Public finance

Central, regional and local authorities

Current trends

Underlying trends

According to the figures currently available, the fiscal position of the central, regional and local authorities deteriorated in the fourth quarter of 2000 compared with the same period in 1999. The budgetary result for 2000 as a whole likewise showed higher year-on-year deficits if the proceeds from the auction of UMTS licences are disregarded. Including those proceeds, which accrued to the Federal Government in the amount of € 50.8 billion, public authorities recorded a significant surplus. While the Federal Government (even net of the UMTS proceeds) and the Länder Governments posted somewhat more positive results, the fiscal balances of the special funds, in particular, and of the local authorities are likely to have deteriorated. On the whole, a strong rise in tax revenue was accompanied by a marked decline in non-tax receipts (such as the Bundesbank profit, loan repayments, and privatisation proceeds). Expenditure seems to have risen only slightly, not least due to the impact of the Retrenchment Package 2000, moderate pay settlements in the public sector, the continued subdued trend in interest payments, and positive labour market developments.

Tax receipts in the fourth quarter ...

In the last quarter of 2000, the public authorities' tax receipts[1] fell by almost 1 % compared with the fourth quarter of 1999, due *inter alia* to a sharp decline in revenue from

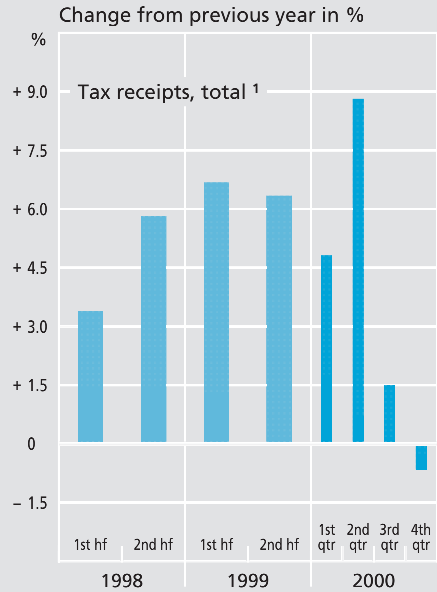
1 Including EU shares in German tax revenue, but excluding receipts from local authority taxes, which are not yet known.

assessed taxes. Assessed income tax yielded 12½ % less than in the same period in 1999, while the year-on-year drop in corporation tax receipts amounted to as much as 15 %. The main reason for this appeared to be that many enterprises had their advance tax payments adjusted downwards at the end of last year. One of the chief reasons for this was presumably that they brought forward investment activities in order to take advantage of the more generous pre-tax reform depreciation facilities. At the same time this enabled them to post lower pre-tax profits for the year 2000, which were still subject to the higher tax rates prevailing before the reform came into effect. Wage tax revenue increased by barely 1 %. Its growth continued to be depressed by the impact of the measures that took effect at the beginning of 2000. The trend in indirect taxes, too, was partly responsible for the fall in revenue at the end of last year. Despite the increase in mineral oil tax rates at the beginning of 2000, receipts fell 3 % short of the corresponding 1999 level. This was due not only to consumers' reactions to the surge in oil prices, but also to payments being deferred until 2001. Turnover tax yielded a moderate rise in receipts (+ 1 %). Its growth was dampened *inter alia* by declining (taxable) housing construction investment.

... and in 2000 as a whole

According to the provisional figures (which include an estimate for local authority taxes), the amount of taxes raised in 2000 as a whole was just over 3 % higher than in the previous year. Owing to the disappointing trend at the end of last year, tax revenue for 2000 fell more than € 3½ billion below the latest official forecast of November. Even so, tax receipts (adjusted for the impact of changes in tax law) exceeded the autumn 1999 estimate, on which budget plans had been largely based, by almost € 4 billion, and they also grew slightly faster than nominal GDP. As a result, the overall tax ratio (as defined in the financial statistics) went up by 0.1 percentage point to around 23 %.

Trends in tax revenue *



* 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.

Deutsche Bundesbank

This rise in receipts relative to the budget figure was mainly due to direct taxes. Non-assessed taxes on earnings (mainly the investment income tax on dividends), in particular, exceeded expectations, yielding almost one-fifth more than in 1999. This was mainly attributable to enterprises' large profit distributions, which may have been partly influenced by the announced tax reform as from the be-

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Change from previous year in %
	Full year		
	1999	2000	
Wage tax	133.8	135.7	+ 1.4
Assessed income tax	10.9	12.2	+ 12.3
Corporation tax	22.4	23.6	+ 5.4
Turnover tax	137.2	140.9	+ 2.7
	of which: 4th quarter		
Wage tax	40.5	40.8	+ 0.8
Assessed income tax	5.6	4.9	– 12.6
Corporation tax	5.8	5.0	– 15.2
Turnover tax	36.0	36.3	+ 1.1

Deutsche Bundesbank

ginning of this year.[2] Although corporation tax receipts were diminished by these larger profit distributions and the increase in enterprises' profits fell far short of the original expectations, growth in revenue from corporation tax, at 5½%, was somewhat greater than anticipated. The main reason for this was that tax receipts relating to previous years rose further. This was the case also for assessed income tax; buoyed in addition by larger advance payments, this tax yielded over 12% more than in 1999. By contrast, wage tax revenue increased by a mere 1½% in the wake of the further cut in the income tax rate at the beginning of 2000 and the renewed rise in child benefit, although it likewise exceeded expectations thanks to the positive trend in employment. Conversely, receipts from turnover tax were well below the projected level, rising by less than 3% compared with 1999 as nominal economic growth turned out to be weaker than originally anticipated. Revenue from mineral oil tax fell short of the expected level by an even larger margin, growing by not quite 4% in consequence of the above-mentioned consumer restraint in response to the rise in crude oil prices and the raising of tax rates. This points to a conflict of aims of the "ecology tax": on the one hand it is intended to steer the use of resources, on the other hand it is relied on as a means of finance.

Federal Government in the fourth quarter ...

The Federal budget showed a deficit of just under € 2 billion in the fourth quarter, compared with a surplus of € 4½ billion in the same period in 1999. This was due mainly to poorer receipts. Tax revenue decreased on the year. However, the drop was caused principally by non-tax receipts, which considerably undershot their corresponding 1999 level, above all because privatisation proceeds had been particularly abundant in the last few months of 1999.

... and in the year as a whole

In 2000 as a whole, the Federal Government recorded a budget deficit of almost € 24 billion, which was € 1½ billion less than anticipated and € 2½ billion smaller than in 1999.[3] Receipts exceeded the budget target by just over € 1 billion. Actual expenditure was almost € ½ billion less than the appropriated figure, thus declining by 1% against 1999. On the one hand, the Federal Government

2 See also the explanations given in Deutsche Bundesbank, Monthly Report, November 2000, page 52.
3 The proceeds from the auction of the UMTS licences were not recorded in the budgetary accounts as receipts but instead were directly allocated to debt redemption.

had to cope with some extraordinary and higher-than-expected expenditure items, in particular indemnification payments to war-time forced and slave labourers, housing allowance, subsidies for heating costs granted in connection with the oil price surge, and a higher grant to the Post Office benefit funds. On the other hand, some items of spending (mainly labour-market related measures, interest payments, and other operating expenditure) turned out to be lower than anticipated. On the whole, the Federal Government made considerable consolidation headway in 2000, not least owing to the effects of its retrenchment programme. The deficit reduction understates the real improvement in the budgetary position if it is borne in mind that, besides incurring some one-off expenditure items, the Federal Government sold off assets to a far smaller extent than in 1999.

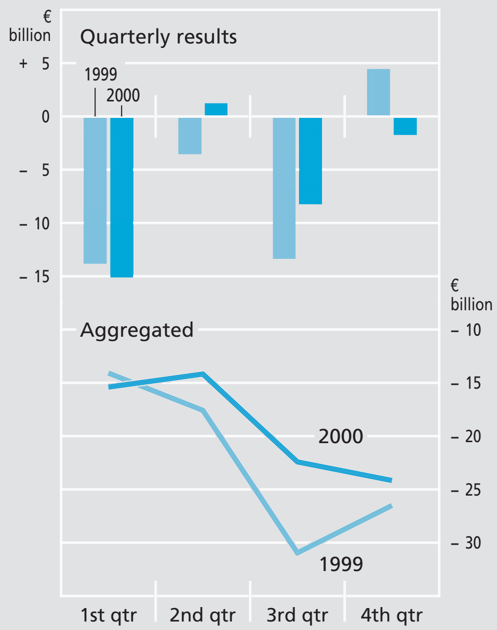
Special funds

The budgetary result of the off-budget special funds last year deteriorated sharply compared with 1999. This was due, firstly, to the € 4½ billion fall in the Bundesbank profit (to not quite € 4 billion), of which any balance in excess of DM 7 billion (€ 3.6 billion) is allocated to the Redemption Fund for Inherited Liabilities. Secondly, the ERP Special Fund generated a deficit amounting to slightly over € 2½ billion, after it had recorded surpluses during the four preceding years or had at least more or less broken even in 1998. The key factor was that loan repayments dropped considerably.

Länder Governments

Full data are not yet available on the fiscal out-turn of the Länder Governments in the fourth quarter. Contrary to the result projected in the budget, the deficits for 2000 as a whole appear to have been smaller than in 1999 (in that year, the deficit amounted to almost € 10 billion). This was due not least to a sharp rise in tax receipts, despite the disappointing performance towards the year-end. Expenditure grew only marginally. This was chiefly attributable to the trend in personnel costs, which account for a large part of the Länder Governments' budgets, thanks mainly to a postponement of most of the rise in civil servants' remuneration.

The Federal Government's financial balances in 1999 and 2000

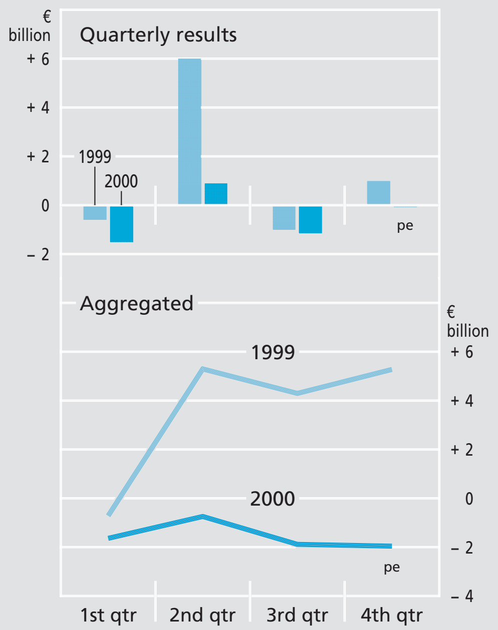


Deutsche Bundesbank

Local authorities

Data on local authorities' budgetary performance are available for the first three quarters only. These figures point towards a slight deterioration in budgetary results for the year as a whole, although it may be assumed that

The special funds' financial balances in 1999 and 2000



Deutsche Bundesbank

the local authorities again recorded a surplus. Receipts look likely to have increased only marginally, mainly owing to a sharp fall in sales of fixed assets. Expenditure was driven by the first sharp rise since 1996 in local authority spending on social welfare benefits. On balance, the municipalities stepped up their capital formation only marginally, with a fairly steep rise in western Germany being largely offset by a sharp drop in the eastern part of the country.

Indebtedness

According to the information available, the central, regional and local authorities' aggregate debt fell by € 4½ billion in the fourth quarter, primarily owing to the fact that part of the proceeds from the auction of UMTS licences went directly towards debt redemption.[4] The public authorities cut their money market debt by € 19 billion, while obtaining funds in the capital market to the tune of not quite € 15 billion, mainly in the form of bonds. In 2000 as a whole, their aggregate debt rose by € 17½ billion, the focus being on the sale of bonds (€ 23 billion). Particularly loans and Federal savings bonds were redeemed on balance. On the whole, the share of long-term debt has increased somewhat.

Budget plans for 2001

Increasing deficits in the wake of the tax reform

In 2001, the large revenue losses resulting from the tax reform (amounting to an estimated € 23 billion, or just over 1 % of GDP)[5] look likely to lead to a marked decrease in tax receipts. Forecasts based on the official tax estimate of November had pointed towards a decline in total tax receipts in 2001 by slightly more than 2 %. As tax revenue in the base year 2000 turned out to be lower than estimated at the time, actual tax receipts in 2001 might likewise be lower than the forecast figures. Although it may be expected that the central, regional and local authorities will seek to offset the likely decrease in tax revenue through expenditure restraint and substantial asset sales, their deficits will probably increase significantly vis-à-vis last year.

4 These transactions were not recorded in the budgetary accounts. Therefore, the borrowing requirement deviates sharply from the recorded deficits in the fourth quarter. It was not until January that the bulk of the UMTS proceeds was used for redeeming debt of the Currency Conversion Equalisation Fund.
5 For details see Deutsche Bundesbank, Monthly Report, August 2000 (page 54 ff.) and November 2000 (page 54).

Federal Government

The Federal budget for 2001 approved by Parliament envisages a deficit amounting to € 22½ billion, whereas the original budget plan drawn up by the Federal Government[6] had anticipated a deficit of € 23½ billion. This lower sum is mainly attributable to cutbacks in Federal grants to other levels of government. In addition, the Federal Government will take advantage of the savings in interest payments following debt redemption made possible by the UMTS proceeds in order to step up investment spending. The Federal Government's intention to reduce the Federal budget deficit further this year despite substantial tax shortfalls is a welcome signal. However, this can only be achieved by resorting to substantial asset sales, which means that there will be considerably greater need for structural consolidation in the Federal budget than last year.

Länder Governments

The Länder Governments' budgets will be squeezed hard in 2001 by tax reform-induced falls in receipts amounting to almost € 10 billion. Many regional authorities will have to struggle to stay within their statutory limits for new borrowing. They will be helped by the fact that the grants from west German Länder Governments (like those from the Federal Government and western local authorities) to the "German Unity" Fund will be smaller than envisaged in the original draft budget, which will lead to a correspondingly slower debt reduction of that special fund. Furthermore, many Länder Governments had taken the precaution of building up reserves from the unexpectedly large tax receipts in the past few years, which they will now release in order to limit new borrowing. Yet this will enable them to counteract the pressure to cut expenditure, which will increase in the medium term, *inter alia* in connection with further tax cuts, only in the short run. The fiscal deficits, which remain unaffected by the transfers of reserves, will rise sharply this year, thus highlighting the need for action.

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

€ billion

Period	Total	of which: Securities	of which: Loans against borrowers' notes 1	Memo item Acquisition of public debt instruments by non-residents
1999	+ 34.8	+ 44.8	– 9.7	+ 16.2
of which				
1st qtr	+ 12.7	+ 14.7	– 2.0	+ 0.7
2nd qtr	+ 2.9	+ 2.9	+ 0.0	+ 1.2
3rd qtr	+ 10.1	+ 15.2	– 5.0	+ 11.3
4th qtr	+ 9.1	+ 11.9	– 2.7	+ 3.0
2000 pe	+ 17.4	+ 29.1	– 10.5	...
of which				
1st qtr	+ 14.0	+ 7.5	+ 6.5	+ 0.3
2nd qtr	– 1.3	+ 3.8	– 5.1	+ 12.4
3rd qtr	+ 9.1	+ 4.8	+ 5.4	+ 7.5
4th qtr pe	– 4.3	+ 13.1	– 17.3	...

1 Including cash advances and money market borrowing.

Deutsche Bundesbank

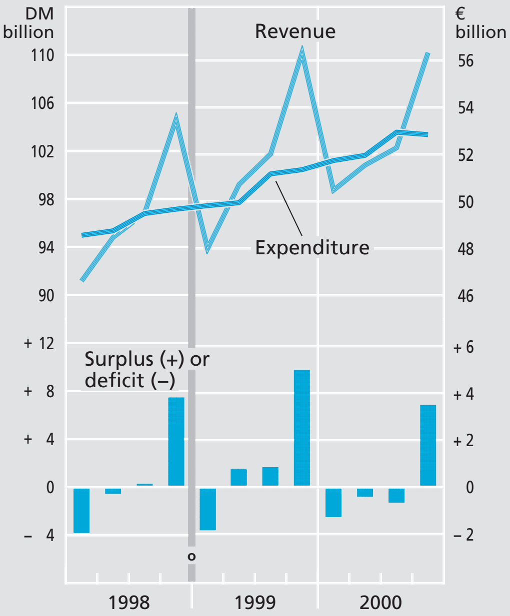
Local authorities

The local authorities will be affected by the tax reform indirectly as well as directly, as they share tax receipts with the Länder Governments under mutual tax-sharing arrangements. On balance, their expenditure is likely to increase only slightly this year, even though they anticipate a renewed acceleration in the rise of spending on social welfare benefits. All in all, however, the shortfalls in receipts will

6 For details see Deutsche Bundesbank, Monthly Report, August 2000, page 61.

Wage and salary earners' pension insurance scheme

Quarterly



o From 1999 in euro.

Deutsche Bundesbank

probably push the local authorities into deficit this year.

Social security funds

Statutory pension insurance scheme in the fourth quarter ...

In the fourth quarter of 2000 the statutory pension insurance scheme recorded a surplus – which is usual for the final quarter – of € 3½ billion; this was distinctly smaller than the surplus of € 5 billion generated in the same period in 1999. Contribution receipts were pushed down by the lowering of the contribution rate on January 1, 2000 from 19.5% to 19.3% and the reduction of pension contributions paid out of the Federal budget on behalf of recipients of unemployment assistance in the wake of the Retrenchment Package 2000. As a result, fourth-quarter receipts did not quite match the corresponding prior-year figure. Expenditure on pensions rose by just over 2½%; this was caused mainly by an increase in the number of pension recipients and only to a lesser extent by the 0.6% increase in pensions from July 1, 2000.

... and in 2000 as a whole

In the year 2000 as a whole the wage and salary earners' pension insurance scheme recorded a surplus of € 1 billion. This fell € 4 billion short of the 1999 result. However, as the fluctuation reserves had reached their statutory minimum level of one month's expenditure already at the end of 1999, this relatively small positive balance sufficed to adjust the reserves of the statutory pension insurance institutions to the growing expenditure.

Outlook for 2001

On January 1, 2001 the contribution rate was cut by a further 0.2 percentage point to 19.1%. This was made possible partly by the positive prospects on the employment front but more especially by a further increase in the Federal grants out of revenue from the "ecology tax".[7] On the expenditure side, by contrast, significant additional costs will be incurred from the middle of the year from the annual adjustment of pension rates. As things stand at the moment, that will probably amount to 2.1% based on the assumption of

7 A capital gain also accrues from the fact that the upward revaluation of the shares held by the Federal Insurance Office for Salaried Employees (BfA) in the non-profit public limited company for employee housing "Gemeinnützige Aktiengesellschaft für Angestelltenheimstätten" (GAGFAH) amounting to around € ½ billion is to be booked as regular income.

a rise of 1.6 % in average gross wages and salaries.[8]

Pension reform concept

The Federal Government's pension reform concept has passed its third reading in the *Bundestag* (lower house of parliament) and, following the rejection of parts of the bill by the *Bundesrat* (upper house of parliament), will now be dealt with by the Mediation Committee. Amendments were made on some important points compared with the version of the bill presented in November 2000. In particular, the "compensation factor", which initially was to have applied only to new pensions from 2011, has been replaced by a pension formula under which the pension increases of all pensioners will be a little smaller.[9] In the long term this modification implies an increase in the pension level of 3 percentage points and higher contribution rates under the pay-as-you-go system; this would increase the burden to be shouldered by future generations somewhat compared with the original reform concept (see box on page 56). Nevertheless, the reform as a whole represents an important step towards a more strongly mixed system of old age provision.

Federal Labour Office in the fourth quarter ...

In the fourth quarter of 2000 the Federal Labour Office recorded a slight surplus compared with a break-even position in the same quarter in 1999. Whereas receipts grew by just under 3 %, expenditure rose by almost 2 %. Spending on unemployment benefits was merely 1½ % less than during the same period in 1999, which substantially lessened the year-on-year decrease. This was chiefly due to the implementation of a ruling by the Federal Constitutional Court, which stipulates that contributions made on one-off bonus payments are to be taken into account when calculating wage substitutes. Almost 5 % more was spent on active labour market policy measures, within which there was a further shift away from job creation schemes (– 7 %) and towards vocational training and retraining (+ 9 %).

... and in 2000 as a whole

In the year 2000 as a whole the Federal Labour Office budget recorded a deficit of almost € 1 billion, which was a considerable improvement on 1999 (deficit of € 3½ billion). The size of the Federal grant required to plug the gap was likewise – as expected – far smaller than the almost € 4 billion earmarked in the budget. A rise in receipts by 3½ % was accompanied by a 2½ % fall in expenditure. Spending on unemployment benefits dropped by 5 %, while expenditure on active labour market policy measures contracted by 1 %.

Outlook for 2001

The Federal Labour Office budget for 2001 puts the topping-up grant required from the Federal Government at just over € ½ billion. Besides a further sharp rise in revenue (+ 3 % compared with the actual out-turn for 2000), an increase in expenditure is also expected (+ 2½ %). That appears realistic as the effects of the aforementioned Federal Constitutional

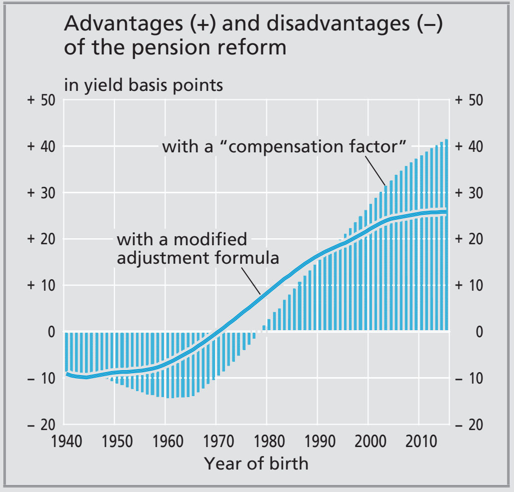
8 According to the new pension adjustment formula, the adjustment in 2001 will be based solely on the change in average gross wages and salaries (less the contributions paid into the statutory pension insurance scheme) in 2000 compared with the previous year.
9 This will be achieved by stipulating that an increase in the contribution rate to the statutory pension insurance scheme from 2011 reduces the adjustment more sharply than before.

Changes in the pension reform concept and their impact on the pension "yield"

The pension reform concept approved by the *Bundestag* (lower house of parliament) at the end of January contains several major changes vis-à-vis the original "Bill promoting private pension plans";[1] these include the abandonment of the "compensation factor", which would have placed an increasing burden on new retirees from 2011. Instead, the Federal Government now plans to introduce a modified wages-based pension adjustment formula, according to which increases in the contribution rate to the statutory pension insurance scheme will lead to smaller pension adjustments than envisaged in the original reform concept. In technical terms this will be achieved by basing pension adjustments not, as before, on the rate of change in the full amount of average gross wages and salaries but only 90 % of that amount – in each case less the contribution paid into the statutory pension insurance scheme and a notional percentage paid into a supplementary private pension plan. This approach will spread the burden over old pensions as well as new pensions, thus lessening the planned reductions in benefits paid to new retirees while simultaneously maintaining in full the envisaged downward effect on contribution rates. However, this amendment of the original concept is expected to push up the net standard pension level by roughly 3 percentage points in the long term, i.e. beyond the year 2030. As under the original reform scenario, the contribution rate to the statutory pension scheme should not exceed 22 % up to 2030. Thereafter, however, the contribution rate may now be expected to rise further. By contrast, the projections under the original concept (with its "compensation factor") envisaged keeping contribution rates stable after 2030, too, as its stronger dampening effect on expenditure would have been sustained until all pensions would have been subject to the full impact of the limitation of statutory benefits effective for new retirees in 2030.

The intergenerational effects of the amendment of the pension reform concept were again computed using simplified model calculations of real yields to be expected by a "model" insured person (an average earner who pays contributions over 45 years and receives a pension for 15 years; surviving dependants' pensions have been disregarded). This calculation shows that the new reform concept, too, will result in lower yields for older generations, whereas future generations will receive a higher yield than under the no-reform scenario (and excluding the "demographic factor"). However, a comparison between the "compensation factor" and the modified pension adjustment formula shows that future generations will benefit less under the new reform concept, while the burden to be borne by the older generations will be reduced. Moreover, there are some shifts between individual age cohorts.

The "compensation factor" would have posed a burden especially on individuals retiring from 2011 onwards, i. e. those borne around 1945 and after. That specific burden has now been eliminated and replaced by a gradual reduction in the general pension level, which will leave the total yield to be expected by older generations virtually unaffected. Middle age groups will benefit from smaller benefit cuts than under the "compensation factor". Their yield will not decline quite so rapidly, or, in the case of those born around 1970 and after, will even increase compared with the previous reform scenario. In the long term, however, future generations of pensioners will be burdened by the fact that the benefit level to be financed under the pay-as-you-go statutory pension scheme will be roughly 3 percentage points higher than originally planned. Hence these generations will have less leeway for additional old-age provision under a private pension plan (which is assumed to be higher-yielding), so that their overall yield will be lower in the long run.



Other key amendments to the original bill relate to: a uniform special deduction facility for all tax payers of up to 4 % of the general income ceiling for social security contributions (instead of 4 % of the actual income on which each individual pays contributions) for payments made into a private pension plan; surviving dependants' pensions (child-related allowances will continue to be raised in line with pensions); in the case of married couples, the option to split pension entitlements (to be granted only if each spouse has accumulated pension entitlements over 25 years at least); and technical measures to facilitate legislation, in particular, to regulate minimum pensions and the promotion and certification of private pension plans in seperate laws.

In the field of company pension schemes, "defined contribution plans" have been introduced as an additional option. Furthermore, "pension funds" are explicitly mentioned as a new external medium of accumulation. The precise provisions governing investments under private pension plans and the calculation of the required premium reserve will be regulated directly by the Federal Government or the Federal Ministry of Finance. Also, the exemption from social security contributions of employee contributions to company pension schemes will cease at the end of 2008. That does not apply to employee entitlements arising from employer contributions.

1 See Deutsche Bundesbank, Monthly Report, November 2000, page 59.

Deutsche Bundesbank

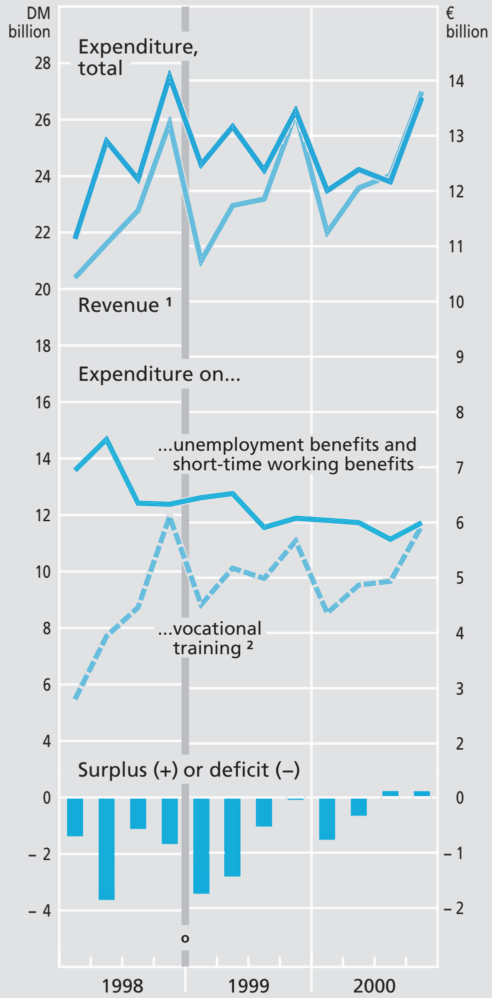
Court ruling will continue to make themselves felt in a further growth in spending in the first half of 2001. In addition, the Federal Government has transferred to the Federal Labour Office the burden of financing the structural adjustment measures and the programme for reintegrating the long-term unemployed, which were previously funded by the Federal Government. For the rest, the budget is based on the assumption that labour market conditions will ease further.[10]

Statutory health insurance funds

Last year the statutory health insurance funds probably just managed to avoid running up a deficit, even though the average contribution rate was largely held steady. For the current year, however, various financial risks are apparent which will again increase the pressure to raise contribution rates. For example, the Federal Constitutional Court's ruling on contributions made on one-off payments is likely to lead to higher sickness benefits, too. Moreover, the contributions from the Federal budget to the health insurance funds on behalf of recipients of unemployment assistance have now likewise been reduced.[11]

Federal Labour Office

Quarterly



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

Deutsche Bundesbank

Outlook for the general government sector as a whole

Provisional national accounts result for 2000

In January the Federal Statistical Office submitted initial national accounts results for the year 2000, although a large portion of the figures for the fourth quarter are estimated. For the general government sector those provisional results indicate a deficit amounting to 1.2 % of GDP,[12] compared with 1.4 % in 1999. In contrast to the position as defined in the budgetary accounts, the deficit has fallen because privatisation proceeds and loan re-

10 Last year the number of unemployed fell by 210,000 on an annual average and this year the figure is expected to decrease by a further 270,000.
11 Previously contributions to the health insurance funds on behalf of recipients of unemployment assistance were calculated on the basis of 80 % of their last gross pay. As from the start of 2001, this percentage was lowered to 58 %.
12 The proceeds of the UMTS auction are not included. Inclusion of this income, which in the official national accounts is recorded negatively on the expenditure side (acquisitions less disposals of non-financial non-produced assets), yields a surplus of 1.3 % of GDP.

payments are not counted as receipts in the national accounts, with the result that their decrease in 2000 did not have a deficit-widening effect. Expenditure rose by 2 %. Whereas personnel costs and interest charges were more or less unchanged and labour market-related spending went down, expenditure on old age pensions, in particular, increased at a faster-than-average pace, mainly due to a sharp increase in new pensions. The indemnification payments to forced and slave labourers dating back to the pre-1945 era also had an impact. The general government spending ratio fell by 0.3 percentage point on balance to 48.7 %. Revenue rose by just under 2 ½ %. While tax receipts grew at a distinctly faster rate, the income from social security contributions expanded only moderately, mainly on account of the lowering of the contribution rate to the statutory pension insurance scheme. The substantial decline in the Bundesbank profit likewise depressed overall revenue.

All in all, the underlying position of German public finance seems to have improved somewhat in 2000 compared with 1999. Although the decline in the deficit ratio was principally attributable to the favourable macroeconomic setting last year, it should also be remembered that the indemnification payments to wartime forced and slave labourers incurred in 2000 were a one-off expense. Moreover, the 1999 result had been boosted by temporarily high surpluses accruing to the statutory pension insurance scheme (necessitated by the legal requirement to replenish the fluctuation reserves).

Outlook for 2001

In 2001 the government deficit ratio will widen considerably because the substantial revenue losses ensuing from the tax reform will not be offset by expenditure savings. From the present perspective the deficit might exceed 1 ½ % of GDP; a key role will be played not least by the trend in tax receipts, which was rather unfavourable at the end of last year.

Medium and long-term fiscal policy objectives

Following the increase this year caused by the tax reform, the deficit ratio is to be reduced progressively in the coming years. After the Federal Government had set out its medium-term fiscal policy objectives in October last year with its updated stability programme,[13] the Federal Ministry of Finance presented its long-term fiscal policy strategy in November in the form of some "Guiding Principles of Fiscal Policy"[14] (for details see box on page 59). In particular, the Guiding Principles emphasise the need to maintain the consolidation efforts. The first objective is to reduce the government debt, which is imperative given the crushing burden of interest payments but also the burden arising from demographic changes. The second objective is to create scope subsequently to cut the taxes and social security ratio, which is still too high, with a view to improving the overall prospects for growth.

A dependable fiscal policy framework is an important national competitve advantage

The basic orientation of German fiscal policy outlined in the programme is in keeping with the financial and macroeconomic require-

13 For details see Deutsche Bundesbank, Monthly Report, November 2000, page 61f.
14 Federal Ministry of Finance, Guiding Principles of Fiscal Policy – Seven pointers for future-oriented, equitable fiscal policy in a European context, Economic and Financial Reports, 2000.

The "Guiding Principles of Fiscal Policy" of the Federal Ministry of Finance

The "Guiding Principles" published by the Federal Ministry of Finance in November 2000 are intended to set a dependable orientation framework for future fiscal policy decisions, extending beyond the medium-term horizon of the stability programme. They have two main objectives:

- "Reduce debt for sustainable public finances and greater equity between the generations";
- "Promote growth and employment by a sustainable and equitable system of taxes and fiscal charges".

Action guidelines have been drawn up for the main fiscal policy areas, some of which are based on existing binding provisions (such as the European Stability and Growth Pact and Article 115 of the German Constitution). They include the following:

- Government activity is to be regularly reviewed and where necessary restructured; the potential for privatisation is to be systematically exploited and the linear staff-cuts of 1.5 % a year in central government are to be implemented.
- A balanced Federal budget is to be submitted in 2006. Subsequently surpluses are to be generated in order to reduce government debt. Surpluses (amounting to 1 % of GDP) are likewise to be generated by general government in times of normal cyclical activity and used for debt redemption.
- More stringent criteria than in the past are to be applied to any borrowing to finance public investment. Loans are to be redeemed within the lifetime of the assets financed.
- In the Financial Planning Council the Federal Government will call for the locking-in of an expenditure growth ceiling of 2 % until general government surpluses have been attained.
- Spending on physical and human capital is to play a greater role within the overall expenditure framework.
- The reduction of subsidies is to be accelerated and any new assistance is to be granted for a limited period only and at diminishing rates.
- The social benefits system is to be reviewed in the light of the employment target, and decisive action is to be taken to counter fraudulent claims.
- Once the tax reform has been implemented and general government surpluses have been attained, the resulting greater scope for fiscal policy action is to be used in part to further cut taxes and social levies. In addition, tax law is to be streamlined.
- The system of vertical and horizontal financial transfers between the different levels of government, while maintaining the principle of solidarity between richer and poorer regions, is to foster adequate financial self-responsibility on the part of each individual authority.
- Coordination between the various levels of government is to be improved, particularly with a view to complying with obligations at the EU level.

These Guiding Principles are fundamentally suited to giving fiscal policy a clear basic orientation and to stabilising expectations in respect of a dependable and sustainable fiscal policy. However, the details of the budgetary and tax policy measures will have to be spelled out by fiscal policy makers in the future. The credibility of the long-term objectives also depends on meeting the short and medium-term targets. Since medium-term financial plans were first inaugurated in the 1960s, the set targets have been frequently missed at all budgetary levels, especially in the last few planning years, as fiscal policy makers failed to implement the consolidation aims announced in the plans. In the light of these past problems, it is desirable to anchor the proposed rules in an institutional form.

Deutsche Bundesbank

ments and therefore deserves support. The medium and longer-term fiscal policy framework and the public confidence that it can engender in the government's scope for action are a key criterion determining the private sector's future investment and consumption decisions. The long-term sustainability of public finance should be gauged especially by the future outlook for government debt and the burden of taxes and social security contributions. In view of the present level of government debt and the burden of taxes and social security contributions as well as the demographic problems in this country, it is crucial for fiscal policy makers to give a clear and timely signal that they are taking measures to deal with the problems.

Implementation is key fiscal policy task

The key requirement now is to underpin the fiscal policy objectives through concrete measures. An important start has been made towards this end with the retrenchment package and the tax reform. Nevertheless, the aspired goals continue to require a rigorous review of government activity and a persistent check on government spending. Public confidence in the long-term fiscal policy strategy will be fostered only if the government's short and medium-term financial plans are upheld. In this process care must be taken to defend the basic orientation of fiscal policy against the vested interests of individual groups or sections of the population.