Public finance

Budgetary development of central, state and local government

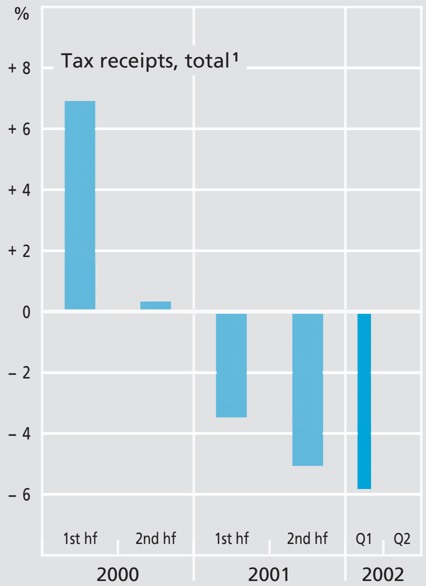
Overview

The budget outturn of central and state government (the figures for local government are not yet known) deteriorated significantly in the first quarter of 2002. The deficit rose by €10 billion to €27 billion compared with the same period in 2001. A key factor in this was the fall in revenue (-7½%) due mainly to an unfavourable trend in tax receipts. By contrast, expenditure increased by almost 2%, not least owing to a sharp rise in interest payments and transfers to the social security funds.

In the remainder of this year, by contrast, central, state and local government should record a more favourable outturn than last year. Thus, in contrast to the trend in the first three months, a significant increase in tax receipts may be expected. In addition, revenue will be boosted by the much higher Bundesbank profit. Finally, it is likely that expenditure growth will decelerate, particularly as several *Land* Governments recorded high extraordinary expenditure in the second half of last year. The budget deficit of central, state and local government could marginally decrease overall in 2002 after having jumped last year by €15½ billion to €48 billion. Even so, it will presumably be higher than envisaged in the budgets (if no additional measures are taken) owing above all to the likely large tax shortfalls.

Tax revenue

Change from previous year



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

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Tax trend in the first quarter ...

The tax receipts[1] of central, state and local government again developed unfavourably in the first quarter of this year. They were 5.8% lower than the corresponding figure in the same period of last year. That figure, however, had been only marginally depressed by the tax reform. Besides this "base effect", the persistently sluggish macroeconomic situation – especially falling corporate earnings and retail trade turnover – and technical tax factors also contributed to the lower receipts.

Among the different types of income tax, the outturn for assessed taxes, in particular, worsened considerably. Corporation tax yielded €0.7 billion, which was €1 billion less than in the first quarter of 2001. In the case of assessed income tax, the negative balance of inpayments and outpayments widened by a further €1.3 billion to -€3.6 billion). The persistent slide in corporation tax receipts seems to be due mainly to the fact that the advanced payments fell further because of the unfavourable trend in profits. Another significant factor in the year-on-year comparison is that the tax cuts which came into force at the beginning of 2001 did not have a full impact in the first three months, so that receipts in the first quarter of last year were still quite high. This had a negative influence on assessed income tax receipts, too, although they were depressed (even more sharply than last year) by the tax grant to home buyers, which is predominantly paid in March.[2] Non-assessed taxes on earnings likewise yielded far less than a year earlier (-29%), reflecting the lowering of investment income tax rates on dividends at the beginning of 2002 and a decline in disbursements. In addition, revenue from wage tax was 2.6% down on the corresponding figure last year because of the further raising – likewise with effect from the beginning of 2002 – of child benefit, which is booked against wage tax receipts. Furthermore, last year's corresponding figure had only been partly affected by the tax cut of 2001 and had been inflated by the delayed payment of end-of-year bonuses.

In the case of indirect taxes, the decline in turnover tax receipts that had already been recorded last year continued (-1.6%). This was caused partly by the decline in retail

1 Including EU shares in German tax revenue but excluding receipts from local authority taxes, which are not yet known.
2 This is due to the addition of another year's cohort to the group of beneficiaries of this grant (which is payable for eight years) following its introduction in 1996.

trade turnover and partly by the further reduction in taxable investment in the housing sector and in government investment. By contrast, receipts from mineral oil tax (+4.6%), electricity tax (+14%) and insurance tax (+7.8%) rose sharply in the wake of the increases introduced at the beginning of the year.[3]

... and in 2002 as a whole

During the remainder of this year tax receipts are expected to develop more favourably because several negative factors in the year-on-year comparison will cease to apply and the revenue trend is likely to be buoyed increasingly by the expected economic recovery. According to the latest forecast of the Working Group on Tax Estimates, tax revenue will increase by 1.9% in the course of this year.

However, receipts look set to fall €11.7 billion short of the figure envisaged in the comparable forecast from autumn last year – on which the budget is largely based – given that the tax expectations contained in that forecast were not even met in respect of 2001 and that the macroeconomic growth assumptions for this year have meanwhile been revised downwards further.[4] These expected large shortfalls primarily relate to corporation tax and turnover tax, reflecting the less favourable profit trend and the weaker growth of taxable domestic sales compared with the earlier expectations. Furthermore, the additional revenue from combating turnover tax evasion is likely to be lower than initially expected. In addition, a marked fall is expected in wage tax receipts, above all owing to the less favourable employment trend vis-à-vis the assumptions made last autumn. Based on expected growth in nominal GDP of 2½%, the national tax ratio (as defined in the government's financial statistics) will marginally contract compared with last year (to 21.5%), despite the tax increases which came into effect at the beginning of 2002.

Trends in the revenue from major taxes

Type of tax	Revenue in € bn		Change from previous year in %
	Q1		
	2002	2001	
Wage tax	30.4	31.2	– 2.6
Assessed income tax	– 3.6	– 2.3	.
Corporation tax	0.7	1.7	– 60.4
Turnover tax	34.5	35.1	– 1.6

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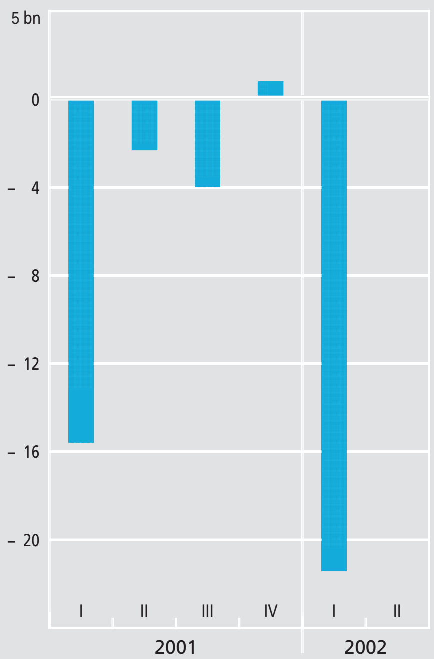
Federal Government in the first quarter ...

In the first quarter of 2002 the Federal budget recorded a deficit of €21½ billion, after €15½ billion in the first quarter of 2001. Overall revenue fell by 6½%, pulled down es-

3 By contrast, revenue from tobacco tax declined by 10.6%, despite the increase in this tax at the start of 2002, after increasing by 24% in the fourth quarter of 2001 owing to "hoarding" effects in anticipation of the tax rise.
4 Thus the Federal Government now expects real economic growth this year of only ¾% and a nominal growth of 2½% (compared with a corresponding assumption of 1¼% and 3%, respectively, in autumn 2001).

The Federal Government's financial balance



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pecially by a decline of 7% in tax revenue. Expenditure, by contrast, increased by 3½%. Expenditure on interest payments rose particularly sharply (+15½%), partly because Federal securities did not enjoy a high premium in the first quarter of 2002, in contrast to last year. Furthermore, transfers to the statutory pension insurance scheme again increased considerably.

... and in 2002 as a whole

Compared with the outturn for 2001, a deficit increase of €2½ billion to just over €23½ billion is envisaged in the Federal budget for 2002.[5] Considerable risks are discernible on the revenue side, however. Thus, according to the most recent tax estimate, there will be shortfalls vis-à-vis the planning of around €3 billion. It is only because transfers to the EU – which are offset against tax receipts – will be considerably lower than originally planned that revenue shortfalls of the Federal Government will be noticeably limited. Expenditure on the whole could develop along the same lines as expected, by increasing considerably after a decrease in the last two years. This owes strongly to the fact that the Federal Railways Fund's need for grants will go up again considerably after being temporarily sharply lowered last year by the extraordinary revenue out of the sale of railway workers' dwellings. In addition, grants to the statutory pension insurance scheme, which are financed by revenue from the "ecology tax", will continue to increase sharply. Interest payments will rise markedly, too. Moreover, the Government plans to step up expenditure on external and internal security.

Special funds

The special funds recorded a deficit of just over €½ billion in the first quarter, which was just over €½ billion lower than the previous year. For 2002 as a whole a large surplus is expected which will significantly exceed the €5 billion recorded in 2001. This improvement is due to the higher distribution of Bundesbank profits by €3 billion compared with last year. From the total amount of just over €11 billion, €3½ billion, as in the previous year, accrues to the Federal budget, the larger share is transferred to the Redemption Fund for Inherited Liabilities in order to repay debts.

5 The deficit trend, as reflected in the actual outturn for 2001 and the predicted outturn for 2002, deviates strongly from net government borrowing. This is due to the high rate of coin collection last year and high coin seigniorage budgeted for this year in connection with the changeover to the euro. These financial transactions affect net borrowing but not the deficit. The Government plans to cut net borrowing from just under €23 billion in 2001 to €21 billion in 2002.

Land Governments

The budgets of the *Land* Governments recorded a deficit of €9 billion in the first quarter of 2002, thus exceeding last year's figure by almost €5 billion. While expenditure grew by almost 1½%, revenue fell by 7%. In addition to the decrease in tax receipts by 6½%, other revenue also declined noticeably. In the remainder of the year, however, tax revenue, in particular, is expected to develop more favourably. Furthermore, extraordinary burdens, which significantly affected several *Land* Government budgets in the latter part of last year, have disappeared. Against this background, the deficit this year should be lower overall than in 2001, when a record amount of €27½ billion occurred. The deficit of €18 billion predicted in the budget planning is, however, likely to be overshot owing primarily to the shortfalls in tax revenue.

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

€ bn

Period	Total	*of which* Securities 1	Loans against borrowers' notes 2	*Memo item* Acquisition by non-residents
2000	+ 16.1	+ 29.1	– 11.8	+ 21.2
2001 pe	+ 14.2	+ 56.3	– 6.6	+ 1.0
of which				
Q1	– 10.4	+ 13.9	+ 9.7	– 12.2
Q2	– 6.1	+ 7.5	– 13.7	– 0.3
Q3	+ 15.6	+ 18.5	– 1.8	+ 14.9
Q4 pe	+ 15.2	+ 16.4	– 0.9	– 1.5
2002				
Q1 pe	+ 27.3	+ 15.2	+ 12.1	...

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

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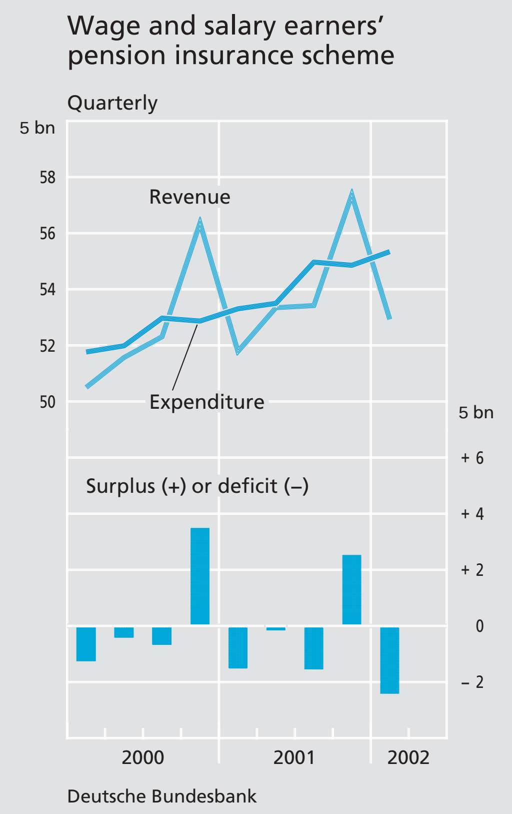
Local authorities

For the local authorities only the outturn from 2001 is available in which there was a deficit of almost €4 billion, following a surplus of just under €2 billion in 2000. Revenue fell by just over 2% in total. This was mainly due to the sharp decline of well over 5% in municipal tax revenue but also to the significant decrease in transfers – the bulk of which are funded out of the general tax-sharing arrangements – from the *Land* Governments. Expenditure, by contrast, rose more sharply than in previous years by almost 2%. However, special effects, such as a voluminous acquisition of participating interests in Baden-Württemberg and the disbursement of one-off heating subsidies, also played a role. In view of the weak development of tax revenue and the cut in municipal transfers in several *Länder*, there is still no sign of a significant easing of local government's budgetary situation for this year.

Indebtedness

The indebtedness of central, state and local government rose sharply by just under €27½ billion in the first quarter. €11½ billion, on balance, was borrowed from the capital markets. Money market debt increased by €16 billion. The credit markets received considerable claims amounting to €20½ billion, in particular from the Federal Government. The *Land* Governments and the special funds required borrowed resources amounting to almost €5 billion and €¾ billion respectively. Local government are also likely to have raised their indebtedness noticeably in the first three months of this year.



Social security funds

Statutory pension insurance scheme

In the first quarter of 2002 the wage and salary earners' pension insurance scheme recorded a deficit of €2.4 billion, which was €0.9 billion higher than in 2001. The revenue from contributions between January and March overshot the figure for the previous year by a mere 0.6%, which was also influenced by the unfavourable employment situation. Overall revenue increased by 2.2% owing to the sharply increasing Federal grants. Expenditure grew significantly more strongly by 3.8%. Compared with the first quarter of 2001, 3.6% more was spent on pensions. This was not only due to the pension adjustments mid last year of 1.91% in western Germany and 2.11% in eastern Germany but also to the – albeit marginally slower – increase in the number of pensioners by 1.3%.

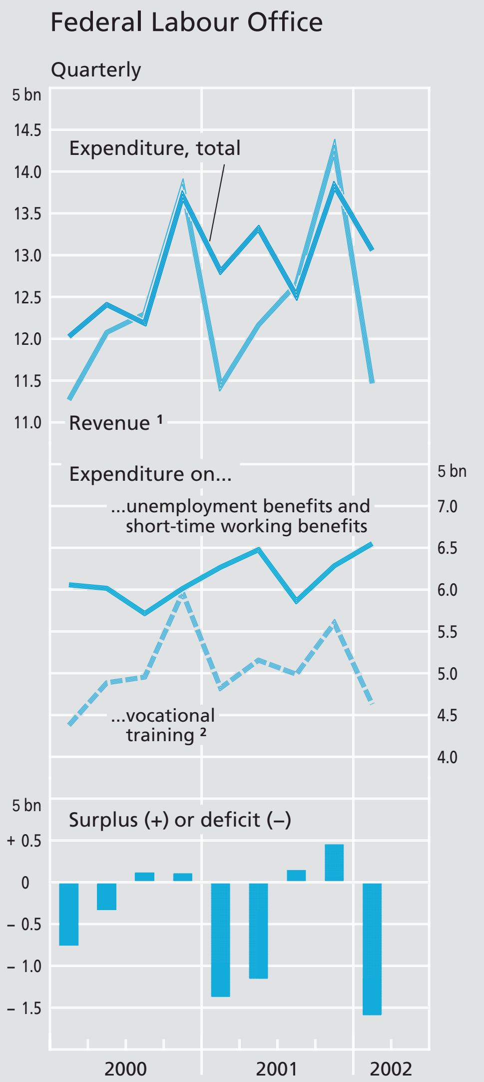
In 2002 as a whole, too, the statutory pension insurance scheme will record a considerably higher deficit than last year. In the second half of the year the expenditure pressure will increase even further since pensions are to be raised by 2.16% in western Germany and 2.89% in eastern Germany with effect from 1 July 2002. In addition, the higher health insurance contributions to be paid on behalf of pensioners will effectively increase expenditure. The Federal Government refrained from raising the contribution rate to the pension insurance scheme, a move which would, in principle, be required for a balanced budget. The financial gap arising from this will be closed by a recourse to the fluctuation reserves, whose statutorily required minimum level has been lowered from 1 to 0.8 month's expenditure. In view of the unfavourable employment trend and the stronger pension adjustments effective from mid-2002 it cannot be ruled out altogether that even this value will be undershot at the end of the year.

Federal Labour Office

The Federal Labour Office showed a slight financial deterioration in the first quarter of 2002. Thus the deficit grew by €0.2 billion to €1.6 billion compared with 2001, although the increase in expenditure, at 2.0%, was on the whole moderately low. However, total revenue, primarily as a result of the deterioration in the employment situation, overshot last year's figure by a mere 0.3%. Spending on unemployment benefits increased by 4.1%. While in western Germany 10.8%

more was spent, in the eastern part of the country there was a sharp decline of 8.7%. Apart from the considerably larger rise – in relative terms – in unemployment in the West, the fact that an ever increasing number of jobless persons in the East are losing their claim to unemployment benefits the longer they have been unemployed also seemed to play a role. This is also likely to be linked with the constant decline of job creation measures (which give rise to new claims to unemployment benefits). In the first quarter, expenditure on such measures in Germany as a whole declined by just over one-fifth on the year. The level of spending on vocational training remained virtually the same as in 2001, leading to a total decrease of 4.0% of the costs of active labour market policies.

The Federal Labour Office's demand for grants in the amount of €2.0 billion for the whole year as planned in the budgets appears to be rather limited now in view of the sustained strain on the labour market. So as not to exceed this amount, a tight spending constraint is required for active labour-market policies.



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

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Statutory health insurance funds

For the financial development of the statutory health insurance funds and nursing care insurance scheme, only results until the end of 2001 are available. According to these results, the health insurance institutions recorded a deficit of €2.8 billion last year which was a serious deterioration and which was due particularly to sharply increasing expenditure on pharmaceuticals. Expenditure on benefits in total increased by 3.6%, while revenue from contributions grew by a mere 1.4%. Many health insurance institutions were forced to raise their contribution rates at the beginning of 2002 not only to avoid more deficits but also to replenish the statutory minimum reserves.[6] The average contribution rate now amounts to 14.0%.

6 Pursuant to section 261 of the Social Security Code V, the reserve of a health insurance institution must amount to at least 25% and at most 100% of an average month's expenditure. It cannot be ruled out that some health insurance institutions additionally financed themselves by loans in 2001.

Statutory nursing care insurance scheme

The statutory nursing care insurance scheme was able to finance its slight deficit of €0.1 billion in 2001 out of its reserves, which, in contrast to those of the health insurance institutions, were abundant with slightly more than €4½ billion. As revenue from contributions grew by 1.5%, the nursing care insurance institutions profited from a comparatively low increase in expenditure of 1.1%. Thanks to a one-off payment from the Federal Government amounting to €0.6 billion,[7] the outturn for 2002 is expected to be more favourable, although the 2001 Supplementary Nursing Benefits Act envisages additional expenditure on benefits, particularly for people suffering from dementia.

Trends of the general government budget

General government deficit ratio for 2001 not far from the 3% ceiling

Last year the general government deficit ratio (central, state and local government and the social security funds as defined in the national accounts and excluding UMTS sales in 2000) rose by 1.4 percentage points to 2.7%, primarily following the extensive revenue shortfalls in the wake of the tax reform. This figure is therefore not far from the 3% ceiling set in the Maastricht Treaty.[8]

Consolidation requirement has grown over the long term, too

In a long-term approach, too – which also considers future demographic developments – the government consolidation requirement increased again last year. This is clear in the outturn of new calculations undertaken within the context of generational accounting which was set up on the basis of the legal framework in force in 2001. As explained in detail on page 72, the long-term sustainability of public finance deteriorated vis-à-vis 2000, mainly owing to the considerable revenue shortfalls following the tax reform and other non-cyclical factors.

Tight budget management is required to prevent a deficit increase in 2002

This year the cyclical share of the government deficit will increase because macroeconomic developments, seen on an annual average, will continue to lag behind potential output growth. There are also additional requirements out of the increase in child benefit, higher expenditure on internal and external security, increased spending on old-age provision and rising interest payments. These are offset by the fact that the taxes and social security ratio is likely to rise perceptibly. The reasons for this are the further stage of the "ecological tax reform", the tobacco and insurance tax increase and the pronounced rise in the average contribution rate to the statutory health insurance funds. The additional measures for combating turnover tax evasion could also result in additional revenue. Finally, general government budgets will be relieved in 2002 by the fact that profit distribution of the Deutsche Bundesbank has been higher than in 2001 and various one-off expenditure items from last year will no longer have an impact.[9] The Federal Government's transfers

7 In 1995 the nursing care insurance institutions gave the Federal Government €0.6 billion to support the building of care facilities in eastern Germany. Pursuant to Article 52 of the Nursing Care Insurance Act, this amount is to be repaid in 2002.
8 For information on the cyclical influence and the development of public finances in 2001, see also Deutsche Bundesbank, *Monthly Report*, February 2002, p 48-60.
9 These concern, *inter alia*, the subsidy for heating costs introduced at the beginning of 2001 in connection with the increase in oil prices, burdens caused by animal diseases and the reimbursement of promotional payment which had been unlawfully levied in Lower Saxony.

Development of the long-term sustainability of public finance in 2001

The question as to whether the long-term sustainability of public finance improved or deteriorated last year can be analysed using the technique of generational accounting. The annual consolidation requirement derived therefrom gives some indication of the change in the long-term fiscal burdens which are to be expected, in particular, in view of the projected demographic developments.[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 status quo prevailing in the base year to be sustained over the long term without any further changes. Changes in the macroeconomic setting ensuing from demographic trends or reactions to policy measures are disregarded, however.

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

Under the status quo scenario – adjusted for cyclical and other exceptional factors – the annual consolidation requirement (which, unlike the current deficit, includes the long-term demographic trend) increased significantly last year by 1¾ percentage points to 4½% of GDP. This sharp deterioration was primarily due to the revenue shortfalls linked to the tax reform, which far exceeded the additional receipts from the increase in indirect taxes. Furthermore, the revenue trend for several taxes was much weaker in 2001 than might have been expected in the light of the changes in legislation and overall economic developments. In addition, the contribution rate to the statutory pension insurance scheme was lowered. On the expenditure side, the increase in several social benefits and the rise in spending by the statutory health insurance funds was offset by generally tight budget management.

Under the policy scenario the annual consolidation requirement last year was noticeably lower, at 3¼% of GDP, than in the adjusted status quo scenario owing to the measures due to come into effect at a later date. This was attributable to future savings by the statutory pension insurance scheme which far exceed the additional tax relief measures adopted for the next few years. But under the policy scenario, too, the sustainability of public finance worsened considerably in 2001 compared with 2000. The annual consolidation requirement rose by 1¼ percentage points. The tax reform played no part in this, however. As it had already been adopted in 2000, the resultant tax shortfalls in subsequent years were included in the policy scenario for 2000. By contrast, those deteriorations in the adjusted status quo scenario that are not due to statutory measures adopted before 2001 are also reflected in the policy scenario.

Measures adopted in 2001 but which will only come into effect at a later date also contributed greatly to this deterioration, especially the dropping of the "demographic factor", which with the adoption of the pension reform was abandoned in formal terms, too. By contrast, a comparison of two other elements of the pension reform – the dampening impact of notional private pension plan contributions on the size of the pension adjustment, on the one hand, and the tax shortfalls due to the government promotion of private pension plans, on the other – shows a marginal net improvement in fiscal sustainability.[2] The other policy changes adopted in 2001 for future years had no significant influence on the annual consolidation requirement: the rise in child benefit from the beginning of this year should be largely offset by additional revenue expected from the "Act Combating Fiscal Evasion" and the increase in tobacco and insurance tax. The policy scenario shows an overall deterioration in the long-term sustainability of public finance compared with 2000 even after stripping out the effect of the demographic factor which, although in formal terms it was dropped only with the adoption of the pension reform, was abandoned in political terms much earlier.

Even though the figures shown here must be interpreted with caution, the results show that last year fiscal policy was still not sustainable. Compared with 2000, the long-term sustainability of public finance actually deteriorated noticeably.

1 For the methodological and empirical basis of the calculations for the results shown here, see Deutsche Bundesbank, The long-term sustainability of public finance – an analysis based on generational accounting, *Monthly Report*, December 2001, p 29-43, and B Manzke (2000), *The long-term sustainability of public finance in Germany*, Discussion paper 10/02 of the Economic Research Centre of the Deutsche Bundesbank. — **2** Other aspects of the pension reform – such as the new rules for disability pensions, the increased offsetting of surviving dependants' pensions against income and the change in the pension formula after 2010 – have been disregarded.

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to the EU budget are also likely to be relatively low once again. Overall a further increase of the deficit ratio can, therefore, be avoided – provided that a consistent policy of expenditure restraint is carried out at all levels of government.

Stronger consolidation efforts required in 2003 and 2004

A sharp reduction of the general government deficit is required in 2003 and 2004 in order to reach at least a close-to-balanced budgetary position. Every EU member state committed themselves to this common position by adopting the Stability and Growth Pact in 1997. The last two German stability programmes envisaged reaching this objective by 2004. In connection with the discussion of a possible "early warning", the Federal Government once again pushed for this commitment, thus contributing, not least, to preserving the credibility of the financial political rules in monetary union. However, in order to reach this objective by 2004, extensive consolidation efforts are required. Although the macroeconomic trend in the next two years can be expected to support the reduction of the government deficit, in view of the fact that the bulk of the deficit is structurally related, it can only be durably reduced by sustainable measures. In view of the next stage of the income tax reform coming into force in 2003 and the fiscal objective of lowering the taxes and social security ratio further, it will also be imperative to stringently limit government expenditure.

Decisions of the Financial Planning Council

Due to the defined federal structure of public finance in Germany and the high deficits which are also existent at *Land* Government level,[10] it was of particular importance that in a special meeting of the Financial Planning Council in March, the Federal Government and *Land* Governments clearly recognised their joint responsibility vis-à-vis European commitments and the objective of a balanced budget for their respective level of government. In order to achieve this goal, it was, *inter alia*, decided that in 2003 and 2004 the Federal Government would reduce its expenditure by an average ½% p.a. and the *Land* Governments and the local authorities would, in principle, each step up their expenditure by a maximum of 1% p.a. This will require a considerably larger constraint on spending than has been envisaged in the current medium-term plans. In addition to very tight budget management, cuts in current benefits could prove necessary, too. In order to ensure that consolidation efforts will be crowned with success in the entire general government sector, however, shifting the cost between the government levels is to be avoided as much as switching from expenditure to tax concessions.

Any expansion of government benefits would require tighter savings in other areas

If specific government benefits were to be extended or if tax cuts were to exceed the amounts appropriated in the budgets, this would necessitate tighter savings in other areas. As has been seen in the past, fiscal policy-makers should not rely on an "automatic consolidation" by, say, hoping for more favourable macroeconomic developments resulting in additional receipts or by counting on the short-term self-financing effects of tax

10 As defined in the national accounts, last year the deficit of the Federal Government and its special funds as well as that of state and local government was €27 billion each. The social security funds recorded a shortfall of €2 billion.

cuts. Such a fiscal policy based on hope would not tie in with the European commitments which – together with the more detailed national decisions – form the framework for fiscal policy decisions and which should be specified and credibly underpinned by suitable consolidation measures.

Reduction of the deficit ratio in line with macroeconomic requirements

Irrespective of its key importance in enhancing the credibility of European fiscal regulations, the reduction of the deficit ratio in 2003 and 2004 does not contradict macroeconomic requirements. Measured against a structural deficit ratio of around 1½% in 2000, fiscal policy in 2001, a year which was characterised by a low growth rate, was expansively arranged. The structural deficit ratio rose to just over 2½%. It is likely to fall again this year but still be noticeably above the level of 2000. The years 2003 and 2004, when fiscal policy makers will have not only to compensate for higher deficits but also to achieve the consolidation needed to attain a close-to-balanced underlying budgetary position, will, according to general expectations, be marked by a cyclical revival. Should the deadline by which a balanced budget is to be reached be put back again despite the commitments, the credibility of fiscal rules in the EU and of German fiscal policy could be impaired. The concomitant negative effects on financial market participants' expectations and the increased uncertainty, which could be reflected in interest rate increases in financial markets, would have a negative impact on the macroeconomic outlook.