Public finances*

General government budget

General government budget set to remain broadly balanced in 2014 and …

The general government budget has been broadly balanced for the past two years and, as things stand, this is expected to continue in 2014. On the one hand, the economic upturn, favourable financing conditions and the higher Bundesbank profit compared to 2013 are, besides other factors, likely to ease the pressure on the general government budget. On the other hand, strains will arise, in particular, from the various spending programmes agreed after the national elections. In structural terms, too, the budget should be close to balance. The debt ratio fell to 78.4% at the end of 2013 (end-2012: 81.0%) and is expected to record another considerable decline to around 75% by the end of 2014. With the general government budget at least broadly balanced, this reduction in the ratio is largely attributable to growth in nominal gross domestic product (GDP) in the ratio's denominator. In addition, government-owned bad banks are likely to continue to reduce their liabilities as they sell off financial assets. However, the decline in the debt ratio will be slowed down by the payments agreed as part of the euro-area financial assistance mechanisms, although these are much lower than in previous years.[1]

… debt ratio to decline considerably

Revenue and expenditure ratios may remain stable on the whole

The revenue ratio may change very little in 2014. Fiscal drag,[2] in particular, will be partially offset by income tax relief measures. The expenditure ratio could also remain virtually unchanged despite the various new spending programmes (especially for pensions, transport infrastructure, childcare, education and research). This is due to three factors. First, only part of these measures will come into effect in 2014. Second, the economic upturn is pushing down the expenditure ratio, above all via nominal GDP growth in the denominator. And third, the interest expenditure ratio could fall because, as things stand today, both the average interest rate on government debt and the debt ratio are set to decline.

Broadly balanced budget and declining debt ratio currently expected for 2015, too

In 2015, too, the general government budget could remain broadly balanced and the debt ratio may decline further. Positive economic developments are likely to increasingly boost public finances and, not least as a result of the declining debt ratio, the interest expenditure ratio will probably fall further. However, these relief-providing factors will contrast with growing strains from the latest spending programmes. Furthermore, with expenditure dynamics continuing unabated and reserves at a high level, the statutory health insurance contribution rates are likely to see a modest and temporary decline. The pension adjustment rules may also dictate a cut in the contribution rate to the statutory pension insurance scheme to ensure compliance with the upper reserve limit; however, as with the statutory health insurance institutions, it is only a matter of time before the rate will have to be put up again.

The Federal Government presented its updated stability programme for the 2014-18 period in April.[3] As things stand, achieving the envisaged

* The analysis in the "General government budget" section is based on data contained in the national accounts and on the Maastricht ratios. These data, in turn, are based on the European System of Accounts (ESA) 1995 (currently still valid but due to be replaced as of September 2014 by the revised ESA 2010). The subsequent reporting on the budgets of the various levels of government and the social security funds is based on the figures as defined in the government's financial statistics (which are generally in line with the budget accounts).
1 There are also general budgetary risks, not least as a result of uncertainty in the global and European context.
2 In this context, the term "fiscal drag" encompasses the (positive) revenue effect of bracket creep in income taxation and the (negative) impact of the fact that specific excise duties are largely independent of prices.
3 As part of European budgetary surveillance, EU member states have to present a stability or convergence programme every April. As in previous years, the programme is based on central government's macroeconomic forecast from the beginning of the year. This projection was updated in mid-April and a revised official tax estimate on that basis was presented at the start of May (see p 73). However, the implied revisions for the fiscal forecast are only minimal on the whole as a result of this new information.

Key data of the Federal Government's updated stability programme

Item	2013	2014	2015	2016	2017	2018
Real GDP growth (%)						
Stability programme April 2014	0.4	1.8	2.0	1.4	1.4	1.4
Stability programme April 2013	0.4	1.6	1.4	1.4	1.4	–
General government fiscal balance (% of GDP)						
Stability programme April 2014	0.0	0	0	0	½	½
Stability programme April 2013	– ½	0	0	½	½	–
Structural fiscal balance (% of GDP)						
Stability programme April 2014	0.7	½	½	½	½	½
Stability programme April 2013	0	½	½	½	½	–
Debt-to-GDP ratio						
Stability programme April 2014	78.4	76	72½	70	67½	65
Stability programme April 2013	80½	77½	75	71½	69	–

Source: Federal Ministry of Finance.
Deutsche Bundesbank

Stability programme envisages compliance with European rules

development should be possible and the intention of complying with the European rules governing the structural fiscal balance and the reduction of the debt ratio while also leaving an added safety margin is welcome. The aim is to ensure that the general government budget remains balanced and that a surplus of ½% of GDP can be attained as of 2017.[4] The stability programme shows a significant decline in the debt ratio to 65% by the end of 2018. According to the programme, the medium-term objective of a general government structural deficit ratio of no more than 0.5% of GDP will thus be maintained with a margin of around 1 percentage point throughout this period. However, this is partly due to a further decline in the interest burden. Overall, general government fiscal policy will be relaxed as time progresses if it is evaluated on the basis of the cyclically adjusted primary balance (excluding interest expenditure). Central government's various expenditure-increasing measures, besides other factors, will play a key role here. These will only be partially offset by additional revenue from fiscal drag and increases in social contribution rates as well as the somewhat restrained expenditure policy assumed for other areas (eg personnel).

Assessment of structural situation seems too favourable

The structural surplus of ½% of GDP envisaged in the stability programme is also based on the assumption that cyclical factors are having a significant unfavourable impact in 2014 and their influence will remain negative until 2017. This assumption is based on the method of cyclical adjustment used in European budgetary surveillance. All in all, however, the recent macroeconomic data suggest that the cyclical situation in Germany is not unfavourable. The macroeconomic forecast used by the government puts the cyclical impact in the forecast period on the positive side. The unadjusted fiscal development outlined in the stability programme, showing a balanced budget and slight surpluses, would thus partly reflect favourable cyclical factors, and the structural budget would, in fact, be balanced or slightly negative.[5]

Marked surpluses appropriate given favourable underlying conditions

Given the exceptionally favourable underlying conditions, the fact that the economy as a whole is expected to grow smoothly and uncertainty in the global and European context, it would seem wholly appropriate to achieve larger surpluses. The debt ratio could then be

4 For the forecast period, the only figures available are in relation to GDP and have been rounded to the nearest ½, which makes them more difficult to analyse.
5 Past estimates of the cyclical components have often been too negative; see Deutsche Bundesbank, The impact of biased potential output estimates within fiscal rules, Monthly Report, April 2014, pp 33-34.

Fiscal developments in the euro area

Distinct decline in euro-area general government deficit ratio in 2013, but further rise in debt ratio

At the end of April, Eurostat published data on the general government deficits and debt levels of the EU member states as part of European budgetary surveillance. These figures show that the euro-area general government deficit ratio declined from 3.7% to 3.0% last year, an improvement achieved amidst unfavourable cyclical developments. According to the European Commission, the decline amounted to around 1 percentage point after cyclical adjustment. This consolidation was achieved in equal measure via the revenue and expenditure sides; the cyclically adjusted expenditure ratio also benefited from the year-on-year fall of 0.3 percentage point in temporary outlays to support the banking sector. By contrast, the debt ratio continued to rise distinctly in 2013, increasing from 92.7% to 95.0%.[1]

2014: further but moderate deficit reduction, yet continued rise in debt ratio

The European Commission's spring 2014 forecast projects a continued decline in the euro-area deficit ratio this year, down to 2.5% of gross domestic product (GDP). However, this reduction is being helped along by positive cyclical conditions, and temporary factors are almost negligible, which means that the structural improvement will amount to only ¼% of GDP. Despite the rather more significant pick-up in economic activity projected for 2015, the European Commission expects only a slight decline in the deficit ratio next year (to 2.3%), which would amount to a loosening of the fiscal policy stance in structural terms. However, this figure does not include all the measures envisaged in the national stability programmes, as it only incorporates measures known in sufficient detail by the cut-off date for the forecast. For 2014, the Commission projects that the debt ratio will rise further to 96.0%. It expects the debt ratio to decline in 2015 for the first time since 2007, falling slightly to 95.4%.

More consolidation needed in most cases, even in countries whose deficit ratios are below the threshold

Only a few euro-area countries (Estonia, Finland, Germany, Italy, Latvia and Luxembourg) are not currently subject to an excessive deficit procedure. Austria, Belgium, Malta, the Netherlands and Slovakia kept their deficit ratios below the reference value again in 2013.[2] It must now be established whether these countries meet the criteria for closing their procedure, notably the requirement to keep their deficit ratio below the reference value for a sustained period of time and to lower their debt ratio sufficiently. However, even if a country exits the excessive deficit procedure or has already eliminated its excessive deficit, this does not mean that the consolidation process is yet complete. Indeed, most of these countries still need to achieve the minimum requirement of a balanced (or close to balance) budget in structural terms – ie net of cyclical effects and one-off measures.[3] The

1 Unlike the data reported in the Eurostat notification, the European Commission debt ratio figures cited in this box also include lending between euro-area countries.
2 However, Eurostat expressed some reservations concerning the data provided by the Netherlands because of uncertainty about the statistical impact of government intervention in the nationalisation and restructuring of SNS Reaal in 2013. This matter is currently being clarified with the Dutch statistical agencies.
3 In addition, countries with a debt ratio of more than 60% must rapidly bring it down to this threshold.

countries that have signed the Fiscal Compact are also obliged to enshrine this rule in their national legislation. The Six-Pack of regulations passed in 2011 was also aimed at achieving stricter compliance with the rules and a stronger binding force for the preventive arm of the Stability and Growth Pact. Notably, the Six-Pack created options to impose sanctions (interest-bearing deposits) in cases where countries fail to meet the structural budgetary objective and where the annual improvement in their structural balance remains significantly below the benchmark of at least 0.5% of GDP. Despite failing to meet the structural budgetary objectives, many countries' structural balances are expected to improve only marginally this year, with some even projected to deteriorate. The European Commission (and the Ecofin Council) now have a duty to strictly apply the new procedures in order to strengthen the reformed preventive arm of the Stability and Growth Pact and to safeguard sustainable budgets in the long term. A departure from the jointly agreed requirement to achieve a balanced budget in structural terms could be particularly problematic for countries with high debt ratios.

Number of countries subject to excessive deficit procedure still high

The countries subject to an excessive deficit procedure which still had deficit ratios of more than 3% in 2013 have been given until 2015 (France, Ireland, Portugal, Slovenia) or 2016 (Cyprus, Greece, Spain) to correct their deficits. According to the updated stability programmes, in which the governments present their budgetary plans for the coming years, all of these countries are set to correct their deficits on time. However, based on a no-policy-change assumption,[4] the European Commission's forecast shows this to be unlikely for all of these countries except Greece and Portugal, and projects a significant slackening in the pace of consolidation. The Commission's forecast predicts that Slovenia's deficit ratio will be just above the threshold in 2015 and foresees a more substantial infringement in France despite the deadlines for both of these countries having been extended by two years in 2013. It also projects that Ireland's deficit ratio will remain significantly above the threshold in 2015 under a no-policy-change assumption. While the 2016 correction deadline lies beyond the Commission's forecast horizon, the deficit ratios of Cyprus and Spain are expected to remain very high in 2015.

European Commission responsible for strict application of excessive deficit procedure

As part of the European Semester, the Commission must now critically assess whether the stability programmes are based on realistic plans. In the context of the excessive deficit procedure, moreover, it is essential to establish whether the countries have achieved the set milestones or whether their procedures need to be stepped up.[5] The crucial criterion in the excessive deficit procedure is essentially the improvement in the structural balance, for which France and Slovenia missed their targets by a considerable margin. However, the EU committees and forums have agreed that assessments of compliance should also take account of additional aspects; adjustments are to be made for forecast errors, for example. Failure to achieve a structural improvement can be excused if it is caused by estimates of potential growth and/or revenue growth (adjusted for legislative changes and cyclical factors) being lower at the time of assessment than at the (earlier) point in time when the recommendation was made. It

4 In a departure from its usual procedure for the forecast, for the programme countries the European Commission does not solely take account of measures that have already been passed.
5 Special procedures apply to programme countries.

can also be excused if the combined volume of the measures taken is equal to the volume of the consolidation requirements in the recommendations.

On first reflection, it might seem logical not to take account of missed targets which are not directly caused by government actions. However, the fundamental aim of the rules is to ensure sustainable public finances, and budgets still become less sustainable and the objective of lowering the debt ratio is still missed even if the burdens that cause the deterioration are unexpected. Another problematic aspect concerning the binding force of the rules is that the reformed procedure is now extremely complex, which makes it very difficult to retrace how assessments are reached. The procedure creates incentives for countries to make optimistic forecasts or optimistic estimates of the financial impact of policy measures if they wish to avoid prompt and sweeping consolidation. If, for example, the correction recommendation in an excessive deficit procedure is based on an overly optimistic estimate of revenue developments, it is more likely that missed targets will be excused later on. In addition, there is also substantial scope for *ad-hoc* decisions in the excessive deficit procedure. All in all, everything hinges to a large extent on the assessment of the European Commission, whose role has been strengthened by the reforms.[6] However, it would seem advisable to be cautious about using such scope, not least in view of the very high debt ratios in many countries. If insufficient deficit reduction is excused and deadline extensions are granted on a regular basis, there is a danger that this will progressively erode the binding force of the rules – an element which is also important in the long term. In particular, the inadequate implementation of the fiscal rules before the crisis should be regarded as a problematic development which, in some cases, was a contributory factor in the debt crisis.

Not least in view of this situation, the reformed Stability and Growth Path is also directly targeted at reducing excessive debt ratios. It requires governments to reduce the differential to the 60% mark by an average of one-twentieth per year until the reference value has been reached. Yet this also entails a complex procedure which does not allow a direct assessment of whether a country has met its target. The annual average change over the previous three years, or alternatively over the period spanning the past, current and following year, is the key criterion in this assessment; cyclical effects or other special factors can also be taken into account on a case-by-case basis.[7] In 2014, only Estonia, Latvia, Luxembourg, Slovakia and Finland are likely to comply with the 60% reference value. According to the Commission's estimates, most member states' debt ratios will continue to rise in 2014 and this will not change until 2015.

The reforms to the fiscal framework, not least through the Six-Pack legislation, have essentially created scope for improvements, such as the firmer anchoring of European requirements in national legislation and the somewhat more prominent role of the debt ratio. However, experience to date of how the rules are applied in practice suggests that the procedures will be made far more complicated, the rules will become less clear and scope for *ad-hoc* decisions will in-

6 The estimation of output gaps is also significant in this context, as they form the basis for measuring the impact of cyclical factors on public finances. See Deutsche Bundesbank, The impact of biased potential output estimates within fiscal rules, Monthly Report, April 2014, pp 33-34. However, across the various methods, the change in the structural balance generally varies to a lesser extent than the level.

7 Transitional provisions specify that these requirements will not apply to the member states that were already subject to an excessive deficit procedure when the rules were established (in November 2011) until three years after that procedure has been closed. Until then, they will be subject to special provisions designed to ensure that, by the end of the transitional period, the countries have achieved a budgetary position which is compatible with the debt criterion then in place.

Forecast and plans for the public finances of the euro-area countries

Country	European Commission spring forecast, May 2014						Stability programmes,[1] April/May 2014			Deadline for correcting excessive deficit
	Budget balance as a percentage of GDP			Government debt as a percentage of GDP			Budget balance as a percentage of GDP			
	2013	2014	2015	2013	2014	2015	2014	2015	2016	
Austria	– 1.5	– 2.8	– 1.5	74.5	80.3	79.2	– 2.7	– 1.4	– 0.7	2013
Belgium	– 2.6	– 2.6	– 2.8	101.5	101.7	101.5	– 2.1	– 1.4	– 0.4	2013
Cyprus	– 5.4	– 5.8	– 6.1	111.8	122.2	126.4	.	.	.	2016
Estonia	– 0.2	– 0.5	– 0.6	10.0	9.8	9.6	– 0.7	– 0.5	– 0.4	–
Finland	– 2.1	– 2.3	– 1.3	57.0	59.9	61.2	– 2.0	– 1.1	– 0.5	–
France	– 4.3	– 3.9	– 3.4	93.5	95.6	96.6	– 3.8	– 3.0	– 2.2	2015
Germany	0.0	0.0	– 0.1	78.4	76.0	73.6	0	0	0	–
Greece	– 12.7	– 1.6	– 1.0	175.1	177.2	172.4	.	.	.	2016
Ireland	– 7.2	– 4.8	– 4.2	123.7	121.0	120.4	– 4.8	– 3.0	– 2.2	2015
Italy	– 3.0	– 2.6	– 2.2	132.6	135.2	133.9	– 2.6	– 1.8	– 0.9	–
Latvia	– 1.0	– 1.0	– 1.1	38.1	39.5	33.4	– 1.0	– 0.8	– 0.7	–
Luxembourg	0.1	– 0.2	– 1.4	23.1	23.4	25.5	0.1	– 0.5	0.2	–
Malta	– 2.8	– 2.5	– 2.5	73.0	72.5	71.1	– 2.1	– 1.6	– 0.7	2014
Netherlands	– 2.5	– 2.8	– 1.8	73.5	73.8	73.4	– 2.9	– 2.1	– 1.9	2014
Portugal	– 4.9	– 4.0	– 2.5	129.0	126.7	124.8	– 4.0	– 2.5	– 1.5	2015
Slovakia	– 2.8	– 2.9	– 2.8	55.4	56.3	57.8	– 2.8	– 2.8	– 2.0	2013
Slovenia	– 14.7	– 4.3	– 3.1	71.7	80.4	81.3	– 4.1	– 2.4	– 1.5	2015
Spain	– 7.1	– 5.6	– 6.1	93.9	100.2	103.8	– 5.5	– 4.2	– 2.8	2016
Euro area	– 3.0	– 2.5	– 2.3	95.0	96.0	95.4	.	.	.	–

Source: European Commission. **1** Member states subject to a macroeconomic adjustment programme are not obliged to submit a stability programme.
Deutsche Bundesbank

crease. Yet for fiscal policy rules to have the necessary binding force, they need to be transparent, as well as being comprehensible to the general public. A certain degree of clarity and simplicity therefore appears essential, even if this means that the rules cannot explicitly take account of each specific situation.

Troika confirms that programme countries are broadly on track

The assistance programmes have been closed for Spain, Ireland and, more recently, Portugal (subject to the last programme review report being approved by the Troika). Although these countries will still have to undergo special semi-annual assessments until they have repaid three-quarters of the financial assistance they have received, they will not be set any more separate targets (other than those in the excessive deficit procedure). It is now crucial that these countries continue to steer a consistent course of sustained budgetary consolidation, rapidly reduce their (particularly high) debt ratios, and both achieve and maintain a budgetary position that is sustainable over the long term.

By contrast, Greece is still subject to an assistance programme, which was launched in May 2010 and reformulated (as the "second economic adjustment programme") in March 2012. As well as supplying especially long-dated loan commitments totalling around 125% of Greek GDP (€225 billion), the international assistance providers are charging very low interest rates on their assistance loans to Greece, which is also a form of financial support. The euro-area countries are also making direct transfers to Greece (by passing on the assumed profits made by their central banks from the purchase of Greek government bonds). Taking account of Greece's unscheduled tapping of the capital market in April 2014, the Troika still expects a funding gap of €2½ billion for 2014, which is scheduled to be the last year of the euro-area programme (the IMF programme will run until 2016). If government revenue and expenditure continues to develop as planned, no assistance loans are yet envisaged for 2015 to cover the funding needs of just under €12½ billion. Ultimately, it is crucial that the will to consolidate public finances and implement fundamental reforms does not weaken in Greece. Since 2010, Greece has taken substantial consolidation measures and has therefore managed to cut its deficit ratio considerably despite a very unfavourable macroeconomic backdrop. Greece more than fulfilled the 2013 budgetary objective agreed in the programme,[8] and the Troika expects it to meet its programme targets for 2014, too. Even so, the success of Greece's second economic adjustment programme is not yet assured. In the past, inadequate implementation of measures, such as agreed structural reforms, led to instalments of financial assistance being delayed. Despite private creditors having taken a haircut on Greek government bonds in March 2012, Greece's debt ratio was by far the largest in the euro area in 2013, totalling around 175%. It is set to continue rising this year, before falling from 2015 onwards. If a primary surplus amounting to 4½% of GDP were achieved and maintained from 2016 onwards, the debt ratio could be reduced relatively rapidly, provided that the forecast of a recovery in economic growth proves correct.

An assistance programme was launched for Cyprus in April 2013. This financial package covers up to €10 billion in loans (around 60% of Cypriot GDP), of which around €5 billion have actually been disbursed to date. The programme envisages extensive fiscal consolidation measures. Thanks to expenditure cuts and, in particular, better-than-expected economic developments, Cyprus more than fulfilled its targets for 2013. In addition, the reform of the Cypriot banking sector, which is a component of the programme, is a particularly important step. While some risks remain, substantial progress has been made in this area, with an extensive bail-in of owners and creditors through the split and subsequent merger of the country's two largest banks, the recapitalisation of another bank with private funds and the restructuring and recapitalisation of the cooperative banking sector. Some of the capital controls imposed in Cyprus following its financial crisis have now been relaxed. Progress with plans to privatise state-owned enterprises has been slow, however. The ongoing success of the assistance programme and, in particular, the desired reduction in the government debt ratio, which has risen very sharply since 2008, depend not only on fiscal consolidation, which remains a necessary task, but also, notably, on the swift implementation of a sustainable solution to reduce the very high share of non-performing loans in the banks' total loan portfolio and on the positive macroeconomic forecast proving correct. The considerable challenges involved in rebalancing the Cypriot economy mean that there are still risks attached to this endeavour.

8 Greece reported a budget balance of -12.7% of GDP, which was confirmed by Eurostat at the end of April. To calculate the primary balance, the interest expenses (4% of GDP) included in this figure have to be deducted. Deducting, in particular, outlays on support for the banking sector (10.8% of GDP) and the revenue transferred to Greece from the other euro-area countries in connection with the purchase of Greek government bonds by the central banks, as well as other special items, results in the oft-cited "primary surplus" of 0.8% of GDP. In principle, the programme targets for all programme countries are defined in this way, in contrast to the usual definition of the primary balance, which only factors out interest expenses.

brought below the 60% threshold earlier, thus enabling Germany to make greater provisions for managing the effects of demographic change, which will soon be noticeable. It would seem appropriate, for instance, to use additional savings resulting from lower interest expenditure to improve the budget balance. With a view to the national budget rules, too, it would be advisable to use the current positive developments in the economy to rapidly bring down the remaining deficits at the various levels of government and to establish sizeable safety margins below the long-term deficit ceilings. Safety margins are particularly important in view of the strict rules enshrined in the German constitution to help ensure sound public finances. Past experience has shown that estimates of the structural budget position are subject to major uncertainty and that negative macroeconomic shocks often trigger a fundamental reassessment of the growth outlook and an upward revision of structural deficits. Taking this uncertainty into account by factoring safety margins into the budget plans can reduce the need for procyclical consolidation in phases of economic weakness.

Budgetary development of central, state and local government

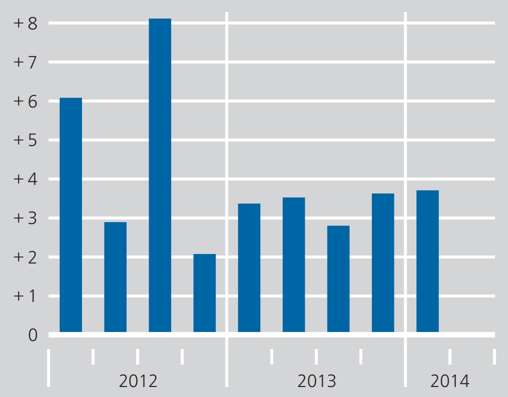
Tax revenue

3½% rise in Q1

Year-on-year growth in tax revenue[6] came to just over 3½% in the first quarter of 2014 (see the chart above and the table on page 74). Ongoing favourable developments in gross wages and salaries, which have a key influence on tax receipts, played a significant role in this rise. Combined with tax progressivity, this resulted in dynamic growth for wage tax. The stagnation of child benefit (which is deducted from revenue) also contributed to the higher growth rate. By contrast, legislative changes (above all, the increase in the basic income tax allowance as well as the increasing tax exemption of pension expenditure) had a moderate dampening effect. However, at 2½% on balance, the rise in profit-related taxes was weaker and was supported considerably for the last time by the phasing out of grants to homebuyers. Assessed income tax, in particular, contributed to the rise in profit-related taxes while receipts from withholding tax on interest income and capital gains as well as from corporation tax declined. With a rise of just under 3% in the first quarter, growth in receipts from turnover tax was somewhat stronger than previously and was thus generally in line with the macroeconomic reference variables. By contrast, receipts from other consumption taxes were down slightly. This was probably attributable, *inter alia*, to temporary, dampening special effects resulting from the transfer of responsibility for levying motor vehicle tax to central government, and to delayed electricity tax refunds as part of the tax cap for the most energy-intensive users *(Spitzenausgleich).*

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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Solid revenue growth expected for year as a whole, too

The latest official tax estimate expects revenue growth (including local government taxes) to be solid (at just under 3½%) for 2014 as a whole, too. This growth primarily reflects the

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

Tax revenue

Type of tax	Q1 2013	2014		Estimate for 2014[1,2]
	€ billion		Year-on-year percentage change	Year-on-year percentage change
Total tax revenue[2]	135.0	140.0	+ 3.7	+ 3.4
of which				
Wage tax	36.5	39.0	+ 7.0	+ 6.0
Profit-related taxes[3]	23.4	23.9	+ 2.3	+ 0.2
Assessed income tax	10.7	11.8	+ 9.8	+ 7.5
Corporation tax	6.0	5.6	− 6.7	− 7.5
Investment income tax[4]	6.6	6.5	− 1.8	− 5.9
Turnover taxes[5]	49.2	50.5	+ 2.8	+ 3.3
Energy tax	4.7	4.7	+ 0.1	+ 0.2
Tobacco tax	2.1	2.5	+ 15.7	+ 3.5

Source: Federal Ministry of Finance and Bundesbank calculations. **1** According to official tax estimate of May 2014. **2** Including EU shares in German tax revenue, excluding receipts from local government taxes. **3** Employee refunds, homebuyers grant and investment grant deducted from revenue. **4** Withholding tax on interest income and capital gains, non-assessed taxes on earnings. **5** Turnover tax and import turnover tax.

Deutsche Bundesbank

macroeconomic developments.[7] Fiscal drag is giving revenue an extra boost. However, legislative changes will slightly reduce revenue on balance. A higher basic income tax allowance and the gradual changeover to downstream taxation of pensions is resulting in perceptible shortfalls, whereas the phasing out of the homebuyers grant (which is deducted from cash revenue) and the rises in real property transfer tax and tobacco tax are generating smaller amounts of additional revenue. Tax refunds due under the ruling by the European Court of Justice on the taxation of dividends paid to EU/EEA companies are slowing revenue growth.[8]

After 2014, revenue growth expected to be somewhat more dynamic

After this year, the official tax estimate initially expects revenue growth to accelerate to 4% in 2015 and to average 3½% per year in the 2016-18 period, mainly as a result of macroeconomic growth assumptions and fiscal drag. Legislative changes which have already been approved are expected to curb this expansion slightly on balance. The tax ratio (as defined in the government's financial statistics) is projected to increase from 22.6% (2013) to 22.9% by the end of the forecast period. Taken in isolation, fiscal drag is expected to raise the tax ratio by roughly ½ percentage point.

Revenue expectations largely confirmed for 2014; revised upwards for subsequent years

The official tax estimate largely confirms the revenue estimate for 2014 in the November 2013 projection. However, the estimates have been revised upwards somewhat for the subsequent years as a result of more favourable macroeconomic assumptions. Compared with the November 2013 estimate, the revision for 2014 amounts to -€½ billion, rising from +€3 billion to +€7 billion in the subsequent years. Compared to the figures that were revised upwards in spring (as the basis for the benchmark figures for the central government budget and the stability programme) the official tax estimate is largely unchanged.

Central government

Deficit decline at start of year reflects higher Bundesbank profit and lower interest burden

Central government recorded a deficit of €10½ billion in the first quarter of 2014 compared with a deficit of €13 billion one year previously. Revenue rose considerably by 4½% (€3 billion). However, at 2½% (€1½ billion), growth in tax revenue was much more moderate, partly because deductions for transfers to the EU budget increased by €½ billion. The Bundesbank's profit distribution made a significant contribution to the rise in total revenue, with the maximum amount permitted by law of €2½ billion being transferred to the budget (previous year: €½ billion). On the expenditure side, the rise was only ½% (€½ billion). A notable rise was recorded for payments to the social security

7 This estimate is based on central government's current macroeconomic projection. For 2014, real GDP growth is expected to be 1.8% and nominal growth 3.5% (November 2013: +1.7% and +3.3%, respectively). Growth for 2015 is forecast to be 2.0% and 3.8%, respectively (November 2013: +1.4% and +3.0%, respectively). In the medium term, nominal growth of 3.1% per year is forecast (November 2013: +3.0%).
8 Ruling of 20 October 2011 on case C-284/09.

funds (€1 billion). The further (and greater) cut in the transfers to the statutory health insurance fund did not yet have an impact on central government expenditure in the first quarter.[9] Transfers to households were €½ billion up on the year due to higher payments for parental benefit, the childcare supplement and unemployment benefit II. Transfers to state government were also up by €½ billion, not least due to the final increase in central government's cost assumption of the basic allowance for the elderly. By contrast, significant relief was provided by interest expenditure, which was one-eighth (€1½ billion) lower.

Fiscal balance virtually unchanged in revised draft budget

The Federal Cabinet adopted the revised draft budget for 2014 in mid-March. At €6½ billion, the planned deficit remains broadly the same as in the draft budget adopted by the previous government in summer 2013. The measures agreed by the new governing coalition have led, *inter alia,* to a rise of €½ billion in investment in transport infrastructure that is not financed by motorway tolls for heavy good vehicles (but a moderate cut in toll-funded investment) and a modest increase in development aid estimates and grants to the pension insurance scheme (as the contribution rate will not be lowered). As no decision has yet been reached on how to divide up the planned additional funds for childcare, education and research, global additional expenditure of €½ billion has been factored in for these measures. Thus, the upward revision of €1 billion to appropriations for unemployment benefit II – following the previous government's intended efficiency savings of €1½ billion as part of the 2010 "package for the future" – and of €½ billion to appropriations for parental benefit are more significant. All in all, additional expenditure is €3 billion higher than in the summer 2013 draft budget. However, this is to be more or less offset by central government reclaiming €1 billion of funds which appear not to be required by the flood assistance fund, through an increase of almost €1 billion in privatisation proceeds and the fact that income from the Bundesbank's profit distribution was €½ billion higher than forecast.

Reported structural surplus questionable

The revised budget plan for 2014 envisages a surplus of €1½ billion for the structural fiscal balance as defined in the debt brake rule. This is €½ billion below the figure estimated in the summer 2013 draft budget. However, it puts the cyclical burden deducted from this balance at €5½ billion. Given the fact that capacity utilisation appears to have returned to more or less normal levels and that unemployment is low, such a high cyclical burden does not seem appropriate as it entails a very favourable structural financial position for the central government.[10] With regard to the structural surplus reported, it should additionally be noted that the flood assistance fund, an off-budget entity, has rightly been factored into the calculation of the structural balance but that the marked outflows from the fund this year are still factored out of the draft central government budget. While it is true that the exact size of these outflows is not yet known, it nevertheless does not seem logical to not even include an estimate, especially given the particular importance of the planned structural budget balance for the budget rules. Following this approach actually means a decrease in the central government structural deficit in the draft budget as the calculations factor in €1 billion worth of reclaimed funds but omit the outpayment of this sum from the fund.

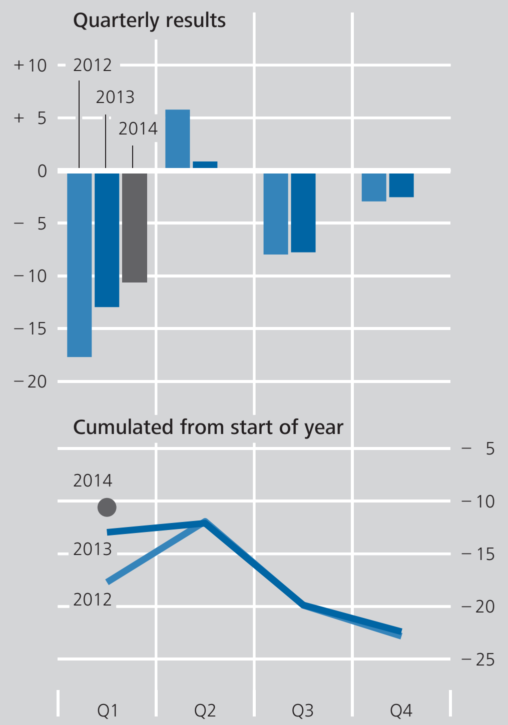
Estimated figures seem attainable

All in all, as things stand, the planned figures seem to be attainable on balance. The latest tax estimate expects revenue shortfalls of €½ billion. Furthermore, the Hamburg Fiscal Court recently ruled that central government has to repay revenue of just over €2 billion from nuclear fuel tax until a supreme court ruling is issued, which may not be in 2014. On the other hand, there is some doubt as to whether the estimated additional expenditure on transport infrastructure will actually be made this year due, not least, to the foreseeable delay in final-

9 If the cut were spread equally over all quarters, the transfers would have been down €1 billion in the first quarter.
10 Additional scope has arisen vis-à-vis the summer 2013 draft budget by raising the estimate for the cyclical burden and, at the same time, revising tax revenue upwards.

Central government fiscal balance

€ billion



Source: Bundesbank calculations based on data from the Federal Ministry of Finance.
Deutsche Bundesbank

ising the Budget Act; the same applies to the additional funds for childcare, education and research, which have yet to be divided up between the different ministries. Furthermore, a number of budgeted figures, such as interest expenditure, are likely to have again been calculated rather cautiously. However, general budgetary risks remain, not least in the international context.

Benchmark figures for 2015 central government budget and financial plan up to 2018: higher primary expenditure, while previous plans to achieve surpluses abandoned

Along with the revised draft budget, the Federal Cabinet also adopted the benchmark figures for the 2015 budget and the financial plan up to 2018. Compared with the summer 2013 plans, these included, in particular, the priority measures in the coalition agreement concluded at the end of 2013 (totalling €23 billion until 2017), which – supplemented by a significant increase in funds for local government to provide integration assistance for disabled persons – have probably also largely been extrapolated until 2018. Although the goal of no net new borrowing in the central government budget set out in the coalition agreement was adhered to, the previous plan of building up surpluses from 2016 onwards to repay existing debt (target surplus of €9½ billion in 2017) has fallen by the wayside. As in previous years, the benchmark figures allow only limited conclusions to be drawn regarding how the plans will be put into practice. Compared with the summer 2013 financial plan, the benchmark figures for 2015 (in line with the coalition agreement) envisage an additional €1 billion for the transport budget and evidently also another €1 billion in financial support for local government budgets ahead of the announced central government contribution to spending on integration assistance for disabled persons. Moreover, additional funds totalling €½ billion were allocated to development aid. As was the case for 2014, there were particularly sizeable upward revisions (€1½ billion) relating to expenditure on the long-term unemployed. These revisions are probably ultimately due to previously planned cost savings in connection with efficiency improvements now being viewed as unrealistic.

Pro rata counterfinancing through further cuts in planned expenditure on interest and health insurance fund

It seems that central government will counterfinance the additional burdens set out in the 2015 benchmark figures primarily by making further downward revisions to spending appropriations for debt servicing (€3 billion), implementing a further discretionary cut in transfers to the health insurance fund (down by €2½ billion vis-à-vis the level currently envisaged in principle (€14 billion per year)) and by cancelling the appropriation of just over €½ billion from 2015 onwards aimed at financing a social equalisation component in connection with the current non-income-related additional contributions to health insurance institutions. The data do not reveal the annual scope of the additional payments envisaged in the areas of childcare, education and research (which are recorded as global additional expenditure), and the same applies to the financial plan up to 2018. However, it is likely that the additional burdens stemming from the coalition agreement will increase significantly over time. Overall, despite the sustained very favourable underlying conditions that are assumed right through to 2018, surpluses are no longer envisaged, even though, given the general risks and in particular the looming demographic burdens, it would seem advisable to reduce interest expenditure on a lasting basis by making sizeable repayments.

Off-budget entities: after large positive balance in 2013, only slight surplus in 2014

Central government's off-budget entities (excluding bad banks and the loss compensation payments they receive) recorded a surplus of €3 billion in the first quarter of 2014, compared with a figure of €1 billion in the same period last year. As was the case at the start of 2013, the pension reserves and the postal workers' pension funds both recorded a moderate surplus. In contrast to 2013, the Bundesbank's profit distribution exceeded the amount earmarked to finance central government's core budget. The excess of €2 billion was transferred to the Investment and Repayment Fund (which was established in 2009 to help overcome the severe economic crisis) to repay outstanding debts. Outflows from the assistance fund set up in summer 2013 to tackle the damage caused by the flood were still very modest at the start of the year. However, the fund is expected to experience sizeable outflows during the remainder of 2014, not least because of central government plans to reclaim €1 billion from the fund. Nevertheless, overall, the positive balances which are on the cards for the precautionary reserves and the Investment and Repayment Fund are likely to ensure that central government's off-budget entities post a slight surplus in 2014, after recording a positive balance of almost €11 billion in 2013 owing to the advance payments to the flood assistance fund and Commerzbank's repayment of capital assistance to SoFFin.

State government budgets[11]

Deficit up in Q1 due to high expenditure growth

Following the positive developments in 2013, in the first quarter of 2014 the deficit of state government core budgets doubled on the year to €2 billion. Revenue rose considerably overall (by 4%, or €3 billion). Tax revenue made the largest contribution to this rise, likewise climbing by 4%, or €2½ billion. Transfers received by state government went up by as much as 6% (€1 billion). However, expenditure increased at an even faster pace than revenue (by 5%, or €4 billion), despite a further significant drop in the interest burden (-€½ billion). Current transfers to other budgets in the general government sector alone – including higher central government payments to local government for the basic allowance, which are passed on via state government – increased by €2 billion. Spending on personnel also grew substantially (by 4½%, or €1½ billion), even though in some federal states the pay agreement concluded in spring 2013 was not adopted in its entirety for civil servants and retired civil servants.

But further improvement in finances expected overall

Despite the less favourable developments at the start of the year, state government as a whole is likely to see a further improvement in its finances in the 2014 budget year, heading towards a balanced budget. Continued dynamic growth in tax revenue will probably play a significant role in this development (the May tax estimate forecasts a sizeable increase of 3½%), while growth in personnel expenditure – which is a particularly large item – is set to wane during the remainder of the year, and the interest burden could even decrease further. Furthermore, refunds that are still outstanding in connection with flood assistance payments made by state government could have a positive influence on the state government budget. In the medium term, the decisions made by the coalition government which are reflected in central government's new benchmark figures envisage additional funds of €5½ billion for state and local government between 2015 and 2017 (earmarked for the areas of higher education, schools and day care for small children). Provided not all of these funds are put towards additional spending, they will also help ease

11 The development of local government finances in 2013 as a whole was analysed in greater detail in the short articles in the Bundesbank's April 2014 Monthly Report. These are the most recent data available.

the strain on state and local government budgets.

Despite favourable developments overall, finances of some federal states still noticeably strained

According to the revised cash data, state government's core budgets were €2½ billion in deficit in 2013, while the deficit figure including special funds amounted to €½ billion.[12] Although the financial situation and outlook for state government as a whole are positive, individual federal states still have a long way to go to meet the minimum target of a balanced budget by 2020. In order to comply with the debt brake requirements and the European budgetary surveillance procedure, the off-budget entities must ultimately also be included in the budget balance (after adjustment for financial transactions and consolidation assistance received during the transitional period, which are to be factored out of the calculations). In some cases, entities which regularly record a deficit – such as construction companies – have been spun off from the core budgets and given their own borrowing authorisations. However, the off-budget entities also include numerous precautionary units, such as the pension reserves, which are currently still being topped up in order to shoulder part of the expected sharp increase in pension expenditure in future years. Their surpluses should therefore actually be factored out of the calculation of the borrowing limits due to their precautionary nature.[13] As no figures are available for the individual off-budget entities, the data now available for 2013 as a whole should thus be interpreted with particular caution. The consolidation needs per inhabitant are, as expected, particularly high in Bremen and Saarland, which are receiving consolidation assistance. However, Hamburg also recorded a very high deficit if this extended definition of the budget balance is applied. The other federal states have seen an easing of their financial situations under this definition. However, there is still a marked need for consolidation in Hesse, North Rhine-Westphalia and Rhineland Palatinate, although the outcome for the latter two states is much better if the surpluses recorded by the off-budget entities are included. The east German states including Berlin recorded high surpluses in some cases even under the extended definition of the budget balance. Nevertheless, demographic developments combined with the foreseeable sharp rise in pension expenditure, as well as the fact that special supplementary central government grants to the east German states will tail off up to the end of the decade, ultimately continue to pose substantial long-term challenges, which can scarcely be offset by possible cost savings provided by falling pupil numbers, for example. Therefore, the currently very favourable underlying conditions, not least for taxes and interest expenditure, should resolutely be used to rapidly achieve balanced budgets and to aim for marked safety margins below the debt limit.

Social security funds[14]

Statutory pension insurance scheme

Financial improvement achieved by waiving contribution rate cut

As usual, the statutory pension insurance scheme posted a deficit in the first quarter of 2014, but, at €½ billion, the figure was €1½ billion down on the year. The marked improvement was due, on the one hand, to revenue growth of just over 3½%, which reflects the favourable employment and wage developments. On the other hand, expenditure rose

12 See also press release No 119 of the Federal Statistical Office dated 31 March 2014. The difference between the revised figure and the initial preliminary result for the core budgets (deficit of €½ billion) appears to be due in particular to transfers to pension funds – which are traditionally recorded in the budgets as not affecting the deficit – having an impact on the balance.
13 In principle, in the national accounts – which are used as the basis for assessing the Maastricht criteria – a current surplus in a precautionary fund is neutralised owing to its finances being consolidated with those of the core budget (which records corresponding burdens) in the year that the financial resources are set aside. If the funds are withdrawn at a later point in time, the deficit which is then recorded by the precautionary fund does not reduce the Maastricht deficit (as the off-budget entity's finances are consolidated with those of the core budget at that point in time, too).
14 The financial development of the statutory health and public long-term care insurance schemes in 2013 as a whole was analysed in the short articles of the March Monthly Report. These are the most recent data available.

extremely moderately (by just over ½%) because the mid-2013 pension increase in western Germany amounted to only 0.25% (+3.29% in eastern Germany). Moreover, there was no rise in the number of pensions.[15] The contribution rate should have automatically been lowered from 18.9% to 18.3% at the beginning of the year, but this statutory requirement was overridden and the rate was kept at its previous level so that the planned selective benefit increases could initially be financed using current revenue.

Surplus for year as a whole; contribution rate cut in 2015 feasible

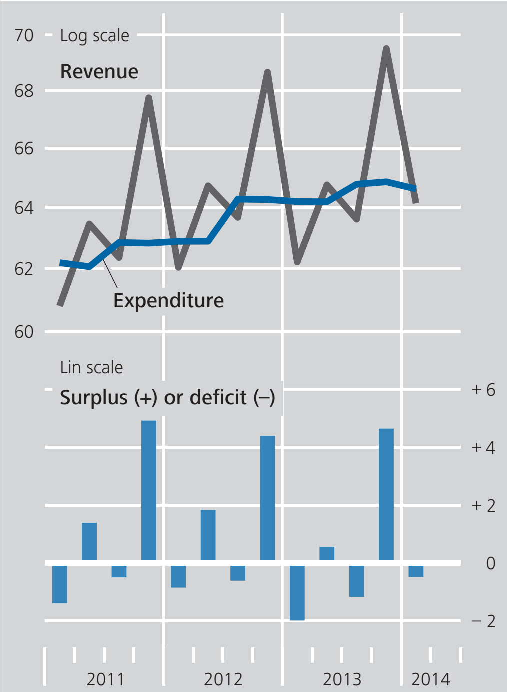
Expenditure is expected to rise perceptibly in the second half of 2014, partly as a result of pensions increasing more sharply overall (+1.67% in western Germany and +2.53% in eastern Germany), but primarily owing to the possible implementation of the draft Act on Improvements in Pension Insurance Benefits *(Rentenversicherungs-Leistungsverbesserungsgesetz)*. As overall economic activity is currently looking more favourable than assumed when making the projections in the annual pension insurance report in November 2013, it cannot be ruled out that the reserves of the statutory pension insurance scheme will even be topped up again by the end of 2014, provided the costs of the planned benefit increases do not prove to be higher than the figures envisaged in the draft legislation. If this is the case, in accordance with the current statutory requirement, it could be necessary to lower the contribution rate in 2015 so that reserves are brought back below the upper limit of 1.5 times the scheme's monthly expenditure by the end of 2015. This would result in higher deficits in subsequent years and the minimum level of reserves of 0.2 times the scheme's monthly expenditure would be reached more quickly, thus triggering a rise in the contribution rate.

Substantial financial burdens from selective benefit increases

The Act on Improvements in Pension Insurance Benefits envisages, in particular, larger recompense for periods spent bringing up children born before 1992 (two pension points per child rather than one) and the possibility to take early retirement (initially from the age of 63) on a full pension without actuarial deductions after 45 years of contributions (including periods of unemployment). It also envisages a longer reckonable time for those receiving a disability pension (up to the age of 62 rather than 60) and additional funds for rehabilitation purposes. The Act (which is scheduled to enter into force in mid-2014) is already set to create additional expenditure of €4½ billion up to the end of the year, which will climb in subsequent years from €9 billion to €11 billion by 2030 (based on current pension values). The higher pensions for periods spent bringing up children ("mothers' pensions") account for by far the greatest share of the costs, at around €6½ billion per year. Overall, in terms of financial requirements, the fiscal policy priorities of the new Federal Government are centred on benefit increases for the statu-

Finances of the German statutory pension insurance scheme

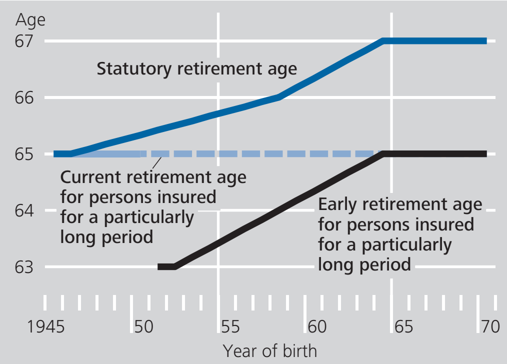
€ billion, quarterly data



Source: German statutory pension insurance scheme (Deutsche Rentenversicherung Bund).
Deutsche Bundesbank

15 In addition to the generally low number of persons approaching retirement age, this is also due to the gradual increase in the statutory retirement age (2014: 65 years plus three months) and the abolition of the special age limit for women, which had allowed them to retire at 60 up until the end of 2011.

Age at which full pension without actuarial deductions can be drawn



Source: Sixth Book of the Social Security Code (Sozialgesetzbuch VI) and draft Act on Improvements in Pension Insurance Benefits (RV-Leistungsverbesserungsgesetz).
Deutsche Bundesbank

tory pension insurance scheme (which can probably be classed as non-insurance-related for the most part). These are significantly higher than additional expenditure on transport infrastructure, childcare, education and research, for example, which amounts to €3½ billion on an annual average. The higher pension benefits will be financed through a higher contribution rate in future years, an even sharper discretionary rise in central government grants over and above the automatic adjustment (to avoid the contribution rate exceeding the cap of 22% applicable until 2030), and lower increases in the general pension level.[16]

Full pension without actuarial deductions at 63 creates negative incentives

With regard to the incentives created by these measures, retirement at the age of 63 should be viewed particularly critically, as it constitutes a return to incentivising early retirement, something which had only recently largely been eliminated. The planned inclusion of periods receiving unemployment benefits (during which contributions are paid on behalf of the recipients) – combined with the particularly long period of entitlement to unemployment insurance benefit (I) (up to 24 months as of 58 years of age) – could encourage people to leave employment subject to social security contributions early, at the age of 61, and receive unemployment benefit for two years before going on to receive a full pension without actuarial deductions. Of course, in practice this only applies to persons born in 1951 and 1952. For those born later, the age of entitlement to a full pension without actuarial deductions increases by a further two months each year, reaching 65 years from 2029. As the increase in the statutory retirement age to 67 years will occur largely in parallel with this, the relative advantages are spread over the different birth years, but are broadly stable (see adjacent chart).

Persons insured for particularly long period favoured

The actuarial deductions for early retirement are intended to ensure that, in principle, early retirement does not worsen the community of insurees' overall finances, as, based on equal contributions being paid overall, early retirement reduces an insuree's pension to the extent that over the entire period that it is paid out it approximately equals the total pension that would have been received if the insuree had retired at the statutory retirement age. Therefore, given the gradual rise in the statutory retirement age, the current entitlement to a full pension without actuarial deductions from the age of 65 is already extremely advantageous for persons who, with 45 contribution years, have been insured for a particularly long period of time. For the beneficiaries, extending the period without actuarial deductions essentially amounts to two more years of pension payments compared with those who have paid the same amount of contributions but have fewer contribution years. The existing option of retiring on a full pension without actuarial deductions from the age of 65 would have gradually become more and more advantageous in line with the rising actuarial deductions resulting from the statutory retirement age increasing to 67 years of age. Access to a full pension without actuarial deductions from the age of 63 offers this advantage in full now and extends it, in particular, by counting periods of unemployment.

16 This will reduce expenditure by around €3 billion on an annual average.

Federal Employment Agency

Finances virtually unchanged at start of year

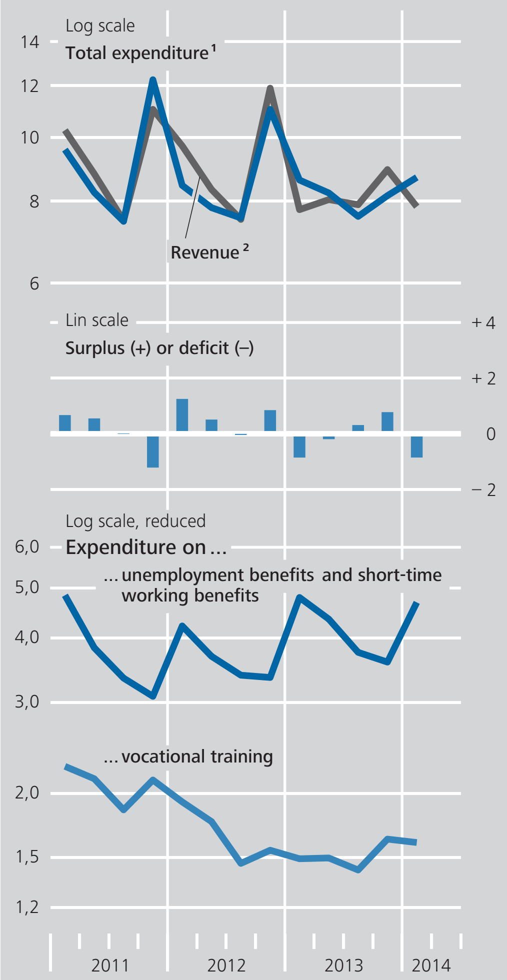
At just under €1 billion, the Federal Employment Agency's deficit in the first quarter of 2014 was virtually on a par with the figure recorded one year previously. While revenue grew by just over 1%, expenditure rose by almost 1%. Contribution receipts continued to rise at a strong pace (just over 4%), but in February 2013 central government had transferred a final refund of excess reintegration payments to the Federal Employment Agency. On the expenditure side, spending on unemployment benefits only increased by just under 2% on the year, following the marked pick-up in economic activity. Outlays for (seasonal) short-time working benefits were significantly lower. By contrast, spending on active labour market policy measures rose by 7½%.

Marked surplus possible in 2014

The Federal Employment Agency envisages a virtually balanced budget in its 2014 budget plan. However, as there has been a significant improvement in the macroeconomic projections since the budget plan was drawn up, as things stand it appears that the Federal Employment Agency could record a sizeable surplus. The plans have already factored in ample provision for the possibility of a sharper increase in expenditure on active labour market policy. In addition to macroeconomic developments, which mainly impact on the expenditure side of the agency's budget, financial risks are posed in particular by periods of unemployment being counted towards pensions drawn at the age of 63. The more insurees this encourages into early retirement – including in the form of unemployment with insurance contributions paid – the higher the corresponding additional expenditure on unemployment insurance benefit (1) will be. The impact of this is likely to be felt all the more in periods of somewhat less favourable cyclical developments.

Finances of the Federal Employment Agency

€ billion, quarterly data



Source: Federal Employment Agency. **1** Including transfers to the civil servants' pension fund. **2** Excluding central government liquidity assistance.

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