

## Public finance

### Central, regional and local authorities

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#### Current developments

In the second quarter of 2001, the central and regional authorities (the figures for the local authorities are not yet known) reached a financial surplus of € 1½ billion. In comparison with the previous year this implies a significant decrease of € 3 billion. This was due to a drop in receipts (2½ %). In the second quarter of the year, the distributed Bundesbank profit was € 4½ billion more than in 2000. This could not, however, compensate for the pronounced decline in tax revenue. Compared with the preceding year, expenditure increased only slightly.

*Underlying trends*

In 2001 as a whole, too – despite a sharp increase in proceeds from the sale of participating interests – the central, regional and local authorities' budgetary position will be less favourable than last year when a deficit of € 34 billion (after adjustment for the UMTS proceeds amounting to just under € 51 billion) was recorded. The significant pressure on the budgetary situation is due to the revenue shortfalls following the tax reform. On the other hand, additional cyclical burdens due to the decline in economic growth should remain low.

After a marginal increase in the first quarter, tax receipts<sup>1</sup> in the second quarter were almost 7 % lower than the corresponding figure for the previous year. The revenue short-

*Tax receipts in the second quarter...*

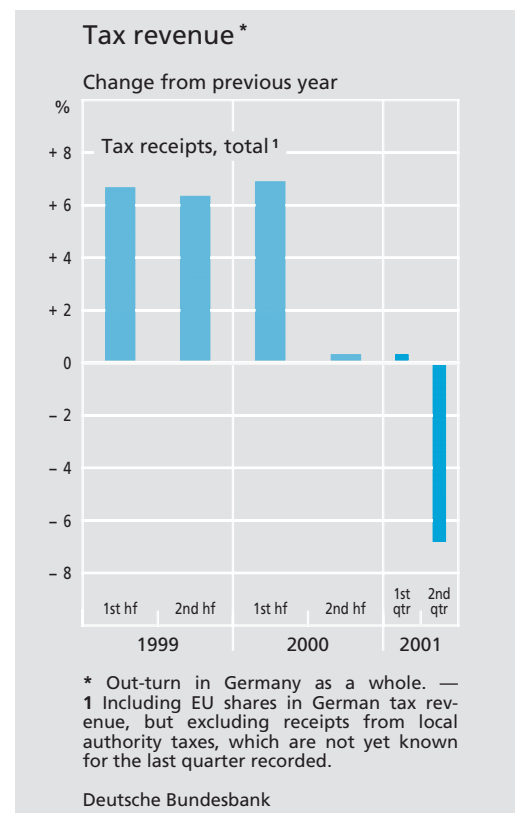
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<sup>1</sup> Including the EU shares in German tax revenue but excluding receipts from local authority taxes, which are not yet known.

falls caused by the tax reform are having a greater influence on the trend in direct tax revenue now than they did at the beginning of the year. Indirect taxes also declined, in comparison with the first quarter.

Of the direct taxes, corporation tax suffered a severe slump in receipts. With € ½ billion it only yielded just under 6% of the previous year's figure. On account of the tax reform, corporate prepayments have been considerably reduced and retrospective payments for previous years have also sharply declined. Finally, corporation tax revenue also fell as profits retained in earlier years were distributed, thereby reducing this tax burden. At the same time, this factor was reflected in a further sharp revenue increase of 29% in non-assessed earnings tax. The receipts from assessed income tax declined considerably (– 22%). This was due mainly to lower retrospective payments for previous years. Until now, despite the tax reform, prepayments, by comparison, have only been reduced slightly. Considering the significant tax cuts, the decline in wage tax (of slightly under 1%) has also remained particularly moderate.

Low revenue in the second quarter was also due to a marked decline in turnover tax receipts of just over 3%. Apparently this was mainly because the capital spending on housing construction – which is subject to taxation – was much lower than in the same period in 2000. Government investment also had a dampening effect on turnover tax receipts, whilst nominal private consumption has increased.<sup>2</sup> Despite the introduction of a further stage of the ecological tax reform at



the beginning of 2001, mineral oil tax still only recorded a growth of 1½%. This was mainly attributable to consumer restraint following the sharp price increase on mineral oil products.

The first half of the year saw a greater reduction in tax receipts (– 3½%) than – according to the official tax estimate in May – was expected for the whole year (– 2½%). The figure for 2001 may therefore be lower than estimated, even though, from the present perspective, the shortfalls are likely to remain moderate. The biggest losses may be record-

*... and in 2001  
as a whole*

<sup>2</sup> In the case of turnover tax trends, it should generally be borne in mind that the revenue from this tax constitutes only about one quarter of the gross revenue accruing from the taxation of turnover before input tax deductions. Due to the large volume of input tax deductions, any changes in the trends can have a strong impact on net revenue.

### Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Change from pre- vious year in %
	1st half-year		
	2001	2000	
Wage tax	62.2	61.9	+ 0.4
Assessed income tax	0.8	3.9	- 78.6
Corporation tax	2.1	13.8	- 84.7
Turnover tax	68.8	70.3	- 2.2

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ed on turnover tax, which in the first half of the year yielded just over 2 % less than a year before. In addition, corporation tax revenue decreased more substantially in the first half of the year than was forecast for the whole year in the tax estimate. However, increased distributions of retained profit, concerned with higher revenue from non-assessed tax on earnings, will thus provide a counterbalance. Furthermore, there is a chance that wage tax revenue – after rising ½ % in the first half of the year despite the tax reform – will be higher than was expected in May.

*Federal Govern-  
ment in the  
second  
quarter...*

In the second quarter, the Federal Government saw a deficit of just under € 2 ½ billion, following a surplus of just over € 1 billion in the same period last year. This was due to the decline in receipts – totalling 6 % – influenced

by the tax revenue trends. The Federal Government's spending was moderately reduced. For instance, the interest payments after redemptions from the UMTS proceeds were just over 5 % lower than in the second quarter of the preceding year. Labour market related expenditure has, by comparison, risen. Admittedly, expenditure for unemployment assistance and for the Federal Government's active labour market policy was down on last year's figure. The Federal Labour Office, by contrast, required significantly higher liquidity assistance.

For this year as a whole, a decrease in the deficit by € 1 ½ billion to € 22 ½ billion is provided for in the Federal Government budget plan. The prospective trend for total revenue should by and large run according to estimations. Lower transfers to the EU (which are deducted from the receipts) should largely compensate for unexpected tax shortfalls. Non-tax receipts could also be higher than expected. On the expenditure side, labour market-induced costs, in particular, will exceed budget appropriations. As with the subsidies for the Federal Labour Office, payments for unemployment assistance will also be considerably higher than planned. Spending on other items in the Federal Government budget is, however, likely to decrease. This applies, amongst others, to interest payments. This was partly due – in the first half of the year – to the topping up of securities issues because of the drop in interest rates resulting in a considerable premium (which is deducted from the interest payments for this year). Calls on funds put aside for investment grants may also be lower than planned. Final-

*... and in 2001  
as a whole*

ly, expenditure on guarantees may also be lower than expected. At this point, it seems therefore possible for the Federal Government to keep net borrowing within the budgeted amount.

*Special funds*

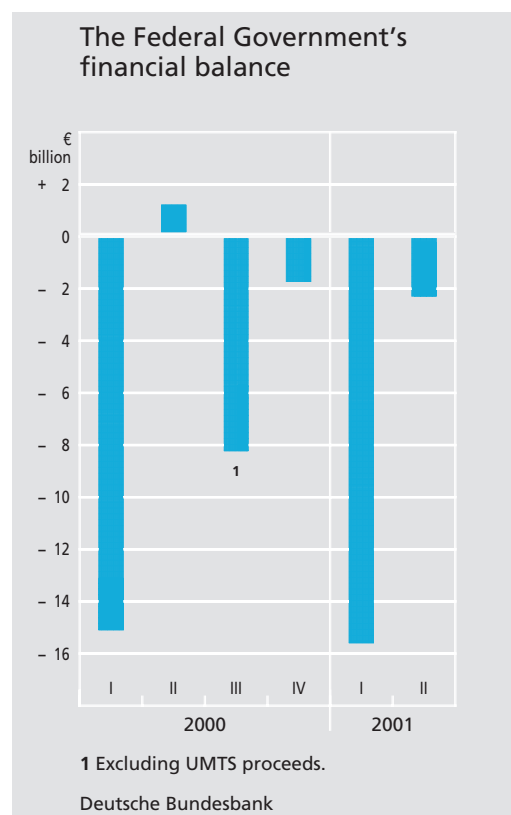
In the second quarter, special funds reached a surplus of € 5½ billion, against € 1 billion in 2000. This owed to the considerably higher distribution of the Bundesbank profit. The portion in excess of € 3.6 billion (DM 7 billion) was transferred, as in previous years, for debt redemption of the Redemption Fund for Inherited Liabilities. Therefore, almost € 5 billion accrued to this special fund, compared with just under € ½ billion in the preceding year.

*Länder Governments*

The Länder Governments saw a budgetary deficit of € 1½ billion in the second quarter, compared with a surplus of € 2½ billion in the same period last year. As was the case with the Federal Government, revenue decreased sharply while the volume of expenditure hardly changed. Many Länder Governments therefore resorted to a budget freeze. In 2001 as a whole, the budget deficits, which (based on the quarterly figures shown here) in the preceding year reached just over € 10 billion, will sharply increase as a result of the tax reform. They could even so much as double if the excess burdens – especially that of the critical trend in the shareholdings of the Land of Berlin – fully materialise.

*Local authorities*

There are signs that the local authorities' fiscal balance will also become more unfavourable this year. In the first quarter, the deficit reached € 3½ billion, compared with just



over € 2 billion a year ago. It is true that the decline in tax revenue by nearly 4½ % could partly be offset by additional revenue from other sources. The increase in expenditure by almost 3½ % is, however, putting pressure on the budget. Along with personnel expenditure and other operating expenses, social security costs also markedly increased. By contrast, spending on fixed capital formation went down somewhat as the result of another sharp decrease in capital spending in the new Länder. If the increase in expenditure is not successfully mitigated, 2001 as a whole will see quite a significant deficit, following a recent surplus of € 2 billion.

The indebtedness of the central and regional authorities decreased – mainly through the transfer of the Bundesbank profit – by just

*Indebtedness*

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

€ billion

Period	Total	of which		Memo item Acquisition by non-residents
		Securities 1	Loans against borrowers' notes 2	
2000 P	+ 16.1	+ 29.1	- 11.8	+ 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 P	- 5.7	+ 13.1	- 18.6	- 2.2
2001				
1st qtr P	- 10.4	+ 13.9	+ 9.7	- 11.8
2nd qtr P <sup>e</sup>	- 6.2	+ 7.6	- 13.8	...

1 Excluding equalisation claims. — 2 Including cash advances and money market borrowing.

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over € 6 billion in the second quarter. Whilst net liabilities in the money market went down by almost € 13½ billion, more than € 7 billion net was raised in the capital market. The amount outstanding of short and medium-term securities, in particular, rose. Net redemptions were concentrated on the Federal Government,<sup>3</sup> which reduced its total debt by just over € 8 billion. Furthermore, the "German Unity" Fund was able to repay € ¾ billion of its debt. By contrast, the Länder Governments stepped up their net liabilities by € 2½ billion. The indebtedness of the local authorities should hardly have changed at all in the second quarter.

### Outlook

The Federal draft budget for 2002 and the medium-term financial plan until 2005 were approved by the Federal Cabinet in June this year. The deficit in the next year is to remain virtually unchanged from the plan for 2001; this means that it will be some € 1 billion higher than stated in last year's financial plan.<sup>4</sup> Revenue is to increase by 1.9%, with tax receipts going up by 3.9%. These figures are generally based on the recent tax estimate. Additionally this includes, on the one hand – following a decision made by the Federal Constitutional Court – the required rise in family assistance which will result in a revenue shortfall of € 1.1 billion and, on the other hand, measures combatting turnover tax fraud which should generate additional revenue of € 1.2 billion. At the moment, the uncertainties about the tax revenue of the Federal Government tend to predominate. Thus, the result for the current year may bring an unfavourable baseline effect in its wake. The Federal Government, in its draft budget, also still expects to halve the burdens created by the intended increase in child benefits, while, in the meantime, the Länder Governments have successfully demanded a higher share from the Federal Government. Besides this, additional revenue from the improved measures against turnover tax fraud can only be quantified with great uncertainty. In the case

*Federal budget for 2002*

<sup>3</sup> Including the debt it has assumed, especially that of the Redemption Fund for Inherited Liabilities.

<sup>4</sup> By contrast, net borrowing is to be reduced from € 22.3 billion in 2001 to € 21.1 billion in 2002 as envisaged in last year's financial plan. The difference between the deficit trends lies in the significantly higher appropriation for the seigniorage (€ 1.2 billion) in connection with the introduction of the euro.

of privatisation proceeds, a volume of € 5 billion is planned for 2002, against the sum of € 8 billion assumed for this year.

In 2002, expenditure is expected to rise by 1.6 % (€ 4 billion) compared with the figure budgeted for in 2001. € 2½ billion of this amount will be attributable to the increased grant for the pension insurance scheme – financed by another rise in “ecology tax”. In addition, the Federal Railways Fund will require € 2½ billion more than it did this year because the same amount of extraordinary revenue budgeted for this year from the proceeds of asset sales will fail to accrue. It must also be noted, however, that the increase in children’s benefit in the budgetary definition is not reflected in an increase in spending, but will operate as a tax reduction factor on the receipt side. As far as labour market expenditure is concerned, no more grants for the Federal Labour Office and almost unchanged unemployment assistance payments have been budgeted. According to the plan, investment expenditure will decrease by € 1½ billion to € 28½ billion. This concerns, amongst others, investment grants to the Länder Governments, calls on guarantees, and construction work linked to the Government’s move to Berlin.

*Medium-term  
financial plan*

Regarding the deficit trends, the medium-term financial plan (see table above) largely corresponds to last year’s figures. In light of the expected shortfalls following the latest tax estimate, it is now necessary to greatly reduce the envisaged growth in spending. It should amount to an annual average of 0.9 % between 2003 and 2005. Therefore,

### The Federal Government’s financial planning over the medium term

€ billion					
	2001	2002	2003	2004	2005
Expenditure	243.9	247.8	249.4	251.9	254.4
of which					
Investments	29.6	28.3	27.7	26.2	26.2
Revenue	221.4	225.5	233.0	241.3	249.0
of which					
Taxes	196.6	204.2	212.3	223.1	227.9
Privatisation sales	1 8.0	5.0	5.1	5.4	5.7
Deficit	- 22.5	- 22.3	- 16.4	- 10.6	- 5.4
Seigniorage	0.1	1.2	0.9	0.4	0.4
Net borrowing	22.3	21.1	15.5	10.2	5.0
Memo item					
Change in expenditure in %	- 0.2	+ 1.6	+ 0.6	+ 1.0	+ 1.0

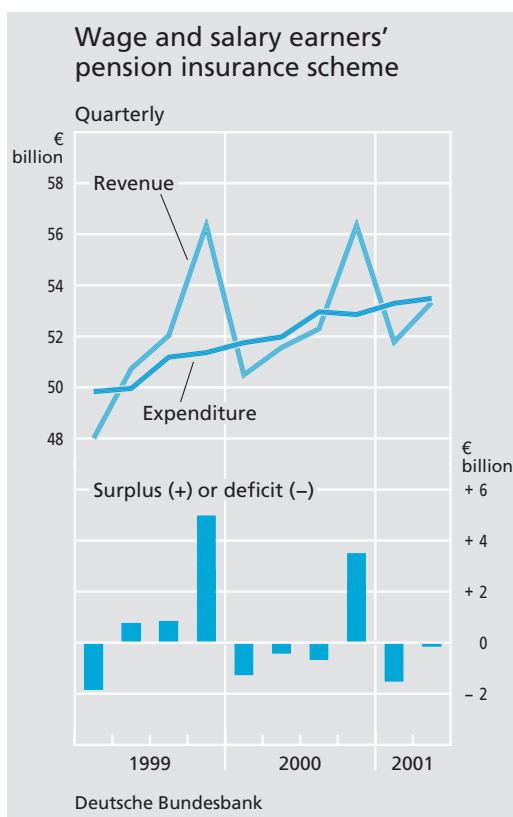
1 Excluding proceeds of the federal Railways fund’s asset sales amounting to approximately € 2½ billion.

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the volume of expenditure in 2003 and 2004 will be € 4 billion and € 5 billion, respectively, lower than that of the previous financial plan. The aim to be able to finance the Federal budget in 2006 without incurring debt has been retained.

The draft budget for 2002 signifies a contribution to consolidation. Admittedly, the deficit will not be reduced any further. However, the proceeds of asset sales (including the Federal Railways Fund) – used for funding – will be more than € 5 billion lower than this year’s budgeted figure so that financing from unsustainable sources of revenue will be reduced considerably. The trend stated indeed requires – in particular for the medium term – a consequent retrenchment course with re-

*Consolidation  
requires tight  
spending limits*



strictions on benefits, especially since the revenue trend is subject to some risk.

### Social security funds

*Statutory pension insurance scheme*

In the second quarter of 2001, the wage and salary earners' pension insurance scheme ended up close to balance, following a deficit of € ½ billion in the same period last year. Despite the lowering of the contribution rate from 19.3 % to 19.1 % at the beginning of the year, contribution receipts experienced a fairly sharp increase, at 2 %. If the contribution rate had not been lowered, the increase would have been 3 %. The grants from the Federal budget which were funded by the "ecology tax" rose much more substantially. Total receipts increased by 3 ½ %. Expend-

iture went up by almost 3 % in the second quarter, with pension expenditure growing by 2 ½ %. This can be put down to the increase in the number of pensions by approximately 2 % and the mid-year rise in 2000 in pensions by 0.6 % in line with the rate of inflation.

In the first half of this year, the deficit was just over € 1 ½ billion and thus just as large as last year. On 1 July 2001, pensions were raised for the first time using the amended pension adjustment formula<sup>5</sup> adopted as part of the recent reform. Following this, there was a rise of 1.9 % and 2.1 % in the old and new Länder respectively. Due to the higher pension adjustments this year, a steeper rise in expenditure and – in comparison with last year – more adverse fiscal balances are to be expected in the second half of 2001. The required reserves of one month's expenditure at the end of the year could nevertheless be reached because the book value of the Federal Insurance Office for Salaried Employees (BfA) was raised by just over € ½ billion in February.

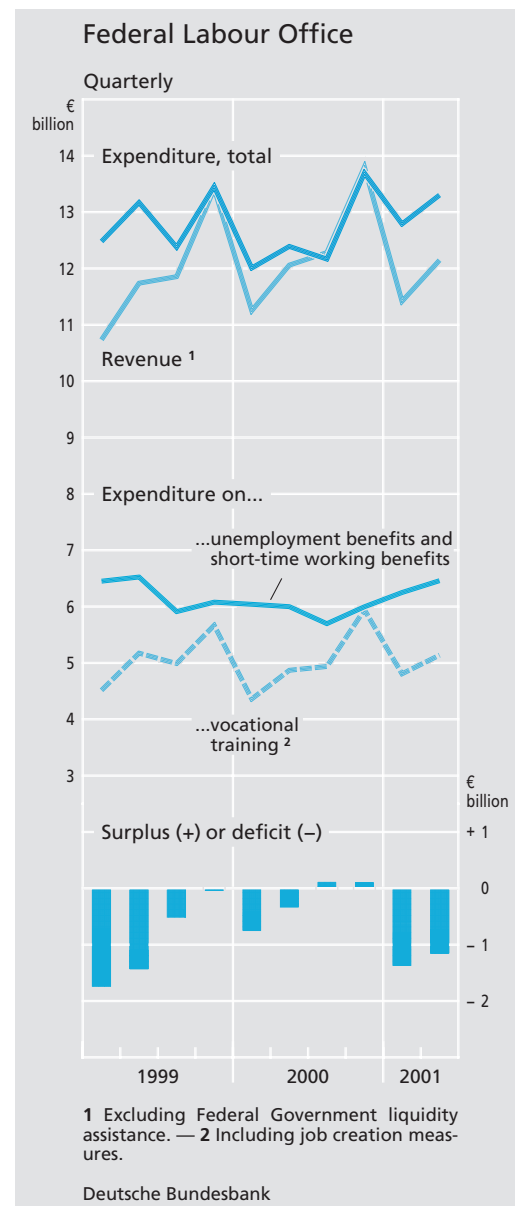
*Federal Labour Office*

In the second quarter, the Federal Labour Office experienced a deficit of just over € 1 billion against just under € ½ billion for the same period in 2000. An increase in receipts of slightly more than ½ % was accompanied

<sup>5</sup> According to this formula, pensions are adjusted to correspond to the rise in the average gross remuneration for the previous year less contributions to the pension insurance scheme and less a notional percentage paid as contributions into a supplementary private pension plan. The annual average contribution rate dropped from 19.7 % in 1999 to 19.3 % last year. The wage and salary increase per employee was 1.4 % in the West and 1.6 % in the East. Only from 2003 will the contributions paid into private pension plans cause the pension adjustment to be just over a 0.6 percentage point lower.

by a rise in expenditure of almost 7½%. The weak trend of receipts is, however, not related to contributions – which with a growth of just under 3½% have considerably picked up – but rather due to the fact that since the start of 2001 the structural adjustment measures for the recipients of unemployment assistance are no longer paid from the Federal budget. The Federal Labour Office also received considerably fewer payments from the European Social Fund.

The expenditure on unemployment benefits in the second quarter exceeded the corresponding figure of the previous year by just under 7½%. This sharp rise was due to the stipulation that – since the middle of last year – one-off payments be taken into account when determining claims for wage substitutes, thus the payments per unemployed person increased significantly. Because the decline in the unemployment rate has increasingly slowed down in comparison with last year, the trend of the labour market has provided only slight relief. Admittedly, in the second quarter, the active labour market policy received 5½% more funding, but still the rate of increase slowed down. Within this total increase, there was a rise of 14% for vocational training and further training schemes, which owes much to the fact that the Federal Government transferred the special programme for the reintegration of the long-term unemployed from its own budget to that of the Federal Labour Office. By contrast, job creation schemes received 21% less. An extremely steep (41%) drop was seen in expenditure for structural adjustment



measures – which have particular significance in the new Länder.<sup>6</sup>

By the middle of the year, the Federal Labour Office deficit had reached a level of € 2½ bil-

*Outlook*

<sup>6</sup> The Federal Labour Office can award grants for work on the improvement of the environment, social services, mass sport, cultural activities, residential amenities, the economic infrastructure and preservation of historical monuments. In the new Länder (including Berlin), industrial and commercial companies can also claim these grants.



lion, compared with just over € 1 billion last year. It would seem possible – mainly due to the unfavourable labour market trend – that the demand for grants this year will exceed the € 0.6 billion predicted in the budgetary plan. However, neither is a substantial increase on the mid-year deficit figure to be expected, because the decision to take into account one-off payments when determining unemployment benefits will bring about very few additional burdens, compared with the previous year. Due to the worsening financial position this year, the scope for an early lowering of the contribution rate is rather limited.

*Statutory  
health  
insurance funds*

For statutory health insurance funds, only the data for the first quarter are available. They show that the deficit rose by € ¼ billion, compared with the previous year, to just over € 1 billion. However, eastern and western Germany show different pictures. While the deficit grew by almost € ½ billion to slightly more than € 1 billion in the old Länder, the health insurance institutions in the new Länder in fact saw a small surplus following a practically balanced result in 2000. The east German health insurance funds are profiting from their increasing inclusion in the all-German risk structure compensation scheme. Furthermore, at the beginning of the year, the income limit for the assessment of contributions of the statutory health insurance in the new Länder was raised to the same level as that in western Germany.

*Contribution  
rate trends*

These diverse trends are also reflected in the contribution rates. In the first quarter, the average contribution rate in the new Länder

was lowered by almost 0.2 % to just under 13.7 %, while in the West the figure remained virtually unaltered (13.5 %). The contribution rate increases announced since then are initially confined to some individual west German health insurance institutions, which are in particular affected by an exodus of people with a “favourable risk structure”. In addition to the current steeper rise in expenditure driven mainly by pharmaceuticals, structural differences are also emerging between the various health insurance institutions. The consequence may be an increasing divergence between contribution rates. However, there are already efforts under way to further develop the burden-sharing scheme between health insurance institutions.

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

In 2001 as a whole, the deficits for the general government sector – in ESA definition on which the criteria of the Maastricht treaty are also based – will be considerably larger than in 2000, when they totalled (excluding UMTS proceeds) 1.0 % of GDP. This is due to the impact of the tax reform, which will lead on balance to a shortfall in receipts of just over 1 % of GDP. There will, by contrast, be an increase in energy taxation (of 0.1 % of GDP). These receipts will, however, be transferred to the statutory pension insurance scheme so that the social security contributions will drop accordingly.

*Deficit increase  
through tax  
reform*

The German stability programme for 2001 aims for a deficit ratio of around 1½ %. The

tight limits on the expenditure increase are partly to compensate for the deficit-increasing impact of the tax reform. Even so, the planned growth in deficit represents an expansionary fiscal policy stance in terms of business cycle policy, this is now to be regarded differently to last autumn when it was still widely criticised as pro-cyclical.

*Limited cyclical  
burden on the  
general govern-  
ment budgets*

As things now stand, the government deficit ratio could reach 2 % (and slightly more) for this year. The margin for the absolute deficit of between DM 65 billion and DM 75 billion stated in the stability programme has already slightly exceeded the rounded target value of 1½ %. Compared with original premises, overall economic conditions are also more unfavourable now. Even so, the cyclical burdens on the general government budgets are likely to remain limited this year. In addition, these burdens will probably be accompanied by relief in other areas. Tax shortfalls, compared with plans, are likely to be moderate although the expectations for real aggregate growth have worsened. It should be noted that tax revenue trends are influenced by nominal economic growth which has been decelerating less severely than real growth. The official tax estimate in May showed losses of revenue of € 3½ billion, most of which, however will be offset by lower payments to the EU. The slower economic activity is primarily reflected in turnover tax and, partly – with a lag – in profit-related taxes. By contrast – in the light of a continuously solid growth in gross wages and salaries – wage tax and the receipts of the social security funds show a fairly positive trend. On the expenditure side, there will also be additional la-

bour market-related expenses, which, however, will be offset by savings in other sectors.

Next year, more buoyant economic growth is generally expected again. A credit-financed active governmental business cycle policy – such as, for instance, the early implementation of the next few stages of the tax reform – would, therefore, not be appropriate in the expected economic situation. It is also worth taking into account the bad experience of similar measures in the past not least because of “bad timing”.

*Active business  
cycle policy in-  
appropriate*

In general, fiscal policy, like monetary policy, should provide medium and long-term reliable underlying conditions for private economic agents. A good start would be a tax reform implemented in stages, which aims to lower the existing heavy tax and social security contributions burden while at the same time reducing the sizeable deficits through a cut-back in government spending. Since the deficit ratio will rise again this year, further credit-financed tax decreases – which ultimately mean a relocation of financial burdens to the future and would lead to a significant relaxation of consolidation efforts – would not be suitable to enhance sustained economic activity. The hope for the implementation of short and medium-term self-financing effects of deficit-increasing tax cuts should not be a central element of a fiscal strategy that is geared towards consolidation.

If Germany, as one of the biggest countries of the euro area, were to relax its fiscal policy stance in the next few years, the path towards medium-term balanced budgets or sur-

pluses – on which the EU countries agreed in the European Stability and Growth Pact – would be highly jeopardised, particularly as other countries would be likely to follow this

example. This would lead to the markets losing trust in a long-term sustainable fiscal policy for the euro area and have adverse effects on interest rates and overall economic trends.