

Public finance

Central, state and local government budgets

The central, state and local government budgets continued to deteriorate in the third quarter. The deficit (excluding that of local government, the results of which are not yet known) was €11 billion – €2 billion higher than in the same period last year. While revenue continued to be weak, mainly owing to sluggish tax receipts, expenditure rose considerably due, in particular, to labour market-related spending.

Underlying trends

After having already climbed to €48 billion last year, the general government deficit for 2002 as a whole is likely to exceed €60 billion. According to the budget plans, however, the deficit should have declined. This deterioration was primarily caused by the dramatic shortfall in revenue. Tax receipts are likely to decline by 1½% and therefore end up more than €25 billion lower than in the original plans. However, expenditure – particularly labour market-related spending – is also growing faster than expected. Next year a fall in the deficits may be recorded if tax receipts develop more favourably again, the budgetary position improves due to statutory measures and a very stringent expenditure policy is implemented.

Tax receipts¹ in the third quarter declined by ¼% vis-à-vis the same period last year, after falling by just over 5% in the first half of 2002. Although this slide has now probably

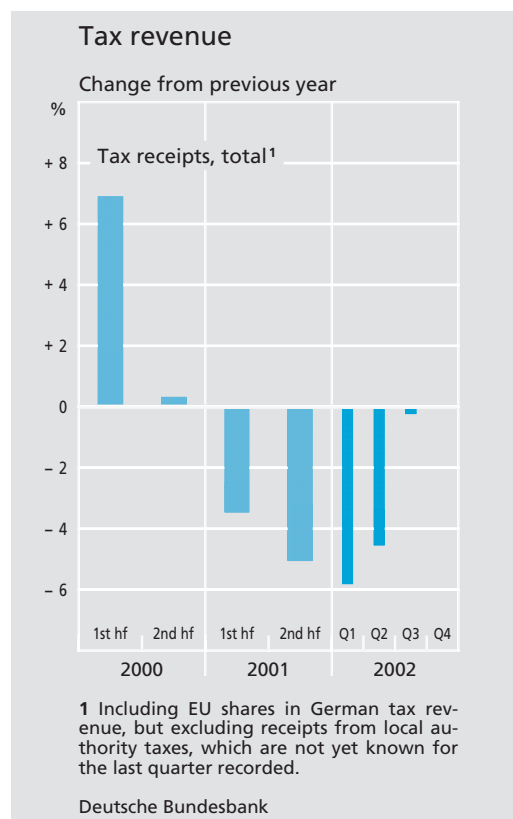
Tax receipts in the third quarter...

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

bottomed out, the recovery in the revenue trend, which was expected in spring, failed to materialise, above all because of the persistent economic slowdown.

Among income taxes, wage tax receipts grew by 1¼% in the third quarter after stagnating in the second quarter. Before deducting child benefit, which was increased at the beginning of the year, the rise amounted to 3%. The impact of the higher pay settlements this year – which included back payments for previous months – made itself felt for the first time in the third quarter. By contrast, the employment trend continued to dampen revenue growth. Receipts from assessed income tax also went up (by 2%), with prepayments apparently being somewhat higher. The outturn for corporation tax improved for the first time since mid-2000, yielding almost €1 billion, whereas in the third quarter of 2001 refunds had exceeded receipts by just over €½ billion. This more favourable result was, however, mainly attributable to the fact that corporation tax receipts were not dented as sharply as last year by the distribution of profits retained in earlier years. Revenue from non-assessed taxes on earnings declined by 41% as a result of the fall in profit distributions and the lowering of the investment income tax rate on dividends from 25% to 20% at the beginning of the year. In addition, receipts from the withholding tax on interest payments went down by just under 12% owing to a fall in the average rate of interest.

In the case of indirect taxes, the decline in turnover tax receipts continued (-¾%). This was caused partly by lower retail trade turn-



over and also by the fact that taxable investment in the housing and government sectors declined further. Among excise duties, receipts from tobacco tax and insurance tax rose steeply (by 15% in each case) in the wake of the tax increases at the beginning of the year, whereas receipts from mineral oil tax in the third quarter only reached the same level as last year despite the increased tax rates.

Tax receipts in 2002 as a whole will be much lower than forecast in May, mainly as a result of the pronounced economic slowdown – which to some extent is being reflected in the development of revenue only with a delay. The new official tax estimate projects a decrease of 1½% vis-à-vis 2001, with a revenue total €15 billion down on the figure esti-

... and in 2002
as a whole

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Change from pre- vious year in %
	Q1 to Q3		
	2001	2002	
Wage tax	93.7	93.3	- 0.4
Assessed income tax	4.1	3.0	- 26.5
Corporation tax	1.5	- 0.3	.
Turnover tax	103.3	102.2	- 1.0
	<i>of which: Q3</i>		
Wage tax	31.5	31.9	+ 1.2
Assessed income tax	3.2	3.3	+ 2.1
Corporation tax	- 0.6	1.0	.
Turnover tax	34.5	34.2	- 0.8

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mated in May. Despite the tax increases which came into effect at the beginning of 2002, the overall tax ratio will again decline significantly; based on the Federal Government's assumption of nominal economic growth of 2% (and real growth of ½%), the tax ratio (as defined in the government financial statistics) will contract by 0.8 percentage point this year to 20.8%.

The shortfalls vis-à-vis the spring estimate relate chiefly to corporation tax and trade tax. In addition, receipts from turnover tax and wage tax are considerably lower than projected in earlier forecasts because both taxable domestic demand and gross wages and salaries are growing far more slowly than previously anticipated. Moreover, the measures aimed at combating turnover tax fraud,

which were adopted at the end of 2001, will apparently not yield much additional revenue this year.

The tax shortfalls vis-à-vis the estimate in May will widen even more next year because the assumed rate of economic growth in 2003, too, will be significantly below the earlier expectations (nominal growth of 3½% and real growth of 1½%) as a result of the delayed economic upturn.² It is now estimated that tax revenue – adjusted to account for recent amendments in tax legislation – will be €22 billion lower. But unlike this year, tax receipts will increase again markedly in 2003 by nearly 4½%. This figure includes additional revenue, compared with the May estimate, of around €6 billion raised to finance the assistance to the flood disaster victims (ie in particular by postponing the next stage of the tax reform by a year to 2004). However, this estimate excludes the plans to reduce current tax breaks and increase taxes, which have not yet been passed by parliament. The tax ratio in 2003 is therefore likely to notably surpass the increase by 0.2 percentage point (to 21.0%) – as defined in the Government's financial statistics – which is expected in the new official tax estimate.

*Tax receipts
in 2003*

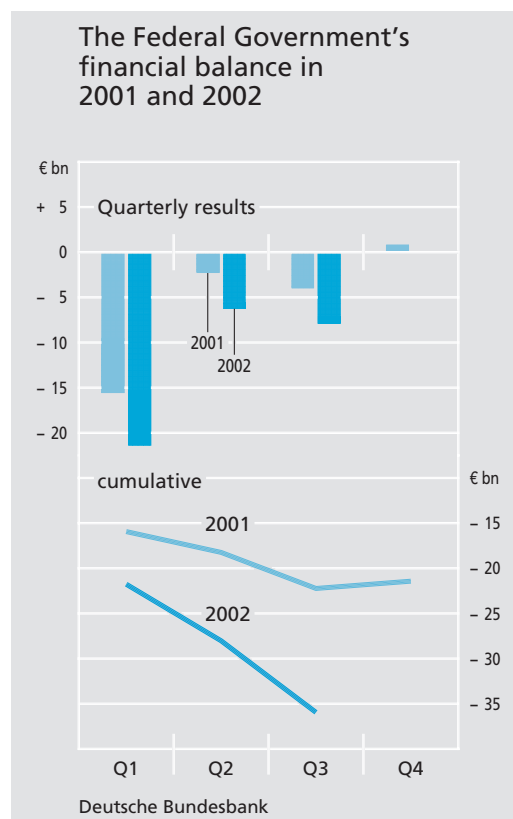
In the third quarter the Federal Government recorded a deficit of €8 billion, which was €4 billion more than in the same period last year. Revenue stagnated. While tax receipts grew by 1½%, non-tax revenue contracted by 3½%. Expenditure grew by a steep 6½%.

*Federal
Government*

² In spring, by contrast, the Federal Government had expected that GDP would grow in 2003 by 4% in nominal terms and 2½% in real terms.

This was primarily due to the €1½ billion rise in labour market-related expenditure. Furthermore, transfers to the statutory pension insurance scheme and to the Federal Railways Fund, as well as other operating expenditure, also went up substantially.

For 2002 as a whole, the deficit is likely to be much higher than expected (€24 billion). This is due to the fact that, firstly, tax receipts – according to the latest estimate – will be almost €12 billion lower than anticipated and that, secondly, expenditure of the Federal Labour Office and unemployment assistance together will exceed the budgeted total by some €5 billion. Compensatory movements in other areas – including transfers to the EU, guarantees and non-tax receipts – will in no way suffice to offset this higher spending and lower revenue. Savings in the course of implementing the budget will be partly offset by the additional financial requirements associated with overcoming the flood damage. Net government borrowing must also compensate for coin seigniorage, the trend in which is significantly below that estimated in the budget plans. Since the borrowing authorisations still available from earlier years will not be sufficient to cover the additional requirements, a supplementary budget will have to be adopted for this year. The required level of net borrowing will exceed the budgeted amount of investment spending. According to Article 115 of the Constitution, this is permitted in exceptional circumstances if it serves to avert a disruption of the overall economic equilibrium.



The Federal budget draft for 2003 envisaged a decline in the deficit to €16 billion. In view of the looming additional shortfalls reaching sums in the tens of billions, the government coalition parties agreed on an extensive package of measures.³ Firstly, this should yield savings on the expenditure side – in labour market-related spending in particular – of around €6 billion next year. Secondly, numerous tax measures, which in the first year notably include additional revenue from turnover tax and from energy taxation, should boost the Federal Government's tax receipts by just over €4 billion. Thirdly, central government is intending to raise its net borrowing by €2½ bil-

³ It had already been decided that general government's additional shortfalls associated with the flood damage are to be offset by postponing the next stage of the tax reform to 2004 and by temporarily raising the corporation tax rate from 25% to 26.5%.

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

€ billion

Period	Total	of which		Memo item Acquisi- tion by non- resi- dents
		Securi- ties 1	Loans against borrow- ers' notes 2	
2001	+ 14.2	+ 56.3	- 6.6	+ 1.1
<i>of which</i>				
Q1	- 10.4	+ 13.9	+ 9.7	- 11.8
Q2	- 6.1	+ 7.5	- 13.7	- 0.5
Q3	+ 15.6	+ 18.5	- 1.8	+ 14.9
Q4	+ 15.2	+ 16.4	- 0.9	- 1.6
2002				
Q1	+ 25.6	+ 15.2	+ 10.5	+ 7.2
Q2	+ 1.5	+ 22.9	- 21.4	+ 11.7
Q3 <i>pre</i>	+ 18.3	+ 25.6	- 6.1	...

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

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lion to €18 billion; it would, however, be well below the level of investment spending (for details of the overall consolidation package, see page 57 f). All in all, if these targets are reached, the Federal Government would make considerable consolidation progress in comparison to this year. Although there are fiscal deviations vis-à-vis the deficit goal set in the medium-term financial plan for 2003, most of the financial gap will be closed.

Special funds

The surplus generated by the off-budget special funds in the third quarter, at nearly €1 billion, was a little higher than in the same period last year. The surplus expected for the whole of 2002 will increase markedly compared with 2001, when it reached €5 billion. The main reason for this is the Bundesbank profit paid in April, which rose by €3 billion

over twelve months to €11 billion. Any part of this profit which exceeds €3½ billion is allocated to the Redemption Fund for Inherited Liabilities.

In the third quarter the *Land* Government budgets recorded a deficit of €4 billion after €5½ billion in the third quarter of 2001. Tax receipts declined further, even though this fall was only marginal compared with the first six months. By contrast, non-tax receipts rose steeply. Although expenditure grew by only 1%, when adjusted for the bloating of last year's base figure caused by the one-off injection of capital into Bankgesellschaft Berlin the growth in spending amounted to 4%. The cumulative deficit in the first nine months reached €19½ billion, compared with €12 billion in the same period last year. This was mainly attributable to the fall in revenue of just under 3% but also to the fact that expenditure rose by another 1½% despite the exceptional burden in 2001. In 2002 as a whole, last year's record deficit of €27½ billion is likely to be exceeded (in contrast to the planned decline to less than €20 billion), with the full-year shortfall topping €30 billion.

*Land
Governments*

The announced tax measures would result in additional revenue next year for state government, too, although this rise (by just over €2 billion) will be only half as large as that of central government. The extra spending necessitated by the flood damage is to be financed by the additional tax revenue measures adopted for this purpose. However, it cannot be ruled out that the majority of *Land* Governments' budgets – taking into account the downward revisions in the latest tax esti-

mate – will overshoot the constitutional ceilings for new borrowing.⁴ Even based on earlier more favourable tax estimates, several *Land* Governments had resorted to problematic appropriations in order to keep the budgeted amounts for net borrowing below the level of self-financed investment.⁵ Given the extreme financial constraints on the *Land* Governments, they need to take comprehensive consolidation measures.

*Local
government*

For local government, only the results for the second quarter are available so far, according to which overall revenue rose marginally thanks solely to a large sale of participating interests in Baden-Württemberg. Expenditure grew sharply by almost 3%, which was mainly attributable to the development of social benefits, expenditure on staff and other operating expenses. By contrast, fixed capital formation fell further. The financial balance deteriorated by nearly €1 billion vis-à-vis the second quarter of 2001. In the first half of 2002 the deficit had thus already widened by €2 billion to almost €5 billion, and no improvement in the budgetary position is expected in the second half of the year either.

Indebtedness

In the third quarter the indebtedness of central, state and local government rose by €18½ billion. The Federal Government alone drew on the credit markets to the net amount of €10 billion. Although it redeemed money market loans to the value of €3 billion, it raised €13½ billion in the capital market. The indebtedness of the special funds barely changed in the third quarter. On the other hand, the *Land* Governments expanded their indebtedness sharply by €7½ billion. Local

government debt probably increased by almost €1 billion.

Social security funds

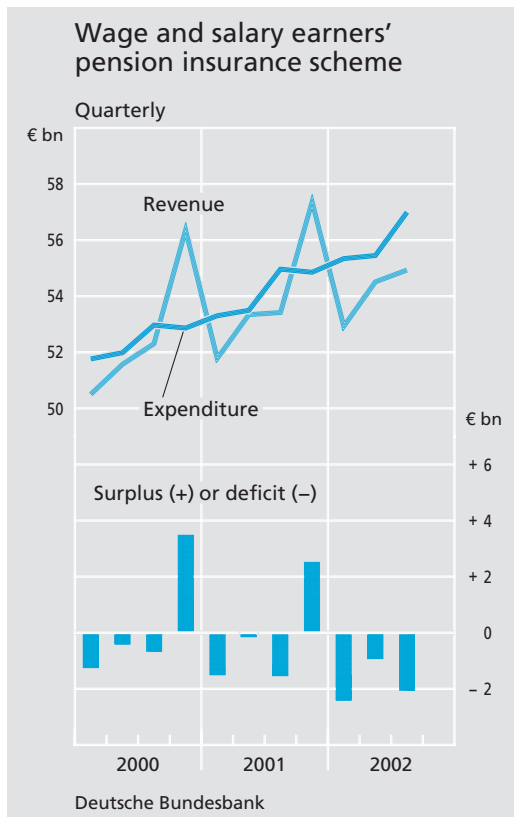
In the third quarter the wage and salary earners' pension insurance scheme recorded a deficit of €2 billion, which was €½ billion higher than in the same period last year. While expenditure grew by just over 3½%, revenue exceeded the figure for last year by just under 3%. Despite the relatively high pay settlements concluded in the spring, compulsory contributions rose by only ½%. By contrast, grants from the Federal budget increased by a little under 6% in total. Although the pension increases from 1 July 2002 were higher than in 2001, the growth of expenditure on pensions did not accelerate (not quite 3½%).⁶ The main reason for this is that the number of pension recipients has risen more slowly, which is due in part to the introduction of deductions from the pension amount for pensioners taking early retirement. By contrast, considerably more (almost 6½%) was spent on pensioners' health and nursing insurance because from mid-year the applicable rate is the contribution rate to the statutory health insurance institutions valid at the beginning of the year, and this increased

*Statutory
pension
insurance
scheme*

⁴ This could be avoided by most state governments in 2002 through recourse to unused borrowing authorisations and reserves.

⁵ Examples of this are the investment grants of state government which are explicitly financed from current transfers from central government, the EU and the municipal tax-sharing arrangements as well as unspecified additional revenue and lower expenditure.

⁶ On 1 July 2002 pensions were raised by 2.16% in western Germany and 2.89% in eastern Germany. The comparable figures for 2001 were 1.91% in western Germany and 2.11% in eastern Germany.



at the start of 2002 from 13.65% to 14.0% on average.

Outlook

The required minimum fluctuation reserve of 0.8 month's expenditure is likely to be considerably undershot at the end of this year. In the light of the less favourable outlook for employment in 2003, too, the contribution rate is expected to rise from 19.1% to 19.5%. In order to avoid an even higher level, the fluctuation reserve is to be reduced further and the income ceiling for contributions significantly raised.⁷ It should be noted in this connection that the smaller the required fluctuation reserve, the greater the probability is of having to rely on liquidity assistance from the Federal Government during the year. A second consequence is that the additional contribution payments that will

now be deducted from persons whose income exceeds the current contribution ceiling will result in correspondingly higher pension claims in the future. This means that the burden on future contribution payers will be even heavier in a period when the strains caused by demographic developments will already be greatest.

In the third quarter of 2002 the Federal Labour Office recorded a deficit of just over €1 billion, whereas it had ended up close to balance in the corresponding quarter of last year. A rise in expenditure of nearly 11% was accompanied by virtually stagnating revenue. The main cause of the worsened financial situation, besides the disappointing development of the trend in revenue from contributions (+½%), was increasing unemployment. This resulted in 13% more being spent on unemployment benefit. By contrast, the number of registered unemployed persons on average over the quarter exceeded last year's corresponding figure by just 6%. This discrepancy can be explained by higher *per capita* payments and a rising share of benefit recipients among the total unemployed. This constellation, which is typical during a labour market downturn, indicates a big influx of unemployed persons with "fresh" claims. Furthermore, long-term unemployed persons without entitlement to unemployment benefit have probably deregistered. This pattern is determined by the development in western Germany. In eastern Germany, conversely, an increase in the number of unemployed was

Federal Labour Office

⁷ From €4,500 per month in western Germany and €3,750 in eastern Germany to €5,100 and €4,250, respectively.

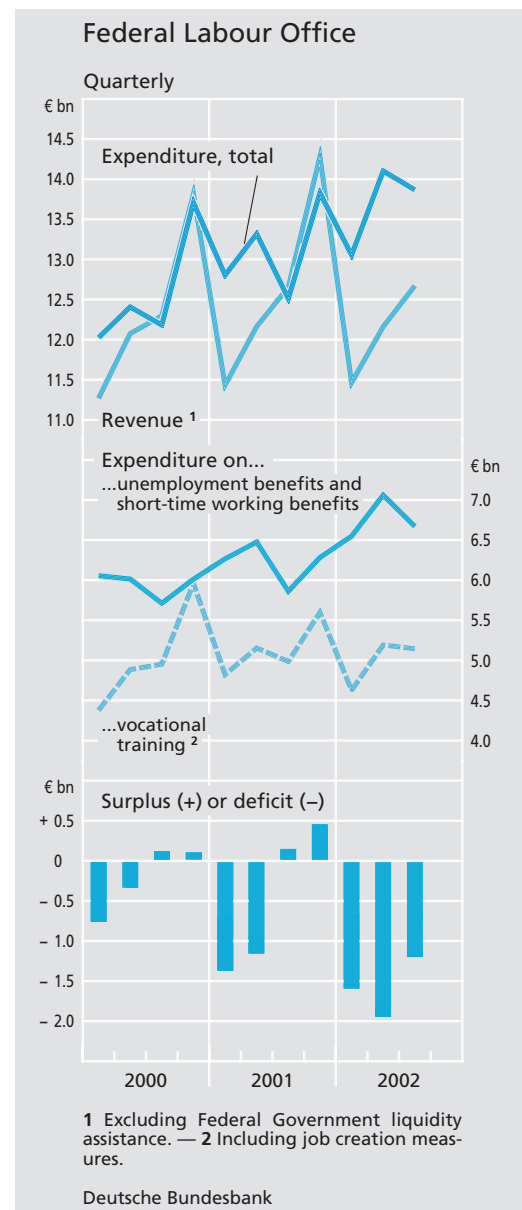
again accompanied by a decline in expenditure on unemployment benefit. This suggests an entrenchment of long-term unemployment there.

Deficit this year significantly higher than anticipated

Between January and September the deficit of the Federal Labour Office doubled vis-à-vis last year, reaching just over €4½ billion. The envisaged required grant of €2 billion from the Federal budget for 2002 will therefore be considerably overshoot. However, the deficit is not expected to increase further in the last quarter because the revenue from contributions is likely to be relatively high thanks to Christmas bonuses and the substantial wage increases concluded in the spring. If, as planned, the need for a Federal budget grant is to be obviated next year, considerable re-trenchment efforts will have to be made that go beyond a restructuring of active labour market policy.

Statutory health insurance fund

In the first six months the statutory health insurance fund recorded a deficit of €2½ billion, which was only marginally lower than in the same period last year. Despite the average rise in contributions at the beginning of the year from 13.65% to 14.0%, revenue from contributions did not suffice to cover current expenditure, which rose significantly in the case of pharmaceuticals and hospitals, in particular. Consequently, no financial resources were available to replenish the statutory reserves. The growth in expenditure is not expected to slow down noticeably before the end of the year. The impending rise in contribution rates as a result of the tense financial situation is to be avoided by means of the draft Act to Stabilise the Rate of Contribu-



tions presented by the Government. This Act envisages savings in expenditure. A rise in contribution rates should only be possible in exceptional circumstances. Many health insurance institutions are, however, likely to invoke this clause.

The debate on amending the Stability and Growth Pact

The European Stability and Growth Pact was adopted in Amsterdam in 1997 to ensure sound public finance in European monetary union (and also in those countries of the European Union which have not yet introduced the single currency). The rationale underlying the Pact is the realisation that sustainable public finance promotes sustainable economic growth and a favourable employment trend and makes it easier for the European Central Bank to perform its task of safeguarding monetary stability in the euro area. The Pact, which was initiated principally by Germany, is thus an integral part of the economic policy framework of monetary union. It details and expands on corresponding rules in the Maastricht Treaty, which was adopted in 1992.

While the majority of EU member states had at least achieved a balanced budget in 2001, Germany, France, Italy and Portugal have still not fulfilled the requirement of a budgetary position that is close to balance or in surplus over the business cycle – five years after the adoption of the Pact. Some of these countries are even having difficulties keeping below the 3 % ceiling for the general government deficit ratio that was already set by the Maastricht Treaty, or have actually exceeded it. These fiscal problems have recently triggered an extensive debate about the Pact's meaningfulness as well as various proposals to change it.

A number of commentators have suggested excluding public investment expenditure from the calculation of the government deficits. They argue that public investment has positive growth effects and that present-day generations are placed at a disadvantage if such expenditure cannot be financed

through deficits. The counterargument to this is that government activity redistributes burdens between the generations in other ways besides public investment and indebtedness. For example, if the ageing of the population develops as expected, future generations will be heavily burdened by the current pay-as-you-go statutory pension insurance systems. It is therefore wrong to consider public investment in isolation in the context of the inter-generational implications of government activity. Although certain types of public investment may indeed boost economic growth potential, it is very difficult in practice to distinguish them from other forms of government spending. For example, government investment expenditure intended for consumption purposes (such as swimming baths or old people's homes) is hardly likely to generate longer-term economic growth impulses, whereas spending on education – which has more positive consequences in this connection – is classified as government consumption expenditure. It should also be noted that a considerable proportion of public investment merely serves to maintain the existing capital stock and also that investment projects may entail considerable follow-up costs. Hence defining the concept of investment in this context is extremely contentious and probably could not be implemented in a transparent, internationally harmonised and accepted fiscal policy rule. Furthermore, the Stability and Growth Pact does not restrict public investment that boosts productivity; it merely stipulates that such investment may not be debt-financed.

Another point that features prominently in the current debate about amending the Stability and Growth Pact is the claim that the Pact is not flexible

enough to take sufficient account of cyclical fluctuations. The proponents of this view say that in the present phase of sluggish cyclical momentum the Pact is forcing policy makers to pursue a restrictive fiscal policy and is thus acting as an additional drag on economic growth. What such critics overlook is that the Stability and Growth Pact is explicitly designed to allow cyclical fluctuations in the government fiscal balance so that, to this extent, fiscal policy can perform its stabilisation function. Thus if the member states meet the requirement of reaching a budgetary position that is at least close to balance under normal economic circumstances, they will generally have a sufficient safety margin below the 3% ceiling for the deficit ratio. Consequently, they can cope with cyclical strains on the budget without breaching the deficit limit. During a severe recession the 3% ceiling may even be temporarily exceeded. Contrary to many claims, therefore, the Stability and Growth Pact shows considerable flexibility with regard to cyclical fluctuations.

However, budgetary problems arising from insufficient consolidation in the past are a different matter. Only those countries which have not yet reached a structural budgetary position that is at least close to balance cannot cope for long with cyclically induced increases in the deficit. This also applies to Germany which in 2000, following a phase of relatively strong economic growth, was still far from reaching a balanced budget and in the two following years saw its deficit ratio rise by around 2 percentage points – not least for structural reasons. The countries concerned are faced with a dual task: they must lower their deficit ratios below the 3% ceiling – or not exceed it in the first place –

and achieve a structurally balanced budgetary position as quickly as possible.

The Stability and Growth Pact's provisions and sanctions in the event that the deficit limit is breached are appropriate. If the ceiling is overshoot and none of the precisely defined exceptional circumstances obtain, effective consolidation measures are to be taken swiftly to bring the deficit back under the threshold. Otherwise sanctions are envisaged for the member state concerned in the course of a multi-stage procedure. Stringent implementation of these rules by the European institutions is called for so as to prevent any backsliding into the policy of debt accumulation pursued during the previous decades, with the associated negative repercussions for medium and long-term growth and employment prospects. This will also make it easier for the European Central Bank to carry out its task of safeguarding monetary stability.

Given that no deadline was specified in the Pact for achieving a budgetary position which is at least close to balance, the European Commission has suggested relaxing the current rules in order to take account of the considerably deteriorated overall economic outlook.

It no longer foresees 2004 as the deadline. Instead, those countries with high deficit levels are to reduce them annually by at least 0.5% of GDP, measured on a structural basis, which will ultimately mean that the target must be reached by 2006 at the latest. The consolidation path required for the individual countries must be reinforced by specific measures to ensure that the Pact's objectives are attained – even if with a delay.

Outlook for the general government sector as a whole

The 3% ceiling will be breached in 2002

This year Germany's deficit ratio will markedly exceed the 3% ceiling set by the Maastricht Treaty, after it had already doubled last year to 2.8%. Yet whereas last year fiscal policy – particularly as a result of the comprehensive tax cuts – largely contributed to the deficit increase, the further rise this year is mainly due to cyclical developments and other (temporary) influences.

Marked drop in revenue

The main reason for the unexpected deficit increase is the marked drop in revenue. The dampened trends in gross wages and salaries and in private consumption are leading to losses in revenue from social security contributions, wage tax and turnover tax. In addition, taxes related to profits have developed very unfavourably. This was probably due, *inter alia*, to temporary factors, such as write-downs and the combination of lower prepayments and a speedier assessment of the 2001 fiscal year when profits were low. The tax and social security ratio (as defined in the national accounts) will decrease by around ½ percentage point to 41½%, despite the noticeable rises in excise duties and in the average contribution rate to the statutory health insurance fund. This pronounced – and unexpected – decoupling of taxes and levies from the trend in GDP and its sub-components is, however, likely to abate at least partly in the next few years. Expenditure in 2002 will increase more sharply than last year (+1.7%), mainly as a result of the trend in labour market-related expenditure and the rise in child benefit. Spending on measures to over-

come the flood damage is unlikely to have its main impact until 2003 and is therefore not a decisive factor in the deficit exceeding the 3% ceiling in 2002.

Even with stringent budgetary implementation, if no additional consolidation measures are introduced next year it is not certain that the general government deficit ratio can be brought back below 3%. But this is absolutely essential if the excessive deficit procedure prescribed by the Stability and Growth Pact is to be terminated as quickly as possible. This procedure is set in motion as a rule if the deficit ratio exceeds 3% and may ultimately result in severe financial penalties.

The objectives of the Stability and Growth Pact and their implementation have recently been called into question by various commentators. Any amendments or even the abolition of the Pact, however, would impair the foundations of the single European currency and future economic development (see box on page 54 f). By contrast, a convincing consolidation strategy, which results in a decrease in the general government deficits and ultimately demonstrates that fiscal policy makers have the capability to implement ambitious objectives with a view to lastingly limiting the burden of taxes and social security contributions and government activity, could also create a more positive consumption and investment climate in the short term – particularly if it is coupled with reforms aimed at fostering growth, not least on the labour market. A stable fiscal policy framework and public confidence that policy makers will comply with transparent and

Need for consolidation

Stability and Growth Pact improves macroeconomic framework

verifiable rules are important conditions for macroeconomic stability in an enlarged European Union, too.

Consolidation measures of the Federal Government

Consolidation package: overall scope ...

Following the German parliamentary elections, the coalition government parties agreed on a consolidation package which, based on the original scope of the package, would ensure that the deficit ceiling set by the Maastricht Treaty is not overshoot again and would support the goal of a medium-term balanced budget. In addition, however, very stringent budget management is also required. The Federal Government estimates that the measures in the coalition agreement will amount to around ¾% of GDP in 2003 and will then rise in subsequent years.

... and structure

The package includes cuts in labour market-related expenditure, cuts in subsidies and numerous tax measures, although amendments to the original plans may be expected during the course of the legislative procedure. While the expenditure cuts would help to reduce the government expenditure ratio – a desirable macroeconomic aim – and to lessen disincentives, the tax and social security ratio would be raised by the taxation measures, and some elements of tax legislation would be made more complicated. These measures range from abolishing exemptions from tax rules to changing certain systemically justified provisions – notably by limiting the ability of firms to offset losses against profits. From a macroeconomic viewpoint, the measures af-

fecting the corporate sector – which, contrary to the curbing of social benefits, are to have a far larger impact in the coming years – would worsen the investment climate and hence the longer-term outlook for growth. The extended taxation of capital gains would make firms' equity financing more expensive and hamper domestic capital formation. In the further course of the decision-making process policy makers therefore need to consider whether perhaps more extensive measures could be adopted that principally curtail government consumption expenditure instead of private-sector investment, which is crucial for longer-term growth prospects. A major potential field of action in this respect is the development of personnel expenditure in the public sector.

Overall, it is necessary to create a clear consolidation perspective that boosts confidence in a sustainable fiscal policy. Not least given the fiscal rules which apply under European monetary union and in the light of a stability-oriented monetary policy, reducing the government deficits is a high priority. It should therefore be ensured that the envisaged volume of relief measures in favour of the government budgets are actually achieved.

The consolidation package will, for the most part, ease the budgetary position of the Federal Government. Reducing the overall deficit, however, requires great efforts at all levels of government. The deficit ratio is attributable – more or less in equal parts – to central government, on the one hand, and to state and local government, on the other. With a view to achieving consolidation on the

Efforts required from all levels of government

part of all levels of government, the Financial Planning Council decided in spring to tightly limit spending in order to achieve the goal of medium-term balanced budgets as well as to finance the adopted tax cuts which will come into force at the beginning of 2004 and 2005. In addition, the goal of medium-term balanced budgets has now been enshrined in German budgetary law by an amendment to the Budget Principles Act. To be able to com-

ply with the agreed expenditure limits, it is very important – for the *Land* Government budgets, in particular – that the pay settlements in the public sector remain moderate. Although the social security funds will be balanced in the medium term, they likewise have a pressing need to limit their expenditure so as to reduce the burden of social security contributions.