

Public finances*

General government budget

Public finances remain favourable in 2018: still considerable surplus and ...

Germany's public finances have been developing very satisfactorily for some time now, and a considerable surplus and falling debt ratio are likely again in the current year. The general government surplus could reach a similarly high level as last year (2017: +1.3% of gross domestic product (GDP)).¹ In particular, public finances are benefiting from the economic upturn and falling interest expenditure. This is taking pressure off the expenditure side amid dynamic growth in other expenditure (cyclically adjusted primary expenditure).² On the revenue side, cyclical developments and fiscal drag³ are having a positive impact, while smaller tax cuts are causing revenue shortfalls. Based on the information currently available, the new Federal Government's projects will have only a limited effect on public finances in the current year. The structural surplus could thus remain above 1% of GDP. The debt ratio had fallen to 64.1% by the end of last year (end-2016: 68.2%). As things currently stand, it will continue to decrease significantly in the medium term, falling below the 60% threshold by 2019 at the latest.

... declining debt ratio

Clearly expansionary budgetary stance on the cards from next year onwards

The current assessment is that government budgets will continue to benefit from the favourable economic conditions and falling interest expenditure beyond the current year. In the absence of new measures, the surplus would therefore continue to improve in the medium term – towards 2% of GDP.⁴ However, the new Federal Government has announced cuts in taxes and social contributions and additional spending. Furthermore, state and local governments are expected to make use of what are, in many cases, perceptible structural surpluses to cover additional needs identified in terms of staffing or fixed asset formation, for instance. Some could potentially also lower their rates on real estate acquisition tax and local government taxes, having raised them significantly in some cases in the past. Furthermore, some-

what greater use could be made of the scope for lowering social contributions, be it at the Federal Employment Agency or at least temporarily in the case of the statutory health insurance scheme.

All things considered, general government surpluses are therefore likely to shrink again in future, especially in structural terms. However, structural surpluses are not currently expected to be fully depleted. Although the fiscal easing coincides with a strong economy and will thus tend to have a procyclical impact, it would not be advisable to delay meaningful additional spending or relief on the revenue side as long as they do not jeopardise the sound structural foundation. As things stand today, the economic problems that this could potentially cause look limited. This notwithstanding, concrete capacity bottlenecks will have to be monitored so that additional investment spending, say, does not dissipate through price increases.

Even so, a certain level of structural surpluses still likely

* The section entitled "General government budget" relates to data from the national accounts and the Maas-tricht debt ratio. The subsequent more detailed reporting is based on the figures as defined in the government finance statistics (which are generally in line with the budget accounts).

¹ The way in which interest expenditure is recorded was amended in the spring notification, which increased the surplus by 0.1% of GDP.

² In 2017, the capital transfers made by general government temporarily increased by a total of €9 billion owing to nuclear fuel tax repayments and guarantee payments made by Hamburg and Schleswig-Holstein for HSH Nordbank. With expected further guarantee payments of €6 billion, burdens will be lower this year. By contrast, it is likely that transfers to the EU will rise sharply, given a temporarily low level last year.

³ This encompasses the effect of bracket creep in income taxation and the impact of the fact that specific excise duties are largely independent of prices.

⁴ In its latest stability programme (excluding measures from the coalition deal), the Federal Ministry of Finance is somewhat more pessimistic about developments in the current year. After this year, both the unadjusted and the structural general government surplus are expected to rise to 1½% of GDP by 2021. The aforementioned upward revision of the surplus has not yet been taken into account here, and the programme is based on central government's macroeconomic forecast from January.

Current fiscal developments in the euro area

2017: lower deficit ratio due to economic developments and interest savings

The general government deficit ratio in the euro area stood at 0.9% last year, compared with 1.5% in 2016. According to the European Commission's calculations in its spring forecast, this significant decrease is primarily attributable to continuing favourable economic developments and – to a lesser extent – to lower interest expenditure. The underlying fiscal stance (ie the change in the cyclically adjusted primary balance¹) was neutral. The debt ratio contracted from 91.1% to 88.8%.² The debt-increasing effect of the deficit (given interest expenditure of 2% of gross domestic product (GDP) and a primary surplus of around 1% of GDP) was more than offset by growth in nominal GDP (denominator effect, around 3 percentage points), in particular.

Marked fiscal loosening expected

The European Commission expects only a marginal decline in the deficit ratio to 0.7% this year and 0.6% next year. The ongoing positive cyclical impact and the reduction in interest expenditure will be contrasted by a marked fiscal loosening. The debt ratio is set to continue on the downward path that began in 2015 and fall to 84.1% by 2019.

Greece: no agreements as yet for the period after programme conclusion

Greece's assistance programme under the European Stability Mechanism (ESM) will run until 20 August 2018. Fiscal developments are therefore assessed not just on the basis of the European fiscal rules but also on the objectives of the assistance programme. In 2017, Greece recorded a primary surplus of just over 4% of GDP, thus considerably exceeding the fiscal target of 1.75% of GDP, which was agreed between the participating institutions

(ESM, European Central Bank (ECB), European Commission, International Monetary Fund (IMF)) and Greece.³ This result was supported, in particular, by temporary factors and lower-than-planned investment spending. Although these alleviating factors are not set to recur in the coming years, the Commission forecast projects that the agreed primary surplus will be achieved in 2018 and 2019 (3.5% of GDP in each case). This outcome should be significantly aided by a cyclical upturn coupled with declining underutilisation, while a structural loosening of fiscal policy is expected at the same time.

To successfully complete the final programme review, Greece still has to implement numerous prior actions. Only then can the final loan tranche be released. From the end of August 2018, Greece will once again be reliant on the financial markets to raise funds, which means that private lenders will have to be convinced of its solvency and willingness to pay. As this is not always considered to be assured, it is sometimes judged necessary to provide additional protection for a transitional period after the programme's conclusion. The ECB and the Greek central bank, for example, are in favour of an ESM precautionary credit line for Greece. In principle, this can be granted once the decision-making body has come to its conclusion and this has been approved by the relevant national parliaments. By contrast, the Greek government is evidently aiming to

¹ The primary balance equals the fiscal balance excluding interest expenditure.

² Unlike the data reported in the Eurostat notification, the European Commission figures on the debt level in the euro area as a whole cited in this box also include lending between euro area countries. Excluding these inter-governmental loans, the debt ratio for 2017 declined by the same magnitude to 86.7%.

³ The assistance programme's objectives concern the general government primary balance, which deviates from the usual ESA definition in that, in particular, it does not include expenditure related to support for the banking sector or revenue from transfers in connection with the Eurosystem's SMP/ANFA transactions.

Forecast for the public finances of the euro area countries

European Commission spring forecast, May 2018

Country	Budget balance as a percentage of GDP			Government debt as a percentage of GDP			Structural balance as a percentage of potential GDP		
	2017	2018	2019	2017	2018	2019	2017	2018	2019
Austria	-0.7	-0.5	-0.2	78.4	74.8	71.7	-0.6	-0.8	-0.6
Belgium	-1.0	-1.1	-1.3	103.1	101.5	100.2	-1.3	-1.4	-1.7
Cyprus	1.8	2.0	2.2	97.5	105.7	99.5	1.4	0.8	0.5
Estonia	-0.3	0.0	0.3	9.0	8.8	8.4	-1.2	-1.3	-0.9
Finland	-0.6	-0.7	-0.2	61.4	60.4	59.6	-0.1	-0.8	-0.9
France	-2.6	-2.3	-2.8	97.0	96.4	96.0	-2.1	-2.1	-3.1
Germany	1.3	1.2	1.4	64.1	60.2	56.3	1.5	1.2	1.0
Greece	0.8	0.4	0.2	178.6	177.8	170.3	4.0	2.5	1.6
Ireland	-0.3	-0.2	-0.2	68.0	65.6	63.2	-0.1	-0.6	-0.4
Italy	-2.3	-1.7	-1.7	131.8	130.7	129.7	-1.7	-1.7	-2.0
Latvia	-0.5	-1.1	-1.2	40.1	37.0	37.3	-1.2	-1.9	-1.9
Lithuania	0.5	0.5	0.3	39.7	36.0	38.2	-0.6	-0.7	-0.6
Luxembourg	1.5	0.9	0.7	23.0	22.6	22.5	1.8	0.8	0.3
Malta	3.9	1.1	1.3	50.8	47.1	43.4	3.5	0.6	1.1
Netherlands	1.1	0.7	0.9	56.7	53.5	50.1	0.5	-0.1	-0.3
Portugal	-3.0	-0.9	-0.6	125.7	122.5	119.5	-1.1	-1.1	-1.1
Slovakia	-1.0	-0.9	-0.3	50.9	49.0	46.6	-1.0	-1.2	-0.8
Slovenia	0.0	0.5	0.4	73.6	69.3	65.1	-0.6	-1.1	-1.5
Spain	-3.1	-2.6	-1.9	98.3	97.6	95.9	-3.0	-3.3	-3.2
Euro area	-0.9	-0.7	-0.6	88.8	86.5	84.1	-0.6	-0.8	-1.1

Source: European Commission.
 Deutsche Bundesbank

create a cash reserve as a safety buffer using funds from the current programme, amongst other sources. Greece could use this reserve to cover its financing needs temporarily, without recourse to the capital market. Yet the deciding factor for future developments in Greece and its ability to tap the capital market will be the expectation of a reliable and sound fiscal and economic policy stance in the longer term. In the past, however, the implementation of reforms was often fraught with considerable difficulties, and seemed dependent on the pressure exerted by the conditionality attached to the release of further loan tranches, in particular. Being largely shielded from market reactions after the conclusion of the programme could reduce the momentum for further reforms.

A final decision on how to proceed after the programme's conclusion is currently expected at the end of June 2018. It also remains to be determined whether additional transfers in the form of debt relief will be granted – not least to pave the way for Greece to raise its own funds in the capital market as far as possible. In May 2016, the Eurogroup held out

the possibility of various stages of additional debt relief, particularly by means of maturity extensions and interest rate cuts. By the end of 2017, some of these measures had already been implemented, which, according to ESM calculations, should lead to a reduction of Greece's debt ratio of 25 percentage points until 2060. Analyses conducted by the European institutions find that Greece's public finances are sustainable, provided that a primary surplus of 3.5% of GDP is maintained over an extended period. Far more ambitious figures were agreed upon at the start of the assistance programme. Now, the requirement is apparently that even this lower figure is to be met only until 2022. If primary surpluses are lower, it will also be deemed necessary to grant further considerable extensions to maturities, which now stand at over 30 years, having already been extended multiple times, in addition to renewed interest payment deferrals. Only then would the sustainability threshold for gross financing needs not be

overstepped.⁴ Furthermore, discussions are currently under way in this context about a relief mechanism pegging repayment of the loans to GDP growth. According to the current Commission forecast, Greece will achieve a structural primary surplus of 5.1% of GDP in 2019. This means that no further restrictive stimulus will be required to ensure a high primary surplus even in the longer term, and primary surpluses of 3.5% of GDP will be reasonable in the longer term, too. As a result, it is not necessary for additional debt relief measures to be taken soon.

From 2018, many countries still quite far from achieving medium-term budgetary objectives and not getting any closer

In 2017, the deficit ratio was still (slightly) over the 3% limit only in Spain. France's figure was back below this threshold for the first time since 2007. According to the European Commission's latest estimate, the ratio should remain below the limit until the end of 2019, which means that the termination of France's excessive deficit procedure can be expected. The forecast projects a further decline in Spain's deficit ratio, giving rise to the expected correction of the excessive deficit this year and the end of the procedure next year.⁵ In almost all other countries, too, deficit ratios continued to narrow in 2017, and in most cases will decline in the coming years as well.

Even so, 11 member states still fell short of the medium-term budgetary objectives in 2017, and the current forecast does not expect them to get any closer. Rather, the European Commission expects the structural deficit to widen in all euro area countries in 2018 – despite further declining interest expenditure ratios. The fiscal stance is thus being loosened in good times, although when the medium-term budgetary objective is not achieved, member states are generally required to improve their structural budget balance by 0.5% of GDP per year.⁶ At the end of 2019, only seven countries (Cyprus, Germany, Greece, Ireland, Luxem-

bourg, Malta and the Netherlands) will record a structural balance of -0.5% of GDP or better.

Of all countries, it is Belgium, France, Italy, Portugal and Spain – which were running especially high levels of debt (over 90% of GDP) in 2017 – that are consistently falling short of their country-specific medium-term budgetary objectives. In those countries and in Cyprus, which also has a particularly high debt level, the structural balance is set to deteriorate up until 2019 in each case. Although the debt ratios will decline in all countries but Cyprus⁷ by 2019, the particularly heavily indebted countries will not achieve the regular reduction before the end of 2019.⁸ Belgium, Greece, Italy and Portugal will then still have debt ratios of more than 100%, and Cyprus, France and Spain of over 90%.

⁴ Both the ECB and the IMF are in favour of granting further debt relief at an early stage. The IMF is even making further debt relief a condition for the disbursement of funds under its current programme with Greece.

⁵ It is concerning, though, that the only reason the reference value is not being exceeded is the favourable cyclical impact and a shrinking interest expenditure ratio. The structural improvement required to correct the excessive deficit has not been achieved a priori in any year since 2014. The structural deficit will even increase to over 3% in 2018 owing to a marked fiscal loosening.

⁶ Both the preventive and corrective arms of the Stability and Growth Pact prescribe structural improvements of 0.5% of GDP per year until the objectives are achieved. However, country-specific recommendations can deviate from this in both processes.

⁷ Despite the budget surplus, Cyprus' debt ratio is expected to increase strongly in 2018. This is because the Cypriot government has placed a large deposit with a Cypriot bank which it is financing by issuing government bonds (amounting to 12% of GDP). As it was assumed that this debt was issued to finance the purchase of financial assets considered to be fully recoverable claims, it constitutes purely a financial transaction which does not increase the deficit (though it does the debt ratio). Furthermore, any legal aspects relating to state aid have to be clarified.

⁸ However, an excessive deficit procedure based on the debt criterion would only be launched if, at the same time, the debt exceeding the reference value of 60% has not been reduced by an average of one-twentieth per year over the preceding three years, and if this reduction is not achieved even when cyclical effects are taken into account. Furthermore, transitional provisions exist for those countries that were subject to an excessive deficit procedure at the time that this debt criterion was operationalised (November 2011). These provisions are valid for three years after their deficit procedure has come to a close.

Bear long-term sustainability in mind

Overall, there are still good reasons for all levels of government to aim for moderate structural surpluses.⁵ A key challenge for fiscal policy is not to lose sight of the demographic strains further down the line despite the good medium-term conditions that are currently anticipated. The sustainability of public finances will come under pressure, in particular, due to the fact that general government spending on pensions, long-term care and healthcare will increase sharply while the aggregate government revenue base expands at a slower rate. Against this backdrop, rigorously reining in general government debt and the associated interest burden – as well as measures to boost employment and strengthen the economy's growth potential – are important.

In pension reforms, secure sound pension finances through balanced burden-sharing

Moreover, further adjustments are needed to put the social welfare systems, in particular, on a sound long-term footing. Amongst other things, the Federal Government has scheduled the statutory pension insurance scheme for a thorough overhaul from 2025. Despite the uncertainties, the reform proposals ought to also factor in developments over the very long term based on relevant projections: only by doing so can the financial impact of demographic shifts towards a larger share of older people in the population be made transparent.⁶ Policy discussions, many of which focus on the pension level and contribution rates, should also take into account the additional tax burden stemming from potentially higher central government grants, as well as the statutory retirement age. For example, by continually raising the statutory retirement age in line with (further rising) life expectancy after 2030, the average ratio of retirement years to working years could be kept broadly constant. The central government grants are currently, for the most part, adjusted in line with the contribution rate and average wage growth, while demographic developments are weighing on employment and thus on contribution receipts from insured persons. This means that – even in the absence of the adjustments currently being discussed⁷ – the burden on the central government budget

and the weight of financing pensions through general taxation will gradually increase further and further.

Budgetary development of central, state and local government

Tax revenue

Year-on-year growth in tax revenue⁸ came to 4% in the first quarter of 2018 (see the chart on page 66 and the table on page 67). Ongoing favourable developments in gross wages and salaries made an important contribution here, giving rise to dynamic wage tax growth (6%). Progressive taxation increased revenue, whereas changes in tax legislation had a dampening effect. In particular, a small tax cut was made at the start of this year which was intended to compensate for bracket creep last year.⁹ Child benefit payments deducted from revenue raised the rate of growth as, despite the slight increase in child benefit, they rose at a slower pace than gross revenue. All in all, profit-related taxes recorded dynamic growth (6%). Starting from high levels in the previous year, there was solid growth in assessed income tax and strong growth in corporation tax. There was a decrease in revenue from non-assessed taxes on earnings, the main component of which is investment income tax on dividends. Intra-year shifts in dividend payments could have played a role here. By contrast, receipts from withholding tax on interest income

Significant rise in tax revenue in Q1

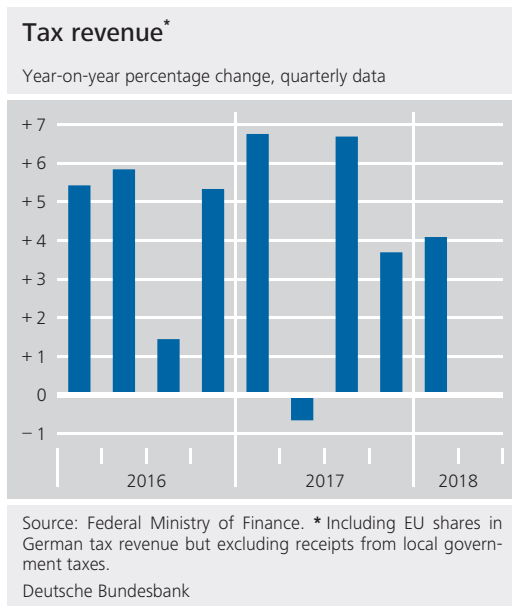
⁵ For more information, see Deutsche Bundesbank, Public finances, Monthly Report, November 2017, p 53.

⁶ For example, the horizon in the EU's latest Ageing Report spans as far as 2070. See European Commission, The 2018 Ageing Report: Underlying Assumptions and Projection Methodologies, European Economy Institutional Paper 065, November 2017.

⁷ See pp 72-74.

⁸ Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.

⁹ The basic income tax allowance and child tax allowances were raised and the other income tax brackets shifted to the right. Furthermore, the increasing level of tax exemption, in particular, of contributions to the statutory pension insurance scheme once again resulted in marked shortfalls.



and capital gains were up sharply, probably as a result of increased capital gains. Turnover tax revenue, which is generally quite volatile, increased by 3%, which is in line with the underlying trend displayed by the macroeconomic reference variables.

Clear revenue increase expected for 2018

According to the latest official tax estimate, tax revenue (including local government taxes) is expected to increase by 5% for 2018 as a whole. Forecast growth in the macroeconomic reference variables¹⁰ already accounts for significant revenue growth, and fiscal drag is another factor. Furthermore, the repayment of nuclear fuel tax after it was ruled void,¹¹ which pushed down revenue by €7½ billion last year, was a one-off event in 2017. Although repayments are also expected this year as a result of court rulings,¹² these will be significantly lower. On balance, legislative changes will have a moderate dampening effect on revenue growth: it is primarily the aforementioned income tax cuts that are behind the shortfalls. By contrast, lapsing refunds of corporation tax credit¹³ will lead to a marked year-on-year increase in revenue.

Somewhat lower growth in subsequent years

According to the official tax estimate, which is generally based on current legislation, growth in tax revenue is set to be slightly lower next year, at 4½%. The main reason for this is the

lesser importance of one-off effects resulting from court rulings.¹⁴ By contrast, developments in the macroeconomic reference variables for tax revenue, fiscal drag and legislative changes will each boost tax revenue to a similar extent as in the current year. Revenue growth of 4% is expected for the subsequent years up to 2022. This projection is shaped primarily by macroeconomic assumptions and fiscal drag. Tax cuts that have already been approved will have only a slight dampening effect in net terms. The tax ratio (as defined in the government finance statistics) is projected to increase significantly to 23.2% by the end of the forecast period (2017: 22.5%; adjusted for the nuclear fuel tax repayment: 22.7%). Taking into account the tax relief measures and, in particular, the partial abolition of the solidarity surcharge announced by the new Federal Government, the ratio could yet go up slightly.

Compared with the November 2017 forecast, the budgeted figures have been revised upwards by €8 billion for 2018. The main reason for this is the upward revision of the assumptions made for the macroeconomic reference

Revenue expectations up significantly overall

10 This estimate is based on the Federal Government's current macroeconomic projection from the end of April 2018. The projection indicates that, in 2018, GDP will rise by 2.3% in real terms and 4.2% in nominal terms (October 2017: 1.9% and 3.6% respectively). GDP growth for 2019 is forecast to be 2.1% in real terms and 4.1% in nominal terms (October: 1.7% and 3.4% respectively). In the medium term, nominal growth of around 3½% per year is forecast (October: roughly 3%).

11 See Federal Constitutional Court, Order of the Second Senate of 13 April 2017 (2 BvL 6/13).

12 This pertains, first and foremost, to rulings (Federal Fiscal Court rulings IR 33/09 and IR 74/12) on section 40a of the Act on Asset Management Companies (Gesetz über Kapitalanlagegesellschaften) and STEKO (section 8b (3) of the Corporation Tax Act (Körperschaftsteuergesetz)); see also Bundestags-Drucksache 18/5560. Unlike the cash receipt developments described here, the effect of these rulings is recorded in the national accounts at the time of each of the rulings (2014), increasing expenditure.

13 These refunds as a result of switching from a full imputation system to the half-income method as part of the business tax reform of 2000-01 were staggered between 2008 and 2017.

14 The refunds in connection with the aforementioned rulings on section 40a of the Act on Asset Management Companies and STEKO are expected to be paid in full this year. However, it is assumed that repayments in connection with a European Court of Justice ruling on the taxation of dividends paid to EU/EEA companies (case C-284/09) will continue into 2019 and 2020.

variables for tax revenue. The fact that, going beyond the revision of the reference variables, growth in profit-related taxes this year was revised upwards owing to cash balances in the first quarter also had a part to play here. In addition, the projected losses as a result of court rulings were reallocated once again to later years. The revised and additional effects of legislative changes will dampen the impact of this marginally. Tax revenue estimates were increased by between €11½ billion and €16½ billion for each of the years from 2019 to 2022, which is attributable in very large part to the upward revision of the macroeconomic assumptions. Another minor contributing factor is the expectation that the higher level of profit-related taxes will continue. The brighter economic setting compared with the benchmark figures for the November 2017 tax estimate had already been discernible for some time. The need for upward revision was therefore already known to some extent during the new Federal Government's coalition negotiations.

Central government budget

Lower surplus at start of year as a result of higher transfers to EU budget

Central government recorded a surplus of €3½ billion in the first quarter of 2018 compared with a surplus of €5 billion one year previously.¹⁵ Revenue declined slightly (-½%). In the case of tax receipts, the decline was more significant (-2½%, or €2 billion). While tax revenue inflows to central government continued to rise markedly, deductions for transfers to the EU budget were up by €5 billion. This was largely due to a one-off factor that had pushed down the level in the previous year.¹⁶ Despite an increase of €1½ billion in the Bundesbank's profit distribution, other revenue did not quite manage to offset the tax shortfall. A moderate increase of 1% (€1 billion) in total was recorded on the expenditure side. Interest expenditure stagnated owing to the fact that persistent re-financing advantages for Federal bonds were offset by lower premiums upon issuance. In particular, there was growth in payments to the statutory pension insurance scheme and to

Tax revenue				
Type of tax	Q1		Estimate for 2018 ^{1,2}	
	2017	2018	Year-on-year change %	Year-on-year change %
	€ billion			
Tax revenue, total ²	165.4	172.1	+ 4.1	+ 5.3
<i>of which</i>				
Wage tax	45.3	48.1	+ 6.1	+ 5.6
Profit-related taxes ³	31.7	33.7	+ 6.2	+ 5.8
Assessed income tax	17.0	17.6	+ 3.7	+ 3.7
Corporation tax	8.5	9.4	+ 10.7	+ 10.5
Investment income tax ⁴	6.2	6.6	+ 7.0	+ 5.5
Turnover taxes ⁵	57.5	59.2	+ 3.0	+ 3.8
Other consumption-related taxes ⁶	19.9	20.0	+ 0.6	+ 0.6

Sources: Federal Ministry of Finance and Bundesbank calculations. **1** According to official tax estimate of May 2018. **2** Including EU shares in German tax revenue but excluding receipts from local government taxes. **3** Employee refunds deducted from revenue. **4** Withholding tax on interest income and capital gains, non-assessed taxes on earnings. **5** Turnover tax and import turnover tax. **6** Taxes on energy, tobacco, insurance, motor vehicles, electricity, alcohol, air traffic, coffee, sparkling wine, intermediate products, alcopops, betting and lottery, beer and fire protection.

Deutsche Bundesbank

state governments¹⁷ (+€1 billion each). By contrast, current transfers to enterprises were down by €1 billion. This could also be the result of stricter spending curbs during the period of interim budget management.

At the start of May, the new Federal Government adopted a revised draft of the 2018 central government budget. Expenditure appropri-

¹⁵ The quarterly figures presented here deviate (in contrast to the annual figures) from the figures published by the Federal Ministry of Finance due to adjustments. This affects regular payments that are to be made in advance and are recorded twice by the Federal Ministry of Finance in January but, as a result, are not recorded in December. Due to updated adjustments, there are deviations from previous Monthly Reports.

¹⁶ One-off relief amounting to €3 billion was provided in early 2017 due to the EU own funds decision of autumn 2016 being applied retroactively to the budget in Germany. In addition, the outflows of funds from the EU budget, and thus, accordingly, Germany's contributions, are set to be considerably higher this year.

¹⁷ The fact that settlements for the basic allowance for the elderly that were still outstanding at the end of 2017 were included in the 2018 budget seems to have played an important role here. By contrast, there were no such refunds in the 2017 budget.

Revised draft budget for 2018 contains significantly lower deficit than initial draft ...

ations were raised by a total of €3½ billion compared with the previous government's draft from summer 2017. Of this total, €1½ billion was earmarked for measures in the coalition agreement, such as home buyers' child benefit (€½ billion). Provisions of €1 billion were made for the increases in negotiated rates of pay agreed in April and the intended adjustment of civil servants' pay based on these, while the planned global spending cut in a comprehensive item was lowered by €1½ billion. Overall, however, tax projections were raised far more significantly, by €10 billion. On balance, it was possible to reduce the estimated deficit by €6½ billion to €2 billion. The withdrawal from the refugee reserve to cover the deficit was thus budgeted correspondingly lower.

... but still includes considerable structural easing compared with 2017

As in the budget plans of previous years, significant easing is foreseen this year compared with last year. Overall, this would lower the balance by €7 billion. At the same time, the cyclically induced fiscal relief to be taken into account under the debt brake will effectively increase by almost €3 billion.¹⁸ Excluding financial transactions, which are likewise to be factored out, the balance is expected to deteriorate by a further €1 billion, and the deficits of the off-budget entities included under the debt brake are set to increase by €½ billion. Overall, the structural balance is thus envisaged to deteriorate by just over €11 billion to -€8½ billion (-¼% of GDP) according to the budget plans. However, the Federal Government is focusing on net borrowing rather than the deficit in the context of the debt brake, with net borrowing, unlike the balance, being lowered by reserve withdrawals and coin seigniorage.¹⁹ This leaves a margin of €5 billion below the debt brake limit of -0.35% of GDP (at present: -€11½ billion).

Another surplus possible in 2018

In actual fact, the budget outturn is set to be more favourable than envisaged so far. It would seem that the additional revenue of €2½ billion expected according to the latest tax estimate (mainly brought about by lower EU contribu-

tions²⁰) is to be used primarily to build up a digitalisation fund, and the inflows in connection with the settlement of the dispute concerning the delayed introduction of the heavy goods vehicle toll could still be redirected. But interest expenditure not least could be lower, mainly because – in a departure from the budget estimates – it is likely that premiums on newly issued government bonds will continue to be received. In the case of investment expenditure, it would appear likely that outflows will be lower than estimated again, not least with respect to the expansion of the broadband network financed directly out of the budget and calls on guarantees and as a result of the spending curbs now in effect until July in connection with interim budget management. Provided no further additional burdens are agreed upon in the course of budget discussions, a surplus could once again be recorded, which would result in the refugee reserve potentially growing again rather than decreasing.²¹ It would still appear advisable to promptly dissolve the reserve, which is not needed for its original purpose, to pay down debt.²²

In early May, the benchmark figures for the 2019 budget and the financial plan up to 2022 were also adopted. The Federal Government is holding on to its goal of refraining from net new borrowing. However, reserve withdrawals of just over €20 billion are planned in order to

¹⁸ In a departure from the Federal Ministry of Finance's approach, the cyclical components for 2017 and 2018 calculated in the April estimate of potential output were taken into account here. The tax projections in the new 2018 draft budget, however, are based on earlier estimates published in the Annual Economic Report, which included an almost €1 billion higher increase in cyclical relief.

¹⁹ For the relevant classifications, see Deutsche Bundesbank, Public finances, Monthly Report, February 2016, pp 68-69.

²⁰ As usual, token entries for which no amount is given are made in the draft budget for EU grants, ie no revenue is factored in. The EU contributes to various areas of central government spending. Although specific amounts are not yet known, contributions regularly totalling around €1 billion are collected per year in the course of implementing the budget; to this extent, they exceed budget plan figures.

²¹ At the end of 2017, the reserves from the surpluses that have accumulated since 2015 stood at €24 billion.

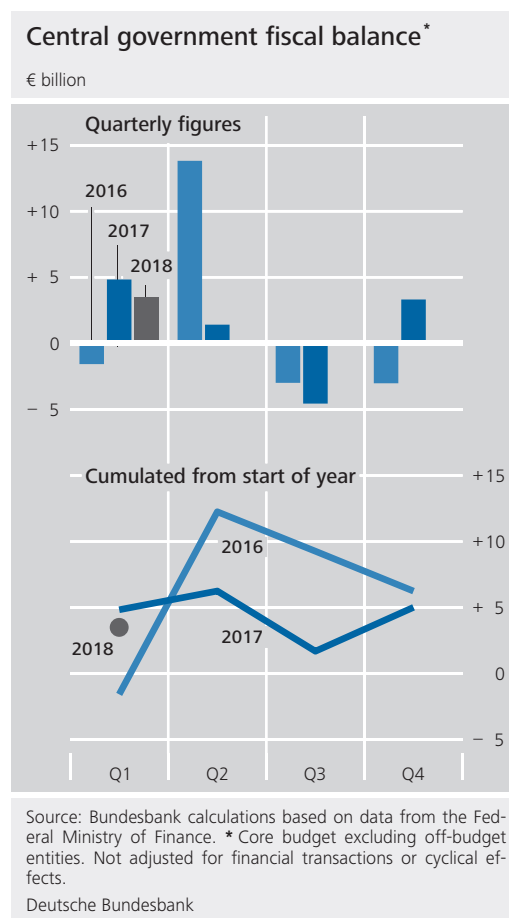
²² See Deutsche Bundesbank, Public finances, Monthly Report, August 2016, pp 63-65.

Benchmark figures up to 2022: no net borrowing even amid new projects thanks to reserve withdrawals and higher tax receipts

finance new projects up to 2021. Moreover, compared with the last financial plan, economic developments are expected to be even better – including in structural terms – bringing in significantly higher tax revenue. The new projects are expected to put a burden of around €7 billion on the 2019 budget, with this figure set to rise further to roughly €22 billion (½% of GDP) by 2021, though the details are not yet known. In addition to the partial abolition of the solidarity surcharge, the extension beyond 2018 of aid to state and local government to cover refugee-related expenses should, in view of its scope, be highlighted in this context. These levels of government are also set to receive higher payments for areas such as kindergartens, after-school childcare for primary school children, social housing and regional policy. Furthermore, an increase in child benefit by a total of €25 a month will be felt more strongly. In addition to these measures, the pay agreement and its application to civil servants also needed to be taken into account. The overall annual impact of these will rise to around €3 billion up to 2020.

2019: continued fiscal loosening and marked structural deficits planned

As in previous years, the structural outcome was only included in the benchmark figures in a press release, even though the associated limit of -0.35% of GDP represents the linchpin of the debt brake.²³ The Federal Government's continued aim is to avoid net borrowing, and it is making full use of the fiscal space it has in this regard. In addition to withdrawals from reserves in the first few years, marked relief is forecast on account of the favourable cyclical conditions. Factoring in the expected deficits of the off-budget entities included under the debt brake, there will be marked structural deficits in some years. It is likely that a value of 0.5% of GDP will be aimed at in 2019. Considerable additional loosening is thus implied, and, according to the budget plans, it will only be possible to comply with the debt brake through envisaged withdrawals from the reserve. Going forward, structural deficits should then start declining again. The assumed fairly high level of potential growth and the resulting signifi-



cant tax revenue growth in structural terms play a particularly important role here. In view of the prospective demographic challenges and only provisional relief provided by extremely favourable financing conditions, it would appear sensible in the medium term not to fully exhaust any fiscal space perceived in the central government budget given the aim of avoiding net borrowing, but to strive for moderate structural surpluses.

On the whole, the budget plans appear to have still been drawn up cautiously for the first years, and there are likely to be reserves, in particular, in the form of global revenue shortfall entries. All in all, it is possible that there are already funds to cover not only the aforementioned

Reserves will remain available initially, but foreseeable needs will deplete buffer

²³ There are no data on the balances of financial transactions and of the incorporated off-budget entities. While reference is made to a "structural deficit" in the press release of 2 May 2018, this must actually be structural net borrowing based on the information in the published background document.

priority projects laid down in the coalition agreement but also additional measures with an impact on public finances such as compensation for bracket creep in the income tax regime or slightly higher EU contributions from 2021 onwards. However, additional demands have been made in areas such as the Ministry of Defence, where no sizeable increase in spending as a percentage of GDP appears to have been planned thus far. Under the coalition arrangements, the lion's share of the expected additional revenue of €2 billion for central government on an annual average up to 2022 (according to the latest official tax estimate) could be spread equally between defence and expanding development aid. Overall, the budget position therefore does not look entirely free from strain despite very favourable conditions.

If mixed financing is expanded, strengthen federal states' individual responsibility

The financial plans also envisage central government being much more involved in tasks generally performed at the state and local government level. A change in Germany's Basic Law is to enable central government to increase grants for local education and transport infrastructure as well as for social housing. However, with notable surpluses being generated almost nationwide by subnational government levels, state and local governments already have financial leeway to implement those projects considered worthwhile without the need for additional central government grants. In the past, it has not proven expedient to blur the responsibilities of the various government levels. It therefore only seems worth considering increasing central government grants if these are for very specific purposes. For instance, in the field of education, grants could be used to help encourage authorities to improve their educational outcomes. In this regard, it would seem appropriate to agree on comparable benchmarks for the federal states and to publish this data on a regular basis. This would enable voters to see the strengths and weaknesses of each state in a timely manner and, where appropriate, to push for improvements in their state. It is also worth considering

giving states the right to introduce surcharges or discounts on income tax – subject to limits – in order to enable individual states to follow the preferences of their population, for instance to spend more on education or to provide fewer services and reduce the level of taxes. This would additionally boost the incentives for efficient budget management and increase the instruments available to comply with the debt brake.

In addition to funding the planned higher transfers to state government, the financial leeway calculated in the central government budget will chiefly be used for a partial abolition of the solidarity surcharge as of 2021. In legal terms, this add-on to income taxes requires central government to have particular financing needs; a situation which can hardly be identified for the medium term without new burdens. To sum up, there seems to be no compelling case for using the remaining parts of the solidarity surcharge on balance to effectively provide nationwide support to state and local governments for use in their own tasks. Once the special assistance for (infrastructure) reconstruction in eastern Germany has come to an end, it would be more appropriate to do away with the solidarity surcharge entirely and to adjust the regular income tax scale should there be an overall need for additional funds. This would ensure that the responsibility for tasks lies with state and local governments alone and avoid the disadvantages associated with mixed financing.

No apparent need to continue the solidarity surcharge

Central government's off-budget entities²⁴ recorded a deficit of €½ billion at the start of the year, compared with a surplus of €½ billion at the start of 2017. Expenditure in the amount of €1 billion by the precautionary fund for redemption payments for inflation-indexed Federal securities had a negative effect. The fund to promote municipal investment, the flood re-

Surplus in off-budget entities again possible for year as a whole

²⁴ The off-budget entities discussed here are those that are included in the Federal Ministry of Finance's quarterly data. This notably does not take into account bad banks and other entities keeping commercial accounts.

lief fund as well as the energy and climate fund (which are included in the central government's debt brake) all again reported only small deficits. For the year as a whole, the precautionary special funds for civil servants' pensions are set to record clearly positive results. On the whole, the off-budget entities could therefore once again conclude the year in surplus (2017: €3 billion).

State government budgets²⁵

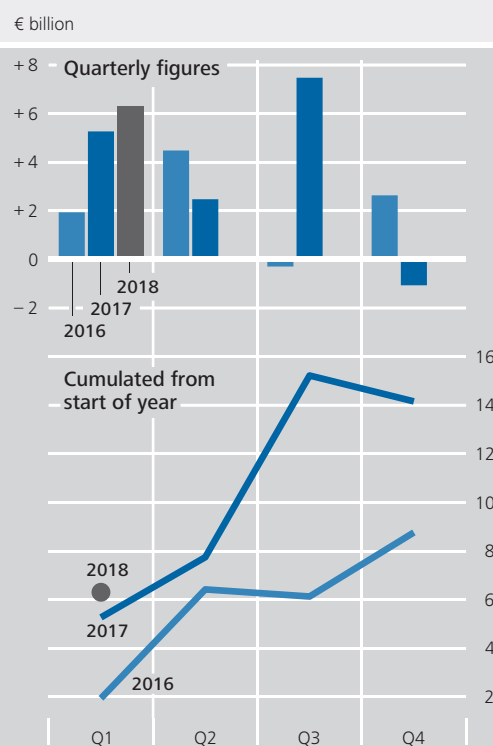
Higher surplus in Q1 owing to steep tax growth

At the beginning of the year, state government's core budgets recorded a surplus of €6½ billion, exceeding the results from the same quarter last year by €1 billion. Overall, revenue was up by just over 4% (€4 billion), driven by steep growth in tax revenue (+5%). Expenditure grew at a slightly slower pace (+3%, or €3 billion). Spending on personnel rose by 5%. Contributory factors were the second adjustment stage of the 2017 collective wage agreement, including rises in civil servant remuneration and pensions, a higher number of retired civil servants as well as apparently increased staffing levels. Current transfers to local government (+3%) as well as the less significant investment (+13½%) also rose. Other operating expenditure stagnated, after having fallen distinctly in most cases in the previous quarters. The decline in the associated refugee-related expenses is evidently slowing.²⁶ By contrast, interest expenditure continued its significant downward trend (-10½%).

One-off effects to lead to lower surplus in current year, ...

For the entire year, state government as a whole is likely to again record a high surplus. This is due to expectations of continued positive tax development (increase of 4% according to the latest tax estimate²⁷) and a further fall in interest expenditure. However, this surplus will probably be somewhat lower than in 2017, as one-off effects (no capital repayment from Bayern LB (€1 billion) and expected further calls on guarantees in connection with the privatisation of HSH Nordbank²⁸) will take their toll.

State government fiscal balance*



Source: Bundesbank calculations based on monthly data from the Federal Ministry of Finance. * Federal states' core budgets excluding off-budget entities.
 Deutsche Bundesbank

Under a no-policy-change assumption, surpluses are likely to again be higher in the coming years. The latest tax estimate expects revenue to increase by an annual average of just over 4% in the medium term and temporary central government funds, such as the flat immigrant integration payment of €2 billion per

... but outlook for medium term remains very favourable

²⁵ The development of local government finances in 2017 was analysed in greater detail in the short articles in the April 2018 Monthly Report. The following data on state government budgets are based, unless otherwise stated, on the monthly cash statistics on the core budgets.

²⁶ Following the sharp influx of refugees, other operating expenditure recorded substantial growth up to the summer of 2016. However, this item then declined up to the end of 2017 (disregarding a one-off effect in North Rhine-Westphalia), evidently in connection with a clear fall in expenses for the initial reception of refugees, which was organised at state government level.

²⁷ Excluding the city states' revenue from municipal taxes.

²⁸ With the privatisation of HSH Nordbank, in 2018 the shareholders – Hamburg and Schleswig-Holstein – will have extra burdens in their core budgets from guarantees in the amount of €3 billion each (classified as a loan payment in the financial statistics but as a capital transfer (and thus affecting the fiscal balance) in the national accounts). This is partly offset by revenue from privatisation of €1 billion (classified as a financial transaction in the national accounts (and thus not affecting the fiscal balance)).

year, are now to be granted beyond 2018. If central government implements its new plans, this would have a financial impact on state government budgets. However, it is still only possible to estimate budget effects in part. Under the current rules, the planned increases in child benefit would push up state government contributions to €2 billion in 2022. Even if central government provides its envisaged contribution, the planned digitalisation of schools and, in particular, the implementation of the legal entitlement to all-day childcare for children of primary school age from 2025 onwards could mean that state governments need to come up with considerable additional funds. All in all, financial scope appears to be available overall that could be used for these and, if applicable, for further measures, such as involvement in an income tax cut. However, it is essential to bear in mind that the current surpluses are partly due to the very good economic situation.

But, further consolidation required in some states

There are still great differences in the structural financial situation of the individual states. Bremen and Saarland, in particular, were still reporting structural deficits of close to €½ billion in their consolidation/restructuring reports for 2017. The gap between this and the relevant upper limits (which are to decline gradually up to 2020) was only very small, despite the fact that the development of cyclically adjusted tax revenue and interest expenditure has been very favourable to date. If the booking rules from the national accounts concerning which financial transactions are to be excluded from the calculations are applied strictly, Saarland at least would actually fall short of the requirement.²⁹

Rigorously implement debt brake and Fiscal Compact

Overall, despite the favourable outlook, it must not be forgotten that the debt brake under German Basic Law will apply to all state government budgets from 2020 onwards. Structural net borrowing will no longer be permitted. Compliance with the European Fiscal Compact will also be mandatory. This limits the structural general government deficit to 0.5%

of GDP. Unlike the central government's debt rules – and those of most of the federal states – which are geared to net borrowing, it is not possible to dissolve reserves to meet this limit. In this respect, the use of this option in connection with the debt brake should be restricted, at least in those cases where there is a risk that the general government requirements may be exceeded. The Stability Council is called on to conduct targeted budgetary surveillance to ensure that the European rules are met. All in all, it is advisable for the state governments, too, to aim for moderate structural surpluses in their medium-term plans as a safety buffer.

■ Social security funds³⁰

Statutory pension insurance scheme

In the first quarter of 2018, the statutory pension insurance scheme recorded a deficit of €1 billion. The deficit – usual for this time of year – thus declined significantly (-€1½ billion) in year-on-year terms. Revenue rose substantially by 4½% despite the 0.1 percentage point lowering of the contribution rate at the beginning of the year.³¹ This was driven by a significant increase in contribution receipts (just over 4½%), due to continued very positive developments on the labour market and growth in *per capita* earnings. By contrast, expenditure rose at a much weaker rate (+2½%). The pension increase of July 2017 amounted to just under 2½% in Germany as a whole and the number of pensions grew slightly.

Significant improvement in Q1 ...

²⁹ For instance, in its 2016 annual report (Landtags-Drucksache 16/290, p 58), the Court of Auditors of Saarland notes that the deficit of Saarland's State Theatre has been offset by a capital injection for years. This practice was continued last year and does not appear to be in line with the objectives of the deficit limits.

³⁰ The financial development of the public long-term care and statutory health insurance schemes in the final quarter of 2017 was analysed in the short articles of the March 2018 Monthly Report. These are the most recent data available.

³¹ Excluding the lowering of the contribution rate, growth would have been ½ percentage point higher.

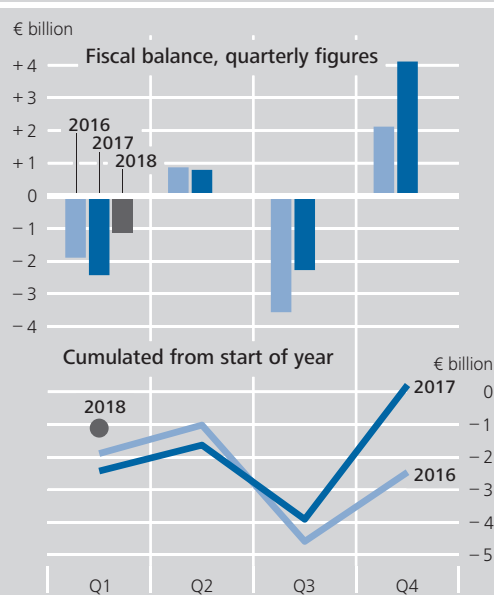
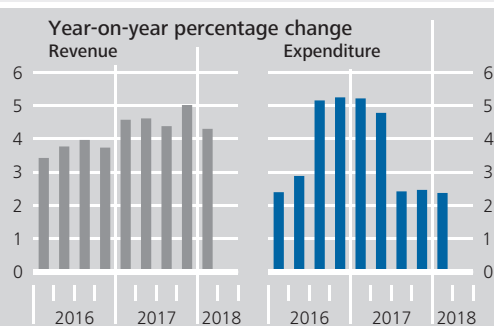
... and same expected for 2018 as a whole

In mid-2018, pensions will be raised by 3.22% in the west German states and 3.37% in the east German states. Overall, this primarily reflects the development of *per capita* earnings over the past year. Owing to the very favourable labour market situation, the number of contribution payers also increased at a somewhat faster pace than the number of pensioners. This has an additional slightly positive impact on the pension adjustment via the sustainability factor. Taking into account the mid-2017 increase, on an annual average – at just under 3% – the overall rise in pensions is significantly lower than in the previous year (3½%) when the impact of the sharp mid-2016 increase could still be felt. Overall, pension expenditure is expected to rise at a somewhat weaker rate this year (2017: just over 3½%). On the revenue side, steep growth is expected to continue over the year as a whole. On balance, the financial situation of the pension insurance scheme is likely to improve markedly and it is set to record a much higher surplus than in the previous year.

Interim peak in finances of statutory pension insurance scheme curtailed by additional burdens

In the absence of new measures, there would have been potential to cut the contribution rate further at the beginning of 2019. However, the new Federal Government's projects will up spending pressure as early as next year (in particular, the increase in the "mothers' pension", but also higher pensions for persons with reduced earning capacity and the introduction of a "basic pension").³² This means that the merely temporarily favourable financial situation is being used to agree to additional burdens that further intensify the strain from demographic change that is already on the cards. This expansion of benefits in favour of individual groups of insured persons will require a higher contribution rate – unless it is financed through additional central government grants. In the current legal environment, this, in turn, reduces the pension level³³ via the annual pension adjustments. As a result, there is a greater risk that the limits for the contribution rate (max 20%) and the pension level (min 48%) anchored in the coalition agreement until 2025

Finances of the German statutory pension insurance scheme



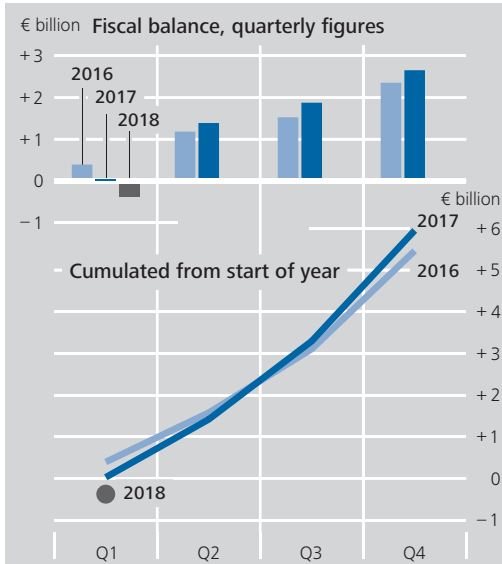
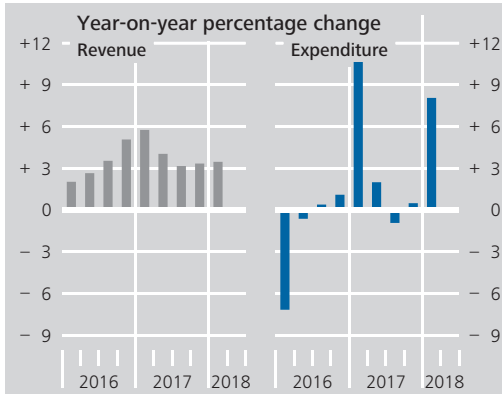
Source: German statutory pension insurance scheme (Deutsche Rentenversicherung Bund). Preliminary quarterly figures. The final annual figures differ from the total of the reported preliminary quarterly figures as the latter are not revised subsequently.
 Deutsche Bundesbank

will not be met in this period without compensatory intervention. This would necessitate further measures – such as an extension of central government funds (which ultimately require

³² As of 2019, the pension insurance scheme will come under additional pressure of €1½ billion from the planned return to full joint financing of the statutory health insurance scheme as it will have to take on half of the individual health insurance institutions' supplementary contribution rates for pension recipients.

³³ The pension level in the statutory pension insurance scheme measures the ratio of the standard pension (given average earnings over 45 contribution years) to average pay (before tax but less social contributions in both cases). The above-mentioned expansion of benefits as well as those in the surviving dependents' pensions and for rehabilitation purposes are not included in the calculation of the pension level.

Finances of the Federal Employment Agency*



Source: Federal Employment Agency. * Federal Employment Agency core budget including transfers to the civil servants' pension fund.
 Deutsche Bundesbank

this effect, the financial situation would have improved by €½ billion.

Total revenue increased significantly by 3½%. Contributions again rose steeply (by almost 5%) while the slightly lower insolvency benefit contributions at the beginning of the year dampened the growth rate somewhat. However, at 8%, the increase in expenditure was considerably higher due to the above-mentioned special allocation. By contrast, spending on unemployment benefits (-3½%) and the active labour market policy (-1½%) continued to decline. Without the extra payments this year and last year, spending would actually have fallen slightly.

Expenditure on unemployment benefits and active labour market policies continues to decline

The favourable developments on the revenue side as well as for unemployment benefits are set to continue as the year progresses. No notable acceleration in active labour market policy seems likely so far. Despite higher special transfers to the civil servants' pension fund (€2 billion for the year as a whole compared to just over €½ billion in 2017), the annual result of the Federal Employment Agency's core budget could still continue to improve somewhat (2017: surplus of €6 billion). It would then once again be well above the budgeted amount (€2½ billion), and the free reserves would again be topped up by a substantial amount (end-2017: €17 billion).

For year as a whole, surplus may be higher than last year despite strain from one-off effects

higher tax rates), a reduction of the benefits not included in the pension level or an earlier increase in the statutory retirement age.

Federal Employment Agency

In the first quarter of 2018, the Federal Employment Agency recorded a deficit of €½ billion in the core area,³⁴ thus worsening the balance by €½ billion on the year. The result was strained by a much higher special allocation (just over €1 billion) to the civil servants' pension fund in comparison with the previous year.³⁵ Without

Special allocation to pension fund strains result in Q1

Current forecasts expect the very positive development on the labour market to continue. If no adjustments are made, surpluses will continue to rise and the free reserves will shoot up. The new Federal Government thus intends to cut the contribution rate. Given the current very positive situation on the labour market – in structural terms, too – there is a good case for cutting the contribution rate by more than the envisaged 0.3 percentage point.

Greater contribution rate reduction appropriate

³⁴ Federal Employment Agency excluding the pension fund, ie the transfers to this fund lower the fiscal balance considered here.

³⁵ For more information, see Deutsche Bundesbank, Public finances, Monthly Report, February 2018, p 73.