Public finance

Central, state and local government budgets

Underlying trends

In the second quarter of 2003, the combined deficit of central and state government (excluding the results of local government, which are not yet known) was again considerably higher (€7 billion) than the deficit in the same period last year (€4½ billion). However, this less favourable development was due not to declining tax receipts, as in the preceding quarter, but rather predominantly to the €6 billion fall in the Bundesbank's profit distribution. Therefore, despite a relatively large increase in tax receipts (+4%), revenue stagnated whilst expenditure rose by 2%.

Following the sharp increase in the deficits of central, state and local government in the first half of 2003, these deficits are also likely to considerably exceed last year's already high amount of €60 billion in 2003 as a whole. The Federal Government and the majority of the *Land* governments will clearly miss their budget targets, which had envisaged a significant reduction in the deficits. Net borrowing will, for the most part, exceed the fundamentally applicable constitutional level of (self-financed) investment. The local authorities' fiscal position is likely to deteriorate discernibly and, in many cases, will probably run into even greater conflict with requirements under budgetary law. The surplus of the special funds will decrease owing to the fall in the Bundesbank's profit distribution. The tense budget situation which central, state and local government is facing, together with the deficit to be expected in the social security funds, will – as last year – result in a breach of the 3% deficit ceiling laid down in the Maastricht Treaty.

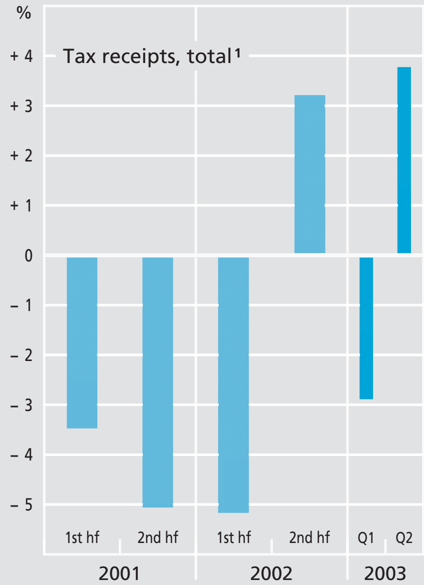
Tax revenue in the second quarter...

In the second quarter, the tax receipts[1] of general government were almost 4% higher than in the corresponding period of last year after having decreased significantly in the first quarter. However, this relatively sharp increase was considerably inflated by last year's low baseline figure, which had been dented by exceptional factors. The strong growth in revenue in the second quarter thus cannot yet be seen as signalling a positive reversal in trend.

Among direct taxes, there were favourable developments in corporation tax receipts in particular. They amounted to just over €1 billion, whereas in 2002 refunds had exceeded tax payments by €2 billion. At that time, the outcome had been strongly affected by major refunds to individual enterprises. Furthermore, higher retrospective payments in respect of earlier years have been received in 2003 and corporation tax has been reduced only marginally by supplementary dividend distributions.[2] On the other hand, revenue from non-assessed taxes on earnings – essentially investment income tax on dividends – has continued to decline substantially (by one-fifth or almost €1 billion). As in the case of corporation tax, it is not yet possible to record a positive reversal in trend with regard to prepayments for assessed income tax. Receipts remained around 22% down on the corresponding figure for last year, although this was due primarily to lower payments in respect of past years. Receipts from tax on interest income have continued to fall (by 7½%), above all as a result of the declining average rate of interest.[3] By contrast, the wage tax yield increased by just over 2%. Revenue growth, which was considerably stronger than in the first three months, was however also boosted by the one-off payments agreed as part of the pay settlements in the public sector and the metal-working industry.

Tax revenue

Year-on-year change



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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1 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known.
2 According to current information, however, the three-year moratorium for the use of tax credits relating to earnings retained before the tax reform, which was introduced by way of the Act to Reduce Tax Subsidies (*Steuervergünstigungsabbaugesetz*), has barely had an impact up to now.
3 Furthermore, there appear to have been portfolio shifts towards open-end real estate funds, the receipts from which are largely exempt from tax in Germany.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion 1st half 2002	2003	Annual percentage change
Wage tax	61.4	62.3	+ 1.5
Assessed income tax	– 0.3	– 2.9	.
Corporation tax	– 1.3	3.7	.
Turnover tax	68.0	67.0	– 1.5
	of which Q2		
Wage tax	31.0	31.7	+ 2.2
Assessed income tax	3.3	2.6	–22.1
Corporation tax	– 2.0	1.2	.
Turnover tax	33.5	33.3	– 0.5

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In the case of indirect taxes, revenue from turnover tax continued to fall somewhat (-½%). This reflected the persistently muted development in domestic demand. By contrast, receipts from energy taxes rose by just over 9% owing to the tax increases which entered into force at the beginning of the year.

... and in 2003 as a whole

In the first half of the year, tax revenue was only ½% higher than the corresponding figure last year, whereas the official tax estimate from May projected revenue growth of just over 2% for 2003 as a whole (excluding local government taxes in both cases). Despite the more favourable result for the second quarter, the downside risks vis-à-vis the May forecast predominate. Thus, following the economic stagnation so far this year, it cannot be expected that the rate of economic growth on which the Federal Government based its estimate at that time (¾% in real terms and just over 2% in nominal terms) will be achieved this year. With regard to the major individual taxes, there is a risk of shortfalls vis-à-vis the spring forecast, above all, for wage tax and turnover tax. At 1½%, wage tax receipts increased in the first half of the year at only half the rate previously predicted for 2003 as a whole. Revenue from turnover tax fell by 1½%, whereas an overall slight increase had been expected in the estimate for 2003 published in May.

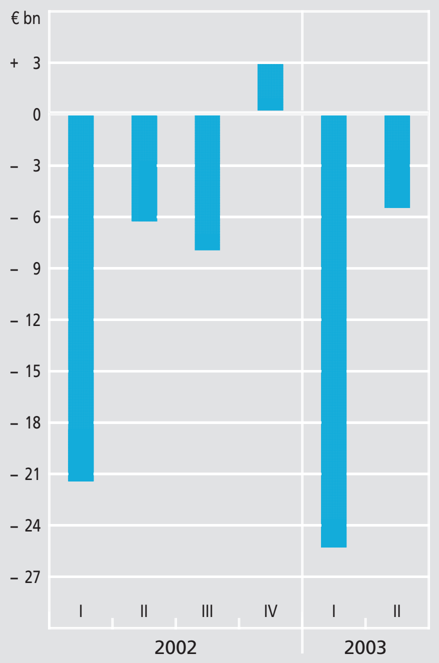
Federal budget in 2003

In the second quarter, the deficit recorded by the Federal Government fell on the year by just under €1 billion to €5½ billion. Revenue increased relatively sharply by 5% owing to the marked rise in tax receipts. However, this was partly offset by a significant increase in expenditure (by just over 3%), which was mainly due to the rise in government grants to the statutory pension insurance scheme and the flood disaster fund as well as to labour market-related spending. The Federal Government's budget plan for 2003 as a whole envisages a sharp year-on-year decline in the deficit (to €19½ billion from €32½ billion). However, this target will be considerably undershot and so a supplementary budget has been announced. Tax revenue will be far lower than expected. According to the May tax estimate, this will result in shortfalls of €4 billion for the Federal Government. In addition, the fact that certain tax measures (Act to Reduce Tax Subsidies, Act on the Tax on Interest Income *(Zinsabgeltungssteuergesetz)* were included in the plans but ultimately not implemented (in full) will result in revenue shortfalls. On the expenditure side, labour market-related spending (unemployment assistance, grant to the Federal Labour Office) in particular will be considerably higher than the budget estimates. Overall, the deficit is likely to exceed last year's figure significantly.

Federal budget in 2004

In July, the Federal Cabinet adopted the draft Federal budget for 2004. In order to limit new borrowing, a comprehensive consolidation package was approved at the same time. Moreover, a decision of principle was taken to bring forward to 2004 that stage of the income tax reform planned for 2005. This will lead to revenue shortfalls of €7 billion for the Federal Government. It was subsequently announced that privatisation proceeds in the amount of €2 billion will be generated and subsidies totalling almost €½ billion will be removed in order to finance these tax shortfalls in 2004. At its meeting on 13 August, the Federal Cabinet adopted a draft Act accompanying the budget in which the previously adopted decisions of principle are consolidated insofar as they have to be regulated by law. Consequently, Federal Government net borrowing now amounts to just under €29 billion and is thus once more considerably higher than investment expenditure (almost €25 billion). According to article 115 of the Constitution, this is permitted only if the excessive new borrowing is suitable for averting a disruption of the overall economic equilibrium. The Federal Government has declared that it will invoke this exemption clause for the third year in succession.

The Federal Government's financial balance



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Although the targeted level of net borrowing would be markedly lower than the level expected in 2003, it would nevertheless be around €19 billion higher than the amount of €10 billion contained in the previous financial plan. The Federal budget will be adversely affected on the one hand by large tax shortfalls resulting both from extensive revisions to the tax estimate (just under €13 billion[4]) and from bringing forward the tax reform (€7 billion). Moreover, allowance has been made for considerable additional spending (around €11 billion) on both unemployment assistance and the grant to the Federal Labour Office. This is, however, to be offset by exten-

4 Total deviation from the tax estimate of May 2002 taking into account changes in tax legislation, changes in transfers to the EU and assessment discrepancies (in particular in relation to a less favourable macroeconomic assessment).

The consolidation package contained in the draft Federal budget for 2004 *

€ billion

Item	Amount
Expenditure	8½
of which	
Savings owing to "Hartz reforms" (grant to the Federal Labour Office and unemployment assistance)	4.0
Reduction in Federal Government's grant to the statutory pension insurance scheme 1	2.0
Continuation of across-the-board ministerial savings	1.0
Reduction of subsidies	0.6
Public sector pay	0.5
Child-rearing benefits	0.2
Revenue	5½
of which	
Act on Tax Honesty (amnesty)	2.1
Reduction in tax subsidies	1.2
Measures combating illicit work/tax evasion	1.0
Act to Reduce Tax Subsidies (basket II)	0.5
Limitation of standard travel allowance	0.5
Elimination of the grant to home buyers	0.1
Total	14

* Financial implications for the Federal budget in 2004. — 1 In addition, the contribution rate to the statutory pension insurance scheme is to be stabilised at 19.5 %.

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sive cost savings, above all from the consolidation package which was presented together with the draft Federal budget in July. The measures (see table above) are to total around €14 billion of which €8½ billion will be on the expenditure side and €5½ billion will be on the revenue side.

Federal Government's medium-term financial plan

The Federal Government's new medium-term financial plan (see table on page 55) also appears to be considerably less favourable than the preceding forecast. As a result, the planned reduction in net borrowing will be noticeably protracted. This is due above all to the distinctly more negative estimate of trends in tax revenue, but also to the upward revision of labour market-related expenditure. Given an annual average increase in expenditure of ½% from 2005 to 2007, a balanced Federal budget will no longer be achieved within the time-frame of the medium-term financial plan.

Proposed relief measures

The relief measures accompanying the draft Federal budget plan may make a significant contribution to consolidating the Federal budget. State and local government would also benefit considerably from this. The planned measures are a step in the right direction, not least with regard to the intended reduction of subsidies. Nonetheless, policymakers need to ensure that the measures – especially the planned changes in business taxation – do not impair investment conditions in Germany.[5] Although disposals of state-owned participating interests reduce net borrowing and are to be welcomed in principle from a regulatory point of view, they make little contribution towards fiscal consolidation. Lower borrowing is achieved at the cost of a corresponding loss of government assets. Such asset disposals are, in effect, even more akin to borrowing if state-owned banks act as the "upstream" purchasers.

Budgetary plans associated with high risks

On balance, the Federal Government's plans still involve a very high degree of uncertainty. Whereas the burdens that will result from the income tax cuts are relatively concrete, the likely relief from the consolidation package is far less certain. Some measures have not yet been specified in detail and – like the advancement of the tax reform – largely require the Bundesrat's consent. Furthermore, the financial implications of major items are very

5 See also Deutsche Bundesbank, *Monthly Report*, November 2002, p 57 ff.

difficult to assess (tax amnesty, measures combating tax evasion and illicit work). Moreover, the underlying macroeconomic assumptions seem decidedly optimistic.

Special funds

In the second quarter, the surplus of the special funds amounted to €5 billion; this was around €3½ billion lower than the comparable figure for last year. This was mainly due to the drop in the Bundesbank's profit distribution, which fell by €6 billion to €5½ billion; any part of this distribution in excess of €3½ billion is transferred to the Redemption Fund for Inherited Liabilities. This contrasted with budgetary improvements on the part of the ERP Special Fund (in connection with large loan repayments) and a surplus in the flood disaster fund of around €1 billion in each case. In view of the decline in the Bundesbank's profit distribution, the surplus of the special funds in 2003 as a whole will fall well short of last year's figure (€9 billion).

Land governments

In the second quarter, the *Land* governments' budgets recorded a 3½% increase in revenue. However, there was only a moderate rise of 2% in tax receipts. In view of the payments to the flood disaster fund, expenditure grew at a relatively moderate rate of 1½%. Personnel expenditure continued to rise by just over 1%. It must be borne in mind, however, that the adjustment of civil servants' pay and pension benefits, which is a major item in the *Land* governments' budgets, was not approved until July.[6] On balance, the quarterly deficit fell on the year by €1 billion to €5½ billion. However, according to the results of the tax estimate, the planned significant reduction of the record deficit of €31 billion recorded in 2002 can no longer be achieved. Although numerous *Land* governments have reacted to this by economising, this will probably not be enough to offset the shortfalls. Apart from a few exceptions, net borrowing will probably far exceed self-financed investment in the *Land* governments' budgets and will therefore breach the constitutional ceiling, thereby triggering special justification obligations. The strain on the *Land* governments' budgets is likely to intensify even further next year, above all if the advancement of the third stage of the tax reform resolved by the Federal Cabinet is not counter-financed. The *Land* governments need the relief measures proposed by the Federal

The Federal Government's financial planning over the medium term

€ billion

Item	Target 2003	Ministry 1 2003	2004	2005	2006	2007
Expenditure	248.2	257.0	251.2	251.2	251.2	254.9
of which Investment	26.7	26.7	24.8	24.7	24.7	24.7
Revenue	228.6	221.3	226.9	229.6	235.6	244.4
of which Taxes	203.3	196.0	208.5	211.5	221.6	229.9
Privatisation proceeds	5.5	5.5	0.1	0.1	0.1	0.1
Deficit (–)	– 19.6	– 35.7	– 24.3	– 21.6	– 15.6	– 10.5
Seigniorage	0.7	0.7	0.5	0.6	0.6	0.5
Net borrowing	18.9	35.0	2 23.8	21.0	15.0	10.0
Memo item						
Change in expenditure in %	– 0.4	+ 3.1	.	+ 0.0	+ 0.0	+ 1.5

1 Most recent assessment of the Federal Ministry of Finance. — 2 Taking into account the decisions to bring forward the tax reform, net borrowing amounts to just under €29 billion.

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6 The resulting additional burdens in 2003 are, however, to be compensated for largely by cuts in Christmas bonuses on the basis of the new flexibility arrangement.

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
2001	+ 14.2	+ 56.3	– 6.6	+ 13.0
2002 p	+ 54.6	+ 67.6	– 11.8	+ 57.4
of which				
Q1	+ 25.6	+ 15.2	+ 10.5	+ 12.2
Q2	+ 1.5	+ 22.9	– 21.4	+ 16.7
Q3	+ 18.6	+ 25.1	– 5.4	+ 19.1
Q4 p	+ 9.0	+ 4.4	+ 4.6	+ 9.4
2003				
Q1 p	+ 34.7	+ 32.6	+ 2.1	+ 19.4
Q2 pe	+ 12.6	+ 11.8	+ 0.8	...

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

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Government in order to limit their borrowing requirements, which are already high.

Local authorities

For local government, only the results for the first quarter are currently available. According to these data, revenue rose by 2% and expenditure increased by 1½%. Personnel expenditure rose steeply by 3½%, reflecting the effects of the relatively high pay settlements for wage and salary earners in the public sector. The increase in expenditure on social benefits was far steeper (9½%). Overall, cost growth was held down, however, by an exceptionally sharp fall in fixed capital expenditure. At €4½ billion, the deficit matched last year's corresponding figure. In the remainder of the year, however, a marked deterioration in the deficit is likely, above all as a result of a less favourable revenue trend.

Indebtedness

The indebtedness of central, state and local government rose by €12½ billion in the second quarter. The Federal Government increased its liabilities by €4½ billion, borrowing just over €2 billion on both the money market and the capital market. Whereas the *Land* governments recorded rather high borrowing requirements totalling €7½ billion, the local authorities are likely to have raised their indebtedness only moderately. Borrowing was focused on balance on the capital market's medium-term segment.

Social security funds

Statutory pension insurance scheme

At €1 billion, the deficit in the wage and salary earners' pension insurance scheme was just as high in the second quarter as in 2002, even though the contribution rate had been raised from 19.1% to 19.5% at the beginning of 2003. Revenue from contributions rose by only 2½%. Adjusted for the increase in the contribution rate, the compulsory contributions for employed persons increased by ½% which – given the slight fall in gross wages and salaries – was attributable to the raising of the maximum level of earnings subject to contributions. The new arrangements applying to low-paid part-time work have apparently not led to a noticeable improvement in the fiscal position despite the large number of new so-called "minijobs" which have been registered. Relief was afforded, however, by the transfers from central government, which were 8% higher owing to the last stage of the ecological tax reform as well as the pegging of government transfers to the contribution rate. Overall expenditure increased by almost 3½%, as in the previous quarter. However, pension expenditure rose somewhat more rapidly owing to higher per capita payments. By contrast, the increase in the number of pension recipients continued to decelerate, amounting to little more than ½%.

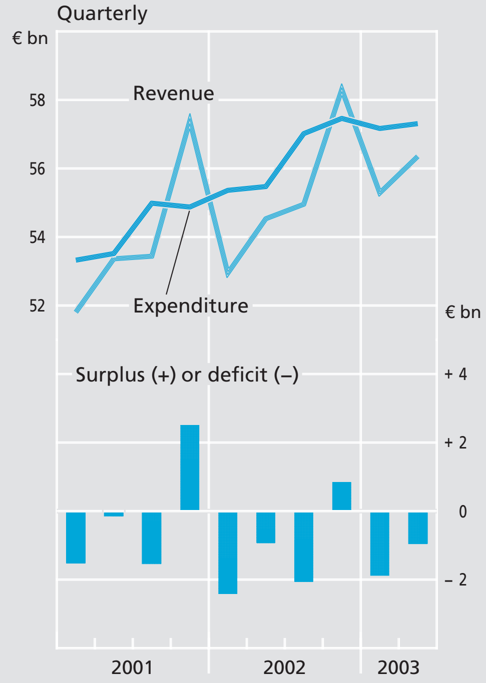
The pension adjustment of 1 July, which was lower than in 2002 (1.04% in western Germany and 1.19% in eastern Germany), is likely to slow down the growth of expenditure in the second half of the year. However, an acceleration in the inflow of contributions is not yet apparent on the revenue side. Therefore, a noticeable deficit is likely to be recorded again at the end of the year. Even based on the Federal Government's optimistic growth assumptions, it is now expected that the contribution rate will have to be raised to 19.9% in 2004. However, the Federal Government wants to retain the current rate and also cut the transfers from the Federal Government by €2 billion. Given these assumptions, savings of around €6 billion will have to be made next year. A further lowering of the required volume of fluctuation reserves, which have already been reduced, would increase the risk of the statutory pension insurance scheme becoming dependent on liquidity injections from the Federal Government and would foster uncertainty regarding the soundness of the scheme's finances. Moreover, the need for structural consolidation would merely be postponed by one year and the general government deficit would increase by up to 0.3% of GDP in 2004.

Federal Labour Office

In the second quarter, the Federal Labour Office recorded a deficit of just under €2½ billion. This was €½ billion higher than last year's figure. Total revenue rose by only ½%. The main reason for this was that contribution receipts grew only slightly despite the increase in the maximum level of earnings subject to contributions. The increase in expenditure slowed down markedly to 3½%. Although spending on unemployment benefit continued to go up (by just over 12%) more sharply than the number of unemployed persons, the 8% reduction in expenditure on active labour market measures was a significant counterweight.

In the first six months of the year, therefore, the deficit already amounted to €5.2 billion despite the cuts in assistance measures and the Hartz reforms. The result is traditionally much better in the second half of the year

Wage and salary earners' pension insurance scheme



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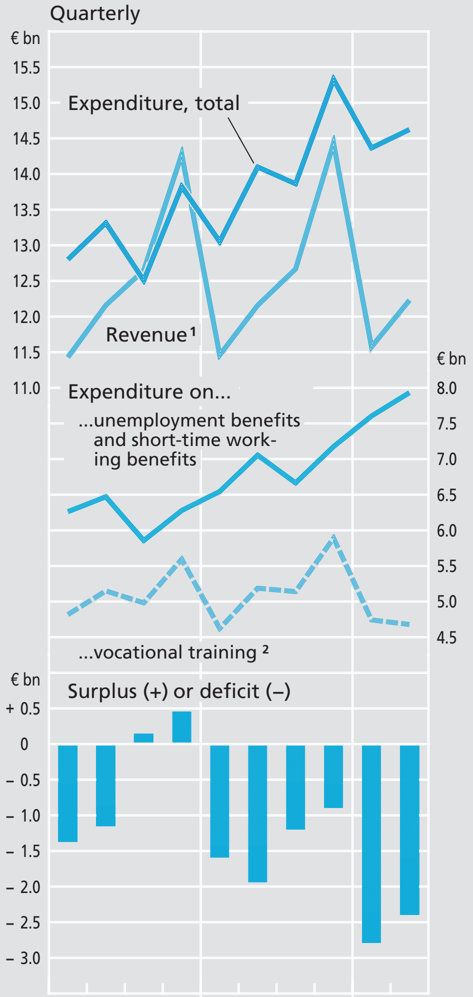

1 Excluding Federal Government liquidity assistance. — **2** Including job creation measures.

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owing to seasonal factors. However, based on the Federal Government's macroeconomic forecast, the Federal Labour Office – whose budget for 2003 does not envisage any need for grants from central government – is now likewise expecting a deficit of around €7 billion. In view of the poor labour market situation, there will also be a need for a grant next year. €5.2 billion has been earmarked for this in the draft Federal budget for 2004.

Statutory health insurance fund

Financial data on the statutory health insurance fund are currently available only for the first quarter. According to these data, the health fund managed to reduce its year-on-year deficit by €¼ billion to just over €½ billion. Revenue was 2½% up on the year. However, adjusted for the 0.3 percentage point increase in the average contribution rate to 14.3% at the beginning of the year, revenue from contributions actually fell somewhat and thus decoupled itself further from the benchmark that serves as a proxy for the assessment base (gross wages and salaries plus wage substitutes and pensions). The budget freezes and price discounts ordained last autumn limited the overall increase in expenditure to 2%. Although spending on pharmaceuticals rose by 2½%, the corresponding figure in 2002 had been curtailed by a one-off "donation" from the pharmaceutical industry in exchange for the Federal Government not introducing certain price-reducing measures for pharmaceuticals. Adjusted for this effect, expenditure declined slightly.

In view of their depleted reserves and a level of indebtedness which is now likely to have reached €3 billion, the health insurance institutions would normally be obliged under current law to raise their contribution rates without delay. However, the prospect of relief through the health system reform which has now been agreed between the Federal Government and the opposition parties (see box on page 60) has evidently prompted most of the health insurance institutions to refrain from doing so. On balance, therefore, the statutory health insurance fund is in danger of running up another marked deficit in

2003, too, which will restrict the scope for lowering contributions in 2004.

General government budget trends

Deficit ratio above 3% ceiling in 2003, too

In 2002, the deficit ratio rose above the ceiling laid down in the Maastricht Treaty (reaching 3.6%). The 3% criterion is expected to be distinctly exceeded in 2003, too. The increase in the deficit is caused, in particular, by continuing unfavourable cyclical developments and several other negative factors (above all the lower Bundesbank profit, higher transfers to the EU and flood-related expenditure). By contrast, there have been a number of increases in taxes and social security contributions (notably concerning the statutory health and pension insurance schemes and excise taxes). In addition, prudent budget management is to be expected, not least because the borrowing of central, state and local government is bordering on the limits laid down under budgetary law. Finally, cost curbs affecting the health insurance fund and labour market-related benefits have been adopted.

Deficit reduction necessary in 2004

Given the fact that, in January 2003, the Ecofin Council established that Germany had an excessive deficit in 2002 and that this breach of European regulations will probably also persist in 2003, it is extremely important that the deficit ratio be lowered to less than the 3% ceiling next year. Otherwise, there is a danger that further damage will be caused to the European fiscal regulations, which guarantee the sustainable development of fiscal budgets, above all in the medium and long term, and are therefore intended to support a stability-oriented monetary policy in the monetary union.

At present, there appears to be an increasing tendency in some euro-area countries to defer the original consolidation targets and seek a way out of the growth crisis with the help of short-term credit-financed government stimulus packages. However, failure to achieve fiscal consolidation is likely not only to dampen economic growth in the medium and longer term, but – owing to the existing general uncertainty about the sustainability of fiscal policy – will also have a negative impact on the consumption and investment climate in the short term. In this respect, the potential short-term "growth dividend" owing to a more expansionary fiscal stance should not be overestimated. It will not solve the far more important structural macroeconomic problems. These require growth-enhancing structural reforms.

Consolidation also a national requirement

A reduction in government deficits is called for not only in the context of the European regulations, however. The room for manoeuvre available to central, state and local government is being increasingly curtailed by the growing indebtedness and the related interest burden. The national upper borrowing limits set by budgetary law, which are not very stringent anyway, are exceeded not only in individual cases, but almost as a rule. Sizeable deficits are also being recorded by the social security funds; their reserves are now largely depleted and debts have already been incurred in some cases.

The reform of the statutory health insurance fund

The key points for a reform of the statutory health insurance fund agreed between the Federal Government and the opposition parties provide for a reduction in the expenses which are financed equally by employers and employees. These key points are also to apply to public sector employees with civil servant status and to retired civil servants. The savings are to increase from €9.9 billion in 2004 to €23.1 billion (including refinancing in the amount of €8.5 billion in favour of employers) in 2007. This will apparently lead to a fall in the average contribution rate from 14.3% at present to 13% in 2007 (employers: 6.1%, employees: 6.9%). The principal measures are:

- Abolition of one-off mortality and maternity payments, in principle also of payments for over-the-counter pharmaceuticals, taxi journeys and spectacles. Saving: €2.5 billion.
- Extension of prescription charges up to a ceiling of 2% of gross income (up to 1% for the chronically ill, children remain exempt): in general, they are to amount to 10% of the price (at least €5 and not more than €10). The supplementary charge for hospital in-patient treatment will be increased from €9 to €10 per day and, in future, will be levied for up to 28 days rather than 14 days. Furthermore, a surgery charge of €10 per quarter is planned for visits to the doctor. If a patient consults several doctors without a referral, the charge will be levied several times. Net benefit: €3.3 billion.
- Financing of non-insurance-related (above all maternity-related) payments through raising tobacco tax. The statutory health insurance fund will initially receive a Federal grant of €1 billion, which will increase to €4.2 billion by 2006.
- Higher health insurance contributions from pensioners out of pensions and any employment income. Additional revenue: €1.6 billion.
- Structural measures: extension of price discount scheme for patented pharmaceuticals, introduction of fixed prices for new patented pharmaceuticals with few additional benefits, more rigorous assessment of pharmaceuticals' utility as of 2005, limitation of administrative expenditure. Net benefit: rising from €1.5 billion to €3 billion in 2007.
- Transfer of financing costs from the employer to the employee through separate insurance for dentures (expenditure by statutory health insurance fund: €3.5 billion) as of 2005 as well as a special contribution of €5 billion for sickness benefits as of 2007.

These measures are aimed predominantly at achieving greater cost-sharing and thereby increasing the individual responsibility of insured persons. However, only the structural measures will bring about real cost savings. While the supplementary charges are also likely to have a steering and containing effect on demand, the cost-efficiency reserves in the system will be mobilised only to a limited extent. The package contains other measures for which the estimate of relief is not quantified. For example, a foundation is to be set up to help improve the quality of service. Its tasks will include not only assessing the utility of pharmaceuticals, but also working out treatment guidelines. Although mail-order pharmacies are to be legally permitted to sell pharmaceutical products, price formation regulations will not be dropped. With regard to doctors' remuneration, payment for standard services at fixed prices rather than an overall professional fee is planned in future. Persons who are voluntarily insured with the statutory health insurance fund even though their salary level would entitle them to opt out are to be given limited options with regard to the scope of their insurance cover.

The relief volume totalling €14.6 billion (excluding transfers from employers to employees) in 2007 is likely to considerably lower the contribution rate. However, it seems doubtful whether the target of 13% can be reached as the current average rate of 14.3% – taken as the point of reference – does not cover costs and the assumed increase in contribution receipts is not certain. A further obstacle to achieving the rate of 13.6% targeted for 2004 is the fact that, according to the current legal situation, around €6 billion (which corresponds to 0.6 percentage point of the contribution rate) must first of all be used for loan repayments and replenishment of reserves. However, the intention in this respect is to spread these obligations over a longer period, which is ultimately tantamount to deferring burdens until a future point in time.

There is already a consensus that the agreed measures to reform the statutory health insurance fund will not be able to solve the fund's long-term problems. Both demographic developments and advances in medical technology will create considerable expenditure pressure, even if the rationalisation reserves, which undoubtedly exist, are mobilised. If contributions remain linked to wages and salaries, this will automatically continue to lead to a rise in the cost of labour. The prospect of sharply rising social contributions over the longer term is certainly one of the reasons for the current scepticism regarding the economic outlook. The generally acknowledged need for more extensive reforms has led the government-appointed Commission for Sustainability in the Financing of Social Security Systems (known as the "Rürup Commission") to develop two models: a "citizens' insurance model *(Bürgerversicherung)*" and a "per capita flat-rate charging model *(Kopfpauschalen)*" with a supplementary tax-financed adjustment based on the principle of solidarity. In both models, the financing basis is to be decoupled from labour income with the flat-rate charging model being more systematic in this respect. Moreover, this concept provides for a clear separation of insurance and solidarity elements. It has further advantages owing to its more competitive orientation. The Rürup Commission's final report has not yet been published, however.

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Outlook for 2004 particularly uncertain

The outlook for the development of public finance in 2004 is marked by great uncertainty, above all because numerous fiscal measures which have already been announced still have to pass the legislative process. Various projects planned as part of the "Agenda 2010" and the Federal budget for 2004 are suitable for strengthening future expansionary forces and improving the state of public finance. However, in order to achieve this they must be forced through against vested interests.

Advancement of the tax reform …

The advancement of the third stage of the income tax reform to 2004, which is likely to result in tax shortfalls of €15 billion, is to be welcomed in principle as it involves a significant reduction in the income tax rates. However, at the same time, it would be regrettable if, without any further counterfinancing, not only the individual national borrowing limits, but also the general government deficit ceiling of 3% laid down in the Maastricht Treaty were to be exceeded.

… must not compromise the Stability Pact

The tax cut should be accompanied by additional measures in order to ensure that these important fiscal targets are met. However, privatisation proceeds or proceeds from the sale of other government financial assets (eg claims in respect of loans) do not lead to a reduction in the deficit as defined in the Maastricht Treaty, as these merely constitute shifts in the government's financial assets. If taxes are to be lowered without breaching the European provisions, not only the Federal Government but also the *Land* governments will be required to reinforce their efforts with regard to reviewing government benefits and tax loopholes. At the same time, new deficits in the social security sector should be avoided and any debts already incurred reduced without delay.

Trade tax reform

On 13 August 2003, the Federal Cabinet also approved a bill concerning a reform of trade tax in the context of restructuring local authority finance. Trade tax is to be retained and tax liability is to be extended to self-employed professionals, although they will be able to largely offset their trade tax liability against their income tax. Despite the envisaged offsetting of tax liability against income tax, this will lead to additional – albeit limited – tax burdens, which will complicate tax law. Calls to include elements which are unrelated to earnings (rents, leasing payments) in trade tax liability were not heeded. By contrast, interest on longer-term debt is no longer to be counted towards trade earnings. The fact that this bill concentrates on the taxation of elements which pertain to earnings is to be welcomed. Given that, with the abolition of payroll tax and trade capital tax, policymakers have been increasingly sensitive to the problems associated with taxing firms' and entrepreneurs' capital base, as this may jeopardise their very livelihood, any return to a policy of taxing capital components in what is a particularly difficult operating environment for enterprises would run counter to the efforts to revive economic growth and would darken the investment climate. The intended objective of freeing trade tax of its remaining non-earnings components and of bringing the assessment base largely into line with that applied for income tax and corporation tax could, at the same time, pave the way to integrating this special tax on earnings in the general income tax regime. The need of local authorities to have their own tax source which, to a certain extent, they could structure themselves can be accommodated by also granting them a share of corporation tax, in addition to their share of wage tax and income tax, and a multiplier or add-on facility for these taxes. Municipal revenue could be consolidated even further if a substantially larger share of turnover tax were to be allocated to local government.[7]

7 See also Deutsche Bundesbank, *Monthly Report,* December 2002, p 30 ff.