Government Budgets 1999/2000: no Departure from the Restrictive Course

In recent years German fiscal policy has been dominated by the efforts to consolidate government budgets. And indeed, the deficits of central, state and local government have been significantly reduced; from DM 120 billion in 1996 to DM 56 billion last year (on fiscal statistics definitions). To some extent this trend reflects substantial asset sales and the particularly large profits transferred to the government coffers by the German Bundesbank. The large number of cutbacks on the spending side also made a contribution. There is expected to be little change in the restrictive fiscal policy stance for the foreseeable future, not least because Germany, under the Dublin Stability and Growth Pact, has committed itself to achieving a balanced budget in the medium term. In order to achieve this aim, central government has adopted an austerity package that is to reduce the central government deficit by a further DM 30 billion next year, compared with the previous financial plan. State governments, too, will stick to their restrictive course. It is only in the case of local government that the pressure to cut back spending has eased.

In spite of the unfavourable macroeconomic parameters, the three tiers of German government have significantly reduced their spending as a share of GDP in recent years. Following the rise to 32% in 1993, a year marked by recession, it has steadily declined to 30% in 1998 (cf. table 1). This was due to cuts in public current spending and – in relative terms – to an even greater extent to reduced public capital spending. It is local government that performs the lion's share of public investment, but their scope for credit-financing is tightly circumscribed by German budgetary law, so that local authorities are forced to respond to declining revenue by cutting capital spending. Yet they have also reduced their current spending; this has been most pronounced in local authorities in eastern Germany, which in recent years have reduced their staffing levels – which had been exorbitantly high – by 175 000 full-time positions, a cut of as much as 40%. The other tiers of government also reduced employment levels substantially. All in all the number of people employed by central, state and local government fell by half a million between 1993 and 1998 to 3.72 million, despite the fact that public sector wage rises – 10% in all – were moderate (overall economy: 15%).

Because of the persistent high level of unemployment, government transfer expenditure has risen slightly faster than GDP. Transfer growth would have been even faster, however, in the absence of the series of cuts imposed by government in the social security net; examples include the reduction in wage compensation benefits, in minimum social benefit and the cutbacks in labour market policy measures.

At around 22½% of GDP, the tax-to-income ratio remained low throughout the period. Whereas taxes on wages have increased somewhat, the burden on companies has declined in the wake of the reductions in corporation tax rates, tax reimbursements for profits initially retained and subsequently distributed, the special depreciation allowances and investment grants for those investing in eastern Germany, and, finally, the abolition of taxes on wealth ownership and trading capital.

Revenues in 1999 and 2000

Tax revenues have expanded surprisingly favourably during the course of this year. Between January and July the tax receipts of central, state and local government were up by more than 6½% over the same period the previous year. This reflects not only the fact that this year the expansion of tax revenue is being bolstered to a greater extent by domestic demand than was the case last year, but also changes in tax legislation (cf. table 2) and the termination of various tax allowances.

The following estimations of tax revenue trends during the rest of the year and in the year 2000 are based on

Table 1

Central, State and Local Government Expenditure and Revenue as a % of GDP[1]

	1993	1997	1998[2]
Consumption expenditure	13.1	11.9	11.6
Gross investment	2.7	1.8	1.7
Transfer expenditure	12.8	13.0	13.2
to social insurance	3.1	2.9	3.2
to other sectors	9.7	10.1	10.1
Interest payments	3.4	3.6	3.6
Total expenditure	32.0	30.3	30.1
Total revenue	28.6	27.7	28.0
of which: taxes	22.8	22.5	22.7
Deficit/surplus	– 3.4	– 2.6	– 2.1
Central government	– 2.2	– 1.7	– 1.7
State government	– 1.0	– 1.1	– 0.7
Local government	– 0.2	0.1	0.3

1 On national accounting definitions. — 2 DIW estimate.
Sources: Federal Statistical Office; DIW calculations.

Table 2

Fiscal Impact of Changes in Tax Laws in 1999 and 2000

Reductions (-) and increases (+) in the tax burden in DM millions

	1999	2000
Tax amendment law 1999/2000/2002, total	57	–2 329
Reductions in tax burden	–10 065	–24 648
Increase in child benefit from DM 230 to DM 250 per month (1st and 2nd child)	–6 400	–5 800
Reduction in the initial rate of income tax from 25.9% to 23.9%	–1 370	–1 310
Reduction in the top rate of income tax for business income from 47% to 45%	–930	–1 120
Reduction in the rate of corporation tax from 45% to 40%	–1 365	–2 868
Increase in the basic tax free allowance on earned income from DM 13 067 to DM 13 499	–	–4 060
Reduction in the initial rate of income tax from 23.9% to 22.9%	–	–620
Reduction in the top rate of income tax from 53% to 51%	–	–1 490
Reduction in the top rate of income tax for business income from 45% to 43%	–	–1 100
Changes in the income-tax progression zone	–	–6 280
Measures to broaden the tax base	10 122	22 319
Definition of taxable profits (inclusion of provisions etc.)	2 985	4 620
Abolition of the reduced tax rate for 'extraordinary income'	1 289	3 551
Halving of the tax-free allowance on interest income to DM 3 000/6 000 (single/married)	–	2 075
Reduction in the deduction of pre-paid turnover tax on vehicles not exclusively used for business purposes	928	1 408
Opening phase of ecological tax reform	8 400	12 340
Increase in tax rates on petroleum products	5 200	7 840
Introduction of a tax on electricity	3 200	4 500
Change in legislation on marginal employment ('DM 630 jobs')	–1 300	–1 700
Law reducing tax burden on families (planned)	–	–5 500
Increase in child benefit from DM 250 to DM 270 per month (1st and 2nd child)	–	–3 800
Tax-free allowance for child care for children under 16 (DM 3 034)	–	–1 700
Total	7 157	2 811

Source: Federal Ministry of Finance.

the assumption that in 1999 nominal GDP grows by just under 2% and in 2000 by 3%. These are significantly lower than the figures – 1999: 2.8%; 2000: 3.7% – set by the federal government in May 1999 for the *'Arbeitskreis Steuerschätzungen'* (Working party on tax estimation).

As far as wage tax is concerned, the increase in child benefit on 1 January 1999 – from DM 230 to DM 250 per month for the first and second child – serves to depress revenues, as child benefit is paid out of wage-tax revenue (cf. figure 1). In western germany actual wage tax receipts, after deducting child benefit, increased by just 1.9% to July; adjusting for the increased deduction, the increase amounted to 4.2%. In the coming year the second stage of the 1999/2000/2002 tax reform, together with the impact of earlier changes in legislation, will depress revenue significantly, namely by DM 8 billion. Collectively agreed wages and salaries are assumed to increase by around half a percentage point less than this year, and there will be scarcely any improvement in the employment situation. Overall, in the coming year wage-tax receipts will increase by just 2½% after deduction of child benefit (cf. table 3).

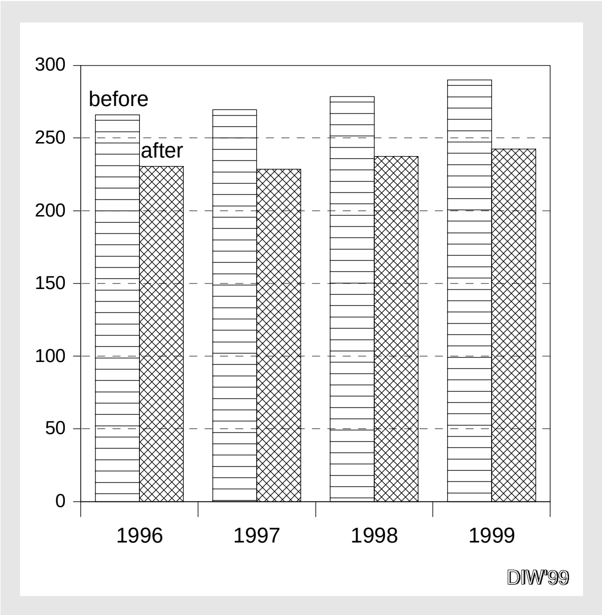
In eastern Germany current receipts of wage tax have contracted markedly in the course of the year to July (–5.2%). The impact of child benefit is considerably greater here. The estimate assumes that the number of employed persons increases slightly during the year, and that this is reflected in tax revenues. Even so, the year as a whole will see a decline in wage-tax receipts (–3.8%). In the year 2000 the picture is dominated by the second stage of the tax reform, which has a greater impact than in western Germany, as the reform eases the burden on low-income groups more than proportionately, and a greater proportion of east German households is on low incomes. Consequently, wage-tax receipts in eastern Germany will increase only slightly.

In the months to July revenue from taxes on profits (assessed income tax, corporation tax, non-assessed

Figure 1

Wage-tax Revenue in Western Germany before and after Deduction of Child Benefit, 1996 to 1999[1]

DM billions



1 1999: DIW estimate.
Sources: Federal Ministry of Finance; DIW calculations and estimations.

profit taxes and withholding tax on interest income) grew by almost 40% in both eastern and western Germany. Income and corporation tax alone recorded an increase of more than DM 13 billion, or 140%. Revenue from profit taxes, which in the years following German unification had been seriously depressed by tax concessions to stimulate investment, is thus now approaching its 'normal' level.

The marked improvement in current revenues from assessed income tax in western Germany is primarily due to the fact that reimbursements have been significantly lower this year. By July tax receipts totalling DM 5.6 billion had been collected, whereas in the same period the previous year receipts were actually negative. As the year proceeds, the broadening of the tax base resulting from the reduction in tax allowances and concessions will increasingly make its effects felt, so that revenue growth of more than 50% can be expected. Strong revenue growth can also be expected next year (10%). The reductions in income tax rates that will take effect in 2000 will be more than offset by the reductions in tax allowances.

In eastern Germany, too, there are signs of an improvement in receipts from assessed income tax. Although the tax offices recorded a negative figure of more than DM 4 billion in the months to July, this was DM 300 million less than in the corresponding period the previous year. Even so, the revenues are still insufficient to finance the investment grants, the reimbursements to employees under § 46 of the income tax law and the tax reimbursements for home-owners, all the more so as these payments increased by DM 450 million in the months to July. By the end of the year, a deficit of DM 4.8 billion is likely to be recorded. Subtracting the reimbursement payments, gross revenue will have doubled on the previous year (cf. table 4). In the year 2000 gross revenue will continue to grow strongly, but the effective deficit at the end of the year will be even larger, at DM 5.8 billion. This primarily reflects the higher investment grants; the new legislation extending economic support for the east German *Länder* has not only prolonged the grants, it has also raised rates, in some cases substantially.

Receipts of corporation tax in western Germany are being largely determined by special factors arising in 1998 in the context of the last opportunity to distribute profits that had been retained and on which 50% tax had been paid (EK50). In 1998 this had led to substantial reimbursements, because distributed profits are only taxed at a rate of 30%, and firms could claim the difference from the tax authorities. This special factor is no longer affecting revenues in 1999. The reduction in tax allowances adopted in recent years and the 1999/2000/2002 tax reform law have already left their mark on corporation tax receipts. Overall, on annual average figures an increase in current receipts of almost one quarter is to be expected. In the year 2000 pre-payments are expected to increase in line with profit trends. Supplementary payments from earlier assessment years, which have been comparatively high this year, are expected to be significantly lower, however, as pre-payments have now been adjusted to the more favourable profitability situation. All in all, corporation tax takings in 2000 are expected to be down by around 7% on the current year.

In eastern Germany the positive evolution of corporation-tax revenues has continued; since 1997 revenue – after subtracting the investment grants and reimbursements to the Federal Office of Finance – has been expanding strongly. By July of this year current receipts have risen by DM 700 million or 135%. The impact of the recent tax laws is also increasingly making itself felt in eastern Germany. Overall, an increase in receipts of 45% is expected for 1999. The picture will be rather different in 2000, because here, too, the continuation of support for the east German economy will lead to a fall in tax revenues. Current receipts in the year 2000 will probably be down by around 10%.

Revenue from taxes on turnover have increased by almost 7% in the first seven months of the year, significantly faster than the tax bases. The increase in the

Table 3
Tax Revenue in Germany 1998 to 2000

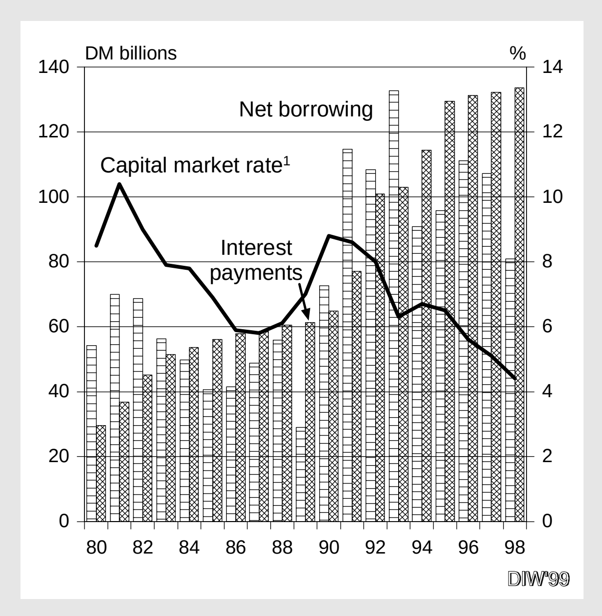
	West Germany[1]			East Germany[2]			Total			West Germany[1]		East Germany[2]		Total	
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1999	2000	1999	2000	1999	2000
	Actual	Estimated		Actual	Estimated		Actual	Estimated							
	DM billion									% change on the previous year					
Joint taxes	554.8	589.5	606.0	35.6	38.2	38.2	590.4	627.7	644.2	6.2	2.8	6.7	14.7	6.3	2.6
Wage tax[3]	237.4	242.5	248.5	20.9	20.1	20.2	258.3	262.6	268.7	2.1	2.5	–3.8	0.5	1.7	2.3
Assessed income tax[3]	16.8	26.0	28.5	–5.7	–4.8	–5.8	11.1	21.2	22.7	54.4	9.6	.	.	90.7	7.1
Non-assessed taxes on profits[4]	22.2	19.5	20.0	0.6	0.7	0.7	22.8	20.2	20.7	–12.0	2.6	8.6	7.7	–11.4	2.5
Tax on interest income[5]	11.7	12.0	14.0	0.1	0.2	0.3	11.8	12.2	14.3	2.1	16.6	7.5	67.7	2.2	17.3
Corporation tax[4]	35.1	43.5	40.5	1.1	2.0	1.8	36.2	45.5	42.3	23.9	–6.9	84.0	–10.0	25.7	–7.0
Taxes on turnover[6]	231.6	246.0	254.5	18.6	20.0	21.0	250.2	266.0	275.5	6.2	3.5	7.4	5.0	6.3	3.6
Customs duty							6.5	6.8	6.7					4.8	–1.5
Federal taxes							130.5	140.6	145.6					7.7	3.6
Petroleum tax							66.7	72.2	75.1					8.3	4.0
Electricity tax							–	3.2	4.5					.	41.0
Tobacco tax							21.7	21.9	22.0					1.2	0.5
Spirits tax							4.4	4.3	4.2					–2.3	–2.3
Insurance tax							14.0	13.8	13.8					–1.1	0.0
Solidarity supplement (on income taxes)							20.6	22.0	22.8					7.0	3.6
Other							3.2	3.2	3.2					–	–
Federal state taxes	32.5	32.3	31.3	4.8	4.8	4.9	37.3	37.1	36.2	–0.6	–3.1	–1.0	–1.0	–0.5	–2.4
Vehicle tax	13.0	11.5	10.5	2.1	2.0	2.1	15.1	13.5	12.6	–11.7	–8.7	–7.0	–10.0	–11.0	–8.9
Wealth tax	1.1	1.0	0.4	–	–	–	1.1	1.0	0.4	–5.7	–60.0	.	.	–5.7	–60.0
Other	18.4	19.8	20.4	2.7	2.8	2.8	21.1	22.6	23.2	7.6	2.9	4.0	2.0	7.1	2.7
Local government taxes	62.8	62.7	64.8	5.4	5.7	6.2	68.2	68.4	71.0	–0.2	3.3	5.6	8.8	0.3	3.8
Trade tax	47.4	46.8	48.4	3.1	3.3	3.7	50.5	50.1	52.1	–1.2	3.4	5.4	12.1	–0.8	4.0
Real estate tax	14.0	14.5	15.0	2.1	2.3	2.4	16.1	16.8	17.4	3.2	3.4	8.0	4.3	3.8	3.6
Other	1.4	1.4	1.4	0.1	0.1	0.1	1.5	1.5	1.5	0.4	1.1	.	.	–	–
Overall actual tax revenues at federal, state and local levels, financial statistics definition[7]							833.0	880.6	903.6	.	.	.	.	5.7	2.6
of which:															
Central government[8,9,10,11]	–	–	–	–	–	–	353.9	386.8	396.0	.	.	.	.	9.3	2.4
State government[8,9,11,12,14]	280.3	292.3	297.6	61.9	65.0	66.4	342.2	357.3	364.0	4.3	1.8	5.0	2.2	4.4	1.9
Local government[13,14]	87.3	89.0	91.8	7.8	7.9	8.3	95.1	96.9	100.1	1.9	3.1	1.3	5.1	1.9	3.3

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: 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 Excl. 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 Incl. trading tax levy. Distribution ratio central/state government: 50/50%. — 12 Incl. community tax of the city states. — 13 Excl. community tax of the city states and after deduction of the trading tax levy. — 14 Incl. 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 Ministry of Finance; DIW estimates.

standard rate of VAT – from 15 to 16% – on 1 April 1998 made its full effects felt in the first four months of this year compared with the corresponding period last year. On top of this come additional revenues resulting from changes in taxation laws amounting to DM 3 billion in the current and DM 4.2 billion in the coming year.

Figure 2

Capital Market Interest Rate, Net Public Borrowing and Interest Expenditure



1 Running yield on fixed-interest government bonds.
Sources: German Bundesbank; Federal Statistical Office; DIW calculations.

Overall, turnover tax revenues are expected to rise by 6.3% in 1999 and 3.5% in 2000.

The revenue trend among taxes whose revenue accrues solely to central government is being strongly influenced by the government's decision to embark on an ecological tax reform. An electricity tax was introduced on 1 April of this year and the tax rates on petroleum products have been raised substantially. Additional revenues from these sources are estimated at DM 8.4 billion in the current year and more than DM 13 billion in the coming year. Because revenue derived from the solidarity supplement will rise strongly, as a consequence of the positive trend on profit-related taxes, revenue from the 'pure' central government taxes will grow markedly; by 7.7% this year and almost 4% next year.

All in all, central, state and local government and the EU can expect strong growth of tax revenues in 1999 (5.7%), representing a total tax take of around DM 880 billion. Revenue growth will be significantly weaker next year, at 2.6%, however.

Expenditure 1999 and 2000

Once again expenditure trends in the current and the coming years will be dominated by cutbacks, even if this is not reflected in the growth figure (4%) for 1999; this is due to one-off factors. The level of spending is expected to stagnate in 2000 (cf. table 5).

These one-off effects impact on the central government budget. For instance, additional spending is incurred by the fact that central government must meet the deficit in the 'Post Support Funds' (*Postunterstützungskassen*) amounting to DM 8 billion. Of even greater quantitative importance are the additional grants to the statutory pension insurance system (DM 15 billion). For this purpose DM 9 billion in revenue have been appropriated from the ecological tax reform, and DM 6 billion from the VAT increase on 1 April 1998; at that time, the turnover tax increase was implemented in order to boost the central government grant to the pension insurance system.

Following the moderate increases in previous years, public sector wages and salaries were increased by 3.1% with effect from 1.4.1999. Unlike in previous years, this increase is only marginally less than the average for the economy as a whole. Net job losses are set to con-

Table 4

Income Tax Revenue from January to July, 1998 and 1999

	West Germany			East Germany		
	1998	1999	Change in %	1998	1999	Change in %
	in DM billions			in DM billions		
Current receipts	–0.61	5.62	.	–4.35	–4.06	.
+ investment grants	0.02	0.02	–20.0	0.23	0.16	–32.2
+ reimbursements (§ 46 of income tax law)	24.01	23.70	–1.3	3.71	3.57	–3.8
+ grant to home-owners	4.46	7.04	58.0	1.19	1.80	51.0
+ reimbursements to Federal Office of Finance	0.96	1.05	8.5	–	–	–
Gross receipts	28.84	37.42	29.7	0.78	1.46	87.9

Sources: Federal Ministry of Finance; DIW calculations.

∞

Table 5

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					
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
	in DM billion																				
Revenue	429.9	455.5	442.6	90.8	54.7	47.2	364.9	377.4	380.4	95.4	98.8	100.3	230.9	233.8	238.9	50.2	50.8	51.9	1030.8	1075.5	1065.9
Taxes	353.9	386.8	396.0	–	–	–	280.3	292.3	297.6	61.9	65.0	66.4	87.3	89.0	91.8	7.8	7.9	8.3	791.2	841.0	860.1
Transfers from other levels of government	4.5	4.5	4.5	63.0	26.1	24.4	36.2	35.9	35.8	19.2	19.0	18.7	64.8	66.0	67.3	30.8	31.1	31.5	–	–	–
State equalisation	–	–	–	–	–	–	6.7	6.7	6.9	6.1	6.2	6.3	–	–	–	–	–	–	–	–	–
Income from economic activities	26.8	18.8	14.2	–	–	–	7.8	7.9	8.0	0.8	0.9	0.9	12.6	12.7	12.9	2.3	2.3	2.4	50.3	42.6	38.4
Levies and charges	7.1	7.1	7.2	–	–	–	8.4	8.6	8.8	1.0	1.0	1.1	29.9	30.1	30.5	4.4	4.5	4.6	50.8	51.3	52.2
Sales of assets[6]	26.4	27.0	9.2	1.5	4.2	0.5	7.7	8.0	5.0	0.4	0.4	0.4	13.1	12.5	12.5	3.1	3.2	3.2	52.2	55.3	30.8
Other sources	11.2	11.3	11.5	26.3	24.4	22.3	17.8	18.0	18.3	6.0	6.3	6.5	23.2	23.5	23.9	1.8	1.8	1.9	86.3	85.3	84.4
Expenditure	486.5	506.0	494.4	67.1	45.4	40.2	385.5	391.3	396.5	102.9	104.0	105.4	225.3	230.2	237.0	51.0	51.1	52.2	1086.7	1130.0	1129.6
Personnel costs	52.1	52.8	53.5	15.7	15.5	15.0	152.6	155.9	157.8	26.3	26.9	27.2	60.9	62.6	63.8	15.3	15.3	15.3	322.9	329.0	332.6
Current material costs	38.6	41.0	38.5	0.4	0.3	0.3	37.1	37.4	37.8	7.8	7.8	7.8	41.8	42.5	43.4	9.6	9.6	9.6	135.3	138.6	137.4
Interest payments	56.2	81.0	83.3	30.0	8.2	8.1	31.2	32.0	32.7	5.3	5.5	5.8	9.2	9.1	9.0	1.7	1.7	1.7	133.0	136.9	140.0
of which: to other levels of government	–	–	–	–	–	–	0.3	0.3	0.3	–	–	–	0.3	0.3	0.3	–	–	–	–	–	–
Current transfers to	281.1	272.9	265.0	5.2	6.9	4.8	117.2	119.5	122.5	36.1	37.3	38.7	71.4	72.8	76.3	10.5	11.0	12.1	335.6	366.9	367.0
Other levels of government	23.9	24.1	24.0	–	–	–	54.6	56.0	57.7	24.3	24.9	25.5	6.9	6.9	6.9	0.2	0.2	0.2	–	–	–
State equalisation	–	–	–	–	–	–	12.8	12.9	13.2	–	–	–	–	–	–	–	–	–	–	–	–
Special assets	62.9	26.0	24.3	–	–	–	0.1	0.1	0.1	–	–	–	–	–	–	–	–	–	–	–	–
Social insurance	121.0	144.0	138.5	1.6	1.5	1.5	0.5	0.5	0.5	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	123.5	146.4	140.9
Income support	48.5	45.7	44.5	0.3	0.3	0.3	14.4	14.7	15.3	2.7	3.0	3.5	44.8	45.7	48.5	6.4	6.7	7.5	117.1	116.1	119.6
Firms	18.3	26.5	26.5	3.1	2.7	2.5	20.5	20.8	21.0	6.1	6.3	6.5	4.9	5.0	5.2	1.9	2.0	2.1	54.8	63.3	63.8
Abroad	5.0	5.2	6.0	–	–	–	1.2	1.2	1.2	–	–	–	–	–	–	–	–	–	6.2	6.4	7.2
Social institutions	1.5	1.4	1.2	–	–	–	11.5	11.7	11.9	2.2	2.3	2.4	9.9	10.2	10.6	1.5	1.6	1.7	26.6	27.2	27.8
Other	–	–	–	–	–	–	1.6	1.6	1.6	0.7	0.7	0.7	4.7	4.8	4.9	0.4	0.4	0.5	7.4	7.5	7.7
Investment	13.5	14.0	12.0	–	–	–	11.0	10.7	10.5	4.1	4.0	4.0	34.8	35.8	37.0	12.9	12.5	12.5	76.3	77.0	76.0

Table 5 (continued)

	Central government[2,3]			Special assets[4]			State government[2]						Local government						Total		
							West Germany[5]			East Germany			West Germany			East Germany					
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
Capital transfers to	35.9	35.0	34.1	2.3	1.5	1.0	29.2	28.7	28.2	22.0	21.2	20.6	3.9	4.0	4.1	0.6	0.6	0.6	50.7	49.0	47.4
Other levels of government	20.5	19.8	19.4	–	–	–	11.9	11.7	11.5	10.3	10.0	9.8	0.3	0.3	0.3	0.2	0.2	0.2	–	–	–
Special assets	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Abroad	3.9	3.8	3.7	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	3.9	3.8	3.7
Other	11.5	11.4	11.0	2.3	1.5	1.0	17.3	17.0	16.7	11.7	11.2	10.8	3.6	3.7	3.8	0.4	0.4	0.4	46.8	45.2	43.7
Loans and shares	9.1	9.3	8.0	13.4	13.0	11.0	7.2	7.1	7.0	1.3	1.3	1.3	3.3	3.4	3.4	0.4	0.4	0.4	32.8	32.6	29.2
of which: to other levels of government	1.0	1.0	1.0	–	–	–	0.9	0.9	0.9	–	–	–	–	–	–	–	–	–	–	–	–
Financial balance	– 56.6	– 50.5	– 51.8	23.9	9.5	7.2	– 20.6	– 13.9	– 16.1	– 7.5	– 5.2	– 5.1	5.6	3.6	1.9	– 0.8	– 0.3	– 0.3	– 55.9	– 54.5	– 63.7
	% change on the previous year																				
Revenue	9.6	6.0	–2.8	16.1	–39.8	–13.7	3.0	3.4	0.8	1.4	3.6	1.5	4.0	1.3	2.2	–3.1	1.2	2.2	5.7	4.3	–0.9
Taxes	3.1	9.3	2.4	–	–	–	4.9	4.3	1.8	2.3	5.0	2.2	7.9	1.9	3.1	14.7	1.3	5.1	4.3	6.3	2.3
Expenditure	6.8	4.0	–2.3	2.7	–32.3	–11.5	1.0	1.5	1.3	–0.8	1.1	1.3	–0.5	2.2	3.0	–4.7	0.2	2.2	1.7	4.0	0.0
Personnel costs	–0.8	1.3	1.3	–1.7	–1.5	–3.2	1.3	2.2	1.2	0.0	2.3	1.1	0.2	2.8	1.9	–2.5	0.0	0.0	0.3	1.9	1.1
Current material costs	1.3	6.2	–6.1	–45.9	–25.0	0.0	0.8	0.8	1.1	0.0	0.0	0.0	0.0	1.7	2.1	–2.0	0.0	0.0	0.2	2.4	–0.9
Interest payments	5.2	44.1	2.8	–6.8	–72.7	–1.2	2.6	2.6	2.2	8.2	3.8	5.5	–2.1	–1.1	–1.1	0.0	0.0	0.0	1.1	2.9	2.3
Current transfers to	10.8	–2.9	–2.9	–0.4	31.9	–30.4	1.1	2.0	2.5	0.6	3.3	3.8	0.4	2.0	4.8	–1.9	4.8	10.0	4.2	9.3	0.0
Other levels of government	3.0	0.8	–0.4	–	–	–	0.0	2.6	3.0	–0.8	2.5	2.4	–2.8	0.0	0.0	0.0	0.0	0.0	–	–	–
Social insurance	11.1	19.0	–3.8	18.5	–6.3	0.0	66.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	11.3	18.5	–3.8
Income support	–1.4	–5.8	–2.6	–25.0	0.0	0.0	2.1	2.1	4.1	17.4	11.1	16.7	–1.5	2.0	6.1	–1.5	4.7	11.9	–0.8	–0.9	3.0
Firms	1.7	44.8	0.0	–5.2	–13.7	–7.4	19.2	1.5	1.0	24.5	3.3	3.2	2.1	2.0	4.0	11.8	5.3	5.0	9.9	15.4	0.8
Investment	10.7	3.7	–14.3	–	–	–	–3.5	–2.7	–1.9	0.0	–2.4	0.0	–2.5	2.9	3.4	–3.0	–3.1	0.0	–0.5	0.9	–1.3
Capital transfers	11.8	–2.5	–2.6	–	–34.8	–33.3	–3.6	–1.7	–1.7	–3.9	–3.6	–2.8	–7.1	2.6	2.5	–71.4	0.0	0.0	6.5	–3.4	–3.3
Loans and shares	–34.1	2.2	–14.0	24.1	–3.0	–15.4	18.0	–1.4	–1.4	–27.8	0.0	0.0	–2.9	3.0	0.0	–	0.0	0.0	–3.0	–0.6	–10.4

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 and estimates.

tinue at all budgetary levels. For the estimate it was assumed that the overall staffing level falls by 1% in both 1999 and 2000, implying a further decline in public sector employment by 80 000. Next year slightly lower pay increases are expected than in this year. On balance, personnel costs are expected to rise by 1.5% in 1999 and 1.2% in 2000.

Current material costs are expected to rise by 2.5% this year, somewhat more than in recent years. One reason for this is the cost of minting the euro – for which DM 800 million have been earmarked – with additional spending also entailed by the transfer of the seat of government from Bonn to Berlin. In addition expenditure on military procurement is to be increased more than proportionately. In the year 2000 current material costs can be expected to decline, despite the additional burden resulting from the overseas deployment of the German army, not least because of the government's austerity package.

As a result of both reduced borrowing in recent years and the low level of interest rates on money and capital markets, the rise in government interest payments has slowed markedly (cf. figure 2). An additional factor was the replacement of high-interest outstanding debt by low-interest new borrowing; in view of the lower rates on the money market, government has increasingly taken on short-term debt. This trend is likely to be maintained next year. The cost of interest payments for central, state and local government is expected to rise by around 2½% in both years.

The growth of current spending on transfers in 1999 is being strongly influenced by the above-mentioned special factors; without the impact of such factors, transfer spending would rise by just 2%. This figure includes additional spending on labour market policy. Because of the slight fall in unemployment, however, expenditure on unemployment assistance can be expected to fall by DM 2½ billion in the current year. After recent years in which expenditure on minimum social benefit has fallen – an effect due largely to the introduction of social care insurance, but also to the efforts made by local authorities to find work for unemployed recipients of minimum social benefit – moderate growth is expected for the current year. Next year, local authorities will probably have to face substantial additional expenditure, as central government cutbacks in unemployment assistance and housing benefit will impose significant additional burdens on them. Overall, the level of current transfer expenditure is expected to stagnate.

An end to the decline in public capital spending appears to be in sight. The decisive factor here is the improvement in local government finances, particularly in western Germany, permitting local authorities to increase their investment expenditure. Central government, too, will increase its capital spending this year. This will be followed by cuts next year, however, as the austerity package foresees cuts in capital spending.

Trends by tier of government

In spite of the moderate trends on the spending side, the overall government deficit will decline – on financial statistics definitions – by less than DM 2 billion in 1999, to DM 54 billion. This overall figure conceals diverging trends, however, reflecting the influence of one-off factors. Whereas the financial position of central, state and local government continues to improve, with a fall of DM 14 billion in the size of the deficit, the central government 'special assets' (*Sondervermögen*) will earn a significantly lower surplus; probably less than DM 10 billion, compared with DM 24 billion last year. One-off effects will also impact on budget trends in the year 2000, preventing an improvement in the fiscal position, and causing the figures to understate the restrictiveness of the fiscal policy stance. The government deficit is estimated to reach almost DM 64 billion.

This year the central government deficit, at DM 50 billion, is likely to prove lower than planned. The substantial additional revenues (DM 33 billion) result primarily from the higher taxes imposed on energy; these additional resources are to be transferred to the pension insurance fund. Nor is the reduced profit transferred to central government by the German Bundesbank reflected in the deficit, as it is matched by a reduced transfer by central government to the fund responsible for servicing outstanding debts originating from the GDR (*Erblastentilgungsfonds*). Central government interest payments, on the other hand, are rising markedly. This is primarily because the interest obligations from the *Erblastentilgungsfonds* and the central government railway fund (*Bundeseisenbahnvermögen*) have been integrated into the federal budget this year, i.e. central government is directly responsible for debt servicing. In the coming year central government is expected to cut its spending by DM 12 billion, or more than 2%, as the austerity package begins to bite. These savings affect, in particular, the grants to the social insurance funds, especially the Federal Labour Office, but also current material costs and capital spending.

For the purposes of the prognosis it was assumed that state governments *(Länder)* in both eastern and western Germany stick to their restrictive spending policy. This implies, above all, that they continue to reduce staffing levels. State-level grants to local government will increase more than proportionately, as they are tied to the tax receipts of state governments. Only minor differences are expected between revenue and expenditure trends in eastern and western state governments. This year west German state governments can expect a decline in their overall deficits of just under DM 7 billion (to DM 14 billion), east German states by DM 2 (to DM 5 billion). Next year the financial position of the west German states will deteriorate once more (DM –16 billion) and in eastern Germany it will scarcely improve.

Local authorities in western Germany, which earned surprisingly high surpluses last year, will certainly perform almost as well this year; the surplus is expected to amount to DM 3½ billion, with DM 2 billion expected next year. This is assuming that the reduction in staffing levels gradually comes to an end, as does the excision of various levy-budgets from the overall local government budget. For the first time for many years, spending on capital investment will be expanded once again. The financial position of east German local authorities will also improve slightly. On average their budgets will be more or less balanced, although this will be at the cost of investment expenditure. A further decline in employment is to be expected; staffing levels in east German local government are still almost one quarter higher than in western Germany. These overall figures conceal major divergencies, however: the financial problems facing local authorities in structurally weak regions remain serious.

Fiscal policy considerations

It is still the case that the efforts of fiscal policy-makers are focused on limiting or reducing budget deficits. In recent years central, state and local government have managed to reduce their expenditure significantly as a share of GDP. This trend will not be maintained this year, due to a series of special factors. In the year 2000, however, the decline will prove all the more pronounced, provided the government's austerity package is implemented. The contractionary effects on the economy exerted by the expenditure side of fiscal policy will be only partly offset by expansionary measures on the taxation side, so that the overall effect is likely to be restrictive.

There can be no doubt that the scope for fiscal policy action has diminished. It is undisputed that in the longer run the extent to which public goods are supplied cannot be determined without regard to the overall level of economic activity. The same is true, ultimately, of the redistributive mechanisms built in to the fiscal system. Sustained growth weakness inevitably forces the government to adjust its budget in the light of this trend, if it wants to avoid overburdening the economy. Conversely, a self-sustaining economic upturn expands the scope for fiscal policy action, as exemplified by the situation in the USA. On the other hand, it is equally clear that German fiscal policy has manoeuvred itself into a dilemma, by weakening overall economic activity through the pursuit of pro-cyclical policies, and thus contributing to its own financial problems. This has been exacerbated by the fact that mistakes were made in financing the unification process, mistakes whose impact has become increasingly evident in recent years. Instead of raising taxes at that time, taxes were cut; in 1997 the tax burden reached an historical nadir, at 22.5% of GDP. In order to finance the adjustment process in eastern Germany in the face of this taxation trend, the government borrowed excessively; government debt doubled within the space of just a few years. Clearly, the impact of the severe recession in 1993 and the weakness of economic growth since then also played a role, imposing a further squeeze on public budgets. Yet in the face of this the authorities repeatedly sought to reduce deficits by cutting spending. This has finally been achieved, not least against the background of the pressure emanating from the Growth and Stability Pact; on national accounting definitions (including the social insurance funds) the deficit has fallen from 3.2% to 1.9% of GDP. A figure of 1.5% is forecast for this year, with a further decline, to 1.3%, expected next year.[1]

The DIW has repeatedly drawn attention to the negative effects of such a policy on the macro economy. In spite of the reduced scope for action imposed by the crushing debt burden, macroeconomic considerations dictate that the built-in stabilisers should have been allowed to make their effects felt in full. The fact that in recent years economic growth has been so sluggish was at least partly due to the fact that the reduction in budget deficits led to a deterioration in demand-side conditions, and thus reduced the impact on measures on the supply side.

The expectation of cuts in taxation in 2001 and 2002 will hardly be sufficient by itself to give the German economy the required boost. Policy-makers should therefore consider a less rigorous spending policy. The dramatic decline in public investment has led to an accumulation of unmet needs, and the policy of shedding public sector labour cannot be continued at its present

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[1] This appears to be in contradiction to the trend according to financial statistics definitions. Apart from the fact that the deficit ratio falls partly because of the rise in nominal GDP, the deficit trend on fiscal statistics definitions is largely explained by the decline in privatisation receipts, which do not affect the national accounting figures. On top of this comes the fact that the deficit ratio under the Stability Pact includes the social insurance funds – which are recording surpluses – whereas this report considers only the budgets of central, state and local government.

Table 6

Fiscal Impact of the Income Tax Progression in 2002 compared with the 1999 Progression[1]

For a married single earner with one child

Gross annual income	1999 progression				2002 progression				Reductions (-)/ increases (+) 2002 / 1999	
	Income tax	Child benefit[2]	Solidarity surcharge 5,5%	Total	Income tax	Child benefit[2]	Solidarity surcharge 5,5%	Total		
	DM									%
20 000	0	–3 000	0	–3 000	0	–3 000	0	–3 000	0	0.0
25 000	0	–3 000	0	–3 000	0	–3 000	0	–3 000	0	0.0
30 000	0	–3 000	0	–3 000	0	–3 000	0	–3 000	0	0.0
35 000	0	–3 000	0	–3 000	0	–3 000	0	–3 000	0	0.0
40 000	900	–3 000	0	–2 100	326	–3 000	0	–2 674	–574	–27.3
45 000	1 964	–3 000	0	–1 036	1 202	–3 000	0	–1 798	–762	–73.6
50 000	3 124	–3 000	0	124	2 188	–3 000	0	–812	–936	–754.8
55 000	4 482	–3 000	0	1 482	3 362	–3 000	0	362	–1 120	–75.6
60 000	5 838	–3 000	215	3 053	4 546	–3 000	0	1 546	–1 507	–49.4
65 000	7 370	–3 000	298	4 668	5 900	–3 000	230	3 130	–1 538	–33.0
70 000	9 058	–3 000	388	6 446	7 410	–3 000	309	4 719	–1 727	–26.8
75 000	10 750	–3 000	479	8 229	8 938	–3 000	390	6 328	–1 901	–23.1
80 000	12 244	–3 000	559	9 803	10 302	–3 000	463	7 765	–2 039	–20.8
85 000	13 796	–3 000	643	11 439	11 732	–3 000	539	9 271	–2 168	–19.0
90 000	15 342	–3 000	726	13 068	13 168	–3 000	615	10 783	–2 285	–17.5
95 000	16 912	–3 000	810	14 722	14 638	–3 000	693	12 331	–2 391	–16.2
100 000	18 506	–3 000	896	16 402	16 144	–3 000	773	13 917	–2 485	–15.2
105 000	20 162	–3 000	985	18 147	17 720	–3 000	857	15 577	–2 570	–14.2
110 000	21 808	–3 000	1 074	19 882	19 296	–3 000	941	17 237	–2 645	–13.3
115 000	23 478	–3 000	1 164	21 642	20 908	–3 000	1 027	18 935	–2 707	–12.5
120 000	25 210	–3 000	1 257	23 467	22 592	–3 000	1 117	20 709	–2 758	–11.8
125 000	26 932	–3 000	1 350	25 282	24 274	–3 000	1 207	22 481	–2 801	–11.1
130 000	28 678	–3 000	1 444	27 122	25 994	–3 000	1 299	24 293	–2 829	–10.4
135 000	30 450	–3 000	1 540	28 990	27 746	–3 000	1 392	26 138	–2 851	–9.8
140 000	32 284	–3 000	1 639	30 923	29 574	–3 000	1 490	28 064	–2 858	–9.2
145 000	34 108	–3 000	1 737	32 845	31 400	–3 000	1 588	29 988	–2 857	–8.7
150 000	35 966	–3 000	1 836	34 802	33 258	–3 000	1 687	31 945	–2 857	–8.2
160 000	39 838	–3 000	2 044	38 882	37 126	–3 000	1 895	36 021	–2 861	–7.4
170 000	43 864	–3 000	2 259	43 123	41 138	–3 000	2 110	40 248	–2 875	–6.7
180 000	47 996	–3 000	2 481	47 477	45 246	–3 000	2 331	44 577	–2 900	–6.1
190 000	52 326	–3 000	2 713	52 039	49 544	–3 000	2 561	49 105	–2 934	–5.6
200 000	53 660	0	2 951	56 611	50 866	0	2 798	53 664	–2 948	–5.2
210 000	58 190	0	3 200	61 390	55 350	0	3 044	58 394	–2 996	–4.9
220 000	62 874	0	3 458	66 332	59 978	0	3 299	63 277	–3 055	–4.6
230 000	67 656	0	3 721	71 377	64 698	0	3 558	68 256	–3 121	–4.4
240 000	72 644	0	3 995	76 639	69 566	0	3 826	73 392	–3 247	–4.2
250 000	77 730	0	4 275	82 005	74 384	0	4 091	78 475	–3 530	–4.3

1 As the aim here is to illustrate the effects of the 2002 progression, child benefit was held constant. — 2 At a child allowance of zero, the tax-free child allowance (DM 6 912) is more favourable.
Source: DIW calculations.

pace indefinitely. In the area of government subsidies, on the other hand, it seems that the scope for cutbacks has far from been exhausted.

Of central importance is the question to what extent taxation policy can make an effective contribution to stimulating economic growth. The law on the 1999/ 2000/2002 tax reforms contains a number of elements that will serve to stimulate the economy, but they are not to be implemented until the third stage, in 2002. This is evident, for instance, from the reduction in the tax burden for married sole-earners with one child when the taxation table for 2002 is compared with that for 1999. Such a household with an average annual gross income of DM 60 000 will benefit from a reduction in the tax burden of DM 1 550 or 50% (cf. table 6). The federal government would be well-advised to bring forward the income tax progression planned for 2002; this would imply a reduction in the tax burden of around DM 28 billion. Such a proposal would temporarily raise the budget deficit by more than half a percentage point of GDP, but the self-financing effects must be taken into account, as such as step would give a significant boost to the prospects for economic growth.

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