Public finances*

General government budget

Public finances continuing to develop favourably in 2018 …

German public finances are continuing to develop favourably this year as well. The general government surplus is likely to keep rising (2017: 1.2% of gross domestic product (GDP)). The debt ratio is decreasing and is expected to come close to the 60% threshold by the end of the year. It fell to 62.9% in the first quarter, down from 64.1% at the end of 2017.

… due to expansionary measures being slightly outweighed by positive effects

Public finances are benefiting from the favourable economic situation. In addition, temporary burdens are declining due to the nuclear fuel tax repayment in 2017 being a one-off event. Irrespective of the cyclical upswing, the favourable growth trend is giving rise to significant revenue increases. Growth is being further amplified by overall progressive taxation. On the expenditure side, this is being supported by falling interest payments and structurally positive labour market developments. However, spending is set to rise fairly significantly in a variety of other areas. For instance, payments to the EU are likely to go up considerably, while marked spending increases in the areas of investment, long-term care and healthcare are also expected.

Fiscal loosening will cause surplus to decline in coming years

As things stand, the framework conditions for public finances will remain favourable in the medium term. However, the surplus could well shrink in the coming years as the Federal Government is planning to raise spending in numerous areas. The tax and social contributions ratio may change very little – on the one hand, income tax, the solidarity surcharge and the contribution rate for the unemployment insurance scheme are set to be reduced but, on the other hand, an increase in the contribution rate for the long-term care insurance scheme is envisaged, and bracket creep in income taxation will generate additional revenue. Fiscal loosening is also in the offing for state and local governments, which have run surpluses for many years. Overall, fiscal policy is likely to be clearly expansionary as a result. Given that economic conditions are favourable, the effect of this will be procyclical. As things currently stand, however, the risk of this giving rise to cyclical excesses such as increased price pressures appears limited overall. This notwithstanding, government investment in construction, to give one example, will have to be monitored so that additional spending does not dissipate in the face of price increases.

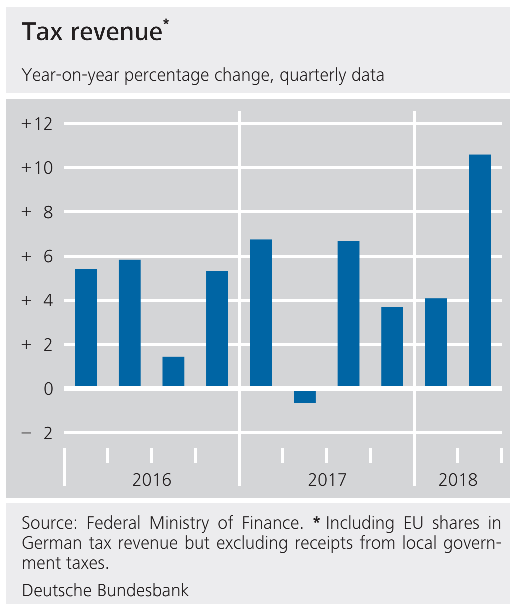
Demographic challenges easier to overcome with low debt ratio

Looking further ahead, public finances will be faced with various challenges, especially that of demographic change. It will cause spending to soar and dampen revenue growth. To this extent, it is a welcome sign that the debt ratio is currently being rapidly reduced. The lower interest burden associated with a low debt ratio provides some breathing space, making it possible to shoulder increasing demographic burdens. This will be important, in particular, even when interest rates go up again.

Spending to initially focus on transfers

The very favourable budgetary situation overall is due not least to positive economic and labour market developments. In view of the high surpluses, however, fiscal policymakers are also under pressure to provide additional public services. The measures currently being rolled out are initially focusing on additional transfers. Means testing is not of primary importance here (as it is, for example, in the case of mothers' pensions or home buyers' child benefit). The scope for spending in other areas – such as education, digitalisation or transport infrastructure, which constitute important cor-

* The section entitled "General government budget" relates to data from the national accounts and the Maastricht debt ratio. This is followed by more detailed reporting on budgetary developments (government finance statistics). As yet, there are no current quarterly data available for local government or the statutory health and public long-term care insurance schemes. These will be discussed in the short commentaries in subsequent editions of the Monthly Report.



Tax revenue*

Year-on-year percentage change, quarterly data

Source: Federal Ministry of Finance. * Including EU shares in German tax revenue but excluding receipts from local government taxes.

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nerstones for economic growth – is thus lower. In addition, the tax and social contributions ratio remains quite high as plans currently stand and will come under substantial upward pressure going forward as taxes and social contributions will be used to finance additional spending in the face of demographic change. Should there be any additional fiscal space available, it would therefore be worth exploring cuts in taxes and social contributions for employees and enterprises rather than expanding transfers.

Planned pension policy measures will increase pressure resulting from demographic trends

The financial challenges arising in connection with demographic trends will increase as a result of current pension policy. The Federal Government's first pension benefits package is set to focus on expanding benefits (particularly mothers' pensions) that are not funded by dedicated social contributions. The lion's share of these costs will initially be borne by contribution payers. However, whenever additional spending on non-insurance-related benefits is approved – to meet certain distribution targets, for instance – it should be financed in a rule-based manner out of general taxation. This is designed, not least, to combat the tendency to exploit the sound state of the social security funds' finances for non-insurance-related purposes.

Put pension finances on sound footing and improve planning certainty

It is important to quickly reach a consensus on the planned fundamental pension reform so as to provide some certainty over the longer term. The main levers for tackling the demographic burden on the pension insurance scheme are the pension level, the statutory retirement age, the contribution rate and the central government grant. At present, there is considerable opposition to further raising the statutory retirement age. At the same time, there are often calls to set a high floor for the pension level and a low cap for the contribution rate. The funding gap that this would open up would then have to be plugged by higher central government grants. It would appear here that central government's ability to shoulder such a burden is sometimes clearly overestimated – not least on account of the still highly favourable budgetary situation, presumably. Central government grants are already set to rise sharply in response to the current legal situation, however, which will increase their share in both central government spending and pension revenue. Private pension arrangements also require a reliable planning basis. It is therefore important to quickly reach an agreement on a burden-sharing plan that will be sustainable in the long term.

Budgetary development of central, state and local government

Tax revenue

Extraordinary rise in tax revenue in Q2 owing to one-off effect in previous year

Year-on-year growth in tax revenue[1] came to 10½% in the second quarter of 2018 (see the chart above and the table on page 59). Excluding the previous year's repayment of nuclear fuel tax amounting to €6½ billion,[2] growth still

1 Including EU shares in German tax revenue but excluding receipts from local government taxes. The latter are not yet known for the quarter under review.
2 In its ruling 2 BvL 6/13, the Federal Constitutional Court declared nuclear fuel tax unconstitutional and ordered central government to repay all payments collected to the operators of nuclear power plants. The aforementioned repayment, made in June last year, was followed in August 2017 by a further amount of €1 billion for accrued interest.

Tax revenue

Type of tax	H1 2017 € billion	H1 2018 € billion	H1 2018 Year-on-year change € billion	H1 2018 Year-on-year change %	Estimate for 2018[1,2] Year-on-year change %	Q2 2017 € billion	Q2 2018 € billion	Q2 2018 Year-on-year change € billion	Q2 2018 Year-on-year change %
Tax revenue, total[2]	326.4	350.2	+ 23.8	+ 7.3	+ 5.3	161.0	178.1	+ 17.1	+ 10.6
of which									
Wage tax	93.6	99.5	+ 5.9	+ 6.3	+ 5.6	48.3	51.4	+ 3.1	+ 6.5
Profit-related taxes[3]	61.6	68.6	+ 7.0	+ 11.3	+ 5.8	29.9	34.9	+ 5.0	+ 16.7
Assessed income tax	31.8	32.5	+ 0.7	+ 2.2	+ 3.7	14.8	14.9	+ 0.1	+ 0.4
Corporation tax	16.4	18.7	+ 2.3	+ 14.3	+ 10.5	7.9	9.3	+ 1.4	+ 18.2
Investment income tax[4]	13.4	17.3	+ 3.9	+ 29.5	+ 5.5	7.2	10.7	+ 3.5	+ 48.6
Turnover taxes[5]	111.7	115.0	+ 3.3	+ 3.0	+ 3.8	54.2	55.8	+ 1.6	+ 2.9
Other consumption-related taxes[6]	42.0	42.1	+ 0.1	+ 0.3	+ 0.6	22.1	22.1	− 0.0	− 0.0

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, fire protection.

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stood at 6½%. But this figure, too, is likely to be somewhat overstated: it is based, *inter alia,* on high additional revenue from non-assessed taxes on earnings. Earlier profit distributions (compared with last year) probably have a part to play in this. As such, a countermovement is expected in the coming months.

Considerable growth expected for year as a whole

The Working Party on Tax Revenue Estimates projects revenue growth (including local government taxes) of 5% for the year as a whole. Excluding the one-off effect of the nuclear fuel tax repayment, the growth rate would stand at 4%. Growth will be slightly depressed owing to other court rulings that are forecast to result in tax repayments later in the year. In addition, there will be revenue shortfalls stemming from legislative changes: income tax cuts, in particular, will reduce revenue. By contrast, lapsing refunds of corporation tax credit[3] will lead to an increase in revenue.

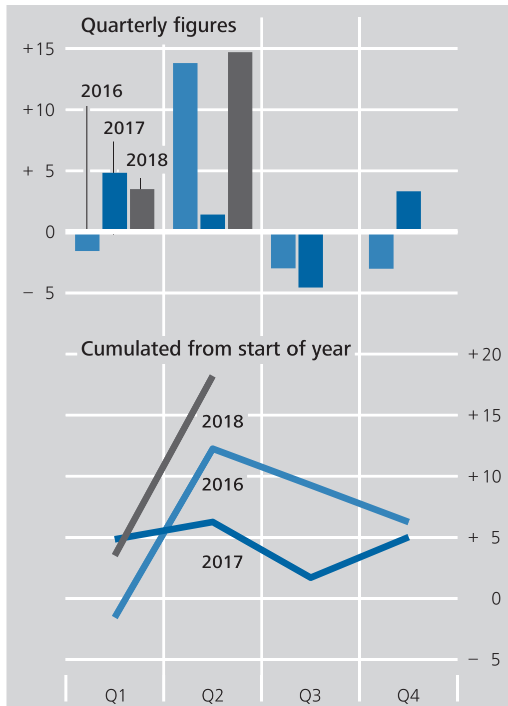
High tax ratio and further upward pressure

The tax estimate indicates that in the medium term, too, tax revenue will rise considerably and the tax ratio will go up. Although the planned income tax and solidarity surcharge cuts have not yet been taken into account, the ratio would probably remain at a historically high level even if they were. Additionally, more tax revenue will be needed in the longer term: it is foreseeable that demographic developments will put considerable funding pressure on the central government budget. In view of the calls for permanent increases in grants to the statutory pension insurance scheme, this pressure could intensify further. With that in mind, it should not be forgotten that rising taxes and social contributions could be detrimental to economic growth, the labour market and investment.

3 This credit was the result of switching from a full imputation system to the half-income method as part of the corporate tax reform of 2000-01. Refunds were staggered between 2008 and 2017.

Central government fiscal balance*

€ billion



Source: Bundesbank calculations based on data from the Federal Ministry of Finance. * Core budget excluding off-budget entities. Not adjusted for financial transactions or cyclical effects.
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Corporate tax burden in Germany becoming less advantageous by international standards

Corporate tax rates are an important part of the decision on where to locate and invest, and enterprises also respond to differences in corporate tax rates from one country to the next.[4] The United States recently cut statutory and effective tax rates for corporations to levels well below those in Germany. On a scale of EU countries' corporate tax rates, Germany already ranks in the top quarter at this time.[5] Some EU countries have announced tax cuts, including countries with relatively high corporate tax rates. But other factors do also play a role in investment decisions. As Germany is a major economy and an oft-attested top-quality business location,[6] a level of taxation that is slightly above average does not appear problematic *per se*. In this respect, it is necessary to maintain that general high level of quality in the long term and cater to new requirements in good time. That said, it is important to also keep an eye on tax competitiveness and, if need be, fine-tune it if the gap between corporate tax rates becomes too great.

Central government budget

Sharp rise in surplus, also as a result of one-off effect

Central government generated a large surplus of €14½ billion in the second quarter of 2018. The budget outturn was €13 billion higher than in the second quarter of 2017. This was partly due to the nuclear fuel tax repayment of €6½ billion in 2017, which pushed down tax revenue that year, being a one-off event. Tax revenue also increased significantly, besides. By contrast, expenditure fell slightly. Amongst other things, interest expenditure declined, particularly in connection with inflation-linked Federal securities. There was also a transfer to the energy and climate fund in the second quarter of last year which was not repeated this year. A surplus of €18 billion was recorded for the first half of 2018 as a whole, which was also well up on the previous year's level (€6½ billion).

Nevertheless, balance set to clearly deteriorate according to 2018 budget plan …

By contrast, the recently adopted budget plan envisages a significant deterioration in the outturn for 2018 as a whole (€7 billion decrease compared with the surplus in 2017). A deficit of €2 billion was estimated. In order to maintain a balanced budget (ie avoid net borrowing), the government is entitled to use, first and foremost, the refugee reserve (see the excursus on pages 69 to 73 on the use of reserves and off-budget entities).

… but debt brake will still be clearly undershot

As the plans stand, the debt brake will be undershot by some way (see the table on page 61). The Federal Ministry of Finance links the ceiling to the level of structural net borrowing, which is lowered by making reserve with-

4 This is suggested by empirical evidence. See, inter alia, RA de Mooij and S Ederveen (2008), Corporate tax elasticities: a reader's guide to empirical findings, Oxford Review of Economic Policy 24(4), pp 680-697; or LP Feld and JH Heckemeyer (2011), FDI and taxation: a meta-study, Journal of Economic Surveys 25(2), pp 233-272.
5 For comparisons of the effective average tax rates and the cost of capital, see C Spengel et al (2018), Analysis of US corporate tax reform proposals and their effect for Europe and Germany: final report – update 2018.
6 See, for example, World Economic Forum (2017), The Global Competitiveness Report 2017-2018.

Central government's fiscal planning up to 2022 and the result as defined in the debt brake rules*

€ billion

Item	Actual 2017	Target 2018	Draft 2019	Fiscal plan 2020	2021	2022
Expenditure[1]	325.4	343.6	356.8	363.2	367.3	373.5
of which						
Investment	34.0	39.8	37.9	37.9	37.9	37.9
Global spending increases/cuts	–	– 0.7	1.7	1.3	0.3	0.6
Revenue[1, 2]	330.4	341.7	351.5	356.6	358.7	374.5
of which						
Tax revenue[1]	309.4	321.3	333.0	333.8	346.8	359.7
Global revenue increases/shortfalls	–	– 1.5	– 7.0	– 6.5	– 17.6	– 14.8
Fiscal balance[3]	5.0	– 1.9	– 5.3	– 6.6	– 8.6	1.0
Allocations to (–)/withdrawals from (+) reserves	– 5.3	1.6	5.0	6.3	8.3	– 1.3
Net borrowing (–)/repayment (+)	–	–	–	–	–	–
Cyclical component[4]	1.4	4.2	6.4	4.0	1.5	0.0
Balance of financial transactions	– 0.8	0.3	1.0	0.8	0.7	0.9
Balance of relevant off-budget entities						
Energy and climate fund	– 0.2	0.0	– 0.4	– 1.0	– 0.2	0.0
Relief fund (2013 flood)	– 0.7	– 0.4	– 0.7	.	.	.
Fund to promote municipal investment	– 0.5	– 1.1	– 1.8	.	.	.
Digitalisation fund[5]	–	2.4	–	.	.	.
Structural net borrowing (–)/repayment (+)[6]	– 2.0	– 3.6	– 10.2	.	.	.
Memo item						
Ceiling	– 10.6	– 11.4	– 11.4	– 11.9	– 12.4	– 12.8
Structural fiscal balance	3.0	– 5.5	– 15.6	.	.	.

* For methodological notes, see Deutsche Bundesbank, Key central government budget data in connection with the debt brake, Monthly Report, February 2016, pp 68-69. **1** After deduction of supplementary central government grants, shares of energy tax revenue, compensation under the 2009 reform of motor vehicle tax and consolidation/budgetary recovery assistance to federal states, excluding allocations to/withdrawals from reserves. **2** Excluding coin seigniorage (consistently €0.3 billion). **3** The difference between revenue and expenditure. Equals net borrowing/repayment less allocations to/withdrawals from reserves and less coin seigniorage. **4** Notwithstanding legal requirements, data for all years taken from the Federal Government's 2018 spring forecast. **5** Planned, newly included in the 2018 budget. **6** Meaning of structural: plus the balance of relevant off-budget entities less the cyclical component and less the balance of financial transactions.

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drawals.[7] Due to favourable economic conditions, the structural balance is less favourable than the unadjusted one. Including the relevant off-budget entities, structural net borrowing amounts to €3½ billion. Nevertheless, the upper limit of 0.35% of GDP will still be clearly undershot.

Plan very prudent, and renewed surplus to be expected

The budget appears very prudent. Recent, highly favourable developments indicate a significant surplus. For example, investment expenditure[8] in areas such as expanding the broadband network or calls on guarantees could once again be lower than estimated. Additionally, surging transfers to the energy and climate fund were earmarked. It seems plausible here that these outflows will be notably lower, even over the remainder of the year. A planned global revenue shortfall of €1½ billion was not explained in any detail. The usual general global spending cut (2017: €2 billion) was struck from the record. If expenditure appropriations are not fully utilised in the course of implementing the budget, the outturn will thus immediately be better than planned as it will not first be netted against a global expenditure cut. All in all, there could be a similarly high surplus as in the previous year rather than the significant deterioration that was envisaged. As a result, the reserve is likely to keep swelling substantially in size rather than being depleted as planned.

Draft budget for 2019 sets out marked expenditure growth …

The draft budget for 2019 was approved by the Federal Cabinet at the start of July. Compared with the 2018 budget estimates, expenditure is expected to rise by almost 4% (€13 billion), with additional funds earmarked for defence and the statutory pension insurance scheme, in

7 By contrast, the deficit cannot be lowered by dissolving reserves. For more details, see Deutsche Bundesbank, Key central government budget data in connection with the debt brake, Monthly Report, February 2016, pp 68-69.
8 Pursuant to the Budget Principles Act (Haushaltsgrundsätzegesetz), investment expenditure includes fixed asset formation, acquisitions of financial assets (loans and shareholding acquisitions), calls on guarantees and financial assistance (intergovernmental and other investment grants).

particular. Spending increases on transport are subdued, despite there being additional revenue from the heavy goods vehicle toll available: the toll rates are set to be increased significantly, and the toll was extended to all federal trunk roads from July 2018. Global additional expenditure of €2½ billion was estimated for projects that have not yet been specified by the Federal Government.

… and considerable burdens on revenue side

Tax revenue growth of €11½ billion is envisaged on the revenue side. This increase will be dampened by the fact that transfers to the EU budget are forecast to be significantly higher again. In the budget, these are deducted from tax revenue. Furthermore, the planned Family Relief Act *(Familienentlastungsgesetz)*[9] is factored in, with revenue shortfalls of €2 billion. As yet unspecified budgetary burdens are taken into account in the form of a single global revenue shortfall item of €7 billion.[10] It is not explained in any further detail and goes far beyond the scope of the priority projects agreed as part of the coalition deal.

Compliance with debt brake only ensured by planned reserve withdrawal, but outturn will probably be more favourable

All in all, a deficit of €5½ billion is estimated for 2019. This, too, is set to be financed mainly by tapping the refugee reserve in order to avoid net borrowing (see the table on page 61). Structural net borrowing will rise to €10 billion. The main reason for this is the deficit recorded by off-budget entities. The outturn will deteriorate significantly in year-on-year terms due to the digitalisation fund no longer receiving a transfer. In addition, cyclical budget relief is set to intensify further. The margin below the debt brake limit will therefore amount to no more than just over €1 billion. If no recourse were made to the reserve, the threshold would be exceeded. That said, the outturn will probably be more favourable than planned in 2019, too. One reason for this is that the significantly better outturn in 2018 is expected to continue making itself felt as a baseline effect. As things currently stand, the global precautionary items will not be needed in the budgeted amount either. Overall, another surplus in the core budget is therefore possible. This would result in the reserve being topped up again rather than being reduced.

Plans for 2018 and 2019 indicate significant fiscal loosening

According to the budget plans for 2018 and 2019, significant fiscal loosening is in the offing. Thus, the structural balance will decrease by €8½ billion in 2018 compared with 2017, and by another €10 billion in 2019 compared with 2018 (see the table on page 61). Such a fiscal stimulus will have a procyclical effect on the back of the very favourable economic situation and cyclical developments that are expected. However, the associated risks to stability policy seem to remain limited. This is due to the fact that price pressures will be contained overall, even taking this stimulus into account. The risk of other stronger cyclical excesses likewise seems limited. In addition, more favourable budgetary developments remain likely, as previously mentioned, with the result that fiscal loosening will be more modest than planned.

Fiscal plan up to 2022 without net borrowing and with provisions for tax relief measures …

The enduring objective of the medium-term fiscal plan for 2020 to 2022 is to achieve a balanced budget (ie no net borrowing). In the final year, reserves are to be topped up again slightly on balance and the positive effect of the economic cycle is expected to have come to an end. To this extent, the plan is to reduce structural deficits. In the case of taxes, bracket creep will bring in a marked increase in revenue. However, this will be counterbalanced by growing shortfalls stemming from the Family Relief Act and, from 2021 onwards, the partial abolition of the solidarity surcharge. Moreover, provisions appear to have been made for a further increase in child benefit, which was outlined in the coalition agreement, and additional

9 This contains the child benefit expansion in 2019 that is enshrined in the coalition agreement. Furthermore, higher basic tax allowances and compensation for the estimated effects of bracket creep in 2018 and 2019 are planned.
10 This probably includes central government grants for state and local governments to cover some of the integration costs for refugees. These will be deducted from central government tax revenue this year (€2 billion annually). These payments were initially only agreed until 2018, but they will now be continued as set out in the coalition agreement. They were not factored into tax revenue, however, as draft legislation on this matter was not yet available.

income tax cuts. The latter are likely to concern raising the basic income tax allowance up to the minimum subsistence level and continuing to offset bracket creep. The sum of these tax measures was adequately taken into account by global revenue shortfalls. These will increase to €17½ billion up to 2021 before falling to €15 billion in 2022. However, this means that the global revenue shortfalls will no longer have a lot to offer in terms of room for fiscal manoeuvre, particularly since the Bundesbank's profit has been budgeted at the maximum amount of €2½ billion.

… amid only moderate expenditure growth

According to the fiscal plan, expenditure (excluding allocations to reserves) will increase by 1½% per year, which marks a substantial slowdown compared with previous years. These rises are significantly lower than anticipated nominal GDP growth and will thus make it possible to scale back the structural deficit. Funds have been primarily set aside for the Federal Ministry of Labour and Social Affairs, more specifically for the pension insurance scheme. Additionally, it is envisaged that a reserve for demographic challenges will receive a new allocation in the amount of €2 billion per year from 2021. This should offset agreed additional pension insurance scheme burdens until 2025 and, in particular, in 2025. Most other ministries' budgets will all but stagnate. A number of priority projects from the coalition agreement still appear to be part of the departmental budget "General financial administration", however. These include, for example, a higher intergovernmental grant to expand childcare facilities.[11] Interest expenditure is expected to rise moderately up until the final year. Thus, provision has been made for a certain interest rate rise.

Additional leeway possible, but also additional burdens and risks

Overall, a certain amount of additional leeway could emerge during the fiscal planning period if the more favourable developments of the preceding years continue to make themselves felt as a baseline effect. In case of such a scenario, it was announced that development aid and defence expenditure would be increased. Planned expenditure relative to GDP in these areas appears to be lagging behind the amounts set in international agreements, and is even declining in some cases. Additional needs may also arise when it comes to payments to the EU; in the context of Brexit, for example. The fact that the solidarity surcharge is only to be abolished in part is sometimes regarded critically under current constitutional rules. However, were it to be completely abolished, the result would be an additional financial requirement of around €12 billion in 2021. There are also certain risks in connection with the macroeconomic outlook: the assumed GDP growth rates seem plausible, but compared to estimates by other institutions, potential output and its rate of growth are set at a fairly high level. This means there is a danger of the favourable cyclical impact being increasingly underestimated and the structural situation being reported too positively. Risks are also posed by factors such as greater trade protectionism, and by renewed tensions within monetary union.

Demographic challenges in the long term

In the longer term, demographic change is set to be one of the greatest challenges facing the central government budget. The associated burdens are likely to have been sufficiently taken into account in the fiscal planning period up to 2022. There is, however, a risk of sharply increasing burdens over time. Central government grants to the statutory pension insurance scheme are already set to rise substantially under the current legislation. This means that central government will fund an ever greater proportion of the scheme with tax revenue.[12] This proportion would be greater still if additional demographic burdens of the pay-as-

11 This constitutes an expansion of mixed financing, which, as a rule, should be viewed critically. See Deutsche Bundesbank, Public finances, Monthly Report, May 2018, p 70.
12 This is also on account of the fact that central government grants are likely to increase at a faster pace than contribution receipts. A large proportion of the central government grant will be increased in line with per capita wages (and the contribution rate). By contrast, contribution receipts grow along with gross wages and salaries (and also the contribution rate). The foreseeable demographic decline in employment will therefore dampen contribution receipts, but not the central government grant.

you-go pension system were to be transferred to central government. Such would be the case if the stringent limits set for the pension level and the contribution rates were to remain in force after 2025. The scope for forward-looking expenditure would then shrink considerably, and tax increases would be inevitable.

Transparency of plans substantially impaired

Central government's budgetary and fiscal plans are becoming increasingly difficult to follow. A medium-term analysis is particularly challenging as important aspects have not been illustrated in a transparent manner. An example of this is information relating to the debt brake. Compliance with the debt brake cannot be assessed unless the budget estimates for all relevant items are shown. However, data are still missing for most of the off-budget entities.[13] Furthermore, a detailed explanation for, in some cases, very extensive global revenue shortfall and expenditure increase items would be needed to evaluate risks and budgetary buffers. In addition, the increasing number of reserve pots, the planned allocations to and withdrawals from these, and their levels would have to be clearly shown.

Potentially stable surplus for the year for off-budget entities

Central government's off-budget entities[14] recorded a surplus of €1½ billion in the second quarter of 2018, compared with a figure of €2 billion in the same period last year. Lower central government grants had a negative effect. A marked surplus is expected once again for the year as a whole (2017: €3 billion). The fund to promote municipal investment may conclude the year with a somewhat larger deficit. Higher payouts are now expected from this fund since the conditions for funding investment in schools have been agreed on. Last year's surplus of €1½ billion for the repayment fund for inflation-linked Federal securities is not likely to be replicated, chiefly because a bond had to be repaid this year. Central government's current transfers were also somewhat smaller as a result of decreased price pressures. The planned digitalisation fund, by contrast, is set to have the opposite effect. It is planned to pre-finance this fund with €2½ billion from the central government budget. These financial resources will only be called upon in the coming years.

State government budgets[15]

Financial situation significantly improved again in Q2, also due to one-off effects

In the second quarter of 2018, state governments achieved a very high surplus in their core budgets amounting to just over €11½ billion. The financial situation therefore improved considerably compared with the result of the same period last year (+€2½ billion). Revenue rose by 9%, significantly more strongly than in the first quarter. The fine that Volkswagen was required to pay on account of the diesel scandal had a positive impact in Lower Saxony (€1 billion). Expenditure, by contrast, declined by 1½%, mainly because a shift in North Rhine-Westphalia during the course of the year decreased other expenditure.[16] Personnel expenditure – a major component of state government spending – showed only weak growth. Transfers to local government and other operating expenditure, conversely, increased strongly.

High surplus foreseeable for year as a whole

Overall in the first half of the year, the surplus increased significantly to €18 billion. As the year progresses, however, various negative factors will take effect. Schleswig-Holstein and Hamburg are anticipating extensive calls on guarantees from their Landesbank.[17] In North Rhine-Westphalia, a negative countermovement resulting from the rescheduled payment, as mentioned above, will make itself felt in a year-on-year comparison. In addition, the

13 A medium-term financial plan has only been drawn up for the energy and climate fund.
14 In line with the Federal Ministry of Finance's quarterly overviews. These notably do not include bad banks and other entities keeping commercial accounts. The refugee reserve is not considered to be an off-budget entity.
15 The following data are based, unless other sources are stated, on the monthly cash statistics for the core budgets.
16 Grants to universities were brought forward to the second quarter last year (approximately €2 billion).
17 On account of transactions with their Landesbanken, in the second half of the year the state governments could face a burden that is €6 billion higher, on balance, than in 2017. Aside from developments in the above-named federal states, a now lapsed capital repayment from BayernLB in 2017 also played a role.

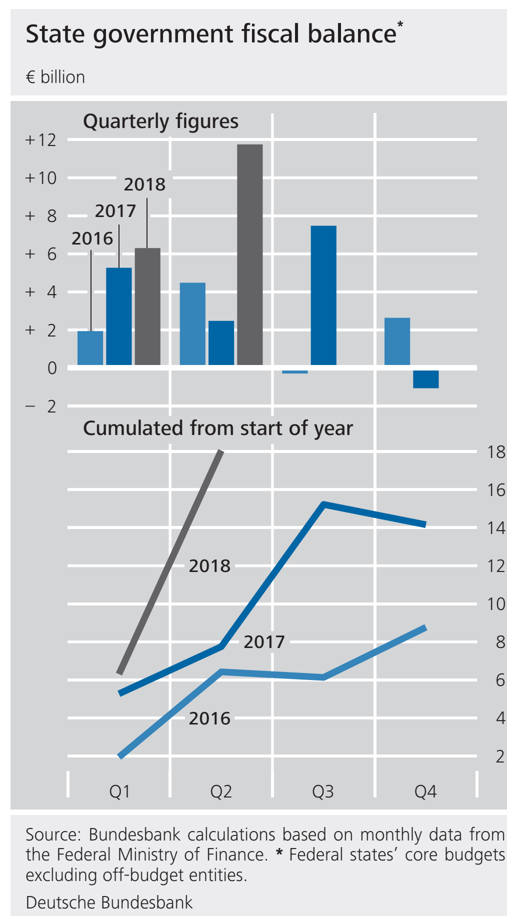
growth in tax revenue is likely to slow markedly, according to the tax estimate. Personnel expenditure, on the other hand, is set to rise significantly more strongly, according to the June projection for the Stability Council. For the year as a whole, the surplus could nevertheless be close to the record level (€14 billion) achieved in 2017.

Medium-term outlook remains very positive

In the medium term, conditions are set to remain favourable for state government finances. This is particularly the case for tax revenue, which is expected to continue to increase significantly. Additionally, central government will continue to provide funds for the integration of refugees, for instance. This means that, on balance, the burdens resulting from the planned Family Relief Act will probably be more or less offset. Further strong growth in pension expenditure is on the horizon in the years to come, and the relief provided by the positive economic situation also has to be factored out. On the whole, however, there is sufficient budgetary leeway to focus on the areas of need with future benefits identified by many state governments. These areas include, in particular, education and childcare facilities, infrastructure, internal security and strengthened administration. Central government projects, such as the digitalisation of schools and all-day childcare for children of primary school age, provide additional support here. Conditions are also favourable for local government finances. This equally presents an opportunity to correct structural imbalances while conditions are good – potentially with targeted support from state government.

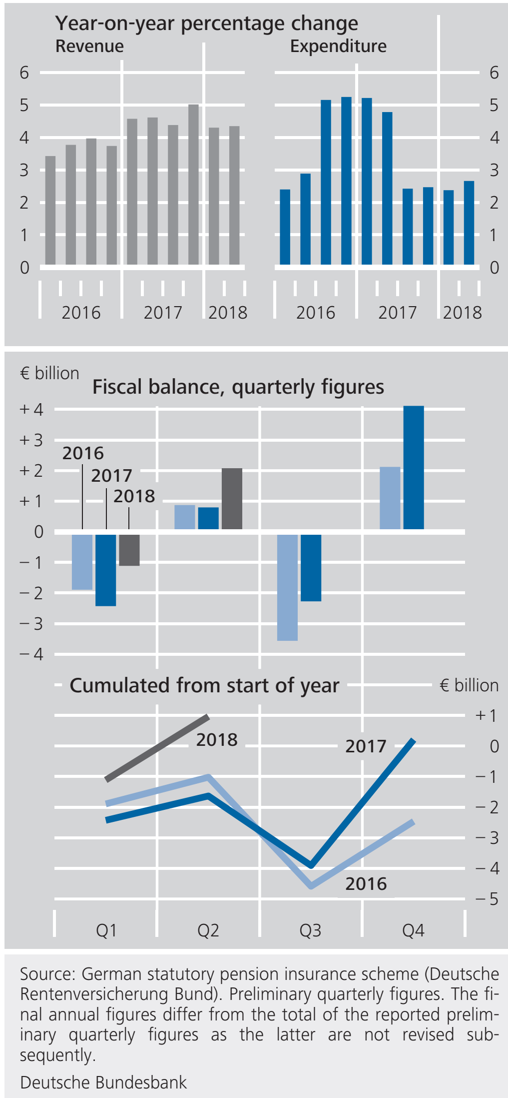
Bremen and Saarland just keeping within structural deficit limits

The Stability Council established at the end of June that the five federal states in receipt of consolidation assistance had fulfilled their obligation to reduce their deficits in 2017 as well.[18] However, Bremen's safety margin now appears to be very small. In Saarland, funds were set aside for a "rainy day", on the one hand, which reduced the safety margin. On the other hand, loss compensation was recorded as financial transactions, meaning that the structural budget outturn looked more positive. Most state governments now have sufficient financial leeway to absorb nationwide tax cuts or unforeseen negative developments. However, this will probably not be the case going forward, particularly in Bremen and Saarland. But from 2020 onwards, both states are to receive more extensive financial aid from central government for at least fifteen years (€400 million each). These funds will have only low debt redemption obligations attached. This will give Bremen and Saarland additional budgetary leeway, but will also weaken their incentives to run an autonomous and sustainable budgetary policy.



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

18 The federal states of Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein are receiving consolidation assistance for the years 2011 to 2019. The payments amount to a total of €800 million per year. To qualify for this assistance, the federal states have to eliminate their structural deficits by at least reducing them in equal increments along a single path by 2020. Central government and the state governments as a whole each provide half of the financial resources.



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

Social security funds

Statutory pension insurance scheme

Considerably higher surplus in Q2 …

The favourable developments in the finances of the statutory pension insurance scheme continued in the second quarter of 2018. At €2 billion, the surplus was more than twice as high as one year earlier. Total revenue continued to rise sharply, by 4½%. Contribution receipts increased somewhat more strongly again in spite of the slight reduction in the contribution rate at the beginning of the year (0.1 percentage point). This reflects the positive employment and wage developments. Expenditure grew by 2½%. This is primarily due to the pension increase in mid-2017, which amounted to an average of just under 2½% for Germany as a whole.

… and probably in year as a whole, too

Growth in pension payments is likely to gain momentum over the course of the year. Although the number of pensions paid continues to increase at just a subdued pace, the mid-year pension adjustment in 2018 was perceptibly higher than in the previous year, at just under 3½%.[19] Nonetheless, revenue will probably continue to rise faster than expenditure. A distinctly higher surplus than in 2017 is therefore on the cards for the year as a whole (€½ billion).

Benefit expansion rather than possible contribution rate cut in 2019

Pension finances will benefit from the expected positive developments in wages and employment in the medium term, too. It would be possible to considerably reduce the contribution rate again next year if no further interventions are made in the meantime. The draft bill prepared by ministry officials for the first pension benefits package[20] puts the potential contribution rate cut at 0.3 percentage point (€3½ billion). In the first few years, however, the extensive benefit expansions provided by this package are largely to be financed by increased contributions. In a first step, therefore, a possible reduction in the contribution rate is being avoided.

Higher benefits for different groups, and limits set for pension level and contribution rate

The pension benefits package is intended to take effect as of 2019. Mothers with children born before 1992 are to receive increased mothers' pensions. In addition, new pensions for persons with reduced earning capacity are

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19 On 1 July, pensions were raised by 3.22% in the west German states and 3.37% in the east German states.
20 Draft bill prepared by ministry officials of the Federal Ministry of Labour and Social Affairs for the Act on Improvements in Benefits and Stabilisation of the Statutory Pension Insurance Scheme (Gesetz über Leistungsverbesserungen und Stabilisierung in der gesetzlichen Rentenversicherung) of 12 July 2018.

set to be higher. In the case of "midi-jobs",[21] social security contributions will be reduced for those earning a monthly wage of up to €1,300 (as opposed to €850 up to now). Furthermore, pension entitlements from midi-jobs are to be upgraded. This means that pension entitlements will no longer be derived solely from the reduced but the assumed full contribution level. Finally, new limits will be set for the pension level[22] and the contribution rate (a measure referred to as the "double limit") up until the end of 2025. The pension level may not fall below 48%, and the contribution rate is not to exceed 20%. It is intended to plug any funding gap with additional central government grants.

Additional expenditure on mothers' pensions in particular

The financial impact of individual measures up to 2025 is set out in the draft bill. The additional annual costs for mothers' pensions are estimated to be €3½ billion. The reduced contribution for those with low incomes is forecast at just under €½ billion. The increased spending on pensions for persons with reduced earning capacity is to rise gradually, reaching €1 billion in 2025. However, no potential changes in behaviour resulting from the more advantageous new rules have been taken into account. The total cost of the above measures will initially be €4 billion per year. This will increase to €5 billion by 2025.

Additional non-insurance-related benefits chiefly financed by higher contributions

By far the largest share of the additional burdens on the statutory pension insurance scheme will be financed by contributions up to 2025 (based on the burdens cumulated up to that point). Without the pension benefits package, the contribution rates would be below 20% up to and including 2025, according to the projection. The package generally results in a markedly higher contribution rate, which will reach the 20% limit in 2024. A higher contribution rate also results in a lower level of pension growth when the pension adjustment formula is applied. According to the draft bill, the pension level will already have reached the limit by 2022. Without the package, this would only have been the case in 2024.[23] Consequently, pensioners are also to make a financial contribution (albeit significantly smaller) to the agreed expansion of benefits. However, the increase in mothers' pensions and decreased contributions for midi-jobs can be classified as non-insurance-related benefits (€4 billion per year). As such, it would be appropriate to fund these benefits with additional central government grants, and thus with general tax revenue, by extension.[24] However, central government's additional burdens amount to only around €1 billion on average each year between 2019 and 2024. Only in 2025 will they rise significantly to €5 billion, as the contribution rate would otherwise increase to over 20%.

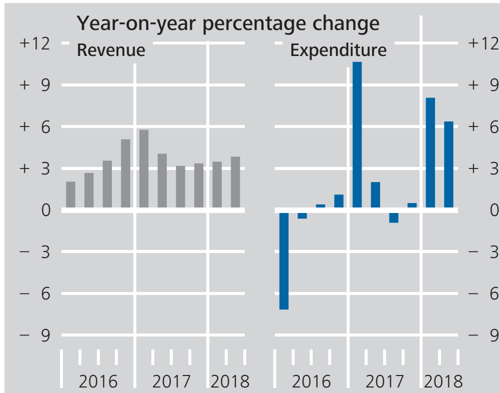
Further complications in overcoming foreseeable demographic burdens

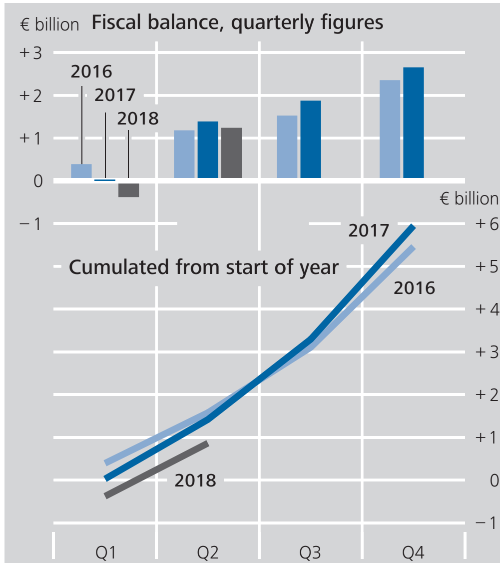
Overall, the package places a considerable burden on pension finances, mainly on account of the expansion of mothers' pensions. As a result, the financial leeway for other government priorities currently under discussion is reduced. The special benefit expansions are not means-tested. While the current favourable budgetary situation will ensure that the additional financial burdens are likely to make less of an initial impact, spending on pensions will increase in structural terms, although expenditure will face strong demographic pressure in any case.

Future pensions for persons with reduced earning capacity will be significantly increased. In some cases, they will be substantially higher

21 Midi-jobs are forms of employment for which the monthly wages usually lie between €450 and €850. In this area, certain reductions have been granted for social security fund contributions (section 20 (2) of the Fourth Book of the Social Security Code (Sozialgesetzbuch IV)). However, this has also meant lower pension entitlements up until now.
22 The pension level is the ratio of the current standard pension (given respective average earnings subject to insurance contributions over 45 contribution years) to current average pay. Income before taxes but less the relevant social contributions is used.
23 The envisaged adjustments to the contribution rates for the public long-term care and unemployment insurance schemes have not yet been included. They will reduce the pension level.
24 Generally speaking, it would be desirable to define those benefits regarded as non-insurance-related, and to finance them with central government grants in a rule-based manner. This would enhance transparency and clarity. The fact that the classification of individual benefits is not always straightforward should not hinder this.

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

Future pensions for persons with reduced earning capacity substantially higher than regular early retirement pensions in some cases

than regular early retirement pensions. This increases the incentive to exploit pensions for people with reduced earning capacity so as to retire early. From now on, it will be even more important to make provision for this. People working in professions which are detrimental to their health are intended to benefit from increased pensions for reduced earning capacities. In this respect, concerns regarding a rising statutory retirement age have been taken into account, and this issue should therefore be regarded as less problematic.

The reduced contribution rate for those in midi-jobs will make this form of employment more attractive. The impact on the total number of hours worked, however, is unclear and is likely to be marginal. Only part-time employees will benefit from the reform, regardless of their hourly pay rate and of any other sources of income. The main criticism of the new midi-job rules appears to be that full pension entitlements are to be accrued despite the reduced contributions, thereby breaching the principle of equivalence. Furthermore, this subsequent preferential treatment is not precisely based on means testing at the time the pension is drawn, and there are likely to be "free-rider" effects.

Midi-job reform unlikely to be focused

Measures to stabilise pension finances necessary after 2025

Serious financial problems are set to arise within the statutory pension insurance scheme as a result of demographic trends, particularly after 2025. Key variables therefore need to be adjusted to ensure the sustainability of the scheme. However, the relevant fundamental decisions have been put off for the years to come. A pensions commission was tasked with the preparations in the first instance. The cost trends and burden-sharing expected in the long term must be presented in a transparent manner if a sustainable solution is to be found. In addition, all material parameters of pension finances should be regarded as parts of an interconnected system. Aside from the pension level, contribution rates and central government grants, this also includes the statutory retirement age, which has already been linked to life expectancy in other countries. It would also make sense to take longer contribution periods into account when calculating the pension level, as these are set to increase in step with a rising statutory retirement age and will increase the level of benefits.[25]

Federal Employment Agency

In the second quarter of 2018, the Federal Employment Agency posted a surplus of al-

25 See Deutsche Bundesbank, Excursus: longer-term pension developments, Monthly Report, August 2016, pp 68-77. For the burden on the central government budget, see also p 63 f. of this report.

Surplus at previous year's level in Q2

most €1½ billion in the core budget.[26] This stood just around the level of the previous year. As in the first quarter, a higher special transfer to the civil servants' pension fund[27] placed a strain on the Federal Employment Agency's finances compared with the previous year.

Strongly increased contribution receipts amid declining operating expenditure

As a result of a further steep rise in contribution receipts (5%), revenue increased by a total of 4%. Expenditure grew by 6½%. The increase was driven solely by additional payments to the civil servants' pension fund. In particular, expenditure on unemployment benefits and active labour market policies declined further (by around 3% in each case).

Higher surplus and growing reserves foreseeable for the year as a whole

Conditions are very favourable for the Federal Employment Agency's finances – employment is increasing, unemployment is declining and per capita earnings are rising more sharply. No further special transfers to the civil servants' pension fund have been planned for the second half of the year. Against this backdrop, a high surplus is also expected for this year. It could even exceed the prior-year figure of €6 billion, thus surpassing the budgeted amount of €2½ billion by a significant margin. The free reserves would rise to a record level of over €23 billion.

Greater contribution rate reduction feasible

The positive development on the labour market is likely to continue. High surpluses and increasing reserves are therefore still expected, even if the contribution rate is reduced from 3.0% to 2.7% in accordance with the coalition agreement. Even if spending were to increase somewhat – for active labour market policy measures, for example – the Federal Employment Agency's finances would still be able to cope with a lower contribution rate.

Excursus: the use of reserves and off-budget entities by central and state government

Current developments

Sound position used to set aside reserve funds

Central government and numerous state governments have used the sound budgetary situation of the past few years to channel more funds into reserves and off-budget entities (special funds). Reserve funds were thus set aside to be used when needed in future.[28]

Varying effects in context of debt brake

However, this future use of reserves only expands budgetary scope if it is permitted under the debt brake rules. Central government links its debt brake to net borrowing. As net borrowing can be reduced by a withdrawal from reserves, it is easier to comply with the budget ceiling by using reserves. As for central government's off-budget entities, their inclusion in the debt brake varies. Here, it is possible to achieve the same effect as with reserves if the off-budget entities are not consolidated under the debt brake: pension funds, for instance, are not included in the debt brake. In other words, transfers of funds from central government are recorded as central government expenditure and, under the debt brake, restrict its budgetary scope in the same year. Subsequent pension payments from the off-budget entity are not recorded as central government spending, however. The situation is different for the newer off-budget entities, such as the fund to

26 Excluding the civil servants' pension fund. The transfers to the fund are recorded here as expenditure and reduce the core budget balance. Including the fund, the surplus amounted to €2 billion in the second quarter.
27 The additional transfer totalled just under €1 billion, compared with a little under €½ billion in the same period last year.
28 In most cases, no (financial) assets were set aside. In the central government budget, for example, topping up the refugee reserve was counted towards net borrowing in budgetary terms. In actual fact, however, the surpluses were used to repay debt. Ultimately, the refinancing of debt in the capital market was thus deferred. This occurs when, under the budget, funds are withdrawn from reserves without having to record net borrowing in the budget.

promote municipal investment or the planned digitalisation fund. These are included in the debt brake. Transfers from the core budget thus do not constitute a burden; overall, they do not change the sum of net borrowing in the core budget and the balances of the relevant off-budget entities – the relevant metric under the debt brake.[29] Subsequent outflows from the funds then constitute spending from the core budget in the context of the debt brake.[30] In contrast to reserves, then, when it comes to these consolidated off-budget entities, it is not possible to purposefully extend the debt brake limit using surpluses from previous periods when drafting the budget.

Sizeable refugee reserve not needed for actual purpose, …

One important example of a reserve is the refugee reserve. It was established by central government at the end of 2015 and stocked up using budget surpluses.[31] Originally, its intended use was to cover budgetary burdens stemming from the heavy influx of refugees at that time. However, no funds have so far been withdrawn, even though this was regularly envisaged in the budget plans. On the contrary, the reserve was topped up with further surpluses and grew to €24 billion by the end of 2017. As things stand today, it is not needed for its original purpose. To date, it has been possible to cover refugee-related expenditure without using the reserve, and this expenditure is already declining markedly at the general government level.

… but instead of being dissolved, it is now an instrument to finance new projects

In keeping with the intention of the debt brake, it would thus be logical to dissolve the refugee reserve by budgeting for a debt repayment. But instead, it is being used as an additional budget instrument, serving as a general overflow pot for surpluses during the budget implementation phase. In subsequent periods, the cumulated funds allocated to the reserve make it easier to avoid net borrowing, as the budget plans make the reserve available to fund additional increases in expenditure or tax cuts, for example. The reserve thus allows central government to avoid net borrowing even in the event of a fiscal loosening (see the table on page 61).

Additional reserves planned at central government level

Another example at the central government level is the new arms reserve. If the funds approved in the budget for military procurements (€5 billion) are not fully tapped in the current year, the reserve will be topped up by up to €½ billion in the event of a surplus. Moreover, €2 billion is to be channelled each year from 2021 to 2024 into a reserve set up for demographic challenges. This reserve is intended to cover central government's additional outlays in subsequent years stemming from the planned limits set for the pension insurance scheme up until 2025.

Some state governments also have growing reserves

At the state government level, not only different forms of reserves but also off-budget entities, in particular, are gaining in importance. The aim is for unused budgetary leeway to be carried over into the future. This appears to be possible because these entities are evidently not to be consolidated in the context of the relevant state government's debt brake.[32]

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29 However, there is one difference regarding the supplementary objective of no net borrowing: since this objective relates to the core budget, it is harder to achieve when transferring funds to an off-budget entity, and easier when withdrawing funds.
30 However, there is one difference in the budget implementation phase. If outflows from pre-funded off-budget entities turn out to be higher than estimated during budget implementation, no new borrowing authorisations are required. Additional expenditure of this kind is not restricted by the debt brake at that moment. In the central government budget, by contrast, new borrowing authorisations are restricted in the form of a supplementary budget: the standard limit may be exceeded by a maximum of 3% of the planned tax revenue. Each time the debt brake limit is exceeded during budget implementation (core budget and relevant off-budget entities taken together), however, the control account is debited (for more on the control account, see p 71).
31 Plus central government's coin seigniorage. Certain state governments established similar reserves. These federal states sometimes ultimately transferred borrowing authorisations that were not needed when the budget was implemented to a reserve.
32 This also applies to state governments receiving consolidation assistance. At the end of the last fiscal year, Berlin, Schleswig-Holstein and Saarland, for example, topped up off-budget entities intended to finance future investment.

Difference from central government's control account

Debt brake control account impaired by accumulation of reserves

Under the debt brake, a control account was established for central government from 2011. At first glance, this resembles the aforementioned reserves, but in fact differs from them crucially. The debt brake stipulates a ceiling for central government's structural budget outturn (-0.35% of GDP). Positive and negative deviations from this ceiling during the budget implementation phase are added up on the control account.[33] A more favourable budget outturn thus results in a credit entry on the control account. However, a credit balance may only be used to offset unplanned breaches of the ceiling in the current fiscal year (during budget implementation).[34] The control account therefore is not designed to open up additional fiscal space in coming years. By contrast, the reserves and the central government off-budget entities not included in the debt brake (also called reserve funds from now on) explicitly aim to do this, and make it possible. When reserves are accumulated, the surpluses to be booked to the control account are accordingly lower.[35]

Pros and cons of reserve funds

Reserve funds can stabilise budgetary policy

Reserves and off-budget entities excluded from the debt brake are budget instruments with specific pros and cons. It would be beneficial if they were used to further stabilise budgetary policy.

Reserve funds can compensate for unpleasant surprises

In good times, reserve funds can be topped up as a precaution against unpleasant surprises. Such surprises can have a serious impact, particularly when it comes to tax revenue. Often, they are not classified as cyclical by the conventional cyclical adjustment methods. Consequently, they affect the structural result, which is limited by the debt brake. Without reserve funds, an unexpected structural deterioration induced in this way would have to be fully compensated for when the next budget was drawn up, at the very latest, if the previous financial plan had not included a safety margin below the debt brake ceiling.[36] A procyclical policy in bad times is more likely in the absence of safety margins.

Better control of expenditure burdens in budget

Reserve funds can also be used to frontload the burdens stemming from spending programmes with uneven outflows, the timing of which is difficult to estimate (such as military procurements). When there is scope in the core budget, funds can be made available in advance which are then called upon if needed in future.

Special pots may impair transparency and control by parliament and general public

These potential benefits also stand in contrast to serious problems, however. Important budgetary principles, such as annuality and budgetary clarity, could be undermined. In particular, transparency can be lost if the plans become increasingly opaque due to numerous special pots. This is all the more true if overviews and information on key metrics are not provided or not provided in good time – or if these metrics can only be determined with some difficulty. Control by parliament and the general public can then be significantly impaired.

Risk of budgetary imbalances being concealed

In particular, it is critical if structural imbalances are concealed by reserves. For instance, a structural spending increase or tax cut could initially be funded from a reserve. The politically difficult decision on counterfinancing could thus be shelved relatively unobtrusively. Only when the reserve is fully depleted would the need for consolidation come to light.

Taking on debt via off-budget entities could erode budgetary rules

Off-budget entities are particularly problematic if they are used to take on extra-budgetary debt. This could result in the actual debt position being incorrectly assessed and risk being

33 For more details on the control account, see Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40.
34 Budget legislators are obligated to make realistic budget estimates. Tapping the balance by making optimistic budget estimates should therefore remain restricted.
35 In 2017, €5½ billion was transferred to the refugee reserve from the core budget outturn (total available funds: €24 billion). The control account was credited with €7½ billion from the remaining margin to the debt brake ceiling (credit balance: €18½ billion).
36 See Deutsche Bundesbank (2011), op cit, p 32.

understated. Under certain circumstances, the normal budgetary rules could also be undermined. While central government has closed this previous loophole in the German Basic Law *(Grundgesetz)* for its own special funds, many state governments have not yet rigorously addressed this issue.

Use of reserve funds could lead to conflict with European fiscal rules

As the volume of reserve funds at the various levels of government rises, so too does the risk that the national rules no longer sufficiently safeguard compliance with the European rules. This safeguarding by means of the national rules is laid down in the Fiscal Compact and the Basic Law. Yet the national and European rules are not identical. The debt brake limits net borrowing by the relevant central and state governments, which is decreased by a withdrawal from reserves or shifting expenditure to off-budget entities excluded from the debt brake. On the other hand, the EU rules target the annual general government deficit (as defined in the national accounts), which is not positively affected by either of these actions.[37]

Minimise problems with appropriate design

Use rules to limit risk of reserve pots

All things considered, the disadvantages of reserves and special funds described above seem quite serious. If these budget instruments are to be used nonetheless, the associated risks should be recognised and minimised by the rules on their application.

Transparency and clarity

Timely full disclosure and transparent planning important

It is crucial that central and state governments disclose their special pots transparently, clearly and completely. The budgetary policy they are pursuing should also be well substantiated. The call for transparency applies to the short and medium-term plans, the budget implementation phase and the budget outturn. The relevant fund levels as well as the financial links to the core budget would have to be shown in a timely manner using suitable overviews. There is considerable room for improvement here, for central government but especially for state government, too.

Safeguard national fiscal rules

Declining debt ratio still prudent

The standard limits imposed by the debt brake place relatively tight constraints on net new borrowing by government. In relation to the size of the economy, this is likely to further reduce debt, ie the debt ratio, significantly. This appears prudent as a precaution against demographic challenges and with resurgent interest rates in mind.

Accumulation of reserves given structurally balanced budget

To avoid undermining the objectives of the debt brake, various aspects should be considered when using reserves. First, it should only be possible to establish a reserve if the standard limit is met. This means, for example, that it should be impossible to accumulate reserves if the standard limit was exceeded owing to exceptional circumstances. Otherwise, debt could be higher over time than permitted by the standard limit. Moreover, the Basic Law explicitly makes provision for a control account. If central government were to regularly record the full margin below the standard limit as a reserve, the control account would conversely be transformed into a permanently available reserve. However, as central government is currently using a budget without net new borrowing as a benchmark, only a part of the margin below the ceiling is being transferred to reserves. This stabilises and effectively puts a brake on central government's debt level.[38]

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37 Aside from this aspect, there are other differences between the national and European rules. Important examples are the definition of financial transactions and the cyclical adjustment methods used in each case. For more details, see Deutsche Bundesbank (2011), op cit, pp 28 ff.
38 The objective of no net borrowing is not to avoid structural new borrowing; instead, an unadjusted figure is targeted. Thus, cyclical fluctuations are not taken into account. In this respect, the objective of no net borrowing appears less suited to ensuring a stable budgetary policy than a structurally balanced budget. Furthermore, there is the risk of conflict with the European rules.

Rule-based use of reserves to cushion negative shocks

One particularly important advantage of reserves is their potential to stabilise budgetary policy in the face of unpleasant surprises. However, this does not ultimately line up with planning a full depletion of existing reserves on a regular basis in the medium term. Instead, it would make sense to use them only as an insurance policy for unexpected structural budget shortfalls. To this end, directly after a surprise of this kind, greater use of the reserves could be made at first and then subsequently scaled back (ie the withdrawals should gradually decline over the years). Any consolidation that may become necessary to close the unexpected funding gap could thus be stretched out over time. The spending path would be stabilised or an abrupt tax hike avoided, as the reserves would have served as an additional stabiliser. Safety margins below the normal ceilings could therefore be smaller. With a rule-based restriction on the use of reserves, it would be possible to prevent this from fostering an erratic or unsound budgetary policy.

Avoid structural problems through use of reserve funds

Use of reserves for structural burdens should require decisions on counter-financing after depletion of reserves

The budget should be structurally sound after the reserves are depleted, at the latest. This applies given their function as insurance against unexpected unpleasant surprises, as described above. However, it also applies, in particular, if reserves are to be used not just in response to surprises, but on a discretionary basis for any additional measures that burden the budget. This refers to central government's current approach of budgeting for the full use of the reserve to finance the budget. Thus, it would be least concerning if the budget were to be burdened with measures that largely have a temporary effect, such as major investment projects. Structural burdens that still exist even after the reserve is depleted should be offset by tax hikes or spending cuts already agreed in advance (global cuts in expenditure or increases in revenue do not achieve this). Central government's new reserve for demographic challenges highlights the difficulties that arise otherwise: it is planned to use these funds in 2025 to compensate for extensive financial burdens. However, it is still unclear how the significant additional structural burden after 2025 expected as part of the pension benefits package is to be financed.

Compliance with European rules

Compliance with EU rules currently assured

Finally, it must be ensured that the European fiscal rules are complied with. Given the significant surpluses and sound underlying conditions, there is currently no indication that the EU limits will be exceeded. However, the structural surpluses are likely to shrink in future.

Stability Council needs much better information

The European rules are based on the general government structural deficit as defined in the national accounts, for which a standard limit of 0.5% of GDP applies. Under these rules, central government bears responsibility for the social security funds, and the state governments are responsible for their local authorities. In Germany, fiscal surveillance of general government's compliance with the European rules is the task of the Stability Council. Amongst other things, the Stability Council has to monitor whether there is a risk of the limit being exceeded even in the event of compliance with the relevant national rules. If this were the case, the Council would have to submit proposals to prevent such a breach of the rules. But to do this, it needs detailed information about central and state government's plans. Notably, this includes comprehensive disclosures about the planned use of reserves and off-budget entities by these levels of government. The documents presented to the Stability Council do not appear to be adequate in this respect, particularly in the case of the state governments. This has been pointed out, not least, by the independent Advisory Board.[39]

39 See Independent Advisory Board to the Stability Council, Ninth statement on compliance with the upper limit for the structural general government budget deficit pursuant to section 51 (2) of the Budgetary Principles Act (Haushaltsgrundsätzegesetz), June 2018, pp 17-18.