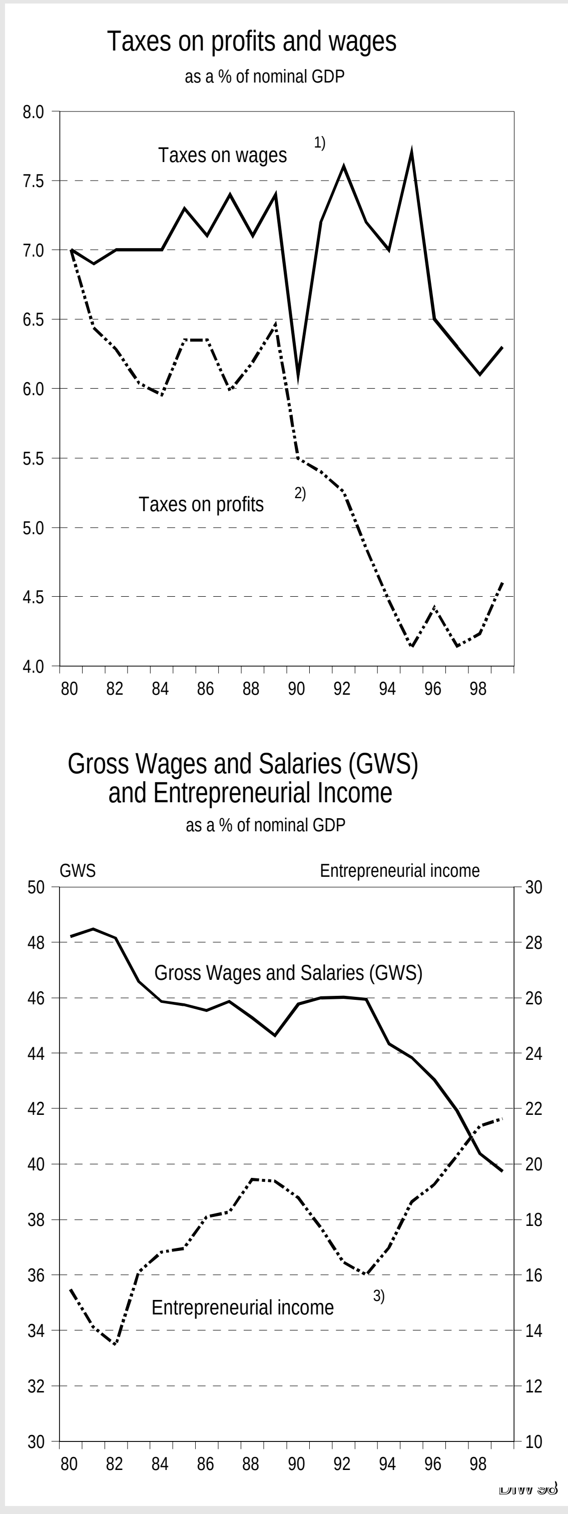
Government Budgets 1998/99: The Need for a Change of Course

In spite of the difficult macroeconomic parameters, German central, state and local government managed to bring down the overall budget deficit considerably – from DM 120 to 94 billion. This major reduction must be seen as a result of the efforts to meet the fiscal criteria set out in the Maastricht Treaty. While genuine savings were made, the reduction was also achieved by a number of "one-off" measures. More importantly, the cut in the deficit has been at the cost of a significant fall in aggregate demand. This year the restrictive stance has been maintained in all tiers of German government; on fiscal statistics definitions the net borrowing requirement of the three tiers of government is expected to fall to DM 76 billion. In contrast to the situation at the end of the 1980s, the current economic upturn has not received any support from fiscal-policy impulses, which is one reason why the growth trajectory has been relatively flat.

Similarly to the situation in the mid-1990s, much of the 1980s in Germany were characterised by moderate economic growth and sharp increases in trade surpluses. An economic upturn worthy of the name did not begin until the end of the decade, following a change of course by German economic policy, specifically by monetary and fiscal policy. At that time policymakers perceived the need to change course following the dislocations that occurred in the autumn of 1987 (stock exchange crash) – which was largely a consequence of the global balance of payments disequilibria – that had damaged the business climate. Expansionary impulses were provided in particular by the tax cuts realised during the three-stage tax reform subsequently implemented; the tax cuts benefited broad sections of the population, bolstering mass purchasing power. The losses in tax revenue resulting from the reform were not offset by cuts in public spending; rather, public spending, not least capital spending, was expanded in line with potential output growth. Following substantial initial budget deficits, the process of budgetary consolidation was initiated more or less automatically as economic growth accelerated.

By contrast, for some time now German fiscal policy has been exerting a restrictive effect on the economy. A comparison of the demand impulses exerted on the economy by public spending in the periods 1986-88 and 1994-97 clearly reveals the differences in fiscal-policy stance in the two phases (cf. table 1). Between 1994 and

Figure 1



1) Wage tax prior to deduction of child benefit, plus pro rata share of solidarity supplement, minus reimbursements to employees (under §46 of the income tax law). — 2) Assessed income tax plus reimbursements to employees (under §46 of the income tax law), corporation tax, non-assessed taxes on profits, pro rata share of solidarity supplement, tax on interest earnings, net worth tax and trade tax. — 3) Gross entrepreneurial and property income minus property income.
Sources: Federal Statistical Office; DIW calculations.

Table 1

Fiscal Demand Impulses[1] (+ expansionary/ – restrictive)

DM billion

	1985	1986	1987	1988	1994	1995	1996	1997	1998[2]
Taxes									
Actual volume	458.5	471.2	489.4	509.4	808.2	835.3	814.7	819.0	844.0
Neutrality line	451.1	478.8	487.6	504.5	806.0	837.7	863.7	840.7	843.6
Difference	–7.4	7.6	–1.8	–4.8	–2.2	2.4	49.0	21.7	–0.4
Social insurance contributions									
Actual volume	319.5	336.8	349.9	365.8	640.3	670.1	702.1	728.3	741.5
Neutrality line	313.2	333.6	348.5	360.7	621.7	663.7	692.9	724.6	750.2
Difference	–6.2	–3.1	–1.4	–5.1	–18.7	–6.5	–9.2	–3.8	8.7
Other revenue									
Actual volume	38.0	38.4	38.0	39.1	70.1	75.1	67.1	67.1	69.5
Neutrality line	37.9	39.7	39.7	39.1	73.0	72.7	77.6	69.2	69.1
Difference	–0.1	1.3	1.8	0.0	2.9	–2.4	10.5	2.1	–0.4
Total revenue									
Actual volume	816.0	846.4	877.3	914.2	1 518.6	1 580.5	1 583.9	1 614.4	1 655.0
Neutrality line	802.3	852.2	875.8	904.3	1 500.7	1 574.0	1 634.2	1 634.5	1 662.9
Difference	–13.7	5.8	–1.4	–9.9	–17.9	–6.5	50.4	20.1	7.9
Government consumption ./. depreciation									
Actual volume	352.6	369.0	383.2	397.7	634.0	661.0	678.6	678.5	688.0
Neutrality line	348.1	368.2	381.8	395.0	639.6	657.2	683.5	700.3	698.8
Difference	4.5	0.8	1.4	2.7	–5.6	3.8	–4.9	–21.8	–10.8
Gross fixed capital formation									
Actual volume	42.9	47.3	48.0	48.9	86.4	83.1	76.7	69.5	69.0
Neutrality line	43.4	44.8	48.9	49.5	90.8	89.6	86.0	79.1	71.6
Difference	–0.5	2.5	–0.9	–0.6	–4.4	–6.4	–9.3	–9.7	–2.6
Interest payments									
Actual volume	47.1	47.4	46.2	48.1	82.6	108.0	108.1	113.2	118.0
Neutrality line	47.2	49.2	49.0	47.6	81.5	85.6	111.6	111.5	116.6
Difference	–0.1	–1.8	–2.8	0.5	1.0	22.4	–3.6	1.7	1.4
Transfers									
Actual volume	377.6	391.8	412.1	429.6	782.8	816.4	798.8	806.6	825.0
Neutrality line	381.5	394.3	405.5	424.8	809.9	811.3	844.2	824.4	830.8
Difference	–3.9	–2.4	6.6	4.8	–27.1	5.1	–45.4	–17.7	–5.8
Total spending									
Actual volume	820.1	855.5	889.5	924.4	1 585.8	1 668.5	1 662.1	1 667.8	1 700.0
Neutrality line	820.2	856.5	885.3	916.9	1 621.8	1 643.6	1 725.3	1 715.3	1 717.8
Difference	0.0	–1.0	4.2	7.4	–36.0	24.9	–63.2	–47.5	–17.8
Budget deficit									
Actual volume	–4.1	–9.1	–12.3	–10.1	–67.2	–88.0	–78.3	–53.4	–45.0
Neutrality line	–17.9	–4.3	–9.4	–12.6	–121.1	–69.6	–91.0	–80.8	–55.0
Difference	–13.8	4.8	2.8	–2.5	–54.0	18.4	–12.8	–27.4	–10.0
Demand impulse excl. interest payments	–13.6	6.6	5.7	–3.0	–55.0	–4.0	–9.2	–29.1	–11.4

1) Excluding transactions with the rest of the world. — 2) Estimated. — 3) Excluding Bundesbank profits.
Sources: Federal Statistical Office; DIW calculations.

1997 the fiscal-policy impact on the economy as a whole was consistently negative. Allowing for multiplier and accelerator effects, the loss of macroeconomic demand is likely to have exceeded an annual average of 1% of GDP; restrictive effects are also expected for 1998. For the 1986-88 period, on the other hand, the impulses were expansionary. The fruits of this policy took the form of substantially higher rates of economic growth than those currently recorded. This, in turn, generated higher tax revenues and reduced public spending requirements; indeed, in 1989 the overall government budget, on national accounting definitions, was actually in surplus.

Tax receipts in 1998 and 1999

The statistics on tax receipts during the first seven months of this year do not confirm the fear, frequently expressed last year, that tax receipts have become detached from the economic tax base: the tax receipts of central and state government and of the EU in the months to July increased by around 3% compared with the same period last year. The revenue elasticity of the taxation system,[1] which in recent years had been substantially less than unity, and most recently actually negative, is thus once more approximating to the long-term average of unity; that is, tax revenue expands at approximately the same rate as nominal GDP (cf. figure 2).

The tax revenue prognosis presented here is based on the key macroeconomic data recently forecast by the DIW for 1998 and 1999.[2] On this basis, nominal GDP is expected to grow by around 3½% per annum. In west Germany wages and salaries are forecast to increase by 1.7% and 2.7% in 1998 and 1999 respectively; the figures for east Germany are 0.2% and 2.4%.

During the first seven months of the current year, receipts of taxes on wages in west Germany, following the deduction of child benefit by employers and the "family funds" (*Familienkassen*), rose by more than 3% on the same period the previous year. Child benefit payments out of gross wage-tax revenue amounted to around DM 24 billion. In eastern Germany the decline in current receipts of wage tax experienced in 1996 and 1997 – which had been exclusively due to the changed mode of payment of child benefit – has been reversed: during the first seven months the increase was actually slightly greater than in west Germany, at 3½%. The decisive factor in this reversal was that, for demographic reasons, child benefit payments in east Germany were down by almost DM 500 million compared to the same period the previous year.

Figure 2

Revenue Elasticity of the Taxation System, 1981 to 1999

1) Increase in total tax revenue (in %) in relation to change in nominal GDP (in %).
Sources: Federal Statistical Office; Federal Ministry of Finance; DIW calculations.

For the remainder of this year a slight increase in wage tax receipts is to be expected in west Germany, based on the assumption of a slight improvement on the labour market. All in all an increase of 3% can be expected for 1998 (cf. table 2). The wage and salary trends expected for 1999, together with the progressive effects of the income tax system, will lead to stronger growth of wage tax revenue, at around 5%. In eastern Germany revenue trends will continue to suffer from the less favourable situation on the labour market compared with west Germany. Not least for this reason, the rates of growth will be lower than in west Germany, despite the fact that the increase in gross wages and salaries per employee will be somewhat higher than in the west of the country. For 1998 revenue growth of 3% is expected, a figure that is expected to rise slightly to 3½% in 1999.

Contrary to what had been expected as recently as last year, profit-oriented taxes (assessed income tax, corporation tax, non-assessed taxes on profits and the withholding tax on interest earnings) increased by one-fifth during the first seven months of this year. However, this increase reflected not only a broadening of the tax bases, but also a windfall effect in corporation tax revenue. Until the end of this year firms are able to distribute profits recorded in their balance sheets as having been taxed at 50% ("EK50") to shareholders; they are then only taxed at 30%, i.e. the difference of 20 percentage points is reimbursed to firms by the tax office out of cor-

[1] Revenue elasticity is calculated as the increase in tax revenue (in %) in relation to the growth of nominal GDP (in %). An elasticity of one means that tax revenues and GDP have increased at the same rate. If, on the other hand, the revenue elasticity is greater than unity, it means that tax revenues have increased faster than GDP, while a value below unity indicates slower revenue growth compared to economic growth. A negative value indicates that tax revenue has declined (increased) while GDP has increased (declined).

[2] German Economic Trends 1998/99: the economic recovery lacks dynamism, in: *Economic Bulletin,* no. 8, August 1998.

Table 2

Tax Revenue in Germany 1997 to 1999

	West Germany[1]			East Germany[2]			Total			West Germany[1]		East Germany[2]		Total	
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1998	1999	1998	1999	1998	1999
	Actual	Estimated		Actual	Estimated		Actual	Estimated							
	DM billion									% change on the previous year					
Joint taxes	520.9	548.9	584.9	33.8	35.4	40.6	554.7	584.3	625.5	5.4	6.6	4.7	14.7	5.3	7.1
Wage tax[3]	228.5	235.4	247.0	20.2	20.8	21.5	248.7	256.2	268.5	3.0	4.9	3.0	3.4	3.0	4.8
Assessed income tax[3]	11.1	12.7	19.0	–5.3	–6.2	–4.5	5.8	6.5	14.5	14.4	49.6	.	.	12.1	123.1
Non-assessed taxes on profits[4]	14.2	20.3	16.5	0.5	0.6	0.7	14.7	20.9	17.2	43.0	–18.7	20.0	16.7	42.2	–17.7
Tax on interest income[5]	11.3	11.6	11.9	0.1	0.2	0.2	11.4	11.8	12.1	2.7	2.6	100.0	0.0	3.5	2.5
Corporation tax[4]	32.7	34.5	44.5	0.5	1.0	2.7	33.2	35.5	47.2	5.5	29.0	100.0	170.0	6.9	33.0
Taxes on turnover[6]	223.1	234.4	246.0	17.8	19.0	20.0	240.9	253.4	266.0	5.1	4.9	6.7	5.3	5.2	5.0
Customs duty							6.9	6.7	6.6					–2.9	–1.5
Federal taxes							135.3	131.0	133.0					–3.2	1.6
Petroleum tax							66.0	66.5	67.0					0.8	0.8
Tobacco tax							21.2	21.4	21.5					0.9	0.5
Spirits tax							4.7	4.5	4.4					–5.3	–1.1
Insurance tax							14.1	14.0	14.2					–0.7	1.4
Solidarity supplement (on income taxes)							25.9	21.3	22.6					–17.8	6.1
Other							3.4	3.3	3.3					–2.9	0.0
Federal state taxes	29.9	31.3	31.2	4.8	4.7	4.8	34.7	36.0	36.0	4.7	–0.3	–1.8	2.2	3.8	0.0
Vehicle tax	12.3	12.7	11.7	2.1	2.1	2.1	14.4	14.8	13.8	3.3	–7.9	2.0	–2.2	3.1	–7.1
Wealth tax	1.8	1.0	0.5	–	–	–	1.8	1.0	0.5	–44.4	–50.0	.	.	–44.4	–50.0
Other	15.8	17.6	19.0	2.7	2.6	2.7	18.5	20.2	21.7	11.4	8.0	–4.8	5.8	9.0	7.7
Local government taxes	60.7	60.5	61.7	4.9	5.2	6.6	65.6	65.6	68.3	–0.4	2.1	5.3	28.1	0.0	4.2
Trade tax	45.8	45.5	46.5	2.8	3.0	4.3	48.6	48.5	50.8	–0.7	2.2	5.4	45.7	–0.3	4.8
Real estate tax	13.5	13.5	13.7	2.0	2.1	2.2	15.5	15.6	15.9	0.0	1.5	5.5	4.7	0.7	1.9
Other	1.4	1.5	1.5	0.1	0.1	0.1	1.5	1.6	1.6	4.3	5.5	.	.	4.0	5.1
Overall actual tax revenues at federal, state and local levels, financial statistics definition[7]							797.2	823.6	869.5					3.3	5.6
of which:															
Central government[8)9)10)11)]							343.1	351.1	377.8					2.3	7.6
State government[8)9)11)12)14)]	267.2	276.0	287.0	60.5	61.9	62.8	327.7	337.9	349.8	3.3	4.0	2.3	1.4	3.1	3.5
Local government[13)14)]	80.9	87.1	90.4	6.8	7.3	8.9	87.7	94.4	99.3	7.7	3.8	6.5	21.7	7.6	5.1

1) West Germany incl. West Berlin. — 2) East Germany incl. East Berlin. — 3) Distribution ratio central/state/local government: 42.5/42.5/15. — 4) Distribution ratio central/state government: 50/50. — 5) Distribution ratio central/state/local government: 44/44/12; distribution between west and east Germany: 91/9. — 6) Distribution ratio central/state government: 50.5/49.5 (1997); for 1998 central government initially 3.64; from 1999 on 5.63; of the remainder local government initially receives 2.2, the remains being divided 50.5/49.5 between central and state government; distribution between west and east Germany within the framework of the system of horizontal financial compensation. — 7) Excluding EU shares, incl. para-fiscal charges. In the financial statistics West and East Berlin are counted as part of west Germany. — 8) Turnover tax distribution by the German Unity Fund added to federal, deducted from state government. — 9) Supplementary central government grants to financially weak federal states deducted from central and added to state government. — 10) EU VAT own resources and EU GNP own resources deducted. — 11) Including trading tax levy. Distribution ratio central/state government: 50/50. — 12) Including community tax of the city states. — 13) Excluding community tax of the city states and after deduction of the trading tax levy. — 14) Including participation of west German local authorities in German Unity Fund via the increase in the trading tax levy on west German state governments. — Columns may not sum due to rounding.
Sources: Federal Finance Ministry, DIW estimates.

poration tax revenue. This results in a corresponding increase in revenue from non-assessed taxes on profits: on distribution the dividends are taxed at 25%.

The recovery has not yet manifested itself in receipts from assessed income tax. In west Germany reimbursements continued to exceed gross revenue between January and July, although the revenue loss, at DM 600 million was significantly lower than in the corresponding period the previous year. Alongside reimbursements to employees (under §46 of the income tax law), which virtually stagnated in the period to July, the "own-home grant" (*Eigenheimzulage*), which in 1996 replaced fiscal support for homeowners, is playing an increasingly important role. Given that the revenue-reducing effects are expected to weaken as the year progresses, an increase in current receipts of almost 15% is expected. Next year the increase is likely to be even greater: profitability trends are favourable, resulting in higher pre-payments, and it is expected that following assessment of their 1997 and 1998 profits firms will have to make substantial retrospective tax payments. In east Germany fiscal support for housing construction and commercial investment has significantly reduced receipts of assessed income tax, particularly in the years 1995 to 1997. For 1998 as a whole an improvement is to be expected, following the sharp decline last year, although actual receipts will still record a deficit of more than DM 6 billion. In 1999 the deficit is expected to be significantly smaller at DM 4½ billion.

In west Germany corporation tax receipts are being influenced this year by the effects of the EK50 ruling. This effect is concealing the positive underlying trend in corporation tax receipts. Higher pre-payments are expected in September and in December, while in the intervening months the volume of reimbursements – investment grants paid out of corporations tax receipts and reimbursements by the Federal Finance Office (*Bundesamt für Finanzen*) – will decline. All in all an increase of 5½% in current receipts is expected. In 1999 the EK50 effect will longer apply, suggesting a marked acceleration of corporation tax receipts by virtue of this factor alone; overall revenue will be up by around one third.

In east Germany the outlook for corporation tax – unlike assessed income tax – is positive. This is not due to favourable profitability trends, however, but rather primarily to a fall of one-third in investment grants (paid out of corporation tax revenue). All in all an increase in current revenue of half a billion D-Mark can be expected for 1998. In the coming years corporation tax revenues are expected to expand even faster. Alongside the improvement in profitability, technical fiscal reasons will play a prominent role: the tax concessions for firms granted in the 1996 annual taxation law, which amounted to almost DM 2 billion in 1998, will reach just DM 400 million in 1999.

Revenue from non-assessed taxes on profits will be determined by two factors in both regions of Germany. Firstly, favourable profitability trends will lead to increased dividend payments by firms to their shareholders; secondly, significant additional revenue will result from the additional profits distributed in connection with the EK50. A marked increase is expected for the year as a whole (42%). In spite of the continued higher level of dividend payments, tax receipts in the coming years will be almost one-fifth lower due to the absence of the EK50 effect.

So far turnover taxes have expanded slightly faster than total domestic demand. From January to July revenue for Germany as a whole was 3.3% higher than in the corresponding period 1997. This was partly due to the increase in the standard rate of VAT from 15% to 16% on 1 April 1998, which has generated additional revenue since May. Assuming that turnover taxes broadly keep pace with domestic demand trends, and allowing for the increase in the standard rate of VAT, revenue growth of 5% appears realistic for 1998 as a whole. The key macroeconomic data suggest that the rate of increase in 1999 will be only slightly lower than in the current year.

Tax revenue accruing to central government has been affected in the current year primarily by the reduction from 7.5% to 5.5% in the solidarity surcharge on income tax. All in all, central government tax revenue will be down almost 3½% on the previous year. A slight increase in receipts is expected next year.

Federal state governments will benefit from a substantial increase in taxation revenues resulting from the reform of road vehicle and inheritance taxes and the increase in the rates of tax on land purchases from 2% to 3%. All in all state governments can expect a double-digit rate of growth in 1998 (12%). The rate of increase will weaken somewhat next year (8%).

Revenue trends for local government taxes will be determined largely by trading tax. Originally a marked decline had been expected for the current year following the abolition of the trading capital tax. So far this year, however, the figures point to a marked increase. The assessment of corporate earnings in 1996 has generated unexpectedly positive tax yields. These effects will not continue at the same order of magnitude in the remainder of the year, revealing more clearly the effect on local government finances of the abolition of the trading capital tax. All in all the prognosis is for a stagnation of local government tax revenue. Next year revenues are expected to increase by more than 4% as the dampening effect of the abolition of the trading capital tax will no longer be felt.

In the current year central, state and local government and the EU can expect total taxation receipts of DM 823 billion, representing an increase of 3½%. The revenue trend will be even more favourable next year, with taxation receipts expected to rise by 5½% to almost DM 870 billion. This year taxation receipts as a share of output will remain just under 22%, rising to 22½% in the coming year, and thus reattaining the level recorded in 1996 (cf. figure 3).

Public spending in 1998 and 1999

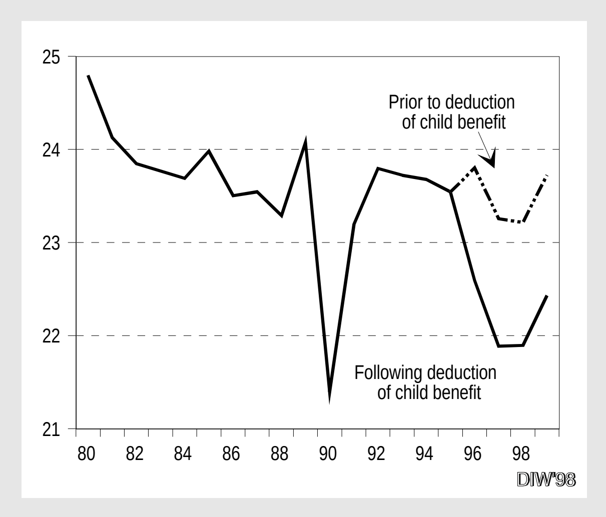
This year the restrictive fiscal stance on the spending side will be maintained at all levels of government, although the pressure to limit budget deficits has eased somewhat now that Germany has met the deficit criterion required for participation in European Monetary and Economic Union. Even so, it is now necessary to bring outstanding government debt closer to the Maastricht criterion, which Germany failed to achieve last year.

Spending to meet personnel costs continues to be characterised by the very moderate pay settlements in the public sector. In both 1998 and 1999 pay increases amount to just 1½% per annum (cf. table 3). Moreover, the impact of the pay rises on spending are mitigated by cuts in staffing levels. The very limited rise in public sector incomes in recent years has failed to prevent a massive reduction in public sector employment. Between 1993 and 1997 the number of employees in central, state and local government fell in both in west and east Germany by around 2000 in each region. This trend is somewhat exaggerated in the statistics, however, as local government bodies are increasingly being excised from local government core budgets, so that their staff are no longer counted as part of the public sector. This year the decline in employment is likely to flatten out, a trend that will continue in 1999: even so, the decline in public sector employment will amount to 50 000 and 30 000 respectively. Once again job losses will be concentrated in east German local government, where – in terms of population size – staffing levels are still significantly higher than in west Germany.

Current spending on procurement and overheads will also expand only moderately, at around 1% in both 1998 and 1999; this is despite the planned increase of 8% in military procurement during the current year. As the size of the German army has declined in recent years, defence spending has been reduced by more than one quarter since 1990. Due to the still considerable size of the public borrowing requirement, expenditure on interest payments will increase more than proportionately, although the increase will continue to be constrained by low nominal interest rates. A dampening effect on spending is also to be expected from a policy of replacing outstanding debt at high interest rates by low-interest borrowing; additional savings are being realised by means of shorter maturity periods.

Whereas last year current government transfers were in decline, an increase of almost 4% is expected for the current year, and 3% for 1999. This turnaround is due almost exclusively to central government grants to the social insurance funds, which are expected to reach

Figure 3
Tax to Output Ratio
Tax revenues as a % of nominal GDP



Sources: Federal Ministry of Finance; DIW estimates.

DM 127 billion by 1999 (1997: DM 111 billion). This is despite a reduction in the transfer to the unemployment insurance fund (Federal Labour Office) to DM 4 billion, compared with almost DM 10 billion in 1997. This decline occurred in spite of the unexpected provision of additional funding for labour market policy in the current year. The additional resources fail to offset the original cutbacks, however, while in addition the conditions of entitlement to unemployment assistance have been tightened. The decline in the level of unemployment has played a comparatively minor role. The sharp rise in transfers to the statutory pension insurance scheme reflects the so-called "second central government grant" of almost DM 10 billion in 1998 and DM 16 billion in 1999. These additional transfers will be financed out of the increase in the standard rate of VAT imposed on 1 April 1998. By this means a rise in the contribution rate was avoided, covering out of general taxation revenue the non-insurance-related benefits paid out by the pension insurance scheme to some extent. The "normal" central government grant is linked both to the contribution rate and income trends.

The cutbacks in public capital spending continued in 1997. German budgetary regulations set strict limits on borrowing by local authorities. Their current revenues must suffice to cover not only the costs of running the administration, including interest payments, but also repayments of principal. Moreover, their capacity to borrow is linked to their revenue trends: the greater a local authority's potential revenue, the greater its scope for borrowing in order to finance capital spending. Thus cash-strapped local authorities are forced to impose cuts on capital spending. This is all the more the case if state governments reduce their allocations to local government. Capital spending by central, state and local government will decline by 1% in the current year, with a slight recovery expected for 1999.

Fiscal trends by tier of government

According to the estimations presented above, overall (central, state and local) government revenue will expand in the current year by 3½%, while spending will increase by 1½%. On financial statistics definitions the total budget deficit will decline from DM 94 billion last year to DM 76 billion in the current year. For the coming year a further decline in the government deficit to DM 70 billion is expected; at just under 3%, revenue growth will once again exceed spending growth (2%).

Looking separately at the three tiers of government, the picture is decidedly heterogeneous (cf. table 3). Unlike the trend at state and local government level, the central government deficit is initially unlikely to decline perceptibly. By the end of the year a deficit of DM 61 billion will probably have been run up (1997: DM 63 billion); this compares with a planned figure of DM 56 billion. Next year spending (adjusted for changes in the transfer of Bundesbank profits to the central government budget) is expected to grow by around 2%, while revenue growth will exceed 5%. The central budget deficit will narrow significantly to DM 48 billion.

State governments will stick to their consolidatory course in both the current and the coming years. Given the very considerable weight of personnel costs in their budgets, they are drawing particular benefit from the moderate pay settlements in the public sector. On top of this come renewed public sector job losses at state level. The estimation is based on the assumption that state governments will gradually relax their restrictive financial compensation policy, allowing local government to participate in the additional tax revenue expected in 1999. There will be scarcely any differences in spending trends between east and west German state governments, with expenditure increasing by between 1% and 2%. Revenue growth will probably be slightly higher in both regions. On this basis west German state governments can expect their budget deficits to narrow from DM 27 billion to DM 22 billion in the current and DM 19 billion in the coming year. East German state governments on the other hand, will experience scarcely any improvement in their budgetary position.

At local government level, too, revenues can be expected to expand considerably faster than expenditure. Already in 1998, west German local authorities will be earning a surplus, one that is expected to rise to DM 3 billion by 1999. The financial position of local authorities in eastern Germany will also improve; they will close 1999 with a balanced overall budget. Even so the major differences in the tax base between local authorities will remain. Many authorities in structurally weak regions will only be able to balance their budgets by refraining from implementing infrastructure projects.

Fiscal policy considerations

The current economic upturn is lacking in dynamism not least because of the substantial restrictive effects on the German economy exerted by fiscal policy. There would be no problem involved in maintaining the consolidatory fiscal stance if the German economy was experiencing a self-sustaining upturn, as in the USA. The restrictive impact of the fiscal squeeze would also be more easily bearable if more expansionary impulses were coming from other policy areas, in particular monetary policy and collective wage bargaining. Yet this is not the case. For this reason it is necessary in the current phase for fiscal policy to at least return to a stance in keeping with the growth of potential output, that is to a policy in which both spending and revenue are oriented towards the (nominal) growth of potential output; specifically, this implies refraining from further reductions in budget deficits. This policy goal can be attained more or less automatically in a sustained economic upturn, provided policymakers refrain from spending the additional revenue generated by the upturn.

The prime task in the current situation is to stimulate domestic demand. Even allowing for the fact that the room for fiscal policy manoeuvre is limited – not least due to the Dublin Stability Pact – fiscal policymakers have sufficient scope to adopt a potential-oriented stance. This can be achieved by way of taxation policy itself, boosting public investment and/or increasing spending on education and research. Such activities mobilise domestic demand in the short run, while in the longer run they increase the productivity of the economy and raise real incomes. Above all else the trend in public investment is alarming, having fallen by more than one quarter between 1992 and 1997. A change of course here must be an urgent priority.

Following the failure to bring about a major reform of the income tax system at the first attempt, such a reform project must be one of the central fiscal policy tasks after the general election. Essentially, two steps need to be distinguished. The first task is to make German taxation laws simpler and more transparent. This

Table 3

Revenue and Expenditure of German Central, State and Local Government[1)]

	Central government[2)3)]			Special assets[4)]			State government[2)]						Local government						Total		
							West Germany[5)]			East Germany			West Germany			East Germany					
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
	in DM billion																				
Revenue	392.3	417.9	427.7	78.2	81.3	66.3	354.1	362.3	371.9	94.1	95.7	97.0	222.1	229.8	235.5	51.8	52.7	55.3	975.3	1010.2	1036.2
Taxes	343.1	351.1	377.8	0.1	0.1	0.1	267.2	276.0	287.0	60.5	61.9	62.8	80.9	87.1	90.4	6.8	7.3	8.9	758.6	783.5	827.0
Transfers from other levels of government	4.8	4.8	4.8	48.5	59.3	44.2	36.0	35.7	35.7	18.8	18.7	18.8	64.0	65.0	66.7	32.9	33.4	34.4	–	–	–
State equalisation	–	–	–	–	–	–	6.0	6.1	6.2	6.3	6.5	6.7	–	–	–	–	–	–	–	–	–
Income from economic activities	11.7	27.0	12.0	–	–	–	6.6	6.7	6.8	0.8	0.7	0.8	12.1	12.2	12.3	2.4	2.4	2.5	33.6	49.0	34.4
Levies and charges	8.0	8.2	8.3	–	–	–	8.5	8.6	8.8	1.1	1.2	1.2	30.7	30.2	29.8	4.6	4.4	4.2	52.9	52.6	52.3
Sales of assets[6)]	13.0	15.0	13.0	2.9	2.0	2.0	11.4	10.5	8.5	0.2	0.1	0.1	10.5	11.0	11.5	2.8	2.9	3.0	40.8	41.5	38.1
Other sources	11.7	11.8	11.8	26.7	19.9	20.0	18.4	18.7	18.9	6.4	6.6	6.6	23.9	24.3	24.8	2.3	2.3	2.3	89.4	83.6	84.4
Expenditure	455.7	479.2	475.4	65.3	64.4	63.1	381.5	384.8	390.5	103.7	104.8	106.7	226.4	228.4	232.6	53.5	54.1	55.0	1068.8	1086.2	1105.8
Personnel costs	52.5	52.4	52.9	16.0	15.7	15.7	150.6	151.5	153.0	26.3	26.4	26.6	60.8	60.7	61.0	15.7	15.5	15.3	321.9	322.2	324.5
Current material costs	38.1	39.0	39.8	0.7	0.7	0.7	36.8	36.6	36.6	7.8	7.8	7.8	41.8	42.4	43.0	9.8	9.9	10.0	135.0	136.4	137.9
Interest payments	53.4	56.5	60.0	32.2	31.8	30.7	30.4	31.6	32.6	4.9	5.3	5.7	9.4	9.5	9.6	1.7	1.8	1.8	131.5	136.0	139.9
of which: to other levels of government	–	–	–	–	–	–	0.3	0.3	0.3	–	–	–	0.2	0.2	0.2	–	–	–	–	–	–
Current transfers to	253.6	273.0	263.9	5.3	4.9	4.7	115.9	118.0	121.0	35.9	36.5	37.7	71.1	72.9	75.2	10.7	11.2	12.0	322.3	333.4	343.5
Other levels of government	23.2	23.0	23.0	–	–	–	54.6	56.0	57.7	24.5	25.0	26.0	7.1	7.2	7.2	0.2	0.2	0.2	–	–	–
State equalisation	–	–	–	–	–	–	12.3	12.6	12.9	–	–	–	–	–	–	–	–	–	–	–	–
Special assets	48.0	58.8	43.7	0.2	0.2	0.2	0.1	0.1	0.1	–	–	–	–	–	–	–	–	–	–	–	–
Social insurance	108.9	118.0	124.5	1.4	1.3	1.3	0.3	0.3	0.3	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	111.0	120.0	126.5
Income support	49.2	48.5	47.9	0.4	0.4	0.4	14.1	14.0	14.5	2.3	2.3	2.3	45.5	46.7	48.5	6.5	6.9	7.4	118.0	118.8	121.0
Firms	18.0	18.3	18.4	3.3	3.0	2.8	17.2	17.5	17.7	4.9	5.0	5.1	4.8	4.9	5.0	1.7	1.7	1.8	49.9	50.4	50.8
Abroad	4.8	4.9	4.9	–	–	–	1.2	1.2	1.2	–	–	–	–	–	–	–	–	–	6.0	6.1	6.1
Social institutions	1.5	1.5	1.5	–	–	–	11.5	11.7	11.9	2.1	2.1	2.2	9.5	9.8	10.1	1.4	1.5	1.6	26.0	26.6	27.3
Other	–	–	–	–	–	–	4.6	4.6	4.7	2.0	2.0	2.0	4.0	4.1	4.2	0.8	0.8	0.9	11.4	11.5	11.8
Investment	12.2	12.4	12.7	–	–	–	11.4	11.2	11.2	4.1	4.2	4.2	35.7	35.3	36.0	13.3	13.4	13.6	76.7	76.5	77.7

Table 3 (continued)

	Central government[2)3)]			Special assets[4)]			State government[2)] West Germany[5)]			State government[2)] East Germany			Local government West Germany			Local government East Germany			Total		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
Capital transfers to	32.1	32.1	32.2	0.3	0.3	0.3	30.3	29.9	30.0	22.9	22.8	22.9	4.2	4.2	4.3	2.1	2.1	2.1	47.6	47.8	48.1
Other levels of government	20.5	20.3	20.4	–	–	–	12.2	11.8	11.8	10.7	10.5	10.5	0.5	0.6	0.6	0.2	0.2	0.2	–	–	–
Special assets	0.2	0.2	0.2	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Abroad	3.9	4.0	4.0	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	3.9	4.0	4.0
Other	7.5	7.6	7.6	0.3	0.3	0.3	18.1	18.1	18.2	12.2	12.3	12.4	3.7	3.6	3.7	1.9	1.9	1.9	43.7	43.8	44.1
Loans and shares	13.8	13.8	13.9	10.8	11.0	11.0	6.1	6.0	6.1	1.8	1.8	1.8	3.4	3.4	3.5	0.2	0.2	0.2	33.8	33.9	34.2
of which: to other levels of government	1.1	1.1	1.1	–	–	–	1.2	1.2	1.2	–	–	–	–	–	–	–	–	–	–	–	–
Financial balance	–63.4	–61.3	–47.7	12.9	16.9	3.2	–27.4	–22.5	–18.6	–9.6	–9.1	–9.7	–4.3	1.4	2.9	–1.7	–1.4	0.3	–93.5	–76.0	–69.6
	% change on the previous year																				
Revenue	0.8	6.5	2.3	–2.6	4.0	–18.5	2.1	2.3	2.6	1.6	1.7	1.4	–2.4	3.5	2.5	–5.8	1.7	4.9	1.5	3.6	2.6
Taxes	–1.2	2.3	7.6	.	0.0	0.0	–1.1	3.3	4.0	0.7	2.3	1.5	1.3	7.7	3.8	6.3	7.4	21.9	–0.8	3.3	5.6
Expenditure	–2.5	5.2	–0.8	–4.0	–1.4	–2.0	–0.2	0.9	1.5	–0.7	1.1	1.8	–2.2	0.9	1.8	–7.0	1.1	1.7	–1.1	1.6	1.8
Personnel costs	–0.8	–0.2	1.0	–1.2	–1.9	0.0	0.5	0.6	1.0	1.5	0.4	0.8	0.0	–0.2	0.5	–7.6	–1.3	–1.3	–0.2	0.1	0.7
Current material costs	–1.6	2.4	2.1	.	–5.4	0.0	–1.6	–0.5	0.0	1.3	0.0	0.0	1.2	1.4	1.4	–3.9	1.0	1.0	–0.5	1.0	1.1
Interest payments	4.9	5.8	6.2	–6.1	–1.2	–3.5	4.8	3.9	3.2	16.7	8.2	7.5	–3.1	1.1	1.1	0.0	5.9	0.0	1.7	3.4	2.9
Current transfers to	–3.5	7.6	–3.3	–22.8	–6.7	–4.1	1.0	1.8	2.5	–3.8	1.7	3.3	–4.3	2.5	3.2	–10.8	4.7	7.1	–2.3	3.5	3.0
Other levels of government	9.4	–0.9	0.0	–	–	–	–1.1	2.6	3.0	–6.1	2.0	4.0	–2.7	1.4	0.0	0.0	0.0	0.0	–	–	–
Social insurance	1.4	8.4	5.5	12.5	–3.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.5	8.2	5.4
Income support	–1.8	–1.4	–1.2	0.0	0.0	0.0	2.9	–0.7	3.6	–11.5	0.0	0.0	–6.2	2.6	3.9	–17.7	6.2	7.2	–4.2	0.7	1.9
Firms	–12.2	1.7	0.5	–34.0	–9.1	–6.7	2.4	1.7	1.1	0.0	2.0	2.0	11.6	2.1	2.0	0.0	0.0	5.9	–6.2	1.0	0.8
Investment	0.8	1.6	2.4	–	–	–	2.7	–1.8	0.0	–6.8	2.4	0.0	–4.5	–1.1	2.0	–7.6	0.8	1.5	–3.4	–0.3	1.6
Capital transfers	–13.5	0.0	0.3	–66.7	0.0	0.0	–4.7	–1.3	0.3	1.8	–0.4	0.4	–6.7	0.0	2.4	40.0	0.0	0.0	–3.4	0.4	0.6
Loans and shares	6.2	0.0	0.7	14.9	1.9	0.0	–24.7	–1.6	1.7	–25.0	0.0	0.0	–5.6	0.0	2.9	–60.0	0.0	0.0	–1.5	0.3	0.9

1) By financial-statistical definition, excl. hospitals with their own accounting system. — 2) Turnover tax share of supplementary transfers to financially weak states and tranfers of petroleum tax within the regionalisation of short-distance passenger traffic substracted from central, added to state governments. — 3) The transfer of Bundesbank profits has been recorded in full as federal government revenue; the difference to DM 7 billion has been recorded as a federal government transfer to the Erblastentilgungsfonds. — 4) Surpluses are used to repay principal. — 5) Incl. Berlin. — 6) Real assets and shareholdings. — Columns may not sum due to rounding.
Sources: Federal Statistical Office; DIW calculations.

involves the abolition of numerous exceptions and other tax concessions, including a reform of the system of income "splitting" by married couples, which in its current form generates advantages that cannot be justified and incurs high costs. It should be restructured towards a system of "family splitting".

The greater the extent to which the tax base is widened, the greater is the scope for a cut in income tax rates. Yet the growth and employment-stimulating effects of such a reform should not be overstated: it should not be forgotten that to a considerable extent the prevailing taxation system performs steering functions. Many of the tax concessions are oriented towards stimulating investment. The extent to which, at the end of the day, the economy is stimulated by a tax reform depends – and this is the second step – on the planned net reduction in the tax burden and the concrete changes in the tax progression. An expansionary effect can be expected if the net reduction in taxes is not offset by cuts on the spending side.

Those arguing for a reduction in the tax burden often point to the situation in other countries. It is claimed that the burden of taxes and contributions is higher in Germany than in its neighbouring countries and that this is one cause of its growth and employment problems. According to OECD taxation statistics, however, Germany cannot be described as a "high-tax country" compared with other leading industrialised countries. Indeed, in terms of taxes on income and profits, Germany was in the lower half of the rankings, with a tax burden of less than 12% of nominal GDP.[3] Even if the nominal rates of income tax are taken as a comparison, Germany can scarcely be termed a high-tax country. Particularly given the reduced tax rate for business incomes (47%), Germany's marginal tax rates – 55.92% including the solidarity surcharge – are far from top of the list (cf. table 4). Including income tax surcharges, Belgium, Denmark, Italy, the Netherlands and even Japan have higher rates, in some cases considerably so.

Also relevant in international comparative terms is the point at which the top rate of tax is applied. It is generally the case that the income tax progression is the steeper, the "earlier" the top rate of tax is applied. In Luxembourg the top rate of tax (51.25%) is imposed on taxable income above DM 67 246. At this income level the marginal rate of taxation in Germany is less than 40% (cf. table 4, right-hand column). Last but not least, it is important to recognise that tax rates do not indicate the effective tax burden. This is determined by the regulations governing the determination of the respective tax base to which the rate of taxation is then applied. This take account of the various tax concessions, which in Germany tend to be rather generous.

The course taken by the effective burden of income taxes and social security contributions in Germany shows that the progression is not continuous, but is rather particularly steep for middle-range incomes (cf. figure 4). For married and single taxpayers, in the lower and medium-range income categories – up to DM 75 000 – a rapidly rising proportion of any additional earned income is taken in the form of additional taxes and contributions. For incomes above DM 75 000, although the tax burden increases continuously, the overall increase in the burden flattens out because of the ceiling of DM 75 000) on the calculation base for the health and social care insurance funds. For incomes above DM 100 000 the percentage burden scarcely increases at all, because this marks the ceiling on contributions to the pension insurance scheme. From this point on the progressive burden of taxation is sharply retarded by the regressive impact of the social insurance contributions.

Consequently, a reform of the German taxation system should aim at making the progressive rise in the overall burden more even. Reducing the burden of taxes and contributions for middle-income taxpayers would have the added advantage of bolstering mass purchasing power. Two years ago the DIW made a proposal for an income tax reform that meets these requirements and would reduce tax burdens on a broad front.[4] Compared with current tax legislation it would involve revenue losses of around DM 40 to 45 billion. Tax cuts of this order of magnitude and the urgently needed expansion of public investment and expenditure on education and research would, however, far exceed the financial scope currently available. For this reason it is vital that the volume of tax concessions is reduced.

One of the central issues in the current fiscal-policy debate in Germany centres on the distribution of revenues between central and state government and between richer and poorer state governments. The renewed dispute between the economically stronger and weaker federal states centres on the allegedly excessive "levelling out" and the confiscatory nature of the present system, and has led to demands from the richer states for a greater share of revenue. This dispute must not be allowed to conceal the fact, however, that the west German states continue to benefit substantially from German unification and did not, on balance, suffer financial losses from the 1995 reform of the system of fiscal equal-

[3] Cf. Revenue Statistics of OECD Member Countries 1965-1996.

[4] An initial rate of income tax of 20% and a general reduction in the top rate of tax to 47%, i.e. to the tax rate currently applying to business income. Cf. D. Teichmann, D.Vesper, 1996/97 Budget: fiscal policy still treading a narrow path, in: *Economic Bulletin*, no. 10, October 1996.

Table 4
Top Rate of Income Tax in Selected Countries

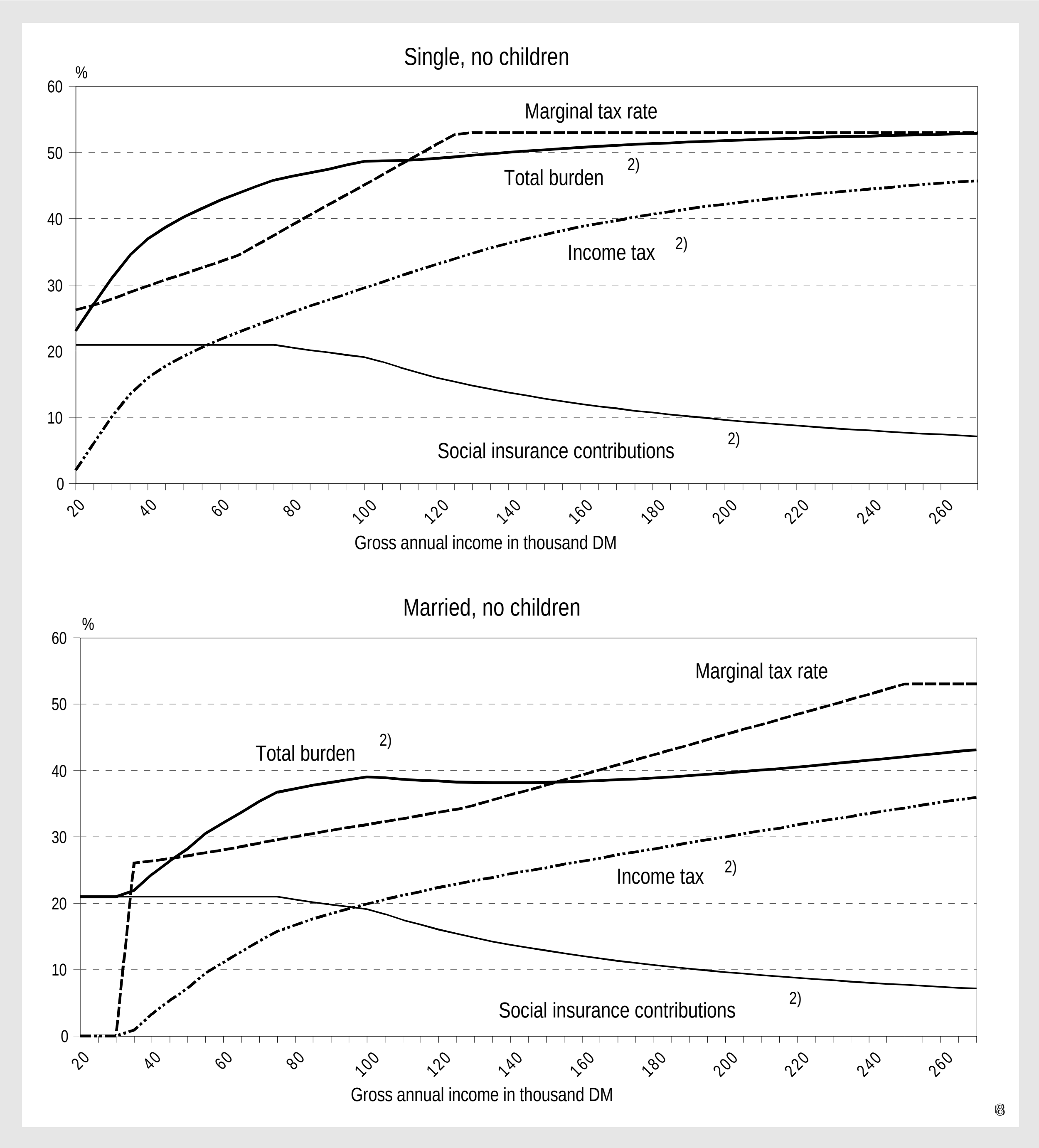
	Top rate of tax in %	.... applies from a taxable income of		
		in domestic currency	in DM[1)]	Marginal tax rate in Germany at this income level[2)] in %
Belgium				
Rate	55.00	2 420 Mill. bfr	117 583	52.26
Surcharges	5.77			2.87
Total	60.77			55.13
Denmark	62.00	243 100 dkr	63 938	38.66
Germany				
Business income	47.00	100 024 DM	100 224	47.00
Surcharges	2.59			2.59
Total	49.59			49.59
Non-business income	53.00	120 042 DM	120 042	53.00
Surcharges	2.92			2.92
Total	55.92			55.92
France	56.80	282 731 FF	84 508	44.52
Ireland	48.00	8 900 irL	22 384	29.26
Italy				
Rate	51.00	300 Mill. Lira	305 370	53.00
Surcharges	16.20			2.92
Total	67.20			55.92
Luxembourg				
Rate	50.00	1.384 Mill. lfr	67 246	36.97
Surcharges	1.25			2.03
Total	51.25			39.00
Netherlands				
Rate	60.00	92 773 hfl	82 373	41.56
Surcharges				2.29
Total	60.00			43.85
Austria				
Rate	50.00	700 000 ATS	99 631	46.81
Surcharges				2.57
Total	50.00			49.38
Spain				
Rate	56.00	10.222 Mill. Ptas	120 855	53.00
Surcharges				2.92
Total	56.00			55.92
Japan				
Rate	50.00	30 Mill. Yen	373 230	53.00
Surcharges	15.00			2.92
Total	65.00			55.92
Switzerland				
Rate	11.50	501 700 sfr	601 137	53.00
Surcharges	30.94	201 700 sfr	241 677	2.92
Total	42.44			55.92

1) Exchange rates prevailing on 25 August 1998. — 2) Including solidarity surcharge.
Source: *Die wichtigsten Steuern im internationalen Vergleich.* Informationsdienst zur Finanzpolitik des Auslands (publication issued by the Federal Ministry of Finance, 30 July 1996).

isation. In particular it needs to be remembered that the differences in economic and tax-rasing potential between west and east Germany are enormous and that massive transfers from west to east will remain necessary. If the economically stronger states, whose infrastructural endowment remains far superior, were provided more resources at the expense of the poorer states, this would imply a loss of welfare at the macroeconomic level, as the marginal return on capital invested in infrastructure can be expected to be higher in east Germany than in the richer west German states. If the system of fiscal equalisation were reformed to generate more competition between states, the problem is not just that initial endowments would be highly unequally distributed,

Figure 4

The Burden of Income Tax and Social Insurance Contributions on Gross Income, 1998[1)]



1) Including solidarity surcharge. In calculating taxable income the deductions that form part of the wage-tax tables (provident-expenditure allowance, employee allowance, special expenditure allowance) have been allowed for. — 2) As a % of gross income.
Source: DIW calculations.

it is also likely that states would enter into competition to cut taxes; the poorer states would almost certainly lose such a race because of their lack of "clout" in regional fiscal competition. More seriously, it can be expected that the supply of public services would be cut back. Only when greater progress has been made in east Germany towards achieving west German standards can fundamental reforms along such lines be considered.

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