Public finances

Budgetary development of central, state and local government

Overview

The deficit of central and state government (the results for local government are not yet known) was €38 billion in the first quarter and therefore €2½ billion below the very high value in the same period of 2004. Owing to a strong increase in non-tax receipts, revenue grew by just under 5%. Tax revenue stagnated; this was partly due to income tax cuts and higher transfers to the EU. Expenditure went up by 1½%.

The deficit, having gone down only marginally in 2004 to €67 billion, is expected to fall more visibly this year. This will be chiefly facilitated by a strong increase in non-tax revenue due mainly to greater central government asset disposals. By contrast, only a small increase in tax revenue is expected according to the most recent tax estimate. In the light of budget law requirements, the rise in expenditure is likely to remain very limited. As a result of the pay settlement of February 2005 and the expected continuation of staff cuts, expenditure on personnel will barely increase. Although the temporary cessation of grants to the Post Office pension fund will also provide relief on the expenditure side this year, this will lead to additional expenditure in the future. On the whole, the current budget plans are fraught with considerable risks.

Tax revenue in the first quarter

Tax revenue[1] increased by just under 2% in the first quarter compared with the same

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

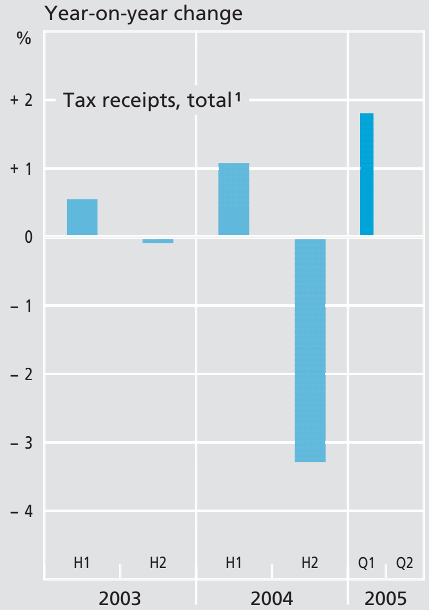
period in 2004. Revenue from assessed taxes grew noticeably. Besides the positive trend in profits, corporation tax receipts were also bolstered by various statutory measures aimed at broadening the assessment base. In the case of assessed income tax, lower tax refunds to employees, the cut in grants to homebuyers starting in 2004 and final inflows in connection with the tax amnesty had a noticeable impact. By contrast, wage tax revenue declined by 5½%. The effects of this year's tax cuts were compounded by the fact that last year's tax relief measures had only a partial impact in the first quarter of 2004 in terms of actual cash receipts. Among the indirect taxes, turnover tax revenue went up by just under 2%. However, this revenue is very volatile over the course of the year. Revenue from tobacco tax grew by 5%; however, the impact of the tax increases from March and December 2004 was diminished by the sustained decline in the consumption of taxed cigarettes. With the continued rise in energy prices, the revenue from mineral oil taxes based on the actual amounts sold also went down again (by 4½%).

Further outlook

In the new official tax estimate, which assumes real GDP growth of 1% and nominal GDP growth of 1.6%, an increase in tax revenue of merely 0.5% (including local government taxes) is expected for 2005. Compared with the autumn 2004 estimate, shortfalls amounting to €5 billion are anticipated.[2] This is based on the worsened expectations concerning developments on the labour market and in private consumption, which are especially reflected in lower revenue from wage tax (€4 billion) and from turnover tax (€1½ billion). Furthermore, the projected revenue from mineral oil tax and tobacco tax has now been revised downwards (by €1 billion in total). On the other hand, the forecasts for profit-related taxes were revised upwards (by €2 billion) as a result of more favourable profit expectations. In 2005 the tax ratio (as defined in the government's financial statistics) will go down again to 20.1% owing above all to the additional lowering of income tax rates. Over the next few years it will then go back up somewhat. By 2008 the shortfalls will increase vis-à-vis the comparable forecast from May 2004, which has since been adjusted for amendments in tax legislation, and will then amount to €21 billion or 0.9% of GDP.

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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2 Excluding recent amendments in tax legislation, which play no significant role.

Trends in the revenue from major taxes

Type of tax	Revenue in € billion		Annual percentage change
	Q1		
	2005	2004	
Wage tax	27.9	29.5	– 5.6
Assessed income tax	– 3.8	– 5.8	.
Corporation tax	4.4	2.2	+ 102.8
Turnover tax	34.9	34.2	+ 1.9

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Reduction of business tax burden ...

Since the official estimate is based exclusively on existing legislation, the tax relief measures for enterprises, which were discussed at the "job summit" between the government and opposition parties in March 2005, adopted by the cabinet on 4 May and thus only at the beginning of the legislative process, are not contained in the current estimate. The decision provides that from 2006 the corporation tax rate will be lowered from 25% to 19%. For non-corporations the entitlement to offset local business tax against income tax will be extended, and inheritance and gift tax in connection with transferring business assets will be phased out as long as the enterprise is not sold. The total expected shortfalls of just over €6 billion are to be partly counterfinanced by tightening the loss-offset facility for special "tax-saving mutual funds" and further restricting the tax loss-carry-forward facility. Furthermore, it is assumed that, owing to the lower tax rates, profits taxed in Germany will increase considerably, thus financing just over €2 billion of the tax shortfalls. Given that the tax burden on corporate profits in Germany is high by international standards, the planned cut in the corporation tax rate is a step in the right direction. Unlike eliminating tax loopholes, the objective of limiting the tax loss-carry-forward facility, which has a legitimate function within the overall tax system, appears problematic. Attempts to alter inheritance tax need to heed the requirements of equal treatment of different types of assets and the practicability of such measures. Moreover, given the tense budgetary position, the very high degree of uncertainty and the frequently disappointed expectations in the last few years with regard to the financial impact of tax measures, short-term self-financing of relief measures should not be part of a conservative budget plan.

... should be integrated into a comprehensive reform

However, the planned measures will not resolve the structural weaknesses of the current tax system. The main problems are the high marginal income tax rate combined with an assessment base restricted by numerous exemptions, the distortions regarding the taxation of labour income and capital income, corporate financing and the different legal forms of the business organisation, as well as the associated intransparency. A comprehensive reform of income tax and corporation tax is, however, made more difficult by the fact that the tight budgetary situation will barely justify any further tax shortfalls. A dual income tax, such as that suggested by the German Council of Economic Experts[3] and now being further elaborated on behalf of the Federal Ministry of Finance, might be a pragmatic interim step despite the problematic taxation of capital income and labour income at different rates. This would, however, be subject to the condition that a satisfactory solution is found for the various problems relating to the concrete implementation, particularly the difficulty of distinguishing between capital and labour income.

Central government in the first quarter ...

Central government's deficit in the first quarter was €29 billion and therefore more or less at the same level as in 2004. Despite stagnating tax revenue, overall revenue rose by just under 3%. Non-tax revenue grew sharply by just under €1½ billion. This was due to the compensatory amount paid by the Federal Employment Agency, a higher Bundesbank profit vis-à-vis the previous year and revenue from motorway tolls. Expenditure grew by just over 2% owing largely to high labour market-related spending.

... and in 2005 as a whole

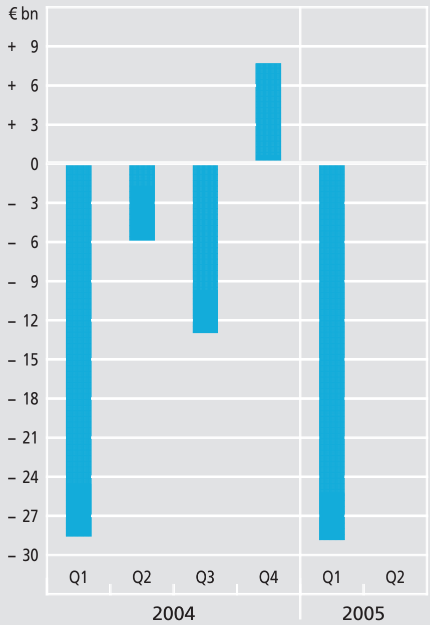
Central government's deficit is expected to be reduced by €17½ billion to around €22½ billion in 2005. However, this is fraught with considerable risks. For example, the Bundesbank profit was just under €1½ billion lower than planned. Furthermore, the latest tax estimate anticipates shortfalls of €3½ billion. This will make it difficult to achieve the revenue target even if the sharp increase in asset disposals (doubled from last year's figure to €17 billion) is attained. On the expenditure side, labour market-related spending in particular is subject to considerable risks. Although the transfers from central government to the municipalities (contributing to accommodation and heating costs for the recipients of "unemployment benefit II") are likely to be lower than envisaged, the high number of recipients means that additional expenditure on "unemployment benefit II" payments is unavoidable. Overall, central government spending to provide basic social security protection for job-seekers will exceed budget estimates (just over €27½ billion). In these projections, which are based on central government plans, it must be noted that reorganising the basic social security system will bring about a considerable easing of the financial burden on the general government budget over the medium term compared with continuing to disburse unemployment assistance and social assistance side by side – provided administrative expenditure does not increase considerably.

Outlook

Central government is faced with a large task of consolidation. The budget plan envisages that structurally – ie excluding the merely temporary relief afforded by asset disposals or reduced grants to the Post Office pension funds – the constitutional ceiling for net borrowing will be overshot in 2005 by just over €20 billion.[4] The medium-term outlook will

3 See the Annual Report 2003/04 of the German Council of Economic Experts, *Bundestags-Drucksache* 15/2000, sections 584-612 (full report available in German only). In the case of a dual income tax, the various forms of capital income are decoupled from the taxation of labour income and taxed at a uniform proportional rate. This should reduce the existing distortions influencing entrepeneurs' decisions concerning investment, financing and the legal form of an enterprise while at the same time minimising tax shortfalls compared with a more comprehensive reform embracing taxation of labour income, too.
4 See Deutsche Bundesbank, Deficit-limiting budgetary rules and a national stability pact in Germany, *Monthly Report,* April 2005, pp 23-37.

The Federal Government's balance of revenue and expenditure



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also be clouded by the considerably more unfavourable expectations regarding tax revenue. Even if labour market-related spending is lowered and the growth of interest expenditure were to remain dampened despite high new borrowing owing to favourable financing conditions, there will still be a considerable need for adjustment. Additional burdens resulting from tax cuts which are not counterfinanced or from increased grants to other government levels can therefore not be sustained.

Special funds

The deficit of the special funds was €½ billion in the first quarter and thus €1 billion below the figure for the same quarter in 2004. This was mainly due to central government assuming joint responsibility for the German Unity Fund's debt and to the improved result of the ERP special fund. For 2005 as a whole, as in 2004, the special funds may record a small surplus.

State government

In the first quarter of 2005, state government reduced its year-on-year deficit by €2 billion to just under €9 billion. Although tax revenue declined marginally in the wake of the last stage of the tax reform and the reallocation of turnover tax shares to central government, overall revenue rose by 6% owing to the subsidy repayments which some *Landesbanks* have been ordered to make by the European Commission. Expenditure went up by just over 2%, mainly due to the recapitalisation of one *Landesbank* in the wake of the subsidy repayments. The rise in expenditure on personnel was limited to 1% partly because of further staff reductions which were promoted by the increase in weekly working hours for the majority of civil servants and following the termination of the working-hours contract for many employees subject to wage negotiations.

In 2004 the deficit was reduced somewhat more sharply than planned to just over €25 billion. However, this was partly due to initial subsidy repayments from *Landesbanks* (€1 billion). As with most of the subsidy repayments received this year, the attendant, and almost equally high, injections of capital mandated by the European Commission will not put a burden on budgets until later in the year. State governments plan to lower their deficits only moderately this year to €23 billion. According to the results of the latest tax estimate, these plans are then only likely to be achieved if stringent fiscal prudence is practised. This is also necessary in the medium term in order to end the structural underfunding of the budgets without raising taxes.[5]

Local government

For local government, results are currently available only up to the end of 2004. The deficit for 2004 as a whole was more than halved to just under €4 billion. This owed largely to the noticeable increase in revenue of almost 3%. As a result of tax cuts, local government also had to contend with falls in revenue from their share of income tax. However, the very strong rise in local business tax revenue, in conjunction with the reduction in the levy on trade tax payable to central and state government, caused local government tax revenue to increase by just under 9½%. The key grants from state government were likewise raised. By contrast, overall expenditure went down by just under ½%. While social benefits continued to grow substantially, expenditure on personnel was kept stable mainly owing to the persistent decline in the number of employees. Expenditure on interest and for non-financial assets declined significantly.

The deficit is likely to continue its decline this year. In addition to the promised €2½ billion in relief from the amalgamation of unemployment assistance and social assistance, local business tax revenue is also expected to continue its favourable development. In the light of the recent rise, to just over €20 billion, in cash advances – which, contrary to the budgetary provisions, are used not only for liquidity management but frequently also for longer-term financing of current expenditure – many local governments still have a considerable need for consolidation.

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
2003	+ 81.2	+ 73.4	– 0.8	+ 26.9
2004 pe	+ 71.8	+ 70.9	– 16.2	+ 42.9
of which				
Q1	+ 45.3	+ 34.6	+ 4.1	+ 16.9
Q2	+ 8.2	+ 14.6	– 9.6	– 3.6
Q3	+ 17.6	+ 17.1	– 0.9	+ 18.6
Q4 pe	+ 0.7	+ 4.6	– 9.8	+ 11.0
2005				
Q1 pe	+ 27.3	+ 17.1	+ 10.2	...

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

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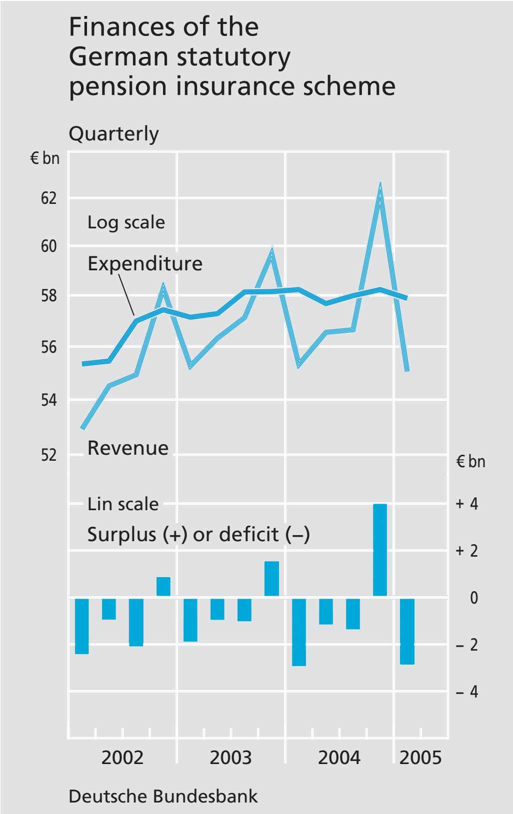
Debt

In the first quarter central, state and local government debt rose very sharply, by €27½ billion. The largest borrower was central government, which increased its debt by €19½ billion. However, state government, too, had a considerable need for funds (€7 billion). Three-fifths of total new borrowing consisted of medium and long-term borrowing. The remaining borrowing requirement was covered by short-term securities, money market loans and cash advances.

5 For specifics, see Deutsche Bundesbank, loc cit, p 29.



Social security funds

Statutory pension insurance scheme

The deficit of the statutory pension insurance scheme in the first quarter of 2005 was just under €3 billion and therefore almost as high as in the previous year. Both revenue and expenditure declined marginally. Revenue from compulsory contributions was 1½% down on the first quarter of 2004. This negative underlying trend was offset somewhat by the additional revenue for unemployed people insured in the statutory pension insurance scheme. The reclassification of numerous people previously receiving social assistance but not insured in the statutory pension insurance scheme to recipients of „unemployment benefit II" insured in the statutory pension insurance scheme boosted revenues. After the non-adjustment of pensions in mid-2004, expenditure on pensions was only around ½% above the value for the previous year. Expenditure on the statutory health insurance scheme and the long-term care insurance scheme for pensioners went down by 13%. This was partly due to the fact that since 1 April 2004 pensioners have had to pay the full contribution to the long-term care insurance scheme.

In the middle of the year there will be further – albeit weaker – relief resulting from the levy of a special contribution to the statutory health insurance scheme of 0.9% which is to be paid in full by the insured person. The consequent reduction of the general contribution rate by the same percentage, which then becomes possible, will then give the statutory pension insurance scheme relief regarding its expenditure on the statutory health insurance scheme for pensioners. Furthermore, the individual pension amount will not be raised this year. Using the pension adjustment formula should have actually reduced this figure, but this was prevented by the safeguard clause.[6] The persistently weak growth of wages will make it impossible to maintain the ratio between wage growth and the increase in pensions factored into the pension adjustment formula and envisaged in the long-term calculations for stabilising the contribution rate.

Over the course of the year, mainly as a result of the drop in revenue, liquidity constraints may occur; these will have to be bridged by bringing forward the Federal grants or

6 According to this clause, the individual pension amount can only be lowered if this is based on a corresponding decline in the income of insured persons.

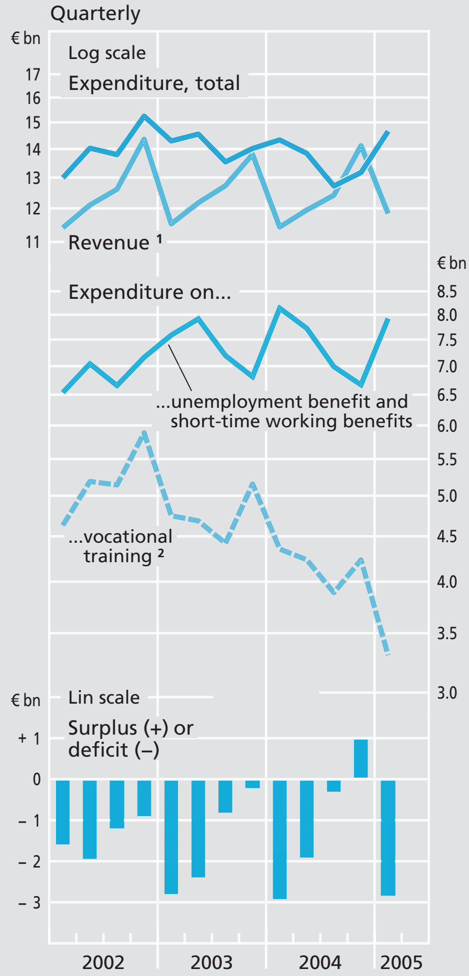
through additional liquidity assistance from the Federal Government. Even though reserves will still be available at the end of the year, they are likely to be significantly lower than the minimum reserve of 0.2 month's expenditure. The idea is to avoid raising the contribution rates in 2006, which will then be necessary according to current legislation, by having employers transfer the social security contributions at the end of the month in which the wages or salaries are being paid instead of in the middle of the following month. This one-off measure would significantly improve the liquidity of all social security institutions in 2005, although it will not solve the longer-term structural problems.

Federal Employment Agency

The Federal Employment Agency recorded a deficit of nearly €3 billion in the first quarter of 2005; this was about as high as the figures for the last two years. The relatively sharp rise in both revenue (3½%) and expenditure (almost 2½%) is mainly due to the fact that the higher administration costs associated with the introduction of basic social security protection for job-seekers are refunded by central government. Revenue from contributions declined by a little over 1½% as a result of the persistently weak growth of employment and wages.

Spending on unemployment benefit was 2½% lower. The dampened development in the number of recipients – not least owing to increasing long-term unemployment – is likely to have continued. Expenditure on active labour market policy measures went down by 24% or €1 billion. However, this decline is not attributable solely to savings but is mainly due to the fact that job promotion measures for recipients of „unemployment benefit II" are no longer being funded by the Federal Employment Agency. This was, however, offset by a compensatory amount of €1½ billion paid to the Federal budget.

Finances of the Federal Employment Agency



1 Excluding Federal Government liquidity assistance. — **2** Including job creation measures, excluding compensatory amount to central government.

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Statutory health insurance funds

For the statutory health insurance funds, preliminary results are only available up to the end of 2004. These showed a surplus of

€4 billion for last year compared with a deficit of €3½ billion for 2003, although with the decrease in the average contribution rate from 14.3% to 14.2%, revenue was down by around €1 billion. The dramatic improvement in the results can be attributed to the recent health system reform, which primarily led to a reduction in expenditure of just over 3%. Revenue grew by just over 1½% particularly because of the heavier burden of social security contributions on company pensions and the new Federal grant.

The high surplus was probably used largely to repay part of the debt accumulated up to end-2003. Most health insurance institutions therefore exceeded the repayment objective of at least one-quarter of the previous year's debt as prescribed by the Social Security Code.[7] The health insurance institutions were also supposed to use part of the savings achieved by the Act modernising the statutory health insurance scheme *(GKV-Modernisierungsgesetz)* directly to lower contribution rates. However, if persistently weak contribution growth and a reduction in the impact of the expenditure cuts make a significant financial deterioration appear likely, the health insurance institutions would be forced to raise the contribution rates again. The success of the reform is largely evident in the fact that a sharp increase in the contribution rates was averted.

Long-term care insurance scheme

The long-term care insurance scheme recorded another record deficit of almost €1 billion in 2004. Liquid reserves consequently fell to €3½ billion at the end of 2004, coming closer to the statutory minimum level of just over €2 billion. Whereas revenue persisted at the same level as in 2003, expenditure rose by just under 1%. The shift – which has been observed since the long-term care insurance scheme was launched in 1995 – from cash benefits for carers within the family to benefits in kind through professional care services continued. On the whole, the non-automatic adjustment of benefits is having a positive effect on the financial development. Additionally, there will be a slight relief this year since all childless persons born after 1939 will have to start paying a 0.25% higher contribution rate once they reach the age of 23. The depletion of reserves will therefore be delayed and the pressure for a reform will be temporarily reduced.

General government budget trends

Deficit ratio also threatens to exceed the 3% ceiling in 2005

The situation of public finances will not relax noticeably this year either. With the overall deficit ratio (as defined in the national accounts) for 2004 of 3.6% exceeding the 3% ceiling for the third year in succession, a decline for 2005 is possible. However, there is a high risk that the reference value will be overshot again.

7 Gross borrowing totalled €8.3 billion at the end of 2003. According to section 222 (5) of the Fifth Book of the Social Security Code (*Sozialgesetzbuch,* SGB V) as interpreted by the Federal Social Insurance Authority *(Bundesversicherungsamt)*, debt in 2004 had to be reduced by at least one-quarter. The debt remaining at the start of 2005 is to be reduced by at least one-third this year and so on until it has been completely repaid by the end of 2007. Starting in 2008, the minimum reserves are to be replenished up to one-quarter of a month's expenditure.

Economic activity will continue to have a negative impact on the deficit development. By contrast, temporary factors may help to lower the deficit. For example, the Federal Government is expecting relief from the sale of Post Office pension fund claims and from *Landesbank* payments to state government budgets.[8]

Revenue ratio nearly stable

Following a significant decline in 2004, the revenue ratio is likely to decrease only moderately in 2005. On the one hand, the last stage of the income tax reform will result in revenue shortfalls. Furthermore, the measurement bases for wage tax, social security contributions and excise taxes are likely to grow relatively sluggishly. On the other hand, an increase in profit-related taxes is to be expected. Non-tax revenue will grow noticeably, particularly given that the motorway toll system has now been introduced and taking into account the grant repayments from *Landesbanks.*

Declining expenditure ratio

The decline in the expenditure ratio is also likely to continue – at a slower pace. According to central government's plans, the absence of a grant payment to the Post Office pension funds will help curb expenditure growth. Furthermore, savings on personnel expenditure and the comparatively slow-growing expenditure of the statutory pension insurance scheme will also make themselves felt. The favourable refinancing conditions for maturing debt securities are likely to result in a relatively small rise in interest expenditure despite the sharp increase in debt. Expenditure on health care may, however, go back up mainly as a result of the expiry of measures for cutting costs on pharmaceuticals.

Compliance with 3% ceiling not certain in 2006 either

As things stand today, no substantial tax cuts are expected to come into force next year if the planned changes to business taxation have a largely neutral effect on revenue. Expenditure on personnel, in particular, is likely to provide further relief, and presumably also labour market-related expenditure, which may benefit not least from the increased impact of Hartz IV. On the other hand, the abolition of the temporary influences planned for this year will burden public finances. On the whole, compliance with the 3% ceiling will then be endangered if economic growth remains weak. In the national accounts, the contemplated bringing forward of the transfer deadline for social security contributions is not likely to have a deficit-lowering impact and the social security funds will probably record a significant deficit.

The state of public finances therefore remains critical. The debt ratio is rising continuously. The individual levels of government still face serious budget problems. Central government and some state governments will only be able to comply with the national deficit ceiling, if at all, by resorting to temporary measures, and the depletion of assets by general government is also likely to continue. Extensive consolidation of public finances remains a central task for all levels of government.

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8 At least for the sale of Post Office pension fund claims, the statistical entry in the national accounts is still uncertain.