

Public finances in crisis – the causes and the need for action

In 2003 the general government deficit and debt levels in Germany reached new highs. While it is true that the economic slowdown of recent years contributed to this development, the financial problems are primarily of a structural nature and can therefore only be overcome by following a determined path of consolidation and implementing comprehensive reforms. Initial important steps were agreed last year. It is now important to resolutely pursue this path.

A sound fiscal policy which creates a favourable framework and clear prospects is a precondition for higher growth and employment. The fiscal consolidation which this requires can only be achieved by reducing the government expenditure ratio, especially as further cuts in the fiscal burden appear necessary in the medium term. The ageing of the population also poses a significant challenge for fiscal policy.

This article aims to provide an idea of the scale and urgency of the problems which have accumulated and identify some of the measures necessary. It is a follow-up to a policy document published by the Bundesbank one year ago entitled "Ways out of the crisis".

Pinpointing the problem

Fundamental problems

Problems in the field of public finances which have been accumulating for a long time have recently become manifest – partly as a result of the three-year period of macroeconomic stagnation. High general government deficit and debt levels, the growth-inhibiting taxation and transfer regime, a federal financial constitution which does not clearly delineate responsibilities, the mass of regulations and the foreseeable demographic burdens have triggered an in-depth public debate about the need for reform. Last year, in particular, substantial changes were agreed which will have a positive impact in the future. Nevertheless, further reforms are essential in order to restore confidence in the sustainability of public finances and create a favourable macroeconomic framework in Germany.

Government deficit and debt at historically high levels

In 2003 both the government deficit (€82 billion) and the level of government debt (€1.37 trillion) reached a record peak.¹ They were also exceptionally high in relation to gross domestic product (GDP) at 3.9% and 64.2% respectively. Only twice in the history of the Federal Republic of Germany, in 1975 and 1981, has the deficit ratio been higher (see adjacent chart).

Maastricht thresholds ...

As a result of the sharp deterioration in public finances, the deficit and debt limits agreed in the European Union were considerably overshoot. Before the onset of macroeconomic stagnation, Germany had failed to fulfil the requirement of the European Stability and Growth Pact to achieve a budget position at least close to balance in the medium term,

General government debt and deficit ratios*

As a percentage of GDP



* Up to 1990 western Germany, from 1991 the whole of Germany. — 1 Up to 1990 according to the national definition, from 1991 pursuant to the Maastricht Treaty. — 2 As defined in the national accounts. In 2000 excluding UMTS proceeds.

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and in 2002 the deficit and debt ratios exceeded the ceilings set by the Maastricht Treaty. In January 2003 it was therefore formally established that Germany had an excessive deficit. However, in November 2003 the Ecofin Council refrained from implementing the rule-based procedure initiated by this decision (as it also did in the case of France). As a result, considerable damage was done to the EU fiscal policy rules, which were drawn up above all at Germany's initiative and constitute a key element of European monetary union.

¹ The figures given in this article are as defined in the national accounts or in the Maastricht Treaty. In particular, transactions related to the assumption of the Treuhand agency's debt by the Redemption Fund for Inherited Liabilities in 1995, as well as the one-off proceeds from the auctioning of UMTS licences in 2000, have been factored out.

... and national
limits overshoot

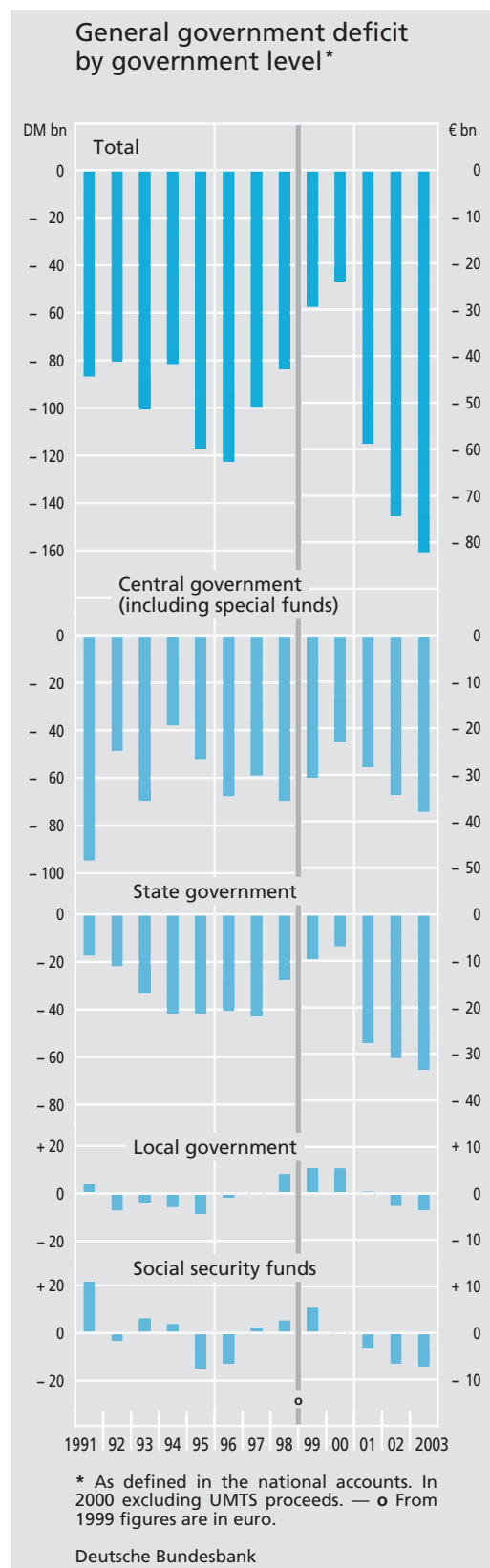
The upper borrowing limits set by national budgetary law were also clearly overshoot. Last year new borrowing by both central government and most of the state governments was well above the limit, linked to investment expenditure, specified in Article 115 of the Constitution (*Grundgesetz*) or in the largely comparable provisions of the state government constitutions.² The Budget Principles Act, which was amended in 2001 to incorporate the European rules, obliges central and state government to pursue the objective of a balanced budget. At local government level, the applicable borrowing limits laid down under budgetary law were likewise overshoot in many cases. As regards the social security funds, at the end of 2003 the fluctuation reserve of the statutory pension insurance scheme once again fell below the statutory minimum level, despite the fact that this had been progressively and substantially lowered. In 2003 the statutory health insurance institutions recorded significant deficits for the third year in a row. In many cases the reserves had been used up, resulting in borrowing for which there is no direct legal provision. The adjacent chart illustrates the deficit trend at the various levels of government.

Deficit
predominantly
structural

Although the sharp rise in the deficit over the past three years partly reflects the unfavourable cyclical development,³ the high deficit level is mainly structural. The cyclically adjust-

² Pursuant to Article 115 of the Constitution, an exception is only permissible where borrowing in excess of investment spending serves to avert a disruption to the overall economic equilibrium.

³ For the development since 1997 see Deutsche Bundesbank, The development of public finances in Germany following qualification for European monetary union, *Monthly Report*, April 2003, pp 15-32.



ed deficit in 2003 is estimated to be around 3% to 3½% of GDP. This means that even when the economy recovers, the deficits will not “automatically” disappear. Rather, consolidation measures are still required to reduce them.

German reunification

Since the 1990s, the development of public finances has been strongly shaped by German reunification. Massive government transfers to eastern Germany, which even today still amount to approximately 4% of total German GDP, had and still have to be financed. This was initially done by resorting to large-scale debt financing, resulting in a rapid rise in government debt in the first half of the 1990s.⁴ In addition, the contribution rates to the social security funds were raised, especially for the Federal Labour Office, various indirect taxes were increased and a surcharge on income tax and corporation tax was introduced (solidarity surcharge). By contrast, apart from the gradual abolition of the subsidies for Berlin and the area along the former intra-German border, there was a failure to carry out a fundamental review of government benefits and activities and to adapt them to the underlying conditions which had changed as a result of reunification and the increased international competition. Instead, the west German social security benefit system remained largely in place or was even expanded, particularly with the introduction of a long-term care insurance scheme. These benefits were also implemented in eastern Germany, further increasing the need for adjustment which had, in any case, been generally underestimated at the time. The unbalanced financing also led to a deterioration in

the underlying conditions for the German economy compared with other countries.

In 2000 the public finance situation still seemed favourable. The deficit ratio had been decreasing continuously since 1996 and had reached 1.2%, the macroeconomic outlook was regarded as positive and a significant rise in growth potential was widely expected. In retrospect, this assessment proved wrong and the improvement in government finances was only temporary. The exceptionally buoyant development of profit-related taxes up to 2000 turned out to be an exaggeration and was reversed in the following years. Economic growth did not accelerate. Instead a three-year period of stagnation set in accompanied by a noticeable rise in unemployment. Despite a relatively small increase in expenditure, the structural expenditure ratio barely decreased because the nominal trend-growth of GDP was also low. However, the main reason for the sharp rise in the deficit between 2001 and 2003 was the fall in the revenue ratio, which was partly due to tax cuts, but mostly to a general weak level of revenue.⁵

Dramatic rise in the deficits since 2000

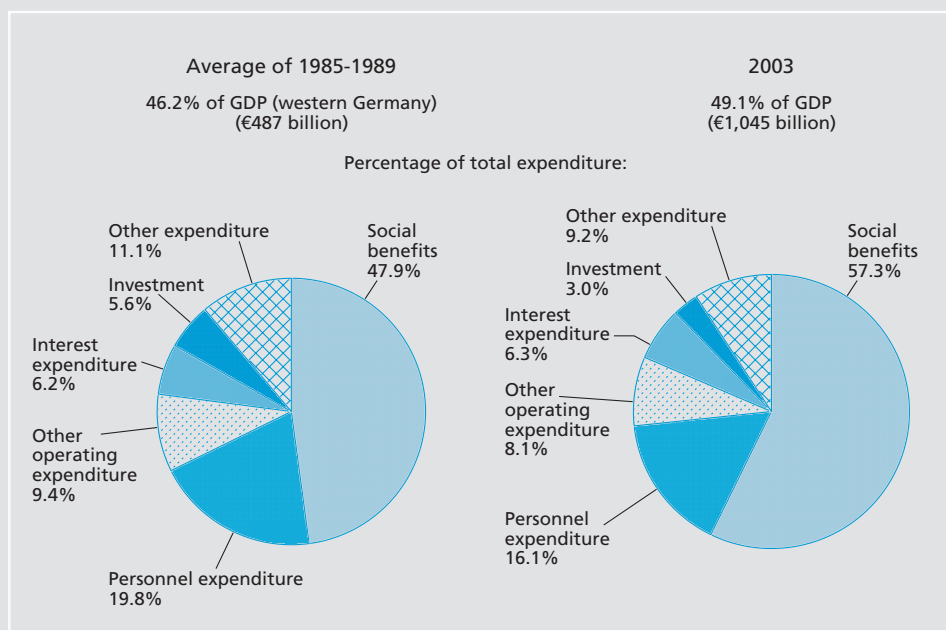
The government expenditure ratio, having initially risen sharply as a result of reunification, has been decreasing since the mid-1990s. Nevertheless, in 2003, at approxi-

Sharp rise in social benefits

⁴ Between 1991 and 1994, the general government deficit and debt levels were underestimated in that the Treuhand agency was not included in the government sector in the national accounts. The cumulative deficits were only attributed to the government sector upon the assumption of the Treuhand agency's debt by the Redemption Fund for Inherited Liabilities in 1995.

⁵ See also Deutsche Bundesbank, *Monthly Report*, April 2003, p 15f.

Breakdown of government expenditure *



* As defined in the national accounts.

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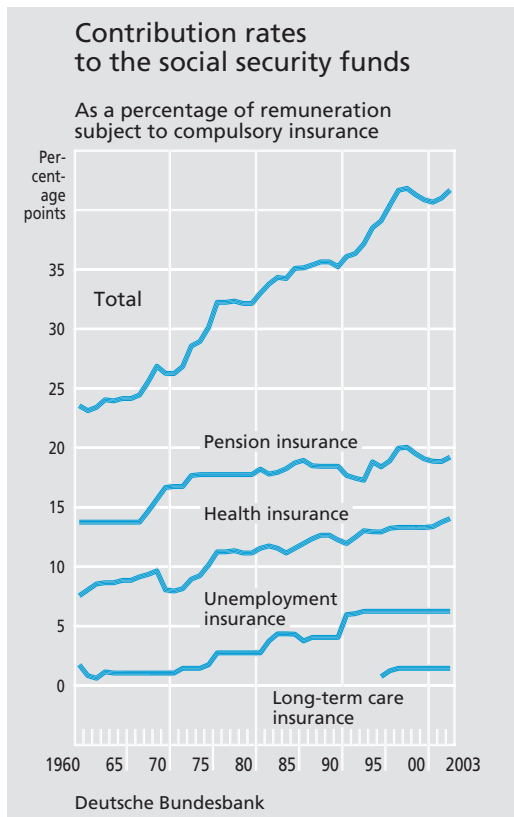
mately 49%, it was still well above the average level that prevailed in the second half of the 1980s (just over 46%).⁶ Adjusted for cyclical influences the difference is, however, more moderate. The structure of government expenditure changed significantly over this period. Particularly striking is the fact that social benefits have risen sharply as a percentage of total government expenditure (currently accounting for 57% of general government expenditure compared with 48% in the second half of the 1980s). They are primarily responsible for the rise in the government spending ratio. The main factor was the increase in spending on pensions. This in turn is caused by the general ageing of the population, which has become very apparent over the past ten years, and the relatively high pension entitlements in eastern Germany due

mainly to the adoption of the west German benefit system in an unmodified form. This was compounded by the sharp increase in labour market-related spending, rises in child benefit and additional costs in connection with the introduction of the long-term care insurance scheme.

The sharp rise in social benefits was accompanied *inter alia* by a declining weight of investment expenditure. Despite the additional resources required for eastern Germany compared with the second half of the 1980s, the ratio of investment spending to total expend-

Fall in the weight of investment expenditure and personnel expenditure

⁶ This trend is, however, partly due to changes in the methodology used in the national accounts: family allowance payments and grants to homebuyers are now mostly recorded under expenditure whereas previously they had depressed tax revenue. Conversely, some items have been outsourced from the government budgets.



iture declined by almost half to 3%. If the consumption of fixed capital shown in the national accounts is taken into account, net government expenditure was in fact negative for the first time in 2003. Even if this sharp decline is overstated because of outsourcing, it remains problematic given the particular importance of the infrastructure for economic growth. In addition to the decline in investment expenditure, there was also a significant reduction in the share of personnel expenditure from just under 20% to 16%, above all owing to job cuts in the public sector. This was admittedly also partly due to outsourcing.

Negative incentives in the lower wage segment

The rise in social benefits poses a major problem for public finances, particularly as in many cases the structure of the transfer sys-

tem, in conjunction with the tax and social security regime, weakens the incentive to take up regular employment, especially in the lower wage segment.

The total burden of taxes and social security contributions – the fiscal burden – amounted to 41½% of GDP last year. Although this was 2 percentage points below its peak in 1999 and 2000, it was still higher than the level in western Germany prior to reunification (just over 40½% in the second half of the 1980s and just over 39% in 1990).⁷ This was mainly due to the development of social security contributions, whose ratio to GDP last year, at 18½%, was approximately 2 percentage points above the level in the second half of the 1980s despite the fact that a growing share of pensions has been financed out of taxation since 1998. The sharp increase in contribution rates – from a total of just under 36% of earnings subject to compulsory insurance in 1989 to 42% in 2003 – contributed to the significant rise in labour costs after reunification and consequently to one of the key macroeconomic problems in Germany (see adjacent chart). By contrast, after a significant interim rise (reaching just over 25% in 2000), the tax ratio, at 23%, is once again below the level reached in the second half of the 1980s, not least because of the tax reform which came into effect in 2001.

Development of the fiscal burden

A declining tax ratio alone is not, however, a sufficient indication of a fiscal system that is

Marginal tax and social security burden

⁷ See footnote 6. A much sharper rise (from 52½% in the second half of the 1980s and 50½% in 1990 to almost 56½% in 2003) ensues if the ratio of tax and social security contributions to national income is considered instead of the ratio to GDP.

more conducive to growth. Rather, high tax rates and complicated tax legislation with many allowances and “loopholes” can lead to evasion and misallocation with relatively low government revenue. In many cases, the “marginal fiscal wedge” on additional labour or capital input plays a greater role in many economic decisions. Since the beginning of the 1990s, the marginal fiscal burden on labour has increased considerably more than it would appear from the average overall taxes and social security ratio. Last year an unmarried average wage-earner (in western Germany) had to pay almost 64% of his additional gross income in taxes and social security contributions, 11 percentage points more than in 1990. Furthermore, the tax regime for corporate profits in Germany is still less attractive than in many other countries even though the tax rates were noticeably decreased in the course of the 1990s and especially with the 2001 reform (concerning the marginal fiscal burden see the box on page 22).

Mass of regulations and increasing complexity of tax law

As well as the high marginal fiscal burden, the mass of regulations is also weakening the growth conditions. For smaller enterprises, in particular, the “costs of red tape” are relatively high.⁸ Another factor is that the tax system has become ever more complicated and opaque amid an increasingly dense mass of promotional rules, subsidies, and exceptions. For example, after German reunification, there was massive subsidising especially of capital invested in eastern Germany. A wide range of instruments were used, including high special tax depreciation facilities and investment grants. This system of incentives

and assistance was both voluminous and complex and, moreover, brought about considerable macroeconomic distortions and a virtual erosion of the tax assessment base.⁹ The “ecological tax reform” introduced further tax breaks. The reform of corporate taxes, which came into effect on 1 January 2001, also created new artificial tax constructs. Instead of tackling the root-causes of the additional tax burden borne by businesses by abolishing the local business tax, a complicated alternative solution was chosen allowing the partial offsetting of local business tax against income tax.

Moreover, a federal system of public finances which blurs the responsibilities of central, state and local government impairs the efficiency of the provision of services by general government. Extensive linkages within and between the different levels of government weaken their individual vested interest in an economical use of resources and in improving their own financial strength. On the revenue side, the predominance of the general tax-sharing arrangements is partly responsible for this. For example, almost three-quarters of total tax receipts are joint taxes (including local business tax) in which various tiers of government participate. Furthermore, state government – unlike central government – does not have any noteworthy legislative powers to levy taxes, not even in respect of those taxes which accrue solely to it. This lack of autonomy goes hand in hand with a com-

Financial constitution blurs responsibilities

⁸ See German Council of Economic Experts, *Jahresgutachten 2002/03*, section 362 (available only in German).

⁹ See Deutsche Bundesbank, Recent tax revenue trends, *Monthly Report*, August 1997, pp 83-101.

Marginal tax and social security burden on employee compensation and corporate earnings

Last year an unmarried average wage earner (in western Germany) had to pay almost 64% of his or her additional gross income¹ in tax and social security contributions, over 11 percentage points more than in 1990. For single employees with above-average earnings (just below the income threshold in western Germany for contributions to the statutory health insurance scheme) the marginal tax and social security burden was as high as around 71%, as opposed to just under 57% in 1990. By contrast, various tax cuts brought the marginal tax and social security burden for top earners down somewhat from its 1990 level to just over 51% in 2003. In this income bracket, no social security contributions have to be paid on the additional income but there are no additional entitlements either.

Of the considerable increase in an average earner's marginal levy wedge, 4½ percentage points were accounted for by social security contributions. The marked increase in contribution rates in the 1990s and the introduction of the long-term care insurance scheme were reflected in this figure. Most of the increase in the marginal burden of tax and social security contributions is attributable to income tax. By the end of the period under review, an unmarried average earner was having to pay around 29% in tax on his/her additional gross income as opposed to roughly 22% in 1990. The marginal tax rate on above-average earned income rose even more strongly, by nearly 10 percentage points to around 36%. Apart from the introduction of the solidarity surcharge, this was attributable to the various adjustments of the income tax rates, which tended to ease the burden at the lower income levels and overall were far from sufficient to offset the additional marginal tax burden arising from the progressive taxation of higher earnings.² By comparison with other countries, too, the marginal burden of levies on earned income in Germany is very high. In 2002 the burden for an unmarried average wage earner was the highest in the OECD countries after Belgium.³

A specific problem occurs in the low income bracket, which, given the high level of structural

unemployment primarily among unskilled workers, is particularly important. Owing to the relatively high social assistance entitlement (compared with the negotiated minimum wages) coupled with high marginal rates of deductions from additional earnings, the incentives to take up regular employment are still very limited, even if the rigorous deduction regulations have been relaxed somewhat and the criteria for being able to turn a job down have been tightened.

The earnings of corporations, which are more exposed to international competitive pressures than other types of firms, were subject last year to an average marginal tax rate of some 40% overall in Germany, comprising corporation tax, the solidarity surcharge and local business tax.⁴ In the current year, this marginal tax rate on earnings has been reduced by just over 1 percentage point owing to the fact that the temporary increase in the corporation tax rate from 25% to 26.5% was reversed. The marginal tax wedge at company level (ie excluding taxes paid by shareholders) is thus considerably lower than in the early 1990s, when it reached around 58% for retained profits of corporations. Before 1990 – when the corporation tax rate was cut from 56% to 50% – retained profits of corporations were even subject to a marginal tax rate of more than 60% in all. However, the cuts in the tax rates have not been enough to improve Germany's international position substantially as, in response to the more intense tax competition arising from increasing globalisation, other countries had taken earlier steps to cut their tax rates on earnings to a considerably lower level. Even after the 2001 tax reform, marginal tax rates on corporate earnings thus put Germany at the top (after Japan) of the international league tables. The effective marginal tax burden, ie after taking account of the actual tax base, was also considerably higher than the corresponding ratios in other countries (such as Italy, the Netherlands and the United Kingdom); corporations' tax-related cost of capital is thus comparatively high in Germany.⁵

1 In this review, this includes the employer's share in social security contributions, which is an additional part of labour costs on top of gross wages. The marginal burden is affected to a certain extent by the leaps in the underlying wage tax tables. — 2 The average tax burden on the earned income (including the employer's share of the social security contributions) of an unmarried average wage earner in western Germany went up in the period in question by 1 percentage point to just over 15% and that of an employee with an income just below the ceiling for contributions to the statutory health insurance scheme by almost

3 percentage points to 20%. See A Boss, *Arbeits- und Investitionsanreize in Deutschland: Die Rolle der Abgaben- und Transferpolitik als Determinante des Wachstums des Produktionspotentials*, Kieler Arbeitspapier Nr. 1148, Kiel 2003, particularly pp 4ff (available in German only). — 3 See OECD, *Taxing Wages 2001-2002*, Paris 2003, p 86. — 4 Local business tax is recorded in the national accounts as indirect taxation, which makes it difficult to interpret the relevant rates. — 5 See German Council of Economic Experts, *Jahresgutachten 2001/02*, Table 78 and *Jahresgutachten 2003/04*, Table 58 (available in German only).

plicated revenue-sharing arrangement which, in spite of the new rules due to enter into force in the coming year, still virtually levels out the differences in tax revenues among the individual states.¹⁰ Even if some kind of revenue-sharing arrangement is necessary in a country with a federal structure, such extensive levelling-out weakens the incentive for individual states to strengthen their tax-raising efforts.

On the expenditure side, a clear demarcation of responsibilities has been hampered up to now above all by the fact that numerous tasks are financed by various levels of government. Such tasks include, for example, the joint tasks pursuant to Article 91a of the Constitution. Central government influences the discharge of these tasks via joint overall planning with state government. This co-financing of state government tasks by central government breaks the necessary linkage between the responsibility for performing duties and the responsibility for the associated expenditure, thus contradicting the connexity principle. A further criterion for federal efficiency, namely the principle of fiscal equivalence,¹¹ is also disregarded, especially in those areas where, in the context of conflicting legislation, the legislative powers have been very much centralised. This limits the discretionary leeway of the lower levels of government and consequently inhibits a more efficient use of resources and greater budgetary flexibility.

Major determinants of the future development of public finances

Whether or not the German economy manages to return to a higher path of sustainable growth and, above all, improve labour market conditions will be of crucial importance for the future development of public finances. A 1% rise in employment, or approximately 340,000 more people in employment, would – if spread equally across all sectors – lead to an increase of roughly €5 billion or ¼% of GDP in revenue from social security contributions and wage tax alone.¹²

Crucial significance of economic growth and employment

On the expenditure side, a decline in unemployment would noticeably relieve the pressure on public finances. Roughly €75 billion, or around 3½% of GDP, is currently spent on unemployment payments alone, both via the Federal Employment Agency and through the unemployment assistance which is financed by central government. A reduction in unemployment could ease the pressure on the Federal budget, in particular, and make it possible to cut unemployment insurance contributions. Overall, if the number of persons out of work were reduced by 100,000, this would relieve the general gov-

Reduction in unemployment

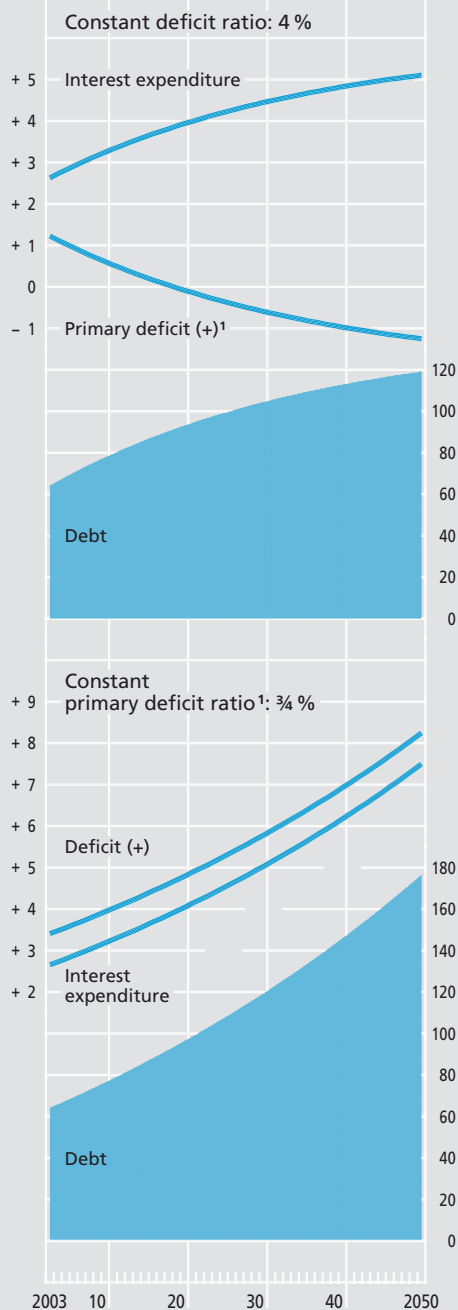
¹⁰ For an assessment of the current revenue-sharing scheme see Deutsche Bundesbank, Trends in Länder Government finance since the mid-nineties, *Monthly Report*, June 2001, in particular p 65 f.

¹¹ The principle of fiscal equivalence demands that the beneficiaries and financers of government activities should coincide as far as possible in terms of their geographical spread. This is intended to prevent misincentives resulting from external effects.

¹² Furthermore, greater economic growth would also result in additional tax receipts from corporate profits and capital income, as well as private consumption. On the other hand, additional costs would also be incurred, not least in the statutory pension insurance scheme.

Scenarios for the development of public finances*

As a percentage of GDP



* Assumptions: nominal GDP growth 3%, interest rate 4.5%. Calculations do not take into account transactions which affect the debt level but not the national accounts deficit, eg privatisation proceeds. — ¹ Expenditure (excluding interest expenditure) less revenue.

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ernment budgets on average by around €2 billion or 0.1% of GDP.¹³

The strong influence of economic growth on public finances can be seen by considering the updated German stability programme.¹⁴ In this programme the Federal Government assumes that if there is nominal economic growth of 2½% in 2004 and 3¼% in each year thereafter, in 2007 the deficit ratio will still be 1½%. If annual nominal growth were merely ½ a percentage point lower (higher), the deficit ratio in 2007 would increase (decrease) by a full 1 percentage point. This is based on the assumption that a 1 percentage point increase in growth reduces the general government deficit ratio in the year in question by ½ a percentage point, or around €10 billion.

Influence of GDP growth on the deficit ratio...

The mathematical relationship between the different GDP growth rates and the longer-term development of the debt ratio, which is an important indicator of the state of public finances, is also revealing. For example, in the longer term a deficit ratio in line with the 3% Maastricht ceiling coupled with nominal GDP growth of 5% would result in a debt ratio of just over 60%. If, however, nominal growth were only 3%, the debt ratio would rise to over 100% in the long term. If the general government deficit ratio of approximately 4%, which was reached in 2003, were main-

... and debt ratio

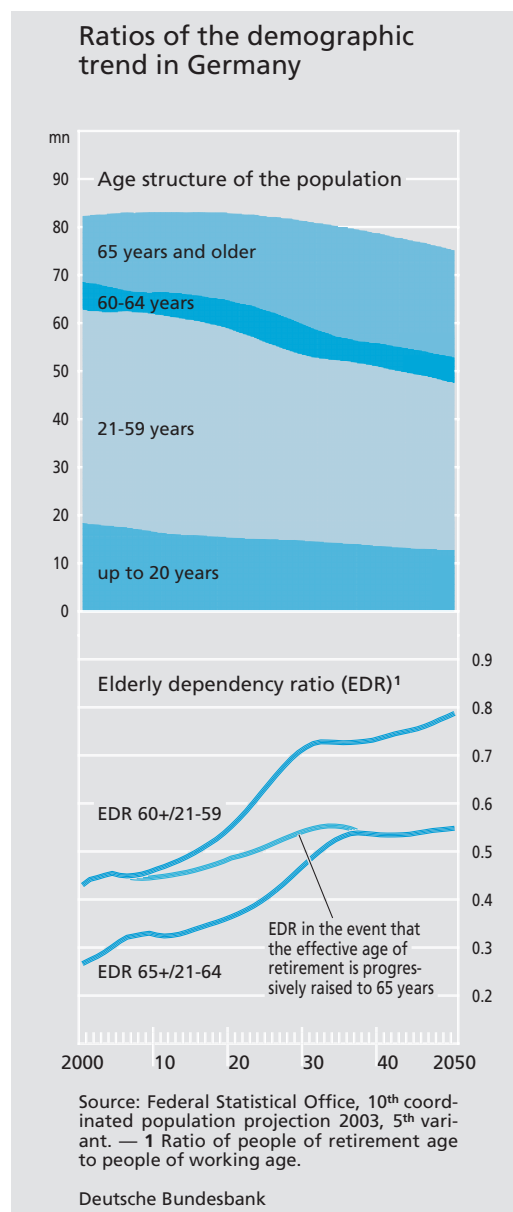
¹³ Including additional tax and social security receipts, without any repercussions for expenditure on active labour market policy. See Hans-Uwe Bach and Eugen Spitznagel, *Was kostet die Arbeitslosigkeit*, in *IAB Kurzbericht*, No 10/2003.

¹⁴ For an assessment of the stability programme see Deutsche Bundesbank, *Monthly Report*, February 2004, pp 68-69.

tained and there were 3% nominal growth, the debt ratio would rise by almost 20 percentage points to more than 80% within the next ten years. In the long term it would reach almost 140%, with an ever larger share of government revenue having to be spent on interest payments, which would crowd out other expenditure (see chart on page 24). Assuming the current primary balance (ie the balance excluding interest expenditure) were to remain unchanged in relation to GDP, future nominal GDP growth of 3% and an interest rate of 4½% would lead to a soaring debt ratio because of the "snowball effect". On the basis of the assumed growth conditions, a reduction of 2 percentage points in the deficit ratio would be needed simply to maintain the current high debt ratio. A steep reduction of the debt ratio would require virtually balanced budgets.

Demographic burdens

A rapid reduction of the debt ratio is imperative, not least because of the demographic trend (see adjacent chart). The current forecasts for Germany indicate a major shift in the age structure, with the share of the population of working age shrinking.¹⁵ The declining proportion of this section of the population can be expected to have a negative impact on economic growth. Apart from the shrinking labour force, it remains to be seen what effect a higher average age will have on the productivity of employed persons. Positive assessments based on greater work experience are opposed by sceptical predictions which anticipate less innovative potential. Alongside larger-scale immigration, considerable relief may also be provided by exploiting the labour force potential more effectively,



for example by raising today's average retirement age of approximately 60 years. However, these measures can do no more than limit the negative impact of the demographic trend.

¹⁵ By 2050 the numerical ratio of people over the age of 59 to people between the ages of 21 and 59, currently at 0.46, can be expected to rise to 0.79.

Impact of the demographic changes on old-age provision, ...

In addition to its possible negative impact on economic growth, the demographic shift also affects public finances directly. This applies mainly to the pay-as-you-go social security systems which are reliant primarily upon individuals of working age for their revenue, with expenditure being concentrated on the older age groups. Both factors come to bear on the statutory pension insurance scheme. The clearest forecasts regarding future financial developments can be made for this sector. Without the latest pension reform, there is a danger that the current contribution rate of 19.5% will rise to well over 22% by 2030 despite the fact that the pension level will fall steeply. Thus, as the statutory pension insurance scheme's yield inevitably declines, the fiscal burden will rise.

... healthcare...

Growing financial problems are also foreseeable in the statutory health insurance schemes. However, in this sector it is less clear to what extent ageing will push up healthcare expenditure. Age-specific spending profiles certainly indicate that health-care costs are higher the older the insured persons are. However, it is questionable whether this structural feature can also be applied to an ageing society *in toto*. For example, studies indicate that healthcare costs depend less on the absolute age of the person insured than on the temporal distance from death. Irrespective of the demographic trend, progress in medical technology plays an especially large role in pushing up costs.¹⁶ This is because it is primarily concerned with new products and methods and less with cost-saving process innovations. On the other hand, it is clear that the financing base of the

statutory health insurance scheme will be narrowed as a result of the ageing population. In 2003 contributions per pensioner were just under three-fifths of the level of the other members. These problems are even more acute in the long-term care insurance scheme. As the need for long-term nursing care primarily affects the very old, the greatest financial problems in this case are still to come.

The demographic changes pose the least problem for the statutory unemployment insurance scheme. On the contrary, as the labour supply declines, a fall in unemployment can be expected. However, given the high level of structural unemployment, it is by no means certain whether this will happen more quickly than the predicted decline in the labour force and thus cut the unemployment rate.

A comprehensive assessment of the sustainability of public finances which takes into account the long-term demographic burdens is not possible using conventional fiscal indicators such as the budget balance. For this reason, generational accounting was developed to determine the sustainability gap. This can be expressed as an annual consolidation requirement. The consolidation requirement indicates by how many percentage points the deficit ratio would have to be lastingly lowered to enable the fiscal position prevailing in the base year to be sustained over the

...and unemployment insurance

Assessment of long-term sustainability using generational accounting

¹⁶ See Friedrich Breyer and Volker Ulrich, Ageing, Medical Progress and Healthcare Expenditures: A Regression Analysis, *Journal of Economics and Statistics* 220, 2000, pp 1-17.

long term without any further changes.¹⁷ According to the calculations based on 2003, if the reform measures which have already been adopted (but had no impact in the base year) are disregarded, the consolidation requirement amounts to almost 6% of GDP. This indicates that in the future it will only be possible for the government to continue to provide the benefits it does today if there is a sharp increase in the fiscal burden. Even if the adopted reform measures which were not yet in force in 2003 are taken into consideration, there is still a consolidation requirement of 3½% of GDP even though a significant reduction was achieved last year (for further details see the box on page 28).

Need for fiscal policy action

Role of government in market economies

Government defines framework

The critical situation of public finances and the big future challenges require a fiscal policy which is oriented to the basic role of government in a social market economy. According to this concept, government primarily defines the framework for economic activity. It is particularly important that the economic processes can generally be steered via the price mechanism, which – wherever possible – is not to be limited or distorted by government intervention. Such intervention can at most be justified by the existence of externalities. Government also ensures greater equality of opportunities and provides a social security system. Furthermore, given sound public finances government can help to steady economic growth in the event of economic

fluctuations, notably by allowing the automatic stabilisers to take effect. As a general rule, government should only intervene in market processes in exceptional circumstances and in a precisely delimited manner, particularly to allow sufficient scope for individual performance and responsibility.

Government activity must define stable and reliable framework conditions but at the same time create confidence in the implementation of reforms if any adjustments are required over the course of time. In this context, a clear strategy and a constant economic and fiscal policy course are the necessary basis for the mostly long-term decisions of the economic agents. Overregulation as well as complicated and opaque tax and transfer systems hinder private economic activity and encourage the pursuit of special interests. Attempting to maximise fairness at the individual level may be perceived as unfair *in toto*.

Reducing the budget deficits in the medium term

Sound public finances are a crucial requirement for enabling government to perform its duties continuously and investors and consumers to have confidence in a stable economic framework. In addition, they are an important foundation for a stability-oriented monetary policy. High deficit and debt levels

Importance of sound public finances

¹⁷ The basic idea behind generational accounting is that government revenue and expenditure are divided between the individual age cohorts and then updated on the basis of the demographic trend. For a description of the methodology (and limitations) of this procedure see Deutsche Bundesbank, The long-term sustainability of public finance – an analysis based on generational accounting, *Monthly Report*, December 2001, pp 29-43.

On the development of the long-term sustainability of public finances

The question of the long-term sustainability of public finances 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 already been adopted 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 marginally last year to just under 6% of GDP compared with 5¾% in 2002. This deterioration was exclusively due to the unfavourable cyclical development. Adjusted for cyclical influences and temporary additional expenditure to overcome the flood damage, the annual consolidation requirement actually decreased by just over ½ percentage point. This was partly attributable to the increase in contribution rates to the statutory pension and health insurance schemes and in indirect taxes. On the expenditure side, central, state and local government have pursued a stringent budget management course. Furthermore, sav-

ings were made, in particular, in labour market spending. This was, however, offset by the fact that payments to the EU in 2003 were higher than in 2002. In addition, revenue from social security contributions grew more sluggishly than was to be expected considering the development of gross wages and salaries and the increase in the contribution rates and in the assessment bases.

Under the policy scenario the annual consolidation requirement last year was noticeably lower, at just under 3½% of GDP, than in the adjusted status quo scenario. This was chiefly attributable to future savings by the statutory pension insurance scheme. Moreover, cost-cutting measures in respect of labour market-related spending, healthcare expenditure and tax consolidation measures will more than offset the tax cuts which will take effect primarily in 2004 and 2005. Compared with 2002, the sustainability of public finances has improved to a remarkable extent under the policy scenario. The annual consolidation requirement declined by 1¼ percentage points. This was mainly attributable to the measures adopted last year but which will take effect only in the future. Heading the list are the reform measures for the statutory health insurance scheme and labour market-related expenditure.² Additionally, the cuts in tax subsidies and the other measures adopted for the statutory pension insurance scheme have also made a sizeable contribution.

Even though these figures must be interpreted with caution, the results show that the measures adopted in 2003 have significantly improved the state of public finances compared with 2002. The dramatic increase in the annual consolidation requirement in the previous years – which was primarily attributable to the adopted tax cuts and the shortfalls in revenue from the taxes on capital income, turnover tax and social security contributions which exceeded these changes in legislation and the development of the macroeconomic assessment bases – was reversed. Even so, the fiscal policy course last year was still not sustainable.

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 It was assumed that the contribution rate to the statutory health insurance scheme will remain constant in the future. The extent to which savings result in contribution rate cuts will reduce the long-term sustainability again in the future.

will restrict government's room for manoeuvre in future years and may crowd out private investment. The increasing interest burden has to be financed by higher taxes or lower expenditure elsewhere.

The imperative of sound public finances has no specific implications for the scale or nature of government activity but simply means that government expenditure must be financed by revenue in the long term. If lower taxes and social security contributions are desired, these also need to be funded by cutting government expenditure. The scale and nature of government activity should ultimately make allowances for preferences of the population. At the same time, however, the implications for future macroeconomic development, particularly in terms of international competition, should be taken into account.

Comprehensive consolidation requirements at all levels of government

The high (structural) deficit and debt levels and the foreseeable demographic development necessitate a comprehensive consolidation of public finances in Germany – not least in order to comply with national and EU budgetary rules. This particularly requires achieving lasting structural savings on the expenditure side. Given the already high levy burden, an increase in taxes or social security contributions would have negative repercussions for the overall economic outlook. Moreover, international experience shows that, above all, consolidation strategies which are focused on curbing government consumption expenditure are the most likely to succeed. Fiscal consolidation is required at all levels of government. The largest proportion of the government deficits, which amounted to €82

billion in 2003, was accounted for by central, state and local government (€75 billion). In the case of the social security funds, deficits should generally be avoided by adjusting the contribution rates; however, further increasing them would be extraordinarily problematic.

The consolidation of central, state and local government budgets requires strict spending limits. However, the requirement of constant or marginally increasing overall expenditure for central, state and local government makes cuts necessary, since various expenditure items already indicate a dynamic tendency.

For example, pension payments for civil servants, which amount to €35 billion and make up more than 5% of all central, state and local government expenditure, will go up considerably,¹⁸ even though saving measures have already been adopted. Federal Government grants to the statutory pension insurance scheme will also increase further because they are largely coupled to the evolution of contribution rates and gross wages and salaries. Whereas the expenditure share of the grants to the social security funds amounted to merely 8% for central, state and local government in 1991, by 2003 it had grown sharply to almost 13%, in part owing to the greater financing of pensions out of general taxation; central government's expenditure share (as defined in the national accounts) amounted to as much as 29%. The further rise is, however, likely to decelerate if

Strict spending limits for central, state and local government

Ageing-related expenditure

¹⁸ For details, see *Zweite Versorgungsbericht der Bundesregierung, Bundesdrucksache 14/7220, 2001.*

the increase in contribution rates to the statutory pension insurance scheme is limited by further reforms and progress is made in reducing unemployment so that the Federal grant to the Federal Employment Agency can also be lowered.

*Interest
expenditure*

Interest expenditure will also go up at least in the medium term as a result of the continuous growth in debt, which is expected to continue in the coming years. However, the dynamics of this expenditure item will initially still be dampened by a favourable refinancing of maturing debt securities. In the last few years, central, state and local government have already profited considerably from the declining interest rates. Although indebtedness has risen by nearly €340 billion in the last eight years, annual interest expenditure remained almost unchanged. The average interest rate¹⁹ on government debt went down from around 8% in 1992 to 5% in 2003. If it had stayed at the same level as in the early 1990s, the government deficits would currently be almost €40 billion (or 2% of GDP) higher. Based on overall debt, an increase in the average interest rate of 1 percentage point would have resulted in additional expenditure of €14 billion or just over ½% of GDP.

*Personnel
expenditure*

Expenditure on employees of central, state and local government amounts to just over €150 billion or 24% of total expenditure, thus constituting the largest spending item. At best, this can be limited by further lowering staffing levels, which can be achieved by comprehensively reviewing government tasks and services and by reducing government

regulations. However, it should be noted that certain tasks – labour-intensive education, in particular – may require additional resources.

It will be essential to scrutinise all services provided by central, state and local government and to exploit additional efficiency reserves in carrying out government tasks. This must also comprise additional subsidy cuts. This requires a fiscal policy which can also be enforced against pressure from vested interest groups.

Limiting the burden of social security contributions

The social security funds are not only particularly affected by the weak growth momentum and the demographic changes, they are also partly responsible for the unsatisfactory employment situation in Germany owing to the fact that their financing is based on wages and salaries. Crucial requirements for the future are therefore to promote a higher participation rate of the shrinking labour force in the macroeconomic production process as well as to limit social security contributions and decouple them as far as possible from the payroll. Any society must bear the burdens associated with the ageing of its population. A rise in the financing burdens of the social security systems can hardly be avoided, but it can be contained and distributed in a more even and employment-friendly manner.

*Rising social
security
contributions
hinder
employment*

¹⁹ Calculated here as the ratio of interest expenditure (as defined in the national accounts) to the average debt level in each year.

*Social benefits
under scrutiny:
unemployment-
related items, ...*

In order to reduce non-wage labour costs, it is necessary to monitor social benefits with regard both to their entitlement preconditions and their amount. Important measures have already been taken: the maximum period of entitlement to unemployment benefit has been shortened, the rules governing jobs which the unemployed can reasonably be expected to accept have been tightened, and unemployment assistance and social assistance paid to persons able to work have been merged to create the new "unemployment benefit II". This will not only result in savings on expenditure but will also increase incentives for labour supply and demand in the lower income bracket, consequently helping to reduce the high structural unemployment in Germany. Considerable potential savings appear possible, in particular, on expenditure in the area of active labour market policy.

*... health
insurance ...*

If the misguided incentives arising from social security contributions are to be limited, the equivalence concept must be respected more. The levy wedge driven between the wage from a consumer's and from a producer's perspective by social security contributions has a distortionary impact on insured persons if contributions are not linked directly to corresponding entitlements. Especially in the statutory health insurance scheme, a rise in contribution payments leads to practically no additional claims to benefits and is therefore tantamount to a tax. Furthermore, the longer-term trend of rising expenditure in the health sector means that the current method of financing via wage-related contributions drives up labour costs. If higher contributions

are not compensated by a corresponding restraint in pay agreements, this leads to additional unemployment. Therefore, it would seem appropriate for the statutory health insurance funds to concentrate on their primary task, ie insuring against intolerable financial burdens in the event of illness, as well as to decouple financing from wages and hence employment. Shifting the income redistribution function that is currently performed within the statutory health insurance scheme to the tax and transfer system could contribute to greater transparency and help to overcome undesirable and inefficient redistribution effects. The currently discussed proposal of a health premium on independent income coupled with a supplementary tax-financed adjustment based on the principle of solidarity points the way forward.

Under the "Pension Insurance Sustainability Act", future pension adjustments are to be corrected whenever the ratio of pensioners to contribution payers shifts. As a result of demographic changes, the new "sustainability factor" will usually mean that pensions go up more slowly than the incomes of employed persons. In this way, it is possible to stabilise the statutory pension system against demographic changes. As things stand today, the contribution rate can be prevented from rising to more than 22% up to 2030. Although the associated need for enhanced supplementary private pension provision will increase the burden on today's contribution payers, it will not necessarily raise labour costs and may offset the demographically related lower yield provided by the statutory pension insurance scheme as a result of the

*... and pension
insurance*

higher rate of return which private pension plans may be expected to generate. This would also contribute to more equal inter-generational burden-sharing. To compensate for the longer period of drawing pensions owing to higher life expectancy, an increase in the statutory retirement age appears unavoidable. Ultimately, a balance between the level of contributions, the level of pension payments and the retirement age has to be found.

Need to make the tax system more efficient

Initial progress in tax policy

Over the past few years efforts have already been made in the field of tax policy to reduce the marginal tax burden on income, thereby improving longer-term growth and employment conditions. In 2004 and 2005 more income tax cuts will come into force as part of the "2000 tax reform"; this will significantly reduce tax again on both the bottom and top income brackets (to 15% and just over 44%, respectively).²⁰ On the other hand, various measures have also been taken to abolish current tax breaks and thus broaden the tax base. Initially these were largely concentrated on the corporate sector. However, the Act Accompanying the 2004 Budget also makes a start on eliminating tax subsidies for households, although some of the cuts are lower than the Federal Government's original plans.

Further need for fundamental tax reform

Despite this progress, a fundamental tax reform is required if performance and investment incentives are to be strengthened further and the tax system, which has become exceedingly complex and unwieldy, is to be

made more transparent and efficient. Such a reform should primarily aim to further lower the income tax rates, continue to abolish subsidies which distort allocation and at the same time massively simplify tax legislation. Not least, the impending EU accession of the central and east European countries increases the pressure – owing to their tax structures – to pay greater heed to macroeconomic efficiency than to redistribution aspects. However, given the current high general government deficit, it is not acceptable to finance more tax rate cuts by incurring additional government debt. Therefore, such a reform must be financed by further savings on the expenditure side and the abolition of tax subsidies. In this context the possibilities for eliminating the current preferential treatment in the field of VAT – particularly in the form of the reduced rate applied to certain goods and services – should also be placed on the agenda.

The public debate on tax policy has been promoted considerably by the fact that various concepts for a radical reform have been presented (see table on pages 34-35). All major reform concepts aim to further reduce income tax rates and, on the other hand, to broaden the tax assessment base considerably. This should make the tax system more neutral and at the same time macroeconomically more efficient. Another aim is to improve the public perception of the tax regime by drastically simplifying tax assessment and collection procedures.

Various reform concepts

²⁰ Including the solidarity surcharge which is not levied on low incomes.

The most radical proposals from the point of view of macroeconomic allocation are approaches which – like the Kirchhof concept – suggest a move towards taxing all types of income at a standard marginal tax rate (as is already the case in several acceding countries). Compared with a continuous direct progressive tax schedule, such proposals have the advantage of greater neutrality also in the inflation process and concurrently enable the levying of taxes to be simplified by broadly instituting a system of final taxation with deduction at source. However, critics doubt whether such proposals take sufficient account of income redistribution aspects. But the concepts put forward by the German Council of Economic Experts and the opposition parties likewise aim to broaden the assessment base while reducing income tax progression and to greatly simplify tax legislation. A problem common to all reform concepts is that they would result in sizeable tax shortfalls for government, at least during the transitional phase. A gradual process would therefore be necessary in connection with a wide range of additional consolidation measures.

Untangling the financial relationships between the different levels of government

The goal of a more efficient fiscal policy also entails the need to revise the financial constitution so as to enable the individual levels of government to bear more responsibility and increase their own interest in improving their economic and tax-generating potential. The link between public services and the fiscal

burden should be made more visible. In the long term, this could create greater incentives to use public sector resources more efficiently. This primarily requires a clearer separation of legislative powers between the different levels of government, which should be accompanied by a relaxation of the revenue-sharing scheme and greater tax autonomy for state government. The Commission to Modernise the Federal System has a mandate to draw up proposals for reforming the current federative system by the end of the year.

On the expenditure side, at least part of the current mixed financing arrangements should be reduced. As a general rule, the expenditure burden should be allocated to the level which has the relevant legislative powers so as to make the political responsibilities more transparent for the citizens.²¹ In order to achieve greater budgetary flexibility for state government, it would be necessary – given their high proportion of personnel expenditure – to create greater latitude in the field of public sector remuneration as well.

On the revenue side, the budgetary leeway of state government could be expanded by the transfer of legislative powers concerning taxes. The most radical solution would be to replace the current tax-sharing system in the case of the joint taxes by a segregated system in which central government has the legislative power and revenue competence for turnover tax and state government is allocated income tax and corporation tax. The

On the expenditure side main need is to reduce mixed financing

On the revenue side greater tax autonomy required for state government

Need for greater individual responsibility at all levels of government

²¹ See German Council of Economic Experts, *Jahresgutachten 1997/98*, especially section 349 (available only in German).

A comparison of selected aspects of important tax reform concepts

Feature	Kirchhof	CDU/CSU	FDP	German Council of Economic Experts (dual income tax)
Income tax				
– Types of income	One (income from earning activities)	Four	One (income from economic activity)	Two (capital income, labour income)
– Basic allowance	€8,000	€8,000	€7,500	Not specified
– Type of rate	Flat tax with progression effect for natural persons through deductions from the tax base (social compensation amounts)	Initially (Immediate Programme for 2005) a linear progressive tax, later a graduated tax	Graduated tax rate	Flat tax for capital income, progressive rate for labour income
– Marginal tax rates	15% (for taxable annual income ≤ €13,000) 20% (€13,000 < taxable annual income ≤ €18,000) 25% (for taxable annual income > €18,000 and taxable legal persons in general)	12% to 36% (top rate for taxable annual income > €45,000)	15% (for taxable annual income ≤ €15,000) 25% (€15,000 < taxable annual income ≤ €40,000) 35% (for taxable annual income > €40,000)	Uniform rate of approx. 30% for capital income, progressive rate of 15% to 35% for labour income
– Treatment of marriage and family	Basic allowance and social compensation amounts may be transferred between spouses. Annual child benefit allowance of at least €2,000	Continued application of spouse's pooled liability as well as basic allowance for children	Continued application of spouse's pooled liability; child benefit as an alternative to basic allowance	Continued application of spouse's pooled liability; child benefit not specified
– Treatment of capital gains	Flat tax of 2.5% on proceeds from the sale of participating interests	Taxable, unless assets can be attributed exclusively to private income	Tax-free, as long as they are reinvested within four years	Taxable at the same rate as for capital income, tax exemption for proceeds from the sale of participating interests
– Taxation of capital income	Final tax rate, abolition of the savers' tax allowance	Decision still pending from the point of view of the neutrality of different modes of financing	Final tax rate of 25%, retention of banking secrecy, abolition of savers' tax allowance	Final tax rate of approx. 30%, tax exemption for shareholder dividends, abolition of savers' tax allowance
Corporation tax				
Tax rate, treatment of capital gains from disposals	Corporation tax to be incorporated into income tax so that taxable legal persons are also liable for income tax	Alignment of the corporation tax rate with the income tax rate (probably 36%). "Moderate" taxation of capital gains between corporations	Corporation tax to be at the same rate as income tax	Corporation tax rate to equal capital income tax rate, capital gains from participating interests to be tax-free

Feature	Kirchhof	CDU/CSU	FDP	German Council of Economic Experts (dual income tax)
Local business tax	Abolish	Abolish	Abolish	Abolish
Calculation of profit				
– Loss offset	Abolition of the loss carryback, loss carryforward only within the source of earnings where losses were incurred	Loss carryback open, unlimited loss carryforward	Loss carryback to preceding year, unlimited loss carryforward	Loss offset between different types of income, intertemporal loss offset not specified
– Depreciation	Only linear asset depreciation	Only linear asset depreciation	Retention of declining-balance asset depreciation, too	Not specified
– Tax balance sheet	Commercial balance sheet not to determine the tax balance sheet, new tax balance sheet legislation to be introduced	Commercial balance sheet not to determine the tax balance sheet, choice between balance sheet and net receipts accounting	Commercial balance sheet to determine the tax balance sheet	Not specified
Deduction of income-related expenses of households	Non-deductibility of mixed costs (eg commuting costs, home office), instead a standard allowance of €2,000 for income-related expenses	Standard allowance of €840 for employees, reduced commuter allowance of 25 cents per km for distances up to 50km	Flat-rate allowance of 2 % for income-related expenses of employees	Not specified
Deduction of special expenses	No ceiling on contributions to statutory and private pensions; no other deductions	Retention of the main tax deduction facilities, but abolition for individual purposes	Pension contributions may be deducted up to the maximum contribution limit for the statutory pension, other contributions may be deducted up to 15% of the assessment base for statutory health insurance contributions	Abolition for individual purposes
Tax collection				
– Deduction at source	Tax declaration for entrepreneurial income, otherwise deduction at source. Income from participating interests to be taxed finally at company level with taxation of shareholders abolished	Still no decision as to how capital income is to be deducted at source.	Final tax rate of 25% on capital income.	Final tax rate of approx. 30% on capital income
– Other methods for simplifying tax collection		The tax office will draw up a draft tax declaration on the basis of electronic data transmission using the income tax ID number for each taxpayer	Aim is to simplify the tax declaration procedure considerably	

main argument against such a segregated system is, however, that these taxes have different revenue trends. Not least for this reason, a more moderate reform would be preferable in which, while the current tax-sharing system would remain, state government would be given a degree of tax autonomy through a limited right to impose a supplement or discount on their shares in income tax and corporation tax. On the whole, such a solution would increase the self-responsibility of state government without resulting in overly strong divergences in the revenue trends between the different tiers of government.

Conclusion

Current crisis...

German reunification created extraordinary tasks for fiscal policy. The largely unchanged continuation of the existing west German tax, social security and transfer systems – which were already in need of reform – as well as the financing of the massive transfers to eastern Germany mainly by raising social security contributions and incurring new debt contributed to the current difficult situation. The sharp increase in the number of pensioners (including retired civil servants), which already became apparent in the 1990s, has also led to a considerable rise in retirement-related expenditure. Also as a result of the macroeconomic problems, public finances are currently characterised by high deficits, which

infringe both the national ceilings and the fiscal rules of the EU and thus lessen their credibility. Together with the unclear fiscal policy outlook, this has led to uncertainty on the part of consumers and investors. Furthermore, the current design of the tax and transfer systems, not least in the light of the increased competitiveness arising from globalisation and European integration, is hampering economic growth. The problem is compounded by the demographically induced burdens.

However, the critical situation of public finances also presents an opportunity for renewal and change if it releases forces that could successfully overcome the fiscal policy problems. The preconditions for this improved significantly last year. An intensive reform discussion is under way and in many areas the first important steps have already been taken. The reform process must not come to a halt, however. The consolidation of government finances, further reform of the social security funds, the tax system and the financial constitution remain on the agenda. The broad consensus that has meanwhile been reached on the need for reform must now be followed by detailing and implementing the other necessary measures. Together with the equally urgent reform of the labour market, this would create favourable conditions for sustainable economic growth and the promotion of social welfare.

... should be used to improve the fiscal policy framework