

Public finances

Budgetary development of central, state and local government

In the second quarter of 2004 general government¹ recorded a deficit of €8 billion, which was more unfavourable than in the same period of last year (€6 billion). This was mainly attributable to the fact that a large Bundesbank profit had been distributed in the second quarter of 2003, whereas this year the profit was far smaller and had been booked in the first quarter. Overall revenue therefore declined even though tax revenue grew considerably. Expenditure, which fluctuates sharply in the course of the year, decreased by just under 1%.

*Underlying
trends*

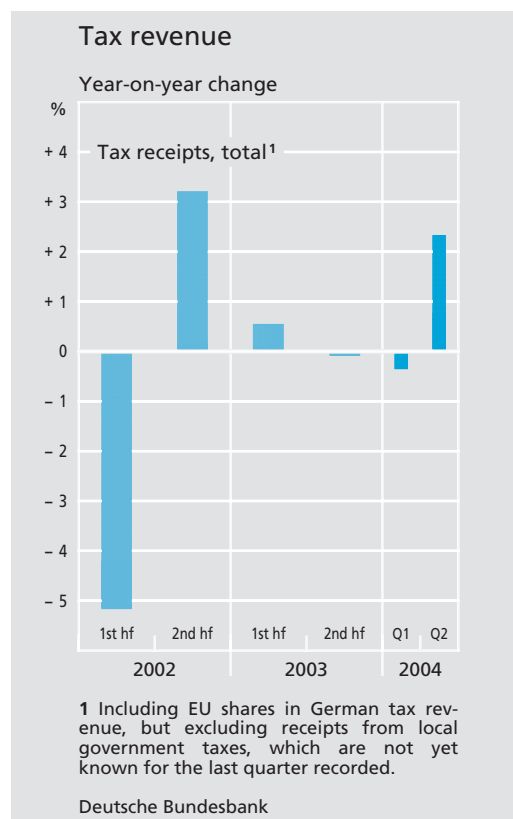
The general government budget deficit has doubled in the last three years from around €35 billion in 2000 to almost €70 billion in 2003. Another rise is expected this year. Although expenditure is not likely to significantly exceed last year's level, thanks to a stringent spending policy at all levels and favourable interest rates, revenue will probably fall further. Tax revenue is likely to increase only marginally owing to the extensive tax cuts and the persistent weak growth of the tax base. Non-tax revenue is set to decline noticeably, primarily because of the very small Bundesbank profit. On the whole, as in the preceding years, new borrowing is likely to significantly overshoot the estimates in the budget plans.

¹ Excluding local government, the results for which are not yet known.

*Tax revenue in
the second
quarter...*

In the second quarter, the tax revenue of general government² was just over 2% higher than in the corresponding period of last year, after the first-quarter figure had fallen slightly short of the corresponding level in 2003. However, this increased inflow of revenue does not necessarily imply a persistent upward trend in tax receipts because the picture is distorted by several special factors. The revenue trend was affected positively by the recovery of corporate profits and negatively by the continued weak domestic demand.

Among the direct taxes, corporation tax recorded a very favourable result. It raised €4½ billion, which was just over €3 billion more than in the second quarter of 2003. This sharp improvement was, however, largely attributable to the fact that high tax refunds had reduced revenue last year. In addition, current tax prepayments from enterprises went up steeply; this was due to improved profitability and to the moratorium for claiming accrued corporation tax credits. The outcome of assessed income tax revenue likewise improved noticeably (+17½%). This was primarily attributable to higher tax receipts for earlier years as well as declining payments for grants to homebuyers and investment grants. The trend in income tax prepayments seems to have been curbed only partly by the cut in income tax rates this year. The lower tax rates affected wage tax to a much greater extent, reducing the revenue from this tax by almost 7% in the second quarter. Of the investment income taxes, non-assessed taxes on earnings yielded 9% more than in the same period last year as a result of higher dividend payments, whereas revenue from



tax on interest income went down by 16%, not least owing to a further decline in the average interest rate.

Among the indirect taxes, revenue from turnover tax again increased only moderately (+1%), mainly because of the ongoing sluggishness of private consumption. Revenue from mineral oil tax – the most important excise tax – decreased by just over 1%. This was partly because energy consumption continued to be dampened by high oil prices. The level of receipts from tobacco tax was even more unfavourable; despite the rise in the tax rate which came into force on 1 March, this tax yielded almost 6% less than

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

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Annual percent- age change
	1st half		
	2003	2004	
Wage tax	62.3	59.1	- 5.1
Assessed income tax	- 2.9	- 2.8	.
Corporation tax	3.7	6.7	+ 81.7
Turnover tax	67.0	67.9	+ 1.4
	<i>of which Q2</i>		
Wage tax	31.7	29.6	- 6.7
Assessed income tax	2.6	3.1	+ 17.6
Corporation tax	1.2	4.5	.
Turnover tax	33.3	33.7	+ 1.1

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in 2003 (adjusted for changes in booking techniques). This reflected the fact that, owing to the tax increase, the domestic consumption of tobacco products appears to have gone down or been replaced increasingly by illegal imports.

In the first half of the year, tax revenue (excluding receipts from local government taxes) grew by a little more than 1%. At first glance it appears to have developed somewhat more favourably than was expected for 2004 as a whole according to the official tax estimate from May. However, the bulk of this increase was related to changes in booking techniques.³ Furthermore, the lowering of the income tax rate had only a partial downward effect on revenue during this period. Against this background, the outcome of the first six

months is on the whole broadly in line with current expectations. Risks exist with regard to several major individual taxes compared with the May estimate. This relates, for example, to assessed income tax if the receipts from the tax amnesty do not increase sharply in the second half of the year.⁴ In addition, contrary to previous assumptions, tobacco tax will yield considerably less than in 2003 as a result of the strong consumer reactions to the tax increase. However, there is a chance that corporation tax will recover more sharply than was expected in May. On balance, therefore, actual revenue deviations from the spring forecast are likely to be fairly minimal this year.

In the second quarter central government recorded a deficit of €6 billion, which was €½ billion more than in the same period last year. Revenue went down by 4½%. Although tax revenue grew sharply by 3%, non-tax revenue declined steeply – as already mentioned – owing to the sheer drop in the Bundesbank

*Federal budget
in the second
quarter...*

*... and in 2004
as a whole*

³ Until the end of 2003, in the case of Federal Government excise taxes, partial amounts outstanding at the end of the month were frequently not recorded as revenue until the subsequent month, whereas since the beginning of this year they have been booked in the month in which they are due. This adjustment means that the growth of overall tax revenue in the first half of the year was overstated by nearly ¾ percentage point.

⁴ In the first half of the year the tax amnesty yielded barely more than €0.2 billion. In the May estimate for the whole of 2004 an amount of €1½ billion was anticipated, and this figure was already €3½ billion lower than the original government expectations. However, revenue flows are likely to be concentrated largely on the second half of the year, not least as a result of the considerable amount of time required for the retrospective income declarations (for obtaining the necessary invoices and the required consultations with tax advisers).

profit.⁵ Expenditure, which fluctuates sharply in the course of the year, decreased by 3½% following an increase of 2% in the first quarter. This decline was attributable to the fact that there were no more transfers to the flood disaster fund and that transfers to enterprises (particularly the Post Office pension funds) as well as interest payments were lower than in the second quarter of 2003.

... and in 2004
as a whole

For 2004 as a whole, as things now stand, central government's deficit is likely to exceed the level of 2003 (€39 billion), whereas the budget envisages a volume of €29½ billion. The main reason for this is declining revenue. On the one hand, tax revenue of central government will contract by 1½%, according to the tax estimate in May. On the other hand, non-tax revenue will presumably contract – primarily as a result of the negligible Bundesbank profit – even if the scheduled sizeable proceeds from privatisations and the sale of claims (€7 billion) are actually realised. The expenditure level could remain virtually unaltered after recording noticeable growth in both 2002 and 2003. This is due for the most part to the cessation of transfers to the flood disaster fund. Owing to central government's higher borrowing requirement, a supplementary budget is likely in the second part of the year.

Federal budget
in 2005

The Federal Government's draft budget for 2005 envisages only a marginal rise in expenditure of ½% compared with the spending total budgeted for 2004. Net government borrowing is anticipated to reach €22 billion, which is somewhat lower than investment expenditure. The constitutional ceiling for net



borrowing could, however, only be complied with through a planned recourse to sizeable proceeds from asset disposals (€15 billion); this raises fundamental questions with regard to the interpretation of this credit limit.⁶ Thus, on the one hand, the purchase of assets is seen as investment expenditure, which justifies debt financing. On the other hand, the sale of an asset does not entail a corresponding need to redeem debt; the associated proceeds are being used instead to comply with the borrowing ceiling.

⁵ The Bundesbank profit is allocated to the Federal budget up to an amount of €3.5 billion. Any amount exceeding that sum accrues to the Redemption Fund for Inherited Liabilities to repay debt. Whereas in 2003 the profit distribution had amounted to €5½ billion and had been posted in April, the amount transferred in (March) 2004 was only around €¼ billion.

⁶ See Deutsche Bundesbank, Development of public sector investment, and its financing, *Monthly Report*, April 1999, p 37 ff, particularly pp 42-43.

The Federal Government's financial planning over the medium term

€ billion

Item	Actual 2003	Target 2004	Draft 2005	2006	2007	2008
Expenditure	256.7	257.3	258.3	253.6	257.1	260.0
of which						
Investment	25.7	24.6	22.8	22.3	22.2	20.8
Revenue	217.5	227.7	236.0	231.7	235.7	240.3
of which						
Taxes	191.9	197.7	194.5	202.6	210.3	216.8
Privatisation proceeds	5.2	7.1	15.5	3.3	0.1	0.1
Deficit	39.2	29.6	22.3	22.0	21.5	19.8
Seigniorage	0.6	0.3	0.3	0.3	0.3	0.3
Net borrowing	38.6	29.3	22.0	21.7	21.2	19.5
<i>Memo item</i>						
Change in expenditure in %	3.0	+ 0.2	+ 0.4	- 1.8	+ 1.4	+ 1.1

1 Most recent assessment of the Federal Ministry of Finance: around €40 billion.

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Nevertheless, according to the 2005 draft budget, there will be a marked improvement in the budget situation compared with the expected outcome for this year even if the proceeds from asset disposals are disregarded. On the whole, however, the draft budget is subject to risks. On the revenue side, besides the uncertainty about the impact of the various changes in tax legislation (including measures to combat illicit work and tax evasion) and the development of the macroeconomic tax base, these risks are likely to depend not least on the realisation of non-tax revenue, which includes sizeable proceeds from motorway tolls. On the expenditure side, the details of an across-the-board cut in spending still need to be spelled out. Moreover, additional burdens for central government vis-à-vis the draft budget will arise from

the – now concrete – provisions for the amalgamation of unemployment assistance and social assistance.

When it adopted the draft budget, the Federal Government reaffirmed its intention to lower the general government deficit ratio to under 3% in 2005 and announced that it would take additional measures if necessary. As things stand today, there is indeed a risk that this deficit ceiling will be overshoot once again. Since the sale of financial assets does not lower the Maastricht deficit, the central government deficit (as defined in the Treaty) will develop far more unfavourably next year than as recorded in the budget accounts. According to an agreement reached by the Financial Planning Council – the decisions of which are assigned great importance also in the context of the German stability programmes – central government (including the social security funds) may utilise no more than 45% of the 3% ceiling, a threshold that will be considerably overstepped at least this year and is likely to require further consolidation efforts if it is to be kept to next year.

The Federal Government's new medium-term financial plan until 2008 (see the adjacent table) indicates that net borrowing is to be lowered only slightly, even though it is based on a fairly positive macroeconomic scenario. This reflects not least a significant decline in the sizeable proceeds expected from asset disposals in 2005. Projected net borrowing for 2007 was raised by €11 billion to €21 billion compared with the previous financial plan. No substantial progress towards a balanced budget is envisaged for 2008 (€19½

Consolidation requirement with regard to the 3% ceiling

Federal Government's medium-term financial plan

billion) either. The main reason for the higher level of new borrowing vis-à-vis the previous financial plan is the markedly poorer revenue outlook anticipated in the recent medium-term tax estimate. Average expenditure growth is expected to be merely ¼% between 2006 and 2008.

Special funds

In the second quarter the special funds recorded a surplus of just under €2 billion, which was considerably smaller than in the second quarter of 2003 (€5 billion). This was primarily due to the fact that, contrary to last year, the Redemption Fund for Inherited Liabilities received none of the Bundesbank's profit distribution (2003: €2 billion). Furthermore, the flood disaster fund recorded a marginal deficit after revenue had exceeded expenditure by €1 billion in 2003. Following a large surplus of €10 billion in 2003, overall the special funds may close more or less in balance this year.

State government

State government succeeded in lowering its deficit in the second quarter by €1½ billion compared with the same period of last year to not quite €4 billion, thus continuing the improvement observed at the beginning of the year. Overall revenue grew favourably by just over 2½% on the back of the sharp increase in tax revenue of 6%. This comparatively strong rise is primarily related to state government's higher share in turnover tax revenue this year as well as to a sharp increase in its own taxes. By contrast, expenditure remained almost unchanged.

For 2004 as a whole a deficit of €24½ billion is envisaged for state government; this would

be a considerable reduction compared with last year's record high of almost €32 billion. Savings on expenditure as a result of longer working hours, cuts in civil servants' remuneration and reduced transfers are making an ongoing contribution to consolidation. However, next year state government will be burdened by the further income tax cuts and the reallocation of turnover tax shares to central government. Consequently, a number of state governments are also likely to find it hard to stay below the constitutionally defined ceiling for new borrowing. Some states even announced that they would struggle to achieve this in subsequent years, too.

Local government was able to reduce its deficit in the first quarter of 2004 (latest available data) by almost €½ billion to just over €4 billion. The main reason for this was the sharp rise in tax revenue (+7¾%). It was primarily local business tax that rose unexpectedly sharply – although the amounts raised vary considerably from one state to the next. Overall revenue expanded much more slowly (2¾%) owing to the virtually unchanged level of non-tax revenue. Expenditure grew moderately (+¾%). Although a marked increase in social benefits again caused additional burdens, personnel expenditure declined, not least because last year's base figure had included one-off payments related to collective wage agreements. Fixed investment was reduced by one-tenth, although some states are still having to overcome the consequences of the 2002 floods. This evidently reflects the tight statutory credit limit for the municipal budgets. After cash advances (which strictly speaking should only be used to bridge liquid-

Local government

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

€ billion

Period	Total	of which		Memo item Acquisition by non-residents
		Securities 1	Loans against borrowers' notes 2	
2002	+ 54.5	+ 67.6	- 11.9	+ 57.4
2003 p	+ 80.3	+ 73.4	- 1.8	+ 35.8
of which				
Q1	+ 35.3	+ 32.6	+ 2.7	+ 19.5
Q2	+ 13.2	+ 11.8	+ 0.5	+ 16.3
Q3	+ 20.0	+ 9.4	+ 5.0	- 6.5
Q4 p	+ 11.7	+ 19.5	- 9.9	+ 6.5
2004				
Q1 p	+ 45.0	+ 34.4	+ 3.9	+ 4.7
Q2 p ^e	+ 8.6	+ 14.7	- 9.3	...

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

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ity shortfalls during the year but in actual fact are frequently used to finance expenditures stretching over several years) had already made up one-sixth of local government debt by the end of last year, many municipalities are apparently finding it difficult to obtain the authorisation (which is principally linked to fund-raising ability) needed to take up regular loans for investment purposes.

The lowering of local business tax transfers agreed at the end of 2003 should provide just over €2 billion of relief to local government this year. However, not least the emerging sharp growth in social benefits and the income tax cuts are likely to absorb a large part of this amount, which means that a significant decline in the local government deficits can no longer be expected in 2004. In 2005,

local government should receive additional relief of €2½ billion from the amalgamation of unemployment assistance and social assistance. According to the Federal Government's plans, the bulk of this sum is to be used to expand day-care provisions for young children. This is, however, offset by the considerable need for fiscal consolidation.

The indebtedness of central, state and local government rose by €8½ billion in the second quarter. Following a sharp increase of €35 billion in the first quarter, central government liabilities went up by merely €1½ billion. A €5½ billion decrease in money market loans was accompanied by a €7 billion net increase in capital market debt. The net borrowing requirement of state government amounted to €6½ billion. The special funds redeemed liabilities on balance, whereas local government debt is likely to have continued its moderate upward trend.

Indebtedness

Social security funds

In the second quarter of 2004 the wage and salary earners' pension insurance scheme recorded a deficit of just over €1 billion, which was somewhat higher than in the same period last year. Nonetheless, this was a noticeable improvement on the first quarter, when a deficit of just under €3 billion had been recorded. This owed something to the fact that since April pensioners have had to pay the full contribution to the long-term care insurance scheme themselves. This was the main reason why overall expenditure rose only half as much (by just over ½%) as the ex-

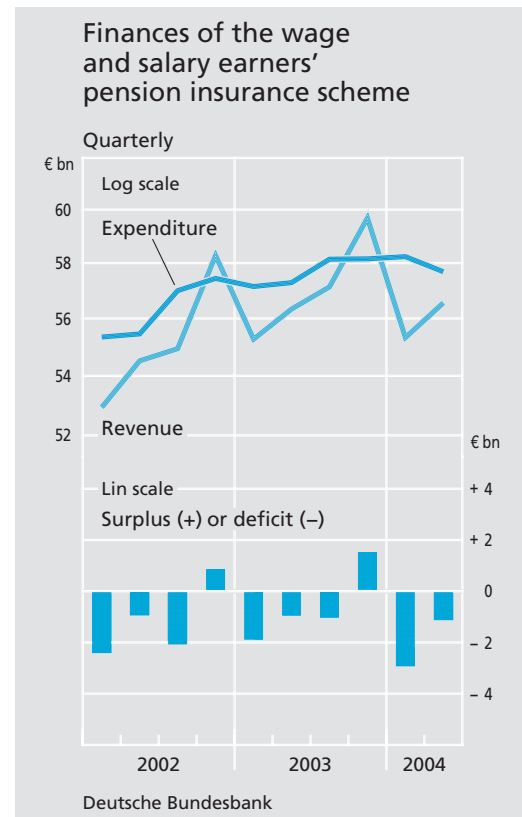
Statutory pension insurance scheme

penditure for pension benefits. However, revenue increased even more slowly by just under ½%. Revenue from compulsory contributions declined somewhat as a result of the weak evolution of employment and pay levels. Grants from the Federal budget, which this year are no longer being topped up by a further stage of the ecology tax, increased by almost 1%.

The lowering of the required minimum fluctuation reserve from 0.5 to 0.2 month's expenditure signalled that from the outset a deficit was expected for 2004 and was designed to avoid the need to raise the contribution rate. The resultant risk of liquidity shortages in autumn this year will, however, be significantly reduced by the agreed sale of the GAGFAH housing company – the net sales price of which is €2.1 billion, ie €0.5 billion higher than its book value. The continued weak revenue base will be partly offset by cost-curbing effects in the second half of the year. For example, no pension increase was made on 1 July 2004, the saving effect of abolishing the statutory pension insurance scheme's contribution to the long-term care insurance scheme will continue, and the increase in the number of current pension recipients is likely to remain below 1% – also because the widely introduced deductions in benefit levels will deter early retirement.

Federal Employment Agency

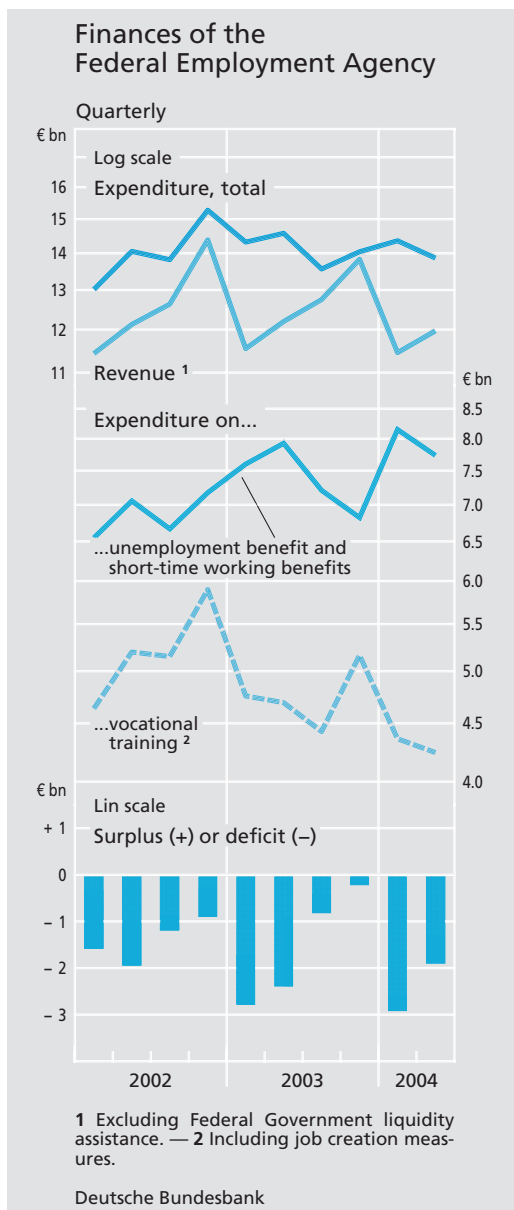
The deficit of the Federal Employment Agency reached almost €2 billion in the second quarter, which was just under €½ billion lower than in the same period last year. Although revenue fell by 2% year on year, expenditure decreased by the much steeper



margin of 5%. Revenue from contributions was ½% down on the second quarter of 2003. The sharper decline in overall revenue was attributable to a reduction in income from the insolvency compensation levy, which was, however, offset on the expenditure side by decreases in insolvency benefit.

Compared with 2003, 2½% less was spent on unemployment benefit even though the number of unemployed persons⁷ increased by just under 1½%. The increasing number of long-term unemployed and the associated loss of entitlement to unemployment benefit are reducing the corresponding expenditure

⁷ Including participants in aptitude tests and training measures, who are no longer counted as unemployed as from the beginning of 2004.



requirement.⁸ Spending on active labour market policy measures decreased by 9½% as the retrenchment efforts were continued. Cuts in the area of job creation measures were again particularly large (-29%). Although growing payments for the new instruments personnel service agencies (PSAs) and self-employed start-ups (“Me plcs”) meanwhile account for almost 7½% of the total resources available for vocational promotional

schemes (including job creation measures), this is outweighed on balance by the decline in expenditure on the “traditional” active labour market policy measures.

Savings in the field of active labour market policy are likely to continue during the remainder of the year. Similarly, the growing number of unemployed persons exhausting the maximum period of entitlement to unemployment benefit will continue to dampen the related expenditure, although this will be offset by a rise in spending on unemployment assistance which is financed out of the Federal budget. The supplementary grant to the Federal Employment Office of €5.2 billion envisaged for the current year may nevertheless be exceeded somewhat owing to the persistently weak revenue trend. Looking ahead to the far-reaching reforms due next year, it is likely that the Federal Employment Agency will be only marginally relieved by the introduction of “unemployment benefit II” (the amalgamation of unemployment assistance and social assistance paid to persons able to work). Although the measures to re-integrate the recipients of unemployment benefit II into the labour market will be financed by central government in future, this will be offset by a compensatory amount which the Federal Em-

⁸ Under a grandfathering clause, the shortening of the maximum period of entitlement to unemployment benefit to 12 months (or 18 months for persons over 55) applies only to persons who become unemployed as of 2006.

Statutory
health
insurance
scheme

ployment Office will have to pay to central government.⁹

The financial development of the statutory health insurance scheme was positively influenced in the first quarter (latest available data) by the recent health system reform (Act modernising the statutory health insurance scheme). It recorded a surplus of €1 billion compared with a deficit of €½ billion in the same period last year. Revenue from contributions¹⁰ went up by 2%, primarily because the full contribution now has to be paid on company pensions instead of the previous half-contribution. An overall rise in revenue of 1½% was accompanied by a fall in expenditure of 3½%. Expenditure items which registered a particularly sharp drop included pharmaceuticals, travel expenses and death benefit – which has now been completely abolished. This was facilitated both by significantly higher patients' co-payments and by the direct restriction of benefits. By contrast, expenditure on dentures went up sharply. This was presumably triggered by uncertainties regarding the outsourcing of insurance coverage for dentures next year as patients sought treatment ahead of the change.

The improvement in the financial outcome in the first quarter is, however, overstated by a "stampede" effect at the end of 2003 in anticipation of the pending health reform. The curbing of expenditure resulting from patients' co-payments is also likely to become less significant during the remainder of the year as chronically ill patients, in particular, reach the defined co-payment ceiling. On the other hand, the new Federal grant to cover

non-insurance-related benefits, totalling €1 billion, was not drawn on in the first quarter. Overall, a surplus is expected for this year; and it is certainly needed in order to redeem at least one-quarter of the (gross) debt of €8.3 billion which had accumulated by the end of 2003 and also to create financial leeway for lowering contribution rates. At the beginning of May, the average contribution rate amounted to 14.2%. Although it cannot be ruled out that it may fall to below 14% by the end of the year, it is unlikely to fall below this threshold on an annual average .

General government budget trends

The general government deficit ratio (as defined in the national accounts) was 3.9% in 2003, thus exceeding the 3% ceiling for the second year in succession. As things stand today, no major changes are expected this year. On the one hand, the expenditure ratio will probably fall considerably. This is likely to be partly attributable to the health reform, the currently muted growth in spending on pensioners, the decline in the number of staff in the public sector in conjunction with moderate pay adjustments, the generally stringent spending policy at all levels of government and the ongoing favourable interest rate level. On the other hand, the ratio of revenue

Deficit ratio still well above the 3% ceiling in 2004

⁹ The compensatory amount, which is to be paid on a quarterly basis, is calculated according to the average expenditure in respect of recipients of unemployment benefit II who changed over from the old to the new benefit in the previous quarter. This is intended to encourage the Federal Employment Agency to intensify its job placement efforts.

¹⁰ Including contributions for low paid part-time jobs ("mini jobs") booked under the risk structure compensation scheme.

The Stability and Growth Pact following the European Court of Justice's judgement of 13 July 2004

The objective of the Stability and Growth Pact is to attain and safeguard sound public finances in economic and monetary union. Sound public finances not only promote growth and employment, they are also a *sine qua non* for the ability of the European System of Central Banks to ensure price stability at low interest rates.

To achieve this objective, the member states of the European Union need to ensure that the Stability and Growth Pact is rigorously implemented and, if they have not already done so, achieve structurally balanced budgets as quickly as possible. They should take advantage of the emerging economic recovery to undertake the necessary fiscal consolidation measures.

Hence in Germany, too, the various tiers of government (central, state and local government) are faced with the task of achieving a balanced general government budget in the medium term through structural consolidation measures. Another key requirement for this would be the rigorous implementation of a national stability pact.

It is becoming apparent that Germany will make virtually no progress towards structural consolidation this year. In 2004, for the third year in succession, the deficit ratio will exceed the 3% ceiling specified under Community law. It is therefore all the more urgent to sufficiently curtail the general government deficit ratio in 2005 so that it falls below the 3% ceiling. As things stand now, this is an achievable target. Should it emerge that the current budget plans will not suffice to achieve this aim, additional consolidation measures would be necessary. The Federal Government also announced this when it presented the draft budget for 2005.

The requirements imposed on the member states by the Stability and Growth Pact have not lost any of their urgency in the wake of the European Court of Justice's judgement of 13 July

2004. The upshot of that judgement in response to the case filed by the European Commission against the Council of the European Union in connection with the excessive deficit procedures against France and Germany is that the excessive deficit procedures against those countries are being held in abeyance and correspond to the state of the Council's recommendations pursuant to Article 104 (7) of the EC Treaty from January and June 2003.¹

It follows that the excessive deficit procedures should now be continued in line with the rules laid down by the Stability and Growth Pact. Renewed recommendations pursuant to Article 104 (7) of the EC Treaty would, by contrast, contradict the Pact's intention of effectively combating excessive budget deficits.

The demands to be issued to Germany and France in the further course of the excessive deficit procedures could be oriented to the Commission's recommendations from autumn last year. In any case they should contain the demand to comply with the 3% deficit ceiling in 2005. The economic situation has developed since then largely as forecast. Given the macroeconomic recovery, a further extension of the deadline for correcting the excessive deficits beyond the end of 2005 is therefore likewise unwarranted on economic policy grounds.

The European Court's judgement has also reanimated the public debate about a possible reform of the Stability and Growth Pact. However, the Pact essentially satisfies the requirements regarding appropriate fiscal policy rules for economic and monetary union. It is not the Pact's form that is causing problems but its implementation. The current fiscal policy difficulties of some member states are due not least to the fact that these countries failed to sufficiently reduce their budget deficits in the past when the macroeconomic setting was more favourable.

¹ If the Council decides that an excessive deficit exists, it simultaneously makes recommendations pursuant to Article 104 (7) to the member state concerned with a view to correcting the excessive deficit within a given period. If the

member state fails to put these recommendations into practice, the Council is called upon to initiate the further steps envisaged in the Pact.

to GDP will also decrease noticeably. This particularly reflects the sizeable income tax cuts made at the beginning of the year. Furthermore, despite the rise in macroeconomic growth, the assessment base for taxes and social security contributions is developing relatively weakly. Non-tax revenue will fall as a result of the sharp decline in the Bundesbank profit and the proceeds lost on account of the delayed introduction of a motorway toll system for heavy goods vehicles.

*Comprehensive
need for con-
solidation in
2005*

Whereas in the past few years the general government deficits have risen considerably in the context of an unfavourable macroeconomic setting coupled with extensive cuts in taxes and social security contributions, it is now high time to achieve a comprehensive consolidation of public finances – especially since the macroeconomic outlook has meanwhile improved. This requirement stems not least from the commitments which were entered into within the framework of European monetary union and which were expressly recognised by representatives of all levels of government (for details, see the box on page 64).

The deficits are indeed expected to decrease in 2005. Although the taxes and social security ratio will fall further, particularly as a result of the last stage of the income tax reform, non-tax revenue may increase substantially owing to the introduction of the motorway toll announced for the beginning of 2005. The crucial requirement is to strictly curb expenditure at all levels of government so as to facilitate a marked lowering of the expenditure ratio. This may be aided by the structural reforms adopted in connection with labour market-related expenditure, even if these have an impact only after a time lag. In addition, it is to be expected that expenditure on pensions will continue to develop weakly and that an overall stringent spending policy will be pursued. The continuously favourable interest rate level should also help to ease the pressure on public finances. All in all, however, there is a danger, judging from the present perspective, that these efforts will not be sufficient to achieve compliance with the 3% ceiling next year. Should that appear likely, additional consolidation measures would have to be taken in good time.