Public finance

Central, regional and local authorities

Current trends

Underlying trends

In the second quarter of 2000, the central and regional authorities (no results are available for the local authorities yet) recorded a surplus of € 4¾ billion, which was € ½ billion more than one year earlier. While receipts rose by just under 2 %, increase in expenditure amounted to 1½ %. The receipts side for the second quarter was characterised by a sharp rise in tax revenue, accompanied by a decline in the profits distributed by the Bundesbank, which were down around € 4½ billion on the year. Among factors having a moderating impact on expenditure were a decline in labour-market induced spending and the delayed impact of the public sector pay settlement.

For 2000 as a whole, the budgets of the central, regional and local authorities will show, on balance, a considerably more favourable financial position than last year, when they recorded an aggregate deficit of € 28 billion. Thanks to exceptional Federal Government receipts from the sale of mobile-phone licences, the public authorities are even likely to post an appreciable surplus. They will also benefit from the fact that actual tax revenue will surpass original budget estimates. Moreover, the central, regional and local authorities intend to continue disposing of assets on a large scale. Not least among the factors working to reduce expenditure will be improvements in the labour market situation, this year's pay settlement (which was more moderate than in 1999) and the favourable interest-rate level.

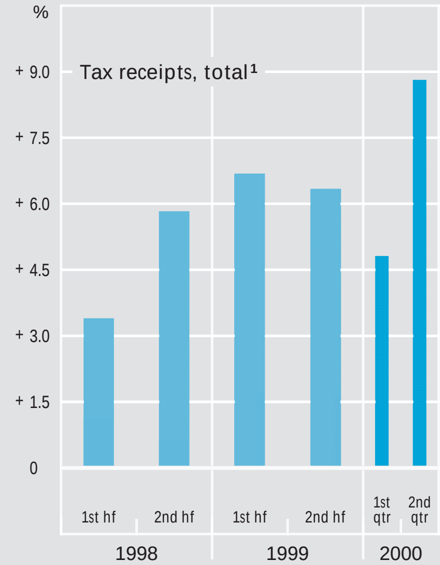
Tax receipts in the second quarter ...

At almost 9 %, tax receipts[1] grew at an even more rapid pace in the second quarter. The extremely favourable developments in assessed taxes were the main reason for this improvement. The reduction in special tax allowances over the past few years and the renewed upward trend in profits allowed assessed income tax, which reached € 4 billion, to exceed its corresponding 1999 level by three-quarters. Gains in enterprise profitability also had an impact on corporation tax, receipts from which were more than one-third up on the year, amounting to € 7½ billion. Moreover, larger profit distributions helped receipts from non-assessed taxes on earnings rise by 40 % to slightly over € 5 billion. By contrast, wage tax receipts increased by no more than ½ %; here measures which came into effect at the beginning of the year, i.e. the second stage of the tax-rate cut and the rise in child benefit, were continuing to exert downward pressure.

Indirect taxes also contributed to the sharp growth in revenue. Following implementation of the second stage of the "ecological tax reform" at the beginning of the year, total receipts from mineral oil tax and electricity tax were up not quite 15 % on the corresponding period in 1999; at that time, only some of the tax increases associated with the first stage had begun to exert an impact on revenue. In addition, revenue from turnover tax rose by almost 5 %.

Trends in tax revenue *

Change from previous year in %



* Out-turn in Germany as a whole. — 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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... and in 2000 as a whole

The remarkably positive trend for the second quarter suggests that tax revenue in 2000 will exceed the official May tax estimate by a wide margin. In the first six months of the year, revenue growth (excluding local authority tax receipts, which are not yet known) amounted to almost 7 %, topping estimates made for 2000 at that time by four percentage points. There is some evidence that revenue growth will decelerate slightly in the second half of the year; thus, a year-on-year comparison of energy consumption taxes indicates that the first round of last year's tax increases will cease to have an impact. Moreover, retrospective payments of assessed taxes are likely to decrease markedly as more

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

Trends in the revenue from major taxes

Type of tax	Revenue in € billion 1st half-year 1999	2000	Change from previous year in %
Wage tax	60.9	61.9	+ 1.6
Assessed income tax	2.2	3.9	+80.1
Corporation tax	11.1	13.8	+23.6
Turnover tax	66.8	70.3	+ 5.4
	of which: 2nd quarter		
Wage tax	31.1	31.3	+ 0.5
Assessed income tax	2.3	4.1	+74.4
Corporation tax	5.5	7.5	+36.4
Turnover tax	33.2	34.8	+ 4.8

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and more tax returns for 1999, which was a "low-profit" year, are assessed. Nevertheless, the figures forecast in May will lag substantially behind the actual outcome, especially with regard to receipts from assessed income and corporation taxes. Turnover tax will probably yield additional revenue as well in the wake of stronger economic growth. Contrary to initial expectations, it appears unlikely that the overall tax ratio will decline.

Federal Government in the second quarter ...

In the second quarter, the Federal Government recorded a budgetary surplus of € 1¼ billion, compared with a deficit of € 3½ billion for the same period in 1999. The main reason for this improved position was a steep rise in receipts amounting to slightly more than 6½%, which was, in turn, chiefly attributable to an increase in tax revenue of just over 7½%. Although the Federal Government will receive a redistribution dividend from the sale of its shares in Deutsche Telekom AG, which it had transferred to the state-owned Reconstruction Loan Corporation *(Kreditanstalt für Wiederaufbau (KfW)),* no such payments have yet been posted in the Federal budget as revenue. Expenditure fell 1½%. Although additional payments financed through the second stage of the "ecological tax reform" boosted grants to the statutory pension insurance scheme by almost 17%, labour-market related spending, in particular, fell considerably short of the corresponding 1999 figures.

... and in 2000 as a whole

For 2000 as a whole, the Federal Government budget assumes that the deficit will narrow by just under € 1 billion to € 25½ billion. The year-on-year decline in the deficit for the first six months of 2000, taken together, which amounted to € 2½ billion, suggests that the budgetary position will improve substantially during the remainder of this year. Still, the year 2000 will entail additional expenditure beyond that envisaged in budget estimates. Current plans, for example, call for indemnification payments amounting to € 2½ billion, which had not been set aside in the budget for 2000, to be issued to persons forced into slave labour under National Socialism as early as this year. Moreover, transfers to the Post Office benefit funds and spending on unemployment assistance will presumably be larger than expected. By contrast, the Federal Labour Office's demand for grants is likely to be much smaller than previously. On the receipts side, it looks as if tax revenue will outstrip budget estimates significantly. Nevertheless, what will tip the budgetary balance in favour of receipts will be the large proceeds from the auction of UMTS licences, for which no provision had been made in the budget. Thanks to these exceptional one-off receipts, the Federal Government will record a budgetary surplus for the first time in 30 years.

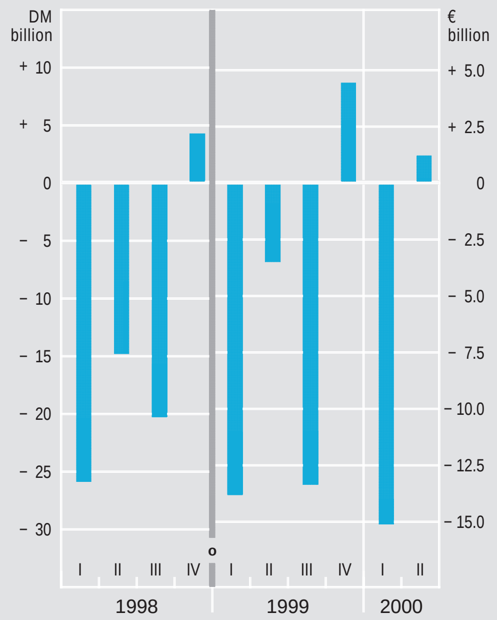
Special funds

The special funds showed an aggregate surplus of nearly € 1 billion in the second quarter, which was € 5 billion less than one year before. The main reason for this decline was the appreciably smaller Bundesbank profit, which resulted in the amount being transferred to the Redemption Fund for Inherited Liabilities – not quite € ½ billion – falling short of the 1999 figure by almost € 4½ billion.

Länder Governments

The Länder Governments' budgets continued to improve slightly. The surplus of € 2½ billion achieved in the second quarter was larger than the surplus of the corresponding 1999 period by almost € 1 billion. This larger surplus may be attributed chiefly to the rapid rise in tax receipts; at 7½ %, this rise comfortably exceeded expenditure growth, which, when viewed in isolation, was rather high at approximately 3½ %. The budget figures for the remainder of the year are also expected to be more favourable than the corresponding 1999 figures. However, the degree of improvement will depend not least on whether the public sector pay settlement will be extended to include civil servants and pension recipients or whether – as originally envisaged in the Federal Government's austerity programme – pay increases for these groups will be calculated on the basis of last year's inflation rate. Given the impending shortfalls in revenue associated with the tax reform, it is absolutely imperative that expenditure on personnel, which places a particularly large burden on Länder Government budgets, be lowered if the required reduction in regional authority deficits, which continue to be large, is to be achieved.

The Federal Government's financial balance



o From 1999 in euro.

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Local authorities

At this stage, data for the local authorities cover the first quarter only. According to these figures, the local authorities' aggregate deficit, which was slightly over € 2 billion, widened by almost € ½ billion on the year. Expenditure rose by almost 2 %, partly in the wake of a strong expansion in construction spending, whereas receipts grew by no more than nearly 1 %. The outcome for 2000 as a whole is also likely to be less favourable than

Net borrowing in the market by the central, regional and local authorities

To end-1998: DM billion/from 1999: € billion

Period	Total	of which Securities	of which Loans against borrowers' notes 1	Memo item Acquisition of public debt instruments by non-residents
1991 2	+ 106.0	+ 71.3	+ 34.9	+ 50.9
1992	+ 102.6	+ 95.0	+ 8.1	+ 59.4
1993	+ 159.1	+ 120.3	+ 39.3	+ 109.1
1994 3	+ 86.0	+ 45.6	+ 40.8	– 20.9
1995 4	+ 97.7	+ 32.6	+ 81.4	+ 62.1
1996	+ 123.8	+ 65.2	+ 74.1	+ 57.3
1997	+ 95.5	+ 65.9	+ 39.9	+ 80.7
1998	+ 66.9	+ 53.6	+ 15.6	+ 71.0
1999 p	+ 34.8	+ 44.8	– 10.2	+ 17.1
of which				
1st qtr	+ 12.7	+ 14.1	– 2.0	+ 1.2
2nd qtr	+ 2.9	+ 2.9	+ 0.0	+ 1.0
2000				
1st qtr	+ 14.0	+ 7.5	+ 6.4	+ 0.4
2nd qtr pe	– 1.4	+ 3.8	– 5.2	...

1 Including cash advances and money market borrowing. — 2 Excluding Federal Railways debt assumed by the Federal Government. — 3 From 1994 including Federal Railways Fund. — 4 From 1995 including Redemption Fund for Inherited Liabilities.

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in 1999. After the sharp rise recorded in the past two years, tax receipts look set to increase only moderately, while expenditure growth will probably accelerate somewhat. However, the large increase in the funds distributed per quota by the Länder Governments, which was fuelled by ample tax receipts, is expected to lighten the local authorities' budgetary burden. It seems that the aggregate budget for the local authorities will again close the year with a surplus.

Indebtedness

The central, regional and local authorities' indebtedness declined by just under € 1½ billion in the second quarter; by contrast, net borrowing in the first three months of this year amounted to € 14 billion. Ample tax receipts and the Bundesbank's profit distribution of not quite € 4 billion combined to limit borrowing needs in the second quarter. The public authorities obtained slightly less than € 4½ billion in the capital market; at the same time, they cut back their money market liabilities by just over € 5½ billion. Among the individual levels of government, the Federal Government reduced its debt by slightly more than € 3½ billion, concentrating its efforts on the money market, where it paid back over € 6 billion net. By contrast, it tapped the capital market for almost € 2½ billion on balance, largely through the sale of Federal bonds and five-year special Federal bonds. The Länder Governments expanded their debt by just under € 1 billion, primarily by taking up loans against borrowers' notes to the tune of not quite € 2 billion. The sale of bonds yielded slightly over € 1 billion. At the same time, they redeemed what were for the most part cash advances from banks in the amount of € 2 billion. The special funds' total debt rose by almost € 1 billion. At an estimated € ½ billion, local authorities' net borrowing is likely to have remained within narrow limits.

Intermediate reflection: "Tax reform 2000"

Important measures

Extent of tax relief

Following an inter-House mediation hearing, the *Bundesrat,* the Upper House of the German parliament representing the Länder, approved the Federal Government's tax reform package on July 14. The final package had been amended to include additional concessions, which are supposed to be passed into

Financial implications of the Tax Reduction Act (“Tax Reform 2000”)

(Federal Ministry of Finance estimate including Federal Government pledges not yet enacted into law)

Measure	Revenue losses (–) or gains (+) in DM billion					
		Accounting year				
	Year of oper- ation	2001	2002	2003	2004	2005
I. Reform of business taxation, total	– 14.0	– 17.7	– 23.1	– 20.6	– 18.8	– 19.8
Measures affecting corporations, total of which	– 20.4	– 18.2	– 27.9	– 28.4	– 27.0	– 27.0
– Lowering of corporation tax rate on retained profits from 40 % to 25 %	– 14.0	– 11.3	– 14.6	– 15.9	– 17.1	– 18.4
– Lowering of corporation tax rate on distributed profits from 30 % to 25 %	– 2.0	– 5.3	– 4.7	– 3.3	– 3.2	– 3.4
– Lowering of investment income tax rate on dividends from 25 % to 20 % (from 2002)	– 0.1	–	– 3.2	– 2.4	– 0.9	– 0.6
– Replacement of the imputation system on dividends by an income tax relief	+ 5.0	–	+ 3.9	+ 5.1	+ 5.6	+ 5.9
– Transitional arrangement for system change	– 4.1	–	– 5.4	– 6.8	– 6.1	– 5.1
– Tax exemption for capital gains from disposal of domestic participating interests (from 2002)	– 4.2	– 1.6	– 3.4	– 4.1	– 4.2	– 4.2
Measures affecting non-corporations, total of which	– 8.2	– 5.0	– 6.8	– 8.7	– 8.5	– 8.6
– Reduction of income tax liability by 1.8 times the basic amount of trade tax	– 9.9	– 6.9	– 9.2	– 12.1	– 11.9	– 12.8
– Reintroduction of 50 % tax-rate cut on business sales and raising of tax allowance for business sales from DM 60,000 to DM 100,000	– 2.6	– 1.1	– 1.7	– 2.4	– 2.6	– 2.5
– 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	+ 7.5
Financing measures in connection with the reform, total of which	+ 14.6	+ 5.6	+ 11.6	+ 16.5	+ 16.7	+ 15.8
– 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	+ 14.4	+ 13.1
– Reduction of linear depreciation rate for commercial buildings from 4 % to 3 % p. a.	+ 0.5	–	+ 0.2	+ 0.8	+ 1.3	+ 1.7
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	+ 8.6
Sum total of the business taxation measures, including adjusted depreciation tables	– 10.6	– 17.0	– 20.5	– 15.5	– 11.8	– 11.2
III. Reform of income tax schedule, total of which	– 51.9	– 28.4	+ 1.3	– 13.8	– 13.2	– 51.5
– Bringing forward tax change from 2002 to 2001	(– 27.8)	– 28.7	+ 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 top rate to 47 %	(– 13.5)	–	–	– 13.6	– 13.5	+ 0.1
– Tax changes in 2005, raising basic tax allowance further to DM 15,000, cutting entry rate to 15 % and top rate to 42 %	– 52.2	–	–	–	–	– 51.9
All measures, taken together	– 62.5	– 45.4	– 19.2	– 29.3	– 25.1	– 62.8
of which: Federal Government	– 28.8	– 21.7	– 10.4	– 15.0	– 12.9	– 30.1
Länder Governments	– 24.8	– 19.2	– 8.7	– 12.5	– 10.5	– 25.8
Local authorities	– 8.8	– 4.5	– 0.1	– 1.8	– 1.7	– 6.9
Revenue losses (–) or gains (+) vis-à-vis Bundestag act of May 18, 2000	– 17.5	– 0.7	+ 0.7	+ 2.3	+ 5.6	– 11.4

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law by the end of the year. On the whole, the net relief which it will provide for households and enterprises, estimated at slightly over € 23 billion or around DM 45 billion (just over 1 % of GDP), is substantial, compared with current tax law. After a temporary decline, net relief will go on to rise to about € 32 billion (approximately DM 63 billion or 1¼ % of GDP) by 2005 (for more details, see the table on page 55).[2]

Income tax scale

The top rate of income tax will be lowered from its present level of 51 % to 48.5 % in 2001 and then to 47 % in 2003 and, finally, to 42 % in 2005. By contrast, a resolution adopted by the Lower House *(Bundestag)* last May would only have reduced the top income-tax rate to 45 %. From 2005 onwards, the top income-tax bracket will start from a taxable income of DM 102,000 for single persons and from a taxable income of twice that amount for married couples (at present, the corresponding level of taxable income for single persons lies at just under DM 115,000). The bottom rate will be reduced in stages from the present level of not quite 23 % to 15 %; this had already been envisaged in the original Government tax reform bill. The basic tax allowance will be raised successively from the current level of DM 13,500 to DM 15,000 by 2005.

Corporate taxation

As part of the reform of business taxation, the corporation tax rate will be lowered from the present rates of 40 % (for retained profits) and 30 % (for distributed profits) to a uniform rate of 25 % in 2001. The current system for taxing distributed profits will also be replaced in that year. Under the prevailing imputation system, domestic shareholders are able to credit the corporation tax already paid on dividends against their personal income tax liability, with the result that the possibility of distributed profits being taxed twice has been ruled out. This procedure will be replaced by a system which makes no allowance for imputation but is based instead on income tax relief on dividends. In addition to the corporation tax already paid on dividends, the new system will require shareholders to pay income tax on the corporate profits distributed, albeit for only one-half. This, in principle, opens the door to renewed dual taxation; still, while shareholders whose earnings are subject to a marginal tax rate of up to 40 % will be paying more in taxes than under the current system, the tax burden for shareholders subject to a marginal tax rate exceeding 40 % will actually be less. The Federal Government has calculated that adherence to the imputation system would have led to even larger shortfalls in tax receipts. Moreover, in justifying the changeover, the Government has argued that it would eliminate current disparities in the way profits distributed to shareholders by foreign and domestic corporations are taxed.

After the change in dividends taxation, corporate capital gains from the sale of participating interests in German firms will be exempt from taxation (capital gains resulting from the disposal of shareholdings in foreign enterprises are already tax-exempt). The rea-

2 In addition, the Tax Relief Act, which came into effect in 1999, will contribute to a further easing of the tax burden. In 2002, for example, the corresponding relief measures will amount to around € 10 billion or DM 20 billion.

son cited by the Federal Government for their tax-exempt status is that the reserves of the affiliated company, which largely account for any capital gains acquired through its sale, have already been taxed or will be in the near future. Tax-exempt status cannot be claimed until 2002, since the imputation system will still be in use next year.

Non-corporate taxation

The tax reform not only provides relief for non-corporations (i.e. partnerships) at lower income tax rates but – effective next year – also allows them to credit, in part, trade tax paid against their income-tax liability, and that at an amount corresponding to a collection multiplier of 180 %. This relief measure, together with the still viable option of deducting the trade tax paid in full as operational expenditure from taxable income, amounts *de facto* to an almost complete elimination of the additional burden that had been placed on non-corporations by trade tax. By contrast, it has been decided, on account of the complications involved, not to introduce an option that would have allowed non-corporations to pay corporation tax rather than having a part of their trade tax payments count towards their income tax. This notwithstanding, some measures specifically geared towards providing relief for non-corporations were approved. These include the reintroduction of a specific tax law provision for co-entrepreneurs[3] and – subject to specific conditions – of the 50 per cent cut in the tax rate for capital gains from a one-off business sale. Also, the repeal of savings and special depreciation facilities for small and medium-sized enterprises, which had originally been planned, was not carried out.

Counter-financing

The comprehensive relief package will be financed, in part, through a broadening of the tax assessment base for enterprises. This will entail, notably, a significant tightening of the rules for claiming depreciation allowances. In 2001, the diminishing-balance depreciation rate for investment in machinery and equipment will be reduced from 30 % to 20 % per year, and the linear depreciation rate for commercial buildings will be cut from 4 % to 3 % per year. Moreover, an extension of depreciation allowance deadlines, although not yet finalised, is expected to be implemented by administrative regulation.

Effects

Major step forward for growth and employment

The tax reform represents a major step forward in improving the underlying conditions for economic growth and employment in Germany. The substantial reduction in tax rates means that the disruptive effects which the tax system had hitherto exerted on work incentives will, in principle, become less pronounced and that the government – assuming public sector expenditure is reduced accordingly – is reducing its claim to national economic resources. In addition, the tax exemption granted to corporations for capital gains deriving from the sale of participating interests will also encourage corporate restructuring. At the moment, the entire macroeconomic constellation – in particular, the cost discipline already acquired in Germany and the impetus to new investment imparted by technological innovation – suggests

3 This provision allowed co-entrepreneurs to transfer assets tax-free (in their capacity as partners) in exchange for partnership rights.

A note on some allocation effects of tax reform

The possibility of different kinds of distortion affecting enterprises' financing and appropriation of profits, the equal distribution of the tax burden among different types of business ownership, and the non-preferential treatment of profits vis-à-vis other forms of income has been discussed in connection with the envisaged tax reform. In the following, some basic comparative figures are used to examine whether the tax reform will, in fact, give rise to such distortions and, if so, to determine their extent.

The first table compares the tax reform with current tax law in terms of their effect on marginal tax rates for corporate profit appropriation:

%

Item	Retained profits		Profits distributed to shareholders (taxed at top rate of income tax)		
	Under current tax law	After reform of business taxation	Under current tax law (imputation system)	After reform of business taxation (income tax relief on dividends)	New tax rates, assuming adherence to imputation system
Pre-tax profits	100.0	100.0	100.0	100.0	100.0
./. Trade tax (assuming a 400 % collection multiplier) 1	16.7	16.7	16.7	16.7	16.7
= Profits after trade tax	83.3	83.3	83.3	83.3	83.3
./. Corporation tax 2	33.3	20.8	25.0	20.8	20.8
./. Solidarity surcharge on corporation tax (5.5 %)	1.8	1.1	1.4	1.1	1.1
= Corporate profits after taxes	48.2	61.4	57.0	61.4	61.4
./. Income tax paid by shareholder 3	.	.	42.5	12.9	35.0
./. Solidarity surcharge on shareholder's income tax liability	.	.	2.3	0.7	1.9
+ Tax credit	.	.	26.4	.	22.0
= Profits minus total tax liability	48.2	61.4	38.5	47.8	46.4
Total marginal tax rate for profits	51.8	38.6	61.5	52.2	53.6
Tax bias against profit distribution vis-à-vis retention (in percentage points)	.	.	9.7	13.6	14.9

1 The collection multiplier used approximates to the weighted average collection multiplier applied in Germany. In individual cases, the actual collection multiplier may deviate considerably from this percentage. — **2** Under current tax law, the rate for profit retention lies at 40 %, for distribution at 30 %. On implementation of the tax reform, the corporation tax rate will be a uniform 25 %. Although investment income tax on dividends is levied on distributed profits as a further form of deduction at source, it is disregarded here, since it has no impact on the eventual tax liability of domestic shareholders, who receive an additional tax credit associated with such deductions at source. — **3** Top rate currently at 51 %; after the tax reform in 2005 it will be 42 %.

Assuming an average trade tax collection multiplier of 400 %, the reform will reduce the total marginal tax on retained corporate profits from the present level of approximately 52 % to 38 ½ %. If the shareholder is assumed to be in the uppermost income-tax bracket both now and in 2005, the reform will result in the marginal tax rate for dividends being lowered from 61 ½ % to slightly more than 52 %. The bias towards profit retention over profit distribution, which has been inherent in tax law up to the present time, would increase by around four percentage points to 13 ½ percentage points. Given the actual combination of tax rates, however, it would be wrong to ascribe the additional distorting effect on profit appropriation to the changeover from the imputation system to the income tax relief system. Indeed, adherence to the imputation system would, in conjunction with the new tax rates, result in an even greater distortion, albeit only marginally greater. Retained profits receive even more pronounced preferential tax treatment primarily because the decrease in the corporation tax retention rate is far more substantial than that in the top rate of income tax.

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Assuming the top rate of income tax is applied and the partial trade tax credit is included in the overall taxation picture, a comparison of the tax treatment of non-corporations with that of corporations would yield the following results:

%

Item	Corporations						Non-corporations			
	Retained profits		Profits distributed to shareholders (taxed at top rate of income tax)				Under current tax law [1]	Partial trade tax credit (at top rate of income tax) [2]		
	2000	from 2001	2000 51 %	2001 48,5 % [3]	2003 47 %	2005 42 %	2000 43 %	2001 48,5 %	2003 47 %	2005 42 %
Pre-tax profits	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
./. Trade tax (assuming 400 % collection multiplier) [4]	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7
= Profits after trade tax	83.3	83.3	83.3	83.3	83.3	83.3	83.3	83.3	83.3	83.3
./. Corporation tax [5]	33.3	20.8	25.0	20.8	20.8	20.8	.	.	.	.
./. Solidarity surcharge on corporation tax (5.5 %)	1.8	1.1	1.4	1.1	1.1	1.1	.	.	.	.
= Corporate profits after taxes	48.2	61.4	57.0	61.4	61.4	61.4	.	.	.	.
General income tax rate	.	.	42.5	14.9	14.4	12.9	35.8	40.4	39.2	35.0
Deductible share of trade tax paid [6]	.	.	.	.	.	.	.	7.5	7.5	7.5
./. Income tax	.	.	42.5	14.9	14.4	12.9	35.8	32.9	31.7	27.5
./. Solidarity surcharge on income tax	.	.	2.3	0.8	0.8	0.7	2.0	1.8	1.7	1.5
+ Tax credit	.	.	26.4	.	.	.	.	.	.	.
= Profits less total tax liability	48.2	61.4	38.5	45.7	46.1	47.8	45.5	48.6	49.9	54.3
Total marginal tax rate for profits	51.8	38.6	61.5	54.3	53.9	52.2	54.5	51.4	50.1	45.7
Added for purposes of comparison: Total marginal tax rate for other types of income	.	.	.	.	.	.	53.8	51.2	49.6	44.3

1 Including the ceiling on tax rates for industrial earnings. — 2 Assuming a basic tax rate of 5 %, which presupposes that profits exceed DM 144,000. — 3 Strictly speaking, the figures in this column apply only for the period after 2001, since the imputation system will continue to be in use throughout 2001. — 4 See footnote 1 of previous table. — 5 See footnote 2 of previous table. — 6 A share of trade tax equivalent to a collection multiplier of 180 % is offset against the income tax liability.

During the final stage of the tax reform in 2005, non-corporate profits will be taxed at a marginal rate amounting, at most, to not quite 46 % (assuming a trade tax collection multiplier of 400 %). Although this tax rate is significantly higher than the rate at which retained corporate profits are taxed, an overall comparison of these two forms of legal ownership must take into account the fact that corporate profit distributions, which account for a large portion of profit appropriation, are subject to far higher tax rates. If lower income tax rates are applied, or if average tax rates rather than marginal tax rates are used, a slight shift in bias results in favour of non-corporations. Thus, the manner in which operating results are taxed would appear to provide no evidence that corporate ownership has been given an unfair tax advantage over the non-corporate form of legal ownership, although it should not be forgotten that many of the income tax cuts will not come into effect until 2005. Even when other types of income are taken as a basis of comparison, using the top tax rate for each category, no major distortions are to be expected during the final stage of tax reform in 2005.

Thus, it seems safe to conclude that corporations' financing and appropriation of profits will be the "only" areas to be noticeably affected by additional distortions associated with the new reform, this outcome being attributable to the new combination of tax rates, which favours self-financing over external financing to an even greater degree than previously.

that such tax relief will fall on "fertile soil". The positive effects associated with a lowering of tax rates are, however, partly offset by a marked deterioration in the conditions governing depreciation allowances, which make domestic fixed capital expenditure appear less attractive than financial investments.

Cyclical effects

Given the good economic prospects for 2001, the coming-into-force of the first stage of reform, which will be accompanied by a deterioration in the general government fiscal balance, is likely to have a pro-cyclical effect. At all events, the resulting surge in domestic demand – attributable, in particular, to a rise in private consumption – is estimated to account for around ½ % of GDP. Still, the intense competition in the retail trade sector and the fact that the consumer goods sector has spare capacity would seem to indicate that the effect on consumer prices will be restrained. The expansionary fiscal stimulus has already been taken into account in the economic forecasts for 2001, which assume that domestic demand will increasingly come to replace foreign demand as the engine for economic growth. Generally speaking, it is difficult, given the long preparatory period involved in designing far-reaching reforms, to schedule the timing of tax reforms in such a way that they will conform to the then prevailing economic conditions.

Corporate and non-corporate taxation

As for the individual elements of the new tax rate pattern, the large cut in the corporation tax rate will reduce the marginal burden for retained corporate profits, including trade tax and the solidarity surcharge, from its current level of well over 50 % to under 40 %. Germany's standing in this respect will then be somewhere in the middle of the international tax-league table. The tax disadvantages to which enterprises had previously been subject will be reduced. Although even during the final stage of tax reform in 2005 the largest burden for non-corporate profits, at almost 46 %, will still be significantly higher than the corresponding burden for retained corporate profits, such a comparison also has to take into account the fact that corporate dividends are subject to a much larger tax burden (for details, see the accompanying overview on page 59). Besides, the tax situation of non-corporations improves if attention is called to the fact that the average tax burden here is lower. Thus, overall, the operating results of non-corporations are not likely to be taxed more severely than those of corporations. To the extent that they will suffer from a tax disadvantage, it is because most of the applicable income tax cuts will not come into effect until 2005 and because the tax concessions associated with the sale of participating interests are smaller than those awarded corporations.

Tax bias in favour of profit retention strengthened

As things stand, the manner in which the present imputation system treats retained and distributed corporate profits amounts to privileged tax treatment of retained profits for shareholders with high incomes since the corporation tax rate for retained profits is significantly lower than the top rate of income tax. As the overview on page 58 also makes clear, the changeover to a system of income tax relief on dividends will, in conjunction with a substantial lowering of the corporation tax rate, lead to an even greater bias in favour of profit retention over distribution. Even as late as 2005 distributed profits will still be subject to a peak tax burden totalling 52 %. The clear favouring of self-financing over equity financing will tend to interfere with the allocation function of capital markets and will put young firms at a disadvantage. "Saving" within corporations is thus being encouraged at the expense of other forms of saving, which might ultimately be used to finance investment as well. Future efforts at reform should therefore concentrate on eliminating the remaining tax distortions.

Outlook

Federal draft budget for 2001

The Federal draft budget for next year, which was approved by the Federal Cabinet on June 21, envisages net borrowing of € 23.6 billion, which is slightly less than the estimated amount for 2000 (€ 25.3 billion) but in keeping with the medium-term financial plan approved last year. The budget for 2001 had to make allowance, however, for an additional burden of over € 10 billion, most of which is attributable to a loss of revenue associated with the tax reform. Public finances in 2001 will also be adversely affected by the fact that last year's austerity programme has not yet been fully implemented. However, these factors will be offset by reductions, especially in labour-market related expenditure, and by a considerable increase in receipts from privatisation.

Weak growth in receipts

Federal Government receipts are projected to be 0.8 % higher than the corresponding budget item for the year 2000. Expected tax receipts were based on the May tax estimate, after adjustment for the Government's tax reform bill. As a result, tax receipts will fall 1.1 % short of this year's target figure, notwithstanding the fact that the budget assumes favourable economic conditions and a further increase in taxes on energy consumption. As a counterweight, the budget forecasts strong growth in privatisation proceeds (which should rise by around € 4 billion to almost € 9 billion).

No increase in expenditure

At € 245 billion, expenditure remained virtually unaltered from the 2000 budget. Although this includes larger transfers to the statutory pension insurance scheme (€ 5 billion), to the "German Unity" Fund (€ 1½ billion) and to the Post Office benefit funds (€ 1 billion), this additional expenditure will be offset by the cessation of grants to the Federal Labour Office (2000 target figure: not quite € 4 billion) in expectation of an improving labour market and by the Labour Office's taking responsibility for certain elements of active labour-market policies which had hitherto been financed by the Federal Government. Budget appropriations for unemployment assistance have remained unchanged vis-à-vis 2000. In addition, the budget presupposes that transfers to the Federal Railways Fund may be lowered significantly, given that the sale of railway workers' dwellings, which failed several times in the past, is to be closed in 2001, with a corresponding reduction in the grants needed to cover this special fund. Federal Government investment was valued at € 28 billion and was thus € 1½ billion less than this year's target figure, the difference being attributable, *inter alia,* to savings asso-

The Federal Government's financial planning over the medium term

€ billion

	2000	2001	2002	2003	2004
Expenditure	244.8	244.8	249.4	253.2	256.9
of which Investments	29.4	27.9	27.1	26.6	26.6
Revenue	219.5	221.2	228.3	237.6	246.7
of which Taxes	198.1	195.9	207.5	216.7	228.3
Privatisation sales	4.7	8.7	4.3	4.6	4.9
Net borrowing	25.3	23.6	21.1	15.5	10.2
Memo item					
Change in expenditure in %	– 0.8	– 0.0	+ 1.9	+ 1.5	+ 1.5

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ciated with the Federal Labour Office's assuming responsibility for structural adjustment measures, to a decline in those investments associated with the Government's move to Berlin, and to the abandonment of construction plans for a high-speed magnetic-levitation train, the *Transrapid.*

Deterioration in the structural budgetary position

All in all, the amount shown in the 2001 draft budget for net borrowing would appear adequate. This notwithstanding, the structural budgetary position will deteriorate next year. Despite positive cyclical conditions, which will result in savings in expenditure, especially in labour-market related spending, and in increased tax receipts, the narrowing of the deficit, which the budget puts at a slight € 1½ billion, will be due entirely to an increase of € 6 billion in receipts from asset disposals, which, after all, cannot be regarded as making a lasting contribution to consolidation.[4] The main reasons for the limited progress in consolidation are an increase in the size of certain benefits (i.e. housing allowance, benefits paid under the Federal Act on the Promotion of Education, subsidies for farmers' purchases of mineral oil, child-rearing benefits), and sizeable losses in revenue associated with the tax reform. This situation makes it all the more important to pursue sustainable progress towards consolidation. In order to achieve this goal, it is especially important that any additional tax revenue this year or any interest payments saved by applying licence sale proceeds to the national debt be used to bring the deficit down more quickly. Generally speaking, positive phases of the economic cycle should be seen as an opportunity to intensify consolidation efforts – an objective which, at the European level, has found the approval of all EU member states.

Medium-term financial plan

Like last year's financial plan, the new medium-term financial plan presented by the Federal Government (see adjacent table) envisages a reduction in net borrowing to € 15½ billion by 2003. Towards the end of the period covered by the financial plan, i.e. in 2004, new borrowing is supposed to decline further to € 10 billion. These figures are based on estimates that place real economic growth at 2¾% in 2001 and at an annual average of 2¼% for the period from 2002 to 2004. On the revenue side, the new

4 These receipts include privatisation proceeds and the Federal Railways Fund's receipts from the sale of railway workers' dwellings, which will be reflected in a reduction of Federal grants to that special fund.

financial plan is based on the May tax estimate, as amended in the light of the Government's tax reform bill. Privatisation proceeds for the period from 2002 to 2004 have been set at around € 4 billion to € 5 billion per year. Average annual expenditure growth is projected to be 1.6 % during that period, with investment expenditure falling somewhat further.

Objective: a balanced budget

The Federal Government intends to balance its budget by 2006. Starting in 2005, however, substantial additional shortfalls in revenue associated with the tax reform (around € 10 billion less than in 2004) will make attaining this objective more difficult. If these shortfalls are to be compensated for in the budget, the Federal Government will have no other alternative but to adopt further consolidation measures. A structurally balanced budget, which the Federal Government is striving to achieve, is essential, not least with regard to the requirements of the European Stability and Growth Pact and in view of the challenges posed by demographic trends.

Central, regional and local authorities running substantial deficit again in 2001

The central, regional and local authorities, taken together, will again incur a substantial deficit in 2001. Their budgetary position would have worsened even if this year's exceptional licence receipts had not been taken into account. The reason is the loss in revenue associated with tax reform. As a result, total tax receipts will decline even though the economic trend is expected to be favourable; only if expenditure growth were to remain well below the 2 % limit specified by the Financial Planning Council could this loss in tax revenue be countered.

Social security funds

Statutory pension insurance scheme

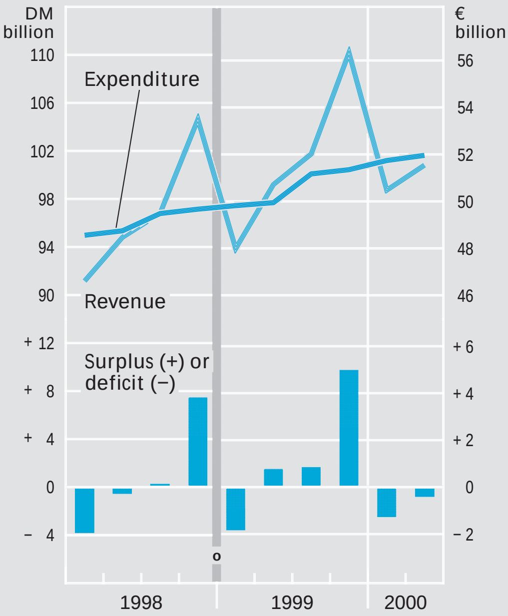
In the second quarter of 2000, the wage and salary earners' pension insurance scheme recorded a deficit of € ½ billion, compared with a surplus of € ¾ billion for the same period last year. The main reason for the weakened financial position is that it is no longer necessary, as it still was in 1999, to replenish the statutory fluctuation reserves by generating a sizeable surplus. This factor, in combination with the forecast trends in non-contributory receipts and in expenditure, made it possible to lower contribution rates from 19.5 % to 19.3 % at the beginning of the year.

Current trends

Total contribution receipts in the second quarter were down by just over 1½ % on the year. A 1 % rise in wage and salary earners' compulsory contributions was offset by a decline of slightly more than one-quarter in contributions paid on behalf of recipients of wage substitutes; this decline was the result of a lowering of the contribution rates for unemployment assistance and of more favourable labour market conditions. By contrast, contributions for Federal Government assistance during periods of child-rearing, which were paid for the first time in June 1999, yielded considerable additional revenue. As a result, total receipts increased by 1½ %. At slightly less than 4 %, pension payments continued to rise rather sharply. The steep climb in pension payments reflected not only the increased number of pensions but also the effects of the pension adjustment of mid-1999, which was still indexed to the trend in net wages. As of July 1, 2000, pensions in both western and eastern Germany were raised by

Wage and salary earners' pension insurance scheme

Quarterly



o From 1999 in euro.

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0.6 % to adjust for last year's inflation rate. Consequently, expenditure is expected to increase more moderately in the second half of 2000. All in all, it remains likely that the pension insurance scheme will run a small surplus this year.

Debate on reform

The debate concerning a reform of the statutory pension insurance scheme, made necessary by demographic trends, has not yet been concluded. Significantly, the key data presented by the Federal Government include more moderate annual pension adjustments and – from 2011 onwards – a deduction in pension payments for people entering retirement, i.e. for those persons who will have had time beforehand to make their own provisions. These measures would contribute to a more balanced distribution of the demographically-induced financing burden among current and future pensioners. Moreover, the planned reliance on an additional funded system would place the financing of old-age provision on a broader basis. It should also be borne in mind that any ceiling that might be placed on contribution rates for the unfunded pay-as-you-go pension scheme as a consequence of a reduction in pension size would create additional leeway for private old-age provision; the Federal Government has plans to introduce other incentives such as tax advantages and transfer payments to low-income earners to encourage future retirees to take advantage of this leeway.

Federal Labour Office

In the second quarter the Federal Labour Office deficit narrowed to just over € ¼ billion, compared with a deficit of almost € 1½ billion for the same period in 1999. An increase in revenue totalling just over 2 ½ % was accompanied by a decrease in expenditure of slightly less than 6 %. A decline in the number of unemployed brought expenditure on unemployment benefits down by slightly over 8 %. Total expenditure on active labour market policies fell by almost 6 %. The fact that the labour market situation improved over the year suggests that the Federal Labour Office may expect a reduction in its financial burden for the remainder of 2000 as well. By contrast, a recent ruling by the Federal Constitutional Court, which stipulates that one-off wage-related payments be taken into account when determining wage substitutes, will result in a substantial increase in expenditure during the last six months of this year. Still, it seems highly unlikely that all of the almost € 4 billion that has been earmarked in the Federal budget in the form of a grant will be spent.

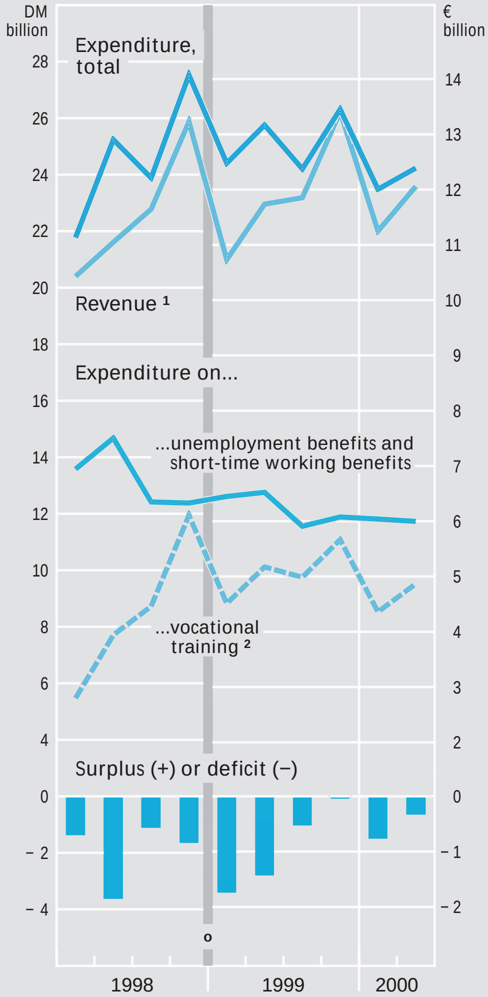
Outlook for 2001

No Federal grants are planned for next year, which seems realistic at this point. The Federal Labour Office will probably continue to benefit from the decline in unemployment, which is cyclical as well as demographic in nature. However, the Labour Office's budget will be adversely affected by its having to assume responsibility for job creation schemes that had hitherto been financed by the Federal Government direct. In addition, expenditure on wage substitutes will be subject to substantial increases owing to the aforementioned ruling of the Federal Constitutional Court, which will result in a benefits boost of up to 10 %. Insofar as this amounts to a significant improvement in the degree of protection afforded to unemployed persons – which is already quite generous by international standards – it poses new problems, especially with regard to work incentive.

Statutory health insurance funds

The financial situation of the statutory health insurance funds improved marginally in the first quarter of 2000 (more recent data are not yet available), accompanied by a relatively small increase in expenditure (+ 1.5 %). At almost € 1 billion, the deficit narrowed somewhat, compared with the same period last year, although the data differ widely, depending on the individual health insurance institution. Nevertheless, there is some evidence that the financial situation will deteriorate over the remainder of the year. For example, the above-mentioned Constitutional Court ruling will also cause a rise in payments for sickness benefits. Moreover, the obligation to pay contributions for part-time workers below a certain earnings level, which became law in April 1999, will no longer result in a year-on-year increase in revenue.

Federal Labour Office



1 Excluding Federal Government liquidity assistance. — 2 Including job creation measures. — o From 1999 in euro.

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Outlook for the general government sector as a whole

Aggregate general government sector in 2000 ...

On balance, the aggregate general government sector for 2000 will show a much stronger financial position than it did in 1999, when, according to the provisional calculations provided by the Federal Statistical Office, the deficit ratio, as defined in the national accounts, was equivalent to 1.1 %. This improvement may be attributed primarily to the additional inflow of funds to the Federal Government budget from the auction of mobile-phone licences, which, in keeping with a decision of the Statistical Office of the European Communities, must be booked as receipts in the year they were generated. As a result, the aggregate general government budget for 2000 will probably show a surplus in the national accounts as well. In the absence of licence proceeds, it would have been possible, at this point in time, to detect only a slight improvement at best in comparison with last year.

... and in 2001

Given that the tax reform will result in a corresponding loss of revenue, it seems likely that the trend for 2000, which was decisively influenced by this exceptional revenue source, will again give way to a substantial deficit in 2001. At the present time, the Federal Government expects the deficit ratio to reach 1½ %. By contrast, most of the other EU countries believe that their financial balances will continue to improve. In 2001, Germany is likely to have one of the highest deficit ratios in Europe. This is all the more reason for the general government sector to impose lasting constraints on expenditure which would allow it to attain structurally balanced fiscal positions in line with the objectives laid down in the European Stability and Growth Pact as quickly as possible. With its updated stability programme of January 2000, which was amended to take account of the effects of the tax reform, the Federal Government is endeavouring to reduce the deficit ratio to ½ % by 2003.