

Public finance

Central, state and local government

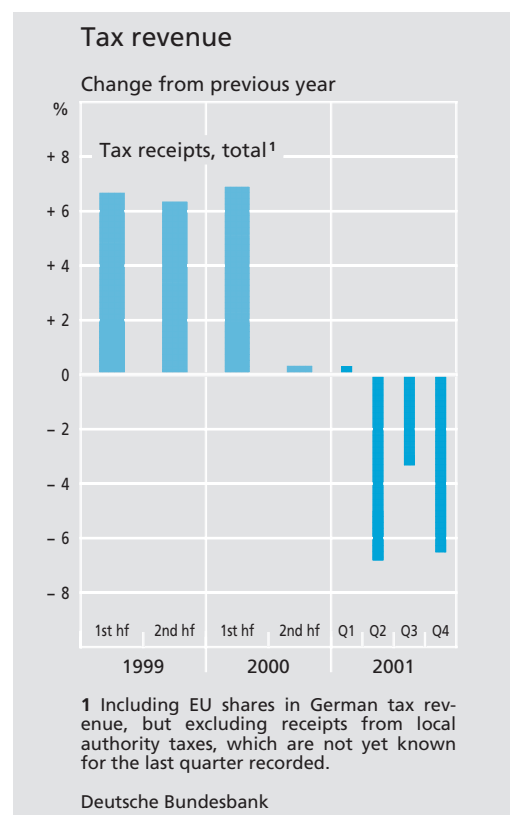
In the fourth quarter of 2001 the budgetary positions of central, state and local government worsened considerably compared with the fourth quarter of the previous year. The deficits for 2001 as a whole also increased sharply. They probably rose from €33 billion in 2000 (excluding the UMTS proceeds) to almost €50 billion – the highest figure recorded since 1996. This was mainly due to a steep drop in tax receipts brought about primarily by the tax cuts. Although other receipts, particularly privatisation proceeds, increased sharply, overall receipts fell perceptibly. Expenditure grew only moderately (by approximately 1%), chiefly because compensation of employees barely increased and spending on interest payments and tangible assets actually decreased. The individual levels of government recorded very different trends, although this owed something to exceptional factors. While the Federal Government's deficit fell somewhat and the special funds recorded more favourable figures, the financial situation of the local authorities and especially the *Land* governments worsened severely. As things now stand, no substantial reduction in the budget deficits may be expected in 2002. Although tax revenue should increase noticeably, despite the persistently unfavourable macroeconomic setting, non-tax revenue is expected to decrease and overall expenditure is likely to rise more sharply than last year.

Overview

Tax revenue in the fourth quarter and in 2001 as a whole...

Tax revenue¹ fell in the fourth quarter of 2001 by 6.5% in comparison with the same period in 2000. This was mainly due to lower receipts resulting from the tax reform and to the economic slowdown. In particular, the downward slide in corporation tax receipts accelerated further, in part owing to sizeable refunds to some enterprises. According to the provisional figures (which only contain an estimate for local authority taxes), tax revenue fell by 4.5% in 2001. The overall tax ratio (as defined in the financial statistics) consequently declined by 1½ percentage points to 21.6%. The principal reason for this was the extensive relief granted by the tax reform which was offset only to a small extent by additional receipts from the third stage of the “ecological tax reform”. Furthermore, actual tax receipts fell far short of the expectations owing to the weaker overall economic climate and other reasons. Actual receipts were €2.8 billion lower than predicted in the last official forecast in November and as much as €12.8 billion below the corresponding tax estimate from autumn 2000 – on which the budget plans had been largely based.

The revenue shortfalls vis-à-vis the budget plans especially affected turnover tax and corporation tax. Receipts from turnover tax decreased by 1.4% and undershot the amount forecast in autumn 2000 by €7.3 billion. These large shortfalls were only partly attributable to the weaker than expected growth in the VAT tax base. Structural shifts in private consumption in favour of tax-free and tax-reduced components likewise appear to have played a role. In addition, there seem to have been considerable insolvency-related short-



falls.² In addition, a good many companies may well have deferred their turnover tax payments on account of their strained liquidity position even though they will be charged interest for such late payments. Corporation tax receipts were a massive €12.7 billion less than forecast in the estimate made in autumn 2000, which had already taken the tax reform into account. Refunds of corporation tax actually exceeded tax payments by €0.4 billion. However, a large part of the revenue shortfalls was caused by high special dividend distributions and was offset by additional re-

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

² These occur because most insolvent companies stop paying turnover tax on their income, whereas their corporate customers can still deduct the related VAT expenditure from their tax liability if shown on the insolvent party's invoice.

Trends in the revenue from major taxes

Type of tax	Revenue in € bn		Change from previous year in %
	Full year		
	2000	2001	
Wage tax	135.7	132.6	- 2.3
Assessed income tax	12.2	8.8	-28.2
Corporation tax	23.6	- 0.4	.
Turnover tax	140.9	138.9	- 1.4
	<i>of which 4th quarter</i>		
Wage tax	40.8	38.9	- 4.6
Assessed income tax	4.9	4.7	- 5.0
Corporation tax	5.0	- 1.9	.
Turnover tax	36.3	35.6	- 1.9

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ceipts from non-assessed taxes on earnings amounting to €7.5 billion.³ Furthermore, the worsened profit situation – due partly to large write-downs on participating interests – and lower payments in respect of earlier years contributed to the disappointing corporation tax result. By contrast, wage tax and assessed income tax marginally surpassed the expectations, although receipts from these taxes still decreased (by 2.3% and 28.2% respectively) in the wake of the tax reform. In the case of wage tax this was due, *inter alia*, to shifting bonus payments to 2001 for tax reasons, while in the case of assessed income tax the partial netting facility for trade tax introduced as part of the tax reform had not yet had a substantial effect on advance tax payments.

In 2002 tax revenue should rise considerably and increase more sharply than nominal GDP. Reasons for this are that the effect of progressive taxation will ensure higher income tax receipts and that the scale of the tax increases will exceed the additional tax relief measures.⁴ The official estimate from November anticipated a 3% increase in tax revenue; taking into account the changes in tax legislation disregarded in the estimate, tax receipts would rise by approximately 4% given nominal economic growth of 3%. However, as things now stand it seems likely that overall economic growth will fail to match the expectations made in autumn. The level of tax revenue will also be influenced by the poorer starting position inherited from last year.

... and this year

The Federal Government recorded a surplus of €0.8 billion in the fourth quarter of 2001. The deficit for 2001 as a whole (€21.1 billion) was €2.8 billion lower than in 2000 and just under €1 billion lower than the budget estimate.⁵ Revenue, which was roughly the same as in 2000, undershot the budget figure by €1.3 billion. In this context, the tax shortfalls

Federal Government budget in 2001...

³ Many companies distributed profits retained in earlier years (and taxed at a rate of 45%) so as to claim a corporation tax rebate of 15 percentage points. Such distributions were evidently also used to offset intra-group losses, which is no longer possible under the new corporation tax system.

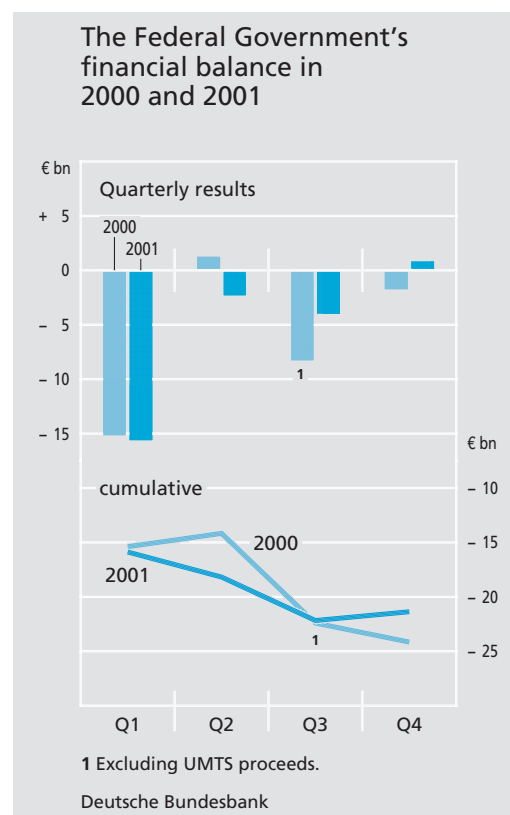
⁴ On the one hand, the increased family assistance measures will push receipts down. On the other hand, additional tax revenue will result from the counterfinancing of the tax reductions, the fourth stage of the "ecological tax reform", the increase in tobacco tax and insurance tax as well as measures to combat turnover tax fraud.

⁵ The budget figures given here are taken from the financial statistics. They differ from the Federal Ministry of Finance figures. For example, in the financial statistics coin seigniorage in 2001 (just over €1½ billion) was recorded as a financial transaction with no impact on the deficit, whereas in the Federal budget it was booked as other current operating expenditure.

of €2.9 billion were moderate in comparison with those at other levels of government because transfers to the EU were lower than expected thanks to a large surplus in the 2000 EU budget. Moreover, they were largely offset by higher non-tax receipts. The Federal Government's expenditure fell by 1.4%⁶ and undershot the estimate by €2 billion. Although the worse-than-expected labour market trend necessitated higher spending on unemployment assistance and grants to the Federal Labour Office (together totalling €2.5 billion), interest payments and guarantees, in particular, were lower than the figures budgeted.

... and this year

The Federal budget for this year envisages a rise in the deficit of €2.6 billion to €23.7 billion.⁷ This is €1.5 billion higher than in the draft budget. Additional burdens resulting from the cyclically-induced lower level of projected tax receipts and extra labour market-induced expenditure (together totalling approximately €5 billion) exceed higher privatisation proceeds and lower projected interest payments and grants to the "German Unity" Fund vis-à-vis the draft budget. Additional expenditure on internal and external security (€1½ billion) will be financed by additional revenue from the increase in tobacco tax and insurance tax. Overall expenditure will rise considerably after having decreased in the previous two years. The main reasons for this are sharp increases in the required transfer to the Federal Railways Fund, labour market-related expenditure, transfers to the statutory pension insurance fund financed by the "ecology tax", and spending on internal and external security. The 2002 budget contains



substantial privatisation proceeds which are only a transitory form of financing. Attaining the targeted figures will require very frugal budget management, particularly since the cyclical trend is now assessed as being less favourable than when the budget was adopted.

⁶ The reasons for this include the non-recurrence of the indemnification payments to wartime forced and slave labourers made in 2000 (approximately 1% of the expenditure volume) and the temporarily lower grants to the Federal Railways Fund (also around 1%) owing to the substantial privatisation proceeds allocated to that fund.

⁷ The deficit trend in the outturn for 2001 and the estimate for 2002 deviates strongly from the development of net borrowing. The reasons for this are high coin seigniorage last year in connection with the currency changeover and the high coin revenue this year contained in the budget. These financial transactions influence net government borrowing but not the deficit. Net borrowing should fall from €22.8 billion in the 2001 outturn to €21.1 billion in 2002. The estimated seigniorage in the 2002 budget was raised by €1½ billion to €2½ billion compared with the draft budget.

Special funds

Last year the special funds recorded a surplus of €5.1 billion following a deficit of €1.7 billion in 2000. Firstly, the share of the Bundesbank profit allocated to the Redemption Fund for Inherited Liabilities was almost €4½ billion higher than in 2000. Secondly, the deficit of the ERP Special Fund decreased by €2 billion owing to reduced lending and greater repayments.

Land Governments

In the fourth quarter of 2001 the deficit of the *Land* Governments (€16.2 billion) was €8.3 billion higher than in the same period in 2000. This was largely caused by the decline in tax revenue by 10.1%. The most severely affected *Land* was North-Rhine Westphalia, which recorded a downturn of one-quarter, not least because of large tax refunds. The *Land* Governments' other revenue fell just as sharply as tax revenue over 12 months. The main reason for this was that at the beginning of December Lower Saxony was obliged by a ruling of the Federal Administrative Court to repay natural gas extraction royalties plus interest amounting to €1¼ billion. The *Land* Governments' expenditure grew by 1.1% in the fourth quarter. If Baden-Württemberg had not made an equity injection into the Landesbank Baden-Württemberg, a slight decrease in expenditure would have been recorded. In 2001 as a whole the deficit increased dramatically from €9.8 billion in 2000 to €27.6 billion, principally because of the revenue shortfalls related to the tax reform, although substantial extraordinary burdens also played a role. Besides the transactions in the fourth quarter already mentioned, these chiefly included the recapitalisation of Bankgesellschaft Berlin. Not least given the

further tax cuts already agreed, the *Land* Governments' objective of reducing their deficits can only be achieved through stringently curbing their spending. This is also necessary because a number of *Land* Governments are struggling to keep below their statutory ceilings for new borrowing.

For the local authorities only the results for the first three quarters are available at present. During that period they accumulated a deficit of €3.2 billion, whereas close-to-balance budget outturns were recorded in the first nine months of 2000. While revenue decreased by 1.6% following a steep slump in municipal tax receipts, expenditure rose further by 1.4%. This was primarily due to an increase in social payments (+3.5%). In contrast to previous years, it seems that the fourth quarter will not exhibit a noticeable surplus, so that for the first time in three years the local authorities will most probably record a deficit for 2001 as a whole.

Local authorities

The indebtedness of central, state and local government increased sharply by €15 billion in the fourth quarter. While money market debt fell by €3 billion, the liabilities on the capital market rose by €18 billion. In 2001 as a whole net borrowing by central, state and local government reached €14 billion. This relatively small amount was mainly due to the debt repayment out of the UMTS proceeds carried out at the beginning of 2001.

Indebtedness

Social security funds

Statutory
pension
insurance
scheme

In the fourth quarter of 2001, the wage and salary earners' pension insurance scheme recorded a customary seasonal surplus which, at €2.5 billion, was nonetheless €1.0 billion less than in the final quarter of 2000. In 2001 as a whole it recorded a deficit of €1.1 billion,⁸ whereas in 2000 it had generated a surplus of €0.6 billion. As a result, the statutory fluctuation reserve requirement of one month's expenditure was not quite reached (93%). This was caused primarily by smaller contributions brought about by the overall economic slowdown.

Outlook for
2002

The deficit is set to expand further in 2002. The main reason for this is that the fluctuation reserve requirement has been lowered from 1.0 to 0.8 month's expenditure to avoid having to raise the contribution rate from 19.1% to 19.4%. Furthermore, a fall in contribution receipts anticipated from the meanwhile less optimistically assessed cyclical trend, and higher contributions to pensioners' health insurance funds are likely from the middle of the year as a result of increased contribution rates.

Federal Labour
Office

In the final quarter of 2001 the Federal Labour Office recorded a surplus of €0.5 billion, although this result was boosted by exceptional substantial receipts from the European Social Fund. The deficit for 2001 as a whole was €1.9 billion, which was more than double the corresponding figure in 2000. It was also way above the budget estimate of €0.6 billion. While total revenue increased by 2.2%, expenditure rose by 4.2%. Spending

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

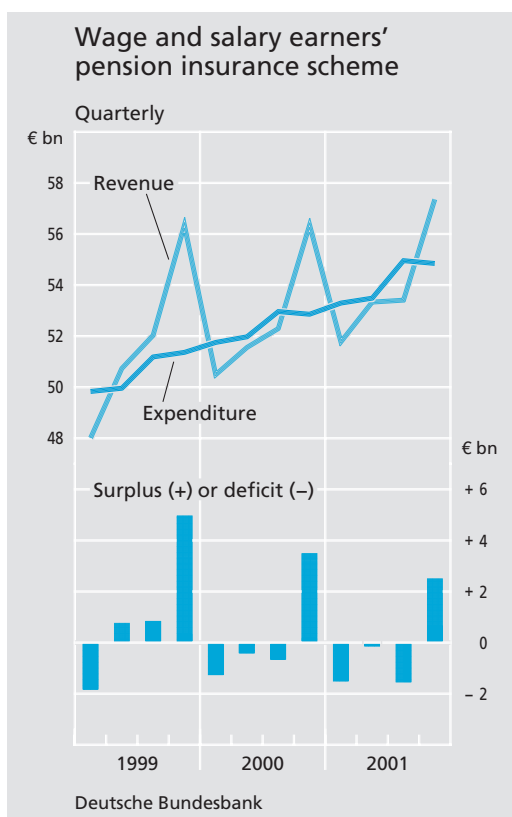
Period	Total	of which		Memo item Acquisi- tion by non- resi- dents
		Securi- ties 1	Loans against borrow- ers' notes 2	
2000	+ 16.1	+ 29.1	- 11.8	+ 21.2
<i>of which</i>				
Q1	+ 14.0	+ 7.5	+ 6.5	- 1.0
Q2	- 1.3	+ 3.8	- 5.1	+ 14.6
Q3	+ 9.1	+ 4.8	+ 5.4	+ 8.6
Q4	- 5.7	+ 13.1	- 18.6	- 1.0
2001 <i>pe</i>	+ 14.1	+ 56.3	- 6.8	...
<i>of which</i>				
Q1	- 10.4	+ 13.9	+ 9.7	- 12.2
Q2	- 6.1	+ 7.5	- 13.7	- 0.3
Q3	+ 15.6	+ 18.5	- 1.8	+ 14.9
Q4 <i>pe</i>	+ 15.0	+ 16.3	- 1.1	...

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

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on unemployment benefits went up by 4.3%. This was due to higher per capita benefits resulting from the requirement since August 2000 to take account of one-off salary payments when calculating benefit claims. By contrast, the number of unemployed actually fell by 0.5% on an annual average. Some 1.9% more was spent on active labour market policy measures. Increased spending on vocational training and retraining by one-tenth offset a decrease by one-quarter in spending on job creation measures. Expenditure on payments pending insolvency proceedings, pre-retirement part-time work-

⁸ The capital gain of €0.6 billion resulting from the revaluation of the shares held by the Federal Insurance Office for Salaried Employees (BfA) in the non-profit public limited company for employee housing (GAGFAH) is not included in the receipts, although it is included when calculating the fluctuation reserve.



ing and refunds to the pension insurance institutions for labour market-related disability pensions also rose sharply.

The budget for 2002 envisages a deficit of €2.0 billion for the Federal Labour Office, which is to be covered by a transfer from the Federal budget. This is based on the assumption of 3.9 million unemployed on an annual average, which implies only a small rise from last year's total. In the Annual Economic Report 2002 the Federal Government assumes an average of just under 4 million unemployed persons. Without savings, therefore, the budgeted grant will probably not suffice to cover the deficit.

Following four years of virtually balanced budgets, the statutory health insurance funds

are expected to register a considerable deficit for 2001, mainly owing to a steep increase in expenditure on pharmaceuticals. Many health insurance institutions raised their contribution rate on 1 January 2002. The average contribution rate to the health insurance funds for 2002 as a whole will increase by almost ½ percentage point to around 14%.

Statutory health insurance funds

Development of the general government sector as a whole

The government deficit ratio as defined in the Maastricht Treaty rose to 2.6% last year according to the first preliminary national accounts figures. In 2000 it had amounted to only 1.3% (excluding UMTS proceeds). This sharp increase vis-à-vis the previous year was cyclically induced only to a small extent.⁹ Although real macroeconomic growth was significantly lower than its medium-term trend, the nominal rate of growth, which is more important for the revenue trend, was more favourable. In addition, the increase in gross wages and salaries (especially the per capita increase), which is relevant for wage tax and social security contributions, proved fairly robust. Finally, unemployment – which is the key factor determining the magnitude of cyclically-related expenditure – was actually a little lower in 2001 on average than in 2000.

Only small part of deficit rise cyclically induced, ...

The sharp increase in the deficit was mainly due to structural causes, above all tax shortfalls resulting from the tax reform. Other im-

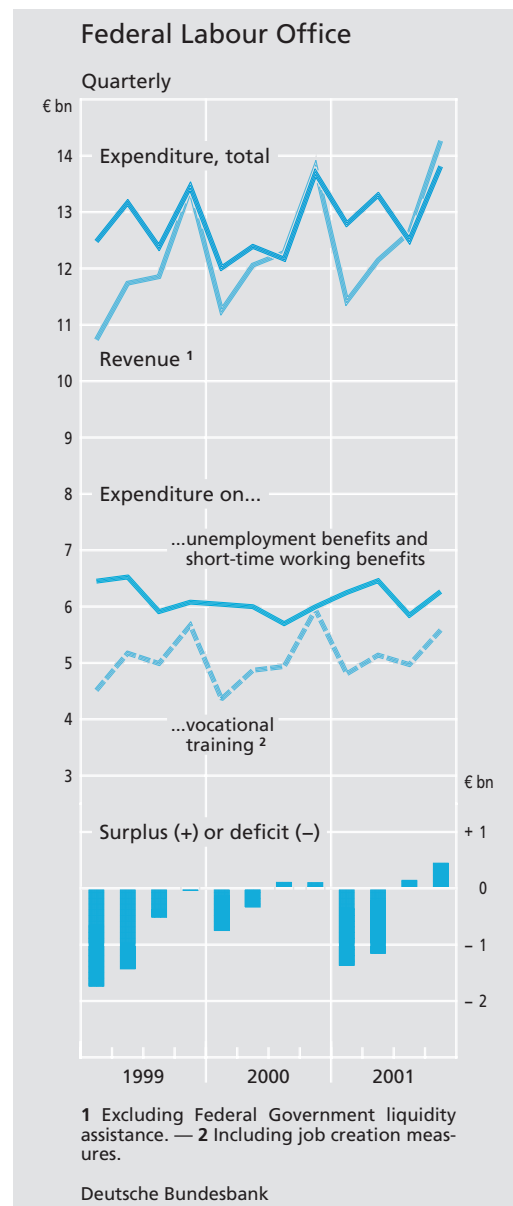
... main factor tax shortfalls due to tax reform

⁹ According to the calculation method used by the Bundesbank, the cyclically adjusted deficit rose from 1.4% of GDP in 2000 to 2.5% in 2001.

portant factors were the lower contribution rate to the statutory pension insurance scheme and a decrease in turnover tax which cannot be explained by macroeconomic developments. Although a further stage in the "ecological tax" entered into force and other revenue also increased sharply – not least due to the significant rise in the Bundesbank's profit – the revenue ratio declined by just under 1½ percentage points to 46.2%.

*Expenditure
growth limited*

Expenditure rose by 1.6%. Given the marginally higher nominal growth of GDP, the expenditure ratio fell slightly to 48.8%. Compensation of employees increased only slightly thanks to a moderate pay settlement on balance and a decline in government staff numbers. Interest payments actually decreased, above all owing to the debt repayment made possible by the UMTS proceeds and the persistently low interest rate level, which eased the refinancing of maturing bonds. Government investment expenditure and Federal Government transfers to the EU also fell. Finally, the one-off burden caused by the indemnification of wartime forced and slave labourers, which had affected the budget in 2000, did not recur. On the other hand, social payments rose sharply by 3%. They were pushed up by the massive surge in spending on pharmaceuticals, the notable increase in expenditure by the pension insurance funds and the raising of unemployment and sickness benefits following a ruling of the Federal Constitutional Court. The cost of civil servants' pensions also increased strongly. At the *Land* government level, the expenditure total was burdened by a large one-off refund of natural gas extraction royalties.



If no additional deficit-raising measures are adopted, a further increase in the deficit ratio in 2002 seems unlikely at the moment, despite the greater strain placed on public finance by current cyclical developments. The structural deficit would then decline noticeably. This expectation is grounded in the fact that the taxes and social security ratio will increase. Thus this year, the progressive scaling of the income tax regime will have a marked

*No further
deficit increase
likely in 2002*

Evolution of public finance as shown in the national accounts *

Item	€ bn			Difference in %	
	1999	2000 ¹	2001	2000	2001
Revenue, total	943	964	953	2.1	- 1.1
<i>of which</i>					
Taxes	490	512	491	4.4	- 4.1
Social security contributions	376	378	384	0.7	1.3
Expenditure, total	974	990	1.006	1.7	1.6
<i>of which</i>					
Social payments	523	533	548	1.9	2.8
Compensation of employees	165	165	165	- 0.3	0.3
Intermediate consumption ²	77	79	81	2.3	2.0
Interest payments	70	68	67	- 2.7	- 2.2
Investment	37	38	36	0.6	- 3.2
				Change in € bn or percentage points	
Balance	- 31	- 27	- 54	4	- 27
<i>Memo item</i> (as % of GDP)					
Expenditure	49.3	48.9	48.8	- 0.4	- 0.1
Revenue	47.8	47.6	46.2	- 0.2	- 1.4
Balance	- 1.6	- 1.3	- 2.6	0.2	- 1.3

* Outturn in accordance with ESA 95. Regarding the differences vis-à-vis the figures of the Federal Statistical Office, see the Statistical Section of this Monthly Report,

Table VIII.3, p 53*. — 1 Excluding UMTS proceeds. — 2 Mainly other operating expenditure.

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impact. Furthermore, the measures to counterfinance the tax cuts which were introduced in 2001 will make themselves more fully felt this year. In addition, several excise taxes (on mineral oil, electricity, tobacco and insurance) have been raised. Additional revenue is also expected from turnover tax as a result of improved anti-fraud measures. Finally, many health insurance institutions were obliged to significantly increase their contribution rates at the turn of the year. The government expenditure ratio is likely to increase somewhat. The growth of expenditure will be driven particularly by the increase in child benefit, a significant increase in labour market-related expenditure, interest payments and the cost of internal and external security.

If, judged from the present perspective, the government deficit ratio remains below the 3% ceiling stipulated by the Maastricht Treaty, this should not be taken to mean that budgetary policy makers have any room for further benefits or tax cuts. That would contradict the more far-reaching objective of the Stability and Growth Pact, which was established in 1997 above all at the initiative of the Federal Government at that time. As explained in detail in the box on page 58, one of the key objectives of this Pact is to define the 3% ceiling not as "the norm" but as the absolute upper limit of the deficit. The requirement of a budget position which is close to balance or in surplus in the medium term – ie on average during the business cycle – sets a far more ambitious fiscal policy orientation. If fiscal policy makers envisaged utilising

No room for manoeuvre in budgetary policy

Government budget deficits and the legal framework of the European Union

The Maastricht Treaty was signed in 1992. As a sound fiscal policy in all member states is a fundamental requirement for a stable European monetary union, the Treaty laid down that member states must avoid excessive government deficits (Article 104 (1) of the Treaty establishing the European Community). The existence of an excessive deficit is gauged on the basis of the fiscal "Maastricht criteria". According to these criteria, the general government deficit may not, as a rule, exceed the reference value of 3% of GDP and government debt may not exceed 60% of GDP. The Maastricht Treaty and the associated protocols spelling out the details themselves envisage sanctions for individual member states with an excessive deficit.

In the run-up to stage three of European economic and monetary union, doubts arose as to whether the EC Treaty provisions would suffice to ensure a sustainable public finance position. It was principally for this reason that – mainly at Germany's instigation – a European Stability and Growth Pact was drawn up and adopted at the European Summit of Amsterdam in June 1997.¹ Besides laying down detailed rules for implementing the excessive deficit procedure and strengthening the surveillance of budgetary positions in the EC – in particular through an "early warning system" – the Pact obliges all member states to achieve a medium-term budgetary position that is close to balance or in surplus. This requirement creates a sufficient safety margin which allows the automatic stabilisers to operate without the risk of running up an excessive deficit within the meaning of Article 104 of the EC Treaty. This implies that deficits are permissible during downturns but that surpluses need to be generated during upturns. In this way a nominally balanced budgetary position will be maintained in the medium term,

¹ The Pact consists of the Resolution of the European Council on the Stability and Growth Pact (Amsterdam, 17 June 1997), Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure. For further information see also European

Central Bank, The implementation of the Stability and Growth Pact, Monthly Bulletin, May 1999, p 45ff. — ² See European Commission, Public Finances in EMU – 2001, in: European Economy, No 3/2001, p 38f. — ³ See also the opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes, endorsed by the Ecofin Council on 10 July 2001.

ie on average during the course of the business cycle. For most countries, the European Commission interprets compatibility with the Pact's objective to mean a cyclically adjusted deficit ratio of 0.5% at most.² The European Commission's demands, which set even more ambitious targets for some countries, are shaped by the following factors.³

- The deficit ratio needs to encompass sufficient room for manoeuvre to safeguard the 3% threshold so as to accommodate the impact of cyclical influences on the budget.
- Allowance has to be made for uncertainty regarding other unforeseen fluctuations in the budgets, such as the interest rate trend.
- Countries with a very high debt level should make sure that their debt ratio is speedily brought down to the reference value of 60% of GDP.

These requirements were met by most of the member states last year. In accordance with the Pact's provisions and within the framework of their own stability and convergence programmes, those countries which have not attained such a position four years after the Pact was signed have set themselves the target of achieving a balanced budget at least from 2004-2005.

In addition to the aforementioned requirements, steps should be taken, in the form of appropriate medium-term budgetary targets, to make provisions for the future burdens on public finance which will ensue from the progressive ageing of the population.

the deficit ceiling to the maximum extent from the outset, this would not only be incompatible with the Stability and Growth Pact but would also give rise to the danger – in view of the unavoidable and unpredictable fluctuations in the budgetary trend – that the 3% limit set in the Maastricht Treaty might be exceeded. This could jeopardise the understanding of the need for sound public finances which was successfully propagated not least by the Stability and Growth Pact. In turn, that would hamper the task of pursuing a stability-orientated monetary policy.

Stability programme reaffirms consolidation course despite a worsened starting position

In December 2001 the Federal Government presented an updated stability programme. It reaffirmed the goal of the preceding programme of achieving a balanced budget by 2004 (see table on page 59). At the same time the starting position worsened noticeably in 2001. Whereas the previous programme had predicted a deficit ratio of 1½% for 2001, the December update (more or less in line with the preliminary outturn) puts the figure at 2½%. This failure to attain the deficit goal is mainly due to the fact that the overall economic development was much worse than expected¹⁰ and that the deficits for the previous years were revised upwards, which also had some effect on 2001. Finally, other factors – not least an extraordinarily sharp increase in expenditure in some areas of the statutory health insurance funds – likewise played a part in the failure to meet the target set by the previous stability programme.

To the extent that the planned deficit target is exceeded owing to an unfavourable macro-

economic development, this overshooting should not be confused with the – considerably smaller – cyclically related deficit increase vis-à-vis the previous year (see page 55). The latter arises because the macroeconomic assessment bases underlying cyclical revenue and expenditure deviate from their medium-term trend. However, for 2001 the previous stability programme assumed a macroeconomic growth rate significantly higher than this trend, namely 2¾%. Therefore, the deviation of the actual deficit from the goal set in the stability programme due to the less favourable overall economic development was likewise inevitably far greater than the cyclically-related additional burden compared with 2000.

For the current year, the updated stability programme envisages a deficit ratio of 2%. However, this value is no longer realistic given the current less favourable assessment of the general economic outlook, which is also reflected in the Federal Government's latest forecast in its Annual Economic Report. A deficit ratio of 2½% is now anticipated. Such a development was included in an alternative scenario in the stability programme, which in the event of lower macroeconomic growth rates projected higher deficit ratios also in the following years – namely 1% for both 2004 and 2005.

Development this year in line with the risk scenario

The clear failure to meet the deficit target in 2001 and the likelihood that the deficit will

"Early warning" for Germany...

¹⁰ The Federal Government had assumed that the increase in the structural deficit in connection with the tax reform would be partly offset by the fiscal effects of stronger macroeconomic growth.

Key data of the Federal Government's updated stability programme

as %

Item	2000	2001	2002	2003	2004	2005
Basis scenario:						
Real GDP growth						
Stability programme 2001	3.0	¾	1¼	2½	2½	2½
Stability programme 2000	2¾	2¾	2½	2½	2½	.
Deficit ratio (-) ¹						
Stability programme 2001	- 1.3	- 2½	- 2	- 1	- 0	- 0
Stability programme 2000	- 1	- 1½	- 1	- ½	0	.
Debt ratio						
Stability programme 2001	60.3	60	60	59	57	55½
Stability programme 2000	60	58	57½	56½	54½	.
Risk scenario (stability programme 2001):						
Real GDP growth	3.0	¾	¾	2¼	2¼	2¼
Deficit ratio (-) ¹	- 1.3	- 2½	- 2½	- 1½	- 1	- 1

¹ Figures for 2000 excluding proceeds from UMTS licence auction.

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not be far below the 3% ceiling in 2002 prompted the European Commission to recommend the Ecofin Council at its meeting on 12 February to issue an "early warning" to Germany. The Commission's action was in complete accord with the relevant provisions of the Stability and Growth Pact, which *inter alia* oblige the Commission to use its right of initiative in a manner that facilitates the strict, timely and effective functioning of the Pact.

However, the Ecofin Council did not take a decision on this recommendation to issue an early warning to Germany. Instead, the Federal Government pledged to take to heart the concerns expressed by the Commission's recommendation. Thus it will seek to ensure that the 3% ceiling is not exceeded this year by intensively monitoring the implementation of

the budget at all levels of government. The Federal Government promised further to avoid fiscal measures which would burden the budget and to use any budgetary leeway in order to reduce the deficits. Finally, the Federal Government reaffirmed that, in keeping with its previous pledges, a close-to-balance budgetary position will be reached by 2004. It pointed out that this may necessitate additional steps over and above the measures indicated in the updated stability programme as soon as the economic situation improves. Through compacts with the *Land* Governments all necessary efforts are to be undertaken to ensure that these commitments are met.

The objective of achieving a close-to-balance budget position by 2004 is a European com-

... avoided by
commitments
made by
the Federal
Government

*Expenditure
growth needs
to be tightly
capped*

mitment which has already been met by most of the member states. In Germany, however, given the size of the deficits, this will require an extremely ambitious policy of spending curbs by all levels of government, particularly as further tax cuts will be implemented in 2003 (and again in 2005). In the medium term, the stability programme envisages keeping the annual growth of general government expenditure below 2% as defined in the national accounts. The expenditure of the social security funds is to grow by around 2½% and that of central, state and local government by 1½%. It should be noted in the context of budgetary policy that in the medium term the expenditure growth recorded in the budget accounts will be lower than that recorded in the national accounts.¹¹ This means that if the expenditure growth of central, state and local government is not to exceed 1½% as defined in the national accounts, an even smaller growth rate is required in the budget accounts. The assumptions in the stability programme are thus more ambitious than the target of the Financial Planning Council, which recommends capping the expenditure growth of central, state and local government (as defined in the budget accounts) to a maximum of 2%.

Germany has a pronounced federal structure. For example, the *Land* Governments make their own decisions on borrowing. The sharp expansion of the deficit among the *Land* Governments last year makes it clear that a general government consolidation goal can only be attained if all tiers of government are involved. This necessitates the adoption of rules that are binding at all budgetary levels. For the medium term, the Stability and Growth Pact prescribes general government budgets that are at least close to balance. A systematic national implementation of the Pact would include firm budgetary regulations requiring the goal of a balanced budget at all levels of government. In a first step in this direction, it is true, the requirement to strive for a balanced budget – due to come into force in 2005 – was adopted in the Budget Principles Act, which applies to the Federal Government and the *Land* Governments. No concrete timetable was laid down, however.

*Balanced
budgets should
be aimed for at
all levels of
government*

¹¹ For example, various items which are currently growing extremely sharply, such as child benefit or the grant to home-buyers, are recorded as expenditure in the national accounts but booked as negative tax revenue in the budget accounts.