The Public Budgets in 2002/2003 – Shortfalls in Tax Revenues May Jeopardise the Economy's Course – Risk of Higher Deficits

Germany was only just able to avoid a corrective 'blue letter' from Brussels this spring, a warning from the European Commission that it seemed likely to come close to the limit for budget deficits laid down in the Maastricht Treaty. The European Commission appeared to think that the safety margin intended to ensure that no country runs an excessive budget deficit could not be maintained.[1] In fact, the aggregate deficit of the federal government, the federal states, the local authorities and the social insurance institutes as defined in the national accounts was only just under the reference figure of 3% of nominal gross domestic product (GDP) in 2001, at euro 56 billion or 2.7%. However, as defined in the financial statistics it was smaller, at just under euro 50 billion or 2.4%. This difference may be one reason why the gravity of the deficit trend last year was underestimated by the political decision-makers. Owing to the methodological differences between the financial statistics and the national accounts[2] it is not possible – if erroneous interpretations are to be avoided – to conclude from the level and development of the public budget deficit in the one system what the figure in the other will be (cf. table 1).

It is clear that the very ambitious deficit targets originally set by the federal government have not been met. In its Stability Programme of October 2000 the German government set itself a state deficit target of only 1.5% of GDP. One reason why this has not been achieved is the loss of tax revenues after the tax reform, which has evidently been greater than expected. Another reason is the shortfall in tax revenues and insurance contributions owing to the cyclical slowdown. Finally, the fact that expenditure by the statutory health insurance institutes has expanded strongly, at a far faster rate than the development in contributions, has also played a part.

For the first time in the history of Germany, revenue from corporation tax was negative in 2001. Not only were the rates of tax lowered in the context of corporate taxation reform, from 40% on retained earnings and 30% on distributed earnings to a uniform rate of 25%, causing enormous shortfalls; up to then the regulations in the corporation tax law on the treatment of retained earnings that are later distributed also played an important part. Up to 31 December 2001 joint stock companies were permitted to distribute previously retained earnings that had been shown in the balance sheet as taxed at 45% to shareholders as dividends and then to claim reimbursement of the difference between the rate of 45% tax paid on retained earnings and the rate of 30% payable on dividends. If the company decided not to distribute the earnings they were to be shown on the balance sheet at a tax rate of 40%. Companies made use of this possibility to a much greater extent than had been expected in 2001.

Beside the 'intended' effects of reform of corporate taxation the cyclical trend also played an important part. In many sectors, especially those that yield the most corporation tax, the recessionary trend in 2001 greatly compressed earnings and some companies suffered losses. Many companies had to revalue their assets as a result of the recession, both their fixed assets and investments and their intangible assets, and in some cases this involved very heavy write-downs that ate into earnings. As a result, companies rapidly adjusted their tax payments on account downwards.

The subdivision of the deficit into the figures for the three levels of government clearly shows that the financial situation deteriorated last year, for the federal states in particular. Their aggregate budget deficit escalated from a good euro 10 billion in 2000 to euro 27 billion (cf. table 2), in a more drastic rise than had ever been experienced. There was a clear differential between east and west Germany, with the deficit in the east increasing only slightly, to euro 3 billion, while the states in the

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[1] On the basis of evaluations by the European Commission and the Committee, under Article 109c of the Treaty the ECOFIN Council examines, as part of its multilateral supervision, whether the medium-term budget target set in the national Stability Programme provides for a safety margin that will ensure that no country runs an excessive deficit.

[2] Unlike the financial statistics, in which the actual expenditure by the state is booked when the payment is made, the national accounts include fictive items on the one side, while on the other pure financing transactions are excluded. Extensive transfers of this nature are necessary to maintain the character of the national accounts as covering all transactions relevant to the cycle at the point in time when assets and liabilities are incurred. For example, in the national accounts loans and shareholdings are not entered as transactions affecting revenue and expenditure, for they do not affect the state in its role as consumer, producer or investor. The differences for the social insurance institutes derive from different methods of calculating the social insurance contributions. The national accounts not only include the actual contributions – as do the financial statistics – but also include 'fictious' contributions derived from the macroeconomic context. For further detail see 'Entwicklung des Staatsdefizits im Jahre 1997 – Ein (notwendiger) Blick zurück' by Dieter Vesper, in: *Wochenbericht des DIW Berlin,* no. 25, 1996.

Table 1

The Trend in the Public Deficits as Shown in the National Accounts and the Financial Statistics

In euro million

	1996	1997	1998	1999	2000[1]	2001
Federal Government[2]						
Financial statistics	–33 907	–25 782	–16 756	–20 826	–25 466	–16 023
National Accounts	–34 540	–30 100	–35 260	–32 080	–24 030	–26 930
Federal States						
Financial statistics	–24 092	–19 895	–14 380	–9 713	–10 355	–26 812
National Accounts	–20 740	–21 950	–14 230	–8 940	–7 940	–25 600
Local Authorities						
Financial statistics	–3 373	–3 041	2 431	2 305	1 923	–3 955
National Accounts	–810	–20	4 270	4 900	4 530	–1 490
Social Insurance Institutes						
Financial statistics	5 229	4 524	4 134	5 707	1 760	–2 797
National Accounts	–6 620	1 080	2 690	5 510	660	–2 270
State total						
Financial statistics	–56 142	–44 193	–24 572	–22 529	–32 138	–49 588
National Accounts	–62 710	–50 990	–42 530	–30 610	–26 780	–56 290

1 Without UMTS receipts. — 2 Including special assets.
Sources: Federal Statistical Office; DIW Berlin calculations.

west (not including the city states) suffered a fourfold increase to nearly euro 17 billion. It had been expected that the tax reform package and the cyclical slowdown would result in a less favourable development in east Germany, but the result for 2001 shows considerable consolidation here, even allowing for the fact that the east German states are less strongly affected by the drop in tax revenues as their economies are not so strong and their tax revenues are in any case lower. The east German states have been on a consolidation course since 1996, and since that year they have succeeded in halving their budget deficits.

As well as the states, the local authorities also came under heavy financial pressure in 2001 after achieving surpluses in earlier years, at least in aggregate. However, the surpluses were achieved at the expense of a fall in investment. Last year the local authorities ended with a high budget deficit for the first time since 1997, despite a continued decline in investment in fixed assets. As with the states, the marked deterioration was mainly in west Germany.

In contrast to the federal states and the local authorities, the financial situation for the federal government actually improved in 2001, if the federal special assets are taken into account and the UMTS receipts of 2000 not included, as they were used to pay off debt. The development in the special assets was particularly positive. They closed with a considerable surplus, which was used to reduce the debts of the Fund for the Redemption of Inherited Debts. But the deficits in the federal budget itself were also reduced.[3]

The strong rise in the profits transferred by the Deutsche Bundesbank contributed to this, as did the high receipts on privatisation. On the expenditure side the economy course was maintained; moreover, expenditure on the federal railways fell markedly, as did interest expenditure owing to debt rescheduling.

The trend in revenues in 2002/2003 – more big shortfalls in tax revenues

Amendments to the tax legislation are playing a much smaller part in tax revenues this year than last. Under the second Family Promotion Law, child allowances have been raised from 1 January 2002 to euro 154 per month for the first and also for the second child. That will reduce revenue from wage tax by an estimated euro 3 billion. The tax-free allowances for children have been adjusted accordingly, to euro 3 648. Moreover, income tax payers with children can claim a child education allowance of euro 612 from 2002, while the child care allowance (euro 1 548) is now given for children over 16 as well. In return, the household free allowance for sin-

3 The discrepancies between the financial statistics and the national accounts were particularly great in the federal deficit in 2001. This is mainly due to the high receipts from the sale of shareholdings on privatisation and to the fact that far fewer loans were made from the ERP Special Fund than in the previous year. Both transactions reduced the deficit as defined in the financial statistics, but they do not affect the level of the deficit as calculated for the national accounts.

Table 2

Financing Balances of the Federal States and Local Authorities

In euro million

	2000		2001	
	State	Local authorities	State	Local authorities
Baden-Württemberg	–690	828	–2 629	–837
Bavaria	939	152	–892	–683
Brandenburg	–455	–19	–562	–152
Hesse	–425	655	–1 226	144
Mecklenburg-Western Pomerania	–639	47	–550	–99
Lower Saxony	–945	108	–3 757	–551
North Rhine-Westphalia	–2 205	291	–6 774	–1 088
Rhineland-Palatinate	–479	–168	–1 013	–546
Saarland	103	–106	3	–104
Saxony	–241	67	–89	–80
Saxony-Anhalt	–846	–8	–1 010	–160
Schleswig-Holstein	–360	32	–621	205
Thuringia	–736	49	–783	6
Old and new federal states	–6 979	1 928	–19 903	–3 944
Former Federal territory	–4 062	1 793	–16 908	–3 459
New Länder	–2 917	135	–2 995	–484
City states	–3 361	–	–6 953	–
Berlin	–2 546	–	–5 235	–
Bremen	–140	–	–305	–
Hamburg	–675	–	–1 413	–
Total	–10 339	1 928	–26 856	–3 944

Sources: Federal Statistical Office; DIW Berlin calculations.

gle parents is being dropped in three stages by 2004.[4] All in all, this amendment to the tax legislation will increase revenue by euro 500 million for this year and again for next year.

As a result of the terrorist attacks on September 11 tobacco and insurance tax were raised under the Law to Finance Combatting Terrorism; that will yield euro 1.5 billion this year and euro 1.9 billion in 2003. Owing to the increase in value added tax evasion the federal government has markedly increased the powers to investigate tax fraud from 1 January 2002 (the Law to Combat Tax Evasion). It estimates that this will bring an increase in revenue of euro 2.3 billion this year alone and of euro 2.5 billion in 2003.

Next year the second stage of the tax reform 2000 is due to come into force for wage and income tax. The tax relief planned for income tax payers is estimated at euro 7 billion (for more details see box). On 19 August the federal government decided to postpone this stage by one year, to 2004, to help finance the extensive repairs needed after the catastrophic flood. At the same time corporation tax is to be raised by 1.5 percentage points to 26.5% (the Flood Victims Solidarity Law); the additional revenue from this is put at just under euro 800 million.

These estimates of the tax revenues to the federal government, the federal states and local authorities and the EU for this year and next are based on the cash receipts up to July and the latest cyclical prognosis made by DIW Berlin.[5] Here a rather moderate recovery in economic activity is expected.

The trend in tax revenues (without local authority taxes) was catastrophic in the first seven months of this year, with a further downslide of 4.4%. Corporation tax in particular has remained far below expectations. Revenues from trading tax, however, have evidently fallen again as well – at a double-figure rate. The slackening of demand in many areas of private consumption is evident in the falling trend in taxes on turnover.

Revenues from wage tax had fallen slightly by July (–0.8%). This reflects both the decline in the number employed and the increase in child allowances from 1 January 2002, which is financed from wage tax. Adjusted for this effect there is a slight growth (1.5%). For the rest of this year a slight acceleration is expected, mainly because the higher collectively agreed wage

[4] In connection with the planned postponement of the second stage of the tax reform 2000 to finance the repair of flood damage the Federal government intends to suspend the reduction in the household free allowance in 2003.

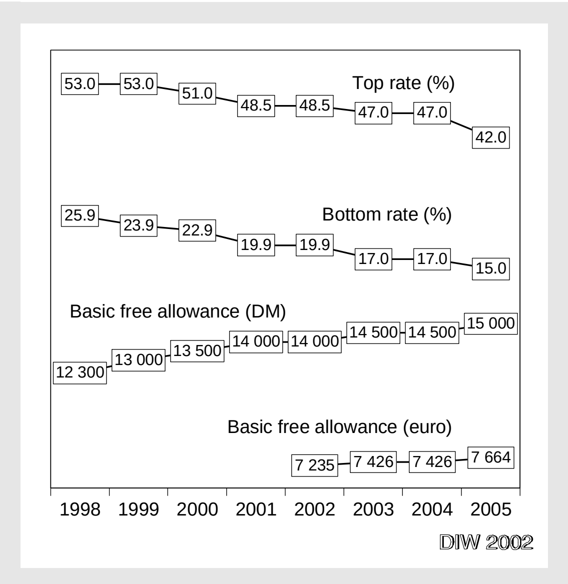
[5] Cf. Study Group Business Cycle: 'Economic Trends 2002/2003.' In: *Economic Bulletin,* vol. 39, no. 1, January 2002.

Box 1

The Three Stages of Tax Reform 2000

In its tax reform 2000 package the federal government has included a three-tier tax reduction programme for income tax payers in addition to the reform of corporate taxation. The first stage, which was originally planned for 2002 and then brought forward to 2001 for cyclical reasons, reduced income tax by euro 14.5 billion. The second stage, which under the federal government's decision of 18 August 2002 is now not to take effect in 2003 but in 2004, will bring relief of half that amount for income tax payers (euro 7 billion). The calculations of the amount of relief tax payers on different income levels will enjoy show how much they will contribute to financing the flood damage restoration. The third stage is planned for 2005; it will provide the highest relief for income tax payers, at euro 19 billion.

The Basic Free Allowance and the Bottom and Top Rates of Income Tax 1998 to 2005[1]



1 Without postponement of Stage 2 of the tax reform 2000.
Sources: Federal Ministry of Finance; calculations by DIW Berlin

The following changes to the tax rates are already in force or planned for the individual stages of the income tax reform package (diagram below):

- Stage 1, 2001: The basic free allowance was raised from DM 13 500 (euro 6 902) to DM 14 000 (euro 7 235).[1] The bottom rate of income tax was lowered from 22.9% to 19.9% and the top rate from 51% to 48.5%.
- Stage 2, 2004 (after postponement): The basic free allowance will be raised to euro 7 426, while the bottom rate of tax will be lowered to 17% and the top rate to 47%.
- Stage 3, 2005: The basic free allowance will rise to euro 7 664, while the bottom rate of tax falls to 15% and the top rate to 42%.

At present a tax payer with an annual taxable income of euro 30 000 pays euro 6 418 in tax, so that the average rate of income tax on his taxable income is 21.4%.[2] The year after next his tax will fall to euro 6 252. That is a reduction of euro 166 a year, or just under euro 14 a month, from the 2002 level.

A tax payer on an income of euro 60 000 pays euro 19 555 in income tax under the present regulations. His new tax bill will be euro 18 967, saving him euro 258 a year, or a good euro 21 a month.

Stage 3 will bring markedly higher reductions. For the lower earner the new scale will reduce the tax burden by euro 446 a year (or euro 37 a month) from the 2004 level, which is a reduction of 7%. For the higher earner on a taxable income of euro 60 000 the result is even better, for on his income he is already in the top tax bracket, and in 2005 this will be reduced by 5 percentage points to 42%. His tax payments will fall by euro 1 683 from the 2004 level (euro 140 a month), and the relative reduction is nearly 9% (2004/2002 1.3%).

For married tax payers the reductions will be slightly larger than those on comparable incomes to single persons, assuming that only one partner is earning. A married couple with a taxable income of euro 40 000 will only pay euro 6 146 in income tax under the 2004 scale, which is 5% less than in 2002. Under the 2005 tax legislation their income tax will fall by a further 7.3% to euro 5 698.

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[1] Basic free allowance for 2002.
[2] The Solidarity surplus of 5.5% on income tax is not included in this comparison.

rates will affect tax payments. That and the progressive effect of the income tax scale, which is not affected by amendments to the legislation this year, should mean that income tax revenue will be euro 134 billion (–1.0%). Compared with the May forecast of the official Working Group Tax Estimates this means a fall in revenue of euro 1.2 billion. For 2003 noticeably higher revenue from wage tax is expected, from both higher income payments and a slight increase in the number employed. The federal government has decided that the wage tax relief of euro 5.5 billion planned for 2003 will be used to finance flood damage restoration. Taking account of this postponement, wage tax revenue is expected to grow by 7.5%; without that contribution to financing expenditure the additional revenue would be 3.7% (cf. table 3).

Although taxes on earnings (assessed income tax, non-assessed taxes on earnings, corporation tax, interest tax and the solidarity surplus) had been expected to normalise this year after the changes due to the tax reform and the special effect, the negative trend has continued in the first seven months of this year, with a decline of 31.5%.

Cash receipts from assessed income tax in west Germany were only just under half the previous year's level

Table 3

Tax Revenue in Germany 2001 to 2003[1]

	West Germany[2]			East Germany[3]			Total			West Germany[2]		East Germany[3]		Total	
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2002	2003	2002	2003	2002	2003
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Estimated					
	Euro billion									% change on the previous year					
Joint taxes	.	.	.	.	.	.	309.7	306.4	320.2	.	.	.	.	–1.1	4.5
Wage tax[4]	123.7	125.0	129.5	9.0	9.0	9.5	132.6	134.0	139.0	1.1	3.6	0.4	5.6	1.0	3.7
Assessed income tax[4]	11.8	11.4	9.4	–3.1	–3.0	–3.4	8.8	8.4	6.0	–3.6	–17.5	.	.	–4.3	–28.6
Non-assessed income tax[6]	20.4	12.0	12.1	0.5	0.4	0.4	20.9	12.4	12.5	–41.1	0.8	–30.0	5.7	–40.9	1.0
Interest tax[6]	8.7	8.7	8.9	0.2	0.3	0.3	9.0	9.0	9.2	–0.3	2.3	8.7	4.0	–0.1	2.3
Corporation tax[5]	0.4	3.2	10.0	–0.8	–0.5	–0.4	–0.4	2.7	9.6	.	.	.	.	.	.
Taxes on turnover[7]	.	.	.	.	.	.	138.9	140.0	144.0	.	.	.	.	0.8	2.9
Customs duty	.	.	.	.	.	.	3.2	2.9	2.9	.	.	.	.	–9.1	–1.7
Federal taxes	.	.	.	.	.	.	79.2	83.2	87.1	.	.	.	.	5.0	4.8
Petroleum tax	.	.	.	.	.	.	40.7	42.4	44.6	.	.	.	.	4.2	5.2
Electricity tax	.	.	.	.	.	.	4.3	5.2	6.1	.	.	.	.	20.1	17.3
Tobacco tax	.	.	.	.	.	.	12.1	13.2	13.6	.	.	.	.	9.4	3.0
Spirits duty	.	.	.	.	.	.	2.1	2.1	2.1	.	.	.	.	0.0	–2.4
Insurance tax	.	.	.	.	.	.	7.4	8.1	8.2	.	.	.	.	9.4	1.4
Solidarity surplus (on income taxes)	.	.	.	.	.	.	11.1	10.6	11.0	.	.	.	.	–4.2	3.8
Other	.	.	.	.	.	.	1.6	1.5	1.5	.	.	.	.	–0.9	0.0
State taxes	17.5	16.9	17.2	2.2	2.1	2.1	19.7	19.0	19.4	–3.3	1.8	–4.9	0.9	–3.5	1.7
Vehicle tax	7.2	6.8	6.9	1.2	1.2	1.2	8.4	8.0	8.1	–5.2	1.5	–5.0	0.9	–5.1	1.4
Inheritance tax	3.1	3.0	3.2	0.1	0.0	0.0	3.2	3.1	3.2	–1.3	3.6	.	.	–2.5	3.6
Real estate purchase tax	4.3	4.2	4.3	0.5	0.5	0.5	4.9	4.7	4.8	–2.8	2.4	–3.7	1.0	–2.9	2.2
Other	2.9	2.9	2.9	0.4	0.4	0.4	3.3	3.3	3.3	–1.7	–0.4	2.3	0.7	–1.2	–0.2
Local government taxes	31.3	29.6	30.8	3.1	3.1	3.2	34.4	32.7	34.0	–5.3	3.9	–1.3	4.9	–5.0	4.0
Trade tax	22.8	21.0	22.0	1.8	1.7	1.8	24.5	22.7	23.8	–7.8	4.8	–3.4	5.9	–7.5	4.8
Real estate tax	7.8	7.9	8.1	1.2	1.3	1.3	9.1	9.2	9.4	1.0	1.9	1.6	4.0	1.1	2.2
Other	0.7	0.7	0.7	0.1	0.1	0.1	0.8	0.8	0.8	2.5	1.1	0.0	0.0	2.2	1.0
Total tax revenues	.	.	.	.	.	.	446.2	444.2	463.5	.	.	.	.	–0.5	4.4
Financial statistics definition[8]	.	.	.	.	.	.	428.3	427.0	444.6	.	.	.	.	.	.
of which:															
Central government[9,10,11]	.	.	.	.	.	.	213.3	214.2	222.4	.	.	.	.	0.4	3.8
State government[9,11,12,14]	140.9	139.8	147.7	24.9	23.9	24.8	165.8	163.6	172.5	–0.8	5.7	–4.2	3.9	–1.3	5.4
Local government[13,14]	45.1	45.1	45.7	3.9	4.0	4.1	49.1	49.2	49.8	0.1	1.2	2.0	1.4	0.2	1.2
Memo item: EU shares[15]	.	.	.	.	.	.	19.7	19.5	21.9	.	.	.	.	.	.

1 Without postponement of the intended tax relief from 2003 to 2004. — 2 West Germany incl. West Berlin. — 3 East Germany incl. East Berlin. — 4 Distribution ratio federal/state/local government: 42.5/42.5/15. — 5 Distribution ratio central/state government: 50/50. — 6 Distribution ratio federal/state/local government: 44/44/12. — 7 Distribution ratio federal/state government: federal government 5.63%; of the remainder: local authorities 2.2% on account; of the remainder: federal government 50.25%, states 49.75%; from 2002 onwards: federal 49,6%, states 50,4%. Distribution between west and east Germany within the framework of the system of horizontal financial compensation. — 8 Excl. EU shares, incl. para-fiscal charges. In the financial statistics West and East Berlin are included in west Germany. — 9 Turnover tax distribution by the German Unity Fund added to federal, deducted from state government. — 10 EU VAT own resources and EU GNP own resources deducted. — 11 Incl. trading tax levy. Distribution ratio: federal government: 19/45; state government: 26/45. — 12 Incl. local government tax of the city states. — 13 Excl. local government 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. — 15 EU VAT own resources, EU GNP own resources, EU customs duties. — Columns may not sum due to rounding.
Sources: Federal Ministry of Finance; Federal Statistical Office; DIW Berlin estimates.

up to July this year. This result is very largely due to the fact that the payments made out of income tax revenue for owner-occupier allowances, reimbursements to employees (§ 46 Income Tax Law) and reimbursements by the Federal Tax Office increased slightly as a whole. Taking this into consideration, the decline in gross revenue from assessed income tax was only slight (–1.1%). For the rest of the year it is assumed that with the economic recovery tax payments on account (gross) will be slightly higher than last year and that earlier amendments to the legislation will increasingly have an effect in increasing revenues. Balancing tax payments should also be higher than last year. On balance, cash receipts of euro 11.4 billion can be expected for this year (–3.5%). For 2003 it is assumed that the better earnings position for companies will lead to higher tax payments on account and that there will again be higher balancing payments on the assessment of earnings in earlier years.

This item of revenue would have been reduced by euro 1.5 billion by the tax relief under the second stage of the tax reform 2000 package. In all, this revenue should fall to euro 9.4 billion (–17.5%), but with the postponement of the tax relief it will be euro 10.9 billion (–4½%).

The tax offices in east Germany are still repaying more income tax than they receive. In the first seven months of this year disbursements exceeded revenues from income tax by euro 2.5 billion, that is to a similar extent to that in the previous year. If it is assumed that the payments on account will stabilise in the rest of this year a slight reduction in the gap can be expected (euro –3 billion). Next year the gap will be slightly larger.

The hope that revenues from corporation tax would return to positive figures has not been realised. On the contrary, in the first seven months of this year the tax offices in west Germany repaid euro 1.5 billion more than they received. This is firstly because at the start of the year companies presumably distributed more earnings on which they could claim tax reimbursement (under EK40). This is evident from the trend in non-assessed taxes on earnings, where dividend payments led to an unexpectedly favourable trend. Secondly, the earnings situation for joint stock companies is still bad, so that tax payments on account and balancing payments are still tending downwards. In addition, evidently some big companies that had to take heavy losses last year have had their tax position reassessed this year, and not with the usual timelag of about two years, and this has burdened the tax revenue with high reimbursements.

Owing to the strong distortions of corporation tax in 2001 from the reduction in tax rates and the change in the system from full offsetting to the half-income procedure, any prognosis involves greater uncertainty than usual. Even if the trend stabilises in the rest of this year revenue of around euro 3 billion is to be expected for the year as a whole. Compared with the prognosis prepared by the official Working Group Tax Estimates, that means a fall in revenue of nearly euro 5.5 billion. For 2003, however, higher revenues are expected, on the assumption that earnings will rise again as the economy recovers. It is also assumed that companies' dividend practices will 'normalise' again. Under the corporation tax legislation companies have 15 years, i.e. until 2016, to clear out 'old earnings' that are entered in the balance sheet at 40% tax. If these earnings are distributed the companies can claim reimbursement of the difference between the rate of tax on retained earnings and the rate on distributed earnings until then.[6] All in all, revenue of euro 10 billion is forecast for 2003.

In east Germany revenues from corporation tax will remain negative for the foreseeable future. In the course of the year up to July the deficit had decreased slightly, to about euro 340 million, but in gross figures, that is, taking account of investment grants and reimbursements by the Federal Tax Office, the revenue was positive although lower than the average for the previous year (–4.2%). In the rest of the year that trend will change only slightly. On balance, the deficit is estimated at euro 500 million and euro –400 million for 2003.

In non-assessed taxes on earnings there will be a clear fall this year after the high special dividend payments affecting corporation tax last year. The deficit up to July is calculated at 30%. For 2002 as a whole revenues of euro 12.4 billion are forecast (–41%). Compared with the estimate in May that is an increase in revenue of euro 1 billion. Next year the increase will be only slight, at 1%.

In taxes on turnover the disappointing trend has continued so far. In the first seven months of this year cash receipts were 2% below the previous year's result. This development reflects the poor turnover in the retail trade, which is showing double-figure minus rates in some sectors, such as durable consumer goods.

According to the macroeconomic forecast by DIW Berlin, there will be a revival in turnover in the next few months, and this should also be reflected in higher taxes on turnover. Altogether, tax revenues on turnover of euro 140 billion are expected, which is a slight increase (0.8%). For the coming year – with the higher economic growth expected – a larger increase in revenues from turnover tax is forecast (2.9%). Compared with the prognosis prepared by the Working Group Tax Estimates in May that means a gap in revenues of euro 2.3 billion in each of the two prognosis years.

Federal taxes rose by 2.3% by July 2002. Revenues from the solidarity surplus have fallen markedly and revenues from spirits tax, slightly. Owing to the increase in the eco tax and other taxes there have been growth rates, some of which were marked, in revenues from petroleum, electricity, tobacco and insurance tax. Federal taxes should grow by 5% this year and next.

In federal state taxes a decline is evident for this year (–3.3%). The main reason is the negative trend in revenues from beer, property acquisition and inheritance tax. There will also be clear falls in revenues from vehicle tax owing to the tax legislation.[7] Next year there should be a slight increase (just under 2%).

[6] Under § 37, Para. 1 of the Corporation Tax Law, a corporation tax credit is calculated at the end of the last financial year that began before 1 January 2001 of 1/6 of that part of earnings on which 40% corporation tax is charged. The difference between the rate on retained earnings (40%) and the rate on distributed earnings (30%) is 10 percentage points, that is, 1/6 of net earnings. Under § 37, Para. 2 of the Corporation Tax law the remaining corporation tax credit must be carried forward for the last time to the end of the last financial year before 1 January 2016 and calculated separately.

Municipal taxes fell again strongly in the first half of this year. Revenues from trading tax have evidently registered a double-figure fall again in the second quarter of this year. The fall appears to be concentrated in sectors that are mostly to be found in larger towns, such as banks, insurance companies, telecommunications, EDP producers, chemical companies and vehicle manufacturers. These trading tax payers are largely identical with the companies paying corporation tax. Even if a rather more positive trend is assumed for the rest of this year, the year as a whole should still show a deficit – of 7.5%. Compared with the official tax estimate the fall in revenue from trading tax will be euro 2.3 billion. Higher revenues are not likely until next year, in the rather better macroeconomic environment (4.8%). Overall, municipal taxes will fall this year by 4.4%, while they will rise next year by 3.9%.

All in all, tax revenues this year will again be lower than last year, at euro 444 billion (–0.5%). For next year growth by a good 4% is forecast. Applying the results obtained by the Working Group Tax Estimates, that means a fall in revenues to the public budgets this year of euro 10.5 billion and nearly euro 11 billion next year. If the second stage of the tax reform is postponed as planned the increase will be just under 6%.

The tax ratio in the economy as a whole (tax revenues in relation to nominal GDP) is the measure of the tax burden on economic activities in the whole of an economy. In this year it is expected to fall to slightly below 21% and so reach its lowest level since 1990. Next year it is expected to be only slightly higher (cf. figure 1).

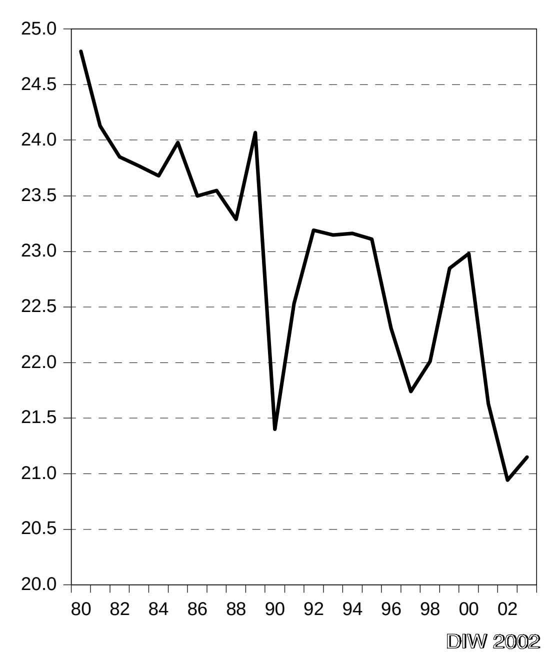
If a distinction is drawn in direct taxes between wage tax and taxes on earnings it is clear that for wage tax payers the burden has been lessened by the tax reform 2000 package (cf. figure 2), but at just under 7% of nominal GDP it is only slightly below the 1980 level. The situation is different for taxes on earnings. By the mid-90s the tax burden had fallen from 7% to 4.5% of GDP; after that it rose again to 5.5% – not least as tax concessions came to an end. The serious consequences of the tax reform 2000, with its special effects, and the fall in revenues in the cyclical slowdown resulted in a drastic slump in the ratio of taxes to earnings (to 3.5% in 2002).

[7] In the reform of vehicle tax in 1997 the rates of tax for more polluting vehicles were raised noticeably from 1 January 2001, and as a result revenues rose last year. Now many of these vehicles have been scrapped and replaced by less polluting vehicles, which has brought about a fall in revenues this year.

Figure 1

Tax Ratio in the Economy as a Whole 1980 to 2003[1]

In % of nominal GDP



1 Without postponement of Stage 2 of the tax reform 2000.
Sources: Federal Ministry of Finance; calculations by DIW Berlin

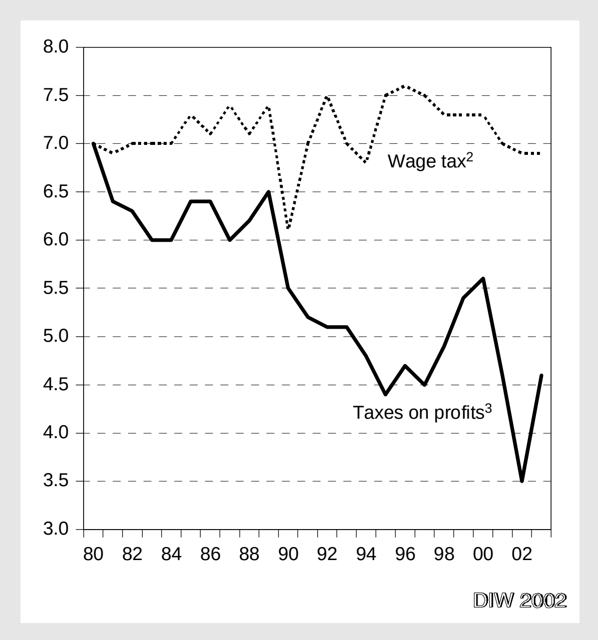
The development in expenditures 2002/2003: an even more stringent economy course

The federal government has not, but probably many of the federal states and local authorities have, responded to their strongly swollen deficits and the expected shortfalls in tax revenues by stepping on the brake and putting a stop on budgetary expenditure. The federal government refrained from doing so in an election year, and in any case its increase in expenditure is slight. Next year the economy course will almost certainly be more stringent. It was agreed in the Fiscal Planning Council in March this year that the federal government should reduce its expenditure in 2003 and 2004 by an average 0.5%, while the federal states and the local authorities should limit any rise in their expenditures to 1% a year. For the federal and state governments and the local authorities as a whole that means that expenditure may only be raised by 0.4% a year. It must be taken into account here that owing to the high deficits interest expenditure will also rise. It will almost exhaust the

Figure 2

Taxes on Earnings and Wage Tax 1980 to 2003[1]

In % of nominal GDP



1 Without postponement of Stage 2 of the tax reform 2000. — 2 Wage tax before deduction of child allowance from 1996, plus proportionate Solidarity surplus, minus reimbursements to employees (§ 46 Income Tax Law) and owner-occupier grants. — 3 Income tax plus reimbursements to employees (§ 46 Income Tax Law), owner-occupier grants, proportionate Solidarity surplus, corporation tax, non-assessed taxes on earnings, interest discount, property tax and trading tax.
Sources: Federal Statistical Office; Federal Ministry of Finance; calculations and estimates by DIW Berlin.

given margin; that is to say primary expenditures, as they are called, cannot be increased.[8]

According to the estimate presented here, aggregate expenditures by all levels of government will rise by 1.5% this year and by just under 1% next year (cf. table 4). The growth in personnel expenditures will also move within that range each year. The collectively agreed increase in remuneration for labour for 2002 will cause a rise of 2%. Pension and support payments will rise at an above-average rate, as the number of pensioners of the public service will be noticeably higher. But the number of jobs may be expected to fall, as in previous years. This not only reflects the reduction in personnel on all levels of government; facilities are also still being removed from the public budgets. That means that they are no longer entered in the budget 'gross', that is, with all their revenues and expenditures, but only 'net', that is, with the grants given by the federal government, the states or the local authorities. These are not only facilities financed from charges, such as utilities enterprises, day nurseries or old peoples' homes; a growing number of universities are being handled in the same way if they use commercial accounting systems.

Whether the very tight targets for expenditure can be met will depend mainly on the results of the coming wage negotiations. So the bargaining may be expected to be tougher than usual. It must also be taken into account that the rates agreed will not necessarily apply for established civil servants, who account for around half of all the personnel in the public service.[9] Nevertheless, the collectively agreed increases in remuneration in the public service cannot be entirely uncoupled from the development of incomes in the economy as a whole. The rise in personnel expenditure by the federal government, the states and the local authorities next year is expected to be just under 1%.

Transfer payments should grow at an above-average rate this year (5.5%). They are determined by the grants given by the federal government to the social insurance institutions. The federal grant to the pension insurance institutions is of outstanding importance here. It depends firstly on the development in the sum of gross wages and salaries and in contribution rates, and secondly on revenues from turnover tax and eco tax. It is to be raised by 4.2% in 2002 and 4.7% in 2003. A grant of euro 2 billion is earmarked for the Federal Labour Office in the 2002 federal budget, but it will hardly suffice to finance the rise in unemployment owing to the cyclical downslide. In the estimate presented here a grant of euro 4 billion is assumed – based on the macroeconomic prognosis by DIW Berlin. The Federal Labour Office will probably not be able to manage without additional funds next year either, but no amount has been earmarked for this in the draft federal budget.

Social benefit payments, too, – mainly social assistance – may well rise at a disproportionately high rate of about 3% in each of the two prognosis years. As child allowances must be aligned with social assistance in order to maintain the necessary gap to income from labour, the development will be dampened by the increase in child allowances at the start of this year; similarly, the local authorities will probably make further efforts to find employment for recipients of social assistance. However, they will face growing expenditure for persons needing care in homes, as payments by the care insurance institutions will remain unchanged while costs will rise.[10] Moreover, the rise in the number of long-term unemployed, especially in east Germany, will require higher spending on social assistance. And

8 Expenditures without interest expenditure.

9 In the past established civil servants' salaries have been excepted from increases in remuneration scales on several occasions, or their salaries have been adjusted after a timelag.

although child allowances were increased at the start of this year, the increase in expenditure of euro 3 billion will not, in contrast to the figures in the national accounts, be reflected in social payments but in the revenues from wage tax.

As so often in the past, the efforts made by the local authorities to limit the rise in their expenditures will mainly affect public investment spending. That is the most flexible item of expenditure, not least because there is least political resistance to the red pencil here. The possibilities for cutbacks in transfer payments are limited for all levels of government, at least over the short term, as they are laid down by law. Expenditure by the local authorities on investment in fixed assets has been falling for some considerable time; in the past decade it has fallen by one-quarter. Most recently the negative trend was dampened slightly by the federal government's Future Investment Programme, which provides for additional investment in the railways, roads and universities, and for vocational training, out of the savings on interest payments by using the receipts of the UMTS licence auctions to pay off debt. A further fall in public investment is to be expected in this year and next, by a good 4% to 7%. Without cutbacks to that extent the targets for expenditure cannot be met. However, funds will become available temporarily from the postponement of the tax reduction programme, and they can be used to finance repairs to the public infrastructure. Taking that into account, public investment expenditure should show a rise in 2003.

As a result of the marked rise in the budget deficits interest expenditure will rise again. It fell last year because federal debt was reduced by a good euro 50 billion by the receipts on the auction of UMTS licences. This year the high Bundesbank profit, which is also used to pay off debt, will keep the rise in interest payments down; next year a lower Bundesbank profit must be expected. Rescheduling should bring some relief, as in previous years, as old debts bearing a high rate of interest are being replaced by new loans at lower rates. All in all, interest expenditure is expected to rise by 3% in each year.

Fiscal policy considerations

According to this estimate of revenues and expenditures of the federal government, the federal states and the local authorities, the aggregate budget deficit will rise this year, despite the restrictive spending policy, from euro 47 billion to euro 57 billion. Revenues will stagnate owing to the decline in tax revenues. Next year a clear fall in the aggregate deficit to euro 45 billion may be expected, as expenditures will rise by just under 1% while revenues will rise by 3%.

It is also estimated here that the area authorities' deficit as defined in the financial statistics will be 2.7% of nominal GDP this year and 2.1% next year. Even if it is not possible to conclude without reservations from the data in the financial statistics what the figure will be in the national accounts system (which is relevant for the Maastricht criteria), there is a high probability that this year the public deficit, as defined in the national accounts, which includes the social insurance institutes, will reach the 3% limit or be actually slightly above it. It is to be feared, then, that the statutory health insurance institutions will face big deficits, as they did last year. Next year the deficit as defined in the national accounts should be a good 2%. In the estimate presented here the billions the public authorities will have to spend to deal with the damage left by the catastrophic flood are taken into account, in that this will be financed in a way that is 'deficit neutral', through blocks on budgetary expenditure this year and by postponing the tax reform from 2003 to 2004. But it is questionable whether the emergency aid provided by the federal government and the means of financing it by imposing blocks on budget items will be sufficient in volume. If the aim is to provide rapid assistance for small and medium-sized firms in particular and start immediately on the most urgent infrastructure repairs, additional borrowing will probably be needed this year. The question of whether this will take the public deficit above the 3% limit is irrelevant in this context, however, because it is possible to exceed the reference figure without incurring sanctions if the development is due to an extraordinary, 'exogenous' event (such as a natural catastrophe).[11]

Fiscal policy is now in a very difficult situation. The economy is gradually recovering, but the upward trend still lacks the necessary dynamic, not least as a result of the very restrictive expenditure policy at all levels of government. All three levels of government are forced to follow that restrictive line because they have subjected themselves to strict fiscal policy rules in the Maastricht Treaty and the Stability and Growth Pact. Moreover, the federal government has given an undertaking to the European Commission that it will virtually balance the aggregate public budget by 2004. Policy would cease to be credible if it did not keep to that target. It is trying to toe the line by reaching agreement with the states to

[10] Cf. H. Karrenberg and E. Münstermann: 'Städtische Finanzen – Kollaps oder Reformen: Gemeindefinanzbericht 2002', in: *Der Städtetag,* vol. 4/2002, p. 51.

[11] Cf. Regulation No. 1497 of the European Council of 7 July 1997, Para. 1, Article 2.

Table 4

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

	Central government[2]			Special assets			State government[2] West Germany[3]			State government[2] East Germany			Local government West Germany			Local government East Germany			Total		
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
	in euro billion																				
Revenue	244.6	246.6	252.5	23.5	25.0	23.3	187.4	186.3	194.8	49.3	48.3	49.4	119.3	119.5	121.9	24.7	24.4	24.4	534.7	534.8	551.5
Taxes	213.4	214.2	222.4	0.1	0.1	0.1	141.0	139.8	147.7	25.0	23.9	24.8	45.1	45.1	45.7	4.0	4.0	4.1	428.5	427.1	444.8
Transfers from other levels of government	2.9	2.9	2.9	12.3	14.6	12.9	23.7	23.6	23.6	16.3	16.3	16.2	33.7	33.3	34.4	15.9	15.3	15.1	–	–	–
Transfers from special assets	0.8	0.9	0.9	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
State equalisation	–	–	–	–	–	–	4.4	4.3	4.6	4.1	4.1	4.2	–	–	–	–	–	–	–	–	–
Income from economic activities[4]	9.6	11.5	10.0	–	–	–	3.0	3.0	3.0	0.5	0.5	0.5	6.9	7.1	7.3	1.2	1.3	1.3	21.1	23.3	22.1
Levies and charges	2.1	2.1	3.5	–	–	–	4.2	4.2	4.3	0.5	0.5	0.6	14.5	14.6	14.7	2.0	2.1	2.1	23.3	23.6	25.2
Sales of assets[5]	8.4	7.7	5.6	2.5	0.5	0.5	1.9	2.0	2.1	0.1	0.1	0.1	6.0	6.1	6.2	0.9	1.0	1.0	19.8	17.4	15.5
Other sources	7.4	7.3	7.3	8.6	9.8	9.8	9.2	9.3	9.4	3.0	3.0	3.1	13.0	13.3	13.5	0.7	0.7	0.7	41.9	43.5	43.8
Expenditure	265.7	275.4	276.1	18.2	17.7	17.4	211.3	212.9	216.3	52.4	52.2	52.3	122.8	123.8	124.1	25.2	25.4	25.3	581.3	592.3	596.9
Personnel costs	26.8	27.1	27.4	7.7	7.6	7.5	80.7	82.1	83.3	13.8	14.0	14.2	32.0	32.5	32.8	7.3	7.3	7.2	168.4	170.6	172.3
Current material costs	16.7	16.4	16.5	–0.1	0.0	0.0	20.8	21.2	21.5	3.7	3.7	3.8	23.8	24.2	24.5	4.8	4.8	4.8	69.5	70.3	71.1
Interest payments	37.6	38.0	38.6	4.0	4.0	3.9	16.5	17.6	18.8	3.1	3.3	3.4	4.4	4.6	4.7	0.9	0.9	1.0	66.3	68.2	70.1
of which: to other levels of government	–	–	–	–	–	–	0.1	0.1	0.1	–	–	–	0.1	0.1	0.1	–	–	–	–	–	–
Current transfers to	156.8	170.4	171.2	2.2	2.1	2.1	67.5	68.0	70.6	19.6	19.5	19.9	39.0	40.1	41.2	6.0	6.4	6.6	197.1	207.5	212.2
Other levels of government	25.4	28.7	28.6	0.9	0.9	0.9	29.7	29.5	31.0	13.3	13.0	13.3	3.8	3.9	3.9	0.1	0.1	0.1	–	–	–
State equalisation	–	–	–	–	–	–	8.5	8.4	8.8	–	–	–	–	–	–	–	–	–	–	–	–
Special assets	12.2	14.5	12.8	–	–	–	0.1	0.1	0.1	–	–	–	–	–	–	–	–	–	–	–	–
Social insurance	76.2	84.3	87.0	–	–	–	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	76.7	84.8	87.5
Income support	20.7	20.8	20.9	–	–	–	7.8	8.3	8.7	1.6	1.7	1.8	23.7	24.5	25.4	3.7	3.9	4.1	57.5	59.3	60.9
Firms	16.7	16.5	16.4	1.2	1.2	1.1	13.5	13.7	13.9	3.1	3.2	3.2	3.0	3.1	3.2	1.1	1.1	1.1	38.6	38.8	39.0
Abroad	3.0	2.9	2.9	–	–	–	0.6	0.6	0.6	–	–	–	–	–	–	–	–	–	3.5	3.5	3.5
Social institutions	0.7	0.7	0.7	–	–	–	5.9	6.0	6.1	1.2	1.1	1.1	6.0	6.1	6.2	0.9	1.0	1.0	14.7	14.9	15.0
Other	1.9	1.9	1.9	0.1	0.1	0.1	1.2	1.2	1.2	0.4	0.4	0.5	2.4	2.4	2.5	0.2	0.3	0.3	6.1	6.3	6.4
Investment	6.9	6.5	6.1	–	–	–	5.7	5.5	5.1	2.3	2.2	2.1	19.0	17.9	16.4	5.2	5.1	4.7	39.1	37.2	34.3

Table 4 (continued)

	Central government[2]			Special assets			State government[2]						Local government						Total		
							West Germany[3]			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	17.1	13.4	12.8	0.1	0.1	0.1	14.2	13.8	13.3	9.5	9.0	8.5	2.2	2.1	2.1	0.8	0.8	0.8	24.0	23.6	22.8
Other levels of government	9.5	6.0	5.8	–	–	–	5.6	5.4	5.0	4.4	4.1	3.7	0.2	0.2	0.2	0.1	0.1	0.1	–	–	–
Abroad	0.3	0.3	0.3	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	0.3	0.3	0.3
Other	7.3	7.1	6.8	0.1	0.1	0.1	8.6	8.4	8.3	5.0	4.8	4.8	2.0	2.0	1.9	0.7	0.7	0.7	23.7	23.3	22.5
Loans and shares	3.8	3.6	3.4	4.3	3.9	3.9	6.0	4.6	3.8	0.4	0.4	0.4	2.4	2.5	2.5	0.2	0.2	0.2	16.9	14.9	14.0
of which: to other levels of government	0.2	0.2	0.2	–	–	–	0.1	0.1	0.1	–	–	–	–	–	–	–	–	–	–	–	–
Financial balance	–21.1	–28.9	–23.6	5.3	7.3	5.9	–23.9	–26.6	–21.6	–3.0	–3.9	–2.9	–3.5	–4.3	–2.2	–0.5	–1.0	–0.9	–46.7	–57.4	–45.4
	% change on the previous year																				
Revenue	–16.2	0.8	2.4	25.0	6.3	–6.7	–5.0	–0.6	4.6	–1.6	–2.0	2.2	–1.9	0.2	2.0	–3.0	–1.4	0.0	–9.4	0.0	3.1
Taxes	–2.6	0.4	3.8	.	0.0	0.0	–6.5	–0.8	5.7	–2.2	–4.4	3.8	–5.5	0.0	1.3	–4.9	0.3	2.5	–4.2	–0.3	4.1
Expenditure	0.3	3.7	0.2	–11.2	–2.8	–1.4	3.2	0.7	1.6	–1.3	–0.3	0.2	2.2	0.9	0.2	–0.6	0.8	–0.6	1.3	1.9	0.8
Personnel costs	1.0	1.3	0.8	–0.7	–1.3	–1.3	0.6	1.7	1.4	1.5	1.5	1.1	0.2	1.4	0.9	–3.4	–0.7	–0.7	0.4	1.3	1.0
Current material costs	.[6]	–1.8	0.9	.	.	0.0	2.5	2.2	1.4	–5.3	1.4	1.4	2.4	1.7	1.3	0.0	0.0	1.1	–4.9	1.0	1.2
Interest payments	–3.9	1.1	1.5	–2.5	–1.3	–2.6	1.9	7.1	6.4	7.0	4.9	4.7	1.2	3.5	3.4	0.0	5.9	5.6	–1.6	2.9	2.8
Current transfers to	.[6]	8.7	0.5	–12.2	–2.3	–2.4	5.1	0.8	3.8	3.0	–0.5	2.3	3.4	3.0	2.7	5.4	5.9	3.2	6.7	5.3	2.3
Other levels of government	–2.5	12.9	–0.3	13.3	0.0	0.0	–0.5	–0.5	5.1	2.8	–2.2	2.3	4.2	1.3	1.3	0.0	0.0	0.0	–	–	–
Social insurance	6.6	10.6	3.2	–	–	–	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	6.5	10.5	3.2
Income support	–3.8	0.7	0.5	–	–	–	12.5	5.9	4.9	23.1	6.2	5.9	2.2	3.7	3.3	7.5	5.6	5.3	2.0	3.1	2.8
Firms	.[6]	–0.9	–0.6	–25.0	–4.2	–4.3	32.0	1.5	1.5	–	3.3	1.6	7.3	3.4	1.6	10.5	4.8	0.0	22.2	0.7	0.4
Investment	2.3	–5.2	–6.3	–	–	–	–5.1	–3.8	–7.5	4.7	–2.2	–6.8	0.0	–5.9	–8.6	–6.4	–2.9	–7.1	–1.0	–4.9	–7.7
Capital transfers	–12.3	–21.6	–4.2	–75.0	0.0	0.0	–5.5	–2.5	–4.1	–9.3	–4.3	–6.2	2.4	–2.3	–2.4	6.7	0.0	–6.2	–8.7	–1.9	–3.3
Loans and shares	–21.1	–6.7	–4.3	–24.3	–9.5	0.0	.	–23.7	–16.7	–57.9	0.0	0.0	38.2	2.1	0.0	.	0.0	0.0	10.7	–12.1	–6.2

1 Without postponement of the planned tax reductions from 2003 to 2004 and the effects on expenditure this will entail. By financial-statistical definition, excl. hospitals using commercial accounting methods. — 2 Supplementary transfers to financially weak states and transfers of petroleum tax within the regionalisation of short-distance passenger traffic substracted from central, added to state governments. — 3 Incl. Berlin. — 4 The transfer of Bundesbank profits has been recorded in full as federal government revenue; the difference to euro 3.6 billion has been recorded as a federal government transfer to the Erblastentilgungsfonds. — 5 Real assets and shareholdings. — 6 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.

pursue a very stringent line on expenditure in 2003 and 2004. The federal government at least will accept the fall in revenue due to cyclical causes and not attempt to compensate this with additional cutbacks in spending. But it is reasonable to doubt whether that line can be kept, for tax revenues are melting away now.

Again the question arises of whether the European limits for indebtedness are sufficiently flexible to allow for cyclical policy. Even the European Commission has recently suggested that national governments should in future be given greater scope in interpreting the Stability and Growth Pact and that more attention should be given to cyclical influences in supervising fiscal policies. However, that is only to be put into practice when the national governments have nearly balanced their budgets. But that is precisely the problem. The European Stability and Growth Pact is based on a 'fine weather scenario', for balanced budgets, or even budgets in surplus are typical of prosperous economies. But Germany and other EU member states are very far from such a situation. Despite the moderate trend in expenditures the latest, very brief upswing has not sufficed to balance the public budgets. It is more realistic to assume that the public deficits will grow, not only in a recession but in a stagnating economy as well, or even with only slight economic growth.

Under these conditions the extremely stringent expenditure policy for the federal government, the states and the local authorities agreed in the Fiscal Planning Council must be implemented. Nevertheless, this course offers no guarantee at all that the deficits will be reduced as agreed. Rather, the restrictive expenditure policy will put a strain on the cycle and weaken the macroeconomic basis for assessment, that is, the denominator of the deficit ratio. A lower assessment basis will in turn generate lower revenues from taxation and contributions. However, despite its counterproductive effect on the economic cycle a continuance of the restrictive expenditure policy is also probably unavoidable, because the third stage of the tax reform is due to come into effect in 2005. Under present conditions only a very small part of this tax relief can presumably be financed by borrowing.

Admittedly, this would make further conflicts inevitable. The downslide in public investment has already accelerated as a result of the tax relief in 2001, because the states and the local authorities had to compensate shortfalls in revenues. A similar development is likely in the next few years. But lower expenditure on the infrastructure could put a brake on growth. Even now, Germany is investing far less in the infrastructure than the European average[12] – although there is much leeway to be made up in both west and east Germany. Greater efforts certainly need to be made to mobilise additional funds for more public investment by rescheduling expenditures, e.g. by reducing maintenance subsidies. Ultimately, however, the crisis in public investment can only be solved as part of a fundamental reform of local authority finance,[13] for the local authorities are the main investors in the public sector. Additional funds must be made available for this, and they can hardly be acquired by rescheduling.

Admittedly, the cleft stick in which fiscal policy now finds itself is not solely due to the European rules and tax reform. The public budgets are still suffering from the cardinal error in fiscal policy that was made in financing the burden of reunification. Taxes were raised to finance German unity, but far too late and by far too little. Instead state borrowing, and with it expenditure on interest payments, have shot up drastically.

To finance the damage from the catastrophic flood, the federal government now plans to postpone the second stage of tax reform to the year 2004 and increase corporation tax for a limited period. That will raise funds totalling up to euro 7.5 billion that will be channelled into a special fund. The three levels of government are to pay into this fund in accordance with their shares in income tax. For the federal government and the states that would be just under euro 3 billion each (42.5% each), and for the local authorities about euro 1 billion (15%). This is assuming that the states agree and do pay into this fund in accordance with the original estimate of their tax revenue shortfall. Politically that is an elegant solution – tax payers have not yet had the tax cuts, and so they will not have to face higher payments from tax increases. For cyclical reasons, on balance rather positive effects are to be expected: tax cuts stimulate demand only to the extent that the funds are not saved by private individuals; in the case of public expenditure all the funds will have a direct effect on demand, first and foremost in the regions that have suffered flood damage. Above all, this solution would be welcome with regard to the principle of distribution, for tax payers are being asked to pay in accordance with the principle that those who can afford more pay more.

Dieter Teichmann and Dieter Vesper

[12] Whereas in Germany at present 1.7% of nominal GDP is being spent on public investment, in the euro zone it is about 2.5%. It is possible that more investment, e.g. in water supplies and sewage treatment, is being made by (public) enterprises and not directly by the state in Germany than elsewhere, and this investment is then entered as non-state investment.

[13] Cf. 'A Crisis in Finance and Investment – Local Government Finance Needs Fundamental Reform', by Stefan Bach and Dieter Vesper, in: *Economic Bulletin,* vol. 39, no. 9, September 2002.