Public finances

Central, state and local government

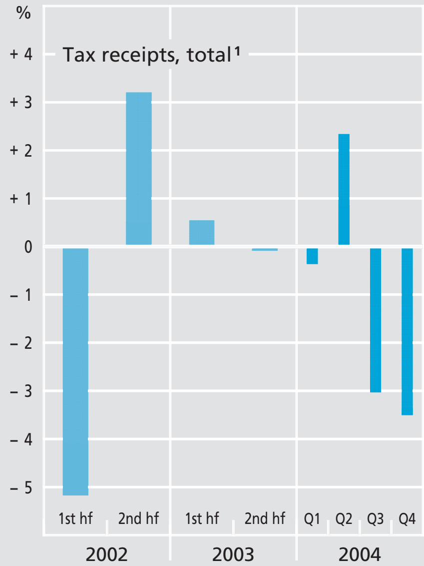
Overview

In the fourth quarter of 2004 central, state and local government appear to have recorded a small surplus, thus improving somewhat on the comparable position in the final quarter of 2003. In 2004 as a whole the deficit will probably be on a par with that run up in 2003, when a new record high of almost €70 billion was reached. On the revenue side tax receipts stagnated owing above all to the cuts in income tax, while non-tax receipts declined, chiefly on account of the sharp drop in the Bundesbank profit. Expenditure declined slightly over twelve months amid countervailing effects such as higher spending on social benefits and a further fall in investment. It is likely that interest expenditure, too, decreased despite the high new borrowing during the past few years thanks to the favourable financing terms. Personnel expenditure and other operating expenditure were very muted.

For the current year the budget plans envisage a reduction in the deficits, not least in view of the national budgetary ceilings for new borrowing. To this end increased recourse will be taken – especially by central government – to asset disposals. Tax revenue will remain subdued, in particular because of the final stage of the income tax reform. In contrast to the situation in the previous years, however, it is expected to increase (albeit only moderately). Tight curbs on spending remain essential if the budget targets are to be met.

Tax revenue

Year-on-year change



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

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Tax revenue in fourth quarter...

Tax revenue decreased by 3.5% in the fourth quarter compared with the same period in 2003.[1] The main reason for this was the sharp fall in wage tax receipts due above all to the extensive income tax cuts. Receipts from mineral oil tax and tobacco tax likewise receded further.[2] By contrast, revenue from profit-related taxes was far more buoyant overall. However, the positive basic tendency weakened somewhat in comparison with the preceding quarters, especially given that the increase was strongly boosted by the surge in receipts from the tax amnesty towards the end of the year.

...and in 2004 as a whole

According to the preliminary outturn – which includes only an estimate for local government taxes – tax revenue in 2004 as a whole largely matched the 2003 level, despite the relatively robust overall economic growth. The overall tax ratio (as defined in the government's financial statistics) consequently decreased by 0.5 percentage point to 20.3%. This was principally attributable to the lowering of income tax rates in 2004. In addition, the overall structure of economic development yielded disproportionately low tax revenue since the growth of domestic demand and gross wages and salaries remained subdued, so that the assessment base for turnover tax and wage tax – the two biggest generators of tax revenue – likewise failed to expand. Receipts from Federal taxes also declined perceptibly in the wake of consumer resistance to the increased prices of mineral oil and the higher tobacco taxes. One offsetting factor was the positive development of profit-related taxes which, given firms' overall improved profitability, yielded 16½% more in the aggregate. Corporation tax receipts, in particular, grew sharply (by nearly €5 billion or 58½%). This was due in part to the moratorium on mobilising accrued corporation tax credits imposed by the Act to Reduce Tax Subsidies and to the limitation of the tax loss carryforward facility. Furthermore, receipts from assessed income tax grew appreciably by 18%, primarily because of income from the tax amnesty amounting to €0.9 billion. Local business tax receipts (the outturn of which for the fourth quarter is estimated) likewise went up substantially.

1 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the fourth quarter.
2 The decrease in the fourth quarter was especially large owing to the change in booking techniques made in 2004 in respect of certain Federal taxes.

While the deviations vis-à-vis the estimates in the forecast from autumn 2003 (on a comparable basis, ie adjusted for changes in tax law since then) were still considerable – at €6 billion – they were far smaller than in past years. Besides revenue shortfalls in the case of mineral oil tax and tobacco tax, the gap between that forecast and the outturn is due mainly to revisions of the pattern of macroeconomic growth, whereas the overall rise in nominal GDP was merely 0.3 percentage point lower than expected. In addition, changes in tax legislation adopted in the meantime caused revenue shortfalls of around €5½ billion. The result forecast in the last official estimate from November 2004 was more or less matched.

Outlook for 2005

It is expected that tax revenue in the current year will be boosted above all by stronger growth of domestic demand and of gross wages and salaries. These positive influences will be partly offset, however, by shortfalls ensuing in particular from the entry into force of the last stage of the income tax reform, which lowers the bottom tax rate to 15% and the top rate to 42%. It is especially difficult to gauge the likely evolution of profit-related taxes. Although their momentum waned somewhat in the fourth quarter of 2004, it seems probable that they will continue to grow significantly. According to the official tax estimate of November 2004, overall tax revenue is expected to increase by 1½% in 2005. The overall tax ratio would then fall again marginally to 20.1%.

Federal budget in 2004 ...

Central government recorded a surplus of over €7½ billion in the fourth quarter thanks to large privatisation proceeds. In 2004 as a whole the deficit exceeded the corresponding figure in 2003 by just over €½ billion to reach almost €40 billion and thus massively overshot the budget target of spring 2004 (€29½ billion). However, it was €4 billion smaller than the amount estimated in the supplementary budget.

Revenue decreased in 2004 by just over €5½ billion or 2½% on the year despite higher proceeds from asset disposals (+ €3½ billion). This was due mainly to a 2½% fall in tax receipts caused notably by the weak momentum of Federal taxes and a temporary change in the allocation of turnover tax to the detriment of central government. This was partly offset, however, by the fact that the payments to the EU out of tax revenue unexpect-

Trends in the revenue from major taxes

Type of tax	Revenue in € billion, Full year 2003	2004	Annual percentage change
Wage tax	133.1	123.9	– 6.9
Assessed income tax	4.6	5.4	+ 18.1
Corporation tax	8.3	13.1	+ 58.6
Turnover tax	137.0	137.4	+ 0.3
	of which Q4		
Wage tax	38.7	35.5	– 8.3
Assessed income tax	4.4	5.0	+ 12.6
Corporation tax	3.4	3.7	+ 8.6
Turnover tax	35.8	35.5	– 0.8

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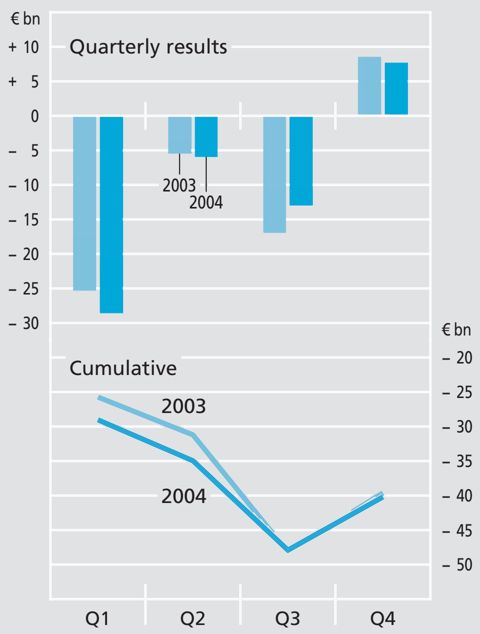
The Federal Government's balance of revenue and expenditure in 2003 and 2004



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edly declined a little. Compared with the original plans, the Federal budget was additionally burdened by the small size of the Bundesbank profit and the delay in introducing motorway tolls for heavy goods vehicles.

Expenditure was reduced appreciably (-2%). This owed much to the fact that no more grants were paid in 2004 to the flood disaster fund. Personnel and other operating expenditure, grants to enterprises and interest expense also decreased. By contrast, spending on unemployment assistance rose substantially (by €2½ billion), although this was almost completely offset by the lower top-up grant required by the Federal Employment Agency.

... and in 2005

The Federal Government's net borrowing requirement for 2005, as defined in the Budget Act, amounts to €22 billion. This is less than the figure budgeted for government investment and is thus in keeping with the Constitution. However, the year-on-year reduction in new borrowing is to be principally achieved by doubling privatisation proceeds to €17 billion. In addition, the Federal grant to the Post Office pension funds is to be cut by around €5 billion by the sale of pension claims. However, these measures merely paper over the urgent need for structural consolidation in the Federal budget.

Special funds

The financial situation of the special funds deteriorated significantly in 2004. They closed with a surplus of just €1½ billion compared with a positive balance of over €10 billion in 2003. The flood disaster fund recorded a deficit of €1½ billion in the wake of disbursements as opposed to a prior-year surplus of €3½ billion. The surplus of the ERP Special Fund fell from €4 billion to just over €2 billion owing to smaller loan repayments. Finally, the positive outcome of the Redemption Fund for Inherited Liabilities declined by almost €2 billion compared with 2003 as no portion of the Bundesbank profit accrued to it in 2004. As things stand today, the special funds may be expected to record a largely unchanged budgetary position in the current year.

State government

In the final quarter of 2004 the deficit of state government amounted to €5 billion, which is €3½ billion less than the fourth-quarter figure in 2003. Overall revenue grew by 2% despite a slight decline in tax receipts. This was evidently due above all to the repayment of grants by certain Landesbanks as demanded by a decision of the European Commission in October 2004. In addition, expenditure was lowered by nearly 3½%. This was attributable not least to the fact that some states cut their traditional bonus payments to staff, or switched to paying monthly bonuses. In 2004 as a whole the deficit run up by state government decreased from the record level of more than €30 billion in 2003 to just over €25 billion. The improvement vis-à-vis the budgeted figure (€26 billion) was ultimately caused by the grant repayments, which so far do not appear to have been neutralised by commitments to return an equivalent amount of funds to the Landesbanks in the form of capital injections.

For the current year the budget plans envisage only a slight decline in the deficits to €23½ billion. Besides shortfalls resulting from the final stage of the income tax reform, state government budgets must also bear the fiscal burden of returning to central government turnover tax shares which it had assigned last year in exchange for the partial advancement of the tax cuts. Based on the current position, Berlin, Bremen, Lower Saxony, Saarland and also Hesse (owing to its more stringent state budget rules) will all breach the statutory ceiling for new borrowing – in some cases by a large margin. The largest state, North Rhine-Westphalia, will avoid this principally by raising the ceiling to include the grant of almost €1½ billion repaid by WestLB and returned by the state to the bank in the form of a capital injection. Even the financially relatively robust state of Baden-Württemberg is having to sell interest claims on a major scale in order to keep its budget in line with the constitution. The breaching of the constitutional ceilings for new borrowing is problematic, especially in the light of the favourable macroeconomic assumptions on which the budget plans are based. Further extensive consolidation measures are crucial.

Local government

For local government only the outturn for the first three quarters of 2004 is currently available. It shows a deficit of €5 billion, which is €4 billion smaller on the year. Overall revenue grew by 4%, with tax receipts expanding by as much as 10%. The weak momentum of receipts from income tax, in which local government shares, was outweighed by the growth of local business tax receipts, only a smaller part of which now has to be passed on by local government to state and central government. Overall spending was marginally reduced, although spending on social benefits exceeded the equivalent level in 2003 by almost 6%. Cost relief was afforded by a drop of 1½% in personnel expenditure. The marked downward trend in capital formation likewise continued with a fall of 8%. The tight budgetary borrowing limits appear to have substantially curbed municipal investment. Consequently, the outstanding long-term debt of local government has barely increased since the end of 2000, whereas cash advances, which are used to pre-finance current expenditure, have been rising noticeably.

In 2004 as a whole the aggregate deficit of local government may have halved compared with the admittedly very high 2003 level of €8½ billion. However, given the continuing growth of bridging loans, this should not be

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

€ billion

Period	Total	of which		Memo item
		Securities [1]	Loans against borrowers' notes [2]	Acquisition by non-residents
2003	+ 81.2	+ 73.4	– 0.8	+ 26.9
of which				
Q1	+ 35.3	+ 32.6	+ 2.7	+ 19.4
Q2	+ 13.2	+ 11.8	+ 0.5	+ 12.4
Q3	+ 20.0	+ 9.4	+ 5.0	– 0.3
Q4	+ 12.6	+ 19.5	– 9.0	– 4.6
2004 pe	+ 71.7	+ 71.0	– 16.4	...
Q1	+ 45.3	+ 34.6	+ 4.1	+ 16.9
Q2	+ 8.2	+ 14.6	– 9.6	– 3.6
Q3	+ 17.9	+ 17.2	– 0.6	+ 18.6
Q4 pe	+ 0.2	+ 4.7	– 10.3	...

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

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interpreted as a sign that the financial problems of local government are easing. In the current year local government budgets will receive additional relief, which is secured by a contractual revision clause, from the amalgamation of unemployment assistance and social assistance. Even so, the financial situation of many municipalities will remain tense.

Debt

In the fourth quarter the indebtedness of central, state and local government showed little change. State government increased its liabilities by €2½ billion, while central government reduced its debt by just under €2½ billion. Once again net borrowing mainly took the form of issuing long and medium-term securities. They yielded €6½ billion net, whereas the stock of money market loans and cash advances was run down by €3½ billion altogether. Short-term securities and other loans were likewise redeemed on balance.

Social security funds

Statutory pension insurance scheme

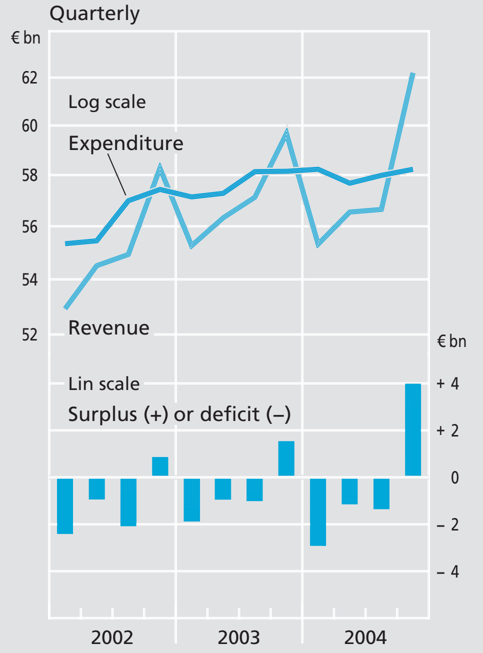
In the fourth quarter the statutory pension insurance scheme recorded a large surplus of almost €4 billion compared with €1½ billion in the same quarter of 2003. A contributory factor in this was that the disposal of the GAGFAH equity stake yielded revenue of just over €2 billion.[3] Additional income accrued from the fact that both the final payments of the old unemployment assistance and the first payments of the new unemployment benefit II due at the beginning of January were booked in December 2004. Moreover, many public sector employers had failed to forward any pension contributions in December 2003.[4] Expenditure was further curbed by the fact that in 2004 there was no mid-year adjustment of state pensions and that since April 2004 pensioners have had to pay the full contribution rate to the statutory long-term care insurance scheme themselves. Total revenue grew by just over 4%, whereas expenditure remained largely unchanged.

In 2004 as a whole the deficit amounted to just under €1½ billion as against almost €2½

3 In the records of the pension insurance funds, by contrast, only the balance of the proceeds in excess of the book value of €1.6 billion was posted as revenue.
4 As part of the latest public sector collective labour agreement employers were given the option, effective from December 2003, of shifting wage and salary payments from the middle to the end of the month. In these cases the associated social insurance contributions were only due one month later in January.

billion in 2003. The reserves of the statutory pension insurance fund at the end of the year stood at 0.32 of a month's expenditure. This means that the expected value of 0.28 of a month's expenditure envisaged in the Pension Insurance Report 2004 was exceeded by just over €½ billion. Consequently, the danger of liquidity shortages in the current year is now less acute. Furthermore, following the sale of the GAGFAH equity stake the reserves are in effect fully liquid. However, this does not rule out a possible need to resort prematurely to government grants in the course of the year. This applies all the more in that the sustainability factor is unlikely to have an impact this year. Given last year's weak wage growth, a negative pension adjustment would be warranted on 1 July under the new pension formula. This is prevented, however, by the pension-cutting constraint contained in the formula. The consequence of this is that the differential between the growth of wages and the increase in pensions envisaged in order to stabilise the contribution rate will fail to materialise whenever per capita wages rise only marginally or fall (see box on page 60).

Finances of the German statutory pension insurance scheme



Federal Employment Agency

In the fourth quarter of 2004 the Federal Employment Agency recorded an unexpected surplus of €1 billion. This compares with a small deficit a year earlier. This improvement was mainly brought about, however, by exceptional factors in December 2004. As in the case of the statutory pension insurance fund, a baseline effect arose from the delayed payment of public sector wages and salaries. As a result, revenue from contributions grew by ½%, whereas it had fallen during each of the first three quarters. Another factor was extra income in the form of refunds from the Federal Government of administrative costs in connection with the labour market reforms. Overall revenue increased by nearly 2½%. Expenditure was lowered by 6%. Despite an increase in the number of unemployed persons, 2% less was spent on unemployment benefit. Spending on active labour market policy measures dropped further by 18%.

In 2004 as a whole the Agency's deficit, and hence its need for transfers from the Federal budget, totalled €4.2 billion; this was €1 billion less than forecast owing mainly to the extensive curbing of active labour market policy. The budget envisages a deficit of €4.0 billion for 2005. The increases in revenue (over 7%) and expenditure (6½%) compared with the actual outturn for 2004 are particularly high

The level of pension adjustments following the introduction of the "sustainability factor"

In general, statutory pensions are adjusted annually in line with the growth of average gross wages and salaries of insured persons in the previous year. However, the adjustment is smaller whenever the contribution rate to the statutory pension insurance scheme or the imputed contribution to a supplementary private pension plan ("Riester pension") increases. In addition, pensions increase more slowly whenever the ratio of (equivalent) pensioners to (equivalent) contribution payers rises (pensioner quotient as part of the sustainability factor). Conversely, a pension increase in excess of wage growth is possible if the contribution rate or the pensioner quotient falls. Given the looming democraphic changes, this formula implies that in future pensions will increase more slowly than the incomes of insured persons on average so as to limit the rise in the contribution rate.

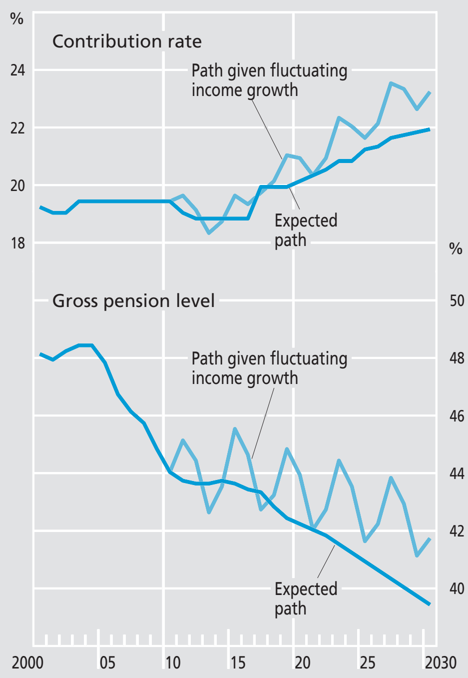
On the other hand, pensions may only be lowered if this is based on a decline in the income of insured persons. The other elements of the adjustment formula cannot trigger a pension cut in the event of only marginally growing or stagnating average incomes and cannot trigger a larger pension cut in the event of falling income levels. This pension-cutting constraint means that the adjustment mechanism will have its full dampening effect on the contribution rate only when wages and salaries grow by at least ½% to 1%. In the current year the combination of practically stagnant incomes and an increased ratio of pensioners to contribution payers in 2004 would imply a negative pension adjustment. Owing to the aforementioned constraint, however, pensions will "merely" be frozen this year. Other things being equal, this will lead to a higher pension level which in turn will necessitate a higher contribution rate.

he constraint of coupling pension cuts exclusively to falling wages could also affect the longer-term forecasts concerning the contribution rate and the pension level on which the introduction of the sustainability factor was based if wages and salaries do not, as assumed, grow by 3% annually from 2009 but instead grow much more slowly or display a very volatile pattern. Whenever the pension-cutting constraint applies, the expected gap between income growth and pension growth will fail to materialise. This will result in a permanently higher pension level and a corresponding increase in the contribution rate. In turn, this could mean that the officially stated objective of preventing the contribution rate from rising above 22% up to 2030 will not be achieved.

If incomes do not grow at a constant annual rate of 3% in the long term but instead, for example, oscillate around this median between 0% and 6%, the pension-cutting constraint will apply in those years when wages do not increase and in each case will necessitate a higher contribution rate. These effects will cumulate across the low-income years and by 2030 could make a contribution rate well above 22% necessary (see chart). The crucial factor is that every time the pension-cutting constraint applies, this has a positive baseline effect on the pension level that will not be reversed and so will necessitate a permanently higher contribution rate.

The risk of a steeper overall rise in the contribution rate stemming from coupling pension reductions exclusively to wage developments could be avoided if offsetting pension cuts were made in subsequent years of stronger wage growth. Pensions would have to be increased at a correspondingly slower rate in such years. In this way pension cuts not based on falling incomes of insured persons could be avoided without permanently increasing the contribution burden.

Key indicators of the German statutory pension insurance scheme



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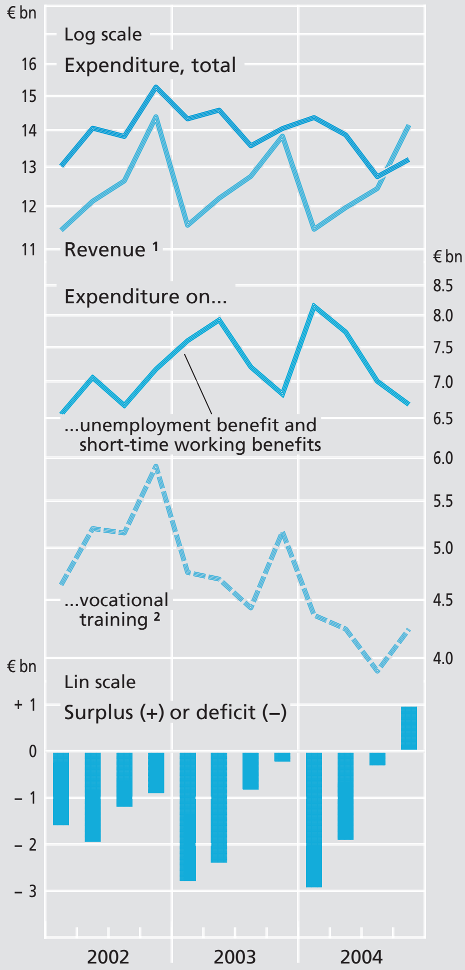
because the Federal Government will make considerable refunds of administrative costs to the Agency which will then have an impact on its expenditure.

Statutory health insurance funds

Only data for the first three quarters of 2004 are available at the moment on the financial development of the statutory health insurance funds. These show that between January and September the statutory health insurance funds accumulated a surplus of just over €2½ billion owing to the healthcare reform, whereas in the same period of 2003 they had sustained a deficit of a similar size. Most of the surplus was presumably used to repay debt.[5] The financial result in the fourth quarter, too, should show an improvement. The spending level in the fourth quarter of 2003 was particularly high as patients sought treatment ahead of the less generous terms introduced at the start of 2004, and in November 2004 the second tranche of the new Federal grant amounting to €0.5 billion was transferred. Furthermore, the contribution trends of the statutory pension and unemployment insurance funds indicate that a more favourable revenue outcome may be expected for the end ot the year.

Finances of the Federal Employment Agency

Quarterly



1 Excluding Federal Government liquidity assistance. — **2** Including job creation measures.

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In the current year the surplus is likely to be markedly smaller. Although the Federal grant has been raised from €1.0 billion to €2.5 billion, expenditure on pharmaceuticals is expected to rise again as the increase in the manufacturers' rebate only applied to 2004 and a price moratorium has expired. On the one hand, the introduction of unemployment benefit II will boost the income of the health insurance institutions for previous recipients of unemployment assistance as the contribution assessment base will be higher on aver-

5 According to figures supplied by the Federal Ministry of Health and Social Security, net indebtedness up to the end of September was reduced by €2.7 billion to €3.3 billion. The gross liabilities of €8.3 billion outstanding at the end of 2003 may therefore have been cut by a similar margin. The health institutions are legally bound to repay each year at least one-quarter of their debt accumulated up to end-2003.

age.[6] On the other hand, previous recipients of social assistance who are able to work now have to be insured on the basis of contributions that do not cover costs.[7]

Development of the general government sector as a whole

General government deficit virtually unchanged in 2004

According to initial provisional figures from the Federal Statistical Office published in January, the general government deficit as defined in the Maastricht Treaty came to 3.9% of GDP last year after reaching 3.8% in 2003.[8] Based on present knowledge, however, the cyclically adjusted balance seems to have improved somewhat. The expansion of GDP was well above the medium-term trend. But taking account of the composition of GDP growth, which led to a relatively low level of taxes and social security contributions, cyclical developments probably hampered public finances on balance.

Falling revenue...

The development of pubic finances was marked, on the one hand, by a decline in the revenue ratio by 1½ percentage points to around 44%. This was caused mainly by the extensive tax cuts and the structure of macroeconomic developments. Gross wages and salaries and private consumption grew more slowly than GDP as a whole, which dampened receipts from wage tax, social security contributions and turnover tax. Moreover, receipts from excise taxes fell sharply. There was also a steep decline in non-tax receipts, which was principally attributable to the far lower Bundesbank profit.

...and expenditure ratios

On the other hand, expenditure was reduced in absolute terms and the expenditure ratio fell likewise by around 1½ percentage points to just over 47½%. Whereas in the previous years growth in spending had been driven especially by the increase in pension payments, the associated rise in 2004 was moderate owing above all to the cost relief measures taken. The healthcare reform – alongside additional revenue – and also the greater restriction of labour market policy measures had a noticeable dampening effect on spending. The precarious budgetary position of central, state and local government led to a restrained expenditure course in which investment spending and personnel expenditure, in particular, decreased. Despite the sharp rise in indebtedness, interest expenditure remained flat since the relatively low level of interest rates continued to facilitate refinancing of maturing debt securities on favourable terms.

3% ceiling must be adhered to in 2005

The general government deficits could decline substantially in 2005. From the present perspective the goal of complying with the 3% deficit limit for the first time since 2001 appears achievable. However, there are major uncertainties concerning especially the path of macroeconomic development and the fi-

6 Until 2004 the amount of unemployment assistance paid (on average around €500 per month) was the basis for assessing the contribution due. As from 2005 the contribution base is defined as 36.2% of the monthly reference value (average pay of insured persons in the previous year), which currently amounts to €874 per month in western Germany and €735 in eastern Germany.
7 By contrast, the social assistance funds pay for the health services provided at the appropriate rate charged by the statutory health insurance scheme.
8 In view of the better-than-expected budgetary outturns of central and state government, which have since become known, the deficit ratio may well be revised downwards a little.

The current status of the excessive deficit procedure against Germany

Last year Germany exceeded the 3% reference value for the general government deficit ratio for the third year in succession without being able to invoke any of the exemption clauses specified in the Stability and Growth Pact. This means that Germany also failed to comply with the recommendation made by ECOFIN in January 2003. In establishing that Germany had run up an excessive deficit, ECOFIN had urged Germany to bring the deficit back down to the reference value by 2004 at the latest. In November 2003 the Council had, it is true, adopted conclusions in which the deadline for correcting the excessive deficit for Germany (and France) was extended to 2005.[1] The Council's conclusions deviated, however, from the normal sequence of the excessive deficit procedure. They were therefore annulled by the European Court of Justice on 13 July 2004. In effect the excessive deficit procedures continue to be suspended. From a legal point of view they are at the stage of the Council's recommendations pursuant to Article 104 (7) of the EC Treaty of January and June 2003 which, however, have since been overtaken by events.[2]

The European Commission did not respond to this unsatisfactory situation until 14 December 2004 when it addressed a communication on the status of the excessive deficit procedures to the Council. In it the Commission expressed the view that the two countries concerned had the right to assume that the Council's conclusions of November 2003 were valid pending the judgement of the European Court of Justice. It stated that, in the light of these unique circumstances, the assessment of the actions taken to correct the excessive deficit situation within the framework of the Stability and Growth Pact should refer to 2005. The Commission deemed the measures announced by the two countries to be adequate. It concluded that no further steps were necessary at this point under the excessive deficit procedure. Should failure in implementing the envisaged correction emerge at a later stage, however, the Commission would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the EC Treaty and the Stability and Growth Pact.

On 18 January 2005 the Council noted the Commission's communication and declared that it, too, considers no further steps within the excessive deficit procedures to be necessary at present. At the same time Germany (and France) reaffirmed their commitment to take all measures necessary to bring their deficits back under 3% of GDP in 2005 and to keep them below that level in 2006.

However, the logical course of action, in keeping with the spirit of the Stability and Growth Pact, would have been to initiate the next stage in the excessive deficit procedures and to give notice to the two countries to take measures to remedy the situation. In Germany's case the aim of not exceeding the 3% reference value in 2005 and 2006 appears achievable if the planned relief measures have the full envisaged impact. At the moment, however, there is no prospect of attaining a safety margin below the 3% ceiling. Given the considerable uncertainty about the further course of macroeconomic development and the effect of the fiscal measures, there is thus a substantial risk that the reference value for the deficit ratio will be breached in 2005 for the fourth year in succession.

Owing to the unsatisfactory implementation of the Stability and Growth Pact and the continuing discussion about changing its parameters, public trust in the fiscal framework of monetary union has already been severely damaged. To ensure that the credibility of a rule-bound fiscal framework is not undermined further, Germany must honour its commitments to the other member states. This necessitates strict budgetary discipline at all levels of government.

1 See also Deutsche Bundesbank, *Monthly Report,* February 2004, p 67 in particular. — **2** See also Deutsche Bundesbank, *Monthly Report,* August 2004, p 64 in particular.

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Key data of the Federal Government's updated stability programme

in %

Item	2003	2004	2005	2006	2007	2008
Real GDP growth						
Stability programme 2004	– 0,1	1,8	1,7	1¾	2	2
Stability programme 2003	– 0,1	1½ – 2	2¼	2¼	2¼	–
Deficit ratio (–)						
Stability programme 2004	– 3,8	– 3¾	– 3	– 2½	– 2	– 1½
Stability programme 2003	– 4	– 3¼	– 2½	– 2	– 1½	–
Debt ratio						
Stability programme 2004	64,2	65½	66	66	65½	65
Stability programme 2003	64	65	65½	65½	65	–

Source: Federal Ministry of Finance.

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nancial impact of the numerous fiscal measures, so that the goal is subject to considerable risks. The Financial Planning Council and the Federal Government have committed themselves unambiguously to achieving this goal – irrespective of the debate surrounding the reform of the Stability and Growth Pact.[9] The European Commission and ECOFIN have declared that, if necessary, further steps in the excessive deficit procedure will be initiated if Germany fails to meet its obligations and an infringement of the Maastricht ceiling for the fourth year in a row seems likely (see box on page 63).

Muted revenue trend

The revenue ratio is expected to fall further owing, above all, to the entry into force of the final stage of the income tax reform, although as things stand today this is likely to be smaller than last year – *inter alia* because the pattern of macroeconomic growth is likely to stimulate greater inflows of taxes and social security contributions. On top of this, non-tax receipts may pick up appreciably, particularly on account of the motorway toll for heavy goods vehicles introduced at the start of this year and the repayment of subsidies by the Landesbanks.

Further lowering of expenditure ratio crucial

The success of the consolidation efforts this year will hinge on further containing expenditure growth and further lowering the expenditure ratio. This will require savings at all levels of government so as to counterfinance the commonly agreed tax cuts and the very

9 In connection with the reform debate see Deutsche Bundesbank's Comments on reforming the Stability and Growth Pact, *Monthly Report,* January 2005, pp 37 to 43.

large deficits. A tight budgetary stance by all tiers of government (which should be reflected not least in personnel expenditure, other operating expenditure and subsidies), restrained spending on pensions and – in view of the low interest rate level – on interest payments, plus savings in connection with labour market-related outlays could all contribute to this.

Stability programme

In the medium term, further consolidation measures are needed to reduce the government deficits, observe the national deficit ceilings and bring the debt ratio back down again. This is being hampered by the fact that a sizeable part of the planned deficit reduction in the current year is to be achieved by non-recurrent relief measures (non-payment of the Federal transfers thanks to the sale of claims of the Post Office pension funds, repayment of interest rate subsidies by the Landesbanks). This partly involves easing present-day budgets at the cost of future budgets. According to the updated stability programme of December, the deficit ratio is to be trimmed to 1½% by 2008 (see table on page 64). The debt ratio is to rise to 66% in 2005 and 2006 and then decline only marginally to 65% in 2008. These plans are based on the assumption of a largely constant revenue ratio, with consolidation to be achieved by containing expenditure growth. Although this strategy is to be welcomed as such, a more ambitious target definition permitting the achievement of a close-to-balance budget position would have been a more appropriate approach to tackling the fiscal problems. This applies all the more since the programme is based on a relatively optimistic assessment of the likely course of macroeconomic development.