time and the assumptions for real economic growth for the year 2001 have been revised downwards vis-à-vis the autumn projection.<sup>5</sup> The "Tax Estimates" working group expects that actual receipts this year will be € 3½ billion lower than forecast in the autumn. On the one hand, these shortfalls relate to turnover tax. On the other hand, a marked fall in corporation tax revenue is becoming apparent, although that will probably be offset by a substantial increase in receipts from higher dividend payments in the case of non-assessed taxes on earnings. The earlier expectations for tax receipts from mineral oil have likewise been revised downwards owing to consumer restraint following the increase in oil prices.

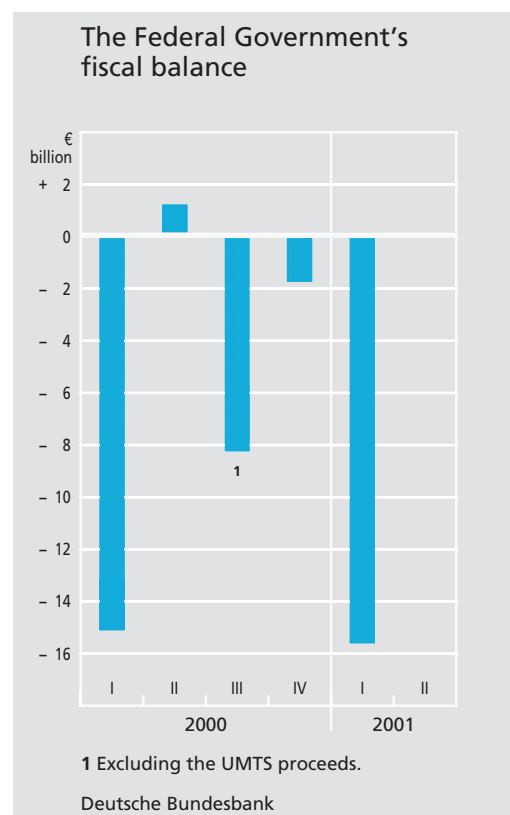
<sup>5</sup> Whereas in autumn 2000 real economic growth of 2¾ % was expected for 2001, the Federal Government now estimates that GDP will grow by only 2 % this year in real terms. Owing to a larger increase in the overall price level, the expected growth of nominal GDP, at approximately 3½ %, is almost as large as assumed earlier.

*Federal Government in the first quarter...*

The deficit run up by the Federal Government in the first quarter increased by € ½ billion compared with the same period last year to € 15 ½ billion. Overall revenue rose by just over ½ %; this was due above all to the substantial increase of a little more than 3 % in tax receipts caused by exceptional factors and the raising of energy taxes. By contrast, non-tax revenue dropped by 19 %, mainly because (in contrast to last year) there were no receipts in the first quarter of 2001 from the sale of equity interests. The Federal Government's spending increased by just over 1 %, with grants to the statutory pension insurance fund (5 %) and interest expenditure (5 ½ %) both rising sharply. The latter is subject to quite strong fluctuations during the year, however. Moreover, the repayment in January of equalisation claims amounting to € 33 billion will not be reflected in lower interest expenditure until the second quarter. Owing to a change in the system of budgetary classification at the start of the year, some major shifts have occurred between various expenditure categories (especially other operating expenditure and current transfers to enterprises), with the result that the comparability of individual figures with those last year is very limited.

*... and in 2001 as a whole*

For 2001 as a whole, the Federal Government budget envisages a slight fall in the deficit to € 22 ½ billion – following € 24 billion last year. On the revenue side, the latest tax estimate suggests that there will be shortfalls of just over € 2 billion, although they will be counterbalanced by lower transfers to the EU. The Federal budget projects a slight decline in spending in 2001 compared with last



year. Relief will be afforded not least by the non-recurrence of the payment made last year to the compensation fund for wartime forced labourers amounting to just under € 2 ½ billion. In addition, the Federal Railways Fund will require smaller Federal grants this year as it will sell off some assets. At the moment, it would appear that the budgeted target for the volume of Federal Government spending will more or less be met, provided that budget management is frugal.

Despite the fact that the deficit may decline further in the current year, the structural consolidation requirement within the Federal budget has increased in 2001. Although the extensive revenue losses caused by the tax reform will largely be absorbed in the short run by extraordinary asset disposals by the Fed-

*Rising consolidation needs despite the falling deficit*

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

| Period            | Total  | of which   |  | Memo item<br>Acquisition<br>of public<br>debt in-<br>struments<br>by non-<br>residents |
|-------------------|--------|------------|--|--|
|                   |        | Securities | Loans<br>against<br>borrowers'<br>notes <sup>1</sup> |  |
| 1999              | + 34.8 | + 44.8     | - 9.7  | + 16.2   |
| 2000 <i>pe</i>    | + 16.3 | + 29.1     | - 11.6   | + 18.9   |
| of which          |        |            |  |  |
| 1st qtr           | + 14.0 | + 7.5      | + 6.5  | + 0.3  |
| 2nd qtr           | - 1.3  | + 3.8      | - 5.1  | + 13.1   |
| 3rd qtr           | + 9.1  | + 4.8      | + 5.4  | + 7.7  |
| 4th qtr <i>pe</i> | - 5.4  | + 13.1     | - 18.4   | - 2.2  |
| 2001              |        |            |  |  |
| 1st qtr <i>pe</i> | - 11.7 | + 13.9     | + 8.6  | ...  |

<sup>1</sup> Including cash advances and money market borrowing.

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eral Government and the Federal Railways Fund, those disposals will not improve the fiscal position as the receipts booked in the budget are offset by a corresponding fall in assets. It should also be borne in mind that the receipts from the ownership and sale of the successor enterprises to the German Post Office are to be used to finance the large deficits of the Post Office benefit funds<sup>6</sup> (which last year already amounted to almost € 4½ billion and in the coming years will probably expand further).

#### Special funds

The off-budget special funds ended the first quarter with a deficit of almost € 1½ billion, which was more or less the same as at the corresponding stage in 2000. In the course of this year their financial position will improve considerably, however, as the portion of the

Bundesbank profit earmarked for redeeming the debt of the Redemption Fund for Inherited Liabilities (i. e. the portion in excess of € 3.6 billion) is € 4½ billion higher this year than last year. Following a deficit of more than € 1½ billion in 2000, substantial surpluses are thus expected again this year.

The Länder Governments' budgetary deficit in the first quarter amounted to just over € 4 billion, which exceeded the comparable figure last year by nearly € 1 billion. Total receipts grew by 1½ %, although tax revenue contracted by 1 %. Expenditure increased faster than revenue, rising by over 2½ %. This was due in part to the increase in personnel spending by the Länder Governments from the beginning of 2001 owing to the 2 % pay increase for employees, one-off payments to civil servants, and the further adjustment of public sector pay rates in eastern Germany to 88.5 % of the west German level. As some Länder Governments had outsourced staff at universities and in construction administration by setting up new off-budget organisations, the overall increase in the personnel expenditure of the Länder Governments was confined to little more than ½ %, however (albeit at the cost of higher grants to public institutions). For the year 2001 as a whole the deficits are expected to rise to more than € 15 billion on account of the large revenue shortfalls resulting from the

Länder  
Governments

<sup>6</sup> The Post Office benefit funds pay the non-contributory pensions of retired civil servants who were employed by the former Post Office when it was still in the public sector. The inpayments into the benefit funds made by the successor enterprises to the Post Office, which are oriented to the pay of present-day employees of those enterprises, by no means cover the outpayments. The Federal Government is committed to making up the difference.

tax reform, compared with around € 10 billion in each of the past two years.

*Local  
authorities*

In the past year the local authorities again generated a surplus of almost € 2 billion. Although their receipts grew by a mere ½%, expenditure growth was limited to less than 1%, not least because of a sharp decline in expenditure on tangible fixed assets in eastern Germany. In the course of this year the municipalities will probably slide into deficit again because of the combined effect of reform-related direct tax losses and lower grants from the Länder Governments under the federal revenue-sharing scheme.

*Indebtedness*

The indebtedness of the central, regional and local authorities decreased by € 11½ billion in the first quarter. This was primarily due to the redemption in early January of claims on the Currency Conversion Equalisation Fund amounting to € 33 billion, which was financed by the proceeds from the UMTS licence auctions. If this exceptional effect is disregarded, net government borrowing in the capital market totalled € 5 billion. Net money market debt rose far more steeply to € 16½ billion, after having been virtually eliminated at the end of last year. Whereas the Federal Government reduced its debt by € 16 billion thanks to the UMTS proceeds, the Länder Governments increased their net liabilities by € 3½ billion and the special funds increased theirs by just under € 1½ billion. Local authorities appear to have tapped the credit markets hardly at all on balance.

## Social security funds

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In the first quarter of 2001 the wage and salary earners' pension insurance scheme recorded a deficit of € 1½ billion. This was virtually the same as at the corresponding stage in 2000.<sup>7</sup> Total contribution receipts were 1% above the corresponding figure in 2000. They were dampened by the lowering of the contribution rate on January 1, 2001 from 19.3% to 19.1%. Whereas receipts from compulsorily ensured persons rose by almost 2%, the pension contributions paid on wage substitutes declined owing to the sharp reduction in payments on behalf of recipients of unemployment assistance. By contrast, a significant increase was recorded in the grants from the Federal budget, which were connected to the higher taxation of energy consumption. Overall revenue exceeded that in the first quarter of 2000 by 2½%. Expenditure rose altogether by 3%. The main cost driver was spending on pensions, which went up by 2½%. This was mainly attributable to an increase in the number of pensioners, whereas the uniform pension adjustment of 0.6% made in mid-2000 merely corresponded to the rate of inflation in 1999.

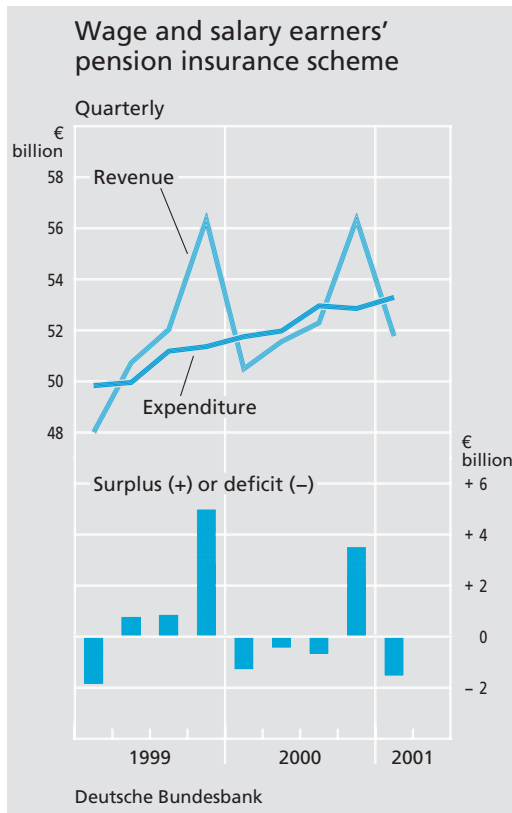
In the course of this year, the financial position of the statutory pension insurance scheme is likely to deteriorate compared with 2000 since the fairly stable increase in revenue will be accompanied by a sharper rise in

*Statutory  
pension  
insurance  
scheme: first  
quarter...*

*... and 2001 as  
a whole*

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<sup>7</sup> The capital gain of € 0.6 billion resulting from the upward revaluation in February of the shares held by the Federal Insurance Office for Salaried Employees (BfA) in the non-profit public limited company for employee housing "Gemeinnützige Aktiengesellschaft für Angestelltenheimstätten" (GAGFAH) is not included in the receipts.



pension expenditure in the middle of the year. On July 1, 2001 pensions in western Germany will be raised by 1.9 % and those in eastern Germany by 2.1 % – i.e. far more steeply than last year's adjustment in line with inflation. Under the new pension adjustment formula which will be used for the first time, the adjustment will be based on the average growth rate of gross wages and salaries less the pension insurance contributions paid.<sup>8</sup> These adjustment rates are based on an increase in gross employee compensation of 1.4 % and 1.6 %, respectively. In addition, the annual average contribution rate in 2000 (19.3 %) was distinctly lower than the equivalent rate in 1999 (19.7 %), which will push up the size of the adjustment. In eastern Germany the defined standard pension will reach

87.2 % of the west German level in the middle of the year (currently 87.0 %).

In the first quarter of 2001 the Federal Labour Office recorded a deficit of just under € 1½ billion, which was almost twice as high as one year earlier. This deterioration was attributable to shifts from the Federal budget to the Office on both the revenue and expenditure side to the detriment of the Federal Labour Office<sup>9</sup> and to legislative changes which prevented the continuing decline in the number of unemployed from passing through to the Office's fiscal balance. On balance, receipts rose by 1½ %, whereas expenditure grew by 6½ %.

*Federal Labour Office: first quarter ...*

Expenditure on unemployment benefits grew by almost 3½ % in the first three months of this year, even though the number of unemployed fell by 4 % over twelve months. This was chiefly due to higher *per capita* spending necessitated by last summer's ruling by the Federal Constitutional Court that contributions made on one-off bonus payments are to be taken into account in future when calculating wage substitutes. Moreover, expenditure in connection with the Act on pre-retirement short-time working, which is not

<sup>8</sup> From 2003 notional supplementary contributions to private pension plans in the previous year will also be deducted from the calculation base. These are to increase in steps of 0.5 percentage point from 2002 to a maximum of 4 % of average pay in 2009.

<sup>9</sup> These relate to the structural adjustment measures concerning recipients of unemployment assistance and the special programme to reintegrate the long-term unemployed.

yet significant, more than doubled.<sup>10</sup> Some 10% more was spent overall on active labour market policy measures compared with the first quarter of 2000. However, this aggregate figure masks disparate trends, namely a further shift away from job creation schemes (-22%) and towards vocational training and retraining (+21%).

... and in 2001  
as a whole

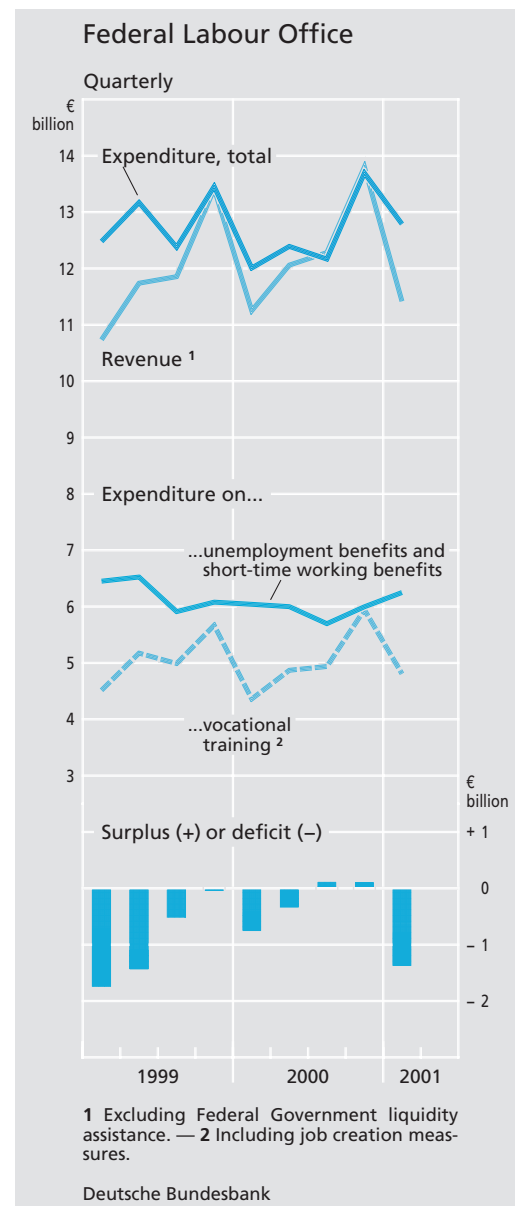
The budget for the year 2001 includes an additional appropriation requirement of € 0.6 billion for the Federal Labour Office. However, that appropriation is based on an assumed decrease of 270,000 in the annual average number of unemployed, which appears rather optimistic in view of the latest labour market trends. It cannot be ruled out that a larger appropriation may be necessary at the end of the year than that earmarked in the Federal budget.

### Outlook for the general government sector as a whole

Trend in 2001

The trend in public finance for 2001 as a whole appears in a much more unfavourable light in the national accounts than in the budgetary accounts. In the latter, for example, tax losses will be partly compensated by privatisation proceeds, whereas in the national accounts these shifts within financial assets do not lead to a decrease in the government deficits.<sup>11</sup>

Judging from the present perspective, the general government deficit ratio as defined in the national accounts – which last year amounted to 1% (excluding the proceeds of



the UMTS auction) – will this year exceed the target of 1½% specified in the German sta-

<sup>10</sup> Under this Act the Federal Labour Office reimburses employers, for a maximum period of six years, for the cost of topping-up the net salary of participants in the scheme to 70% and their contributions to the statutory pension insurance scheme to 90% of the level of an employee working full-time if the employer replaces the participant by a jobless person or a trainee.

<sup>11</sup> Another important factor in the year-on-year comparison is the differently phased booking of tax receipts in the national accounts. Thus the sharp increase in receipts from mineral oil tax and tax on investment income apparent in January of this year were booked already in 2000.



bility programme published in October 2000. The deficit range of € 65 billion to € 75 billion mentioned in the programme could likewise be exceeded unless further retrenchment measures are taken. The principal reason for the widening of the deficit compared with 2000 is the substantial revenue shortfalls in connection with the tax reform, which will probably amount to over 1 % of GDP. Moreover, the economic trend is currently less favourable than was anticipated in autumn 2000.<sup>12</sup> Compared with these burdens, the alleviation on the receipts side stemming from the fact that the Bundesbank profit disbursed this year was appreciably higher than last year has a smaller weight.

The rise in the deficit ratio caused by the unfavourable trends on the revenue side is being held down to some extent by the fact that the budgeted expenditure of the central, regional and local authorities is geared to economical rigour. This is being buttressed by a further decrease in staffing levels in conjunction with the moderate pay settlement in the public sector. In addition, interest expenditure is being dampened by the persistently low level of interest rates and the debt redemption made possible by the UMTS auction proceeds. Moreover, the financial burden ensuing from the payments made last year to the compensation fund for wartime forced labourers will not recur in 2001. However, spending will be increased in a number of areas. Thus there will be increases in year-on-year expenditure on training promotion, housing allowances, child-rearing benefits and (in connection with the Federal Constitutional Court ruling) in unemployment benefits

and sickness benefits. Furthermore, the government heating cost allowance granted in the wake of the surge in oil prices still has to be paid out by the Länder Governments in the course of this year. In addition, public budgets will be additionally burdened by the crises in the agricultural sector. Finally, construction investment and investment grants to the railways are to be expanded substantially – in connection with the interest savings accruing from the debt redemption out of the UMTS mobile phone licence proceeds.

The European Stability and Growth Pact adopted in 1997 committed the member countries to achieving budgets that are close to balance or in surplus in the medium term. Many EU member states have either already achieved this position or look set to do so in 2001. Following the renewed increase in the government deficits this year (arising above all from the extensive reductions in taxes and social security contributions), the task facing German fiscal policy makers is to eliminate the deficits in the coming years, a task which has been made more difficult by the less favourable outlook for tax revenue.

*Medium-term requirements*

Considerable tax shortfalls are likely in the coming years compared with the current medium-term fiscal plans. This is because the new official forecast has markedly reduced revenue expectations vis-à-vis the preceding medium-term estimate of May 2000 and also because a growing volume of tax losses is be-

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<sup>12</sup> It should also be noted, however, that the sagging of cyclical momentum is due mainly to the less favourable external economic developments, which initially have only a limited bearing on tax revenue and on receipts from social security contributions.

coming apparent from additional tax legislation changes. Based on a rate of economic growth for the coming years of 2 ¼ % in real terms and 4 % in nominal terms (the same rates as those estimated in May 2000), the "Tax Estimates" working group expects rising losses in the coming years compared with the previous medium-term forecast (assuming no change in tax legislation). The expected additional shortfalls in receipts will increase from almost € 8 billion in 2002 to just over € 13 billion in 2004. This is compounded by the fact that the structure of economic growth is less "tax-yielding" than assumed a year ago. Further considerable revenue losses will be incurred in 2003 and 2005 from the second and third stages of the tax reform amounting to € 5 billion and over € 19 billion, respectively. Additional burdens will ensue from the rul-

ing of the Federal Constitutional Court requiring a further improvement in the family allowance system and from the growing government promotion of private pension plans.

Given these gloomier prospects compared with last year's medium-term financial plans, the general government sector now has the task of tightly curbing future spending. As measures such as asset disposals or the release of reserves reduce net borrowing only temporarily, they have to be replaced by structural consolidation measures if the strain on public budgets is to be lastingly eased. In a federally structured country such as Germany, however, such stringent and sustained expenditure discipline can only be successful if it covers all levels of government.