Public finance

Central, state and local government budgets

Basic trends

In the second quarter central and state government (the results for local government are not yet known) recorded a deficit of €4 billion, whereas in the same period of 2001 they had generated a surplus of €1½ billion. The main reason for this deterioration was the noticeable decline in revenue (-2½ %). Although the Bundesbank profit distributed in April was considerably higher than last year, this could only partially compensate for the fall in tax receipts of 4½ %. Expenditure rose by 2½ %, not least owing to the increase in labour market-related spending.

While the combined deficit of central, state and local government is likely to have grown substantially by around €17 billion in the first six months, a smaller year-on-year rise is expected for the second half of 2002. This will probably be assisted by a more positive development of tax receipts. Moreover, expenditure growth will slow down significantly – especially since several extraordinary burdens which affected the state governments' budgets in 2001 have ceased to apply. Even so, the aggregate deficit of central, state and local government in 2002 is likely to markedly exceed last year's high figure of €48 billion.

Tax receipts in the second quarter...

Tax revenue[1] continued to develop unfavourably in the second quarter. Although the decrease of 4½ % vis-à-vis the corresponding period last year was not quite as steep as that

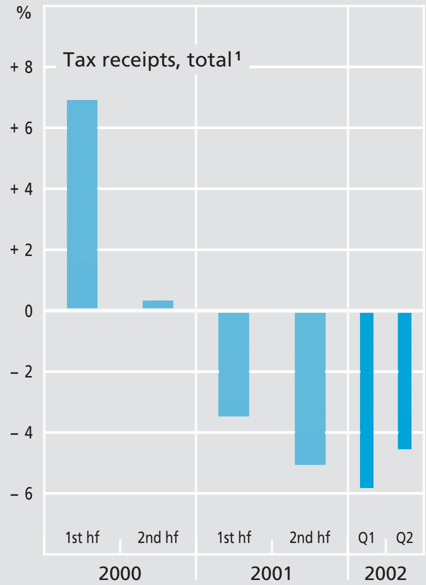
1 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known.

of the first quarter (-6 %), it had been considerably amplified in the first few months by several exceptional factors.[2] Both direct and indirect tax receipts continued to be influenced by the weak economic momentum, which to some extent was reflected in revenue levels only after a time lag.

Among the direct taxes, corporation tax receipts, in particular, continued their downward slide. Refunds exceeded tax receipts by €2 billion, causing the outturn for this tax category to worsen by €2½ billion compared with the second quarter of 2001. This was due in part to sizeable tax refunds to some enterprises (particularly in the telecommunications and banking sectors); furthermore, current tax prepayments were adjusted downwards again as a result of the unfavourable trend in profits. On the other hand, corporation tax receipts were not as sharply dented as last year by the distribution of profits retained in earlier years. Non-assessed taxes on earnings consequently yielded far less than a year earlier (-38 %), although this also owed something to the lowering of the investment income tax rate on dividends from 25 % to 20 % at the beginning of the year. Receipts from assessed income tax went up by 5 %. This was mainly attributable to higher retrospective payments in respect of earlier years, whereas prepayments of this tax – which is only partly related to profits – were apparently likewise even lower than in 2001. Wage tax receipts merely matched the corresponding level last year. Besides the decline in the number of employees, this was also attributable to the rise in child benefit – which is offset against wage tax receipts –

Tax revenue

Change from previous year



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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which came into force at the beginning of this year.

In the second quarter turnover tax yielded just over ½ % less than last year. This was caused partly by lower retail trade turnover and the fact that taxable investment in the housing and government sectors declined further. By contrast, receipts from excise taxes rose steeply as a result of the raising of mineral oil, electricity, tobacco and insurance taxes at the beginning of the year.

... and in 2002 as a whole

In the first half of the year tax receipts were just over 5 % lower than the corresponding fig-

2 Besides considerably higher amounts for the grant to home buyers this year, which is predominantly paid out in March, tax revenue in the first quarter of 2001 was only marginally depressed by the tax reform.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion 1st half 2002	2001	Change from previous year in %
Wage tax	61.4	62.2	– 1.3
Assessed income tax	– 0.3	0.8	.
Corporation tax	– 1.3	2.1	.
Turnover tax	68.0	68.8	– 1.1
	of which: Q2		
Wage tax	31.0	31.0	0.0
Assessed income tax	3.3	3.2	+ 4.9
Corporation tax	– 2.0	0.4	.
Turnover tax	33.5	33.7	– 0.7

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ure last year, whereas the official tax estimate from May had projected revenue growth of 2 % for 2002 as a whole (excluding local government taxes in both cases). In the remainder of this year tax receipts are expected to develop more favourably, particularly if the economy recovers significantly. Not least receipts from wage tax, which so far have barely been affected by this year's (higher) pay settlements, also look set to increase markedly. However, given the disappointing overall result in the first six months, it is highly improbable that the figure estimated in May will be reached. Considerable – and not easily calculable – risks vis-à-vis the estimate exist, in particular, for corporation tax, the outturn of which worsened by almost €3½ billion in the first half of the year. Substantial shortfalls in receipts are likely, even if the dampening effect of profit distributions on receipts eases further during the remainder of the year.[3] Following the decline in the first half of the year, turnover tax receipts are likewise likely to be appreciably lower than estimated in May. This will depend on the trend in domestic demand and on the extent to which the measures aimed at combating tax fraud boost receipts this year.

Federal Government in the second quarter...

In the second quarter the Federal Government recorded a deficit of €6 billion, which was €4 billion higher than during the same period last year. On the one hand, this deteriorating trend was attributable to a decline in revenue (-2 %). Although non-tax revenue rose by 11 %, chiefly owing to higher privatisation proceeds, this was offset by a sharp fall in tax receipts (-4 %). On the other hand, expenditure went up steeply (+4½ %).[4] This was principally due to a rise in labour market-related expenditure of €1½ billion (or one-third). The grants to the statutory pension insurance scheme, which are financed out of revenue from the "ecology tax", also grew substantially.

... and in 2002 as a whole

For 2002 as a whole the Federal budget envisages a deficit increase of just over €2½ billion to almost €24 billion.[5] Even if, as things stand

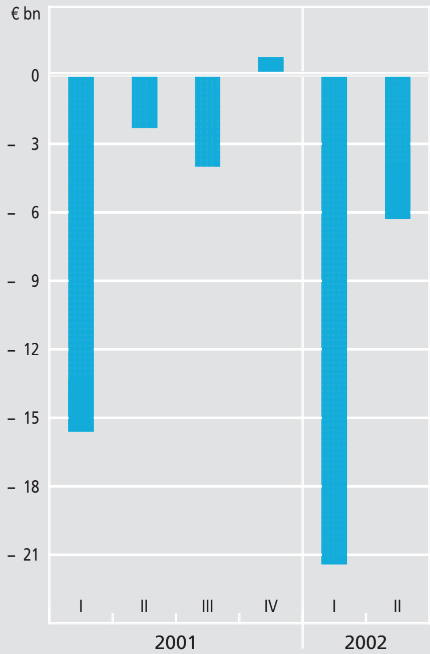
3 Tax refunds in respect of profit distributions are largely offset, however, by additional receipts from non-assessed taxes on earnings.
4 The figures shown here as defined in the government financial statistics differ to some extent from those recorded in the Federal Government budget, since the transfers to state government are generally given as a gross figure and are not deducted from tax receipts.
5 The deficit trend, as it is reflected in the actual outturn for 2001 and the targeted outturn for 2002, deviates strongly from net government borrowing. This is due to the high rate of coin collection last year and high coin seigniorage budgeted for this year in connection with the changeover to the euro. These financial transactions affect net borrowing but not the deficit. Net government borrowing is planned to be cut from just under €23 billion in 2001 to €21 billion in 2002.

at the moment, the development over the next six months improves noticeably compared with the first half of the year, risks are still apparent on balance. For example, on the revenue side tax receipts will be lower than envisaged in the budget estimate. The May tax estimate already projected a revenue shortfall of around €3 billion, and it can be assumed that this amount will also be exceeded. This calculation already takes into account that the shortfalls will be cushioned by the fact that transfers to the EU (which are deducted from tax receipts) will be smaller than the budgeted figures. These savings are thus urgently required to at least partially compensate for additional shortfalls in other areas and will therefore not be available as a source of finance for new projects. In the case of expenditure, the estimates for labour market-related spending, in particular, will be overshot because the number of unemployed persons will be higher than expected. This is all the more reason to make savings in other areas in the course of budget implementation.

Federal Government budget for 2003

The Federal draft budget for 2003 adopted by the Federal Cabinet in June envisages a deficit reduction of nearly €8 billion to €16 billion vis-à-vis the targeted figure for 2002. Revenue should increase by 3 %, fuelled by a growth in tax receipts of just under 3 % according to the tax estimate from May, on which the revenue projection is primarily based. Non-tax revenue is expected to increase by 4½ %. However, privatisation proceeds should go down by €1½ billion to €6 billion. By contrast, revenue is expected for the first time from electronic motorway tolls for heavy goods vehicles (€1½ billion).

The Federal Government's financial balance



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Federal Government expenditure is set to fall by ½ % to €246½ billion, compared with the spending total targeted for 2002. This will be facilitated mainly by a decrease in labour market-related expenditure. For example, the central government grant to the Federal Labour Office will discontinue next year (-€2 billion) and spending on unemployment assistance is to be reduced by €1½ billion. In view of the persistently favourable refinancing conditions and the maturing of high-interest bonds, interest payments – despite increasing indebtedness – are also expected to be lower (-€½ billion).[6] Personnel expenditure is to be

6 Other expenditure-reducing influences include lower investment associated with the relocation of the seat of government to Berlin, decreasing coal subsidies, the discontinuation of payments to state nursing establishments and the non-recurrence of a loan repayment to the nursing insurance scheme which was contained in the 2002 budget.

The Federal Government's financial planning over the medium term

€ billion

	2002	2003	2004	2005	2006
Expenditure	247.5	246.3	245.1	245.5	249.4
of which Investments	25.0	25.3	26.1	25.4	25.6
Revenue	223.7	230.4	234.4	240.0	248.9
of which Taxes	199.2	204.8	214.0	219.5	231.0
Privatisation sales	7.6	6.0	–	–	–
Deficit (–)	– 23.8	– 15.9	– 10.7	– 5.5	– 0.5
Seigniorage	2.7	0.4	0.5	0.5	0.5
Net borrowing	21.1	15.5	10.2	5.0	0.0
Memo item					
Change in expenditure in %	+ 1.8	– 0.5	– 0.5	+ 0.2	+ 1.6

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curbed by a continued reduction in staff levels. The Federal grant to the statutory pension insurance fund, however, is expected to go up again steeply (+€5 billion). For one thing, this is due to the rise in the share of the Federal grant financed by the last stage of the "ecological tax reform". For another, the grant is also pegged to changes in the contribution rate to the statutory pension insurance fund, which in the draft budget is scheduled to rise from 19.1 % to 19.3 %.

Federal Government's medium-term financial plan

The Federal Government's new medium-term financial plan (see table above) foresees an ongoing reduction in net borrowing. As already stated in last year's medium-term plan, no new loans should be taken out in 2006, even though the projected revenue levels have been revised downwards considerably. For example, the shortfalls resulting from the latest tax estimate had to be taken into account. In addition, no more privatisation proceeds are now envisaged as from 2004, compared with annual proceeds of €5 billion recorded in the previous financial plan. After 2003 such proceeds are to be used solely for debt repayment. The projected expenditure trend mirrors the agreement reached within the Financial Planning Council to aim to cut spending by ½ % in both 2003 and 2004. Overall, an annual average increase in expenditure of just 0.2 % is planned between 2003 and 2006.

No fiscal room for manoeuvre

The 2003 draft budget and the medium-term financial plan confirm the fiscal policy objective of consolidating the Federal budget. Although shortfalls in tax receipts had to be taken into account and financing through privatisation proceeds is no longer envisaged as from 2004, the previous deficit targets have been retained. To that extent, a greater structural consolidation has been planned. Regarding the credibility of the agreements adopted by the Financial Planning Council, it is of particular importance that the commitments which it adopted to ensure the attainment of a close-to-balance general government budget in 2004 have been incorporated into the plan. However, the spending trend forecast for next year is largely based on the underlying macroeconomic assumptions, which foresee lower labour market-related expenditure and smaller interest payments. Moreover, the plans for 2003 are subject to risks, not least in the light of the latest budget figures. Ultimately, it will be imperative to implement the intended consolidation policy on the expenditure side through a stringent implementation of the budget or to bolster it through suitable additional measures. This requires utilising any remaining savings potential. There is no scope available to expand existing government benefits or create additional ones. A further recourse to privatisation proceeds or reliance on "growth dividends" likewise offer no stable or lasting basis for financing permanent additional spending and would therefore compromise the consolidation targets.

Special funds

In the second quarter the special funds recorded a surplus of €8½ billion, which was €3 billion higher than in the second quarter of 2001. The main reason for this was the Bundesbank profit, any part of which exceeds €3½ billion is allocated to the Redemption Fund for Inherited Liabilities to repay debts. The resultant revenue expanded by €3 billion to €7½ billion. For 2002 as a whole, too, the special funds are expected to significantly increase their surplus compared with the total of €5 billion generated in 2001.

State government

In the second quarter of 2002 the revenue of state government again declined sharply (-5½ %). The fall in tax receipts of just over 7 % could not be offset by additional revenue in other areas. By contrast, expenditure rose by around 2½ %, thus widening the deficit by €4½ billion compared with the same period in 2001 to €6 billion. A number of federal states reacted to the tax shortfalls envisaged in the tax estimate of May with a budget freeze. So far Saxony-Anhalt is the only state to have adopted a supplementary budget – in connection with the change of government in that state – and plans to cope with the additional burdens induced not least by the tax shortfalls mainly through increased borrowing. As a result, the statutory ceiling for new borrowing – which applies in normal economic circumstances – will be overshot, although not as much as in the state of Berlin's budget, which was adopted only at the end of June. These examples highlight the extreme pressure which many state budgets are under at the moment. Although an improvement in budgetary developments at the state government level is expected in the second half of the year, this is unlikely to fully offset the €9 billion deficit increase recorded in the first six months, even though exceptional burdens which played a role in the latter half of 2001 will not recur this year. In the light of the probable tax shortfalls, the deficit expected for this year is likely to substantially exceed the financial gap of €20 billion currently predicted in the budgets.

Local government

For local government only the results for the first quarter are available, according to which the budgetary position continued to deteriorate. The local authorities' combined deficit grew by just over €1 billion to €4½ billion. Tax receipts again declined steeply, causing overall revenue to fall by 3 %. By contrast, expenditure rose by just over ½ %, although this was due to an unusually high number of land purchases.[7] Without this exceptional factor, aggregate local government expenditure would have gone down by ½ %. Also, surveys show that the decline in trade tax re-

7 The chief reason for this was the purchase of plots of land by the city of Stuttgart, above all in connection with the redevelopment of the city's main railway station.

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

€ 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
2001 pe	+ 14.2	+ 56.3	− 6.6	+ 1.0
of which				
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 pe	+ 15.2	+ 16.4	− 0.9	− 1.5
2002				
Q1 pe	+ 25.6	+ 15.2	+ 10.4	+ 7.5
Q2 pe	+ 1.8	+ 22.9	− 21.0	...

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

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ceipts accelerated in the second quarter, thus tending to further increase the pressure on municipal budgets. In 2002 as a whole the financial balance of local government is therefore likely to deteriorate further following a deficit of €4 billion in 2001.

Indebtedness

The indebtedness of central, state and local government rose only marginally by just under €2 billion in the second quarter thanks in part to the distribution of the very high Bundesbank profit of just over €11 billion. The Federal Government actually reduced its liabilities (including the joint responsibility assumed for the debt of the special funds) by almost €5 billion, with the level of its money market loans, in particular, falling sharply. While the indebtedness of the other special funds rose only marginally, state government took up loans amounting to just under €5½ billion on balance, largely through bond issues. Local government debt probably increased by a little more than €1 billion in the second quarter.

Social security funds

Statutory pension insurance scheme

In the second quarter of 2002, the wage and salary earners' pension insurance scheme recorded a deficit of €1 billion; this exceeded the figure for the same period last year by just under €1 billion. Overall revenue grew by just over 2 %. While receipts from contributions increased by only ½ %, not least as a result of the unfavourable employment trend, the grants from the Federal budget went up by almost 6 %. The pension insurance scheme profited, in particular, from the fourth stage of the "ecology tax". Expenditure grew by 3½ %, with pension payments – which are the predominant expense – going up by just over 3 %. In addition to the pension adjustment in mid-2001 (by 1.91 % in western Germany and 2.11 % in eastern Germany), this was also influenced by the rise in the number of pensioners. However, some relief has been afforded by the fact that the number of pension recipients has recently risen more and more slowly, not least as a result of the gradual introduction of deductions from the pension amount for pensioners taking early retirement.[8] In the second quarter

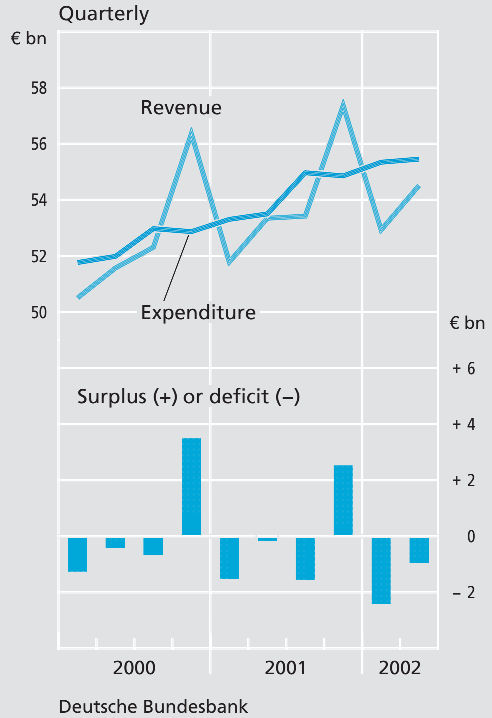
8 Since the end of 2001 men who retire before they are 65 because they are unemployed, opted for pre-retirement part-time working or have earned sufficient pension credits by paying contributions over very many years incur a 3.6 % annual reduction in their pension entitlement. This rule will fully apply to women as well by the end of 2004.

the increase vis-à-vis the same period last year amounted to only 1¼ %.

Unfavourable outlook for 2002 as a whole

The deficit is likely to be higher than expected for 2002 as a whole. The main reason for this is the disappointing level of revenue from contributions, which in turn is influenced principally by the decline in the number of persons employed. Although the relatively high pay settlements concluded in spring are likely to lift the inflow of contributions in the remainder of the year, it is nonetheless doubtful whether the minimum reserve requirement, which was lowered at the beginning of 2002 to 0.8 month's expenditure, will actually be reached at the end of the year.

Wage and salary earners' pension insurance scheme

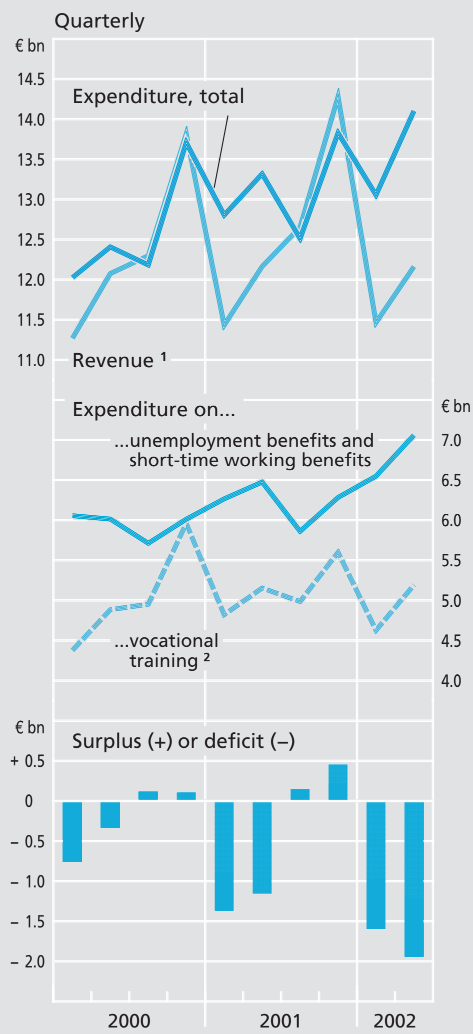


Federal Labour Office

In the second quarter the Federal Labour Office recorded a deficit of €2 billion, which was almost €1 billion higher than in the same period last year. While revenue stagnated, expenditure grew much more steeply than in the preceding quarters (by 6 %). The main reason for this was the weak situation on the labour market, which primarily pushed up expenditure on unemployment benefit (+8½ %) and short-time working benefits (+42 %) – although the latter are quantitatively less significant. The differences between western and eastern Germany, which were already evident in the first quarter, became more pronounced. Whereas in western Germany 16½ % more was spent on unemployment benefit compared with the second quarter of 2001, there was a year-on-year decline of 7 % in eastern Germany, even though the number of unemployed persons there was also higher than in the same period last year. The loss of the unemployment benefit claim after exhausting the maximum period of entitlement evidently outweighed the rise in new claimants. Spending on active labour market policy measures in the second quarter again grew modestly by ½ %. As before, expenditure on job creation measures was reduced sharply while spending on vocational training and retraining, in particular, went up noticeably.

In the first half of 2002 the deficit of the Federal Labour Office widened by €1 billion to €3½ billion. Although for seasonal reasons the financial balance tends to be much better in the second half of the year than in the first six months, the grant of €2 billion included in this year's Federal budget is likely to prove insufficient in view of the significantly higher

Federal Labour Office



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

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level of unemployment vis-à-vis the planned figure.

Statutory health insurance funds

Only data for the first quarter are available at the moment for the statutory health insurance funds. They show a deficit of just under €1 billion, which was €0.2 billion less than the figure at the same juncture last year. However, this was mainly due to the fact that the one-off "solidarity donation" of €0.2 billion from the pharmaceutical industry, which was agreed last autumn, was largely paid in during this period. The financial development in the remainder of the year depends, not least, on whether the efforts to contain costs for pharmaceuticals, in particular, are successful. As a result of the rise in contribution rates, revenue from contributions will probably increase more steeply than in the other social security systems. Even so, revenue is likely to be lower than expected, in part because an increasing number of members appear to be switching to private health insurance institutions.

General government budget

Tight containment of deficits required at all levels of government

The general government deficit (as defined in the national accounts) rose sharply last year (excluding the UMTS proceeds in 2000) by 1.4 percentage points to 2.7 % of GDP. Based on the results of the latest tax estimate, it appears likely that, given stringent budget management at all levels of government, the deficit ratio this year could be similar to that in 2001[9] – the Federal government is predicting a level of around 2½ %. This means that the safety margin below the 3 % ceiling stipulated in the Maastricht Treaty will again be small this year. It should also be borne in mind that the general government fiscal balance is sometimes subject to quite strong short-term fluctuations. Furthermore, additional budgetary risks are on the horizon. Tight containment of the deficits is therefore urgently required at all levels of government

9 For details see Deutsche Bundesbank, *Monthly Report*, May 2002, p 71f.

for the remainder of the year to keep them from reaching the 3 % ceiling set by the Maastricht Treaty.

No relaxation of fiscal policy rules

The Maastricht Treaty and the European Stability and Growth Pact, which augments and spells out certain aspects of the Treaty, constitute the fiscal policy framework of monetary union. They ensure the soundness of public finance in the individual member states of the euro area, which is important for a stability-oriented single monetary policy. In view of the current budgetary problems in several European countries, there have been calls to relax the existing rules. The German Federal Government rightly vigorously opposed such endeavours.

Credibility is of key importance

It is widely accepted that fiscal policy rules are necessary in a monetary union. However, such supranational commitments can have their full impact only if they are transparent, comprehensible to and verifiable by the general public and, in particular, credible. The latter requirement is especially crucial for relatively new institutions. If unanimously adopted agreements are relaxed at the very first hurdle, public confidence in the underlying framework of monetary union will be damaged.

Stabilising function of public finance ensured

One of the main criticisms of the existing rules is the alleged lack of flexibility which would result in a pro-cyclical fiscal policy. The general government sector does not lose its macroeconomic stabilising function, however, on account of the fiscal policy rules that apply under monetary union. By signing the European Stability and Growth Pact in 1997, the EU member states committed themselves to achieving budgets which are close to balance or in surplus in the medium term. This means that revenue and expenditure should be largely equal in the medium term – ie over the business cycle. Yet the fluctuation of the fiscal balance during the business cycle is fully compatible with that requirement. If such a basically balanced budgetary position is reached, there should normally be no danger of overshooting the 3 % ceiling in an economic slowdown.[10] Problems can only occur if such a budgetary position has not been reached and there is only a small safety margin below the 3 % ceiling. But this cannot then be blamed on the fiscal policy rules but rather is attributable to the fact that the agreed targets have not been reached.

Consolidation requirements

Starting from a still unbalanced budgetary position in 2000, the structural deficits in Germany, Italy, France and Portugal widened further, in some cases noticeably. In Portugal the 3 % ceiling for the actual deficit was considerably overshot in 2001, and in the other countries the safety margin has become small or even very small. Two things are now imperative. Firstly, the European bodies need to unswervingly implement the existing rules. Secondly, the fiscal policy makers in the respective member states need to honour the commitments they have entered into and, in particular, to avoid exceeding the 3 % ceiling or – in Portugal's case – to bring the deficit below the ceiling as quickly as possible.

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10 The 3 % ceiling may be overshot, however, if real GDP falls by more than 2 % per year. Exceptions are permissible if GDP falls by between 0.75 % and 2 %.