# Public finance

## Central, regional and local authorities

*Third quarter*

In the third quarter of 2001, the central and regional authorities (the figures for the local authorities are not yet known) recorded a deficit of € 9½ billion. This was € 1 billion lower than during the same period last year (excluding UMTS proceeds). The individual levels of government developed very differently. While the deficit of the Federal Government decreased by € 4 billion, particularly in connection with substantial privatisation proceeds, the deficit of the Länder Governments rose by € 4½ billion. The main reasons for this were the steep drop in tax receipts and the fact that the large capital injection provided to Bankgesellschaft Berlin had an impact on the budgetary position. The off-budget special funds were € 1½ billion up on the figure for the same period last year.

*2001 as a whole*

The final budget positions of the central, regional and local authorities for 2001 will be considerably less favourable than at the end of last year, when the aggregate deficit reached € 34 billion. This is mainly due to the tax cuts which came into force at the beginning of the year, whereas the additional burdens resulting from the general economic slowdown should be fairly limited, judging from the present perspective. Revenue will decrease overall, although non-tax receipts – above all privatisation proceeds and the profit transferred by the Bundesbank – will be significantly higher than in 2000. The very large non-tax receipts should therefore lead to an improved budget position for the Federal Government and the special funds compared with 2000. The financial balances of the Länder Governments and the local authorities will deteriorate considerably, however.

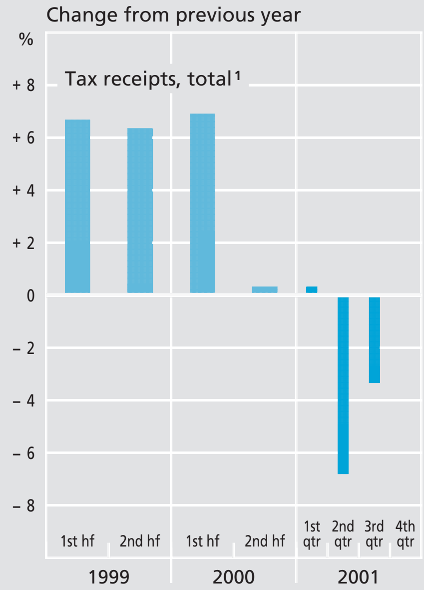
*Outlook*

Next year, tax revenue will increase again while non-tax receipts should decrease and total revenue growth will be muted. In order to achieve a perceptible reduction in the high government budgetary deficit, expenditure growth, as things now stand, needs to be kept below 1%.

*Tax receipts in the third quarter ...*

Tax receipts[1] of the central, regional and local authorities fell by a further 3.3 % in the third quarter in comparison with last year. This was due not only to the tax shortfalls resulting from the tax reform but also to the economic slowdown. In the case of income taxes, wage tax – following the income tax rate cut introduced at the start of 2001 – yielded 4.5 % less than in the same period last year. Revenue from assessed income tax also decreased further (– 3.5 %) in the wake of the tax rate cut. However, tax prepayments were reduced less than expected, apparently because entrepreneurs have made only limited use so far of the new facility to partly offset trade tax against their income tax liability at the tax prepayment stage. A sharp drop in receipts was recorded for corporation tax; in the third quarter outflows in the form of refunds outweighed inflows for the first time in a long while (– € 0.6 billion). This represents a year-on-year decrease of € 5.5 billion. Besides the substantial cut in tax rates, the downward trend in corporate profits also played a role in this. In addition, corporation tax receipts continued to be reduced considerably by the disbursement of profits retained

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.

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in earlier years (under the "EK 45" tax rule), evidently as a reaction by many enterprises to the cancellation of the lower corporation tax distribution rate at the turn of 2001/02. On the other hand, these special profit distributions led to another sharp increase in revenue from non-assessed taxes on earnings (by € 1.8 billion or 47 %).

Among the indirect taxes, turnover tax receipts increased by only 0.9 %. They were depressed by the general economic slowdown as well as a further fall in taxable public and housing investment. By contrast, mineral oil tax yielded a growth of 6.8 % owing to the

**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 to 3rd quarter 2000 | 2001 | Change from previous year in % |
|---|---|---|---|
| Wage tax | 94.9 | 93.7 | – 1.3 |
| Assessed income tax | 7.3 | 4.1 | – 44.0 |
| Corporation tax | 18.6 | 1.5 | – 92.1 |
| Turnover tax | 104.5 | 103.3 | – 1.2 |
| | of which: 3rd quarter | | |
| Wage tax | 33.0 | 31.5 | – 4.5 |
| Assessed income tax | 3.4 | 3.2 | – 3.5 |
| Corporation tax | 4.9 | – 0.6 | . |
| Turnover tax | 34.2 | 34.5 | + 0.9 |

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further tax rate increase which came into effect at the beginning of the year.

*... and in 2001 as a whole*

On account of the economic slowdown, tax revenue for the whole year will be less than was expected in the spring.[2] According to the new official tax estimate, tax receipts will decrease by 3.9 % compared with last year; this would imply € 6.6 billion less than predicted in the May forecast. Particularly due to the large revenue shortfalls related to the tax reform, the overall tax ratio will decline substantially this year by 1.4 percentage points to 21.7 % – as defined in the government financial statistics.

The expected revenue shortfalls vis-à-vis the spring forecast primarily concern turnover tax, corporation tax and trade tax. They will be offset to some extent by additional receipts from non-assessed taxes on earnings. In addition, wage tax and assessed income tax also look likely to show a more favourable out-turn than was expected in spring. This is partly related to a somewhat stronger growth of average actual earnings and to the fact that – contrary to original expectations – the partial offsetting of trade tax against income tax liability will only reduce income tax receipts after 2001.

*Tax receipts in 2002*

Next year the tax shortfalls will increase considerably compared with earlier expectations as a result of the slackening economy. The new official tax estimate predicts that tax revenue – adjusted for the changes in tax legislation – will be € 9.8 billion smaller than the figure estimated in May 2001.[3] In contrast to 2001, however, tax revenue will rise significantly in a year-on-year comparison. Including the expected additional receipts from raising the taxes on tobacco and insurance as well as the measures to combat turnover tax fraud, tax revenue will increase by almost 4 % based on the new official estimate. Lifted also by the effects of income tax progression, tax revenue should therefore grow by roughly 1 percentage point more than nominal GDP so that the overall tax ratio will increase by 0.2 percentage point to 21.9 %.

*Federal Government*

The Federal Government recorded a deficit of € 4 billion between July and September 2001,

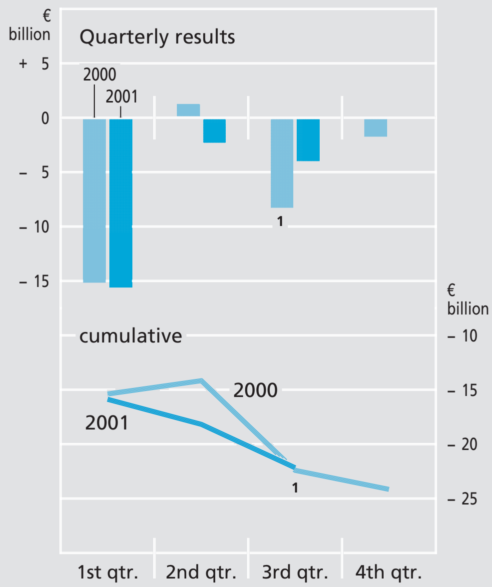
2 Whereas economic growth of 3½ % in nominal terms and 2 % in real terms was expected in spring, the new official tax estimate envisages nominal GDP growth in 2001 of 2 % and real GDP growth of ¾ %.
3 Nominal economic growth is now put at about 3 %, 1 percentage point lower than before.

compared with a budget gap of € 8 billion in the same period last year. The reason for this improvement was the buoyant growth in revenue (6½%). Although tax receipts decreased by 1½%, non-tax revenue doubled to € 9 billion because, in contrast to last year, substantial proceeds from asset disposals were booked in the government's budget accounts. Expenditure decreased by 0.8%. The Federal Government's budget for this year predicts a deficit reduction of € 1½ billion to € 22½ billion. From the present perspective this target seems attainable. It seems likely that additional burdens, especially with respect to tax revenue and labour market-related expenditure, will be offset through favourable trends in other areas (especially transfers to the EU, interest payments, guarantees and non-tax receipts). Next year the Federal Government's net borrowing – according to the recently concluded deliberations of the budget committee – should be somewhat lower than the corresponding total budgeted for 2001. The figure which was already included in the draft budget for 2002 therefore remains unchanged.[4] The revenue shortfalls resulting from the revised tax estimate plus the additional burdens arising from labour market-related expenditure are to be compensated not least by additional privatisation proceeds. The Federal Government's decision not to incur additional debt despite the worsening cyclical position is a positive fiscal sign. However, the expedient of selling public assets will not improve the underlying budgetary position.

*Special funds*

The special funds broke even in the third quarter of 2001, following a deficit of € 1 billion in the third quarter of last year. A large surplus is expected for the year as a whole, after a deficit of € 1½ billion in 2000. The reason for this is that any surplus of the Bundesbank profit exceeding € 3.6 billion (DM 7 billion) is allocated to paying off the debt of the Redemption Fund for Inherited Liabilities. This year the income share from the Bundesbank's profit increased sharply from € ½ billion to almost € 5 billion.

The Federal Government's financial balance in 2000 and 2001




**1** Excluding UMTS proceeds.

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*Länder Governments*

The deficits in the Länder Government budgets showed a further sharp rise in the third quarter. They increased to € 5.6 billion, a deterioration over twelve months of € 4.5

**4** Given a somewhat higher deficit than in the draft budget, this is to be achieved by increasing the estimated income from coin seigniorage – which reduces net borrowing but not the deficit.

## Financial situation of Berlin

In order to overcome the crisis of Bankgesellschaft Berlin, the Land Government of Berlin (as the majority shareholder) approved a supplementary budget for 2001. This includes an increased authorisation for € 3 billion of new borrowing in order, firstly, to facilitate the capital injection needed to ensure the bank's continued existence and, secondly, offset privatisation proceeds foregone because of the crisis. As a result, Berlin's estimated new net borrowing requirement (amounting to almost € 5 billion) exceeds by almost € 1 billion the gross capital formation volume (even without deducting the received investment grants of € 1¼ billion, which in the opinion of the other Länder Governments and of the Federal Government should be deducted from the overall volume of gross capital formation) stipulated in the Land Constitution as the ceiling for new borrowing. Ever since the decrease in the special financial assistance measures to the western part of the city at the beginning of the nineties, Berlin, owing to its very high level of expenditure, has had an extraordinarily large deficit which is being run down very slowly. During the current year this financing shortfall has widened further, mainly as a result of the Bankgesellschaft crisis and the tax reform. Even before the most recent tax estimate, the Senate (Berlin's governing body) also assumed, in the light of the halting inflow of the other budgeted privatisation proceeds, that despite the sharply increased borrowing authorisation, there will be a shortfall of € 1¾ billion. Under budgetary law, this amount must be covered in 2003, which is thus under a heavy strain in advance. Berlin must therefore urgently redress its budgetary position, especially by critically reviewing expenditure in search of potential savings. Other Länder Governments are likewise currently managing to keep below the statutory ceiling for new borrowing only by resorting to special measures, such as the liquidation of reserves. They, too, face considerable consolidation requirements.

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billion. Tax receipts contracted by 5 %, while total revenue decreased by 3 %. Expenditure increased sharply by 4 ½ %. However, this increase was mainly attributable to the cost incurred by the Berlin Land Government in connection with the capital increase at Bankgesellschaft Berlin (see adjacent box). In 2001 as a whole the deficits will be significantly higher than last year's figure of over € 10 billion. In view of the looming tax shortfalls and extraordinary burdens, above all in Berlin, they will distinctly exceed the original planned level of € 18 billion. The task of reducing the deficits will be hampered in 2002 by the forecast declines in tax revenue, by the increased recruitment of teachers announced by most Länder Governments and by the additional expenditure on strengthening national security in the wake of the terrorist attacks in the United States.

*Local authorities*

The figures for the local authorities' fiscal out-turn for the third quarter are not yet known. However, a marked worsening of the financial situation was already evident after the first six months, when the running deficit had reached € 2.8 billion (after € 0.9 billion at the half-way stage in 2000). This was chiefly due to a fall in tax revenue which led to a reduction of 1.2 % in overall revenue. At the same time expenditure rose by 1.5 % in total, despite lower capital formation (– 2.3 %). As the year continues, the deficit accumulated during the first six months could increase further. Thus initial survey results for the third quarter point to a further accelerated decrease in trade tax receipts. Moreover, the sharp fall in the Länder Governments' tax revenue is likely to prompt them soon to cut their important grants to the local authorities.

*Indebtedness*

The indebtedness of the central and regional authorities increased sharply in the third quarter, expanding by € 16.3 billion. Much of this increase was attributable to the Federal Government, whose net borrowing rose by € 6.8 billion. The Federal Government raised € 38 billion gross on the capital market while concurrently redeeming € 33.5 billion. There were net increases in the outstanding volume of Treasury notes (+ € 4.6 billion), *Bubills* (+ € 4.3 billion) and notably Federal bonds *(Bunds)* (+ € 2.7 billion). By contrast, net redemptions were recorded for *Bobls,* in particular (– € 2.9 billion). The indebtedness of the Länder Governments registered an exceptionally sharp increase of € 8.8 billion. They covered their credit requirements predominantly by issuing Treasury notes. The indebtedness of the special funds and the local authorities probably increased only marginally.

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

€ billion

| Period | Total | of which Securities [1] | of which Loans against borrowers' notes [2] | Memo item Acquisition by non-residents |
|---|---|---|---|---|
| 2000 | + 16.1 | + 29.1 | – 11.8 | + 21.2 |
| of which | | | | |
| 1st qtr | + 14.0 | + 7.5 | + 6.5 | – 1.0 |
| 2nd qtr | – 1.3 | + 3.8 | – 5.1 | + 14.6 |
| 3rd qtr | + 9.1 | + 4.8 | + 5.4 | + 8.6 |
| 4th qtr | – 5.7 | + 13.1 | – 18.6 | – 1.0 |
| 2001 | | | | |
| 1st qtr | – 10.4 | + 13.9 | + 9.7 | – 12.2 |
| 2nd qtr | – 6.1 | + 7.5 | – 13.7 | – 0.3 |
| 3rd qtr pe | + 16.3 | + 18.5 | – 1.1 | ... |

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

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## Social security funds

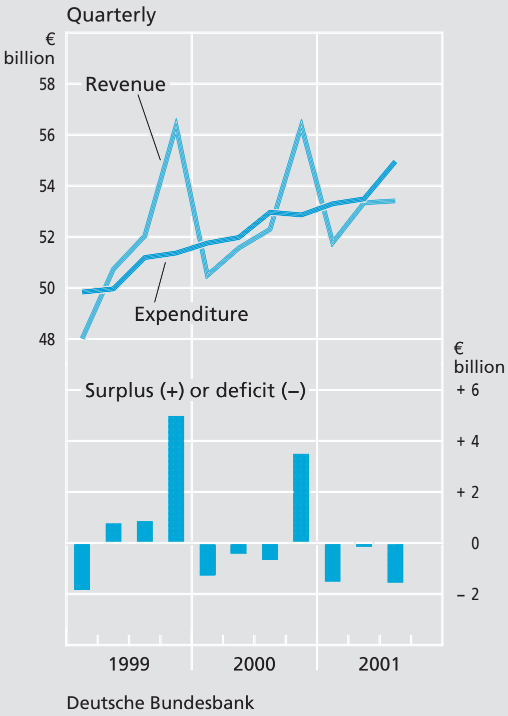
*Statutory pension insurance scheme*

In the third quarter of 2001, the wage and salary earners' pension insurance scheme recorded a deficit of € 1.5 billion. This was € 0.9 billion higher than last year's corresponding figure, although there had been no increase at the six-month stage. Total revenue from July to September exceeded last year's figure by 2.1%, with contribution receipts going up only marginally by 0.4 % (following 1.5 % in the first two quarters). By contrast, the grants from the Federal budget increased at the much faster rate of 6.7 %. Expenditure has increased at an accelerated pace since the middle of the year, primarily due to the relatively sharp rise in pensions on 1 July. The mid-year rise in pensions in 2000 had been limited to the rate of inflation (0.6 %). Based on a new adjustment formula, pensions were raised this year by 1.9 % in western Germany and 2.1 % in eastern Germany. The number of pensions also rose further. By contrast, expenditure was held down by the growing impact of pension cuts for persons taking early retirement. Total expenditure on pensions in the third quarter exceeded the figure for the same period of last year by 3.8 % (after 2.7 % in the first half of the year).

*Trend in reserves*

In 2001 as a whole, the statutory pension insurance scheme will probably close with a deficit, whereas it recorded a small surplus in

Wage and salary earners' pension insurance scheme




2000. Consequently, the fluctuation reserves at the end of December will not quite reach the prescribed statutory level of one month's expenditure. Next year, the current contribution rate of 19.1% would have to be raised in order to meet the minimum fluctuation reserves (particularly on account of the probable weak trend in contribution receipts). In order to avoid such a step in the current downturn, this reserve requirement is to be reduced to 0.8 month's expenditure. The resources released by this measure are to be used to plug the financial gap that will occur if the contribution rate is maintained at its present rate, which will give rise to a deficit next year. Avoiding a contribution rate increase in 2002, however, will mean that the pension increase in the following year will be somewhat larger, which in turn, *ceteris paribus,* will result in a somewhat heavier contribution burden.

*Federal Labour Office*

In the third quarter of 2001, as last year, the Federal Labour Office achieved a surplus of € 0.1 billion. While total expenditure increased by 2.7 %, revenue rose by 2.9 %. This favourable revenue trend was influenced, however, by exceptional factors, above all higher payments from the European Social Fund.[5] By contrast, the increase in contribution receipts continued to slow down and averaged only 1.2 % in the third quarter. Moreover, as from the start of this year the Federal Government no longer reimburses the costs of the structural adjustment measures relating to recipients of unemployment assistance.

Expenditure on unemployment benefits in the third quarter was only 2.4 % above the level in the same period of last year. In comparison with the first half of the year, the rise in these costs has decelerated significantly. This is because the new requirement to take account of one-off payments (such as Christmas bonuses or holiday pay) when calculating wage substitutes, which has pushed up expenditure, no longer shows up in the year-on-year comparison as from July. Some 0.7 % more was spent on active labour market policy measures than in the third quarter of last year. The shift in favour of vocational training and retraining continued. By contrast, far less was spent on job creation measures. Payment

5 The Federal Labour Office receives payments from the European Social Fund to finance additional labour market policy measures. In addition, the immediate programme aimed at reducing youth unemployment as well as labour market and employment research projects are subsidised.

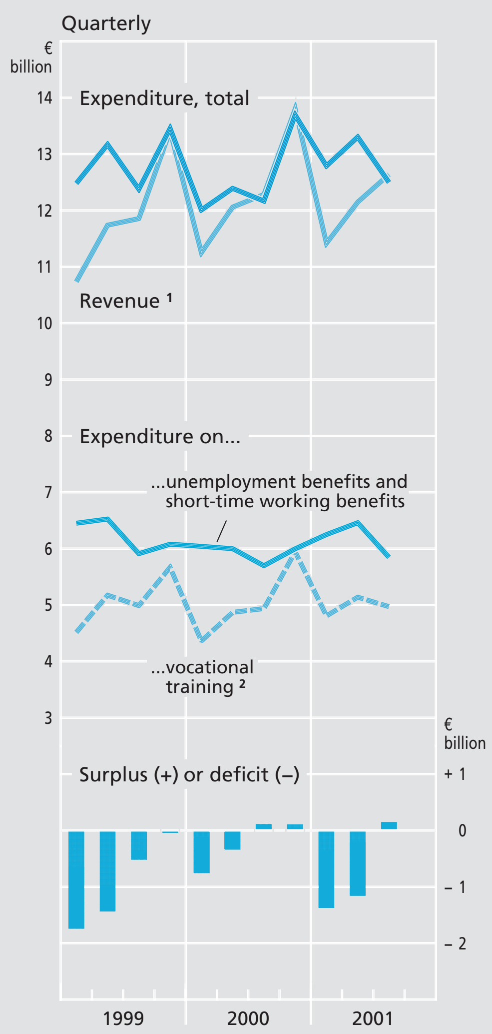
of net earnings over three months before bankruptcy proceedings are opened rose particularly sharply.

The cumulative deficit after the first nine months of 2001 (€ 2.4 billion) exceeded last year's corresponding total by € 1.4 billion. It has been evident for some time that the grant of € 0.6 billion earmarked in the Federal budget will be significantly overshot. In 2002 the less favourable labour market trend will necessitate additional expenditure, so that (if benefit entitlements remain unchanged) once again a grant from the Federal Government will be required. No reduction in contribution rates can be expected in the short run.

*Statutory health insurance funds*

In the statutory health insurance funds, for which only the data for the first two quarters are available, expenditure exceeded revenue by € 2.7 billion. In comparison to the same period in 2000, this is a deterioration of € 1.5 billion. While contribution receipts rose by 1.5 %, spending on benefits increased more than twice as sharply by 3.6 %. This was primarily due to the cost of pharmaceuticals, on which 11 % more was expended. Therefore, many health insurance funds will probably have to raise their contribution rate sharply – especially if it proves impossible to halt the surge in the cost of pharmaceuticals. As a consequence of greater financial burden-sharing, west and east German health institutions continue to show markedly different financial trends. Thus the deficit was concentrated on the western part of the country, whereas eastern Germany almost broke even. The average contribution rate in the east dropped by almost 0.2 percentage point to just under 13.7 % while the rate for the west at the midpoint in 2001 was 13.6 %, 0.1 % higher than in 2000.

Federal Labour Office




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

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## Outlook for the general government sector as a whole

*Sharp increase in deficit ratio*

This year the general government sector deficit (as defined in the national accounts) will grow significantly. Following last year's deficit ratio of 1.3 % (excluding the UMTS proceeds), an increase to around 2½ % is to be expected for 2001. The principal reason for this is the revenue shortfalls resulting from the tax reform, which come to approximately 1% of GDP. Another factor is the poorer financial position of the social security funds – in particular the health insurance funds. In addition, new government benefits were introduced or existing benefit levels raised.[6] However, these will be partly offset by savings in other areas. The central, regional and local authorities are generally pursuing a policy of spending restraint. The moderate public sector pay settlement and the low interest rate level are also keeping expenditure down, while the Federal Government's interest payments are being pushed down in addition by the debt redemptions financed out of the UMTS proceeds. Last but not least, a higher distribution of Bundesbank profit and significantly lower payments to the EU budget were recorded.

*Cyclical burden fairly moderate*

The cyclical rise in the general government deficit will remain limited this year, despite a low growth rate of real GDP – and therefore a perceptible reduction in the overall degree of capacity utilisation. It should be noted that average unemployment will not increase compared with last year, nor will the level of employment decrease. Gross compensation per employee, which is the key determinant of the amount of revenue from wage tax and social security contributions, is developing relatively robustly. On the whole, nominal economic growth, which is ultimately the basis for the evolution of government revenue, is weakening far less than real growth. In fact, nominal GDP growth will only be just under the average for the second half of the 1990s. Whereas last year public finance was given only a marginally positive boost by the cyclical momentum, with aggregate real growth of 3 % (and nominal growth of 2.6 %), this year the boost will be negative but will likewise have only a small impact.

*Higher additional burdens compared with the original budget figures*

These cyclical influences – which measure the current development against the medium-term macroeconomic trend – need to be distinguished from the additional burdens which are caused by a less favourable overall economic development vis-à-vis the original budget figures for this year. The German Stability Programme approved in autumn last year, which predicts a general government deficit ratio of roughly 1½ %, is based on the assumption of real economic growth of 2¾ %, which is well above the trend rate, and a noticeable drop in unemployment. The deterioration of the budgetary position due to the worsening of the overall economic outlook compared with the expectations on which the original budgets were based is thus greater than the cyclical influence. As evidence of this, the latest tax estimate – based on an unchanged tax legislation regime – projected tax shortfalls of just over € 7 billion compared with the spring 2000 estimate (on which the last Stability Programme was based). Furthermore, additional (mostly labour market-related) expenditure has been

6 Unemployment benefit, sickness benefits, housing allowances and student grants were all increased and, at the turn of 2000/01, a heating cost grant was paid to low-income earners. In addition, expenditure in connection with the grant to home buyers has increased because of the additional year's intake into the eight-year assistance cycle.

incurred in the form of the Federal grant to the Federal Labour Office and unemployment assistance (roughly € 3 billion). In total, these additional burdens look set to amount to around 0.5 % of GDP. The deviations from the targets set in the Stability Programme in the other areas, will be of a similar magnitude. While the Stability Programme (interpreted with non-rounded figures) already projected a deficit ratio of 1.6 % to 1.8 %, non-cyclical supplementary spending was incurred by the health insurance schemes, in particular. Finally, the deficit ratio for 2000 was revised from 1.0 % to 1.3 %, which also tends to push up this year's ratio.

*Reduction in the deficit possible in 2002*

In the coming year, the general government deficit ratio could be reduced again. To achieve this, however, expenditure growth must be kept within very narrow bounds – despite the greater expenditure requirements in respect of national and international security and the increase in child benefit. Admittedly, the cyclical development will place a larger burden on public finance than in 2001, even though the economy is expected to pick up next year. However, various measures for counter-financing the tax reductions already in force will make themselves felt more strongly. Diverse tax and levy increases will also bring relief. Thus the average contribution rate to the health insurance funds is likely to rise, and tax on mineral oil, tobacco products and insurance is to go up. Finally, additional revenue is hoped for from stepping up efforts to combat turnover tax fraud.

*Debt-financed stimulus programmes not appropriate*

Debt-financed stimulus programmes, including the proposed idea of bringing forward the planned tax cuts, are not appropriate to the current economic and fiscal situation in Germany. In the first place, it should be noted that fiscal policy has shown an expansionary stance this year anyway. Excluding the years 1990 and 1991, which were influenced by German reunification, the deficit ratio in 2001 should record its highest rise since the mid-seventies. In addition, fundamental doubts about the efficiency of an active anticyclical government economic policy are warranted in view of past experience. Firstly, such a programme takes a long time to have an impact. Secondly, its effects on demand are uncertain. Thirdly, the forecasts for next year assume an economic recovery anyway.

*Danger of undermining the Stability and Growth Pact*

Deficit-increasing measures must be assessed above all in the European context. The European Stability and Growth Pact that was initiated by Germany, which is considered a central institutional component for fostering confidence in the new single currency, stipulates a fiscal position over the course of the business cycle that is close to balance or in surplus. The Pact thereby guarantees fiscal soundness in the EU and is important for maintaining confidence in a stable monetary and real economic development. The Pact takes account of different cyclical constellations because it allows the automatic stabilisers to take effect. Germany has yet to reach a fundamental position close to balance. As already mentioned, the deficit ratio for the current year will actually increase to around 2 ½ %. In this context it is important to point out that the goal of a balanced budget is not being abandoned and remains a key element of fiscal policy strategy in Germany.

Expansionary fiscal programmes would not only hamper the medium-term reduction of the deficits in Germany but would also give undesirable signals to other countries. Attempts are already being made to soften the rules of the Stability and Growth Pact, e. g. by a "complementary" golden rule which would permit deficits equalling total capital formation. This would be tantamount to a permanent deviation from the Pact's objectives and hence from the fiscal underpinning of a stability-oriented monetary policy in the euro area.

*General government strategy necessary*

The medium-term goal of balanced general government budgets is concentrated on the central, regional and local authorities. The social security budgets are already approximately balanced because emerging deficits are funded largely automatically by higher social security contributions. The deficit of the statutory pension insurance funds following the reduction of the required fluctuation reserves is an exception. It is therefore up to the central, regional and local authorities to ensure that the expenditure growth in their budgets is strictly limited. This is even more essential as, over and above the required deficit reduction, further tax cuts have been decided. A national Stability Pact, which would implement the European requirements at the various government budgetary levels in Germany, has not yet been brought into being. A rigorous national implementation could entail an obligation on the part of the Federal Government and the Länder Governments each to aim for a fundamentally balanced fiscal position and to enshrine this in budgetary law. It may be easier to achieve this objective by stipulating a ceiling for expenditure growth. In view of the tax cuts already agreed, a cap on expenditure growth of well under 1% for the central, regional and local authorities would be needed in order to ensure that the general government deficits are eliminated by 2004.