

The German Public Budgets in 2003/2004: No Sign of Improvement – Deficits set to Rise Further

The longer the economic crisis lasts the more evident is the dilemma for the public budgets. On the one side the stagnating economy urgently needs stimulus to enable it to gather pace again, and fiscal policy has an important part to play here. On the other side the political decision-makers are trying to halt the growth in the public deficits by cutting back on spending and opening up new sources of revenue. Despite these efforts there is no sign of improvement in the financial situation for this year or next – on the contrary, DIW Berlin estimates that the deficit for the central, state and local governments together will be 80 billion euros this year (using the financial statistics definitions), which is 20 billion euros more than in 2002. Next year the gap is likely to be even wider, at 87 billion euros, if the third stage of the tax reform is brought forward to 2004. In an estimate based on the definition in the national accounts the deficit ratio will be a good 4% in both years.

A glance back at 2002

Last year the aggregate public deficits amounted to 61 billion euros, again far more than had been expected when the budget plans were drawn up. The growth was mainly deriving from shortfalls in tax revenues owing to cyclical causes and the high deficit on unemployment insurance, which had to be covered from the federal budget.

A breakdown by the three levels of government shows that the greatest deterioration was in the Federal Government's financial situation (cf. table 1), with the deficit growing from 21 billion euros to just under 33 billion. Expenditure increased strongly while tax revenues stagnated. Beside the big increases in the grant to the Federal Labour Office and in federal unemployment assistance necessitated by the economic slowdown, the main growth was in payments to the pensions insurance and the Federal Railways Fund.¹ Interest and investment expenditure, on the other hand, fell – interest expenditure because old debts at high interest rates were replaced by new borrowing at low rates. This was evident not only at federal level but at the other levels of government as well.

The stagnation in tax revenues was not only the result of the bad employment and earnings situation. As in the previous year, companies paid unexpectedly high dividends on which they could claim tax reimbursement, and this greatly depressed corporation tax revenue. For if companies paid out earnings retained in earlier years to shareholders the difference between the tax rate on retained earnings and that on distributed earnings was reimbursed by the tax authorities under old legislation. Clearly many companies made use of this regulation and distributed funds to shareholders – albeit profits on earlier years – even if their earnings were declining fast and some were actually operating at a loss. The decline in revenue from turnover tax was also striking, where the hoped-for increase from efforts to combat turnover tax fraud failed to materialise.

The development in the western federal states' budgets was marked by falling tax revenues and falling expenditure. However, some of the reduction in spending was due to special factors.² For the west German local authorities the financial situation has deteriorated further, although investment has continued to fall and the rise in expenditure has been only moderate on the whole. Again, tax revenues were clearly below the previous year's level, and income from charges also fell. The east German local authorities on the other hand have been able to reduce their deficits by reducing expenditure slightly – mainly in the investment field – and have also achieved a moderate rise in revenues.

It is striking on a comparison of the financial development in the individual federal states that even in the relatively prosperous areas such as Bavaria and Hesse the financial situation has deteriorated markedly in the last two years. The local authorities here have also had to register high deficits (cf. table 2).

Revenues in 2003/2004: only a slight growth in tax revenues

The development in tax revenues is still determined by the low level of economic activity in Germany. A fundamental change is not in sight for next year, either, and the public budgets will continue to be exposed to cyclical

¹ The general federal grant depends on the development in the gross wages and salaries bill per person employed and the change in the contribution rate. An additional grant is paid, which depends on the rate of change in turnover taxes. The pensions insurance also receives funds from the eco tax, which also influences the level of contributions.

² In 2001 funds totalling 1.8 billion euros were paid to Bankgesellschaft Berlin from the Berlin state budget, and this effect was lacking in 2002.

Table 1

Revenue and Expenditure of German Federal, State and Local Governments¹

	Federal government ²			Special assets ³			State governments ²						Local authorities						Total		
	2003		2004	2002	2003	2004	West Germany ⁴		East Germany		West Germany		East Germany		2002	2003	2004	Actual	Estimated		
	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated						
	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated			
in billion euros																					
Revenue																					
Taxes	214.4	216.7	213.0	0.2	0.2	0.2	139.7	141.8	140.3	22.7	22.8	22.6	43.4	44.1	42.9	4.0	4.1	3.9	424.4	429.7	422.9
Transfers from other levels of government	3.4	3.4	3.4	16.6	10.2	9.7	23.5	22.6	22.6	16.4	16.0	16.1	34.5	34.7	34.1	15.8	15.7	15.4	-	-	-
Transfers from special assets	0.7	0.7	0.7	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
State equalisation	-	-	-	-	-	-	3.7	3.8	3.6	2.9	2.9	2.8	-	-	-	-	-	-	-	-	-
Income from economic activities ⁵	11.9	6.0	5.7	-	-	-	3.6	3.5	3.5	0.4	0.5	0.5	8.5	8.4	8.4	1.2	1.2	1.2	25.6	19.6	19.3
Levies and charges	2.1	2.4	4.3	-	-	-	4.5	4.5	4.5	0.6	0.6	0.6	14.1	14.0	14.0	2.0	2.0	2.0	23.3	23.5	25.4
Sales of assets ⁶	6.0	6.0	3.5	0.1	0.5	0.5	0.8	0.9	1.1	0.1	0.1	0.1	5.9	6.1	6.4	0.9	0.9	0.9	13.8	14.5	12.5
Other sources	8.2	8.0	8.0	8.4	8.0	7.9	8.3	8.2	8.2	3.4	3.3	3.3	13.2	12.7	12.7	1.1	1.0	1.0	42.6	41.2	41.1
Total revenue	246.7	243.2	238.6	25.3	18.6	18.1	184.1	185.3	183.8	46.5	46.2	46.0	119.6	120.0	118.5	25.0	24.9	24.4	529.7	528.5	521.2
Expenditure																					
Personnel costs	27.0	27.2	27.1	7.7	7.7	7.5	83.1	84.3	84.3	13.8	14.0	14.0	32.8	33.5	33.8	7.3	7.3	7.3	171.7	174.0	174.0
Current material costs	17.1	17.2	17.3	-0.1	-	-	18.9	19.3	19.6	3.3	3.4	3.4	24.5	25.0	25.4	4.8	4.9	5.0	68.5	69.8	70.7
Interest payments	37.1	37.8	38.5	3.7	3.4	3.2	16.7	17.7	18.7	3.3	3.5	3.7	4.3	4.4	4.5	0.9	0.9	0.9	66.0	67.7	69.5
of which: to other levels of government	-	-	-	-	-	-	0.1	0.1	0.1	-	-	-	0.1	0.1	0.1	-	-	-	-	-	-
Current transfers to other levels of government	173.6	177.2	174.1	1.9	1.8	1.8	68.4	70.4	70.6	20.7	21.6	21.8	40.0	41.6	42.8	6.2	6.5	6.7	211.1	224.9	225.0
of which: to other levels of government	28.6	28.1	28.0	0.8	0.8	0.8	29.7	30.4	30.1	13.5	13.8	13.7	4.0	4.1	4.2	0.1	0.1	0.1	-	-	-
state equalisation	-	-	-	-	-	-	6.6	6.7	6.4	-	-	-	-	-	-	-	-	-	-	-	-
special assets	16.4	10.2	9.5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
social insurance	86.3	94.5	93.5	-	-	-	0.3	0.3	0.3	-	-	-	0.1	0.1	0.1	-	-	-	86.7	95.0	94.0
income support	22.3	24.5	24.5	-	-	-	8.6	9.1	9.6	1.8	2.0	2.2	24.3	25.5	26.4	3.8	4.0	4.2	60.8	65.1	66.9
firms	16.3	16.2	15.0	1.0	0.9	0.9	16.1	16.5	16.7	3.5	3.7	3.8	3.7	3.9	4.0	1.1	1.1	1.1	41.7	42.3	41.5
abroad	2.9	2.9	2.8	-	-	-	0.4	0.4	0.4	-	-	-	-	-	-	-	-	-	3.3	3.3	3.2
social institutions	0.8	0.8	0.8	-	-	-	5.8	6.0	6.1	1.1	1.2	1.2	5.7	5.8	5.9	1.0	1.0	1.0	14.4	14.8	15.0
other	0.0	0.0	0.0	0.1	0.1	0.1	0.9	1.0	1.0	0.8	0.9	0.9	2.2	2.2	2.2	0.2	0.2	0.2	4.2	4.4	4.4
Investment	6.7	6.6	6.4	-	-	-	5.1	5.2	4.9	2.0	2.2	2.0	18.7	18.4	17.1	4.9	5.0	4.7	37.4	37.4	35.1

Table 1 (continued)

	Federal government ²				Special assets ³				State governments ²								Local authorities								Total							
	2003		2004		2002		2003		2004		West Germany ⁴				East Germany				West Germany				East Germany				2002		2003		2004	
	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated	Actual	Estimated				
	14.5	13.4	13.1	-	-	-	14.1	14.0	13.5	9.1	9.1	8.8	2.2	2.2	2.1	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	35.5	35.0	35.0	33.6					
Capital transfers to other levels of government	6.3	5.5	5.8	-	-	5.9	5.7	5.4	4.2	4.1	3.9	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	-	-	-	-	-	-				
abroad	0.3	0.3	0.3	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0.3	0.3	0.3	0.3	0.3	0.3				
other	7.9	7.6	7.0	-	-	8.2	8.3	8.1	4.9	5.0	4.9	1.9	1.9	1.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	23.6	23.5	23.5	22.5	22.5					
Loans and shares of which: to other levels of government	3.4	3.2	3.0	3.2	3.0	3.0	2.7	2.6	0.6	0.6	0.6	1.5	1.5	1.4	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	11.6	11.2	11.2	10.8	10.8					
of which: to other levels of government	0.2	0.2	0.2	-	-	0.1	0.1	0.1	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-				
Expenditure total	279.4	282.6	279.5	16.4	15.8	209.0	213.6	214.2	52.8	54.4	54.3	124.0	126.6	127.1	25.1	25.6	25.6	25.6	25.6	25.6	25.6	25.6	590.2	608.8	608.8	607.9	607.9					
Financial balance	-32.7	-39.4	-40.9	8.9	2.8	2.6	-24.9	-28.3	-30.4	-6.3	-8.3	-4.4	-6.6	-8.6	-0.1	-0.7	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2	-60.5	-80.3	-80.3	-86.7	-86.7					
Revenue	0.9	-1.4	-1.9	7.7	-26.5	-2.7	-1.8	0.7	-0.8	-0.6	-0.4	0.3	0.3	0.3	1.2	-0.4	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-0.9	-0.2	-0.2	-1.4	-1.4					
Taxes	0.5	1.1	-1.7	0.0	0.0	0.0	-0.9	1.5	-1.1	0.4	-0.9	-3.8	1.6	-2.7	0.0	2.5	-4.9	-4.9	-4.9	-4.9	-4.9	-4.9	-1.0	1.2	1.2	-1.6	-1.6					
Expenditure	5.2	1.1	-1.1	-10.0	-3.7	-1.9	-1.1	2.2	0.3	0.7	3.0	-0.2	2.1	0.4	-0.6	2.0	0.0	0.0	0.0	0.0	0.0	0.0	1.5	3.2	3.2	-0.1	-0.1					
Personnel costs	0.7	0.7	-0.4	0.0	0.0	-2.6	3.0	1.4	0.0	0.0	1.4	0.0	2.5	2.1	0.9	0.0	0.0	0.0	0.0	0.0	0.0	2.0	2.0	2.0	1.3	1.3	0.0					
Current material costs	2.4	0.6	0.6	-	-	-9.0 ⁷	2.1	1.6	-10.8 ⁷	3.0	0.0	2.9	2.0	1.6	0.0	2.1	2.0	2.0	2.0	2.0	2.0	-1.4	1.9	1.9	1.3	1.3	0.0					
Interest payments	-1.3	1.9	1.9	-7.5	-8.1	-5.9	1.2	6.0	5.6	6.1	5.7	-2.3	2.3	2.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	2.6	2.6	2.7	2.7	0.0					
Current transfers to other levels of government	10.7	2.1	-1.7	-13.8	-5.3	0.0	1.3	2.9	0.3	5.4	4.3	0.9	2.6	4.0	2.9	2.6	4.8	3.1	3.1	3.1	3.1	7.1	6.5	6.5	0.0	0.0	0.0					
of government	12.6	-1.7	-0.4	-11.2	0.0	0.0	0.1	2.4	-1.0	1.7	2.2	-0.7	5.3	2.5	2.4	0.0	0.0	0.0	0.0	0.0	0.0	-	-	-	-	-	-					
social insurance	13.3	9.5	-1.1	-	-	0.0	0.0	0.0	-	-	-	0.0	0.0	0.0	0.0	-	-	-	-	-	-	13.0	9.6	9.6	-1.1	-1.1	0.0					
income support	7.7	9.9	0.0	-	-	10.3 ⁷	5.8	5.5	12.5 ⁷	11.1	10.0	2.5	4.9	3.5	3.8	5.3	5.0	5.0	5.0	5.0	5.0	5.7	7.1	7.1	2.8	2.8	0.0					
firms	-2.4	-0.6	-7.4	-16.7	-10.0	0.0	19.6 ⁷	2.5	1.2	14.0 ⁷	5.7	2.7	23.3	5.4	2.6	1.9	0.0	0.0	0.0	0.0	0.0	8.2	1.4	1.4	-1.9	-1.9	0.0					
Investment	-2.9	-1.5	-3.0	-	-	-10.5	2.0	-5.8	-13.0	10.0	-9.1	-1.6	-1.6	-7.1	-5.8	2.0	-6.0	-6.0	-6.0	-6.0	-6.0	-4.3	0.0	0.0	-6.1	-6.1	0.0					
Capital transfers	-15.2	-7.6	-2.2	-	-	-0.5	-0.7	-3.6	-4.2	0.0	-3.3	0.0	0.0	-4.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	47.9	-1.4	-1.4	-4.0	-4.0	0.0					
Loans and shares	-10.5	-5.9	-6.3	-25.1	-6.3	0.0	-55.0	0.0	-3.7	50.0	0.0	-37.5	0.0	-6.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-31.5	-3.4	-3.4	-3.6	-3.6	0.0					

1 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 subtracted from central, added to state governments. — 3 Cf. table 4. — 4 Incl. Berlin. — 5 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 Fund for the Redemption of Old Debts (Erblastentilgungsfonds). — 6 Real assets and shareholdings. — 7 Not comparable with the previous year owing to changes in classifications. Sources: Federal Statistical Office; DIW Berlin estimates.

Table 2

Financing Balances of the Federal States and Local Authorities

	Federal States			Local authorities		
	2000	2001	2002	2000	2001	2002
In billion euros						
Baden-Württemberg	-705	-2 647	-2 641	828	-838	108
Bavaria	934	-896	-2 044	152	-683	-1 311
Brandenburg	-455	-563	-1 655	-20	-152	40
Hesse	-426	-1 225	-2 113	650	132	-561
Mecklenburg-Western Pomerania	-639	-549	-1 056	47	-99	-124
Lower Saxony	-936	-3 670	-3 868	109	-550	-175
North Rhine-Westphalia	-2 191	-6 774	-4 665	291	-1 088	-1 973
Rhineland-Palatinate	-480	-1 017	-1 534	-168	-546	-451
Saarland	109	2	-373	-106	-105	22
Saxony	-241	-90	-993	68	-80	47
Saxony-Anhalt	-846	-1 011	-1 532	-8	-160	-175
Schleswig-Holstein	-360	-620	-1 162	31	206	-93
Thuringia	-736	-783	-1 121	49	6	-13
Old and new federal states	-6 971	-19 843	-24 756	1 923	-3 955	-4 658
Former Federal territory	-4 054	-16 847	-18 401	1 788	-3 470	-4 434
New Länder	-2 917	-2 996	-6 356	135	-484	-224
City states	-3 384	-6 970	-6 467	-	-	-
Berlin	-2 553	-5 237	-4 939	-	-	-
Bremen	-146	-305	-592	-	-	-
Hamburg	-686	-1 427	-936	-	-	-
Total	-10 355	-26 812	-31 223	1 923	-3 955	-4 658
Euros per inhabitant						
Baden-Württemberg	-67	-252	-252	79	-80	10
Bavaria	77	-74	-168	12	-56	-108
Brandenburg	-175	-216	-636	-7	-58	15
Hesse	-70	-202	-349	107	22	-93
Mecklenburg-Western Pomerania	-358	-308	-592	26	-55	-70
Lower Saxony	-118	-464	-489	14	-70	-22
North Rhine-Westphalia	-122	-376	-259	16	-60	-110
Rhineland-Palatinate	-119	-252	-381	-42	-136	-112
Saarland	102	2	-349	-99	-98	21
Saxony	-54	-20	-223	15	-18	11
Saxony-Anhalt	-321	-384	-582	-3	-61	-66
Schleswig-Holstein	-129	-223	-418	11	74	-33
Thuringia	-302	-321	-459	20	3	-5
Old and new federal states	-91	-260	-324	25	-52	-61
Former Federal territory	-65	-269	-294	29	-56	-71
New Länder	-210	-215	-457	10	-35	-16
City states	-588	-1 211	-1 124	-	-	-
Berlin	-754	-1 548	-1 460	-	-	-
Bremen	-220	-461	-895	-	-	-
Hamburg	-401	-836	-548	-	-	-
Total	-126	-326	-380	23	-48	-57

Sources: Federal Statistical Office; DIW Berlin calculations.

cal strain. In addition, extensive tax reductions will take effect. The second stage of tax reform was postponed last year to finance the repairs to the flood damage, but this year it will cause revenue shortfalls of 7 billion euros, while the third stage, which is to be brought forward by one year to 2004, will involve revenue reductions of an expected 15.6 billion euros.

According to the estimate presented here the Federal Government, the states and the local authorities can

expect tax revenue this year and next totalling 450 billion euros and 444 billion euros, respectively (cf. table 3). That is a rise of 1.9% and a fall of 1.3%. The estimate has been made on the basis of the receipts up to July and the latest economic prognosis by DIW Berlin.³ The shortfalls due to cyclical causes this year are increased

³ Cf. Arbeitskreis Konjunktur: 'Economic Trends 2003/2004'. In: *DIW Economic Bulletin*, vol. 40, no. 8, August 2003.

Table 3
Tax Revenue in Germany 2002 to 2004

	West Germany ¹			East Germany ²			Total			West Germany ¹		East Germany ²		Total	
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2002	2003	2002	2003	2002	2003
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Estimated					
	Billion euros									Change (%) on the previous year					
Joint taxes	.	.	.	.	.	.	303.2	306.0	297.0	.	.	.	.	0.9	-2.9
Wage tax ⁴	123.5	125.2	113.1	8.6	9.0	8.1	132.1	134.2	121.2	1.4	-9.7	4.7	-10.0	1.6	-9.7
Assessed income tax ⁴	10.6	8.5	7.2	-3.0	-3.3	-3.6	7.6	5.2	3.6	-19.8	-15.3	10.0	9.1	-31.6	-30.8
Non-assessed income tax ⁶	13.6	10.3	10.8	0.4	0.3	0.3	14.0	10.7	11.1	-24.1	4.1	-17.5	3.0	-23.9	4.1
Interest tax ⁶	8.3	7.8	7.9	0.2	0.2	0.2	8.5	8.0	8.1	-5.8	1.0	-25.0	0.0	-6.2	1.0
Corporation tax ⁵	3.5	10.2	13.0	-0.7	-0.4	-0.2	2.8	9.8	12.8	191.4	27.5	-42.9	-50.0	250.0	30.6
Taxes on turnover ⁷	.	.	.	.	.	.	138.2	138.2	140.3	.	.	.	.	0.0	1.5
Customs duty	.	.	.	.	.	.	2.9	2.9	2.8	.	.	.	.	0.0	-3.4
Federal taxes	.	.	.	.	.	.	83.5	87.0	88.2	.	.	.	.	4.2	1.4
Petroleum tax	.	.	.	.	.	.	42.2	43.1	43.4	.	.	.	.	2.1	0.7
Electricity tax	.	.	.	.	.	.	5.1	6.3	6.4	.	.	.	.	23.5	1.6
Tobacco tax	.	.	.	.	.	.	13.8	14.8	15.7	.	.	.	.	7.2	6.1
Spirits duty	.	.	.	.	.	.	2.1	2.2	2.2	.	.	.	.	4.8	0.0
Insurance tax	.	.	.	.	.	.	8.3	8.8	9.0	.	.	.	.	6.0	1.7
Solidarity surplus (on income taxes)	.	.	.	.	.	.	10.4	10.3	10.0	.	.	.	.	-1.0	-2.9
Other	.	.	.	.	.	.	1.6	1.5	1.5	.	.	.	.	-8.1	2.0
State taxes	16.5	16.6	17.3	2.1	2.2	2.2	18.6	18.8	19.5	0.6	4.2	4.8	0.0	1.1	3.7
Vehicle tax	6.5	6.3	6.7	1.1	1.1	1.1	7.6	7.4	7.8	-3.1	6.3	0.0	0.0	-2.6	5.4
Inheritance tax	3.0	3.3	3.5	-	0.1	0.1	3.0	3.4	3.6	10.0	6.1	.	0.0	13.3	5.9
Real estate purchase tax	4.2	4.2	4.3	0.5	0.5	0.5	4.7	4.7	4.8	0.0	2.4	0.0	0.0	0.0	2.1
Other	2.8	2.8	2.8	0.5	0.5	0.5	3.3	3.3	3.3	0.0	0.0	0.0	0.0	0.0	0.0
Local government taxes	30.3	31.9	33.2	3.2	3.3	3.4	33.5	35.2	36.6	5.3	4.1	3.1	3.0	5.1	4.0
Trade tax	21.7	23.0	24.0	1.8	1.9	1.9	23.5	24.9	25.9	6.0	4.3	5.6	0.0	6.0	4.0
Real estate tax	8.0	8.3	8.6	1.3	1.3	1.4	9.3	9.6	10.0	3.8	3.6	0.0	7.7	3.2	4.2
Other	0.6	0.6	0.6	0.1	0.1	0.1	0.7	0.7	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Total tax revenues	.	.	.	.	.	.	441.7	449.9	444.1	.	.	.	.	1.9	-1.3
Financial statistics definition ³	.	.	.	.	.	.	424.4	429.7	422.9	.	.	.	.	1.2	-1.6

Columns may not sum due to rounding.

1 West Germany incl. West Berlin. — 2 East Germany incl. East Berlin. — 3 Excl. EU shares, incl. para-fiscal charges. In the financial statistics West and East Berlin are included in West Germany.

Sources: Federal Ministry of Finance; Federal Statistical Office; DIW Berlin estimates.

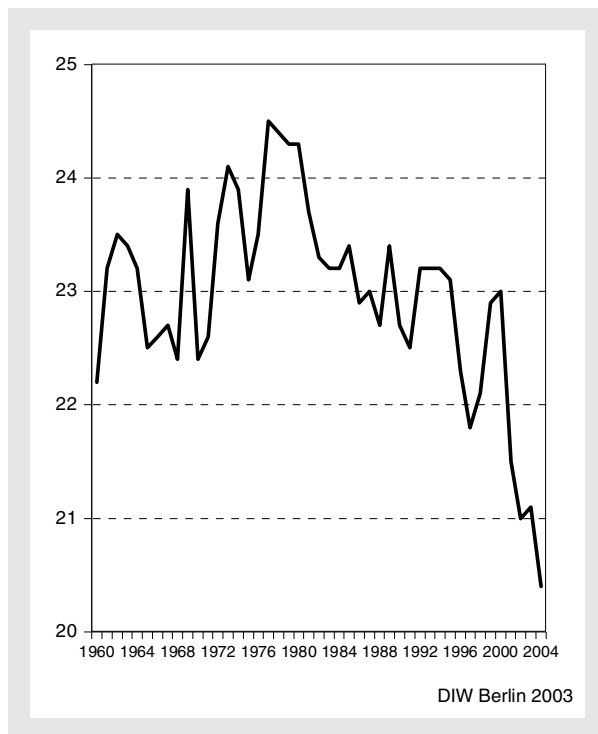
by special effects in earnings-related taxes – namely corporation and trading tax. The tax ratio for the economy as a whole – receipts in relation to nominal GDP – should be 21.2% this year; next year it will drop to 20.4% owing to the tax reductions, and that will be the lowest level since 1960 (cf. figure 1).

Only a moderate rise in *wage tax revenue* can be expected this year (+1.6%), although the progressive effect of the income tax scale will not be affected by the changes in the legislation. Per capita incomes to persons employed will rise only slightly, and the number employed will continue to fall. Next year the number employed should remain stable, however, while it is

assumed that gross wages and salaries will rise rather more than this year. However, large reductions in tax revenues are expected from the tax reform, so that at 121.4 billion euros receipts will be just under 13 billion euros or 10% lower than in 2003. Without the two stages of the tax reform tax revenues would be 138 billion euros (+2.8%).

The development in *earnings-related taxes* – assessed income tax, non-assessed taxes on earnings, corporation tax – will be determined mainly by the very positive trend in revenues from *corporation tax*. After the changes due to the tax reform programme and the special effects evident in earlier years, which caused

Figure 1
The Tax Ratio¹ 1960 to 2004²



¹ Tax receipts in % of nominal GDP. — 2003 and 2004 estimates by DIW Berlin. Sources: Federal Statistical Office; DIW Berlin estimates.

strong distortions,⁴ a big rise can be expected this year, with nearly 10 billion euros registered at the end of the year. The increase in corporation tax, which is limited to one year, will also make a contribution to this – insofar as it is reflected in the prepayments.⁵ Next year the *normalisation* should continue at a slower tempo. However, it is uncertain to what extent companies will offset the losses suffered in earlier years if their earnings start to rise again, and these losses can run to three-figure billions. All in all, revenue of nearly 13 billion euros is regarded as possible.

In *non-assessed taxes on earnings* a strong fall – of 24% – is expected from the previous year, as the level in the two preceding years was extremely high owing to the enormous extra dividend payments made by companies. Here, too, the trend is returning to normal, and a rise of 4% is forecast for 2004. Lower receipts on interest discounts, on the other hand, are again expected for this year, because interest rates have fallen further. Next

⁴ Last year this revenue was just under 3 billion euros; in the previous year the gap was 400 million euros, because the demands for reimbursement of corporation tax exceeded the revenue.

⁵ Corporation tax was raised to obtain a contribution from companies towards flood damage repairs.

year interest receipts should remain stable; capital market rates are not expected to fall further.

Cash receipts from *assessed income tax* are de facto a statistical residual item. They comprise the difference between the final payment due on income tax and the amounts retained at source in the form of wage tax, corporation tax, capital earnings tax and the interest discount. The tax reimbursements to persons employed (under § 46 Income Tax Law), the owner-occupier grants and the investment grants are all paid out of this pot. This year the cash receipts are expected to be only 5.2 billion euros, again clearly lower than the previous year's figure of 7.6 billion euros. However, special effects are at work here which largely explain the poor result. In particular, besides the cyclical developments, changes to the tax legislation are reducing revenues. Next year a further fall in cash receipts – of 6% – is to be expected as tax reductions will be brought forward.

In the last few years *revenue from turnover tax* always grew less strongly than the growth in its assessment basis.⁶ There were a number of reasons for this. Tax-free consumer spending by private households (rents, financial and health care services) rose at an above-average rate, and spending at reduced tax rates also greatly increased following the livestock diseases.⁷ The growing number of bankruptcies also played a part, as did fraud cases in connection with 'carousel transactions', as they are called. In reaction to the increase in turnover tax evasion the Federal Government has widened the scope for tax investigation. The current trend in this type of tax does give rise to the hope that these measures are beginning to pay off. For next year a similar development at + 1.6% is expected to that in domestic demand, on which turnover tax is payable.

In *federal taxes*, especially petroleum, tobacco and insurance taxes, which yield high revenue, and the solidarity supplement, a strong rise is becoming evident (4.5%). At the start of the year the energy taxes and tobacco tax were raised again, and the increase in the rates of insurance taxes last year is still having an effect. For 2004 a rise of only 1.3% is forecast – which corresponds to the forecast growth rate for real GDP. Federal state taxes will expand at only a weak rate owing to a special effect in motor vehicle tax.⁸ Next year a stronger growth can be expected. In local authorities' taxes, on the other hand, a relatively strong rise is evident for this

⁶ The assessment basis for the economy as a whole is calculated by deducting the chief tax-free components – foreign trade and payments, corporate investment (including stocks) eligible for pre-tax deduction – from nominal GDP.

⁷ Cf. Deutsche Bundesbank: 'Neuere Tendenzen der Steuereinnahmen'. In: *Monthly Report for December 2002*, p. 27.

⁸ Changes in the tax legislation resulted in excess payments in 2002.

year, as revenues from trade tax are increasing, another indication that companies' earnings situation is improving.

Expenditures: even more stringent economies in 2004

Big reductions in tax revenues due to the tax reform measures and the cyclical development will spur the fiscal policy decision-makers to even greater efforts to reduce their spending. On the other hand, the high level of unemployment will force higher expenditures. It was agreed in the Fiscal Planning Council that the Federal Government will reduce its expenditures by on average half a percentage point per year in 2003 and 2004, while the federal states and the local authorities will limit the growth in their expenditures to 1% a year. On average the growth rate will be 0.4% per year. According to the estimate presented here all three tiers of government will miss these targets by a wide margin this year, as expenditures are expected to rise by 3.2%. Expenditures are expected to remain stable next year, so that the average for the two years together will be an increase of 1.6%.

In *personnel expenditure* the increase for this year is put at 1.3%. The increases in collectively agreed wage rates will add 2% to the total, but more jobs are being cut in the public service. The number directly employed by the Federal Government, the states and the local authorities has been reduced from 5.5 million to 4.6 million (-15%) in the last ten years.⁹ This year the number of jobs in the direct public service should fall by more than half a percentage point (-30000 persons). In 2004 the wages and salaries for employees in the public service will rise by 1.8% on balance; this includes the postponed salary increases for officials. However, holiday and Christmas bonuses for officials are to be reduced. Cutting out holiday bonuses altogether would save the Federal Government just under 100 million euros, the states 310 million euros and the local authorities just under 50 million euros.¹⁰ If the Christmas bonus is cut by 30%, as planned, the Federal Government will save

⁹ Some of the reduction is due to the fact that through privatisation of some public facilities and their consequent removal from the public budgets some staff who were in the public service are now classified as in the private sector. Where these jobs are shifted from the direct to the indirect public service - examples are creches and day nurseries, old people's homes, cultural facilities and increasingly the universities - this is reflected in a reduction in personnel expenditure and an increase in grants to these facilities. In recent decades the number directly employed in the public service has fallen from 5.3 million to 4.1 million, while the number indirectly employed has risen by 240 000 to 590 000.

250 million euros, the states 940 million euros and the local authorities 120 million euros. In the prognosis it is assumed that the political decision-makers will really do what they have said they will do and that further jobs will be cut. If so, personnel expenditure will remain stable.

Current expenditure on material will rise only moderately in both prognosis years. Sustained economies are hardly possible here, as much of the expenditure is needed to maintain current operations. As in previous years, the Federal Government, the states and especially the local authorities will try to cut down public investment expenditure. The local authorities are particularly constrained in their scope for borrowing, and they react to shortfalls in revenues by cutting down on discretionary items, that is, spending that is not laid down by law. This year investment expenditure should rise slightly as measures to repair flood damage to infrastructure will still be effective. Next year a fall of 6% is expected. It is taken into account here that at federal level the Future Investment Programme will come to an end this year and that in 2004 the funds from the toll payable by lorries are to be used to finance transport investment.¹¹

Judging by the powerful growth in the fiscal deficits, state *interest expenditure* ought to be rising strongly, even taking into account the relatively low nominal interest rates on the capital market. But some of this burden can be lessened as old debt on which high interest rates have to be paid is being replaced by new borrowing at low rates. On balance, interest expenditure should increase by just under 3% in each prognosis year.

Current transfer payments will expand at a far-above-average rate of 6.5% this year. This is due to the high federal grants to unemployment insurance and the expenditure on financing long-term unemployment. This year a federal grant of 8 billion euros to the Federal Labour Office is expected, after 6.4 billion euros last year. No amount is earmarked for this in the budget plan. How high the grant will ultimately be also depends on how effective the labour market reforms and the consolidation measures introduced prove to be. They are evidently beginning to work.

It is also becoming evident that the payments by the Federal Government to the statutory pensions insurance bodies will rise. This grant depends firstly on the general trend in incomes, and secondly on the change in the contribution rate, which has been increased from 19.1%

¹⁰ The 'net' saving would, however, be lower as tax revenue would also be reduced.

¹¹ Under the Future Investment Programme additional investment in the transport and education sectors was undertaken, financed by interest saved from the use of the UMTS auction receipts to pay off debt.

Table 4

Revenue and Expenditure of the Federal Special Assets

In billion euros

	German Unity Fund			Railway Fund			Fund for the Redemption of Old Debts			Other funds ¹			Total		
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004
	Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated		Actual	Estimated	
Revenue	2.5	2.1	2.0	8.7	8.6	8.5	8.6	2.6	2.3	5.5	5.3	5.3	25.3	18.6	18.1
Para-fiscal charges	-	-	-	-	-	-	-	-	-	0.2	0.2	0.2	0.2	0.2	0.2
Transfers from other levels of government	2.5	2.1	2.0	6.1	6.0	5.9	7.9	2.0	1.7	0.1	0.1	0.1	16.6	10.2	9.7
Sales of assets	-	-	-	0.1	0.2	0.3	-	-	-	-	-	-	0.1	0.2	0.3
Other sources ²	-	-	-	2.5	2.4	2.3	0.7 ⁴	0.6 ³	0.6 ³	5.2 ⁴	5.0	5.0	8.4	8.0	7.9
Expenditure	2.3	2.1	1.9	8.7	8.6	8.5	0.7	0.7	0.7	4.7	4.4	4.4	16.4	15.8	15.5
Personnel costs	-	-	-	7.7	7.6	7.5	-	-	-	-	-	-	7.7	7.6	7.5
Current material costs	-0.1	-0.1	-0.1	0.0	0.1	0.1	-	-	-	-	-	-	-0.1	-	-
Interest payments	2.4	2.2	2.0	-	-	-	-	-	-	1.3	1.2	1.2	3.7	3.4	3.2
Current transfers to	-	-	-	1.0	0.9	0.9	0.7	0.7	0.7	0.2	0.2	0.2	1.9	1.8	1.8
Other levels of government	-	-	-	-	-	-	0.7	0.7	0.7	0.1	0.1	0.1	0.8	0.8	0.8
Firms	-	-	-	1.0	0.9	0.9	-	-	-	0.0	0.0	0.0	1.0	0.9	0.9
Other	-	-	-	-	-	-	-	-	-	0.1	0.1	0.1	0.1	0.1	0.1
Capital transfers	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Loans and shares	-	-	-	-	-	-	-	-	-	3.2	3.0	3.0	3.2	3.0	3.0
Balance	0.2 ⁴	0.0 ⁴	0.1 ⁴	0.0	0.0	0.0	7.9 ⁴	1.9 ⁴	1.6 ⁴	0.8	0.9	0.9	8.9	2.8	2.6

Columns may not sum due to rounding.

1 ERP, LAF, Compensation Fund, Coal Industry Fund. — 2 For ERP including revenue from loans and loan repayments; for Railway Fund including reimbursement of DB AG personnel costs. — 3 Including additional revenue from the Bundesbank profit. — 4 Surpluses are used to pay off debt.

Sources: Federal Statistical Office; DIW Berlin estimates.

to 19.5%. The gradual increase in eco taxes affects the additional federal grant. Social benefits – mainly social assistance, which is paid by the local authorities, and federal unemployment assistance – are also expected to expand strongly this year (by 7%). Not only will the rise in long-term unemployment require higher spending; the payments for persons requiring care in homes will also rise. However, expenditure by the Federal Government on provision for war victims will fall as the number receiving these benefits is declining. The prognosis on social benefits for next year currently involves considerable uncertainty, as it is not yet finally clear in what form unemployment and social assistance are to be merged and to what extent this will ease the strain on the budget. The estimate is based on the status quo. For 2004 no further rise in contribution rates is assumed, so that the federal grant to pensions insurance should rise only moderately. The Federal Labour Office will again need a large federal grant, but a smaller one than this year. On balance, current transfer payments should remain stable. The reduction in subsidies will also play a part here.

The development at the three budget levels

The deficits registered by the Federal Government, the states and the local authorities grew last year, in some cases powerfully, and this year they will swell further, from 60 billion euros to 80 billion euros. As a result of bringing forward the third stage of tax reform a further growth in the aggregate deficit – to nearly 87 billion euros – is forecast for next year. This year expenditures will rise by 3.2%, while revenues will fall slightly. For 2004 a fall of 1.4% in revenues and stagnating expenditures are regarded as probable. After adjustment for the cyclical effect – federal grants to the Federal Labour Office and higher expenditure on unemployment insurance – a slight growth is calculated for this year, but a fall in contrast next year.

The present estimate only shows part of the financial effects of the measures to finance the anticipation of the third stage of tax reform and the reform of finances in local authorities. It does not take into account the

Table 5
The Development in the Deficit in the National Accounts and in the Financial Statistics
 In billion euros

	2000 ¹	2001	2002	2003 ²	2004 ²
Central government³					
Financial statistics	-25.5	-16.0	-23.8	-36.6	-38.3
National accounts	-24.5	-28.6	-34.8	-46.0	-46.0
Federal states					
Financial statistics	-10.4	-26.8	-31.2	-36.5	-38.7
National accounts	-7.8	-27.1	-30.9	-36.0	-38.0
Local authorities					
Financial statistics	1.9	-4.0	-4.7	-7.3	-9.8
National accounts	5.4	0.8	-3.7	-7.0	-9.0
All three levels of government					
Financial statistics	-33.9	-46.8	-59.7	-80.4	-86.8
National accounts	-27.0	-54.9	-69.4	-89.0	-93.0

¹ Without UMTS receipts. — ² Estimate by DIW Berlin. — ³ Including Special Assets.

Sources: Federal Statistical Office; DIW Berlin calculations.

financial consequences of integrating social assistance with unemployment assistance, where it must be expected that the Federal Government's plans will be considerably modified in the legislative procedure. This is likely to apply not only to the planned reduction in tax concessions – mainly the owner-occupier grant, the housing construction premium, the global long-distance travel allowance, offsetting allowed for wear and tear, the household free allowance, and petroleum tax concessions for agriculture and forestry – but also to reform of local authorities' finances. And as experience has shown, *compensatory payments* by the Federal Government to the states will probably be made in order to obtain their agreement to the proposed legislation.

The deficit in the *federal budget* is likely to be nearly 40 billion euros, more than twice as high as estimated in the budget plan. This is partly due to clearly lower tax revenues and secondly to higher expenditure on unemployment. The fact that the Bundesbank has transferred a much lower profit than last year will not directly affect the level of the deficit, as the Federal Government has also made a correspondingly lower transfer to the Fund for the Redemption of Old Debts. However, this will be reflected in the *special assets* in that a lower surplus is available to pay off debt (cf. table 4). Next year, despite falling expenditures (-1%) the Federal Government's deficit will rise to 41 billion euros. The chief reasons are

the lower tax revenues due to the tax reform and lower receipts from privatisation.

The *federal states* will not be able to reduce their deficits either – rather this prognosis indicates that their aggregate deficit will rise to nearly 37 billion euros in 2003 and 39 billion euros in 2004. With revenues growing only slightly expenditures will rise this year by a good 2%. Next year revenues are expected to fall while expenditures will remain nearly stable. The federal state budgets are very personnel-intensive, and reducing the Christmas and holiday bonuses will have a big effect here. As a result of the fall in tax revenues following the reform measures the states will cut back the transfers they make to the local authorities under the communal financial compensation arrangements. In some cases this will be done automatically because the transfers to the local authorities take the form of a fixed ratio of the state's tax revenue, while some of the cutbacks will be discretionary (investment grants).

The financial situation for the *local authorities* is expected to deteriorate further, despite the higher revenues from trade tax. Extra expenditure will be needed particularly for social assistance. Deficits of around 8 and 10 billion euros are expected for this year and next.

Fiscal policy considerations

In the Maastricht Treaty and the European Stability and Growth Pact the fiscal policy decision-makers have subjected themselves to very stringent fiscal policy rules. As economic stagnation persists it is becoming increasingly clear how difficult it is to sustain a strategy of adhering to deficit targets set in earlier years under different conditions. By last year Germany had already clearly exceeded the limit for the deficit set in the Treaty and in the Stability Programme, with a deficit of 3.6% of nominal GDP. The estimate for the public budgets presented here is based on the financial statistics; however, the national accounts have to be used to calculate the deficit in accordance with the Maastricht Treaty.¹² A rough calculation using the data in the national accounts gives deficits of 89 billion euros for this year and 93 billion euros for next year (cf. table 5). For the social insurance institutes excess expenditure of 4 billion euros is expected in each year. The aggregate public deficit will be 4.3% of nominal GDP in each year, that is, again far above the target and the limit for the deficit.

¹² In the national accounts pure financing transactions such as loans and shareholdings are excluded. In contrast to the national accounts the financial statistics show the flows of public finance on the date when the payment is made and not on the date when claims and liabilities are incurred.

Table 6

Conversion of the Debt Level as Defined in the Financial Statistics to the Debt Level in Accordance with the Maastricht Treaty

In billion euros

	2000	2001	2002	2003	2004
	Actual			Estimated	
Borrowing in the financial market as defined in the financial statistics	1 198.2	1 203.9	1 253.2	1 328.0	1 408.0
+ Social insurance debt	1.9	2.3	3.0	7.0	11.0
+ Coin in circulation	9.0	7.2	4.2	4.2	4.3
+ Difference between nominal and discounted value of non-interest-bearing Treasury bonds and financial bonds	0.4	0.5	0.5	0.5	0.5
+ Borrowing for current requirements	12.8	19.6	24.1	29.5	35.7
+ Para-borrowing legal transactions	0.5	0.4	0.4	0.4	0.4
– Indebtedness of the three levels of government to the social insurance institutes	0.5	0.4	0.4	0.4	0.4
– Provisions for pensions	0.4	0.7	1.5	2.2	2.9
= Debt level in accordance with the Maastricht Treaty	1 221.9	1 232.8	1 283.5	1 367.0	1 456.6
Debt level in % of gross domestic product	60.2	59.5	60.9	64.3	67.1

Sources: Federal Statistical Office; DIW Berlin estimates.

The limit for the level of debt (60% of GDP) will again be clearly exceeded with 64% and 67% expected for 2003 and 2004 respectively (cf. table 6).

In planning to bring forward the third stage of tax reform, fiscal policy has responded to the recessionary development in the German economy. Without that step fiscal policy would have hampered economic recovery, for the policy was in principle restrictive – both increases in contribution rates to social insurance and cutbacks in public spending are being implemented or are envisaged. The fundamental decision to bring forward the tax reform does appear to have prevented that danger – although only if the fiscal policy decision-makers do not embark on an even more stringent consolidation course on the expenditure side in the short term to finance the tax reform. In terms of stabilisation policy further cuts in public spending cannot be justified. If expenditures are growing more than planned this is solely due to the effectiveness of the built-in stabiliser on the spending side, namely the high expenditures to finance cyclical unemployment.

It is therefore all the more important to differentiate between short- and medium-term perspectives in fiscal policy. Even if it is advisable for cyclical reasons to finance bringing forward the tax reform largely by borrowing, over the medium term the consolidation target must be maintained. That will require a longer term concept, the realisation of which must be politically more binding than has been the case with projects so far. Pol-

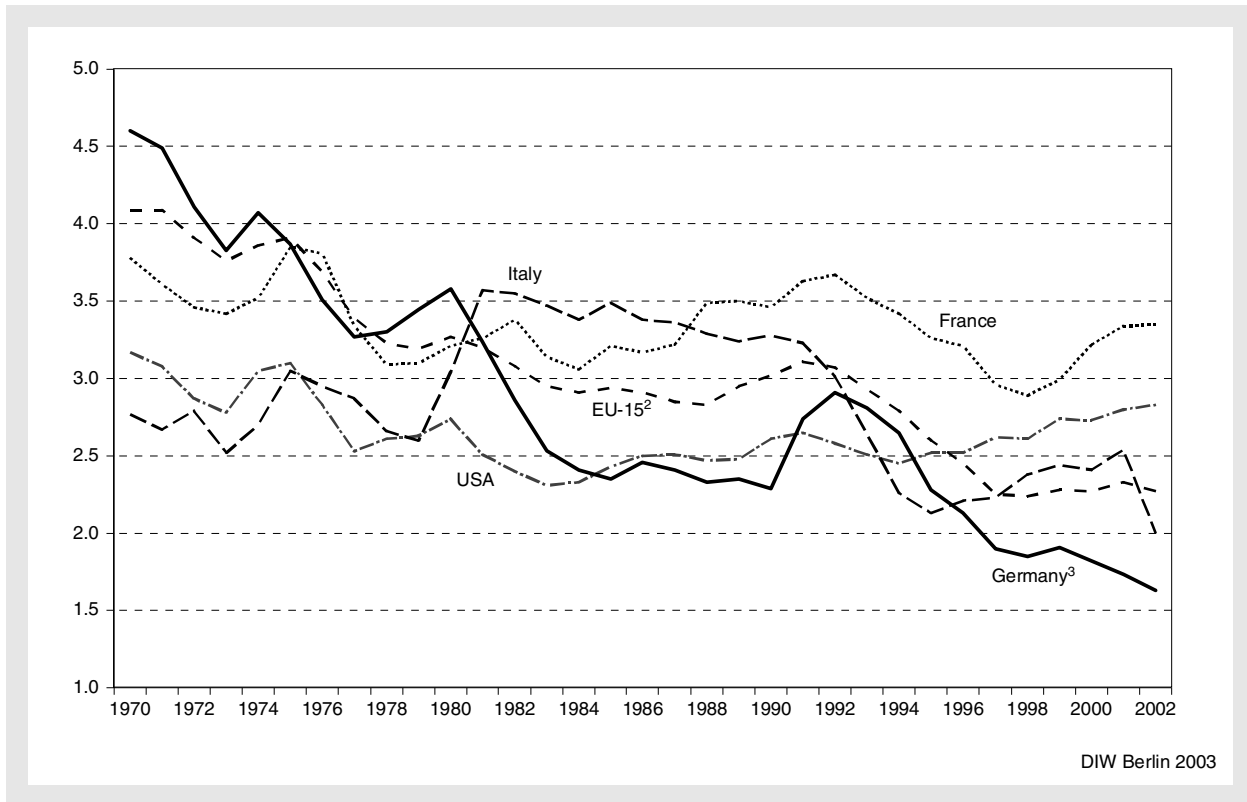
icy should not set itself a binding target for the deficit but keep to an expenditure line, and the grants to the Federal Labour Office should be excluded from this.

A concept of this kind is also necessary to avoid shocks to the sectors affected and to enable the economically active to develop adjustment strategies. For that reason DIW Berlin recently proposed a broadly based reduction in subsidies, but one that would only gradually take effect later.¹³ The same applies to additional economy measures, if they appear necessary in the medium term and will help to make government action more effective. They should only come into force after a time lag, to ensure that the upswing is not blocked before it has started. A recession is not the right time to implement such measures, while in an upswing the negative effects on employment and incomes which such measures entail can more easily be compensated.

Bringing forward the tax reform will certainly narrow the scope for action in other areas of fiscal policy. Public investment is a particular cause for concern. It has been declining for years and is expected to show a big fall again next year. That development contrasts with considerations of growth and investment needs. Infrastructure expenditures are essential because of their intermediate function and because they are complementary to activities in the private sector, where they help to increase companies' production potential or

¹³ Cf. 'Economic Trends 2003/2004', loc. cit.

Figure 2
Public Investment by International Comparison from 1970 to 2002¹
As % of nominal GDP



1 2002 estimate by Eurostat. — 2 Until 1990 without Luxembourg. — 3 Until 1990 West Germany.
Sources: Eurostat; calculations by DIW Berlin.

lower their production costs. Insufficient infrastructure expenditure can act as a brake on growth. The concern is far more than public investment in the narrower sense: we need more spending on education and research, for highly qualified human capital is essential if the German economy is not to fall behind in international competition for production and the supply of knowledge-based services. There is still much leeway to be made up in eastern Germany,¹⁴ and in western Germany comprehensive modernisation of the public infrastructure is urgently needed.¹⁵

An international comparison also shows that Germany is spending too little on infrastructure. While the European average for the share of public investment in

nominal GDP is 2.5%, and bigger countries like France and Spain have even higher shares, Germany has a share of only 1.6% and the trend is downward (cf. figure 2). The difference is significant even though the European average for the investment ratio has also fallen.¹⁶ A comparison of spending on education also shows that Germany is below the average for countries included in the OECD comparison – at least for the elementary school sector and the tertiary level, particularly the universities.¹⁷ The share of public spending (basic funding) on education and research is also declining in Germany.¹⁸ In 1980 Germany spent 5.3% of GDP on education and research, but the share is now only 4.2%.

¹⁴ Cf. Bernhard Seidel and Dieter Vesper: 'Anlagevermögen der ostdeutschen Länder – noch erheblicher Nachholbedarf'. In: *Wochenbericht des DIW Berlin*, no. 24/2000 and Dieter Vesper: 'Zum infrastrukturellen Nachholbedarf in Ostdeutschland'. In: *Wochenbericht des DIW Berlin*, no. 20/2001.

¹⁵ Cf. M. Reidenbach et al.: 'Der kommunale Investitionsbedarf in Deutschland'. In: *Difu-Beiträge zur Stadtforschung*, no. 35, Berlin 2002.

¹⁶ That also applies taking into account that international comparisons are bound to raise problems of classification and definition. It is possible, for instance, that more public investment is undertaken in Germany than elsewhere by companies and enterprises that are not included in the core budget.

¹⁷ Cf. OECD: 'Education at a Glance', Chart B1.3, Paris 2002, p. 152.

¹⁸ Cf. Federal Statistical Office, Finanzen und Steuern: 'Rechnungsergebnisse der Öffentlichen Haushalte für Bildung, Wissenschaft und Kultur 2000'. In: *Fachserie 14*, Reihe 34, p. 15.

A fundamental condition for more public investment is better local authorities' finance. Whatever form reform of local authorities' finance may ultimately take, the result must be to strengthen the position of the local authorities in the federative structure. That means first and foremost making them more financially independent, which in turn means more than equipping them with the financial means to meet their needs, which will help to maintain a relatively stable development. They also need a larger share of *autonomous* tax revenue, and here the main item is trade tax, which is the core of local authorities' taxation. However, property tax is also important, and it needs to be put on a new assessment basis.¹⁹ The justification for a local business tax is based on the idea of equivalence. Local businesses benefit greatly from the supply of local infrastructure, regardless of the level of their earnings. That aspect in particular is being overlooked in current discussion, in which the proposal to widen the assessment basis is rejected with the argument that companies would then be taxed whatever their earning power. Companies use the local infrastructure in good and in bad times. Apart from that, a broader assessment basis would enable the tax rate to be brought down quite considerably. More stable revenue cannot be achieved if the assessment bases for taxation continue to depend as strongly as they do now on cyclical trends, or if the revenue is undermined by the scope for companies to offset losses.²⁰ Moreover, it should be taken into account in the discussion over taxation that companies have already benefited considerably from the tax reform in 2001. Hence it was a political error not to link trade tax reform with reform of corporate taxation at that time.

Dieter Vesper

¹⁹ Stefan Bach and Dieter Vesper: 'A Crisis in Finance and Investment – Local Government Finance Needs Fundamental Reform'. In: *DIW Economic Bulletin*, vol. 39, no. 9/2002.

²⁰ This is done now in two ways. Firstly, by offsetting losses brought forward within a company, and secondly by offsetting profit and loss within one organ for trade tax purposes.