

Public finances

Budgetary development of central, state and local government

In the first quarter of 2004, the deficit of central and state government (results for local government are not yet available) amounted to €40 billion, around €4 billion higher than in the same period in 2003. The main reason was a decline in tax revenue, which reflected the subdued domestic economy and the considerable income tax cuts. This contrasted with a 1½% increase in expenditure.

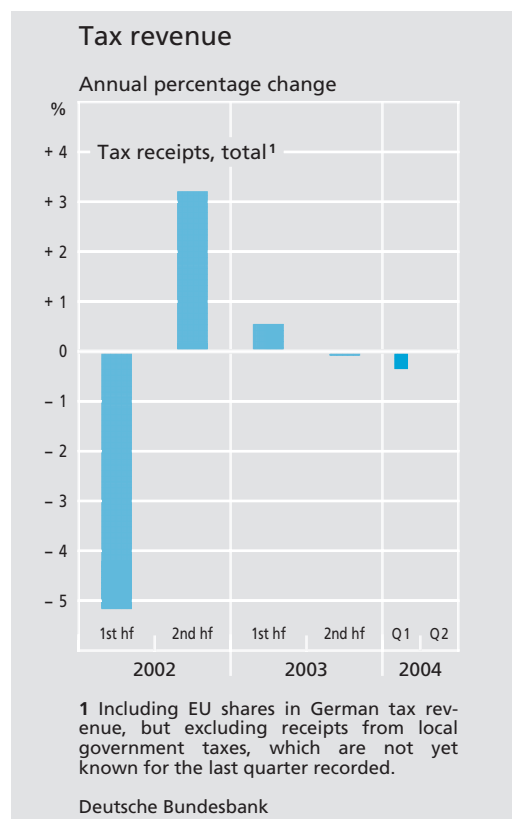
Overview

Following record deficits of central, state and local government of almost €70 billion in 2003, no improvement is expected on the whole for this year. The crucial factor here is the revenue side. For example, according to the most recent forecast, tax revenue will probably increase only marginally. Non-tax revenue is likely to go down, partly as a result of the significant decline in the Bundesbank profit. The level of expenditure could remain largely unchanged compared with 2003. The contributing factors include smaller growth in transfers to the social security funds, a further reduction in staff numbers, moderate pay developments in the public sector, a generally stringent spending policy in view of the tight budgetary position as well as the persistence of very favourable financing conditions on the capital market. Even so, as things stand today, deficits are likely to considerably exceed budget plans (which were optimistic, particularly for central government) owing to the continued weakness in revenue and absent the implementation of additional measures.

*Tax revenue in
the first quarter*

The trend in tax receipts was even gloomier in the first quarter of this year. Tax revenue¹ of central, state and local government was ½% below the already low level of 2003. Adjusted for the change in booking techniques for Federal Government taxes,² they even went down by almost 1½%. This owed much to the cut in income tax rates, which came into force at the beginning of the year. Furthermore, the sustained sluggishness of domestic economic activity was reflected in an unfavourable development pattern of major excise taxes.

Among the different types of income tax, wage tax yielded 3½% less than in the previous year. Still, this decrease was relatively low because, in terms of actual cash flow, the tax cuts had only a partial effect in the first quarter. Moreover, in view of the lower tax rates, a considerable number of special payments at the end of 2003 were shifted into the new year. Although the outturn of assessed income tax likewise worsened (by just under €½ billion), revenue, adjusted for the increased amounts for the grant to home buyers – largely paid out in March – and the tax refunds to employees, actually went up somewhat vis-à-vis the same time last year. The cuts in income tax rates seem to have been only partly accounted for by an adjustment of prepayments. Corporation tax receipts went down by 11% (or €¼ billion) to just over €2 billion. This was, however, attributable to a special factor (caused by the restructuring of a group); adjusted for this effect, they went up by just under €½ billion. Even so, this increase fell significantly short of expectations. Non-assessed taxes on earnings



yielded just over €½ billion more than in 2003 as a result of the aforementioned special factor. Revenue from tax on interest income declined by slightly more than 12% primarily owing to the declining average interest rate on financial assets.

Although, among the indirect taxes, turnover tax receipts went up by just over 1½% compared with the – very low – level from the previous year, the weak domestic consumer

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

2 Until the end of 2003, in the case of Federal Government excise taxes, partial amounts due at the end of the month were frequently recorded in the subsequent month as revenue, whereas since the beginning of this year they have been booked in the maturing month. This changeover led to the decline in overall tax revenue in the first quarter being understated by around one percentage point vis-à-vis 2003.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Year- on-year change (as %)
	Q1		
	2004	2003	
Wage tax	29.5	30.6	- 3.5
Assessed income tax	- 5.8	- 5.4	.
Corporation tax	2.2	2.4	- 10.9
Turnover tax	34.2	33.7	+ 1.6

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demand continued to have a retarding influence on receipts. Mineral oil tax – the most important excise tax – yielded almost 5% less than in the same period last year (adjusted for the aforementioned change in booking techniques). This reflected the decline in energy consumption as a consequence of the sluggish domestic economic activity as well as the increase in oil prices. Tobacco tax – after adjustment – also recorded a noticeable decrease in receipts (-1½%); this reflected lower sales of taxed tobacco products in Germany. The tax increases that came into force on 1 March 2004 did not have an effect on revenue in the first quarter.

Further outlook

Following the unfavourable revenue trend at the beginning of the year and as a result of the economic outlook – which is now being

assessed more cautiously – tax revenue for 2004 as a whole will be noticeably lower than expectations from the fourth quarter of last year, which have now been modified to include the recent changes in tax legislation. According to the recently revised official tax estimate, which assumes real GDP growth of 1.5% and nominal GDP growth of 2.3%, revenue will go up by only just under ½% this year. Vis-à-vis the autumn estimate, which is comparable insofar as it has been adjusted for the changes in tax legislation, shortfalls look likely to amount to €4½ billion. They will primarily affect corporation tax, assessed income tax, mineral oil tax and tobacco tax. In addition, the fact that revenue expected from the tax amnesty is estimated to be down by €3½ billion has exacerbated the shortfall. According to the new official forecast, the overall tax ratio (as defined in the financial statistics) will decline this year by an additional 0.4 percentage point to 20.4%, particularly owing to the considerable reduction in the income tax schedule. Next year the tax ratio will go down again somewhat as a result of the third stage of the tax reform, but then it is likely to go back up slightly in subsequent years if the law does not change. From a medium-term perspective, the new official estimate indicates significantly larger tax shortfalls vis-à-vis the May 2003 forecast, amounting to €27 billion – or just over 1% of GDP – in 2007.

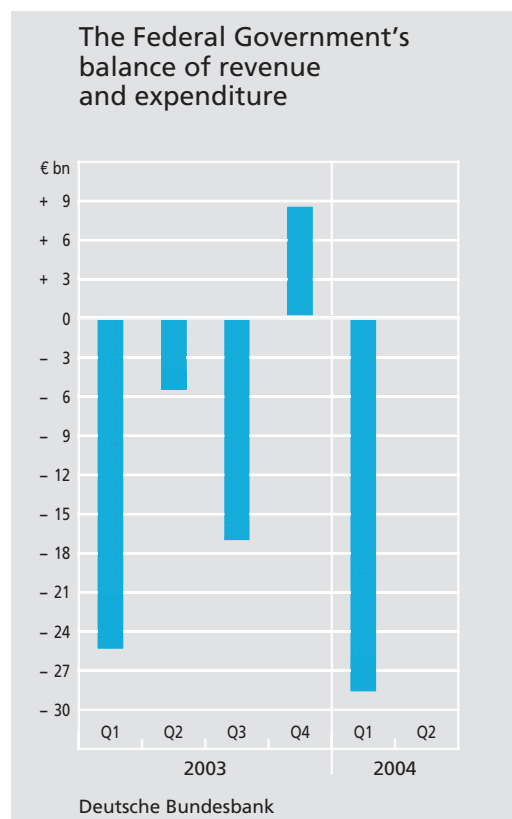
The deficit of central government expanded by €3½ billion to €28½ billion in the first quarter. Revenue went down by 4%. With a decline of around 3%, central government tax receipts developed more unfavourably

*Central
government
in the first
quarter*

than overall tax revenue. One reason was that, in connection with the outcome of the parliamentary mediation committee from December, the distribution of taxes has changed to the detriment of central government because its share in corporation tax has been temporarily reduced³ and the share of local trade tax payable to central and state government has been lowered. Another contributing factor was an increase in transfers to the EU, which are deducted from tax revenue by central government. Non-tax revenue, which tends to fluctuate sharply during the year, declined sharply by just under 15%. Expenditure expanded by 2%, mainly because of a significant rise in interest expenditure. The key factor was that, unlike last year, no premium (which is offset against interest expenditure) was gained from the issuing of securities.

*Outlook for
this year...*

The Federal budget for 2004 envisages a significant decrease in the deficit from €39 billion to €29½ billion. However, as things now stand, there is considerable risk of the previous year's level being exceeded. Expenditure may well stay below last year's level, to be sure; compared with 2003, when the increase amounted to 2½%, no more transfers will be made to the flood disaster fund. Also, transfers to the social security funds are likely to go up only marginally, since the gradual increase in grants to the pension insurance scheme (funded by the "ecology tax") has been discontinued; a decrease in the Federal grant to the Federal Employment Agency is also expected. The low rate of return in the capital market made it possible for maturing securities to be refinanced at very favourable rates, which means that, despite a sharp rise



in debt, interest expenditure looks likely to be very subdued. However, revenue will go down considerably as well. The most recent tax estimate envisaged that tax revenue of central government would fall by 1½%. In the case of non-tax revenue, although the budget envisages an expansion in privatisation proceeds, this effect will be more than offset by the decline in Bundesbank profits booked to the central government budget.⁴ Furthermore, the revenue expected from

³ In the Fourth Act Promoting Modern Labour Market Services ("Hartz IV"), which primarily governs the amalgamation of unemployment assistance and social assistance from 2005 onwards, just over €2½ billion in turnover tax was shifted away from central government in 2004.

⁴ A share of €3.5 billion of the Bundesbank's profit distribution is booked to the Federal Government budget accounts. Any amount exceeding that sum accrues to the Redemption Fund for Inherited Liabilities. Last year the profit distribution reached €5½ billion. This year, it went down to €¼ billion.

motorway tolls for heavy goods vehicles will not materialise.

... and for 2005

As things now stand, next year considerable efforts will be required in order to achieve any significant progress in reducing the huge deficit. To be sure, according to the tax estimate, tax revenue of central government will increase by 3% despite further tax rate cuts because the distribution of corporation tax will shift back in favour of the Federal Government and because it is assumed that underlying economic developments will be more favourable. Most non-tax revenue may also resume developing somewhat more positively. All the same, in view of the high structural deficits, savings on the expenditure side are imperative. Delays in implementing important reform measures, especially those measures with respect to the amalgamation of unemployment assistance and social assistance, may present economic policy and budget problems alike. Although selling off assets might lower net borrowing, this solution would only cover structural deficits on a short-term basis.

Special funds

In the first quarter, the special funds ran a deficit of €2 billion following a surplus of just over €½ billion last year, which had been mainly attributable to payments made by central, state and local government to the flood disaster fund. The financial situation in 2004 as a whole will also worsen considerably. For example, the bulk of the €3½ billion remaining in the flood disaster fund is likely to be used up. Moreover, as a result of the low Bundesbank profit, the Redemption Fund for Inherited Liabilities will receive no share of the distribution, whereas in 2003 it collected

just under €2 billion. If, in the case of the ERP Special Fund, the loan repayments no longer considerably exceed the level envisaged in the budget (as they did last year), the special funds may actually record a minor deficit following a surplus of €10 billion in 2003.

State government budgets recorded a deficit of €10 billion in the first quarter. This represented a decline of €2 billion on the year. Revenue grew by 2½%, not least because the advancement of income tax rate cuts was partly offset by a temporary shift in the distribution of corporation tax revenue in favour of state government. Expenditure went down by just over ½%. Relief was afforded in particular by the fact that no more transfers had to be made to the flood disaster fund. In 2004 as a whole, despite the tax cuts, the state government deficit is likely to go down vis-à-vis the record level in 2003 (of just under €32 billion). In addition to the aforementioned relief, there were also state-specific savings programmes. Next year, however, is likely to see a renewed increase in deficits as a result of further tax cuts, expiring compensation for the tax cuts brought forward to 2004 as well as the shortfalls expected in the tax estimate.

*State
government*

For local government no results for 2004 are available yet. In 2003 as a whole, the municipal deficit almost doubled to €8½ billion. This was mainly attributable to a decline in revenue of just over 2%. Declining tax revenue was accompanied by sharply decreasing transfers from state government and significantly lower proceeds from the sale of participating interests. Expenditure rose only mar-

*Local
government*

ginally, by ½%. Although grants to households and enterprises rose strongly, a counter-balance came in the form of a decline in investment expenditure of just under 8% despite the additional spending in connection with flood relief. Additionally, at the end of the year there was a technical effect arising from the January 2003 pay settlement, which enabled the payment date for wages and salaries to be shifted to the end of the month, thus resulting in a delayed transfer of social security contributions. Overall, not least for this reason, personnel expenditure went up by merely 1% last year.

For this year, a far-reaching reform of local government finances was intended to steady revenue and bring noticeable relief. However, instead of the discussed extensive tax measures, in practice the only decision taken was the lowering of the portion of local trade tax payable to central and state government which had been raised to the benefit of these two levels of government as of 2001. Furthermore, local government was to be included in the savings arising from the amalgamation of unemployment assistance and social assistance. However, this reform has been postponed until 2005.

*Indebtedness in
the first quarter*

The indebtedness of central, state and local government rose very sharply, by €44½ billion, in the first quarter. This development was, however, offset by a €5 billion increase in deposits. The bulk of new borrowing (€31½ billion) was raised in the capital market. However, money market debt also expanded considerably, by €13 billion. Central government had by far the greatest borrow-

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

€ billion				
Period	Total	of which		Memo item Acquisition by non- resi- dents
		Securi- ties 1	Loans against borrow- ers' notes 2	
2002	+ 54.5	+ 67.6	- 11.9	+ 57.4
2003 <i>pe</i>	+ 79.9	+ 73.4	+ 7.5	+ 35.8
<i>of which</i>				
Q1	+ 34.7	+ 32.6	+ 2.1	+ 19.5
Q2	+ 13.5	+ 11.8	+ 1.6	+ 16.3
Q3	+ 19.9	+ 9.4	+ 11.6	- 6.5
Q4 <i>pe</i>	+ 11.8	+ 19.5	- 7.9	+ 6.5
2004				
Q1 <i>pe</i>	+ 44.4	+ 34.4	+ 10.0	...

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

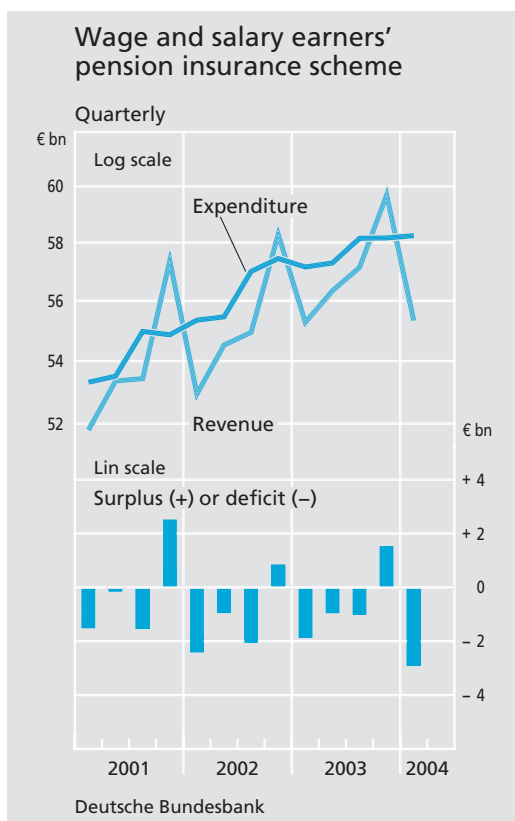
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ing needs (€35 billion). State government also increased its indebtedness markedly, by €9 billion. The growth of local government debt probably remained limited, whereas in the case of the special funds redemptions marginally outweighed new borrowing.

Social security funds

In the first quarter of 2004, the wage and salary earners' pension insurance scheme recorded a deficit of just under €3 billion, an increase of €1 billion on the year. Expenditure increased by almost 2%. By contrast, revenue barely grew any further; one reason was that receipts from contributions stagnated. Since this revenue in January 2003 had still been based on the lower 2002 contribution rate of

*Statutory
pension
insurance
scheme*



19.1%, it actually declined by ½% when adjusted for the increase in the contribution rate to 19.5%. Another reason was that the additional Federal grant financed through energy taxation – unlike in previous years – was raised no further.

Pension expenditure rose by 2%. This was due not only to the pension adjustment from the middle of last year but also in part to a rise of just over ¾% in the number of current pensioners. The decision to make pensioners pay the full contribution to the long-term care insurance scheme adopted as part of the short-term measures to stabilise the contribution rate came into effect in April. Not increasing pensions in the middle of the year will have practically no repercussions compared with the current formula, since even

without this discretionary intervention there would have been virtually no increase in pensions owing to last year's weak wage trend.

This year the minimum level of the fluctuation reserves has been lowered from 0.5 to only 0.2 month's expenditure. The associated recourse to the reserves enabled an otherwise necessary increase in the contribution rate to be avoided. Although for the remainder of this year a noticeably slower rise in expenditure may be expected, additional liquidity assistance from the Federal Government may be needed. This will depend not only on macroeconomic trends but also on the possible sale of the participating interest in the GAGFAH housing construction and management company held by the Federal Insurance Office for Salaried Employees. This might considerably raise the liquidity of the fluctuation reserves. With the new pension reform, the reserves are to be renamed "sustainability reserves" beginning next year, and the upper ceiling is to be raised to 1.5 months' expenditure. Since a lower increase in pension expenditure is expected in the next few years as a result of the "sustainability factor" and a temporary slowdown in the increase in new pensioners, the reserves may actually be replenished in the medium term despite the tense situation next year, if the contribution rate remains unchanged and macroeconomic developments are favourable.

In the first quarter of 2004, the Federal Employment Agency's deficit, at just under €3 billion, was somewhat higher than its €2¾ billion level of last year. Revenue declined by ¾%; receipts from contributions were down

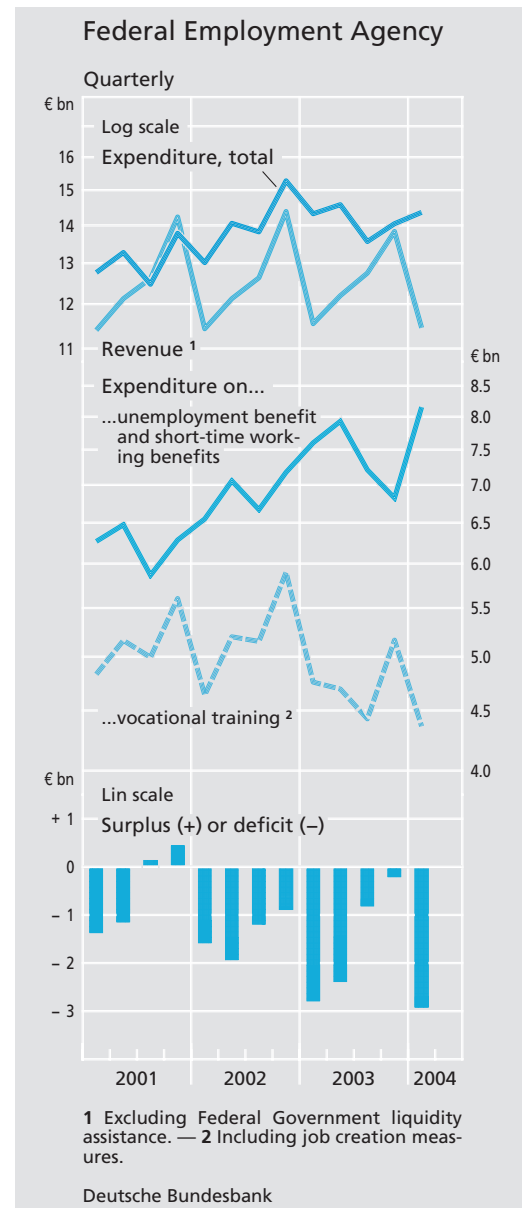
Federal Employment Agency

¼% on the year. Expenditure rose by merely ¼%, although contributions to the statutory pension insurance scheme on behalf of recipients of wage substitutes for January were, for the first time, not booked prematurely in December as had been customary. In the first quarter, this gave rise to an additional burden of €½ billion compared with 2003.

Spending on unemployment benefits increased by just over 7%. Without the aforementioned changeover effect, there would have barely been a rise because the number of unemployed persons – including participants in training measures, who as of January have no longer been classified as unemployed – largely held steady at last year's high level. Active labour market policy measures created renewed considerable savings. The resources for job creation measures were 25% below their previous year's level. Despite additional expenditure for promoting self-employment and for personnel service agencies (PSAs), 6% less was spent on training. The required amount of grants anticipated in the budget plans, amounting to €5 billion for 2004, appears to be sufficient from today's viewpoint.

*Statutory
health
insurance funds*

The statutory health insurance funds recorded a deficit of €3 billion in 2003, unchanged from the year before. Although expenditure rose by merely just under 1½% (the savings measures which came into effect last year contrasting with significant expenditure-raising anticipatory effects arising from the health reform which entered into force this year), revenue likewise only grew by just under 1½% despite the increase in contribution rates. This owed something to an extra-



ordinary drop in revenue in the fourth quarter.⁵

⁵ Besides cuts in Christmas bonuses and a further increase in the number of employees opting for company pension plans with direct payments which are not subject to social security contributions, the postponed transfer of contributions by public sector employers as a result of the January 2003 pay settlements caused receipts from contributions to be particularly low. Furthermore, for 2003 as a whole, the maximum level of earnings subject to contributions was not increased on a discretionary basis, unlike in the case of the pension and unemployment insurance schemes.

The total sum of compensation subject to health insurance contributions actually declined last year by 0.7%, also because of the steady stream of members migrating to private health insurance schemes. This shows that the financial problems encountered by the statutory health insurance funds in 2003 were largely revenue-related. As long as the growth of remuneration subject to compulsory health insurance contributions is weak, relatively small increases in expenditure will be enough to make it necessary to raise the contribution rates. Since there is hardly any chance this year that the volume of earnings subject to compulsory contributions will grow much faster, a stabilisation or reduction of the contribution burden will depend primarily on how effectively the most recent health system reform can contain expenditure. In the light of the increase in patients' co-payments, it appears very likely that the demand for health services will be based to a larger extent upon the associated costs. However, on the basis of present data it is not yet possible to tell whether the decline in expenditure reported at the beginning of the year is due to a structural fall in expenditure or merely a consequence of the anticipatory effects at the end of 2003.

*Long-term care
insurance
scheme*

The long-term care insurance scheme posted a record deficit of €¾ billion in 2003; this was financed by recourse to the reserves, which still held €4¼ billion at the end of 2003. Expenditure rose by just over 1%, even though benefits are not automatically adjusted. However, the – lower – cash benefits to carers within the family continued to decline, whereas there was an increase in expenditure

for benefits in kind through outpatient services and in old people's homes. Revenue from contributions remained almost 1% under the figure from the previous year. This was due in part to the same factors which influenced the health insurance funds. However, the 1.7% contribution rate to the long-term care insurance scheme was not raised. The reserves, which were relatively high in the early stages of the long-term care insurance scheme, are now being tapped further in order to finance recurring deficits. Increases in contribution rates are, therefore, already a medium-term threat.

General government budget trends

This year the overall deficit ratio will exceed the 3% ceiling for the third year in a row. As things stand today, it will reach about the same level as last year (3.9%). The economy is also likely to have a slightly negative impact on the deficit trend.

*Deficit ratio still
well above 3%*

The revenue ratio will continue to decline markedly. This is particularly attributable to the extensive income tax cuts and the lower contribution rates to the health insurance funds. However, it is doubtful whether the tax measures (particularly potential receipts from the tax amnesty), which are intended to boost revenue, will yield the anticipated results. The structure of macroeconomic growth is also likely to prove relatively unproductive with regard to government revenue, since, in particular, private consumption and gross wages and salaries will grow sluggishly. Other revenue will also fall significantly, not

least as a result of the marked reduction in the distributed Bundesbank profit.

Admittedly, the government expenditure ratio is also likely to fall distinctly. This is attributable not least to the health system reform, which will lead to considerable savings for the statutory health insurance funds. The temporarily sluggish increase in the number of pensioners, in conjunction with a lower (compared to earlier years) annual average growth in individual pension payments, will contribute to a curbing of expenditure growth. Finally, central, state and local government's savings measures in the area of personnel and other administrative spending as well as the moderate (if at all) growth in interest expenditure thanks to low interest rates may likewise contribute to a reduction in spending growth.

The European commitments require that Germany return to compliance with the 3% limit by next year at the latest. However, as things now stand, there is still the risk that this will not be achieved. The taxes and social security ratio will be reduced further owing mainly to the next stage of income tax reform. Consequently, greater efforts are required on the expenditure side. In order to ensure compliance with the 3% deficit limit and to end the overshooting of the constitutional limits for new borrowing, it appears right now that adjustments going beyond the adopted consolidation measures will be necessary. Although recourse to sales of participating interests may help to comply with national budgetary law, such shifts in financial assets will not lower the deficit as laid down in the Maastricht Treaty.

*Commitment
to comply with
3% limit by
2005*