

Public finances

Budgetary development of central, state and local government

In the third quarter of 2003, as in the first half of the year, the combined deficit of central and state government (the results for local government are not yet known) increased year on year, rising by €11 billion to €23 billion. Expenditure grew quite sharply by just over 3%; this was fuelled mainly by higher interest payments of central government and a further increase in Federal grants to the statutory pension insurance scheme. By contrast, revenue fell by 3½%, not least because – unlike last year – no sizeable privatisation proceeds accrued to Federal Government.

Underlying trends

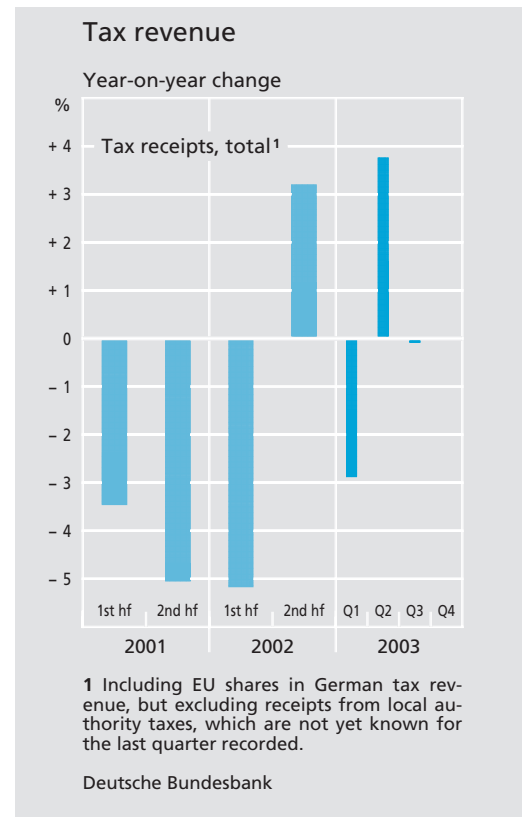
In 2003 as a whole, the combined deficit of central, state and local government will rise again sharply, probably to around €80 billion, having already increased in the two previous years by a total of €26 billion to €60 billion. Consequently, the original budgetary targets, which had envisaged a reduction, will not be met. Moreover, the constitutional upper limit for net borrowing, defined by the level of government investment, will also be clearly overshoot by most tiers of government. This reflects, in particular, the persistent sluggishness in tax revenue and the accelerated expenditure growth compared with the last three years – to which the exceptional additional expenditure in connection with flood relief made a contribution. The precarious budgetary situation, the causes of which are primarily structural, makes comprehensive consolidation necessary. Central and state government must resolutely implement the appropriate measures. Bringing forward the

*Tax revenue in
the third
quarter...*

third stage of the income tax reform without comprehensive counter-financing would aggravate the strained budgetary situation even further.

In the third quarter, the tax receipts¹ of general government barely matched last year's corresponding level, after having increased by ½% in the first six months of 2003. Of the direct taxes, wage tax receipts increased by a mere ¾%; this was considerably less than in the second quarter (just over 2%), which had been buoyed by one-off payments resulting from certain pay settlements. The fall in the employment level continued to have a dampening effect on wage tax receipts. The revenue from assessed income tax remained significantly below its level in the same period last year (-10%), which was caused by both prepayments and retrospective payments. Among investment income taxes, revenue from interest income taxation fell by 10½%, not least because of the lower interest rates. Revenue from non-assessed taxes on earnings – essentially investment income tax on dividends – declined by almost two-fifths owing to lower dividend payments. By contrast, corporation tax receipts continued to rise sharply (+22½%). This was mainly due to the dwindling importance of the special factors related to the changeover in the tax regime introduced by the tax reform, which had had a dampening effect on receipts.

In the case of indirect taxes, receipts from turnover tax only just reached their level in the third quarter of 2002. Thus the weak revenue trend that has been evident since 2001 persisted. This can largely be explained by



the subdued development of domestic demand. By contrast, receipts from mineral oil tax (+4½%), electricity tax (+32%) and tobacco tax (+5%) continued to rise sharply in the wake of the raising of the rates at the beginning of the year.

Tax revenue in 2003 as a whole will be much lower than officially forecast in May, mainly because of the persistent economic slow-down. According to the new tax estimate executed on 4 to 6 November, tax revenue will only just reach last year's level; receipts are expected to fall approximately €8 billion short of the May estimate. Thus, despite some tax increases, there will be a further de-

*... and in 2003
as a whole*

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

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Annual percent- age change
	Q1 to Q3		
	2002	2003	
Wage tax	93.3	94.4	+ 1.2
Assessed income tax	3.0	0.1	-95.7
Corporation tax	-0.3	4.8	.
Turnover tax	102.2	101.2	- 1.0
	<i>of which Q3</i>		
Wage tax	31.9	32.1	+ 0.8
Assessed income tax	3.3	3.0	- 10.1
Corporation tax	1.0	1.2	+ 22.4
Turnover tax	34.2	34.2	- 0.0

Deutsche Bundesbank

cline in the overall tax ratio this year. Based on the Federal Government's assumption of nominal economic growth of around 1% (and a stagnation of real economic output), the overall tax ratio, as defined in the government's financial statistics, will fall by ¼ percentage point to 20.7%.

The revenue shortfalls vis-à-vis the spring estimate relate chiefly to wage tax and turnover tax, mainly reflecting the fact that the decline in employment was even sharper and the growth of nominal domestic demand even weaker than previously expected. Furthermore, revenue from corporation tax, assessed income tax, non-assessed taxes on earnings and mineral oil tax is likewise considerably down on earlier expectations. By contrast, after the surprisingly favourable result in

the second quarter – primarily attributable to higher payments in respect of previous years – revenue from local business tax for 2003 as a whole looks set to be higher than estimated in May.

Tax shortfalls vis-à-vis the May estimate will go up again next year because, as a result of the delayed upturn, economic growth, which the tax estimate is based upon, will again be less than previously expected (with nominal growth at 2½% and real growth at 1½% to 2%).² The new official forecast anticipates that, based on the assumption of no changes in tax legislation, tax revenue will fall €10½ billion short of the May estimate. Compared with the current year, this amounts to an increase of 2¾%. In addition, net tax revenue will decrease by a further €6½ billion if the measures planned by the Federal Government, but which have not yet been agreed by Parliament, come into force. These include, on the one hand, the advancement of the third stage of the tax reform by one year to 2004 and, on the other hand, in particular, the abolition of tax concessions and loopholes envisaged in the 2004 budgetary stability concept, as well as the additional receipts hoped for from the planned tax amnesty. If these measures are implemented, it is estimated that tax revenue in 2004 would increase by little more than 1% on 2003, which would cause the overall tax ratio to decrease further.

*Tax receipts
in 2004*

² In spring, by contrast, the Federal Government had expected GDP to grow in 2004 by 3% in nominal terms and 2% in real terms.

*Federal budget
in the third
quarter...*

In the third quarter the deficit recorded by Federal Government rose over twelve months by €9 billion to €17 billion. This was primarily due to the fact that no privatisation proceeds worthy of mention were posted as revenue, in contrast to last year (€4½ billion). However, tax receipts, too, fell by 3% owing to weak economic activity, as well as a significant rise in transfers to the EU (offset against tax revenue). Overall revenue fell by just over 8%. Expenditure went up substantially by 5½%. In particular, interest payments increased sharply because, in contrast to last year, securities were issued at a sizeable discount. Other factors include the sharp rise in grants to the statutory pension insurance scheme and transfers to the Flood Relief Fund. By contrast, the growth in labour market-related spending slowed down.

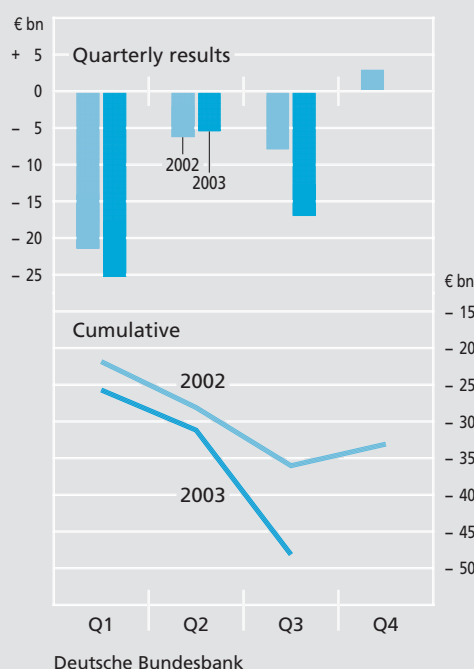
*... and in 2003
as a whole*

The full-year deficit will be far higher than was expected in the budget adopted in spring (€19½ billion). Consequently, the Federal Government has presented a supplementary budget, which envisages a deficit of €44 billion, taking into account shortfalls in tax revenue and additional labour market-related spending. This assumes that a surplus will be generated in the fourth quarter, which seems quite possible, particularly given the budgeted privatisation proceeds amounting to €5½ billion which had not been posted as revenue by the end of September.

*Outlook for
2004*

According to the most recent decisions by the Budget Committee of the Bundestag, it is anticipated that the Federal budget deficit will decline to less than €30 billion in 2004. This takes into account both the shortfalls from

The Federal Government's
financial balance in
2002 and 2003



the planned advancement of the third stage of the income tax reform, as well as a comprehensive consolidation package. The latest tax estimate forecasts shortfalls of almost €6 billion vis-à-vis the Federal Government's original plans³, which will, however, be partly offset by the fact that transfers to the EU will be just over €1 billion less. These shortfalls are supposed to be compensated by privatisation proceeds totalling €7 billion. However, a great degree of uncertainty still surrounds the plans. For example, the date for the introduction of the motorway toll for heavy goods vehicles has still not been set. Furthermore, a global cut in expenditure not yet specified will have to be implemented, not least because the original plan to cut the Federal

³ See Deutsche Bundesbank, Monthly Report, August 2003, p 53 f.

grant to the statutory pension insurance scheme will not be implemented. Moreover, a large part of the planned major consolidation measures also require the approval of the Bundesrat. Finally, it is difficult to estimate the volume of relief which some of the measures will provide (such as the tax amnesty). In order to justify the renewed overstepping of the constitutional upper limit for net borrowing, the Federal Government is once again invoking the exemption clause that this is necessary to avert a disruption of the overall economic equilibrium.

The need for consolidation in the Federal budget

The high deficits both this year and in the coming year highlight the urgent need for consolidation. Comprehensive measures are necessary to reduce the deficit, and the Federal Government has presented corresponding proposals to this end. Measures which lead to budget relief and at the same time improve the outlook for macroeconomic growth are especially suited to contributing to successful consolidation. Such measures include, in particular, cuts in subsidies and the review of social benefits that impair labour supply and demand. If the Federal grant to the statutory pension insurance fund, the largest item of expenditure in the Federal budget even before interest payments, is not included, even greater cuts must be made elsewhere. Privatisation proceeds, which are offset by a reduction in other government assets and are ultimately tantamount to credit financing, can hardly engineer a lasting improvement in the budgetary position.

Special funds

In the third quarter, there was a small deficit in the special funds, whereas a year previous-

ly there had been a surplus. The surplus to be expected for 2003 as a whole is likely to be less than the amount recorded in 2002. This is mainly because the share of the Bundesbank profit allocated to the Redemption Fund for Inherited Liabilities was considerably smaller than in 2002.

In the third quarter, the deficit of state government, at €6 billion, exceeded the deficit in the same period in 2002 by €1 billion. With tax revenue almost stagnant, overall revenue increased only slightly. By contrast, expenditure rose by 2½%. Alongside flood-related expenditure, personnel expenditure went up relatively sharply by 3½% as a result of the adjustment of civil servants' pay in July; the latter primarily affects the west German states because of the composition of staff. For 2003 as a whole, the budgets envisage that the deficits would decline to €25 billion. However, owing to the sluggish development of tax receipts, in particular, it is likely that the record deficit of €31 billion recorded in 2002 will be exceeded.

State government in 2003 ...

The state government budgets will be under a great deal of pressure in 2004, too. The current plans envisage a total deficit of €22 billion. In some budgets, even if the third stage of the income tax reform is not brought forward, the constitutional upper limit for net borrowing will be exceeded yet again despite the fact that numerous states are planning extensive savings. These measures will also affect civil servants in the form of a reduction in annual bonus payments and, in some states, an extension of working hours. In addition, cuts are planned in grants to the private

... and in 2004

sector and to other areas of the public sector. According to the new tax estimate, there will also be further shortfalls in tax revenue. Additional cuts in expenditure are therefore essential in order to limit the deficits.

Local government

For local government, only the results for the second quarter are currently available. During this period a deficit of €2½ billion was recorded, following a balanced result in 2002. There was a sharp decline of 7% in receipts. This was primarily due to a slump in revenue from economic activity by two-fifths or just over €1 billion.⁴ Transfers from state government also fell by 7½%. By contrast, tax receipts increased by just under 1½% thanks to a more favourable trend in local business tax. On the expenditure side, personnel costs rose by 2½%. The fact that year-on-year total expenditure remained virtually unchanged is ultimately due to investment, which was almost one-tenth below the 2002 level despite the funds spent on flood relief. Overall, no improvement is expected for the fiscal situation in the second half of 2003. However, the measures planned for next year to improve local authority finances would bring about perceptible relief.

Indebtedness

In the third quarter, the indebtedness of central, state and local government rose again sharply by €20½ billion. The bulk of the new borrowing (€14½ billion) was raised on the capital market. However, money market debt also increased by €6 billion. The largest borrower was central government, which was faced with a borrowing requirement of €16½ billion. State government borrowed €3 billion on the credit markets. There was a further

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

Period	Total	of which		Memo item Acquisition by non-residents
		Securities 1	Loans against borrowers' notes 2	
2002	+ 54.5	+ 67.6	- 11.9	+ 57.4
<i>of which</i>				
Q1	+ 25.6	+ 15.2	+ 10.5	+ 12.2
Q2	+ 1.5	+ 22.9	- 21.4	+ 16.7
Q3	+ 18.6	+ 25.1	- 5.4	+ 19.1
Q4	+ 8.8	+ 4.4	+ 4.4	+ 9.4
2003				
Q1	+ 34.7	+ 32.6	+ 2.1	+ 19.5
Q2	+ 13.5	+ 11.8	+ 1.6	+ 16.6
Q3 <i>pe</i>	+ 20.5	+ 9.4	+ 12.2	...

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

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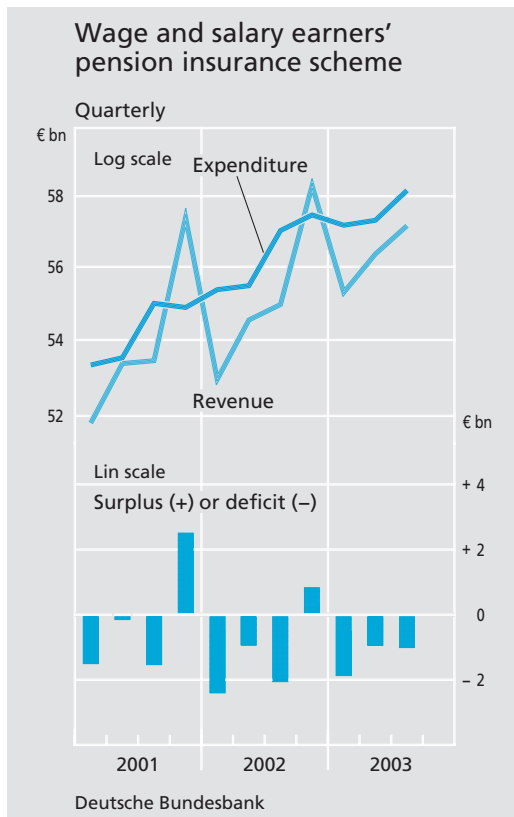
moderate rise in the indebtedness of local government, whereas that of the special funds remained virtually unchanged.

Social security funds

In the third quarter of 2003, the deficit of the wage and salary earners' pension insurance scheme declined to €1 billion, half its level in 2002. Revenue increased by 4%, not least because of higher Federal grants. This was due to the last stage of the ecological tax reform and the fact that Federal grants are also linked to (among other things) the level of the contribution rate, which was raised from 19.1% to 19.5% at the beginning of 2003.

Statutory pension insurance scheme

⁴ This related to large non-recurrent income which accrued to the city of Stuttgart last year.



Although revenue from contributions also increased by 3%, adjusted for the increase in the maximum level of earnings subject to contributions and the higher contribution rate, the increase was negligible, mainly because of the unfavourable employment trend. Expenditure growth slowed down to 2%. This was primarily due to the fact that the mid-year pension increase, at 1.04% in western Germany and 1.19% in eastern Germany, was much lower than in 2002.⁵ Nonetheless, contrary to the budget plan, a considerable deficit can be expected in 2003 as a whole. It is therefore likely that the minimum fluctuation reserve, which has already been lowered to just 0.5 month's expenditure, will not be attained at end of the year.

In order to avoid raising the contribution rate in 2004, which otherwise would have been necessary in view of these developments, a range of measures have been adopted to bring about relief in the short term. These include forgoing the pension adjustment in mid-2004, shifting the payment date for new pensions from the beginning to the end of the month, transferring the full contribution burden to the long-term care insurance scheme to pensioners themselves, as well as further reducing the minimum fluctuation reserve to a mere 0.2 month's expenditure. However, with the reduction of the reserves, the statutory pension insurance scheme could be dependent on liquidity assistance from central government next year to finance its current expenditure. This would noticeably increase the general government deficit ratio, making a renewed breach of the Maastricht deficit criterion next year all the more likely.

Short-term relief measures ...

Beyond 2004, the intention is to implement gradual reforms to take effect over the long term to limit the rise in the contribution rate caused by the demographic trend. Hence as of 2005 the pension adjustment formula is to be supplemented by a "sustainability factor", as proposed by both the Rürup Commission and the Herzog Commission. Future pension adjustments would then be smaller if the ratio of pensioners to contribution-payers increases. In addition, from 2006, the earliest possible retirement age due to unemploy-

... and longer-term reform measures

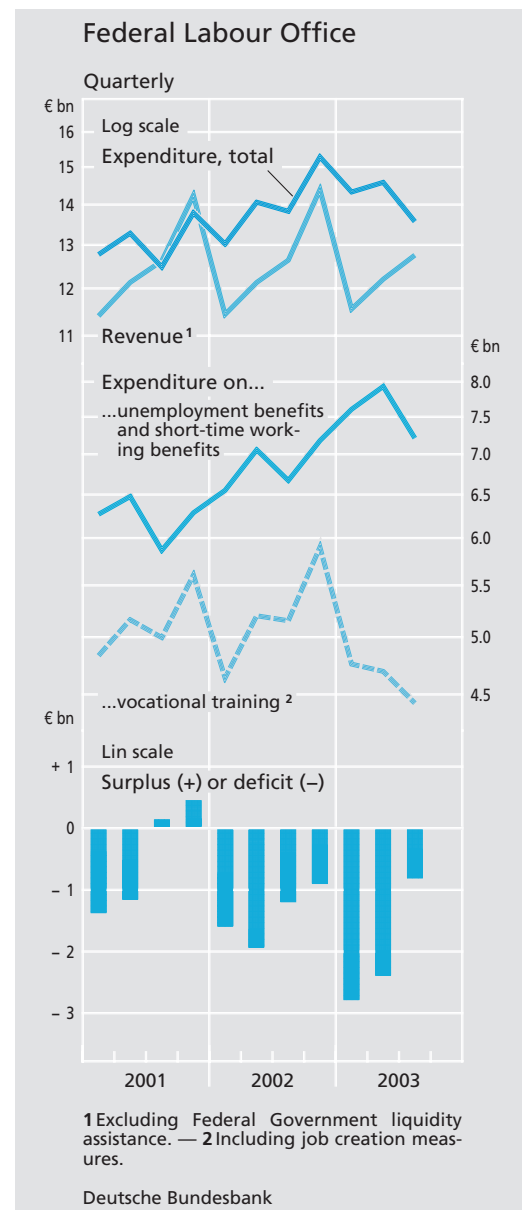
⁵ Alongside the weaker wage trend, this also reflected the fact that notional expenditure on supplementary private pension plans was factored into the pension adjustment formula for the first time. In statistical terms this factor alone will cut pension adjustments by roughly 0.6 percentage point per year from 2003 to 2010.

ment or under pre-retirement part-time working schemes will gradually be raised from 60 to 63 years, and periods of college education will no longer be recognised for the purposes of additional pension entitlements. These measures will help to limit non-wage labour costs and thus ultimately to pave the way for an improvement in the employment situation. However, given the likelihood of a further rising life expectancy, meaning that pensions will be drawn for an increasingly longer period and the volume of benefits payable by the pay-as-you-go statutory pension insurance scheme will constantly expand, an increase in the statutory retirement age beyond 65 years appears essential in the longer term.

Federal Labour Office

In the third quarter of 2003, the Federal Labour Office's deficit, at just under €1 billion, was €½ billion below the figure during the same period last year. While expenditure fell by 2%, revenue increased by 1%. However, the main reason for this rise was the increased revenue from the insolvency compensation levy. Despite the increase in the maximum level of earnings subject to contributions, contribution revenues in the third quarter were slightly down on the year. This was attributable both to the decline in employment and to the subdued wage trends.

Expenditure on unemployment benefit in the third quarter of 2003 was 8% up on last year. By contrast, spending on active labour market policies in the third quarter was almost 17% below the figure in the same period last year. The number of people participating in these measures declined accordingly, which also



contributed to the rise in the number of people registered as unemployed.

The deficit of the Federal Labour Office, which amounted to a total of €6 billion in the first nine months, will probably widen somewhat in 2003 as a whole. The additional revenue from contributions as a result of Christmas bonuses will be offset by a seasonal deterioration on the labour market. The Federal

Outlook for
2003 and
beyond

budget envisages a grant to the Labour Office next year of just over €5 billion. The Third and Fourth Act Promoting Modern Labour Market Services and the Act to Reform the Labour Market will probably have hardly any impact on the Federal Labour Office's budget balance in 2004. It is true that spending on active labour market policy measures in respect of recipients of unemployment assistance is due to cease with the introduction of the new "unemployment benefit II", which amalgamates unemployment assistance and social assistance paid to persons who are able to work and will in principle be financed by central government. However, the Federal Labour Office is to pay a compensatory amount to central government. The shortening of the period of entitlement to unemployment benefit will not have a major impact until 2007 because of the transitional periods.

*Statutory
health
insurance fund*

In the first half of the year, the deficit of the statutory health insurance fund, at just under €2 billion, was a mere €½ billion down on the previous year. Revenue from contributions increased by 1¾%, which is explained entirely by the rise in the average contribution rate from 14.0% to 14.3%. The trend in spending was determined by the cost-saving measures agreed last year, ie compulsory price discounts and strict budget caps. Total expenditure on benefits rose by only ½%. Nor can any surplus be expected in the second half of the year, not least because of shortfalls in contributions owing to declining bonus payments and to contribution payers opting for special occupational pension arrangements which are not subject to social security contri-

butions in their company pension arrangements.

It is anticipated that the health system reform agreed for 2004 will yield substantial financial relief. This is intended to be used to lower the contribution rate to an average of 13.6% next year. However, as things stand now, there would then be a danger of the deficitary financial development persisting, whereas considerable surpluses would be needed to reduce the accumulated debt and replenish the statutory reserves.

Outlook for the general government sector as a whole

The general government deficit ratio as defined in the Maastricht Treaty will increase again this year – possibly to more than 4% – having already significantly overstepped the 3% ceiling last year at 3.5%. The increase is primarily attributable to the negative cyclical impact, which is depressing revenues from tax and social security contributions and resulting in a sharp growth in labour market-related spending.

*Further cyclical
increase in the
deficit*

Without the impact of the adverse cyclical situation, the deficit ratio would have been almost unchanged. On the one hand, measures were being taken to significantly relieve the general government budgets. The European Commission therefore decided that the conditions imposed for 2003 under the excessive deficit procedure had been fulfilled. These relief measures include an increase in social security contributions and indirect

*Consolidation
measures offset
by other factors*

The Stability and Growth Pact is facing its acid test

In January this year, the Ecofin Council reached the decision that Germany has an excessive deficit and called on the country to take consolidation measures amounting to 1% of GDP within four months. Furthermore, Germany is to correct the excessive deficit "as quickly as possible" in line with the Stability and Growth Pact. According to the provisions of the Pact, this has to be completed by next year at the latest, unless there are "special circumstances".¹

Since May 2003, the excessive deficit procedure initiated against Germany has been held in abeyance because the Commission considered that consolidation measures on the necessary scale had been taken within the four-month deadline. Since then, Germany's fiscal policy has been scrutinised closely by the European Commission and the Ecofin Council. If the adopted measures were not implemented or the Council considered them to be insufficient, Germany would be given a warning as the last step before sanctions are imposed. This may very soon be the case because the autumn forecast recently published by the European Commission anticipates that in 2004 Germany will record a deficit ratio of 3.9% under status-quo conditions and a ratio of 3¼% if all measures proposed are taken into account. The reference value of 3% would then have been overshot for the third time in a row. The Federal Government, too, is now expecting a deficit ratio of more than 3% next year.

An excessive deficit procedure was also launched against France in June 2003. Since the Council's recommendations have not been implemented, the Commission has proposed issuing a warning to France. However, the deadline for correcting the excessive deficit is to be extended from 2004 to 2005. The Commission based this proposal primarily on the economic growth outlook in France which deteriorated steeply compared with June. It took the view that the scope of consolidation required to achieve the 3% ceiling in 2004 has expanded sharply. Formally, the Pact may allow such an extension of the deadline. It is, however, questionable whether this also corresponds to the objective of the excessive deficit procedure to achieve a rapid correction of unwelcome budgetary developments, if necessary,

through the use of sanctions. This applies all the more since the consolidation requirement in 2004 is higher in part because the recommendations for 2003 have not been implemented. Now that the deadline is to be extended, a failure to achieve the reference value for the deficit ratio in three consecutive years might likewise not be punished by sanctions. Yet according to the Commission's forecast, real economic growth in France will not be negative in any of these years. Growth of 1.7% is expected next year. According to the Stability and Growth Pact, however, the reference value may only be overshot if real GDP decreases by at least 2% (a decline of at least 0.75% is sufficient if the Council acknowledges "further supporting evidence"). The Commission's recommendation also calls on France to take consolidation measures amounting to 1% of GDP in 2004. In the Council meeting of 4 November, a decision on the Commission's recommendations was postponed until the end of the month.

Generally speaking, a "soft" interpretation of the Pact reduces the credibility of the fiscal rules underpinning monetary union and poses considerable medium and long-term risks. Political incentives to borrow may result in excessive deficits becoming the rule rather than the exception in several countries and may mean that countries lose sight of the objective laid down in the Pact of achieving a budgetary position which is at least close to balance in the medium term. Persistent higher government borrowing may lead to a rise in capital market interest rates, which would have a negative impact on economic growth potential and employment trends. Rising government debt ratios restrict the available budgetary policy options on account of the growing interest burdens and make it harder to tackle the challenges resulting from the foreseeable budgetary burdens arising from demographic developments. Furthermore it will be more difficult for monetary policy to guarantee long-term price stability with low interest rates. Finally, relationships between the euro-area countries may become strained if the euro area as a whole is affected by the negative impact of undesirable fiscal developments in individual member countries.

¹ See also Deutsche Bundesbank, *Monthly Report*, February 2003, p 53 in particular.

taxes. Central, state and local government are also pursuing a stringent budget management policy reflected in, amongst other things, the continued reduction of staffing levels. Furthermore, cost-cutting measures were agreed in respect of labour market-related spending and healthcare expenditure. However, these consolidation measures were largely offset by other negative factors in a year-on-year comparison. For example, the resources being spent by government to overcome the flood damage are temporarily increasing expenditure. Greater funds than in recent years are again required for transfers to the EU. Social security contributions (adjusted for the changes in the contribution rate) are increasing more slowly than might have been expected in view of the growth trend of gross wages and salaries, which is, in any case, lagging behind that of nominal GDP. Finally, non-tax revenue – particularly the Bundesbank profit – is smaller than it was last year.

Deficit in 2004 to breach the 3% ceiling for the third time?

The outlook for public finances next year is very uncertain. A raft of legislative projects that are of major significance for the development of general government finances are still going through the process of parliamentary deliberation. Furthermore, the financial implications of some of these projects – ie in the case of the tax amnesty and the measures to combat tax evasion and illicit work – are very difficult to assess. The Federal Government no longer expects that it will be possible to avoid overshooting the 3% ceiling again. Thus if the third stage of the tax reform were to be brought forward, this would place a heavy burden on public finances, whereas the

consolidation measures might be less extensive than initially announced because there is doubt as to whether they will be implemented in full. Moreover, a further deficit is expected in the case of the social security funds overall. This is because of the plan for a further significant reduction in the fluctuation reserves of the statutory pension insurance scheme, as well as the decision to extend over some years the required debt reduction and the replenishment of reserves in the statutory health insurance fund. The envisaged increase in privatisation proceeds will not reduce the deficit as defined by the Maastricht Treaty because they are merely the result of a sale of government financial assets.

There are signs that German fiscal policy makers are backtracking from the objective of achieving the 3% ceiling laid down in the Maastricht Treaty next year. However, the credibility of the fiscal policy framework in Europe, which is vital for the medium and long-term success of European monetary union, should not be jeopardised by Germany running up an excessive deficit for the third year running (see the box on page 61). As the German Council of Economic Experts has likewise noted, strict implementation of the Stability and Growth Pact would not impede sustainable economic growth. In order to avoid further damage to the Pact as the guarantor of a stability-oriented fiscal policy in the euro area, an advancement of the third stage of the tax reform would have to be coupled with comprehensive consolidation measures.

Stability and Growth Pact in danger...

A functioning European Stability and Growth Pact is of major importance not least because

Development of the long-term sustainability of public finances in 2002

The question as to whether the long-term sustainability of public finances improved or deteriorated last year can be analysed using the technique of generational accounting. The annual consolidation requirement derived therefrom gives some indication of the change in the long-term fiscal burdens which are to be expected, in particular in view of projected demographic changes.¹ The annual consolidation requirement indicates by how many percentage points the general government expenditure ratio would have to be lowered or the general government revenue ratio raised to enable the fiscal position prevailing in the base year to be sustained over the long term without any further changes. Changes in the macroeconomic setting ensuing from demographic trends or reactions to policy measures are disregarded, however.

Two different scenarios are considered within the context of generational accounting. A "status-quo-scenario" assumes that the fiscal conditions prevailing in the base year will remain unchanged in the future. The age-specific per capita amounts for the individual government revenue and expenditure categories that are observed in the base year are kept constant – except for an adjustment for productivity growth. By contrast, a "policy scenario" captures policy changes which have been adopted in the base year but which will take (full) effect only at a future date. This facilitates a more realistic assessment of what additional fiscal policy measures are needed.

Under the status quo scenario, the annual consolidation requirement increased significantly last year by just over $\frac{3}{4}$ percentage point to $5\frac{3}{4}\%$ of GDP. This sharp deterioration was partly due to the unfavourable cyclical development. Adjusted for cyclical influences, the annual consolidation requirement went up by just over $\frac{1}{4}$ percentage point to, likewise, $5\frac{3}{4}\%$ of GDP.² Tax revenue from corporate profits and capital income, turnover tax and social security contributions were much weaker again last year than might have been expected in the light of changes in legislation and the development of their

macroeconomic assessment bases. This could not be offset by the increase in indirect taxes and the rise in the average contribution rate to the statutory health insurance funds. On the expenditure side, the rise in child benefit was accompanied, *inter alia*, by generally tight budget management.

Under the policy scenario the annual consolidation requirement last year was lower, at just over 5% of GDP, than in the adjusted status quo scenario owing to the measures due to come into effect at a later date. This was attributable to future savings by the statutory pension insurance scheme which exceed the additional tax relief measures adopted for the next few years. However, compared with 2001, the sustainability of public finances has deteriorated markedly in the policy scenario, too. The annual consolidation requirement rose by $\frac{3}{4}$ percentage point. The measures that had already been adopted in 2001 for last year, which per se should have suggested a significant reduction of the consolidation requirement in the adjusted status quo scenario, play no part here because they were included in the policy scenario for 2001. The deterioration is attributable to the aforementioned exceptional revenue shortfalls and would have been even greater if the measures adopted in 2002 but which will only come into effect at a later date had not lowered the annual consolidation requirement. Relief was afforded, in particular, by the measures adopted in 2002 which came into effect this year, affecting the social security funds. For example, the contribution rates to the statutory pension insurance scheme and the statutory health insurance funds were raised. In addition, savings were made on the expenditure side in the statutory health insurance funds.

Even though these figures must be interpreted with caution, the results show that last year the fiscal policy course was still far from sustainable. Compared with 2001, the long-term sustainability of public finances – also when adjusted for cyclical influences – actually deteriorated further; this was, however, attributable to exceptional revenue shortfalls and not to fiscal policy measures.

¹ For the methodological and empirical basis used for calculating the results shown here, see Deutsche Bundesbank, The long-term sustainability of public finance – an analysis based on generational accounting, *Monthly Report*, December 2001, pp 29-43 and B Manzke (2002), *The long-term sustainability of public finance in Germany*, Discus-

sionpaper 10/02 of the Economic Research Centre of the Deutsche Bundesbank. — ² The values for 2001 have changed compared with those given in the Deutsche Bundesbank, *Monthly Report*, May 2002, p 72, primarily as a result of a new estimation of the cyclically related budget components.



... and consequently also the achievement of long-term sustainability of public finances

the EU countries will be better able to deal with the prospective long-term budgetary burdens if they fulfil the requirements of the Pact. The results of new calculations made by the Bundesbank based on a generational accounting approach, taking the legislative status quo for government benefits and levies in force in 2002, show that there is a need for

further action to safeguard the long-term sustainability of public finances in Germany (see the box on page 63). Speedily achieving a budgetary position close to balance and the related reduction of the government debt ratio would make an important contribution towards ensuring that future generations are not overburdened.