

German Public Budgets 2001/2002: Falling Investment Dampens Effects of Tax Cuts

In view of the requirements of European economic and monetary union, the German central, state and local governments have been endeavouring to bring their budget deficits down markedly since the mid-90s. And although conditions in the economy as a whole have not been entirely favourable they have succeeded: budget deficits were brought down from DM 120 billion in 1997 to DM 62 billion in 2000.¹ However, not least owing to the latest tax cuts – companies and individuals will pay DM 45 billion less – the aggregate deficit on public budgets will shoot up again this year, to a good DM 80 billion according to the estimate presented here. About half the tax cuts will be 'financed' by savings on the expenditure side. Following the losses in tax revenue from the economic slowdown and the reform measures a dramatic fall at investment is evident, particularly at local level. Next year the aggregate deficit should be much lower, at just under DM 70 billion, as the policy of economising will be continued and no further tax cuts will be taking effect.

The central, state and local governments have reduced their deficits, some of which were very high, on every level in recent years. The deficits developed firstly through funding immense transfer payments to eastern Germany, and secondly because the weak economic trend caused considerable revenue shortfalls and required additional expenditure. Consolidation was essential by 1997 as strict observance of the limits to indebtedness laid down in the Maastricht Treaty became obligatory. The Federal Government was also obliged under the European Stability and Growth Pact to achieve at least a balanced budget over the medium term. Behind this is the idea that budget discipline is absolutely essential for macroeconomic stability. Too high a level of indebtedness limits the scope for using fiscal policy as an instrument of stabilisation – it is feared this could lead to higher capital market interest rates and less fixed asset formation by companies.

A record deficit was tolerated in the recession year 1993, and new borrowing amounted to almost DM 140 billion. In the following years the Federal Government

was the first to reduce its deficit. With its responsibility for unemployment insurance the Federal budget reacts much more strongly to cyclical fluctuations than the budgets of the states and the local governments, where the consolidation process only started after 1997 (cf. table 1). Clearly the states and local governments at first paid little attention to the obligations entered into with the Maastricht Treaty. That is hardly surprising, as the question of how to implement the requirements of the European Stability and Growth Pact at national level is still not resolved. So far the three levels of government have not been able to agree on a key for the vertical or the horizontal distribution of the limits to borrowing.

Nevertheless, the states and local governments did considerably reduce their deficits after 1997, bringing them down from DM 45 billion to DM 17 billion. The local governments have actually achieved surpluses in recent years. Even without formal regulations the pressure on the states to consolidate was evidently strong enough to ensure the implementation of this process. However, it would be inappropriate to conclude that the local governments are now in a healthy financial position. On their level it is not so much the balance sheet as expenditure on investment by which financial viability should be judged; their budget legislation prescribes very narrow limits to borrowing. And the improvement in their financial status was purchased with a dramatic fall in spending on investment.

Altogether, the consolidation successes have been achieved on the expenditure side. While aggregate expenditure rose by only 9% from 1993 to 2000, and so clearly less than nominal GDP (23%), revenue rose by 15%.²

The development in revenues 2001/2002

The development in tax revenues will be determined this year by two components. Firstly, the corporate and income tax reforms (Tax Reform 2000 Programme), the second stage of which was brought forward to 1 January this year, will result in markedly lower tax receipts. Secondly, the unexpectedly weak cyclical trend has also left its mark on tax revenues.

The Tax Reform 2000 Programme contains two main elements: reform of corporate taxation and reform of the income tax scales. In the taxation of joint stock companies and shareholders there has been a change in the system. Since 1 January 2001 corporation tax has been charged at a uniform rate of 25% on retained prof-

¹ According to the definitions in the financial statistics; in 2000 without revenue from the auction of UMTS licences.

² The Federal Government's receipts from the UMTS licence auctions totalling nearly DM 100 billion have not been included in this account.

Table 1

Revenue, Expenditure and Balances on the Three Budget Levels

	Central government ¹			State government			Local government		
	Revenue	Expenditure	Balance	Revenue	Expenditure	Balance	Revenue	Expenditure	Balance
	DM billion								
1993	409.5	491.7	-82.1	399.5	441.3	-41.7	276.2	289.3	-13.1
1994	450.2	511.4	-61.2	405.9	449.0	-43.0	281.2	292.5	-11.3
1995	461.9	511.9	-50.0	417.1	463.9	-46.7	281.8	295.7	-14.0
1996	438.2	504.5	-66.3	426.9	474.0	-47.1	282.4	289.0	-6.6
1997	447.6	498.0	-50.4	433.5	472.4	-38.9	273.9	279.9	-5.9
1998	482.3	515.1	-32.7	448.4	476.5	-28.1	282.2	277.5	4.8
1999	504.5	545.2	-40.7	460.6	479.6	-19.0	286.3	281.8	4.5
2000	488.1	537.9	-49.8	467.4	487.6	-20.2	287.6	283.8	3.8
	Change on the previous year in %								
1994	9.9	4.0		1.6	1.8		1.8	1.1	
1995	2.6	0.1		2.8	3.3		0.2	1.1	
1996	-5.1	-1.4		2.3	2.2		0.2	-2.3	
1997	2.1	-1.3		1.5	-0.3		-3.0	-3.2	
1998	7.8	3.4		3.4	0.9		3.0	-0.8	
1999	4.6	5.9		2.7	0.7		1.4	1.6	
2000	-3.3	-1.4		1.5	1.7		0.4	0.7	

¹ Incl. special assets. — ² Without UMTS receipts. — Deviations in balances due to rounding.
Sources: Federal Statistical Office; DIW Berlin calculations.

its (40% up to then) and on distributed profits (30% up to then). In the taxation of dividend payments the principle of fully offsetting corporation tax against the income tax liability, which had been in force since 1977, has been dropped. Corporation tax on dividends is now charged at a fixed rate while shareholders only pay income tax on half of the net dividend they receive. Unincorporated companies paying income and trade tax are now allowed to offset a fixed amount of their trade tax against their income tax liability; this is 1.8 times the trade tax measurement figure.³ In return, such tax concessions as degressive depreciation on mobile assets and linear depreciation on buildings have been reduced. However, not least for cyclical reasons, the Federal Government has initially refrained from adapting some of the official depreciation tables (sector tables); this has cost a good DM 1 billion in revenue that was originally included in the plans. Altogether, the corporation tax reform measures will relieve companies of payments to the amount of DM 17 billion this year (and DM 19 billion in 2002).

³ A tax measurement figure has to be used to calculate trade tax. This is obtained by applying the basic rate (5%) to the profits from trading. Trade tax is fixed and charged on the basis of the tax measurement figure at a percentage that differs from one local government to another.

To combat tax evasion on VAT the Federal Government has presented draft legislation to give the tax authorities more rights next year to investigate turnover tax fraud. It is claimed this will yield an increase in revenue of DM 4.5 billion. However, it is questionable whether that amount will really materialise.

In income tax the basic tax-free allowance has been raised this year by DM 500 to DM 14 000. The lowest rate of tax has been dropped from 22.9% to 19.9%, while the top rate has been cut from 51% to 48.5%. These changes will increase private individuals' disposable incomes this year by a good DM 28 billion. The estimate for the year 2002 also has to take into account the second stage of the improvements in family benefits. On 1 January 2002 child allowances for the first and second child will rise from DM 270 to DM 300. This will raise the net incomes of families with children by nearly DM 6 billion.⁴ In return, the education free allowances have been reduced and the household free allowance will be abolished in three stages from 2002, falling next year

⁴ Parallel to this the child free allowance will rise from DM 6970 per child to DM 7135 and the free allowance for child care of DM 3028 now also applies for children over 16. Moreover, from 2002 an education free allowance of DM 1200 will be given. Notable reductions in tax revenue are not expected until 2003 owing to the method of assessing income tax.

from DM 5 700 to DM 4 575; these changes will bring in additional revenue of DM 1 billion.

The prognosis of tax revenues presented here is based on the results of the tax statistics up to July this year, and on the macroeconomic forecast by DIW Berlin of June this year.⁵ In the prognosis it is assumed that the German economy will grow by only 1% this year; in nominal terms that is a rise of 2.5%. Growth next year is expected to be 2.3%, 3.6% in nominal terms. Wages and salaries will continue to grow at only a moderate rate, by 2.6% this year and 3% next year.

Tax revenues to the German central and state governments and the EU were 2.6% lower than last year up to July 2001. As expected, the falls were particularly marked in income and corporation tax, owing to the tax reform measures. The fall in taxes on turnover is largely the result of the weak trend in the domestic economy. The shortfalls were surprisingly high in trade tax.

In *wage tax*, receipts have been rather lower so far this year than in the same period last year (-0.4%); without child allowances, which are paid out of wage tax revenue, there is a slight increase (0.5%). In view of the Tax Reform Programme 2000 – which is expected to cause a reduction in revenue of an estimated DM 24 billion for the year as a whole – a weaker trend had originally been expected. If the reductions in revenues from the reform measures have so far been less than expected this is probably mainly due to the fact that employees, wherever possible, have asked their employers to hold back payment of flexible wage and salary components until the beginning of this year, so that they will be subject to the lower tax rates. For the remainder of the year it is assumed that the effects of the tax reform measures will have a stronger impact on revenues. Altogether revenues of DM 259 billion are expected (-2.4%). This is DM 1.5 billion more than forecast by the 'Arbeitskreis Steuerschätzungen' (Working Group on Tax Estimates for the German Government) in May 2001. Next year the progression in the tax rates will again be reflected in wage tax revenues, even taking into account the increases in child allowances. All in all, revenues of just under DM 269 billion are expected, a year-on-year rise of 3.5% (cf. table 2).

The very strong reduction in *profit-oriented taxes*⁶ – 22% in the first seven months of this year over the same period last year – must also be seen primarily in connection with the tax reform measures. But lower profits in 1999 also played a part, leading to lower subsequent payments. In view of the disappointing cyclical trend

the fall in revenues from profit taxes should actually have been greater, for generally companies rapidly adjust their tax prepayments to changing economic conditions.

Revenues from *assessed income tax* in west Germany fell by 62% up to July. However, that is only in very small part due to the tax reform measures, the real reason being that some of the payments made out of income tax revenue – the home ownership grant, the reimbursements by the Federal Tax Office and the investment grants – rose extraordinarily strongly (cf. table 3). But reimbursements to employees (§ 46 Income Tax Law) that are paid out of income tax revenues were hardly higher than in the previous year. Adjusted for these factors income tax fell by only 6%. As well as the effects of the tax reform measures this also reflects lower subsequent payments for periods previously assessed. For the rest of this year it is assumed that the negative effects on revenue will become less important. That applies particularly to the home ownership grant, which is paid in March for all building promotion age groups. All in all, assessed income tax revenue is expected to fall by 25% in 2001, but next year the tax authorities can expect strong growth in this item (16%). However, this will be due less to rising profits than the broader assessment bases from changes in the legislation in past years.

In east Germany the revenues from assessed income tax are still not sufficient to cover the investment and home ownership grants and the reimbursements to employees (§ 46 Income Tax Law). On the contrary, the shortfalls have grown from year to year ever since 1991. In the first seven months of this year they amounted to DM 4.6 billion. Assuming that the trend in prepayments and subsequent payments hardly changes for the rest of this year, a shortfall in revenues of DM 6.3 billion is expected for 2001. Next year this should fall to DM 5.4 billion, as an increase in revenues is likely from the changes to the tax laws and better earnings.

Revenue from corporation tax virtually collapsed in west Germany in the first seven months of this year, falling by 92%. This was due firstly to reductions under the tax laws, which are estimated at DM 14 billion (annualised) for 2001. In addition, as retained and distributed profits are now taxed at the same rate, many companies are now returning to income and paying out to shareholders profits that were earlier allocated to the reserves when they were taxed at 45% under the EK45 law. This has led to high reimbursement payments on corporation tax. As distributed profits were formerly taxed at 30% companies can claim 15 percentage points back. Any retained profits taxed at 45% that are not distributed by the end of 2001 have to be converted to EK40 items in the end-of-year balance sheets. In 2002

⁵ Economic Trends 2001/2002, ed. DIW Business Cycle Study Group, in: *Economic Bulletin*, vol. 38, no. 8, August 2001.

⁶ Assessed income tax, fixed taxes on profits, corporation tax, interest discount tax.

Table 2

Tax Revenue in Germany 2000 to 2002

	West Germany ¹			East Germany ²			Total			West Germany ¹		East Germany ²		Total	
	2000	2001	2002	2000	2001	2002	2000	2001	2002	2001	2002	2001	2002	2001	2002
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Estimated					
	DM billion						% change on the previous year								
Joint taxes	.	.	.	.	.	.	651.8	619.0	639.7	.	.	.	.	-5.0	3.3
Wage tax ³	246.7	241.0	249.9	18.8	18.0	18.6	265.5	259.0	268.5	-2.3	3.7	-4.3	3.3	-2.4	3.7
Assessed income tax ³	29.3	22.0	25.5	-5.4	-6.3	-5.4	23.9	15.7	20.1	-24.8	15.9	.	.	-34.3	28.0
Non-assessed taxes on profits ⁴	25.7	37.5	22.0	0.8	1.0	0.7	26.4	38.5	22.7	46.2	-41.3	22.1	-31.6	45.5	-41.1
Tax on interest income ⁵	14.0	17.0	17.5	0.3	0.5	0.5	14.3	17.5	18.0	21.4	2.9	30.4	4.4	21.7	3.0
Corporation tax ⁴	45.4	15.0	28.0	0.7	-1.6	-1.0	46.1	13.4	27.0	-66.9	86.7	.	.	-70.9	101.5
Taxes on turnover ⁶	.	.	.	.	.	.	275.5	275.0	283.5	.	.	.	.	-0.2	3.1
Customs duty	.	.	.	.	.	.	6.6	6.6	6.5	.	.	.	.	-0.6	-1.5
Federal taxes	.	.	.	.	.	.	147.8	154.1	161.7	.	.	.	.	4.2	4.9
Petroleum tax	.	.	.	.	.	.	74.0	79.0	84.3	.	.	.	.	6.8	6.7
Electricity tax	.	.	.	.	.	.	6.6	7.9	9.2	.	.	.	.	19.7	16.5
Tobacco tax	.	.	.	.	.	.	22.4	23.2	23.4	.	.	.	.	3.6	0.9
Spirits tax	.	.	.	.	.	.	4.2	4.2	4.1	.	.	.	.	0.0	-2.4
Insurance tax	.	.	.	.	.	.	14.2	14.7	14.9	.	.	.	.	3.5	1.4
Solidarity supplement (on income taxes)	.	.	.	.	.	.	23.2	22.0	22.7	.	.	.	.	-5.2	3.2
Other	.	.	.	.	.	.	3.2	3.1	3.1	.	.	.	.	-3.7	-0.6
State taxes	31.9	34.2	33.7	4.1	4.2	4.1	36.1	38.4	37.8	7.0	-1.3	2.3	-2.8	6.4	-1.5
Vehicle tax	11.7	14.2	13.5	2.0	2.3	2.2	13.7	16.5	15.7	21.2	-4.9	15.0	-6.5	20.3	-5.2
Inheritance tax	5.8	5.8	6.1	0.1	0.1	0.1	5.8	5.9	6.2	0.9	5.2	.	.	0.9	5.1
Real estate purchase tax	8.6	8.5	8.6	1.3	1.1	1.1	9.9	9.6	9.7	-1.6	1.2	-15.6	1.8	-3.4	1.3
Other	5.8	5.7	5.5	0.8	0.8	0.8	6.6	6.4	6.3	-2.8	-2.6	-0.4	1.3	-2.6	-2.2
Local government taxes	65.4	62.2	69.0	6.3	6.1	7.0	71.8	68.3	76.0	-4.9	10.9	-4.1	14.9	-4.8	11.3
Trade tax	49.0	45.4	51.8	3.9	3.5	4.3	52.9	48.9	56.1	-7.3	14.1	-9.2	22.9	-7.5	14.7
Real estate tax	15.0	15.4	15.8	2.3	2.4	2.5	17.4	17.8	18.3	2.4	2.6	3.8	4.1	2.6	2.8
Other	1.4	1.4	1.4	0.2	0.2	0.2	1.5	1.6	1.6	1.4	0.7	3.3	3.2	1.6	1.0
Total tax revenues	.	.	.	.	.	.	914.1	886.4	921.7	.	.	.	.	-3.0	4.0
Financial statistics definition ⁷	.	.	.	.	.	.	874.2	848.7	879.3	.	.	.	.	.	.
of which:															
Central government ^{8,9,10}	.	.	.	.	.	.	428.5	420.9	432.2	.	.	.	.	-1.8	2.7
State government ^{8,10,11,13}	294.2	282.6	291.2	50.1	48.3	50.8	344.3	330.9	342.0	-4.0	3.1	-3.5	5.1	-3.9	3.4
Local government ^{12,13}	93.5	89.4	96.7	8.0	7.5	8.5	101.5	96.9	105.2	-4.4	8.2	-5.8	12.5	-4.5	8.5
Memo item: EU shares ¹⁴	.	.	.	.	.	.	42.7	40.6	45.3	.	.	.	.	-4.9	11.5

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: central government 5.63%; of the remainder local government initially receives 2.2%, the remainder being divided as follows: 50.25% central government, states 49.75%; from 2002 onwards: central 49.65%, states 50.35% 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 EU VAT own resources and EU GNP own resources deducted. — 10 Incl. trading tax levy. Distribution ratio: central government: 19/45; state government: 26/45. — 11 Incl. community tax of the city states. — 12 Excl. community tax of the city states and after deduction of the trading tax levy. — 13 Incl. participation of west German local authorities in German Unity Fund via the increase in the trading tax levy on west German state governments. — 14 EU VAT own resources, EU GNP own resources, EU customs duties. — Columns may not sum due to rounding.

Sources: Federal Ministry of Finance; DIW Berlin estimates.

the amount claimed on prepaid corporation tax will fall from 15 percentage points to 10 percentage points, so companies have an incentive to return retained profits to income this year. The effect of the extra distributions to shareholders is expected to diminish as this year goes

on, but the changes in the tax legislation will continue to reduce the revenues at the same rate. Altogether revenues from corporation tax are expected to be two thirds below the previous year's level. Next year there will no longer be an incentive to make special dividend pay-

Table 3
Income Tax Revenues from January to July 2000 and 2001

	West Germany			East Germany			Germany		
	2000	2001	Change as %	2000	2001	Change as %	2000	2001	Change as %
	DM million			DM million			DM million		
Revenues	9 236	3 541	-61.7	-4 248	-4 846	.	4 988	-1 305	.
+ Investment grant	97	208	113.8	494	760	53.9	591	968	63.8
+ Reimbursements (§ 46 ITLaw)	22 701	23 093	1.7	3 480	3 344	-3.9	26 181	26 437	1.0
+ Home ownership grant	9 656	11 827	22.5	2 314	2 738	18.3	11 970	14 566	21.7
+ Reimbursements by the Federal Tax Office	799	1 306	63.3	-	-	-	799	1 306	63.3
Gross revenues	42 490	39 975	-5.9	2 040	1 996	-2.2	44 530	41 971	-5.7

Sources: Federal Ministry of Finance; DIW Berlin calculations.

ments, and for this reason alone there should be a clear rise in revenues. The prepayments for the year 2002 should also be rather higher. However, another fall is to be expected in subsequent payments for previously assessed years. Altogether revenues from corporation tax are expected to be DM 28 billion, a rise of 87%.

In east Germany corporation tax revenues were DM 800 million in deficit again in the period up to July, for the first time since 1997. That is, gross revenues were not sufficient to cover the investment grants, which expanded at an extremely dynamic rate of 54% owing to the Investment Grant Law of 1999, and the reimbursements by the Federal Tax Office (cf. table 4). Adjusted for these payments revenues were positive, at just under +DM 800 million, although this is 44% below the corresponding result for the previous year. The fall mainly reflects the effects of corporate tax reform. Taking the year as a whole, corporation tax revenues in east Germany are expected to show a shortfall of DM 1.6 billion.

There will be a shortfall next year, too, but at DM 1 billion this will be very much lower. The assumed improvement in companies' earnings position will contribute very little to this, the main reason here too being the broadening of the assessment basis in recent years.

The distributed profits that have caused heavy reductions in corporation tax revenues are correspondingly reflected in *non-assessed taxes on earnings*, which rose by 63% up to July. Even taking into account the reimbursements by the Federal Tax Office (+43%) the rise in gross revenues was only slightly lower (at 60%). For the rest of this year the special 'EK 45' factor should become less important; nevertheless, a strong rise is to be expected for 2001 as a whole at 46%. Next year this special effect will cease to apply, so a greater reduction in revenues is to be expected (-41%).

The development in *taxes on turnover* contradicts the macroeconomic trend to a certain extent. While domestic demand rose during the first half of the year

Table 4
Corporation Tax Revenues from January to July 2000 and 2001

	West Germany			East Germany			Germany		
	2000	2001	Change as %	2000	2001	Change as %	2000	2001	Change as %
	DM million			DM million			DM million		
Revenues	23 874	1 807	-92.4	684	-815	.	24 557	992	-96.0
+ Investment grant	164	226	37.4	581	1 509	159.9	745	1 734	132.9
+ Reimbursements by the Federal Tax Office	2 050	2 826	37.8	122	91	-25.9	2 172	2 917	34.3
Gross revenues	26 088	4 859	-81.4	1 386	784	-43.5	27 475	5 643	-79.5

Sources: Federal Ministry of Finance; DIW Berlin calculations.

by 1.3%, revenues from turnover tax, which flow into the public budgets with a timelag of one month, fell by 1.2% up to July. April and June brought particularly heavy shortfalls of -5.5% and -6.8% respectively. This could be mainly due to the fact that companies offset larger amounts from their tax prepayments. For the prognosis it is assumed that the revenues from turnover taxes will adapt to the trend in tax assessment bases in the next few months. For the year as a whole this means that revenues will be about on the previous year's level. Next year these revenues will expand at about the same rate as domestic demand (3.1%), in keeping with the expected cyclical recovery.

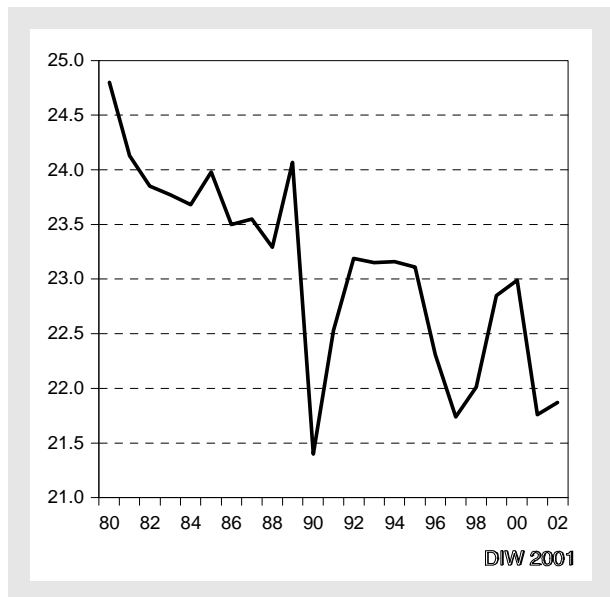
Pure federal taxes increased by 4.4% by July, mainly because the tax rates for petroleum and electricity were raised as part of the ecological tax reform. But this trend is dampened by the solidarity supplement, revenues from which fell following the income and corporation tax reform measures. All in all it is to be expected that revenues from pure federal taxes will rise by 4.1% this year. Next year the rise should be rather greater at 4.9%, firstly because petroleum tax and electricity tax will be increased again as part of the ecological tax reform, and secondly because owing to the rising trend in incomes higher revenues are also to be expected from the solidarity supplement.

The year 2001 should see a clear rise (6.4%) in *state taxes*. This increase is exclusively due to the additional revenues from vehicle tax following the 1997 reform package, in which the tax rates for more pollutive vehicles were raised drastically on 1 January 2001. Next year, however, less revenue from vehicle tax is likely (-5.2%) because more high-emission vehicles are being taken out of service and replaced by vehicles with lower emissions.⁷ Vehicles are tax-free up to a maximum of DM 600. On balance state taxes should fall by nearly 2% in 2000.

In *revenues from local government taxes* a much stronger fall is becoming evident this year than had originally been expected. Trade tax is the most important source of tax revenue to the local governments, and here inflows have almost ceased in east and in west Germany, especially in the second quarter. Prepayments declined strongly in the second quarter, after still being slightly above the previous year's level in the first quarter. Moreover, payments for years assessed earlier have also declined strongly since the first quarter. Against that background it must be expected that revenues from

⁷ Vehicle tax on vehicles that meet the Euro 4 norm is DM 10 (petrol) and DM 27 (diesel) per 100 ccm. Tax is only charged when max. DM 600 or DM 1 200 is reached. But high-emission vehicles have been charged at DM 49.60 (petrol) and DM 73.50 (diesel) per 100 ccm from 1 January 2001.

Figure 1
Tax Ratio in the Economy as a Whole in
Germany 1980 to 2002
in % of nominal GDP



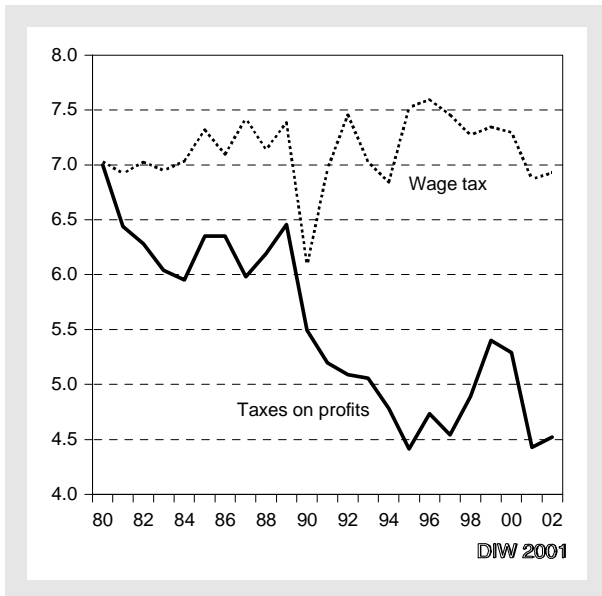
Sources: Federal Ministry of Finance; calculations and estimates by DIW Berlin.

trade tax will be 7.5% below the previous year's level in 2001. This means a fall of just under 5% in total tax revenues to the local governments. However, a clear rise is again expected for 2002 (11.3%). This is on the assumption that revenues from trade tax will increase strongly, because here, too, measures to widen the assessment basis will be taking effect, and they should bring an increase in revenues of DM 4.5 billion.

According to the estimate presented here, tax revenues for the central government, the states, the local governments and the EU should be 3% lower this year, mainly owing to the effects of the income and corporation tax reform measures. That means aggregate tax revenue of DM 886.4 billion. Compared with the prognosis by the Working Group on Tax Estimates of May this year the calculation is for revenues to fall by just under DM 5 billion. Next year tax revenues will rise again, by an estimated 4%, that is, slightly overproportionately to nominal macroeconomic development.

The Tax Reform 2000 Programme has greatly reduced the burden on taxpayers. The tax ratio in the economy as a whole – tax revenues as a percentage of nominal GDP – will fall to one of the lowest levels in the last twenty years this year at 21.8% (cf. figure 1). The tax ratio was nearly 25% in 1980. Next year it will rise again, but probably not beyond the 22% mark. Figure 2 shows that the share of wage tax in GDP is still almost on the same level as in 1980, at 7%. The share of taxes

Figure 2
Taxes on Earnings and Wage Tax in Germany
 in % of nominal GDP



1 Wage tax before deduction of child allowances from 1996, plus share of solidarity supplement, minus reimbursements to employees (§ 46 Income Tax Law), minus home ownership grant. — 2 Income tax plus reimbursements to employees (§ 46 Income Tax Law), plus home ownership grant, plus share of solidarity supplement, corporation tax, non-assessed taxes on profits, interest discount, property tax and trade tax.
 Sources: Federal Statistical Office; Federal Ministry of Finance; DIW Berlin calculations and estimates.

on profits, on the other hand, has fallen drastically, from 7% in 1980 to 4.5% in 2001/2002.

The development in expenditures in 2001/2002

The moderate trend in expenditures will continue at every budget level (cf. table 5). The wage agreements negotiated in the public service will make an essential contribution to this. This year wage increases will be 1.6%, and in 2002 they are expected to be only slightly higher; the current wage agreements run until 31 October 2002.

Despite the moderate wage agreements in recent years there have been huge job reductions in the public service. The number employed by the Federal Government has fallen by 100 000 since 1993 and is now 500 000; that corresponds to a fall of 17% or a good 2% a year. However, the reduction in the size of the Bundeswehr (the German armed forces) by 45 000 professional soldiers and short-term recruits accounts for a large part of this. Now the personnel restructuring in the armed forces is quantitatively of little weight, and the fall in the number employed by the Federal Government

should come to rest at a level of 1% a year. The staff reductions by the state governments should be of similar size. Here the number employed has fallen by 230 000 since 1993, that is just under 1% a year, and is now 2.28 million. Some of this reduction is due to the change in the legal status of some facilities, such as university clinics, that have become independent. This has played an even greater part for municipal employers, and at local government level the number employed has fallen by 380 000 to 1.5 million, that is by nearly 3% a year. The east German municipalities have cut an especially large number of jobs. Nevertheless, there is still overmanning there, and the trend is not likely to lessen.

In the west German state budgets particularly, the growing weight of pension payments to former officials must be taken into account. These payments are not made out of pension insurance funds but directly from the states' budgets. As a consequence of the expansionary employment policy in the 1960s and 1970s the number of pensioners is growing strongly. Altogether in 2001 and 2002 personnel expenditures are expected to rise for all three levels of government by just under 1% each.

Current expenditure on fixed assets and materials is also expected to grow at only a moderate rate of just under 2% each year. Short-term economies are not possible in some of these items, such as rent and leasing. An above-average rise of 4% is earmarked in the Federal budget for military procurements this year; next year this expenditure should stagnate. In accordance with the new state budget system that came into force in 2001, grants for current purposes that have until now been entered as expenditure on fixed assets and materials are now treated as current transfers to firms. While this change in the accounting system was already taken into account in the Federal budget for 2001, it is only being put into practice very slowly by the states; hence the estimates here are based on the old definitions.⁸ As a result of the new system, expenditure on fixed assets and materials will fall this year (unadjusted).

The trend in current transfer payments depends largely on the grants from the Federal Government to the social insurance institutions, which are expected to grow from DM 140 billion in 2000 to a good DM 150 billion in 2002, that is by just under 5% or 3%. The general federal grant to the pension insurance institutions is measured by the rise in gross wages per person employed in the past year and the change in the contribution rate.⁹

⁸ Mainly grants by the Federal Government to Post Office Pension Funds.

⁹ Based on what the contribution rate would be without the federal grant.

Table 5
Revenue and Expenditure of German Central, State and Local Government¹

	Central government ^{2,3}			Special assets ⁴			State government ²						Local government						Total		
							West Germany ⁵			East Germany			West Germany			East Germany					
	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
in DM billion																					
Revenue	570.9	473.7	481.1	36.8	47.1	42.3	385.7	374.1	384.2	98.1	96.1	98.6	237.8	231.6	238.0	49.8	48.6	50.1	1154.8	1056.1	1073.1
Taxes	428.4	420.7	432.1	0.1	0.1	0.1	294.8	283.2	292.8	50.0	48.4	50.9	93.3	89.2	93.3	8.2	7.7	8.7	874.8	849.3	877.9
Transfers from other levels of government	5.5	5.6	5.6	20.3	15.4	20.2	46.6	45.7	44.8	33.1	32.6	32.2	68.8	66.6	68.3	32.5	31.9	32.2	-	-	-
Transfers from special assets	1.5	1.5	1.5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
State equalisation	-	-	-	-	-	-	8.8	8.7	9.1	7.2	7.1	7.3	-	-	-	-	-	-	-	-	-
Income from economic activities	10.4	10.2	10.0	-	-	-	7.6	7.8	8.0	0.9	0.9	1.0	12.7	12.5	12.6	2.3	2.3	2.3	33.9	33.7	33.9
Levies and charges	7.1	7.2	7.4	-	-	-	8.1	8.0	8.1	0.9	0.9	0.9	28.9	28.8	28.9	4.2	4.2	4.3	49.2	49.1	49.6
Sales of assets ⁶	9.9	17.0	13.0	5.3	5.3	-	2.9	3.5	3.8	0.1	0.2	0.2	11.3	11.5	11.7	2.2	2.1	2.2	31.7	39.6	30.9
Other sources	108.1 ⁷	11.5	11.5	11.1	26.3	22.0	16.9	17.2	17.6	5.9	6.0	6.1	22.8	23.0	23.2	0.4	0.4	0.4	165.2	84.4	80.8
Expenditure	518.3	517.9	525.4	40.1	39.4	38.7	400.3	405.1	407.2	103.7	103.3	103.9	234.9	236.6	238.8	49.6	49.6	49.9	1122.6	1136.7	1142.7
Personnel costs	51.9	52.2	52.6	15.2	15.0	14.7	156.9	158.8	160.8	26.6	26.6	26.7	62.5	63.2	64.0	14.8	14.7	14.6	327.9	330.5	333.4
Current material costs	40.7	31.6 ⁸	31.9	0.4	0.5	0.5	39.6	40.3	41.1	7.6	7.7	7.8	45.4	46.1	47.0	9.3	9.2	9.2	143.0	135.4	137.5
Interest payments	76.6	74.5	77.0	8.1	8.1	8.1	31.6	32.5	33.8	5.7	6.0	6.3	8.5	8.5	8.6	1.7	1.7	1.8	131.8	130.9	135.2
of which: to other levels of government	-	-	-	-	-	-	0.2	0.2	0.2	-	-	-	0.2	0.2	0.2	-	-	-	-	-	-
Current transfers to other levels of government	288.3	297.7	304.4	4.9	4.7	4.5	125.6	124.6	127.8	37.2	37.0	37.6	73.7	75.4	77.0	11.2	11.6	12.1	361.2	379.0	383.9
State equalisation	-	-	-	-	-	-	15.9	15.8	16.4	-	-	-	-	-	-	-	-	-	-	-	-
Special assets	20.1	15.2	20.0	-	-	-	0.2	0.2	0.2	-	-	-	-	-	-	-	-	-	-	-	-
Social insurance	139.9	146.5	150.5	-	-	-	0.5	0.5	0.5	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1	140.8	147.4	151.4
Income support	42.0	41.6	41.0	-	-	-	13.6	13.8	14.0	2.6	2.7	2.7	45.3	46.3	47.3	6.7	6.9	7.1	110.2	111.3	112.1
Firms	26.0	34.9 ⁸	34.5	3.2	3.0	2.8	20.0	20.3	20.5	5.1	5.0	5.0	5.5	5.6	5.8	1.9	2.0	2.1	61.7	70.8	70.7
Abroad	5.2	5.5	5.3	-	-	-	1.1	1.1	1.1	-	-	-	-	-	-	-	-	-	6.3	6.6	6.4
Social institutions	1.5	1.4	1.3	-	-	-	11.5	11.6	11.7	2.4	2.5	2.5	11.0	11.4	11.7	1.8	1.9	2.0	28.2	28.8	29.2
Other	2.6	2.6	2.5	0.2	0.2	0.2	4.5	4.5	4.4	1.7	1.7	1.7	4.5	4.6	4.7	0.5	0.5	0.6	14.0	14.1	14.1
Investment	13.2	13.6	12.7	-	-	-	11.7	11.0	10.6	4.3	4.2	4.1	37.2	36.0	35.0	10.9	10.7	10.5	77.3	75.5	72.9

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					
	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002	2000	2001	2002
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
Capital transfers to	38.1	39.0	37.8	0.4	0.4	0.4	29.3	28.5	27.8	20.4	20.0	19.6	4.2	4.1	4.0	1.5	1.5	1.5	51.5	52.5	51.6
Other levels of government	19.6	19.2	18.5	–	–	–	12.1	11.5	11.0	10.0	9.6	9.3	0.5	0.5	0.5	0.2	0.2	0.2	–	–	–
Special assets	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Abroad	0.6	0.6	0.6	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	0.6	0.6	0.6
Other	17.9	19.2	18.7	0.4	0.4	0.4	17.2	17.0	16.8	10.4	10.4	10.3	3.7	3.6	3.5	1.3	1.3	1.3	50.9	51.9	51.0
Loans and shares	9.5	9.3	9.0	11.1	10.7	10.5	5.6	9.4	5.3	1.9	1.8	1.8	3.4	3.3	3.2	0.2	0.2	0.2	29.9	32.9	28.2
of which: to other levels of government	0.4	0.4	0.4	–	–	–	1.4	1.4	1.4	–	–	–	–	–	–	–	–	–	–	–	–
Financial balance	52.6	–44.2	–44.3	–3.3	7.7	3.6	–14.6	–31.0	–23.0	–5.6	–7.2	–5.3	2.9	–5.0	–0.8	0.2	–1.0	0.2	32.2	–80.6	–69.6
	% change on the previous year																				
Revenue	26.1	–17.0	1.6	–33.8	28.0	–10.2	1.9	–3.0	2.7	0.9	–2.0	2.6	1.0	–2.6	2.8	–2.0	–2.4	3.1	8.2	–8.5	1.6
Taxes	10.3	–1.8	2.7	–	0.0	0.0	–0.8	–3.9	3.4	–22.0	–3.2	5.2	1.9	–4.4	4.6	0.0	–6.1	13.0	3.0	–2.9	3.4
Expenditure	2.8	–0.1	1.4	–10.9	–1.7	–1.8	2.2	1.2	0.5	0.6	–0.4	0.6	1.9	0.7	0.9	–3.1	0.0	0.6	0.0	1.3	0.5
Personnel costs	–1.5	0.6	0.8	–1.9	–1.3	–2.0	1.0	1.2	1.3	–0.4	0.0	0.4	1.3	1.1	1.3	–2.6	–0.7	–0.7	0.2	0.8	0.9
Current material costs	1.8	⁸	0.9	–55.6	25.0	0.0	4.5	1.8	2.0	–5.0	1.3	1.3	2.7	1.5	2.0	–3.1	–1.1	0.0	1.7	–5.3	1.6
Interest payments	–4.7	–2.7	3.4	–3.6	0.0	0.0	–0.6	2.8	4.0	1.8	5.3	5.0	–3.4	0.0	1.2	0.0	0.0	5.9	–3.2	–0.7	3.3
Current transfers to	5.3	⁸	2.3	–31.9	–4.1	–4.3	3.2	–0.8	2.6	3.9	–0.5	1.6	3.5	2.3	2.1	3.7	3.6	4.3	–0.3	4.9	1.3
Other levels of government	.	–2.0	–1.4	–46.4	0.0	0.0	3.9	–2.6	3.9	3.3	–1.2	2.4	4.3	1.4	0.0	–33.3	0.0	0.0	–	–	–
Social insurance	–0.1	4.7	2.7	–	–	–	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–1.2	4.7	2.7
Income support	–11.6	–1.0	–1.4	–	–	–	–3.5	1.5	1.4	–46.9	3.8	0.0	1.8	2.2	2.2	3.1	3.0	2.9	–6.5	1.0	0.7
Firms	–1.5	⁸	–1.1	22.1	–6.2	–6.7	7.0	1.5	1.0	–	–2.0	0.0	7.8	1.8	3.6	0.0	5.3	5.0	12.8	14.7	–0.1
Investment	–5.0	3.0	–6.6	–	–	–	4.5	–6.0	–3.6	0.0	–2.3	–2.4	2.2	–3.2	–2.8	–9.2	–1.8	–1.9	–0.6	–2.3	–3.4
Capital transfers	9.2	2.4	–3.1	–69.2	0.0	0.0	3.2	–2.7	–2.5	–4.2	–2.0	–2.0	0.0	–2.4	–2.4	–6.2	0.0	0.0	4.5	1.9	–1.7
Loans and shares	13.1	–2.1	–3.2	–5.1	–3.6	–1.9	7.7	67.9	–43.6	35.7	–5.3	0.0	–17.1	–2.9	–3.0	–33.3	0.0	0.0	2.7	10.0	–14.3

1 By financial-statistical definition, excl. hospitals with their own accounting system. — 2 Supplementary transfers to financially weak states and transfers of petroleum tax within the regionalisation of short-distance passenger traffic subtracted from central, added to state governments. — 3 The transfer of Bundesbank profits has been recorded in full as federal government revenue; the difference from DM 7 billion has been recorded as a federal government transfer to the Erblastentilgungsfonds. — 4 Cf. table 6. — 5 Incl. Berlin. — 6 Real assets and shareholdings. — 7 Incl. UMTS licences (DM billion 99.2). — 8 Not comparable with the previous year owing to changes in classifications. — Columns may not sum due to rounding.

Sources: Federal Statistical Office; DIW Berlin estimates.

This year the rate will fall from 19.3% to 19.1%. Contrary to the political intention, there will probably be no scope for reductions in the contribution rates next year. As well as the general grant, the Federal Government also makes payments funded by the increase in turnover tax on 1 April 1998 and adjusted by the rate of change in turnover tax revenues. In addition, the revenues from eco tax are used to fund the reduction in the contribution rate to pension insurance. As a result of the less optimistic cyclical outlook and the deterioration in labour market prospects, the grant earmarked for the Federal Labour Office will not suffice to cover its deficit this year. Instead of DM 1.2 billion, DM 5.5 billion will probably have to be transferred from the Federal budget. For next year DIW Berlin is expecting a cyclical recovery, in which case much lower grants (DM 1.5 billion) would suffice to cover the deficit.

However, the social benefits funded directly out of the public budgets should grow only slightly. The fall in expenditures for war victims and unemployment assistance will play a part here. But housing and education allowances will rise, because these benefits were increased at the beginning of this year. Next year child allowances for the first and second child will rise to DM 300 each. However, that will not be reflected in the transfer payments but in revenues from wage tax, as child allowances are deducted from this tax.¹⁰ As in past years, social assistance, which is paid by the local governments, is expected to rise at only a moderate rate of around 2%. The main reasons for this were and still are the various activities to reintegrate unemployed recipients of social assistance in the labour market ('jobs not social assistance'), and capped regular rates, as well as lower spending on hospital care following the expansion of home care services. On balance the rise in current transfer payments is estimated at 5% and 1%, respectively, for 2001 and 2002.

In interest expenditures another fall (-1%) can be expected this year. This is due to the fact that the revenues from the UMTS licences auctions were used to pay off debt. A small part is probably due to the restructuring of debt management; a special finance agency was set up last year to improve federal debt management. The rise in interest expenditure will also be reduced by the higher Bundesbank profit, which is also used to pay off debt. Next year interest expenditures are expected to rise by 3.5%, that is to say at an above-average rate.

¹⁰ Since 1996 the option has been available of either paying child allowances in cash or through the employer, and granting a free child allowance on income tax. As part of the annual wage tax review or the income tax assessment the Tax Office is currently examining which method will be better for the taxpayer. In the financial statistics, unlike the national accounts, child benefits are offset directly from wage tax revenues, that is, they are entered net.

Public investment in material and fixed assets – buildings and equipment – will fall again, by 2% and 3% respectively. The scope for investment is being restricted mainly by the fall in tax revenues due to the tax reform and the cyclical slowdown. This applies less to the central and state governments than to the local governments, who are the main investors among the public authorities. Many municipal budgets are 'underfunded', that is, they do not have enough funds to engage in investment. But their scope for borrowing is also tied to these funds, for the local governments can only finance their investment on the capital market if their 'ability to pay' is assured, and the municipal supervisory authorities assess this by the tax revenues. At federal level the downward trend is lessened by the Future Investment Programme, which is funded from the savings on interest expenditures from debt repayment. It is used mainly to build up investment in the railways, roads, universities and vocational training; an important part of these funds are not direct investment expenditures by the Federal Government, but transfers of assets to third parties. Nevertheless, here, too, a downward trend is to be feared next year, especially in investment in fixed assets and equipment.

According to the estimate presented here the public authorities will increase their expenditures by just under 1% both this year and next; last year expenditures almost stagnated.

The development by budget levels

Although expenditures are rising only slightly, the budget deficits for the central, state and local governments will shoot up this year, possibly to a good DM 80 billion. The reasons for this are the tax cuts and the loss of tax revenue due to the cyclical slowdown. Next year the budget deficits should fall to DM 70 billion, while expenditures will again grow only very slightly.

In today's view the *Federal Government* will achieve its aim of bringing its deficit down to DM 44 billion in 2001, although beside the loss of tax revenue due to cyclical causes higher grants to the Federal Labour Office will also have an effect. Next year the deficit will be of the same order; the figure in the draft budget is lower at DM 41 billion. In both this year and next the Federal Government can expect large receipts from privatisation. The estimates for sales of fixed assets and shares are DM 17 billion and DM 13 billion, respectively. These receipts are to be used mainly to cover the growing deficits of the Post Office Pension Fund; federal grants to this institution amount to just under DM 10 billion.¹¹

Table 6

Revenue and Expenditure of the Central Government Special Assets (*Sondervermögen*)

	German Unity Fund			Railway assets			Inherited-debt management fund			Other funds ¹			Total		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
DM billion															
Revenue	6.5	6.5	6.5	18.4	18.0	17.5	2.6	9.3	5.0	9.3	13.3	13.3	36.8	47.1	42.3
Para-fiscal charges	–	–	–	–	–	–	–	–	–	0.1	0.1	0.1	0.1	0.1	0.1
Transfers from other levels of government	6.5	6.5	6.5	12.7	8.7	13.5	0.9	–	–	0.2	0.2	0.2	20.3	15.4	20.2
Sales of assets	–	–	–	5.3	5.3	–	–	–	–	–	–	–	5.3	5.3	–
Other sources ⁴	–	–	–	0.4	4.0	4.0	1.7	9.3	5.0	9.0	13.0	13.0	11.1	26.3	22.0
Expenditure	5.7	5.8	5.8	18.4	18.0	17.5	1.7	1.7	1.7	14.3	13.9	13.7	40.1	39.4	38.7
Personnel costs	–	–	–	15.2	15.0	14.7	–	–	–	–	–	–	15.2	15.0	14.7
Current material costs	–0.1	–	–	0.3	0.3	0.3	0.2	0.2	0.2	–	–	–	0.4	0.5	0.5
Interest payments	5.8	5.8	5.8	–	–	–	–	–	–	2.3	2.3	2.3	8.1	8.1	8.1
Current transfers to	–	–	–	2.9	2.7	2.5	1.5	1.5	1.5	0.5	0.5	0.5	4.9	4.7	4.5
Other levels of government	–	–	–	–	–	–	1.5	1.5	1.5	–	–	–	1.5	1.5	1.5
Social insurance	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Pensions, allowances	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Firms	–	–	–	2.9	2.7	2.5	–	–	–	0.3	0.3	0.3	3.2	3.0	2.8
Other	–	–	–	–	–	–	–	–	–	0.2	0.2	0.2	0.2	0.2	0.2
Capital transfers	–	–	–	–	–	–	–	–	–	0.4	0.4	0.4	0.4	0.4	0.4
Loans and shares	–	–	–	–	–	–	–	–	–	11.1	10.7	10.5	11.1	10.7	10.5
Net effect	0.8	0.7	0.7	0.0	0.0	0.0	0.9	7.6	3.3	–5.0	–0.6	–0.4	–3.3	7.7	3.6

1 ERP, LAF, compensation fund, coal industry fund. — 2 Including the additional receipts out of Bundesbank profits. — 3 Since 1999 interest payments have come directly out of the central government budget. — 4 In the case of the European Recovery Programme including income from loans and the repayment of loans. — 5 Surpluses are used to repay principal.

Sources: Federal Statistical Office; DIW Berlin estimates.

On the expenditures side there will be an improvement, especially as the supplementary payments by the Federal Government to the financially weak west German *Länder* will decline, as will payments to the special assets; the latter will grow again next year. These fluctuations are the result of the Federal Railways Fund's need for finance¹²; this year receipts of a good DM 5 billion should accrue from the sale of railway housing companies, so reducing the Fund's deficit and requiring lower federal grants. Next year, on the other hand, there will be hardly any receipts from privatisation, so that the Federal Government will have additional expendi-

ture to cover the Railways Fund's deficit. As there are higher unemployment insurance deficits, federal grants to the social insurance institutions will rise at an over-proportionate rate this year (just under 5%), but next year the Federal Labour Office is expected to need only slight grants. This year the Federal Government increased its investive spending in connection with the receipts from the auctions of UMTS licences. Nevertheless, the budget forecast for this item is not likely to be realised. Next year, federal investment spending is actually expected to decline. As in previous years, interest expenditure should be notably below the figures in the federal budget plan.

The financial situation for the *Federal Government Special Assets* will improve, after a deficit that had to be tolerated last year. The main reason for that was the strong fall in the Bundesbank profit, of which any amount above DM 7 billion flows not into the Federal

¹¹ As more post office staff retire the cost of post office pensions grows; at the same time the contributions paid to the successor institutions to the Post Office are falling.

¹² The tasks of the Federal Railways Fund include meeting some of the expenditure on personnel and pensions for railway staff, and utilising property not needed for operations.

budget but directly to the Fund for the Repayment of Inherited Debts to pay off debt. This year the Bundesbank transferred DM 16.3 billion, so that debt amounting to DM 9 billion could be paid off. For 2002 the Bundesbank profit is expected to be DM 12 billion, which means DM 5 billion can be used to pay off debt. Altogether the special assets should close the year with surpluses of DM 8 billion and just under 4 billion.

The *west German states* will have to carry a drastic rise in their deficits this year, from just under DM 15 billion to DM 31 billion, after their financial situation had gradually improved as tax revenues rose again and expenditures grew at only a moderate rate. The loss of revenues to the west German states from the tax cuts alone is expected to be DM 17 billion; then there are the tax losses from the cyclical downturn. However, the west German states evidently built up reserves last year to finance the tax reform, and according to their budget plans reserves totalling DM 7 billion are to be returned to income this year.¹³ Admittedly, this is a one-off process, and it is not taken into account in this calculation,¹⁴ particularly as it will be partly offset by a permanent loss of revenues. Next year the west German states' aggregate deficit should fall to DM 23 billion while expenditures almost stagnate.

If expenditures by the west German *Länder* do not rise even less than forecast this year (1.2%) this will be because the Bankgesellschaft Berlin, which is in financial difficulties, needs an allocation to its capital this year of DM 4 billion, and this is being entered as a 'shareholding' in Berlin.¹⁵ However, the moderate growth in expenditures is also due to the fact that the states are cutting back their transfers to the local governments under the financial equalisation regulations following their lower tax revenues. These transfer payments depend on the level of the states' tax revenues, and the actual amounts paid depend in the individual *Länder* on which taxes are included in the arrangement in the individual states, and how high the ratio (the 'association ratio') is set.

The *east German states* have also reduced their budget deficits in recent years. They are not so strongly affected by the reductions in tax revenues as the west German states and their deficits are only expected to

rise slightly this year, from DM 5.6 billion to DM 7 billion. Next year a slight fall can be expected, to a good DM 5 billion. On balance expenditures will hardly rise here either.

Any estimate of *local government finances* in both west and east Germany still encounters the problem that municipal facilities are being taken out of the core budgets and continue to operate as independent facilities or enterprises. This is certainly overstating the consolidation process on the expenditures side, but revenues are also affected, as receipts from fees and charges are being lost. After achieving surpluses in recent years the *west German local governments* are expected to close this year with a large deficit (DM -5 billion); a deficit is to be expected in 2002 as well, although it will be small at DM 1 billion. Part of the shortfalls in tax revenues will probably be made good by cutbacks in investment spending. The financial situation of the *east German local governments* will also deteriorate this year: they will have to accept a deficit of DM 1 billion. Next year, however, there could be a slight surplus. A reduction in employment is still urgently needed, for their staffing is still one fifth above the level in the west German municipalities. Again, declining investment expenditures are to be feared.

Fiscal policy considerations

This year the public authorities' budgets will act as a powerful stimulus to the economy as a whole. Relevant calculations show this will amount to 0.4 percentage points of GDP. The aggregate budget deficits of the central, state and local governments will rise from DM 62 billion to an estimated over DM 80 billion. For the economic cycle the tax cuts that have been brought forward this year - about DM 45 billion - have come at the right time. However, their macroeconomic effect will pale against the strong rise in oil prices that is absorbing far more private purchasing power than originally expected.¹⁶ The effects of the tax reform will also be greatly lessened by cutbacks on the expenditures side. As a result of the lower tax revenues following the tax reform the local governments in particular will face financial constraints, as in many cases they have no choice but to respond to the shortfall in revenues by reducing investment. Not only are their tax revenues falling; the transfer payments from the states are also falling because they are tied to the tax revenues.

The shortfalls in tax revenues are so great that a fall in investment expenditures must be expected next year,

¹³ Cf. Deutsche Bundesbank: Die Entwicklung der Länderfinanzen seit Mitte der neunziger Jahre, in: *Monthly Report* for June 2001, p. 74.

¹⁴ In this calculation the revenues and expenditures are compiled excluding special financing transactions, which include financial transactions to balance the budget beyond the period in question, mainly the allocation to reserves and their return to income, and borrowing and repayments.

¹⁵ Cf. Zuspitzung der Haushaltskrise in Berlin - Ohne Hilfen des Bundes droht Kollaps, ed. Dieter Vesper, in: *DIW Wochenbericht*, no. 25/2001.

¹⁶ Cf. Economic Trends 2001/2002, ed. DIW Business Cycle Study Group, in: *Economic Bulletin*, vol. 38, no. 8, August 2001.

too – although the Federal Government is using the interest payments saved through the UMTS receipts to increase its spending for the future – on research, education and transport infrastructure. However, it would be premature to conclude that this will have an expansionary effect on the economy as a whole, for the high level of spending by firms to acquire the mobile phone licences is limiting their scope for more investment. At the same time they have wider scope for depreciation that in turn will reduce the tax revenue for the Federal Government and the states – which in turn will reduce their scope for spending. All in all the central, state and local governments will probably have a restrictive influence on the economy as a whole: further tax cuts will not come into force, while on the expenditures side the consolidation course will be maintained.

DIW Berlin recently advised against bringing forward the tax cuts planned for 2003/2005,¹⁷ which many are demanding in view of the cyclical stagnation. There should only be recourse to such a step if there is a real threat of recession. In today's view that is rather unlikely; in fact a cyclical upswing is expected later this year. Nevertheless, the difficult financial conditions for the three levels of government must be taken into account, for the latest tax cuts are already causing them considerable problems. It would be easiest for the Federal Government to borrow to finance further tax cuts, but many states would find this very difficult, and the local governments even more so. A further decline in public investment activity would be the result.

The volume of investment by the public authorities has already fallen to a low that is giving cause for concern. A change can only be brought about by reform of the municipal financing system, for it is the local governments that bear the greatest share of infrastructure investment. Moreover, under municipal budget law, and as a result of the transfer payments practice of the states, they are forced to behave in a procyclical way. Local government finance should be reformed to make the municipalities financially more independent and give them a greater share of tax revenues. Evidently the idea of a municipal value creation tax as one option for reform has been dropped from policy. Another element in the trade tax system has been dropped with trade capital tax, and a revitalisation of trade tax is not a realistic option now. One possibility that remains is a higher share of turnover tax; at present the municipalities receive 2.2%.

A greater share of turnover tax would also have the advantage that tax revenues to the municipalities would fluctuate less strongly, for turnover taxes are less responsive to cyclical movements than income tax and

certainly trade tax. In view of the continued erosion of the local governments' revenues basis – there will be further tax cuts in 2003 and 2005 – and the decline in local authority investment activity in recent years, DIW Berlin regards a local government share of 5% of turnover tax as fully justified. That would provide additional revenues of DM 8.5 billion, which would enable public investment to be put back on to a higher path. Admittedly, this could only be done if the Federal Government and the states agreed on a 'fair' distribution of the burden, for the higher local government share would come at their expense. The revenue loss on federal and state level could be compensated by a rise in the rate of VAT or more borrowing. In view of the weak cyclical situation the second variant would be preferable in the short term.

More borrowing does not, at first glance, appear to accord with the European Stability and Growth Pact, but the extent of the additional indebtedness and the delay it would entail in meeting the deficit target would be of relatively minor weight. In any case, the impression is that the Federal Government is orienting to far too ambitious a stability programme, and that the planned rapid reduction in the deficit will limit the scope for action in a way that will put too strong a brake on the economy. Restriction of this kind will be harmful, particularly if the economy is in a weak phase. Then there is a risk that with the narrower macroeconomic base the deficit ratio will assume greater proportions than planned and push the need for action in fiscal policy in the wrong direction – namely towards steps to limit the deficit ratio.

But an 'arithmetically' higher deficit ratio will have to be tolerated for other reasons as well. There is also the need to increase the potential of the economy as a whole, and fiscal policy needs to make a contribution to this by widening the scope on the expenditures side of the public budgets. Higher public spending would help to strengthen growth, certainly if it were investive. And additional expenditure by the Federal Labour Office would prevent fiscal policy from strengthening the downswing if it were not compensated by cutbacks in spending on other items. But shortfalls in tax revenues due to cyclical causes must not be countered by red pencilling on the expenditures side. Hence the stability programme that the Federal Government has to present to the ECOFIN Council every year¹⁸ must be designed so as to enable fiscal policy to react more flexibly to changes in the macroeconomic constellation and enable

¹⁷ Cf. Economic Trends, loc. cit.

¹⁸ Under the regulations of the Stability and Growth Pact the euro states are obliged to present the ECOFIN Council with up to date stability programmes every year. The ECOFIN Council then makes a statement on these programmes.

higher deficits due to cyclical causes to be tolerated. It would only be consistent if the European Stability and Growth pact were interpreted as meaning that the concern is not the target of a balanced budget per se but the removal of structural disequilibria in the public budgets over the medium term.

The recent criticism from the European Commission of the development in the budget deficits in Germany comes at the wrong time. To follow this advice would jeopardise macroeconomic stability and might produce the opposite of what the European Commission has in mind. It is easier to consolidate public finances in a continued upswing than in a period of weak economic activity. But the criticism is not justified objectively either, for an important part of the large deficits is due to the cuts in taxation and contribution rates, which in turn will encourage a cyclical upswing and growth – in themselves these effects must be assumed to be much more marked than any possible effects on interest rates that could accrue from higher deficits.

In conclusion: in view of the unsatisfactory economic trend and the resultant consequences for the public budgets, the German stability programme needs to be revised. The very ambitious consolidation targets cannot be justified in the context of the macroeconomic situation; there is a danger that when the effects of the tax reform lessen the public budgets will prove too restrictive. We need, not short-term 'cyclical programmes' that could at most be a flash in the pan, but a long-term infrastructure offensive, and this requires a redistribution of finances to help the local governments. At the same time the efforts to redirect 'consumer' spending to investive spending must be intensified.

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