

Public finance

Trends in the fourth quarter of 1999 and during the year as a whole

Central, regional and local authorities

According to the data available so far, the budgetary position of the central, regional and local authorities improved in the fourth quarter of 1999. However, that improvement was probably not quite sufficient to offset the deterioration in the first three quarters, in which the deficit had increased compared with the first nine months of 1998 by € 3 billion to € 26 billion. For 1999 as a whole a slightly larger deficit is therefore expected than in 1998 (approximately € 28 billion, or DM 55 billion). A sharp increase in tax receipts was insufficient to fully compensate for the decline in non-tax revenue (especially the Bundesbank profit and, in addition, proceeds from asset disposals) and the faster rise in expenditure.

Overall trend of the central, regional and local authorities

Tax receipts¹ of the central, regional and local authorities in the final quarter of last year were almost 6 % above their level in the fourth quarter of 1998. Receipts from income taxes increased overall by little more than 2½ %, however (compared with 6 % in the third quarter). The main reason for this was that corporation tax, following a marked rise in the amounts raised during the preceding quarters, yielded almost 5 % less than in the fourth quarter of 1998. This may have been caused by value adjustments to banks' portfolios. By contrast, the inflow of assessed in-

Tax receipts in the fourth quarter of 1999 ...

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



come tax showed a further surge (+ 29 %). Both advance tax payments and retrospective tax payments increased significantly. Wage tax recorded only a moderate increase (+ 1½ %). This contrasted with the two principal types of indirect tax, which remained very high-yielding. The amount raised from turnover tax exceeded the figure in the corresponding quarter of 1998 by over 7 %, partly owing to additional receipts resulting from changes in tax legislation;² turnover tax was further affected by the growth of private consumption and by investment in housing construction and public expenditure on tangible goods, which are both subject to turnover tax. Mineral oil tax yielded as much as 11½ % more following the increase in this tax on April 1, 1999.

According to the provisional out-turn (which includes an estimate for local authority taxes), the amount of taxes raised in 1999 as a whole was just over 6 % higher than in the previous year. This exceeded the amount anticipated in the official tax forecast of autumn 1998 (on which the 1999 budget figures were largely based) by € 5½ billion. The overall tax ratio increased by 0.8 percentage point to 22.8 % (as recorded in the financial statistics), but remained below the long-term average.

*... and in 1999
as a whole*

Only a fairly small part of this rise was due to the increase in energy taxation. The chief cause was the strong growth of turnover tax (+ 7 %). Another contributory factor was the continuing reversal of the erosion of assessed income tax, not least owing to the ending of the special depreciation allowances for investment in eastern Germany. The amount yielded by this tax virtually doubled in 1999 to almost € 11 billion, thereby far surpassing initial expectations. Corporation tax receipts likewise expanded substantially (+ 21%).³ Even so, their volume was well down on the figure forecast in the autumn of 1998. Conversely, non-assessed taxes on earnings – which largely comprise investment income tax payable on dividends – yielded far more than had been initially anticipated due to surprisingly high profit distributions in 1999. On the other

² These comprised the reduction or abolition of the input tax offsetting facility for cars not used exclusively for business purposes, dining expenses and employee travel and relocation expenses from April 1, 1999.

³ In 1998 the growth of corporation tax receipts had been considerably stunted by the fact that many firms made use of the "EK 50" tax facility, which expired at the end of that year, to cut their tax burden by disbursing retained profits from earlier years.

hand, wage tax – which rose by less than 1½% – barely met the expectations of autumn 1998, despite higher negotiated pay rates. This was primarily attributable to the lower increase in actual average earnings resulting from the strongly negative wage drift. The measures which came into effect at the beginning of 1999 likewise tended to dampen wage tax receipts.

Federal Government's fiscal position in the fourth quarter...

The favourable financial trend of the central, regional and local authorities in the fourth quarter related mainly to the Federal Government, which recorded a surplus of € 4½ billion – this was twice as high as the budget excess generated in the final quarter of 1998. This was fuelled by very strong growth of tax revenue and disposals of participating interests, especially the transfer of shares in the post office enterprise *Deutsche Post AG* to the German development bank *Kreditanstalt für Wiederaufbau (KfW)*. Consequently, the Federal Government's overall revenue expanded by 8½%. Expenditure likewise grew by the rather high rate of 5½%, principally on account of the payments to the Post Office benefit funds and the higher transfers to the statutory pension insurance scheme.

... and in 1999 as a whole

In 1999 as a whole the Federal Government reduced its deficit by € 2¾ billion compared with 1998 to around € 26 billion (not quite DM 51½ billion). This was € 1¼ billion lower than the amount projected in the budget. Total expenditure was € 1½ billion less than budgeted and just over 5% more than actual expenditure in 1998.⁴ Relief was afforded notably by the fact that the transfers to the Federal Labour Office to make good its deficit

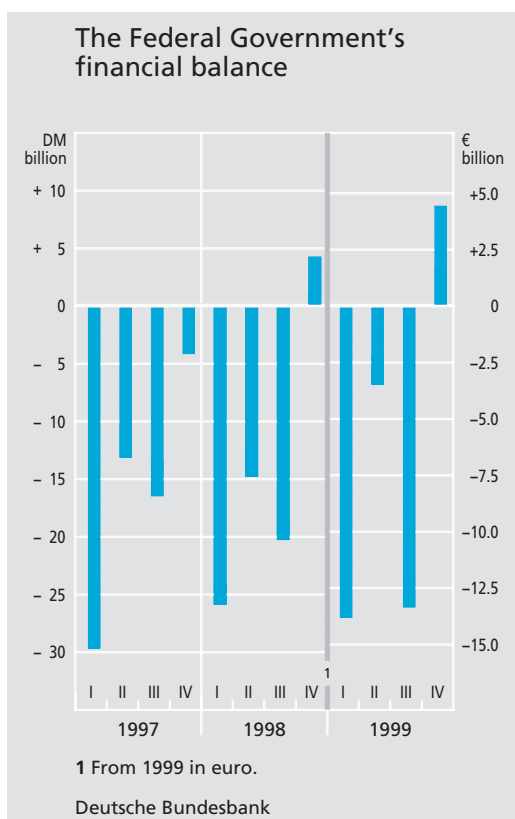
Trends in the revenue from major taxes

Type of tax	Revenue in			Change from previous year in %
	DM billion	€ billion		
	Full year			
	1998	1999	1999	
Wage tax	258.3	261.7	133.8	+ 1.3
Assessed income tax	11.1	21.3	10.9	+ 91.5
Corporation tax	36.2	43.7	22.4	+ 20.8
Turnover tax	250.2	268.3	137.2	+ 7.2
	of which: 4th quarter			
Wage tax	78.0	79.2	40.5	+ 1.5
Assessed income tax	8.5	11.0	5.6	+ 29.2
Corporation tax	12.0	11.4	5.8	- 4.9
Turnover tax	65.7	70.3	36.0	+ 7.1

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were almost € 2 billion less than planned. Claims on the Federal Government arising from guarantees and other operating expenditure were likewise much smaller than projected. Together with various other less-than-budgeted expenditures, this more than compensated for the additional spending due to unemployment assistance and to the transfers to the Federal Railways Fund following the failure to sell off the stock of railway workers' dwellings. On the revenue side, taxes exceeded the expected level by almost € 2½ billion. Moreover, blanket contingency costs totalling around € 1 billion (DM 2 billion) had been budgeted for to cover possible

⁴ If the first-time payments to the Post Office benefit funds and the higher transfers to the statutory pension insurance scheme in connection with the "ecological tax reform" are disregarded, the expenditure total hardly grew at all.



revenue shortfalls which failed to materialise, however. The favourable budgetary trend enabled the Federal Government to postpone scheduled sales of financial assets in the amount of € 5½ billion and thus to provide extra leeway in subsequent budgets.

Special funds

The position of the Federal Government's off-budget special funds deteriorated considerably in 1999. The surplus they generated last year was probably only half as large as the DM 24 billion they recorded in 1998. The chief reason for this was the smaller size of the Bundesbank profit which – to the extent that it exceeds DM 7 billion – is allocated to cutting the debt of the Redemption Fund for Inherited Liabilities. The part of the Bundesbank profit available for this purpose fell by € 4 billion to just over € 4½ billion. The co-

assumption of the debt of the Redemption Fund for Inherited Liabilities by the Federal Government in mid-1999 also had a negative impact on the Fund's financial balance because it was accompanied by the discontinuation of the Federal Government's grants which had previously been paid for the purpose of debt redemption, and which had been reflected in a financial surplus for the Fund in the same amount.

Full data are not yet available on the fiscal out-turn of the Länder Governments in the fourth quarter of 1999. The deficit of € 4 billion which they ran up in the first nine months of the year was over € 3 billion less than their shortfall at the three-quarter stage of 1998. The Länder Governments' deficit for 1999 as a whole may have amounted to some € 10 billion (roughly DM 20 billion), compared with DM 26½ billion in 1998. This was mainly attributable to the buoyant trend in tax revenue. What is more, expenditure growth was again rather moderate, despite the cost burdens arising from the relatively high pay settlements.

Länder Governments

Local authorities

Although no results are available yet for the local authorities' fiscal out-turn in the fourth quarter of 1999, it is likely that they again recorded a revenue surplus in the year as a whole, which, however, probably failed to match the 1998 surplus of almost DM 5 billion. Thus the transfers from the Länder Governments rose only marginally during the first three quarters and receipts from fees and charges and disposals of participating interests decreased markedly. Furthermore, the spending bill was inflated by the higher la-

bour cost and the growth of other operating expenditure.

*Indebtedness
in the fourth
quarter...*

The central, regional and local authorities' net borrowing in the fourth quarter of 1999 totalled € 11½ billion, after having amounted to € 25½ billion in the first nine months. The various levels of government ran down their money market debt by € 5½ billion but incurred new capital market debt amounting to € 17 billion. The bulk of this took the form of sales of Federal bonds (*Bunds*), at over € 8½ billion, and of five-year special Federal bonds (*Bobls*), at just under € 6 billion. By contrast, the government sector redeemed, in particular, Treasury notes and savings bonds on balance.

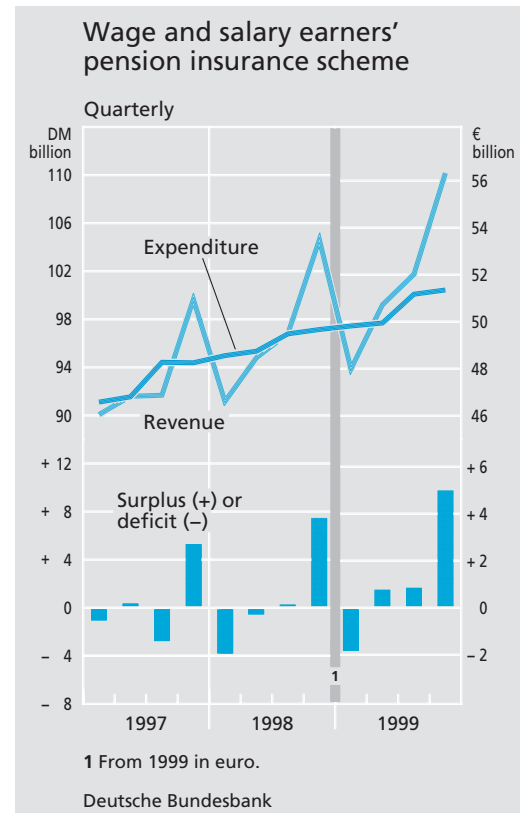
*... and in 1999
as a whole*

According to the figures available so far, the central, regional and local authorities incurred slightly more than € 37 billion in net new debt in the course of 1999, pushing up the cumulative total to around € 1.2 trillion. The year-on-year increase was somewhat greater than in 1998. New borrowing primarily took the form of *Bund* issues, which means that most of the newly incurred debt was once again long-dated.

Social security funds

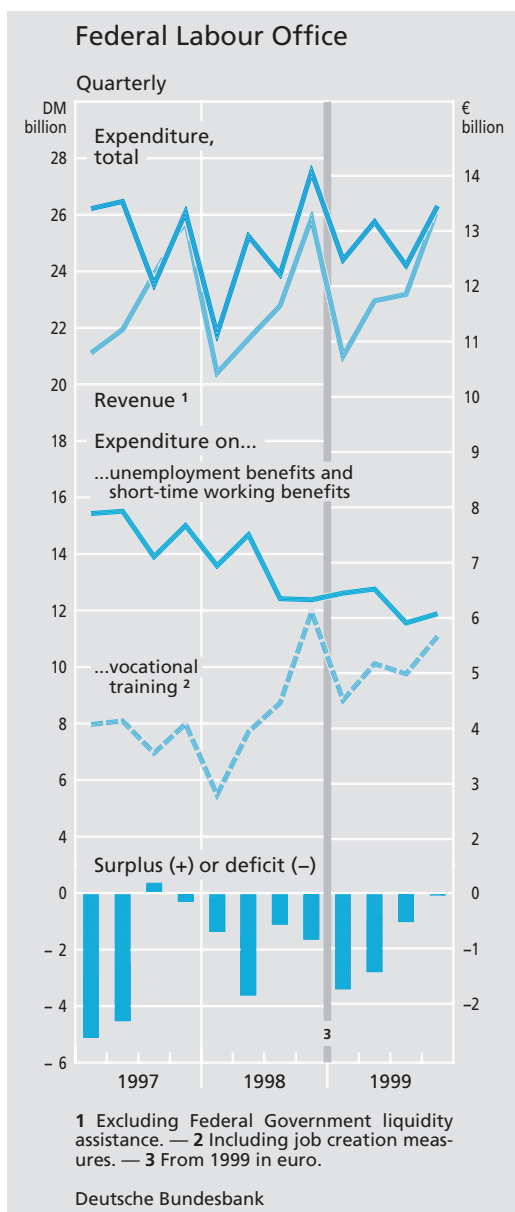
*Wage and
salary earners'
pension
insurance
scheme*

In the last quarter of 1999 the statutory pension insurance scheme of wage and salary earners recorded, as expected, a sizeable surplus of € 5 billion. This was over € 1 billion more than the positive balance generated in the fourth quarter of 1998. Besides the high level of contributions, which were swelled by



the effect of Christmas bonus payments, receipts were boosted above all by the additional grants from the Federal budget, which were financed via the increased taxation of energy consumption and basically did not begin to flow until June 1999. Receipts were further bolstered from April 1999 by first-time contributions for part-time workers below a certain earnings level. Total receipts in the fourth quarter were almost 5½% up on the year. Expenditure grew by just under 3½%, with pension payments – the main expenditure item – growing by just over 3½%.

For 1999 as a whole the statutory pension insurance scheme posted a surplus of € 4¾ billion, or a little less than DM 9½ billion. This substantial improvement compared with 1998 (DM 3½ billion), which was chiefly at-



tributable to additional Federal grants, was necessary in order to bring the fluctuation reserves back up to their legally prescribed minimum level of one month's average expenditure for the first time since 1994. Judging by the quarterly and monthly statistics, this goal was virtually achieved by the end of 1999.

The Federal Labour Office registered a more or less balanced financial position in the last

quarter of 1999, whereas it had showed a deficit of more than DM 1½ billion in the same quarter of 1998. This marked improvement was due above all to a 4½ % fall in spending. The amount spent on unemployment benefits declined further (- 4 %). In contrast to the trend in the first nine months of 1999, payments in connection with active labour market policy measures – which had been stepped up sharply up to the end of 1998 – likewise contracted in a year-on-year comparison (- 7 %). Receipts rose by 1½ %.

For 1999 as a whole the Federal Labour Office ran up a deficit of € 3¾ billion, or nearly DM 7½ billion, compared with DM 7¾ billion in 1998. This was distinctly less than the anticipated topping-up amount of DM 11 billion earmarked in the Federal budget. Given the falling number of unemployed persons, the amount of money spent on unemployment benefits was almost 8 % less than in 1998. By contrast, active labour market policy measures, in the form of training courses and job creation schemes (including the Immediate Programme for unemployed young people) cost almost 17½ % more than in the previous year. Overall receipts went up by 3 %, among which the volume of contributions increased by 2½ %.

General government sector as a whole

The central, regional and local authorities and the social security funds, taken together, achieved more favourable fiscal positions in 1999 (as defined in the national accounts) than had been anticipated at the beginning

Relatively favourable fiscal trend in 1999

of the year. According to the provisional (partly estimated) results published by the Federal Statistical Office, the general government deficit ratio came to 1.2 %, as opposed to 1.7 % in 1998.⁵ This owed much to the plentiful flow of tax receipts. Consequently, overall revenue rose by 3½ % despite the small growth of receipts from social security contributions and the contraction of other receipts. The taxes and social security ratio increased for the first time since 1996 (by 0.8 percentage point to 43.7 %).⁶

Expenditure growth in the public sector doubled in 1999 compared with 1998 to 2½ %. Higher negotiated pay rates contributed to a faster increase in wages and salaries. Spending on social benefits likewise increased more rapidly, above all in the wake of higher expenditure by the statutory health insurance funds and the expansion of active labour market policy measures. Another factor were the first-time payments by the Federal Government to the Post Office benefit funds. As a result, the general government expenditure ratio, which had been declining since 1997, rose slightly to 48.9 %.

The marked decline in the deficit ratio last year, in the context of weak economic growth, represented an advance towards fiscal consolidation. While acknowledging the budgetary improvement, however, it should be borne in mind that the trend in public finance was positively influenced by the pattern of economic growth as, *inter alia*, a disproportionately large contribution to that growth came from tax-yielding domestic demand. Moreover, a role was played by various

extraordinary factors, especially the large surplus of the statutory pension insurance scheme and, in the field of assessed taxes, the substantial extra corporation tax payments in respect of past years in which profitability was buoyant.

Budget plans for 2000 and outlook

The outlook for this year underscores the need for further consolidation in respect of public sector deficits. From the current perspective no progress is likely towards reducing the deficits, as defined in the national accounts,⁷ despite a favourable cyclical momentum and the entry into force of the consolidation package. The main reason for this is that the growth in receipts is likely to be much weaker. Thus the official tax estimate of November 1999 (taking account of recent changes in tax legislation) forecast a rise of only 2½ % in tax revenue compared with the provisional actual out-turn in 1999, even though this was based on a perceptibly faster nominal rate of economic growth of over 3½ % and the second stage of the increase in energy taxation came into force at the beginning of this year. The causes of this weak revenue growth are the shortfalls in receipts resulting from measures – which likewise entered into force at the start of this year –

No noticeable improvement in 2000

⁵ According to the new definition based on ESA 1995 which, from March 1, 2000, will also be used for the first time as the basis for notifications under the excessive deficit procedure.

⁶ The results given here differ in part from the figures of the Federal Statistical Office (see notes to Table VIII.3 in the Statistical Section of the Monthly Report).

⁷ Using the budgetary definition, it is likely that the deficits will actually grow further, above all owing to the lower privatisation proceeds.

relating to the second stage of the 1999/2000/2002 Tax Relief Act and the extension of family assistance measures plus a significant drop in retrospective assessed tax payments for past years. In addition, major non-tax revenue – notably the Bundesbank profit and proceeds from sales of tangible assets – will presumably also decline. Moreover, the surplus of the statutory pension insurance scheme will fall sharply following the replenishment of the fluctuation reserves. On the other hand, public finance trends this year will be positively influenced by the fact that expenditure growth will be dampened, not least thanks to the extensive implementation of the consolidation package.

*Outlook
for the Federal
Government, ...*

Regarding the current budget plans of the various tiers of government, the Federal budget for the year 2000 was approved by the German parliament in December 1999. At around € 25 ½ billion, the deficit projected in the Federal budget remained unchanged vis-à-vis the draft budget. That is roughly € ¾ billion less than the provisional actual deficit for 1999. Both receipts and expenditure have been revised upward somewhat compared with the draft budget figures. Whereas tax receipts are forecast to exceed the amount received in 1999 by 3 %, a steep decline is projected in proceeds from the disposal of participating interests. Overall revenue is therefore forecast to fall by ½ %. Budgeted expenditure is almost 1% lower than the provisional actual figure for last year, mainly on account of the spending cuts agreed as part of the consolidation package. Higher-than-budgeted expenditure can already be foreseen, however, in part because the Federal

Government's withdrawal from the financing of housing allowances – which is factored into the Federal budget – has not been put into practice.

In the case of the Länder Governments higher deficits are envisaged in the budget plans. The amount of tax revenue will probably grow at a below-average rate, *inter alia* owing to the dampened development of the Länder tax receipts. Furthermore, a decrease in the transfers from the Federal budget is to be expected. Overall revenue is therefore likely to exceed the 1999 level only marginally – unless substantial asset disposals take place for budget financing purposes. On the other hand, expenditure is to increase only moderately (by approximately 1½ %), which presupposes that this year's pay rises in the public sector are kept within narrow bounds.

*... the Länder
Governments,...*

The local authorities could record deficits in 2000 for the first time in two years. For example, only a small rise is expected in the volume of trade tax owing to the falling trend in payments of tax arrears for past years. The transfers from the Länder Governments, which play a major role in local authority finances, might likewise be limited on account of the higher deficits which the Länder Governments seem likely to incur. The rather unfavourable outlook on the revenue side will compel the local authorities to exercise restraint in their expenditure policy.

*... local
authorities ...*

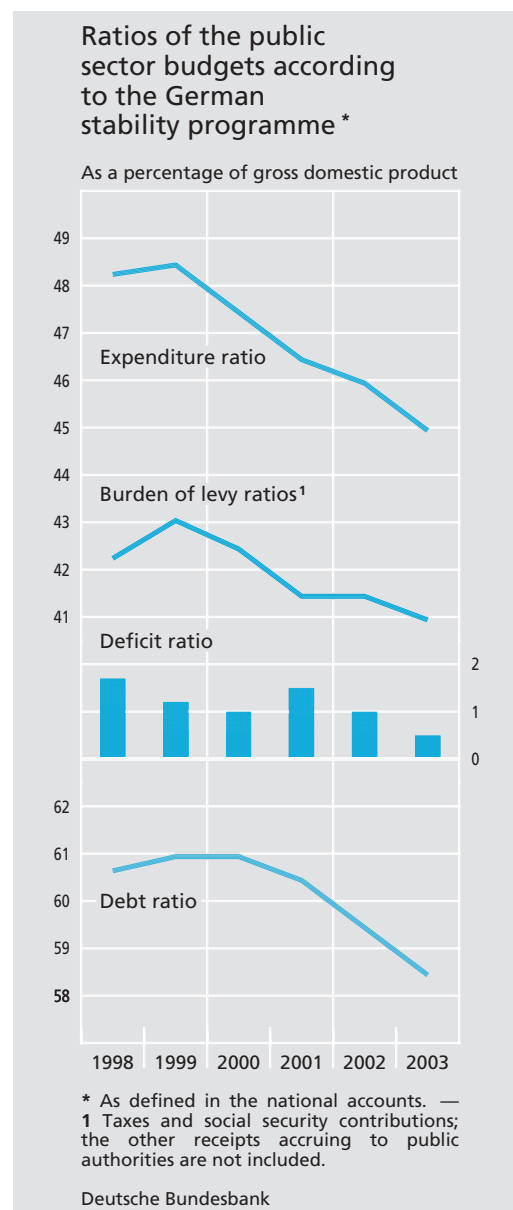
The social security funds, in particular, are likely to have an unfavourable impact on fiscal developments this year. The surplus which was generated last year in the statutory pen-

*... and the
social security
funds*

sion insurance scheme will be largely eliminated. Together with the measures of the Budget Consolidation Act, especially the temporary limitation of the increase in pensions to the rate of inflation, the surplus made it possible to reduce the contribution rate at the beginning of the year to 19.3 %. The Federal Labour Office has budgeted for a deficit (to be covered by the Federal Government) of € 4 billion, which more or less matches the actual deficit in 1999. In view of the reduction in unemployment that is to be anticipated, the actual deficit may well be lower than the target figure – as was the case in previous years. In the statutory health insurance fund, following the abandonment of the originally planned health reform measures, recourse will again be had to the instrument of capping spending through sectoral budgets. As in the preceding years, no deficit-building trend is in evidence for the statutory health insurance fund.

Updated
stability
programme

For the medium term the Federal Government affirmed its determination to pursue a sustained consolidation course in presenting an updated version of its stability programme of December 1999 and in adjusting it in January in the light of the better-than-expected results in 1999 and the implications of the draft version of the Tax Reduction Bill which it submitted recently. The general government deficit ratio (as the chart on this page shows) is to be cut to ½ % by 2003. In the coming year, however, it will rise temporarily (to 1½ %) because of the effects of the comprehensive tax relief measures which are to come into effect in 2001. In addition, the Federal Government intends to achieve a



completely balanced fiscal position by 2006 at the latest. In order to provide financial leeway to achieve that aim – and in addition to lower the taxes and social security burden – the government expenditure ratio is to be reduced from 48½ % in 1999 to 45 % in 2003, a goal which will require considerable efforts at all levels of government. A key task of fiscal policy in the coming years will be to ensure that this planned expenditure course is

rigorously adhered to, particularly as the planned tax cuts are likely to make it harder to meet the deficit targets laid down in the stability programme.

*New
tax-cutting
plans*

The new tax-cutting plans which the Federal Government put forward in December will lead to substantial revenue shortfalls (for details see the table on page 59). The third stage of the 1999/2000/2002 Tax Relief Act, which was initially envisaged for 2002, is to be brought forward to 2001. Additional relief measures are to be introduced in 2003 and 2005 which will progressively raise the basic tax allowance to DM 15,000 and reduce the entry tax rate to 15% and the marginal tax rate to 45%. This will lead in 2003 (for the first twelve months in which the full effect will be felt) to shortfalls amounting to an estimated € 6¾ billion, or DM 13½ billion, rising in 2005 to € 18 billion, or DM 35 billion. The Federal Government has announced that these shortfalls are to be financed without jeopardising its medium-term consolidation target. To this end it will rely on continuing its strict fiscal consolidation course but also on "self-financing effects" resulting from the tax cuts and on additional asset disposals.

*Corporate tax
reform*

In the bill which it has meanwhile presented, the Federal Government also spelled out the details of its reform concept for corporate taxation. The draft bill is largely based on the framework that had been announced earlier. In 2001 corporation tax is to be lowered to a uniform rate of 25% for both retained profits (currently 40%) and distributed profits (now 30%). Non-corporations – i.e. partnerships – will be given the option of paying corporation

tax or of having their trade tax payments partly offset against their income tax liability. Enterprises not subject to trade tax will benefit solely from the general income tax cuts. The present imputation system which allows shareholders to credit the corporation tax already paid on their dividends against their personal income tax liability is to be replaced by an income tax relief on dividends. Another innovation that is envisaged – and which is likely to be of far-reaching significance for structural changes in the corporate sector – is that corporations will no longer have to pay tax on capital gains accruing from the sale of participating interests in German firms (capital gains resulting from the disposal of shareholdings in foreign enterprises are already tax-exempt). After subtracting the effect of various counter-financing measures (especially the tightening of the rules for claiming depreciation allowances), the corporate tax reform is to cut firms' aggregate tax burden by about € 4½ billion, or DM 9 billion. It should be borne in mind, however, that considerable extra net burdens have been imposed on the corporate sector by the 1999/2000/2002 Tax Relief Act.

The proposals put forward by the Federal Government will lead to a considerable reduction in tax rates, especially corporation tax rates. To that extent they will make an important contribution to the pressing requirement to reduce the existing burden of taxes and levies and to improving Germany's fiscal attractiveness to investors. In the longer run, however, further measures will be needed which ensure that different types of income and saving are not subject to differing tax re-

Financial implications of the "Tax Reform 2000" *

Measure	Revenue losses (-) or gains (+) in DM billion				
	Year of operation	Accounting year			
		2001	2002	2003	2004
I. Reform of corporate taxation, total	- 12.4	- 17.2	- 23.6	- 22.5	- 23.7
Measures affecting corporations, total	- 20.1	- 18.8	- 28.3	- 28.4	- 26.6
of which					
- Lowering of corporation tax rate on retained profits from 40 % to 25 %	- 14.0	- 11.3	- 14.6	- 15.9	- 17.1
- Lowering of corporation tax rate on distributed profits from 30 % to 25 %	- 2.0	- 5.3	- 4.7	- 3.3	- 3.2
- Lowering of capital yields tax rate on dividends from 25 % to 20 % (from 2002)	- 0.1	-	- 3.2	- 2.4	- 0.9
- Replacement of the imputation system on dividends by an income tax relief	+ 5.0	-	+ 3.9	+ 5.1	+ 5.6
- Transitional arrangement for system change	- 4.1	-	- 5.4	- 6.8	- 6.1
- Tax exemption for capital gains from disposal of domestic participating interests	- 4.2	- 2.1	- 3.8	- 4.2	- 4.2
Measures affecting non-corporations, total	- 7.5	- 4.1	- 7.4	- 11.2	- 14.3
of which					
- Reduction of income tax liability by the double basic amount of trade tax	- 10.0	- 7.0	- 8.4	- 10.5	- 10.0
- Introduction of option to pay corporation tax	- 2.7	- 0.7	- 3.9	- 7.4	- 11.0
- Abolition of business earnings tax rate limit pursuant to section 32c of the Income Tax Act	+ 5.2	+ 3.6	+ 4.8	+ 6.7	+ 6.8
Financing measures in connection with the reform, total	+ 15.2	+ 5.7	+ 12.1	+ 17.1	+ 17.3
of which					
- Reduction of diminishing-balance depreciation rate for investment in machinery and equipment from 30 % to 20 % p. a.	+ 13.0	+ 5.4	+ 10.9	+ 14.8	+ 14.5
- Reduction of linear depreciation rate for commercial buildings from 4 % to 3 % p. a.	+ 0.5	-	+ 0.2	+ 0.8	+ 1.3
II. Adjustment of official depreciation tables to "more realistic" write-off periods (by administrative regulation)	+ 3.5	+ 0.7	+ 2.7	+ 5.2	+ 7.0
Sum total of the corporate taxation measures, including the extended depreciation periods	- 9.0	- 16.5	- 20.9	- 17.3	- 16.6
III. Reform of income tax schedule, total	- 35.2	- 28.5	+ 1.4	- 14.0	- 13.3
of which					
- Bringing forward tax change from 2002 to 2001	(-27.6)	- 28.5	+ 1.4	- 0.5	-
- Tax changes in 2003, raising basic tax allowance by DM 500 to DM 14,500, lowering entry rate to 17 % and marginal rate to 47 %	(-13.3)	-	-	- 13.5	- 13.3
- Tax changes in 2005, raising basic tax allowance further to DM 15,000, cutting entry rate to 15 % and marginal rate to 45 %	- 35.2	-	-	-	-
All measures, taken together	- 44.2	- 45.0	- 19.5	- 31.3	- 29.9

* According to the draft bill presented by the Federal Government.

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gimes. In particular, the preferential treatment of retained profits – which can lead to distortions in the capital market – should be avoided in a longer-term perspective. Moreover, a deeper reduction of income tax rates would obviate the need for complex make-shift constructions for the taxation of non-

corporations. However, such steps would also imply the abolition of special tax privileges for households and spending cuts that go further than the measures agreed to date if the fiscal consolidation course, which the economy requires and the government is also seeking to achieve, is not to be jeopardised.