Public finances*

General government budget

Little change in surplus this year and next despite fiscal loosening

The favourable development of public finances in Germany has continued thus far into the year; however, there are still a number of risks emanating, in particular, from the international environment. In the absence of any major disruptions, the general government surplus is expected to remain relatively stable in 2015 and 2016 at around ½% of gross domestic product (GDP), and the debt ratio is likely to fall further. Public finances are benefiting from the economic upswing.[1] In addition, one-off proceeds from the recent frequency auction as well as declining interest expenditure are providing relief. This is obscuring the basic trend towards expansionary fiscal policy which, when taken in isolation, causes the balance to deteriorate. Factors behind this include the pension benefits package (which came into effect in mid-2014), additional expenditure on infrastructure, education and research and on social benefits provided by central, state and local government as well as minor income tax cuts. Furthermore, the social security funds are likely to record significant growth in expenditure chiefly due to higher general pension increases and cost pressure in the health system.

Decline in debt ratio

At the end of 2014, the debt ratio amounted to 74.9%,[2] falling to 74.4% by the end of the first quarter of 2015. This was primarily due to nominal growth in GDP in the ratio's denominator. The favourable expectations for the fiscal balance and for nominal growth in GDP indicate that the ratio will continue to decline, and portfolio reductions at government-owned bad banks are set to bolster this trend. In light of current negotiations regarding the European Stability Mechanism's (ESM) assistance programme for Greece (see also the comments in the box on pages 62 to 66), it should be noted that – statistically – the ESM is regarded as an independent international institution. This means that the member states backing the ESM, who ultimately take the loan decisions and are liable therefor, are assigned their capital contributions provided in previous years but not any debt incurred. By contrast, the claims and debt associated with the bilateral loans and European Financial Stability Facility (EFSF) loans granted thus far are directly attributed to the countries providing assistance. The risks for the individual countries inherent in the ESM loans are, however, not greatly mitigated by statistical shifts.[3]

Central government aims for at least balanced budget and safety margins in medium term

According to central government's projections, general government should achieve at least a balanced budget in the medium term, too, and cut its debt ratio to 61½% by the end of 2019. They envisage complying with the general government deficit limit as defined in the European Fiscal Compact as well as with central government's debt brake and maintaining distinct

* The section entitled "General government budget" concerns the national accounts and the Maastricht ratios. The subsequent reporting on the budgets of central, state and local government and of 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 Pursuant to the ESCB's cyclical adjustment procedure, the cyclical impact on the fiscal balance was almost neutral last year. By contrast, the cyclical adjustment procedure used for EU budgetary surveillance and for central government's debt brake when drawing up the budget paints a much less favourable picture of the economic situation. Both procedures indicate that the cyclical impact will become more favourable going forward.
2 As part of the quarterly calculations, the debt ratio was revised upwards by 0.2 percentage point compared with the Maastricht return from April 2015 because student grants and loans as well as the funding thereof are now fully attributable to the public sector.
3 At the Euro Summit held in mid-July, it was agreed to examine whether the deadlines for paying interest on and redeeming the bilateral loans and EFSF loans granted thus far could be extended should Greece be granted an ESM programme. Taken in isolation, if only the deadlines are changed, this would have no notable impact on the Maastricht ratios as they currently stand. For the ESM, additional capital contributions would inflate creditor countries' debt levels due to the corresponding rise in the need for funding. Explicit debt relief or calls by the ESM for capital to cover credit defaults would probably have an impact on the deficit.

Third assistance programme for Greece

The road to a third assistance programme

Following the introduction of the euro, Greece saw very unbalanced macroeconomic and fiscal developments, which were partially masked by inadequate statistics. In 2010, following the outbreak of the financial crisis, Greece virtually lost access to the capital markets. Since then, it has been granted extensive fiscal financial assistance – totalling over €200 billion, or around 115% of Greek gross domestic product (GDP) – via bilateral loans from other euro-area countries (€53 billion) as well as loans from the European Financial Stability Facility (EFSF) and the International Monetary Fund (IMF) (€131 billion and €20 billion, respectively). Assistance was provided in order to enable the economic adjustment process to take place in as orderly a fashion as possible, as well as to ward off risks to the financial stability of the euro area as a whole. The solidarity was contractually tied to compliance with the conditionality agreed under the assistance programmes. This was intended to create a basis for sustainable macroeconomic and fiscal developments. In addition to this, the Greek banking system was granted liquidity assistance via the Eurosystem (see the box on pages 23 and 24).

The Greek debt burden has been sizeably reduced in recent years by restructuring the debt vis-à-vis private creditors as well as vis-à-vis other euro-area member states. For example, in the case of Greece's private capital market debt, maturities were extended, the nominal value was lowered and interest rates were cut. The bilateral and EFSF loans were also subject to sizeable debt relief measures (while the IMF terms remained unchanged). Thus, Greece saw repeated cuts, and in some cases deferrals, in the interest it had to pay under the assistance programmes and the loan maturities were extended substantially. The interest rate terms on the loans are now more or less on a par with the very favourable terms of a country with a good credit rating. Owing to the extensive interest rate subsidies, Greece's general government interest expenditure came to 3.9% of GDP[1] in 2014 and was thus below the corresponding figures for Ireland, Italy and Portugal, despite Greece's significantly higher debt ratio.

The second assistance programme of the euro-area countries was originally supposed to run until the end of 2014 and the IMF programme was scheduled to continue until March 2016. However – as had already been the case under the first programme – there were repeated delays and missed targets. Particularly elementary structural reforms needed for sustainable economic developments were not implemented on the agreed scale and within the envisaged timeframe. In spite of this, there was tangible progress, however. The general government deficit was significantly reduced and the target set for the primary balance (fiscal balance excluding interest expenditure) was exceeded in 2013. It was generally expected that the targets for the years thereafter could also be met. Furthermore, Greece was able to gradually regain trust on the capital markets.

However, as of mid-2014, the willingness to implement the programme waned significantly, even under the previous Greek government, and payment of further financial assistance tied to this was repeatedly postponed. Following the elections in January 2015, the new government ultimately turned its back on the programme agreements. In some cases, the government

1 As defined in the national accounts, where a deferral does not reduce interest expenditure.

backtracked on previous reform measures and on-site checks concerning the implementation of the programme measures were prevented. The Greek government called a referendum on the interim results of the negotiations on extending the second assistance programme and these were rejected by Greek voters.

In the first half of 2015, Greece's banking system was still propped up by increasing amounts of emergency liquidity assistance from the Eurosystem, which financed strong capital outflows. However, after the second programme expired without successful completion at the end of June, a further extension of the emergency liquidity assistance was not granted and capital controls became inevitable. With no programme and no capital market access, Greece defaulted on payments to the IMF, in particular. Probably not least because of the extremely fragile state of the banking system and the ensuing discussion about a possible Grexit, on 12 July 2015 Greece and the other euro-area member states found a common basis for negotiations on a third assistance programme.

For the duration of the programme negotiations, Greece will receive bridging payments in the form of short-term EFSM (European Financial Stabilisation Mechanism) loans, which will initially total €7 billion and are primarily intended to settle the late payments to the IMF and on Eurosystem credit claims that have matured or are maturing. The EFSM loans will be granted via the EU budget, with the euro-area member states having pledged to shield the other EU countries from risk. The prerequisite for the bridging payments and the ESM being given the mandate to negotiate a programme was the Greek parliament passing several specific reform measures and its general commitment to take further measures.

The settlement of the outstanding payments to the IMF means that one of the obstacles standing in the way of the latter's participation in a third assistance programme has been removed. Therefore, during the course of further negotiations, the current IMF programme – which is still running – could potentially be replaced by a new IMF programme. However, further prerequisites, in addition to the settlement of the outstanding payments, are secured funding for the first 12 months of the programme and the IMF certifying the sustainability of the recipient country's public finances.

Proposed features of the third assistance programme

On 11 August 2015, it was announced that a fundamental technical agreement had been reached. As this report went to press, the process of endorsement by the member states (if necessary with the involvement of the national parliaments), as is required before the financial assistance can be granted by the ESM, had not yet taken place. The application review found that the required level of funding amounts to between €82 billion and €86 billion. This primarily comprises servicing outstanding claims from assistance loans and outstanding payments to private creditors, building liquidity buffers and spending on bank recapitalisation. The latter is estimated at up to €25 billion. The programme also envisages *inter alia* extensive privatisation proceeds, which are set to total €50 billion over the term of the assistance loans.

With regard to structural measures, the goals comprise reforming the tax and social system, ambitious product market and labour market reforms, making changes in the area of network industries and significantly bolstering public administration. Furthermore, banks are to be restructured and, in particular, the issue of what to do about non-performing loans is to be clarified.

Compared with the figures contained in the common basis for entering into negotiations, the targets for the primary balance have once again been lowered and are now likely to be set at a deficit of up to ¼% of GDP in 2015, followed by a surplus of at least ½% in 2016 and around 1¾% in 2017. The long-term primary surplus target of 3½% of GDP is still on the cards from 2018 onward. It is envisaged that the first tranche of the new programme will be paid once a final agreement has been adopted.

When the application for the programme was submitted, the European Commission carried out a preliminary calculation which, alongside the original ambitious targets for the primary balance, also contained *inter alia* a long-term projection for real economic growth of nearly 2%.[2] On this basis, the debt ratio under a new programme is forecast to come to 150% in 2022 and 111% in 2030. By contrast, the IMF's analysis was based on less favourable developments with a debt ratio of 170% in 2022, and even this figure was deemed to still be somewhat optimistic.[3] However, the detailed assumptions on which both preliminary calculations are based have not been presented and, if there are no other changes in the underlying conditions, the lowering of the targets for the primary balance is likely to have a negative impact on the preliminary calculations for the debt ratio.

Individual aspects of developments in Greece

When drawing up assistance programmes, the member states concerned must make various decisions, such as which conditionalities they deem to be acceptable and to what extent risks should be assumed. In this context, economic analyses play an important role. However, these are fraught with uncertainty and the potential outcome also crucially hinges on the agreements being implemented. As European monetary union has been formed on a decentralised basis with individual member states having autonomy, it is particularly important that rules and agreements are complied with and have a binding force. Only then will a reliable framework exist in which medium to long-term agreements can also be made and *ex ante* assistance can be provided, for example through assumption of liability. If this is not the case, the basis for long-term agreements erodes. It is important not to lose sight of this, not least during the process of crisis resolution, which entails political constraints, requires short-term action and sometimes a need for pragmatic solutions.

Before an ESM loan can be granted, it must *inter alia* be possible to confirm that the public finances of the country receiving assistance are sustainable. This should thus actually assure repayment of the assistance loans with the appropriate interest rate and maturity terms. The European Commission's preliminary calculation in this regard, which was submitted to the Bundestag in July, concludes that there are serious concerns regarding the sustainability of Greek public finances, but it does not certify an absence of sustainability. By contrast, the analysis submitted by the IMF finds that Greece's public debt "has become highly unsustainable". It can "now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far."[4] The fact that these two assessments contradict each other emphasises that the task of determining the sustainability of public finances is by no means clear cut. It is based on numerous assess-

2 European Commission, Greece – request for stability support in the form of an ESM loan, 10 July 2015.
3 IMF, Greece – An Update of IMF Staff's Preliminary Public Debt Sustainability Analysis, IMF Country Report No 15/186, 14 July 2015.
4 In the event of an absence of sustainability, in principle the private creditors should initially be brought on board to reestablish sustainability. However, as the private sector has already been hit by relatively extensive debt restructuring measures in the case of Greece, this option has evidently been ruled out.

ments regarding future developments, including the government's willingness to pay. However, in principle, any debt level can be rendered sustainable with the right interest rate and maturity terms. Thus, in an extreme case scenario, a loan with a zero interest rate and indefinite maturity would have no associated debt burden. Low interest rates and long maturities for the new assistance loans and a corresponding adjustment of the terms for the existing loans can thus also make Greek public finances sustainable. In economic terms, such interest rate subsidies amount to a transfer, with the relief they provide for the recipient and the burden they place on the provider being no different from a reduction in the nominal value of the debt (relief in the nominal value).

Compared with the original terms of the assistance loans, Greece has already received substantial debt relief and the interest rates are locked for relatively long periods, on a par with those for a highly-rated country. There are now discussions regarding whether the new loans should also be given very favourable terms over a very long period as it is assumed that Greece will not be able to return to the capital markets in the short to medium term, or at least only with very high premiums, which is not considered to be a viable option. Moreover, further maturity extensions and interest deferrals on the existing assistance loans are evidently also being considered. In this context, it should be taken into account that the interest burden will rise in the future – even if it is tied to a largely risk-free interest rate level – if the general market interest rates should rise again and there is a need for refinancing. Greece could be shielded from this by receiving very long-term loans at the current risk-free long-term interest rate. An even further reaching interest rate subsidy would entail the currently even lower short or medium-term interest rate level being fixed over the long term. Greece's interest expenditure would then probably be lower than the ESM's refinancing costs in the long term.

The level of the financing needs and scope of the transfer required (interest rate subsidy or haircut) to ensure sustainability depend not least on the size of the target primary surplus. At the beginning of the first assistance programme in 2010, a medium-term primary balance of 6% of GDP was still deemed to be an appropriate goal. However, the targets have gradually been lowered, and most recently they were repeatedly cut during the negotiations on a third assistance programme. It will now probably be agreed that Greece only has to record a primary surplus of 3½% of GDP over the coming decades. The IMF evidently doubts that Greece can achieve this goal and be able or want to maintain it over a longer period of time. In light of the developments in Greece this year, these doubts are completely understandable. However, in principle, it seems that an ambitious primary surplus in Greece is appropriate and, moreover, in the past there have been various examples of OECD countries recording high surpluses over longer periods of time. For instance, Belgium had an average primary surplus of around 3½% of GDP between the end of the 1980s and 2007. Given Greece's extremely high debt level, the debt relief measures affecting private investors and the high assistance payments from the euro-area countries, an ambitious requirement seems by no means excessive.

Greece should comply with the requirements of the Stability and Growth Pact in the medium term and record a structurally balanced budget overall. This would also result in the debt ratio being reduced relatively rapidly. If a balanced budget is required, the primary surplus agreed in the programme determines the level of the interest burden. If the primary surplus does not exceed 3½%, a very low average interest rate on the outstanding loans would have to be ensured by adjusting the interest rate conditions so that interest expenditure does not surpass 3½% of GDP and the budget is balanced. If, for example, the debt ratio path assumed thus far by the European Commission in its sustainability analyses is taken, this would result in an average interest rate of barely over 2% in 2020 and still only 3% in 2030.[5] Greece's interest expenditure ratio is thus likely to be lower than in many other euro-area countries in the longer term. Against this backdrop, too, ambitious goals would be recommendable and do not appear unattainable. If the structural reforms are implemented, the primary surplus would be achieved during a period of ever improving macroeconomic conditions. Once the basic position has been achieved, there would also be no more need for further consolidation measures.

With regard to the potential privatisation proceeds, which could also contribute to financing, it would seem that caution is called for given past experience. However, if the Greek economy makes a sustained recovery, there could be a more favourable outlook in this regard. Revenue could potentially be generated if the recapitalisation of the banking system puts financial institutions back on a sound footing enabling them to be sold again in future. If Greek banks were currently actually solvent, it would be expected that the recapitalisation funds could be regained in full in the event of privatisation. However, there are likely to be grave doubts in this regard.

It is currently not yet possible to forecast to what extent the Greek banks will have to be recapitalised. In this context, in particular the issue of what to do about the very high level of non-performing loans on banks' balance sheets will be of crucial importance. Greek credit institutions' balance sheets should be cleaned up swiftly so as to strengthen the ability of the banking system to act as an intermediary. This is to be accompanied *inter alia* by a reform of the insolvency law for private debtors, which should facilitate the provision of relief for excessive debt, while at the same time ensuring that there is not a comprehensive exoneration of liability for existing assets to the detriment of banks. There will probably at most be a very limited bail-in of creditors and depositors and the potential for this has furthermore been considerably reduced by the massive outflows of funds in recent months. Consequently, recapitalisation needs will have to be met to a greater extent via public funds and there will be an increased need for transfers.

The agreement on a third assistance programme had not yet been concluded in full as this report went to press. The starting position for a successful programme has deteriorated significantly during 2015. Time and confidence have been lost. Basic prerequisites for a successful programme are that reforms are swiftly implemented, paving the way for a competitive economic model and a more efficient public administration, and that public finances embark on a sustainable consolidation path. To achieve this, it is crucial to regain the trust of all parties, and in particular investors need to be brought back on board. Alongside the financial, product and labour markets, further areas that have been listed for reform are the tax and social system, public administration and the justice system. The insufficient progress made under the previous Greek assistance programmes highlights the need to make sure that the conditionalites are rigorously adhered to. In particular, the onus is crucially on the Greek government to bring about fundamental change.

5 Assuming nominal GDP growth of 4% from 2018 onward. Alternatively, this interest expenditure ratio could be achieved by means of a haircut combined with higher interest rates.

safety margins.[4] The Stability Council and its Advisory Board confirmed in June that they expect compliance with the general government deficit limit.[5]

Structural surplus appropriate and …

As things currently stand, central government's resolutions on budgetary and fiscal planning are in line with its objectives. Endeavours to maintain safety margins vis-à-vis the budget limits in good times are to be welcomed. Should unpleasant surprises occur, the required adjustment process can thus be somewhat milder without endangering the credibility of budgetary rules. At the same time, however, it is advisable to use the protracted demographic lull to rapidly cut the debt ratio to below 60%. The resulting containment of the interest burden would create additional budgetary scope and strengthen the resilience of German public finances overall. All in all, given this background and the favourable economic outlook, the structural surpluses are appropriate. By contrast, calls that have been made in some quarters to additionally boost the economies of other EU member states by launching a further fiscal demand stimulus in Germany appear unconvincing owing, *inter alia,* to the very limited effects that such a national stimulus programme would be likely to have on other countries.

… no obstacle to growth-enhancing fiscal policy

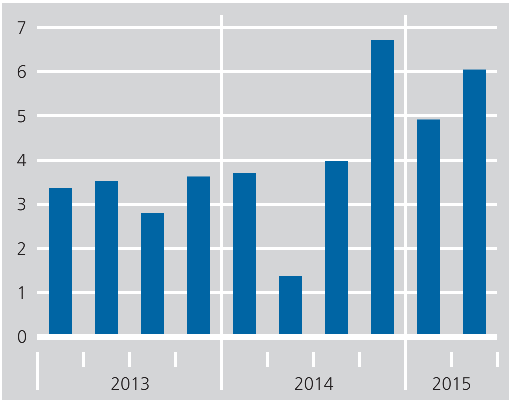
Desirable measures, such as those aimed at maintaining a good public infrastructure or generally increasing potential growth do not require a further easing of the budgetary stance; instead, they can be implemented within the planned financial framework. Ultimately, it is a question of setting the right priorities and tapping the available efficiency reserves.[6]

Consider cuts in taxes and social security contributions should pleasant surprises continue

In recent years, foreseeable budgetary scope has mainly been used to increase spending – for instance, on pensions. Should additional scope arise in the future, it would seem far more appropriate instead to consider easing the burden of taxes and social contributions, which are set to rise further in the face of growing demographic challenges. Thus the government could do more to counter income tax bracket creep, lower social contributions by financing non-insurance-related benefits out of general taxation or consider a more rapid reduction of the "solidarity surcharge", for which the justification as a federal tax surcharge is becoming less and less apparent now that the special-purpose grants to the federal states in eastern Germany are being phased out.

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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4 The structural situation appears to again be too positive when calculated in accordance with the method of cyclical adjustment used for EU budgetary surveillance; however, there would, nevertheless, still be a safety margin even if it were calculated using the ESCB procedure.
5 The European Fiscal Compact provides for independent monitoring of compliance with the deficit ceiling. The Stability Council, which comprises the central and state government finance ministers as well as the Federal Minister of Economics, has received an explicit legal mandate to this effect. The Stability Council is supported by an independent Advisory Board. The Stability Council's resolution on safeguarding the deficit ceiling as well as the statement by the Advisory Board can be found on the Stability Council's website (www.stabilitaetsrat.de).
6 See also Deutsche Bundesbank, Public finances, Monthly Report, May 2015, pp 75-76.

Tax revenue

Type of tax	H1 2014 € billion	H1 2015 € billion	H1 2015 Year-on-year change € billion	H1 2015 Year-on-year change %	Estimate for 2015[1,2] Year-on-year change %	Q2 2014 € billion	Q2 2015 € billion	Q2 2015 Year-on-year change € billion	Q2 2015 Year-on-year change %
Tax revenue, total[2]	284.5	300.1	+ 15.6	+ 5.5	+ 3.7	144.4	153.2	+ 8.7	+ 6.1
of which									
Wage tax	79.8	85.8	+ 6.0	+ 7.5	+ 6.1	40.8	44.3	+ 3.5	+ 8.6
Profit-related taxes[3]	48.4	50.1	+ 1.8	+ 3.6	+ 2.5	24.5	25.5	+ 1.0	+ 4.1
Assessed income tax	23.8	25.5	+ 1.7	+ 7.1	+ 6.4	12.0	12.3	+ 0.4	+ 3.0
Corporation tax	10.7	11.3	+ 0.6	+ 5.7	+ 3.8	5.1	5.9	+ 0.8	+ 15.5
Investment income tax[4]	13.9	13.4	− 0.5	− 3.9	− 5.8	7.4	7.3	− 0.1	− 2.0
Turnover taxes[5]	99.7	102.6	+ 2.9	+ 2.9	+ 2.5	49.2	50.8	+ 1.6	+ 3.2
Energy tax	14.5	14.2	− 0.3	− 2.3	+ 1.9	9.9	9.5	− 0.4	− 3.6
Tobacco tax	6.2	5.9	− 0.3	− 4.5	− 2.9	3.7	3.7	− 0.0	− 0.7

Sources: Federal Ministry of Finance and Bundesbank calculations. **1** According to official tax estimate of May 2015. **2** Including EU shares in German tax revenue but 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.
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Budgetary development of central, state and local government

Tax revenue

Dynamic rise in tax revenue in Q2 …

… due, inter alia, to absence of special effect from previous year

Year-on-year growth in tax revenue[7] came to 6% in the second quarter of 2015 (see the table above and the chart on page 67). This was buoyed by the absence of one-off strains from the previous year as a result of refunding nuclear fuel tax. However, even after adjustment for this special effect, at 4½%, the rise in tax revenue was significant. One especially important contributory factor here was that the development of gross wages and salaries per employee, which are of particular significance in terms of bracket creep, was evidently still favourable thus driving up wage tax revenue. A further factor pushing up the wage tax growth rate was that payments deducted from income, in particular for child benefit, grew slowly. By contrast, changes in tax legislation (above all, the increasing tax exemption of pension expenditure) continued to generate slight shortfalls. At 4%, the increase in profit-related taxes was also significant. This was driven by withholding tax on interest income and capital gains, corporation tax and assessed income tax, whereas receipts from non-assessed tax on earnings fell steeply. At 3%, the rise in turnover tax receipts was in line with expectations for growth in macroeconomic reference variables (in particular, private consumption and private housing construction). By contrast, revenue from other consumption taxes was down by 3%, which is mainly attributable, on balance, to refunds for energy and electricity tax as annual consumption in 2014 was lower than forecast.

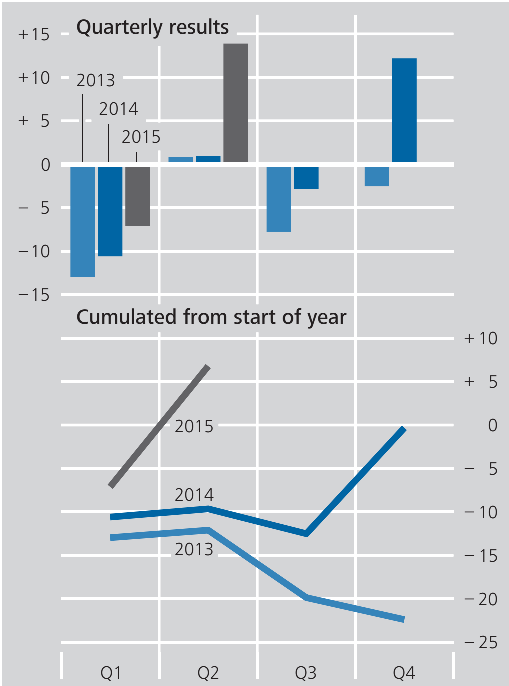
7 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.

All in all, development expected to be roughly in line with tax estimate

According to the official tax estimate from May, growth in tax receipts (including local government taxes) for 2015 as a whole is expected to be solid (3½%). This growth primarily reflects underlying macroeconomic developments. Revenue shortfalls as a result of the legislative package on income tax[8] passed in July are estimated at only just under €1 billion for 2015. However, substantial shortfalls are now expected during the remainder of the year for revenue from corporation and local business tax in connection with various court rulings.[9] Yet revenue has recorded very positive growth of late. On balance, growth in revenue is thus likely to be roughly in line with the results of the tax estimate.

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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Central government budget

Surplus shoots up in Q2 due to sharp growth in revenue and absence of ESM contribution

Central government recorded a high surplus of €14 billion in the second quarter of 2015 compared with only €1 billion one year previously. Revenue rose very sharply by 11½% (€9 billion). At 7%, growth in tax receipts was also substantial (€5 billion; €2 billion of which was due to the temporary refunding of nuclear fuel tax in 2014). Furthermore, it seems that the lion's share of the total revenue of €5 billion from the auction of frequency rights, which was concluded on 19 June, has already been transferred to the central government budget.[10] The expenditure side, in contrast, recorded a fall of 5½% (€4 billion) overall. This was mainly due to the absence of a contribution to the ESM (the last payment of €4½ billion was made in spring 2014). Moreover, interest expenditure again sustained a large decline (of €1½ billion).[11] By contrast, personnel expenditure, current transfers (especially to households) and transfers to state government continued to rise perceptibly.

2015 supplementary budget balanced

As in the outcome of the previous year and in the original budget, the supplementary budget (which was approved at the end of May) does not envisage any net new borrowing for 2015 as a whole (balanced budget). In a departure from the original budget, tax revenue is now expected to be €1½ billion higher and expenditure on debt servicing to be down by €2½ billion. The largest counterpart is the one-off transfer of €3½ billion to the new off-budget entity for the promotion of investment by financially weak local authorities.

Result set to be much better than forecast

However, the implementation of the budget is likely to be much more favourable than forecast. The auction of frequency rights, for which no notable revenue was anticipated, has gen-

8 The main elements of this package are increases in basic tax allowance and child tax allowance as well as in child benefit in 2015 and 2016, and a shift of the income tax schedule to the right in 2016. See also Federal Ministry of Finance, Press Release No 26 from 10 July 2015.
9 According to the response of 15 July 2015 from the Federal Government to a brief parliamentary enquiry from Die Linke party (Bundestag-Drucksache 18/5560), the rulings have not yet been implemented.
10 For the frequency bands in the 700 MHz spectrum, one-third of the total amount of €1 billion is due on 1 July 2016 and another third on 1 July 2017. The other payment obligations were due within five bank business days.
11 This was attributable, in particular, to declining provisions for final payments for inflation-indexed Federal securities.

Central government's medium-term fiscal planning from 2015 to 2019 and structural net borrowing under the debt brake

€ billion

Item	Actual 2013	Actual 2014	Target Supple-ment 2015	Draft 2016	Fiscal plan 2017	2018	2019
Expenditure[1]	307.8	295.9	301.6	312.0	318.8	326.3	333.1
of which Investment[2]	24.8	24.9	30.1	30.4	31.2	31.8	30.5
Revenue[1,3]	285.7	295.9	301.6	312.0	318.8	326.3	333.1
of which Tax revenue[1]	259.8	270.8	278.9	290.0	299.1	312.2	323.8
Net borrowing	22.1	–	–	–	–	–	–
plus cyclical component[4]	– 6.5	– 5.9	– 1.0	– 1.6	– 1.8	– 1.1	–
plus balance of financial transactions[5]	– 4.6	– 2.4	1.4	.	.	.	.
Fiscal balance of relevant off-budget entities							
Energy and Climate Fund	– 0.1	– 0.1	.	.	.	.	.
Reconstruction Assistance Fund (2013 flood)	7.4	– 0.7	.	.	.	.	.
Fund to promote municipal investment	–	–	.	.	.	.	.
Structural net borrowing	3.6	– 7.5	0.4	.	.	.	.
as a percentage of GDP[6]	0.1	– 0.3	0.0	– 0.0	– 0.0	– 0.0	0.0
Memo item Structural net borrowing[7] Upper limit according to Federal Ministry of Finance	33.2	26.6	18.6	10.2	10.6	10.9	11.3

1 After deducting supplementary central government grants, shares in energy tax revenue, compensation under the 2009 motor vehicle tax reform and consolidation assistance from 2011 onwards, which are all remitted to state government. **2** Excluding participating interests in the ESM. **3** Including proceeds from coin seigniorage. **4** Figures for 2013 and 2014 are taken from the 2014 budgetary accounts. For 2015 to 2019, as stated in central government's 2015 spring forecast. **5** As defined for the respective fiscal year. **6** Nominal GDP in the year preceding the drafting of the budget (data for fiscal plan years as stated in 2015 spring forecast). **7** The deficit reduction path from 2011 to 2015 is based on the June 2010 estimate of the starting structural deficit value for 2010 (2.2% of GDP) and a reduction of 0.31% of GDP per year.

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erated sizeable net relief for the central government budget. Additional spending authorisations (to promote the extension of the broadband network) were given only up to the amount of revenue from a smaller share of the frequency bands (€1½ billion). Moreover, signs of additional unbudgeted relief are emerging. For instance, interest expenditure and – as a result of delays in delivery – spending on military procurements may be lower and, as things currently stand, it is possible that tax revenue and refunds from the EU will be somewhat higher. This should then put the expected surplus in the region of €5 billion, which would likely again be used for a larger-than-anticipated redemption payment to the Investment and Repayment Fund (2014: €½ billion).

2016 draft budget again without net new borrowing

The 2016 draft central government budget, approved by the Federal Cabinet at the start of July, also does not envisage any net borrowing. On balance, there were only minor adjustments compared with the benchmark figures from mid-March. The official tax estimate from May largely confirmed the tax revenue figures and there were also no notable revisions to interest expenditure.

Steep growth in expenditure cushioned by higher tax revenue

Compared with the 2015 central government budget (including the supplementary budget), which contains one-off advance financing for the fund to promote municipal investment (1% of total expenditure in 2015), the draft budget for 2016 envisages significant growth in expenditure (just over 3%, or €10½ billion). Chief drivers behind this growth are the rule-based extension of grants for pensions, measures for the future investment programme for 2016 to 2018 announced at the end of 2014 and the reversal of cutting transfers to the health insurance fund. In addition, there are plans for further notable increases in spending on education and research, development aid and transport. Planned additional expenditure will be offset by higher tax revenue.

Structural balance in draft budget too positive

After deduction of a calculated negative cyclical burden of €1½ billion, a surplus of around €1½ billion is expected for the structural balance in 2016. However, provisions for an unfavourable economic situation next year hardly seem comprehensible. Furthermore, no burdens appear to have been included in the calculation for the flood assistance fund and the fund to promote municipal investment (off-budget entities) even though these are expected to record a deficit. This clashes with the fact that transfers from the flood assistance fund have been recorded on the revenue side of the central government budget as decreasing the deficit. In structural terms, a notable deficit thus appears more plausible. The actual safety margin vis-à-vis the upper limit of 0.35% of GDP (€10 billion), which is to apply for the first time in 2016, is thus much lower than forecast. However, it is possible that some developments will be more favourable than assumed in the budgetary figures.[12]

Relaxation of stance for financial plan but lack of details makes precise analysis difficult

The financial plan up to 2019 envisages no net new borrowing for the central government budget throughout this period. As real GDP growth is expected to be slightly above the potential growth rate, the economic outlook is continuing to brighten. Merely maintaining a balanced budget thus equates to a deterioration in the structural balance. Compared with the financial plan from summer 2014, the stance has been relaxed such that the figures budgeted for debt servicing – which are at the most now nearly €10 billion lower – do not have an impact on the balance. However, due to a lack of detail in the information on financial planning that has been presented thus far, it is not possible to conduct a more precise analysis of the structural development. For instance, there is no information about the extent of financial transactions or on the off-budget entities to be included under the debt brake. Furthermore, there has been no breakdown to date of the global items for revenue shortfalls and spending cuts included in the budget. However, the fact that the increase in overall revenue, in particular in 2019, is significantly lower than that for tax revenue indicates that a certain level of provisions has been made for potential burdens.

Off-budget entities record slight deficit in Q2; but signs of improvement for year as a whole

Central government's off-budget entities that are summarised in the quarterly overviews by the Federal Ministry of Finance[13] reported a slight deficit in the second quarter following a surplus of €½ billion one year previously. On balance, the deterioration resulted from the fact that the transfer to the special fund for provisions for final payments for inflation-indexed Federal securities due in mid-April was negative in 2015 due to a decline in the reference price index by ½%. Outflows from the assistance fund set up in summer 2013 to tackle flood damage were still down on the previous year. However, in particular, plans to reclaim €½ billion to compensate for transfers from turnover tax to state governments (in connection with soaring costs for asylum seekers), which are included in central government's supplementary budget, could lead to higher spending during the remainder of the year. Nevertheless, for 2015 as a whole, relief is set to outweigh any burdens. In addition to the repayments to the Financial Market Stabilisation Fund in connection with the privatisation of the Pfandbrief bank, which has now taken place, this relief also includes advance financing provided to the municipal investment fund. By contrast, the special transfer from the central government budget to the Investment and Repayment Fund, which is expected at the close of the 2015 central government budget, may not have an impact on the fund until the following year (as was the case with the 2014 central government budget outturn). Nevertheless, overall, the off-budget entities recorded here are likely to post a notably higher surplus than in 2014 (€4 billion) despite the absence of

12 It is currently unclear whether the ruling by the Federal Constitutional Court against providing childcare support as a transfer by central government will constitute any net relief for the 2016 budget.
13 This notably does not include bad banks and entities keeping commercial accounts.

the €2 billion transfer from the Bundesbank profit.

State government budgets[14]

Improvement of state government budgets in Q2, too, thanks to continued tax growth

In the second quarter of 2015, the surplus in the state governments' core budgets was up significantly on the year (by €2 billion to just over €3 billion). The main reason for this was substantial growth in income (+5%, or €4 billion), which was again chiefly driven by dynamic growth in tax revenue (+6%, or €3½ billion). Income from public administrations also climbed steeply (+6½%, or €1 billion), while the proceeds from asset disposals fell following a larger transaction in 2014. Growth in expenditure came to 2½% (€2 billion). Not least due to a continued large rise in spending on pensions, personnel expenditure recorded marked growth overall (+3%, or just under €1 billion). Even higher growth was recorded for other operating expenditure (+8½%, or €½ billion), transfers to public administrations (+4½%, or €1 billion) and investment (+5½%, or €½ billion), while interest expenditure continued to fall sharply (-10%, or €½ billion).

Outlook still favourable for 2015 and coming years

The core budgets thus recorded a surplus of €3 billion in the first six months of 2015. According to the forecast by the Federal Ministry of Finance published in mid-July, state government core budgets are expected to post slow growth in surpluses in the coming years, despite expected spending growth, in particular for payments to administrations and on personnel. This development is being fostered by continued favourable macroeconomic conditions promoting further clear growth in tax revenue and the fact that interest expenditure is expected to fall up to 2017.

Some states struggling to safeguard sustained compliance with debt brake even in good times

The budgetary situation of the individual states still varies greatly. At the beginning of June, the Stability Council confirmed that five states in receipt of consolidation assistance fulfilled their obligation to reduce their deficit in 2014, too, and approved the disbursement of the envisaged aid around the middle of the year. The Council also expects Berlin and Schleswig-Holstein – which were classed as in a state of budgetary emergency in 2012 – to complete their budgetary recovery procedures in 2016 on schedule. By contrast, in Bremen and Saarland, additional consolidation efforts are required and their budgetary recovery procedures are likely to be extended. Even though the minimum target of achieving a balanced (structural) budget by 2020 should easily be met by the vast majority of the states given the expected conditions, a number of challenges will have to be faced. While the east German states must find a way of compensating for the phasing out of the special supplementary central government grants by then, the west German states, in particular, will have to shoulder a hefty rise in pension payments. It is therefore advisable to continue to follow a restrained spending policy. For this reason, too, it would be worth considering whether to create additional scope on the revenue side as part of the upcoming reform of federal financial relations – for instance by implementing autonomous tax surcharges for income taxation.

Social security funds[15]

Statutory pension insurance scheme

Further clear deterioration in Q2 due to pension benefits package

The statutory pension insurance scheme recorded a slight surplus of just under €½ billion in the second quarter of 2015. The financial deterioration on the previous year is thus around €2 billion, just as it was in the first quarter. Total revenue went up by just under 3%. If the contribution rate had not been cut from

14 The development of local government finances in the first quarter of 2015 was analysed in the short articles in the Bundesbank's July Monthly Report. These are the most recent data available.
15 The financial development of the public long-term care and statutory health insurance schemes in the first quarter of 2015 was analysed in the short articles of the Monthly Reports of June and July. These are the most recent data available.

18.9% to 18.7%, total revenue would have risen by almost 4%, which reflects the ongoing favourable employment and wage conditions. However, at almost 6%, the rise in expenditure was much sharper, which was primarily due to benefit increases in connection with the pension benefits package from the summer of 2014 (in particular, the mothers' pension and full pension at 63).

Growth in expenditure to slow down in H2

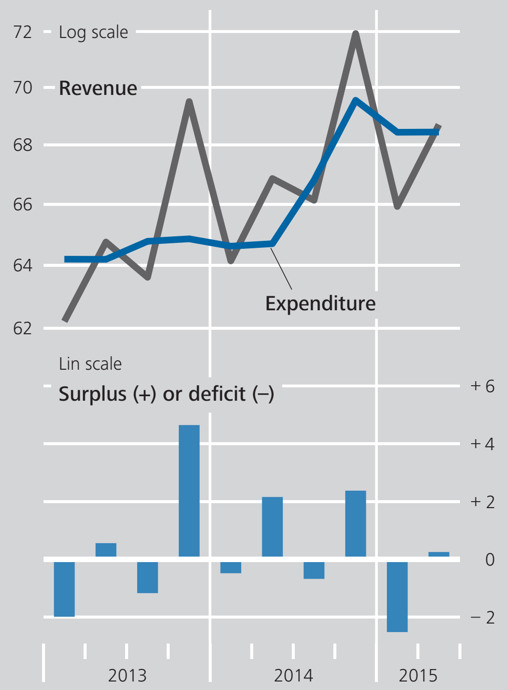
In mid-2015, pensions were raised by 2.1% in western Germany and 2.5% in eastern Germany.[16] Compared with the previous year (1.7% and 2.5%), this constitutes an acceleration for western Germany, where there is a far greater number of pensioners. However, during the remainder of the year, the year-on-year rise in expenditure is set to slow down as the second half of 2014 was notably marked by the pension benefits package. The stability of monthly expenditure since the start of the year indicates that climbing additional expenditure due to the full pension at 63 is likely to have been compensated for by a fundamental trend in the other direction – for instance, continuing to gradually put up the general statutory retirement age towards 67 and the fact that the demographic situation is currently still rather favourable. Additional expenditure has also been generated from the decision to include a second year of child raising for children born before 1992 (mothers' pension), which is the component of the pension benefits package that creates by far the most expenditure. After a one-off hike in the fourth quarter of 2014, no further extraordinary growth has been recorded for this item.

Further cut in contribution rate possible in 2016

When the contribution rate for 2015 was set, a deficit of €4 billion was still expected for the year as a whole. Now a much more favourable financial balance is on the cards. As a result, the legal requirement to bring the reserves back down to 1.5 times the scheme's monthly expenditure by the end of the year will not be met. There are even doubts as to whether this requirement will be met by the end of 2016 as planned if the contribution rate remains unchanged. It is thus possible that the contribution rate will have to be cut again on 1 January 2016.

Finances of the German statutory pension insurance scheme

€ billion, quarterly data



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

Federal Employment Agency

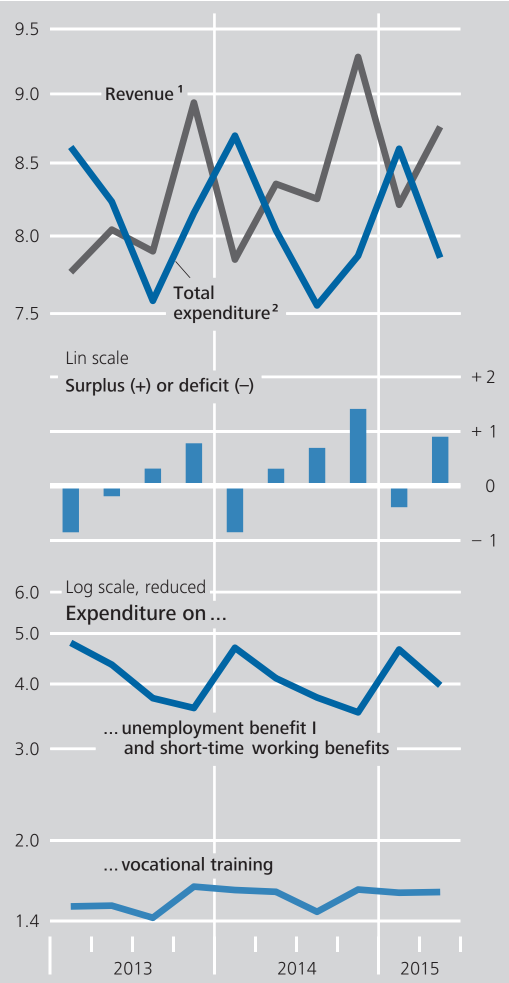
Further improvement in Agency's finances in Q2

The Federal Employment Agency recorded a surplus of almost €1 billion in the second quarter of 2015, which was just over €½ billion higher than at the same time last year. At 4½%, growth in contribution receipts was still substantial. However, the overall growth rate for

16 As a result of the revision of the national accounts in the summer of 2014, the adjustment was around 1 percentage point lower. Gross wages and salaries per employee were revised downwards by around 1% and this revised (smaller) figure for 2014 was compared with the unadjusted figure for 2013 for the pension adjustment. However, as pensions ultimately stay in line with the income subject to contributions of persons in the statutory pension insurance scheme – which is not affected by the revision but for which the data are only available at a later date – a correspondingly higher pension increase will be made in 2016.

Finances of the Federal Employment Agency

€ billion, quarterly data



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

revenue was even higher still at almost 5%, mainly due to an even sharper rise in refunds of administrative costs by central government. On the expenditure side, the decreases in unemployment benefit I (insurance-related benefit; -3½%), insolvency benefit (-18½%) and subsidisation for phased retirement (-36½%) continued and even picked up a little speed. By contrast, spending on active labour market policy no longer fell, despite ongoing growth in employment. Mirroring the refunds on the revenue side, growth in administrative expenditure was again steep (5½%). In the second quarter of 2015, total expenditure by the Federal Employment Agency was just over 2% lower than in the previous year.

Action required for current favourable financial situation to continue

The favourable financial developments recorded by the Federal Employment Agency reflect the fact that the macroeconomic developments are doubly advantageous for unemployment insurance. Growth in employment subject to social security contributions and in wages and salaries has considerably boosted contribution receipts. Furthermore, expenditure has been lower, especially for unemployment benefit I. In this environment, the fact that spending on active labour market policy has stagnated in favour of recipients of unemployment benefit I is more likely to indicate that the policy stance is back on a somewhat more expansionary course. For the year as a whole, the surplus is set to be much higher than forecast in the budget plan (€½ billion, excluding the civil servants' pension fund). In the coming years, the Federal Employment Agency's reserves are likely to record a further increase. In good times, it is wholly appropriate to build up considerable reserves to ensure that the contribution rate can be kept stable when the situation takes a turn for the worse. Before cutting the contribution rate (of currently 3.0%) considerably for a sustained period of time, it must be ensured that the current labour market situation will continue in the future (as the structural norm). Irrespective of this, however, there is scope for cutting the contribution rate if non-insurance-related benefits, which are currently still financed using contributions to the Federal Employment Agency, were (again) to be covered using tax revenue from the central government budget.[17]

Build up reserves when economy is buoyant

17 For more information, see Deutsche Bundesbank, The evolution of labour market-related government expenditure in Germany, Monthly Report, April 2015, pp 13-33.