Public finances

Budgetary development of central, state and local government

Underlying trends

In the third quarter of 2004 central and state government recorded a deficit of €18½ billion; this was €4½ billion lower than in the third quarter of 2003.[1] Despite a fall in tax revenue (-3%), overall revenue grew by 1½% owing to considerable inflows from asset disposals. Expenditure – which is subject to at times strong fluctuations during the year – went down by 2½%.

However, for 2004 as a whole an increase in the deficit of central, state and local government is expected, after already reaching a peak of €70 billion last year. Whereas tax revenue is likely to stagnate as a result of significant income tax cuts and the weak growth of the tax assessment base, non-tax revenue will decrease due to the lower Bundesbank profit. Expenditure is likely to reach roughly the same level as last year. Central government and many state and local governments will once again, as in 2003, exceed the upper limits for new borrowing as specified under budgetary law. The original budget targets will be widely missed, particularly by central government as a result of considerable tax shortfalls.

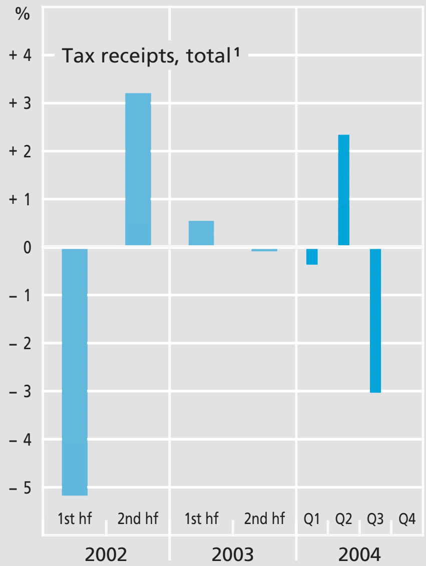
Tax revenue in the third quarter ...

Tax revenue[2] of central, state and local government in the third quarter was 3% below

1 Third-quarter results for local government are not yet known.
2 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known.

Tax revenue

Year-on-year change



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

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the 2003 level[3] after increasing by 1% in the first six months of 2004. Whereas most taxes related to profit and investment income continued to recover, wage tax receipts and revenue from major excise taxes, in particular, declined significantly.

The sharp increase of €1½ billion in revenue from corporation tax was partly the result of the favourable profit trend but was presumably also due to the moratorium for claiming accrued corporation tax credits adopted last year and to the limitation of the tax loss carry-forward facility. Conversely, the moratorium also contributed to a fall in revenue from investment income tax on dividends. Revenue from assessed income tax increased by 5½% despite the tax cuts which entered into force at the beginning of the year. Besides the positive earnings trend, this was attributable to smaller refunds in respect of employees' assessed liability, which are recorded under assessed income tax. Additional revenue from the tax amnesty is still fairly small. Wage tax revenue fell sharply (-8½%), particularly as a result of the tax cuts which came into force at the beginning of the year but also owing to the continued unfavourable situation on the labour market.

Among the indirect taxes, turnover tax revenue was ½% below the figure for 2003. This basically reflects the weak domestic demand. Receipts from the Federal Government's special excise taxes fell much more steeply (-6½%). Besides mineral oil tax and electricity tax, revenue from tobacco tax, in particular, went down. This primarily mirrors the lower energy consumption prompted by high mineral oil prices and the shrinking demand for taxed tobacco products, which more than outweighed the increase in tobacco tax on 1 March this year. However, changes in booking techniques also played a role.[4]

... and in 2004 as a whole

Despite the more positive growth assumptions, expectations for tax revenue in 2004 as a whole were revised downwards somewhat in the official estimate from November.[5] Besides the reduced revenue expectations in connection with the tax amnesty, this was

3 Even after taking account of changes in booking techniques for several special excise taxes of central government, tax revenue still shows a decline of 2¾%.
4 Adjusted for this effect, the decline in these Federal taxes amounted to 5%.
5 The Federal Government is now expecting nominal GDP growth of 2¾% and real growth of 1¾%, whereas in May growth rates of 2¼% and 1½% respectively were anticipated.

mainly attributable to the fact that revenue from wage tax, turnover tax and special excise taxes will be lower because of the depressed tax-generating structure of the current macroeconomic situation and especially as a result of consumer reactions to the increase in the price of tobacco and mineral oil products. On the other hand, in contrast to previous years, profit-related taxes (corporation tax and local business tax, in particular) were revised upwards, which was largely due to the more favourable trend in entrepreneurial and property income. Overall, tax revenue is expected to stagnate. Thus, revenue shortfalls of €1½ billion are anticipated vis-à-vis the May estimate. The overall tax ratio (as defined in the government financial statistics), which was 20.8% in 2003, will fall again this year to 20.3%.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion, Q1 to Q3, 2003	2004	Annual percentage change
Wage tax	94.4	88.4	– 6.3
Assessed income tax	0.1	0.4	.
Corporation tax	4.8	9.4	+ 94.0
Turnover tax	101.2	101.9	+ 0.7
	of which Q3		
Wage tax	32.1	29.4	– 8.6
Assessed income tax	3.0	3.1	+ 5.6
Corporation tax	1.2	2.7	+ 131.9
Turnover tax	34.2	34.0	– 0.7

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Tax revenue in 2005

The new tax estimate puts the likely tax shortfalls next year vis-à-vis the May estimate a little higher at €1½ billion – based on current tax legislation. This is also primarily due to the amended estimate of the growth structure, whereas the assumptions regarding the scale of macroeconomic growth (real +1¾%, nominal +2¾%) were hardly revised. After taking account of the recently adopted changes in tax legislation, tax revenue is expected to increase by merely 1½%. The overall tax ratio will go down again marginally to 20.1%, primarily as a result of a further cut in income tax.

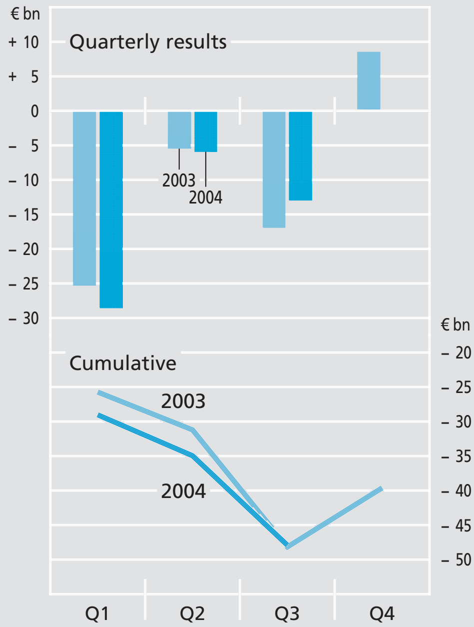
Central government in the third quarter…

In the third quarter central government recorded a deficit of €13 billion, which was €4 billion less than in the same period last year. This was partly attributable to an increase in revenue of 1%. Although tax revenue declined, relatively high proceeds from the sale of financial assets were booked (€4½ billion). Furthermore, expenditure – which fluctuates relatively sharply during the year – decreased by 4½%. A significant decline in interest expenditure, the discontinuation of transfers to the flood disaster fund and also lower operating expenditure all played a role. In the first nine months of 2004, the deficit reached just over €47 billion, thus roughly matching the level from the same period in 2003.

… and in 2004 as a whole

In 2004 as a whole the deficit will far exceed the original target figure (€29½ billion). One of the main reasons for this on the expenditure side is additional labour market-related spending. The principal cause on the revenue side are the tax shortfalls (just over €11 billion according to the recent tax estimate) but the

The Federal Government's balance of revenue and expenditure in 2003 and 2004



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decline in the Bundesbank profit and the smaller-than-expected revenue from motorway tolls are other contributory factors. In the supplementary budget adopted by the Bundestag, a deficit of €43½ billion is now anticipated for 2004. In order to justify again exceeding the constitutional limit for net borrowing, which is defined by the level of investment expenditure, the Federal Government – for the third consecutive year – is invoking the exemption clause that this is necessary to avert a disruption of the overall economic equilibrium.

Outlook for 2005

Next year, according to the Federal Government's draft budget, net government borrowing should amount to €22 billion and thus just stay below the investment expenditure target. The sharp decline in new borrowing should be achieved not least by the realisation of privatisation proceeds amounting to €15½ billion (following €10½ billion in the draft supplementary budget for this year). However, in the meantime new financial burdens have emerged; according to the Federal Ministry of Finance this will amount to just over €8 billion. Thus, the recent tax estimate suggests that tax revenue shortfalls of €3½ billion are to be expected. The Bundesbank profit is expected to raise €1½ billion less than previously anticipated. On the expenditure side, above all the adopted adjustments to the planned amalgamation of unemployment assistance and social assistance will require additional funds of €3 billion.[6] In order to close the new financial gap, the currently envisaged transfers (€5½ billion) to the Post Office pension fund – which has taken over responsibility for Post Office employees' pensions and is refinanced by contributions from Federal Government and the successor enterprises to the old Post Office – are to be discontinued.[7] Additional funds are to be procured by shifting privatisation proceeds from this year to next year (€1½ billion) and by making an across-the-board cut in expenditure (€1 billion). Even if these measures yield the full financial effects hoped for, it should be borne in mind that they will for the most part merely engineer a postponement and

6 This is necessitated by bringing forward the date of the first payment of unemployment benefit II to previous recipients of unemployment assistance to the beginning of January 2005 and by the payments made to the municipalities to alleviate local government by a net amount of €2½ billion per year in the wake of the reform.
7 In order to achieve this, the ongoing contributions currently paid by the Post Office successor enterprises to the Post Office pension fund will be sold in the capital market and the proceeds will go to the Post Office pension fund. This will burden central government more heavily in the future.

are no substitute for a sustainable consolidation process. In the aggregate, asset sales are to relieve the Federal budget by a total amount of almost €23 billion.

Special funds

The special funds recorded a deficit of just under €½ billion in the third quarter. In the same period last year, these budgets were more or less balanced. Although a surplus is expected for 2004 as a whole, this will be much lower than in 2003 (just over €10 billion). Following a surplus in 2003, the flood disaster fund will record a deficit this year because a large part of the accrued funds have now been used up. The financial situation of the Redemption Fund for Inherited Liabilities will also deteriorate markedly owing to the fact that no part of the Bundesbank profit was transferred to it this year.

State government

In the third quarter, state government lowered its budgetary deficit compared with last year by €1 billion to €5 billion. Despite the increase in state government's share of turnover tax (limited to this year) – to compensate for the fact that income tax cuts were brought forward – and a continuing favourable trend in state government's tax revenue, its overall tax receipts went down slightly. Overall revenue stagnated. Expenditure was reduced by ½%. Relief arose, not least, from the fact that grants to the flood disaster fund were discontinued.

For 2004 as a whole, the budgetary plans for state government envisage a decline in its deficits of €7 billion to €24½ billion. Although, as things stand today, the plans will not be fully met,[8] a considerable reduction is still expected. This improvement will, however, not be maintained in 2005. Besides the "return" of the increased share of turnover tax to central government, the state government budgets will also be burdened by the final stage of the tax reform. The breaching of the state constitutional ceilings for new borrowing – which is foreseeable in some federal states – appears difficult to substantiate by declaring that it is needed to avert a disruption of the overall economic equilibrium in the light of the economic growth that is becoming apparent and the fact that central government itself has not invoked this exemption clause. State government is required to make its contribution to the consolidation of public finances also with regard to the fiscal target of reducing the general government deficit below the 3% ceiling as defined in the Maastricht Treaty.

Local government

For local government, only figures for the second quarter of 2004 are available. During this period local government recorded a close-to-balanced budget after recording a deficit of €2½ billion in the second quarter of 2003. The main reason for this was the sharp increase in revenue (+7%). Tax revenue rose particularly steeply (+12%); besides the first-time effects of the lowering of the share of local business tax to be passed on, this was also partly attributable to the persistently favourable trend in gross revenue from local business tax. In addition, key grants distributed from state government by quota increased by 8½% on average – albeit with major differences between the individual

8 For example, the states of North Rhine-Westphalia and Hesse have already adopted supplementary budgets

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

€ billion

Period	Total	*of which* Securities 1	Loans against borrowers' notes 2	*Memo item* Acquisition by non-residents
2003	+ 81.2	+ 73.4	– 0.8	+ 26.9
of which				
Q1	+ 35.3	+ 32.6	+ 2.7	+ 19.4
Q2	+ 13.2	+ 11.8	+ 0.5	+ 12.4
Q3	+ 20.0	+ 9.4	+ 5.0	– 0.3
Q4	+ 12.6	+ 19.5	– 9.0	– 4.6
2004				
Q1	+ 45.8	+ 34.6	+ 4.6	+ 16.9
Q2	+ 9.3	+ 14.6	– 8.5	– 3.6
Q3 pe	+ 18.1	+ 17.2	– 0.4	...

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

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states. Overall expenditure fell somewhat. The marginal decline in expenditure on personnel was offset by a steep rise in social security spending (+6½%), which was caused, not least, by a higher number of recipients. By contrast, spending on non-financial assets were considerably reduced again (-8½%).

Mainly as a result of the favourable trends in local business tax, a reduction of local government budgetary deficits now appears probable for the whole of 2004 as well, following the high level of €8½ billion recorded in 2003. However, this improvement will also be the result of a decline in investment in non-financial assets.

Indebtedness

In the third quarter the indebtedness of central, state and local government rose by €18 billion. Central government was the largest borrower, recording a rise of €10½ billion. State government expanded its indebtedness by €6½ billion in total. There was a preference for borrowing via medium and long-term securities, which accounted for €17 billion. Whereas €1 billion was raised through loans against borrowers' notes, money market loans and cash advances from banks were reduced by €1½ billion.

Social security funds

Wage and salary earners' pension insurance scheme

In the third quarter of 2004, the wage and salary earners' pension insurance scheme recorded a deficit of just under €1½ billion, which was nearly €½ billion higher than in the same period in 2003. Expenditure was almost ½% down on the year, primarily because the pension insurance contribution to the long-term care insurance scheme has been paid by the pensioners themselves since April 2004. Furthermore, this year there was no annual pension adjustment on 1 July, 2004, as a result of which only ½% extra was spent on pensions. By contrast, overall revenue declined more sharply by just under 1%. Revenue from contributions diminished by just over 1%. Although receipts from compulsory contributions showed hardly any decrease, revenue from contributions on sickness benefit and wage substitutes for unemployed persons declined more steeply.[9]

9 The 10% decline in revenue from contributions on wage substitutes for unemployed persons was primarily due to changes in booking techniques. In the second quarter this item had increased by 8%.

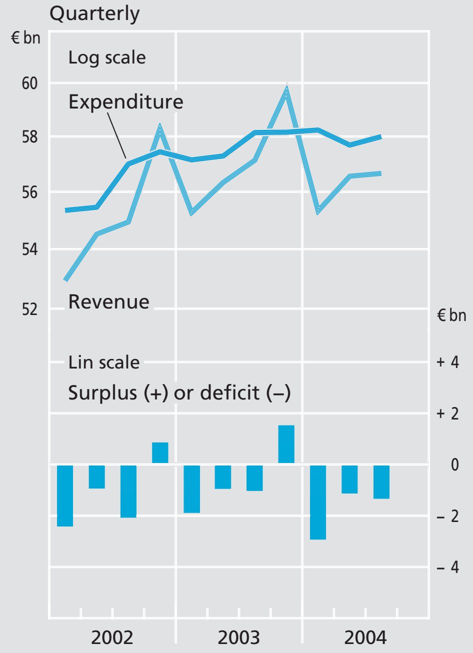
By the end of the year the deficit of €5½ billion which had accumulated in the first nine months is expected to decline sharply. Besides the seasonally higher revenue from contributions in the fourth quarter, proceeds from the sale of the participating interest in the GAGFAH housing company will also boost revenue. The sales proceeds of €2.1 billion will primarily help to increase the degree of liquidity in the fluctuation reserves – which have now been renamed the sustainability reserves. In future liquidity shortages will therefore be less likely given the prescribed level of reserves. However, as the disposed equity stake had a book value of €1.6 billion, the reserves are only being raised by the capital gain of €0.5 billion. Next year there is a risk, in view of the policy makers' professed intention to keep the current contribution rate at 19.5% that a considerable deficit will occur and that at the end of the year the reserves will consequently fall below the statutory minimum level of 0.2 month's expenditure.

Federal Employment Agency

The Federal Employment Agency recorded a deficit of just under €½ billion in the third quarter of 2004; this was an improvement of €½ billion compared with the same period last year. Unlike in the statutory pension insurance scheme, a similarly negative decline in revenue (-2½%) was more than offset by a much steeper fall in expenditure (-6%). Despite an increase in the number of unemployed persons, nearly 3% less was spent on unemployment benefit. The ratio of recipients has continued to go down because more and more unemployed persons are exhausting the maximum period of entitlement to this benefit. Expenditure on active labour market policy

Finances of the wage and salary earners' pension insurance scheme

Quarterly



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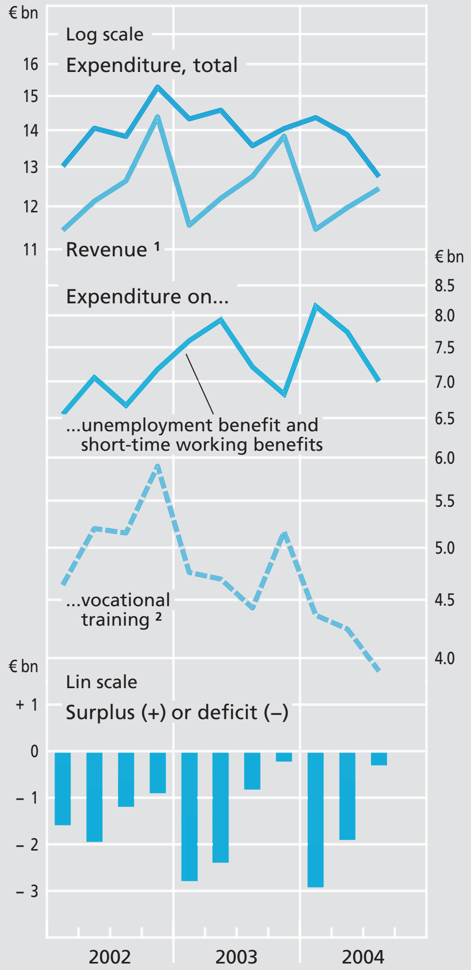
measures contracted by 12%. The fast-growing rate of spending on "Me plcs" and personnel service agencies[10] by no means consumed the savings made in other areas.

In the first nine months the deficit of the Federal Employment Agency amounted to €5 billion. Since the financial outcome of the last quarter is relatively favourable as a rule, the Federal Government grant of €5.2 billion budgeted for the full year should barely be exceeded. Despite the persistently high level of unemployment, another reduction in the deficit is expected next year if spending on active

10 In September expenditure on "Me plcs" and personnel service agencies already accounted for 9½% of overall spending on vocational promotion schemes. However, the more stringent evaluation of the viability of proposed business start-ups is likely to slow down the rate of increase in this item of expenditure.

Finances of the
Federal Employment Agency

Quarterly



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

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labour market policy measures is lowered again. The 2005 Federal budget includes a transfer requirement of €4 billion. Therefore, savings made by the Federal Employment Agency in respect of spending on vocational promotion schemes for former recipients of unemployment assistance, responsibility for which has now been assumed by central government, will be offset by additional expenditure on the compensatory amount[11] to be transferred to central government.

Statutory health insurance scheme

The financial outcome of the statutory health insurance scheme is currently available only for the first half of the year. According to this a surplus of €2½ billion was recorded in total. In the same period last year the scheme ran up a deficit of €2 billion. This pronounced improvement was made possible by the 2004 healthcare reform, which resulted in both higher revenue and greater savings. Revenue was 2½% up on the first half of 2003. The main reasons for this were the levying of the full (instead of half) contribution rate from pensioners (particularly on company pensions) since the beginning of the year, the first instalment of the new Federal grant (financed by revenue from tobacco tax) of €½ billion,[12] and the contributions from mini jobs (which are growing particularly rapidly). Expenditure decreased by 4% in total. Savings on pharmaceuticals, sickness benefit and travel costs were particularly marked. However, the decline in expenditure already began to decelerate marginally during the year. This is firstly attributable to the drop-out effect of expenditure brought forward to the end of 2003, which provided for particularly low expenditure in the first quarter. Secondly, more and more insured persons are reaching the income-related upper

11 The Federal Employment Agency pays the compensatory amount for three months as a reimbursement to central government of the average unemployment benefit II paid to persons who switch from the old unemployment benefit to the new unemployment benefit II. The lower the number of benefit recipients who receive unemployment benefit II, the lower the compensatory amount will be.
12 In the second half of the year a further instalment of €0.5 billion is to be paid. The Federal grant increases to €2.5 billion in 2005 and then to €4.2 billion thereafter.

payment ceiling above which they are exempted from co-payments.

If a significant surplus is expected for 2004 as a whole, this is in part because the health insurance institutions have so far largely refrained from cutting contribution rates. They were prompted to do so not least by their statutory obligation to redeem at least one-quarter of their accumulated debt (€8½ billion gross) this year. It should also be borne in mind that noticeable expenditure growth, especially in connection with pharmaceuticals, is expected as from next year. The trend in 2005 will be additionally burdened by the fact that the decision to outsource insurance coverage for dentures – adopted as part of the healthcare reform – and their financing via non-income related flat-rate insurance premiums has since been cancelled. Instead, the special contribution intended for members of the statutory health insurance scheme of 0.5% that was to be paid on 1 January 2006 is being brought forward to 1 July 2005 and raised to 0.9%. This will save employers and the statutory pension insurance scheme 0.45%, but employees and pensioners will have to pay 0.45% extra. This new arrangement has nullified the option associated with the planned flat-rate denture payment of lowering the contribution rate by 0.4% and concurrently decoupling health insurance financing partly from wages.

Long-term care insurance scheme

The long-term care insurance scheme recorded a deficit of €½ billion in the first half of the year; this was somewhat higher than in the same period last year. A record deficit of almost €1 billion is expected for 2004 as a whole as well as a correspondingly sharp fall in the reserves. However, the long-term care insurance institutions will be relieved next year by the fact that all childless persons born after 1940 will have to start paying a 0.25% higher contribution rate when they reach the age of 23.

Outlook for the general government sector as a whole

Maastricht ceiling will be exceeded again in 2004

In 2004 Germany will once again exceed the deficit and debt criteria stipulated in the Maastricht Treaty. The deficit ratio is likely to match last year's figure (3.8%). The debt ratio will increase again markedly after rising to 64.2% in 2003. Although GDP has expanded quite perceptibly this year, the structure of the current macroeconomic development is hardly boosting government revenue, so that the cyclical situation is a contributory factor to the increase in the general government deficit.

Sharp decline of the revenue and expenditure ratios

On the one hand, the state of public finances in 2004 is characterised by a decrease in the revenue ratio, which could amount to 1½ percentage points. Besides the weak growth of the tax and social security contribution bases, this is also attributable to the extensive income tax cuts which entered into force at the beginning of the year. Furthermore, non-tax revenue will fall as well, not least as a result of the lower Bundesbank profit. On the other hand, the expenditure ratio will fall, too. This is mainly attributable to lower expenditure as a result of the healthcare reform, the dampened development of pensions as well as savings on personnel expenditure and investment. Government budgets are also continuing to profit from the very favourable financing terms, which will yield considerable savings whenever maturing debt securities are rolled over.

Decrease in deficit ratio expected in 2005

The general government deficit ratio is expected to decline next year. Although the revenue ratio is likely to fall further, it will not do so as sharply as in 2004. This is partly because the structure of macroeconomic growth is likely to be yield somewhat more revenue. Furthermore, the last stage of the income tax reform will not cause such large shortfalls as the tax cuts this year. Finally, non-tax revenue may increase again since additional revenue is now likely to arise *inter alia* from the introduction of motorway tolls for heavy goods vehicles. The expenditure ratio is also likely to fall less steeply than it has done this year but still more steeply than the revenue ratio. This will probably be due, in part, to a stringent spending policy at all levels of government, which will be reflected in personnel expenditure in particular. Labour market-related spending may produce savings in view of the adopted reform measures, and the development of pensions as well as interest expenditure should again be relatively subdued. Overall, however, the course of economic development in 2005 is subject to considerable uncertainty. Thus, among other things, the likely financial impact of the various statutory measures is very difficult to gauge. The revenue from profit-related taxes has likewise proved to be exceptionally volatile in the past few years.

Efforts to comply with the 3% deficit ceiling

Despite the expectations of a declining deficit ratio, as things stand today there is a considerable risk that the 3% ceiling will be exceeded next year, too. This, along with the process of preparing a Federal budget in line with the constitutional requirements, prompted the Federal Government to put forward a new package of measures (see pp 58-59), which (including a zero-wage round for public-sector employees) should result in financial relief of €8 billion for the general government budget.[13] It is to be welcomed that in 2005 central government intends to vigorously pursue the objective of complying with the 3% ceiling and therefore meeting its European commitments. This would in fact be the best way to strengthen the credibility of the European Stability and Growth Pact (for more details on the current discussion concerning the reform of the Pact, see the box on p 9). However, it is not certain that the planned measures will be sufficient to comply with the 3% ceiling. Moreover, the measures largely comprise one-off effects which will result in burdens for future budgets. This makes it all the more important to pursue a strict and sustainable consolidation course from now on with the objective of staying permanently below the deficit ceiling and ultimately achieving a structurally balanced budget. For the close coordination that this requires between central and state government, the Financial Planning Council is available, as a national fiscal policy coordination body, to enable additional joint consolidation measures to be agreed on.

13 The original plan to move the public holiday on 3 October (“German Unity Day”) to the first Sunday in October, which would have yielded relief of €2 billion, has been dropped.