

Public finance

Budgetary development of central, state and local government

In the first quarter of 2003 the deficit of central and state government (the results of local government are not yet known) amounted to €36½ billion. This was considerably higher than the deficit in the same period last year which was already very high (€31 billion). Whereas revenue declined by ½% as a result of lower tax receipts, expenditure rose sharply by 4½%. Particularly labour market-related spending increased again considerably.

Overview

In 2003 as a whole, the budgets of central, state and local government appear set to develop very unfavourably, which will result in another increase in the deficit unless further measures are taken. For example, as things stand today, the Federal Government and the *Land* governments will not be able to lower their deficits as sharply as they had originally expected; their deficits will be barely lower than in the previous year. This is attributable to the sizeable tax shortfalls and also the additional labour market-related expenditure of Federal Government. In the case of the local authorities, a considerable deterioration of the budgetary position is expected vis-à-vis 2002. This applies, too, to the special funds which are burdened by the sharp decrease in the Bundesbank profit.

Tax receipts of general government¹ developed disappointingly in the first quarter of 2003 after showing a fairly positive trend for

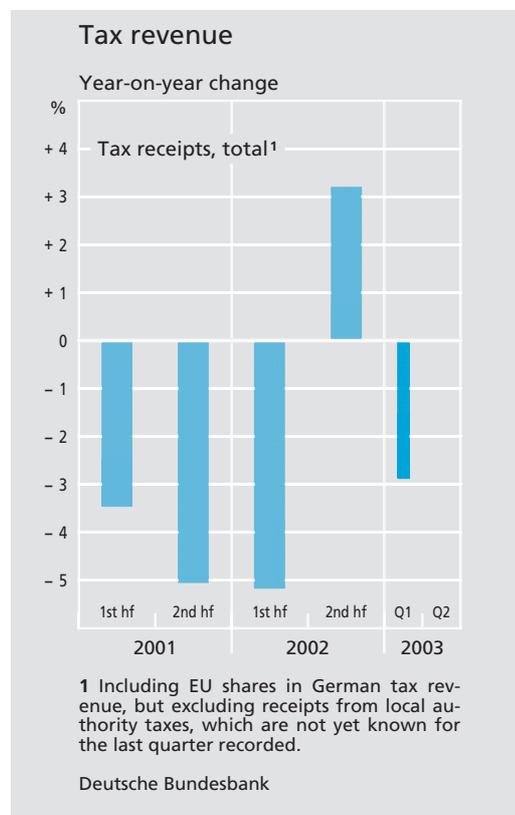
*Tax revenue
in the first
quarter...*

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

a short time in the last quarter of 2002. On the whole, in the first three months of 2003 they were almost 3% lower than the already sluggish figure for the previous year. Besides several special effects, the unfavourable economic situation also continued to dampen the revenue trend.

Among the various types of income taxes, corporation tax receipts went up by €1¾ billion to nearly €2½ billion. The temporary rise in the corporation tax rate by 1½ percentage points to 26.5% to finance flood-related damage also played a role. However, the tax-reducing distribution effects which were considerably lower than the previous year had a far greater impact; this was reflected in a decline in revenue from non-assessed taxes on earnings (by €1¾ billion or almost 40%). In the case of assessed income tax, the negative balance from inpayments and outpayments widened by a further €1¾ billion to €5½ billion. This result was dampened to an increasing extent by the tax grant to home buyers, which is primarily disbursed in March.² Wage tax developed very unfavourably; receipts from this tax were merely ¾% higher than in the previous year. Besides the deteriorated employment situation, the reduction of special payments at the end of 2002 and the shortfalls due to contribution payers opting for direct insurance plans in their company pensions may have played a role in this development.

Among indirect taxes, revenue from turnover tax declined in the first quarter by 2½%. This was caused not least by the unfavourable development of retail trade turnover. Despite



the increases in energy taxes which entered into force at the beginning of the year, revenue from mineral oil tax has actually fallen by almost 15%; besides declining consumption, the shifts in payment dates at the beginning of the year were also an important factor.

Because of the bad start to 2003 and the persistently weak economic development, tax revenue will develop considerably more sluggishly than is expected in the budgetary plans. According to the new estimate which was posted in mid-May by the Working Group on Tax Estimates, which assumes a growth in real GDP of ¾% and in nominal

... and in 2003 as a whole

² This is due to the fact that a further generation grew into this promotion scheme (each promotion measure lasts eight years), which has existed since 1996.

Trends in the revenue from major taxes

Type of tax	Revenue in € bn		Annual percent- age change
	Q1		
	2003	2002	
Wage tax	30.6	30.4	+ 0.7
Assessed income tax	- 5.4	- 3.6	.
Corporation tax	2.4	0.7	+ 267.2
Turnover tax	33.7	34.5	- 2.4

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GDP of just over 2%, revenue will only go up by just under 2%. Compared with the estimate from autumn of last year, this shows shortfalls amounting to €10½ billion. Of these revisions, the two types of individual taxes which yield the highest revenue, wage tax and turnover tax, are affected the most. When evaluating the outturn of the official estimate, it should be borne in mind that, as things stand today, economic growth in Germany is likely to be somewhat weaker than anticipated. According to the official estimate, the overall tax ratio (as defined in the government's financial statistics) will even go down slightly to 20.9% despite the tax increases which entered into force at the beginning of the year. Vis-à-vis the estimate from May of last year the tax estimate forecasts increasing shortfalls in the medium term; these

will amount to €46½ billion or just under 2% of GDP in 2006.

In the first quarter, the deficit recorded in the Federal budget rose by €4 billion to €25½ billion compared with the same figure last year. Revenue fell by 1¾%. This was mainly due to the fact that tax revenue was 3¼% lower. Expenditure rose sharply by 4½%. This was attributable, for one thing, to a significant increase in grants to the statutory pension insurance scheme – the best part of this increase will be financed by the last stage of the ecological tax reform. For another, labour market-related expenditure – unemployment assistance and grants to the Federal Labour Office – will expand considerably due to the higher level of unemployment. In addition, the flood disaster fund received its first injections of funds. By contrast, interest payments went down despite a sharp increase in the level of indebtedness. The low interest rate level made it possible to refinance at more favourable rates. Moreover, the collection of a sizeable premium on the issue of Federal securities had a particular expenditure-reducing impact.

The Federal budget, which was adopted in March, envisages a sharp decline in the deficit for this year by €13 billion to €19½ billion. This target, however, will not be reached, according to the most recent tax estimate which forecasts tax shortfalls vis-à-vis the plans (under comparable tax legislation) amounting to €4 billion. Furthermore, the fact that proceeds associated with the Act to Reduce Tax Subsidies will be lower than anticipated will result in revenue shortfalls. The

Federal Government in the first quarter...

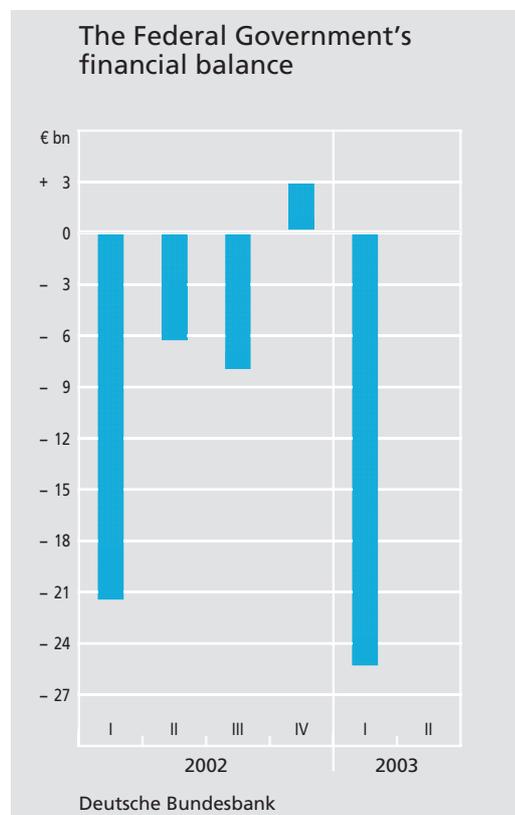
...and in 2003 as a whole

plans also include additional revenue arising from the Act on the Tax on Interest Income (€2 billion), which is still being debated in political circles and whose financial impact can be estimated only with great uncertainty.

On the expenditure side, too, the estimates are likely to be exceeded. Compared with the figure for the previous year, a decline of ½% is expected here, although considerable additional financial resources (€3½ billion) will be necessary to finance the reconstruction aid fund which was founded in connection with the flooding. By contrast, as things now stand, a considerable rise in expenditure is expected. This is mainly attributable to high unforeseen labour market-related expenditure burdens. For example, the grant to the Federal Labour Office will not be repealed, as was originally planned. In the light of the increasing unemployment level – but also due to the fact that additional revenue associated with the Hartz reforms will be lower than expected – the previous year's amount may actually be overshot. Moreover, the expenditure for unemployment assistance – which according to the plans should decline by more than 15% due, also, to the stricter eligibility requirements for benefits – is likely to be significantly higher than the estimated amount.

Special funds

In the first quarter the special funds recorded a surplus of €½ billion, whereas a deficit of the same amount existed in the first quarter of 2002. The main reason was that when the reconstruction fund founded to finance the flood assistance was first included, the inpayments of the Federal and *Land* governments exceeded outpayments by €1 billion. In 2003



as a whole the surplus of the special funds – which amounted to €9 billion last year – will, however, decline considerably. This is because the Bundesbank's profit distribution, which is recorded in the budgets in the second quarter, was €5½ billion; this was almost €6 billion lower than in the previous year when it was characterised by several extraordinary factors. Of this distribution, €3.5 billion accrued to the Federal budget with the rest going to the Redemption Fund for Inherited Liabilities.

The *Land* governments' budgets recorded a deficit of €12 billion in the first quarter. The level from the previous year – which was already high – was thus exceeded by €3 billion. Contrary to expectations, tax receipts went down again by just over 1½%. Total non-tax

Land governments

Net borrowing in the market by central, state and local government

€ bn

Period	Total	of which		Memo item Acquisi- tion by non- resi- dents
		Securi- ties 1	Loans against borrow- ers' notes 2	
2001	+ 14.2	+ 56.3	- 6.6	+ 13.0
2002 <i>pe</i>	+ 54.5	+ 67.6	- 12.0	+ 51.0
<i>of which</i>				
Q1	+ 25.6	+ 15.2	+ 10.5	+ 10.2
Q2	+ 1.5	+ 22.9	- 21.4	+ 15.2
Q3	+ 18.6	+ 25.1	- 5.4	+ 19.7
Q4 <i>pe</i>	+ 8.8	+ 4.4	+ 4.4	+ 5.9
2003				
Q1 <i>pe</i>	+ 34.2	+ 31.4	+ 2.8	...

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

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revenue also went down marginally. However, the strong increase in expenditure of 4% is partly due to the special factors and is likely to recede over the course of the year. In 2003 as a whole, expenditure will go up by 1% as a result of payments to the flood assistance fund alone. Furthermore, the envisaged relatively considerable increase of 2.4% in civil servants' pay is likely to have a significant impact. However, these additional burdens may be constrained through the envisaged flexibility of holiday pay and Christmas bonuses.

Against this background, several *Land* governments already adopted supplementary budgets before the recent tax estimate; most of these envisaged increased borrowing authorisation. As was the case in 2002, several

Land governments ran into conflict with the constitutional ceilings. At the same time, the flood assistance payments, which are actually to be financed by postponing the next stage of the tax reform, have already been cited as grounds to justify increased borrowing by declaring most of them as investment expenditure and thus taking them into account when determining the permissible borrowing.³ The fact that a disruption of the macro-economic equilibrium still needs to serve as justification for new borrowing is a clear sign of how strained the financial situation is. The significant reduction of the deficit to €22 billion which has been planned in the budget will no longer be possible as things stand today. Without further consolidation measures, last year's record deficit of €31 billion may even be reached again this year.

For local government only the results for 2002 are available. In the final quarter, in view of the occasional gushing springs of taxes and declining expenditure, the municipal budgets recorded a surplus of just over €1½ billion following a deficit of a little more than €½ billion in the last three months of 2001. The overall deficit in 2002 amounted to €4½ billion and overshot the amount from 2001 by just over €½ billion, contrary to expectations. Total expenditure grew by just under 1%. Whereas the rise in personnel expenditure accelerated to almost 2%, expend-

*Local
authorities*

³ Furthermore, in other areas, borrowing will also be justified by investment expenditure, which is already covered in the budget plans by clearly allocated current revenue. This procedure is often used not only for investment transfers which are funded out of general tax-sharing arrangements, but also for significant individual cases such as the use of current transfers for investment purposes.

iture on investment went down by 5½%. A further decline in tax receipts of just over 3% was offset, in particular, by an increase in proceeds from the sale of participating interests, causing overall revenue to go up by another ½%. The fact that the outturn at the end of 2002 was ultimately more favourable than anticipated should not be interpreted as an easing of the municipal financial situation. For example, revenue expectations for taxes were also dampened by a renewed rise in trade tax contributions. Moreover, transfers from state government are also likely to be lower due to the final settlement of previous years and the low tax receipts at this level of government, too. Finally, proceeds from the sales of assets are no longer likely to reach the high level of the previous year. On the expenditure side, there will be additional spending on personnel arising from the pay settlements in the public sector. On the whole, the fear is that the deficit will rise sharply this year.

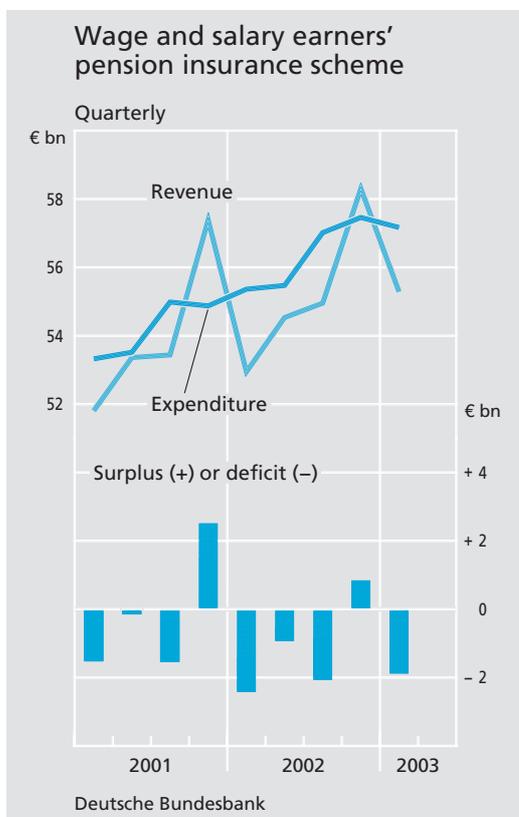
Indebtedness

In the first quarter the indebtedness of central, state and local government rose by €34 billion. Whereas €30 billion net was borrowed on the capital markets, money market debt rose by €4 billion. The Federal Government had the largest net borrowing requirement (€20 billion), even though the Bundesbank's profit distribution (actual cash inflow) had already been posted in the first quarter. However, the *Land* governments also drew considerably on the credit markets. The financing requirement reached €13 billion. Local government appears to have marginally raised its indebtedness.

Social security funds

The wages and salary earners' pension insurance scheme recorded a deficit of €2 billion in the first quarter. This was €½ billion lower than the comparable figure from the previous year. Revenue from contributions rose by 3½%. Adjusted for the increase in contribution rates from 19.1% to 19.5% this meant an increase of 2%. In view of the continued shedding of jobs, the calculated increase in compulsory contributions from employed persons was, however, below average (1%). This subdued rise itself was probably mainly due to the increase in the maximum level of earnings subject to contributions and also partially due to the one-off payment disbursed in March to public sector employees, which was agreed in the pay settlement. By contrast, revenue from contributions for recipients of unemployment benefits and unemployment assistance rose sharply; this is, however, a strain on the budgets of the Federal Labour Office and the Federal Government. Furthermore, Federal grants to the pension insurance scheme were raised considerably. Besides the additional resources in connection with the last stage of the ecological tax reform, the components pegged to the contribution rate also went up relatively steeply. All in all, the revenue from the pension insurance scheme increased by 4½%. Expenditure went up somewhat less (by just under 3½%) than in the past few quarters. In this context, the fact that the increase in the number of pension recipients is decelerating as the discount rules for persons who take early retirement are increasingly taking effect also had an impact.

*Statutory
pension
insurance
scheme*



Outlook for
2003

Contrary to the plans, which envisaged a surplus for this year, the statutory pension insurance scheme is likely to record a deficit in 2003, too. Admittedly, the increase in expenditure is likely to continue decelerating because in the case of the pension adjustments effective 1 July, a discount of around 0.6 percentage point for imputed contributions to the "Riester Rente" will be taken into account and the average earnings in 2002 grew less sharply than in 2001. However, the rise of 1.04% in the western and 1.19% in the eastern German Federal states will consequently be much lower than in the previous year. The considerable deterioration in the labour market situation is likely to result in significant shortfalls in contributions. In addition, an increased use of the possibility for contribution payers to opt for direct insurance

plans in their company pensions, which has existed since 2002, and – as a result of new rules – low-paid employment as well as increased deduction provisions for unemployment assistance may lead to further shortfalls in contributions. In addition, the possibility, as envisaged in the pay settlement for the public sector, to postpone the salary payment date in December 2003 may result in financial gaps. In the light of these risks, it is to be feared that at the end of 2003 the fluctuation reserve will undershoot its minimum reserve requirement of 0.5 month's expenditure. The contribution rates would then have to be raised again in 2004 if no measures are taken on the expenditure side.

In the first quarter, the budget of the Federal Labour Office was dominated by a considerable increase in unemployment. The deficit grew by just over €1 billion to almost €3 billion vis-à-vis the first quarter of 2002. Expenditure rose by 10%. As the number of unemployed persons went up by 10%, expenditure on unemployment benefits went up considerably more sharply (by 16%) because in phases of intense job cuts, the ratio of payment recipients to unemployed persons usually goes up. Following the temporary decline in the eastern German Federal states, spending in this area is now increasing again significantly. Expenditure on active labour market measures rose by 2.5% in total. The announced savings have been concentrated until now on job creation measures, for which considerably less was spent in the first quarter of this year compared with the first three months of 2002. By contrast, more was spent on other vocational promotional

Federal Labour
Office

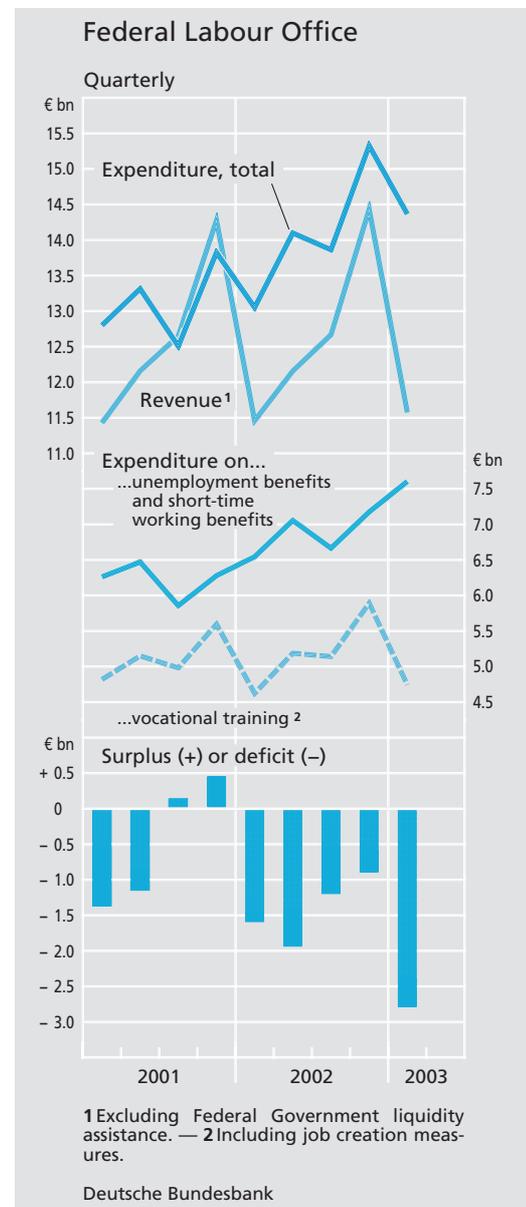
schemes. However, there was a significant overall decline in the number of participants; this also partly explains the sharp increase in the recorded level of unemployment.

Outlook for
2003

According to the budget plan, the Federal Labour Office should get through this year, for the first time since German reunification, without a Federal Government grant. However, the situation has deteriorated considerably since the budget was prepared. For example, the starting position with a deficit of €5.6 billion last year has already proved to be more unfavourable. The total number of unemployed persons envisaged for 2003 of 4.14 million was already overshoot in March by almost 0.3 million after seasonal adjustment. Furthermore, it is debatable whether the anticipated savings of €2 billion can actually be accomplished by implementing the measures more quickly. The cyclical trend is also depressing the revenue from contributions. Ultimately, the Federal Labour Office is, in fact, likely to record a rising deficit this year.

Statutory
health
insurance funds

For the financial development of the statutory health insurance funds results are available only until the end of 2002. According to these results, the deficit reached €3 billion in total. It increased marginally vis-à-vis 2001, even though the contribution rates were raised by just over 0.3 percentage point on average. Despite this raise, revenue increased by only 3%, since the revenue from compulsory contributions paid by insured persons went up only marginally. Moreover, there were considerable strains on the expenditure side. For example, expenditure on pharma-



ceuticals grew by just over 4½% despite assurances by the medical service associations at the beginning of the year that a decrease of 5% was in the pipeline. Additional expenditure of around €2 billion resulted from this deviation alone. In the case of hospital treatment, too, the increase in expenditure of 3% was decidedly higher than planned. On balance, the health insurance institutions were unable to replenish their reserves to the

envisaged minimum level of 25% of one month's expenditure. It is more likely that they will resort to credit financing, which is not actually legal.

*Outlook for
2003*

These loans would have to be repaid this year, which means the health insurance institutions ought to record a surplus of billions of euro. Contributions rates were already raised markedly at the beginning of the year to an average of 14.3%. This adjustment was based on the considerably more favourable assumptions of the financial situation and the continued macroeconomic trend. In addition, the relief measures adopted in autumn 2002 should significantly depress expenditure growth this year. This is, however, not likely to be sufficient to even reach a balanced outturn if the weak trend of revenue subject to compulsory contributions persists. Therefore, another noticeable increase in average contribution rates will be required before the end of the year. In the light of the associated impairment to the macroeconomic outlook, the health care reforms announced for 2004 will also be significant.

*Statutory
nursing care
insurance
scheme*

The statutory nursing care insurance scheme recorded a deficit of €½ billion in 2002 after a virtually balanced outturn in the previous year. Revenue only rose by just over 1%. On the other hand, expenditure growth accelerated to 3% due to an expansion of the range of benefits. The reserves have, however, remained virtually unchanged (€5 billion) because the Federal Government repaid a loan of just over €½ billion.⁴

General government budget trends

Last year the overall deficit ratio – as defined in the Maastricht Treaty – went up to 3.6% and the Ecofin Council declared an excessive deficit for Germany.⁵ As things stand today, the 3% ceiling will probably be overshoot this year, too, if no other relief for the general government budgets is initiated in addition to those decisions which have already been taken. Admittedly, on the revenue side in particular, several special consumer taxes and social security contributions were increased. Moreover, in view of the high budget deficits, stringent budget management is expected at all levels of government. Finally, reductions in statutory health insurance benefits and in labour market-related expenditure may also make themselves noticeable. These are, however, offset by considerable burdens which result, in particular, from the unfavourable cyclical development expected this year and the associated higher level of unemployment. Furthermore, flood-related expenditure, the lower Bundesbank profit and increasing transfers to the EU all have an impact.

*The 3% ceiling
is expected to
be overshoot
again*

The Ecofin Council called on Germany to correct the excessive deficit as quickly as possible and to implement the consolidation measures announced for this year amounting to 1% of GDP or to replace this procedure with one of equal proportions. Otherwise, Germany faces the threat of sanctions under the excessive

*All levels of
government are
under pressure*

⁴ This repayment was not booked as revenue by the statutory nursing care insurance scheme.

⁵ For details, see Deutsche Bundesbank, *Monthly Report*, February 2003, p 53 and Deutsche Bundesbank, *The development of public finances in Germany following qualification for European monetary union*, *Monthly Report*, April 2003, pp 15-32.

deficit procedure. The pronounced federal structure in Germany means that during a fiscal decision-making process, agreement is required from the various levels of government; this ultimately makes it more difficult to allocate responsibility for the overall outturn. All levels of government are showing high deficits, with which the upper borrowing limits under budgetary law were reached and frequently even overshot. Against this background, all fiscal policy decision makers are called upon to undertake the required consolidation efforts. It is essential to fulfil the European commitments and consequently to preserve the credibility of the existing fiscal rules in order to support the single European monetary policy – which is particularly attributable to German initiative. This is a task for all levels of government.

The German Budget Principles Act – in line with the Stability and Growth Pact – envis-

ages the target of a balanced budget for the Federal and *Land* governments. This means that in the light of the high structural deficits, there is also a considerable consolidation requirement in the medium term. If there is a consensus that the burden of taxes and social security contributions will not be increased and that it will, in fact, be reduced further, adjustments have to be carried out on the expenditure side. The agreements made by the Financial Planning Council, which envisages, *inter alia*, a tight constraint on expenditure growth of central, state and local government for this year and the next, should play a part in this. Initially, the provisions need to be fulfilled without shifting the burden to other levels of government. In the light of the medium-term outlook for the budgetary development of Federal and *Land* governments, an extension of the cost-cutting decisions – which currently only cover 2003 and 2004 – also seems necessary.