Public finances*

General government budget

2016: surplus largely depleted …

Last year, general government recorded a considerable budget surplus (0.7% of gross domestic product (GDP)) and the debt ratio continued to fall (71.2%). However, this surplus is expected to be largely eroded in the current year, with cyclical influences and temporary factors likely to play only a minor role.[1] Indeed, there looks set to be a marked deterioration in the structural balance despite the ongoing decline in interest expenditure. In particular, spending relating to the migration of refugees is likely to record a marked rise. Although the influx has decreased sharply in recent months, the year-on-year increase in the number of persons requiring support is likely to be significant on an annual average because, last year, many refugees did not arrive until the autumn, which meant they needed support for just a few months. Moreover, the budgetary stance is expansionary in other areas, too. The debt ratio is nevertheless likely to fall further this year, primarily due to nominal GDP growth in the denominator pushing the ratio down. Furthermore, the liabilities of government-owned bad banks are expected to be reduced further.

… and debt ratio continues to fall

Revenue ratio stable, …

The revenue ratio is not expected to change substantially in 2016. On the one hand, the institution-specific rates for additional contributions to the statutory health insurance scheme have risen on average. On the other hand, changes to income tax imply shortfalls, not least on account of the higher income tax allowances and a rightward shift in the income tax scale. By contrast, the expenditure ratio is set to increase markedly. While the interest expenditure ratio will continue to fall on account of further drops in the average interest rate[2] and the debt ratio, refugee migration is leading to additional spending, particularly on social benefits, intermediate consumption and personnel. As things stand today, this could result in additional expenditure of around ½% of GDP this year compared with 2014 – prior to the sharp influx of refugees. However, the rise in expenditure – which is expected to be significant overall – is also attributable to fiscal measures in other areas such as social payments (eg for healthcare and the housing allowance) and funds earmarked for transport infrastructure and childcare. Lastly, the sharp pension increase at mid-year is also making itself felt.[3]

… while expenditure ratio climbs due to factors such as refugee migration

Balance probably broadly unchanged in 2017

A broadly unchanged fiscal balance and further drop in the debt ratio are on the horizon for 2017. The rather favourable impact of economic activity and positive temporary effects (proceeds from a frequency auction)[4] are likely to provide budget relief. In addition, the interest expenditure ratio will probably continue to fall. On the revenue side, additional revenue generated chiefly by raising the contribution rate for the public long-term care insurance scheme should broadly offset shortfalls resulting from tax cuts (this primarily concerns income tax and the end of nuclear fuel tax). Growth in primary expenditure (ie excluding

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* The section entitled "General government budget" concerns the national accounts and the Maastricht ratios. The subsequent more detailed 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 These two factors are likely to have a broadly neutral effect on both changes in and the level of the balance this year. Additional spending on refugees should not be regarded as temporary in this context because, even if the influx of refugees subsides, government expenditure will still be substantial for several years.

2 At the same time, low interest rates are curbing revenue items such as government interest income, although this is of far less significance.

3 Further additional expenditure could be incurred, for example, in connection with the sale and transfer of certain assets belonging to HSH-Nordbank and in the course of phasing out nuclear energy.

4 Proceeds from the frequency auction in summer 2015 are recorded in the national accounts on an accrual basis (ie as soon as the frequency bands are made available to the buyer). This will cause the balance to improve by €3.8 billion in 2017 (in the form of sales of non-produced assets, which are reflected in the national accounts as negative spending).

Key data of the Federal Government's updated stability programme

Item	2015	2016	2017	2018	2019	2020
Real GDP growth (%)						
Stability programme April 2016	1.7	1.7	1.5	1.6	1.6	1.6
Stability programme April 2015	1.5	1.6	1.3	1.3	1.3	.
General government fiscal balance (% of GDP)						
Stability programme April 2016	0.7	0	0	0	0	0
Stability programme April 2015	¼	0	¼	¼	½	.
Structural fiscal balance (% of GDP)						
Stability programme April 2016	0.8	0	0	0	0	0
Stability programme April 2015	¾	¼	½	½	½	.
Debt level (% of GDP)						
Stability programme April 2016	71.2	68¼	65¾	63½	61¼	59½
Stability programme April 2015	71½	68¾	66	63¾	61½	.

Source: Federal Ministry of Finance.
Deutsche Bundesbank

shrinking interest expenditure) is likely to remain high, albeit somewhat lower than in 2016. Expenditure arising in connection with refugee migration could more or less stabilise. By contrast, the increase in benefits provided under the long-term care insurance scheme will lead to considerable additional outlays. Furthermore, according to the benchmark figures for the central government budget plans approved in March, its expansionary spending policy will remain in place. Furthermore, healthcare and pension spending are set to continue to rise at a rapid pace.

Stability programme envisages balanced general government budgets up to 2020

The Federal Government presented its updated stability programme for the period up to 2020 in April.[5] According to this programme, the aim is to achieve a broadly balanced general government budget in unadjusted and structural terms from 2016 onward. All in all, this appears feasible. Following the significant scale of fiscal loosening this year, the fiscal policy stance is expected to remain broadly unchanged going forward. Compared with previous plans, which had still aimed to achieve a moderate structural surplus, the objectives outlined by the latest programme are less ambitious, although this is partly masked by lower interest expenditure.[6] This is chiefly attributable to additional expenditure in connection with refugee migration[7] as well as sharper rises in spending in other areas. The debt ratio is projected to drop to 59½% by 2020, which would mark the first time in almost two decades that the figure has fallen below the Maastricht ceiling of 60%.

Maintain safety margins and plan for demographic change

On the one hand, the fact that the Federal Government is maintaining its practice of factoring in certain safety margins vis-à-vis the es-

5 As part of European budgetary surveillance, EU member states publish a stability or convergence programme every April. The Federal Government regularly bases its stability programme on its macroeconomic forecast from the beginning of the year. The macroeconomic assumptions are updated shortly afterwards in its spring forecast, on which the official tax estimate from May is also based. The fiscal forecast in the latest stability programme would thus be revised upwards slightly on the basis of the spring forecast. See pp 66 ff for the official tax estimate.
6 The structural primary balance ratio is expected to be smaller and to remain merely static in the medium term instead of once again improving slightly, as envisaged in last year's programme, even though higher estimated growth in potential GDP results in increased scope for structural expenditure (with a given target for the structural primary balance). The upward revision of potential output seems to be at least partly connected to what is – according to the EU procedure for estimating potential output – the highly positive short-term impact of refugee migration on structural labour market developments (see also Joint Economic Forecast (2016), Aufschwung bleibt moderat – Wirtschaftspolitik wenig wachstumsorientiert, pp 49-60). The assumption of (slight) cyclical slack in the German economy up to 2020 does not appear plausible.
7 According to the stability programme, the Federal Government also expects additional expenditure amounting to around ½% of GDP in 2016 and 2017 compared with 2014. It can be assumed that, in the light of the current relatively low number of refugees arriving in Germany, the estimated budgetary burdens are at least not significantly higher for the years thereafter.

Fiscal developments in the euro area

2015 saw first decline in euro-area debt ratio since 2007

At the end of April, Eurostat published data on the general government deficits and debt levels of the EU member states as part of the European budgetary surveillance procedure. According to these data, the euro-area deficit ratio fell from 2.6% to 2.1% in 2015. This was attributable to subdued interest expenditure and favourable economic developments, whereas outlays on support for the banking sector were marginally higher than in the previous year. Viewed in isolation, the underlying fiscal stance (ie the change in the structural primary balance) would have resulted in a slight rise in the deficit. The euro-area debt ratio contracted last year from 94.4% to 92.9%.[1] This was the first time since 2007 that the debt ratio had recorded a decline.

Overall loosening of fiscal stance in 2016 and 2017

The European Commission expects only a marginal decline in the euro-area deficit ratio to 1.9% this year. Marked fiscal easing is being overshadowed by a positive cyclical impact and further relief from interest expenditure. This loosening is forecast to continue – albeit more moderately – in 2017. Assuming that the cyclical and interest-rate developments remain favourable, the deficit ratio is expected to drop to 1.6%. In line with this, the debt ratio is forecast to fall to 91.1% in 2017.

Fiscal policy easing in countries with high debt ratios, too

The Commission is expecting the deficit ratios to decline in the vast majority of euro-area countries, despite the fiscal easing. However, in the absence of additional measures, France and Spain are set to still exceed the reference value of 3% in 2017, meaning that both countries would fail to ensure a timely correction of their excessive deficits (deadlines: 2017 and 2016, respectively). Portugal did not meet its correction deadline last year, but the Commission is expecting a value of below 3% for 2016. The particularly highly indebted countries, ie Belgium, Cyprus, Greece, Italy and Portugal, with a debt ratio of over 100%, as well as France, Ireland and Spain, which are only marginally below this level, consistently pursue, for the most part, a loose fiscal policy stance. Contrary to the general trend, the debt ratio for these countries is not declining in all cases. In Greece with almost 180%, as well as in France and Spain with almost 100%, the debt ratio for 2017 is forecast to be slightly higher than the figure for 2015.

Third Greek assistance programme currently under review

Greece is the only country still in an ESM programme. The first review of the third assistance programme that was approved last year is currently underway.[2] As in the past, there have been delays and problems also appear to have arisen in connection with the implementation. A particularly controversial issue at present concerns the additional efforts that are necessary in order for Greece to be able to meet the agreed primary surplus (ie the surplus excluding inter-

1 Unlike the data reported in the Eurostat notification, the European Commission figures on the debt level in the euro area as a whole cited in this box also include lending between euro-area countries. Excluding these inter-governmental loans, the debt ratio for 2015 declined by a similar amount to 90.7%.
2 For more information on the various aspects of the third assistance programme, see also Deutsche Bundesbank, Third assistance programme for Greece, Monthly Report, August 2015, pp 62-66.

Forecast for the public finances of the euro-area countries

Country	European Commission spring forecast, May 2016						Deadline for correcting excessive deficit
	Budget balance as a percentage of GDP			Government debt as a percentage of GDP			
	2015	2016	2017	2015	2016	2017	
Austria	– 1.2	– 1.5	– 1.4	86.2	84.9	83.0	–
Belgium	– 2.6	– 2.8	– 2.3	106.0	106.4	105.6	–
Cyprus	– 1.0	– 0.4	0.0	108.9	108.9	105.4	2016
Estonia	0.4	– 0.1	– 0.2	9.7	9.6	9.3	–
Finland	– 2.7	– 2.5	– 2.3	63.1	65.2	66.9	–
France	– 3.5	– 3.4	– 3.2	95.8	96.4	97.0	2017
Germany	0.7	0.2	0.1	71.2	68.6	66.3	–
Greece	– 7.2	– 3.1	– 1.8	176.9	182.8	178.8	2016
Ireland	– 2.3	– 1.2	– 0.7	93.8	89.1	86.6	2015
Italy	– 2.6	– 2.4	– 1.9	132.7	132.7	131.8	–
Latvia	– 1.3	– 1.0	– 1.0	36.4	39.8	35.6	–
Lithuania	– 0.2	– 1.0	– 0.2	42.7	41.1	42.9	–
Luxembourg	1.2	1.0	0.1	21.4	22.5	22.8	–
Malta	– 1.5	– 0.9	– 0.8	63.9	60.9	58.3	–
Netherlands	– 1.8	– 1.7	– 1.2	65.1	64.9	63.9	–
Portugal	– 4.4	– 2.7	– 2.3	129.0	126.0	124.5	2015
Slovakia	– 3.0	– 2.4	– 1.6	52.9	53.4	52.7	–
Slovenia	– 2.9	– 2.4	– 2.1	83.2	80.2	78.0	2015
Spain	– 5.1	– 3.9	– 3.1	99.2	100.3	99.6	2016
Euro area	– 2.1	– 1.9	– 1.6	92.9	92.2	91.1	–

Source: European Commission.
Deutsche Bundesbank

est charges) of 3.5% of gross domestic product (GDP) in 2018. As a compromise, it was agreed that Greece should approve precautionary measures, which, however, would only kick in if it were otherwise to fail to meet its target. This mechanism and a number of further measures have to be implemented by Greece before the ongoing programme review can be concluded (referred to as "prior actions"). If the review reaches a positive outcome, this would not only pave the way for the payment of the next tranche of ESM loans but also for discussions regarding the granting of debt relief. This debt relief could, in principle, take the form of a reduction of the repayment amount or the granting of further repayment deferrals or interest rate subsidies. The International Monetary Fund (IMF) sees a need for the other European member states to provide further debt relief in order to be able to ensure – with a high degree of certainty – the sustainability of Greek government debt, which is a prerequisite for Greece to be able to continue to receive financial assistance from the IMF.

An important factor when assessing the future sustainability is the primary balance target in the medium and the long term. Whereas in 2010 within the framework of the assistance programmes a primary surplus target of over 6% of GDP was agreed, the current programme sets a target of just 3.5% from 2018 onwards. The Stability and Growth Pact, in which balanced budgets are anchored as medium-term targets, also prescribes a primary surplus on this scale, as it does for Italy and Portugal, too. Countries with higher levels of debt and interest expenditure need to have a more ambitious underlying fiscal position than other countries. In the past, countries such as Belgium and Finland have shown that more ambitious targets are realistically attainable. Italy, too, can look back on a prolonged phase of high primary surpluses. It now appears that the IMF considers a sustained primary surplus of 3.5% of GDP to be overly ambitious for Greece. It would, however, be alarming if further concessions were to be made. The lower the achieved primary surplus, the greater the amount of additional financial aid that will ultimately be required from the countries providing support. The impression should not be given that the fiscal conditions can be diluted on a regular basis whenever a country puts the blame for missing its targets on political difficulties, and that the agreements in place are consequently dispensable. With regard to Greece, it appears to be fundamentally important for the reform programmes to now be resolutely implemented, without any further concessions. A short-term decision regarding further debt relief measures is not essential, as Greece will, in any case, still be shielded for some time to come by the assistance programme.

Fiscal rules intransparent, with numerous exceptions and a fairly lax approach to implementation

In the coming weeks, the European Council will decide, on the basis of recommendations by the European Commission, whether the requirements of the Stability and Growth Pact have been met by the individual member states. In this context, the debt rule, which ought to be strengthened owing to experiences gained during the sovereign debt crisis, requires, in principle, that any debt above the reference value of 60% of GDP be reduced by at least one-twentieth every year. This requirement has, however, largely proven to be futile to date. According to the European Commission, Italy, Belgium and Finland did not meet this requirement either in their actual results or in their plans. This was, however, excused by the Commission by way of an exception and consequently no excessive deficit procedure was initiated.[3] The European Court of Auditors recently criticised the fact that the debt rule can be deemed to have been complied with even in the case of a rise in the debt ratio, which could undermine the credibility of the process and jeopardise the sustainability of government debt.[4]

Countries that have not yet reached their structural medium-term budgetary objective (MTO) (all except Germany, Estonia and Luxembourg), but are not under an excessive deficit procedure (EDP), are subject to the preventive arm of the Stability and Growth Pact. As a benchmark, they are expected to improve their structural balance at a rate of 0.5% of GDP per year. Of the nine affected member states, this was the case in 2015 only for Lithuania and Austria, while the structural balances actually deteriorated in four countries (Latvia, Malta, the Netherlands and Slovakia). However, numerous exceptions mean that this may not have any consequences.[5] Achieving a budget that is structurally close to balance or in surplus is therefore in danger of turning into a moving target. According to the Commission's forecast, the structural balance in the majority of these countries will deteriorate until 2017, and only Malta and Ireland are expected to achieve the benchmark improvement of 0.5% of GDP at least on an annual average.

Of the countries subject to EDPs, Ireland, Cyprus and Slovenia brought their deficits below the 3% mark in 2015. As the deficit is likely to remain below this threshold according to the Commission's forecast, the procedures are expected to be closed. That would leave France, Spain and Portugal (as well as Greece) under EDP surveillance. The deadlines for correction have already been extended repeatedly for these countries

3 See also Deutsche Bundesbank, Fiscal developments in the euro area, Monthly Report, May 2015, pp 70-74 and European Central Bank, Government debt reduction strategies in the euro area, Economic Bulletin, Issue 3, 2016, pp 46-65.
4 See European Court of Auditors, Further improvements needed to ensure effective implementation of the excessive deficit procedure, Special Report No 10/2016.
5 A "flexible" interpretation of the rules means that the current economic situation and (planned) structural reforms can be taken into consideration, amongst other things. Moreover, under the preventive arm, procedures are opened only in the event of a "significant" deviation.

and, based on the Commission's forecast, the current deadlines are unlikely to be met from today's perspective. Under the corrective arm, structural improvements during the correction period are also taken into consideration and the same benchmark of at least 0.5% of GDP applies. However, again, numerous additional factors are taken into account in the assessment procedure, and the outcome is an overall assessment which may factor in other aspects, which are not specifically named. In the view of the European Court of Auditors, the Commission's analyses lack transparency, and proposals and recommendations are based on vague definitions. All this makes it difficult, at times, to establish a clear link between the analysis made and the conclusions drawn.[6] The complex, opaque and elastic procedure largely prevents a public debate on whether rules have been met. Its design further means that developments are tolerated which fail to match up to the improvement in sustainability originally judged appropriate and necessary. Over the course of the next few weeks, decisions will be taken on France, where the actual structural improvement in 2015 fell short of the recommendation (whereas the objective for the unadjusted deficit ratio was met) and on Spain and Portugal, where not only the deficit ratio target was missed, but the structural balance even deteriorated.

Overall, there is no doubt that fiscal rules do need a certain degree of flexibility – for instance, if problems or unexpected developments occur and these have serious consequences for public finances. However, the very great complexity of budgetary surveillance that now exists is obviously in part also the result of efforts to avoid stepping up the pressure at all costs if member states fail to meet their consolidation targets for reasons that cannot be directly attributed to the governments. Ultimately, this means that consolidation success is no longer the benchmark. This absolves member states of their responsibility for achieving the targets instead of forcing them to make provisions for unexpected negative developments. In addition, such a course of action creates incentives to base recommendations in the excessive deficit procedure on overly optimistic developments. Other worrying aspects are the large scope for discretion built into the rules and the tendency to compromise on the objective of sound public finances in favour of short-term fiscal fine-tuning.

Mooted rule change unlikely to bring about essential improvement

Following much criticism, there is currently debate on whether an expenditure rule should not only be taken into account in the preventive arm but also in the corrective arm. Missed targets would then mainly constitute deviations from the previously recommended expenditure path. This is intended to make it easier to assess whether the member country has taken effective action than is the case when focusing on structural balances. Whether this will actually improve the rules depends on the concrete design. As is currently the case, unexpected adverse developments would, however, be excused and would not need to be compensated.[7] The reforms being discussed at present would not fundamentally change the currently unsatisfactory features and implementation of the rules, and the Commission would still have the option of coming to an overall assessment that is not based on the fundamental criteria.

6 See European Court of Auditors, loc cit.
7 One proposal is, for instance, that an expenditure target in line with the desired structural improvement be set at the time the recommendation is issued. This must take into account expected potential growth, amongst other things. Not updating the target at the time when the assessment is made neglects the fact that important factors may already have changed so much again that the structural improvement achievable with the expenditure target may fall short of what was intended when the recommendation was issued.

Far-reaching reforms desirable

The Commission presents detailed analyses on public finances and closely monitors member states' general government budgets at various points in time. When implementing the rules, it is, however, now acting less and less as a rule-bound fiscal surveillance body and more as a political institution which also pursues other objectives in its decisions and proposals. This has, at times, created the impression that the rules are fluid and negotiable. An independent fiscal authority that would take on the tasks associated with budgetary surveillance instead of the Commission could alleviate this problem, provided the authority's only objective were achieving sustainability and it were to interpret the agreed rules more clearly with this objective in mind.

Probably partly in response to such demands for more independent budgetary surveillance, the Commission has established a new European Fiscal Board, which is to become operational in the autumn. This Board will be composed of five experts that are appointed and funded by the Commission (three of them in consultation with the national fiscal councils, the ECB and the Eurogroup Working Group), and its staff will be attached to the Commission. Although its mandate includes assessing to what extent the fiscal rules have been applied consistently, it is also, in particular, to advise the Commission on whether the fiscal stance in individual countries and the euro area as a whole is appropriate against the backdrop of macroeconomic developments. It therefore does not constitute an independent institution with a clear focus on compliance with the rules and sound public finances.

budget limits in its plans is to be welcomed. This approach has proved its worth, not least in connection with the increased influx of asylum seekers. It was possible to cover the unexpected additional expenditure, which was difficult to gauge, without having to resort to consolidation measures in order to comply with the deficit ceilings. However, on the other hand, it would be highly advisable to once again aim for moderate structural surpluses – as had previously been planned – at least in the medium term. A more rapid scaling-back of the debt ratio and larger safety margins would strengthen the resilience of public finances. This would be beneficial if interest rates were to rise again in future, if macroeconomic developments were to be less favourable than expected in the medium term or if any other unexpected budgetary burdens were to arise. Furthermore, Germany's public finances are faced with the considerable challenge of demographic change. For example, the latest sustainability reports published by the Federal Government and the European Commission make it clear that this will place the general government budget under substantial additional strain in the future. The lion's share of spending growth concerns pensions, although significant increases in healthcare and long-term care benefits are also expected. By creating a more favourable starting position, the prospective need for consolidation in the future – broadly speaking, burdens on future generations – can be reduced.[8]

In this context, the call to make greater use of the budget limits, partially directed at Germany, is not compelling. As it is, Germany is already

8 In the scenarios currently deemed plausible in the reports, a markedly more favourable fiscal balance and a significantly more rapid reduction in the debt ratio would be required to prevent – despite additional spending caused by demographic change – extra consolidation measures needing to be taken at a later date. See Federal Ministry of Finance, Vierter Bericht zur Tragfähigkeit der öffentlichen Finanzen, February 2016 and European Commission, Fiscal Sustainability Report 2015, Institutional Paper 18, January 2016.

Improve fundamental conditions for growth in budget-neutral manner

running a considerably expansionary fiscal policy at present. The economic situation in Germany is rather favourable and shows no need for additional economic stimulus. The spillover effects of such stimulus on other euro-area states would be comparatively low and, at any rate, attempts at economic fine-tuning in the euro area do not appear promising. Even so, economic and fiscal policy measures to improve growth conditions should be taken resolutely but generally be counter-financed. In the light of current economic policy recommendations issued to Germany, it would make sense, for example, to consider strengthening infrastructure – which can also be accomplished by making government investment processes more efficient – or introducing measures to increase employment. Recently adopted increases in benefits provided by the social security funds and current endeavours to partly reverse previous pension reforms are exacerbating the pressure that is already being placed on contribution rates due to demographic change. As an anchor of trust and stability in the euro area, it is important for Germany to comfortably comply with the budget limits as well as establish a good economic policy framework.

Budgetary development of central, state and local government

Tax revenue

Considerable rise in tax revenue in 2016 Q1

Year-on-year growth in tax revenue[9] came to 5½% in the first quarter of 2016 (see the chart and table on pages 67 and 68). While developments in gross wages and salaries remained favourable, wage tax receipts rose at a below-average rate (2½%). This had been expected, primarily due to the changes to income tax implemented at the start of the year (higher income tax allowances, a rightward shift in the income tax scale and the increase in child benefit, which is deducted from revenue). At 14½%, the pick-up in profit-related taxes was higher than average and chiefly driven by corporation tax and assessed income tax. Revenue from non-assessed taxes on earnings edged slightly upwards, while receipts from withholding tax on interest income and capital gains fell steeply. Turnover tax revenue was up significantly by 5%; it is, however, generally volatile over the course of the year. Revenue from other excise duties rose by 2½%. This is primarily attributable to the fact that the increase in receipts from tobacco tax was exceptionally sharp. It would appear that there were anticipatory effects caused by suppliers in connection with the Regulation Governing the Implementation of the Tobacco Products Directive *(Verordnung zur Umsetzung der Richtlinie über Tabakerzeugnisse)*, pursuant to which images of diseases caused by smoking must be included on packaging.

Subdued rise expected for 2016 as a whole

The latest official tax estimate expects revenue growth (including local government taxes) to be subdued (at 2½%) for 2016 as a whole. Given the assumed solid growth in the macroeconomic reference variables for tax revenue,[10] this is predominantly attributable to large-scale tax refunds remaining on the cards owing to court rulings, some of which were made some time ago. Above all, this concerns revenue from profit-related taxes, particularly local business tax, corporation tax and non-assessed taxes on earnings. However, turnover tax rev-

9 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.
10 This estimate is based on central government's current macroeconomic projection from April 2016. According to this, GDP is expected to rise by 1.7% in real terms and 3.6% in nominal terms in 2016 (November: +1.8% and +3.4%, respectively). GDP growth for 2017 is forecast to be 1.5% in real terms and 3.3% in nominal terms (as in November). In the medium term, nominal growth of around 3% per annum is still forecast.

enue is affected, too.[11] The effect of legislative changes is expected to reduce revenue growth distinctly, especially on account of the aforementioned income tax relief measures.

Renewed sharper revenue growth expected in subsequent years

The projected shortfalls resulting from court rulings are set to be reduced to a large extent next year.[12] Furthermore, macroeconomic developments are expected to be stable. As a result, tax revenue is forecast to record a significant upturn of just over 4½%. Revenue growth of between 3½% and 4% is expected for the subsequent years up to 2020. Developments will primarily be determined by growth assumptions and fiscal drag.[13] Changes in tax legislation are expected to curb this expansion slightly on balance. The tax ratio (as defined in the government's financial statistics) is projected to increase to 22.7% by the end of the forecast period (2015: 22.2%).

Revenue expectations up somewhat overall

Compared with the November 2015 forecast, the budgeted figures have been revised upwards by €5 billion for 2016 and by between €6½ billion and €12½ billion for the years thereafter. This is partly attributable to the annual result for 2015 being somewhat better than had been expected as late as in November. Of greater significance than this, however, is the fact that the fundamental outlook – particularly for assessed profit-related taxes – is more optimistic based on the favourable development of cash data in the first quarter of 2016. From 2017 onward, more favourable assumptions regarding macroeconomic developments are also a key factor behind the upward revisions. By contrast, recently adopted legislative changes and the additional (temporary) effects of court rulings will serve to reduce revenue in net terms.

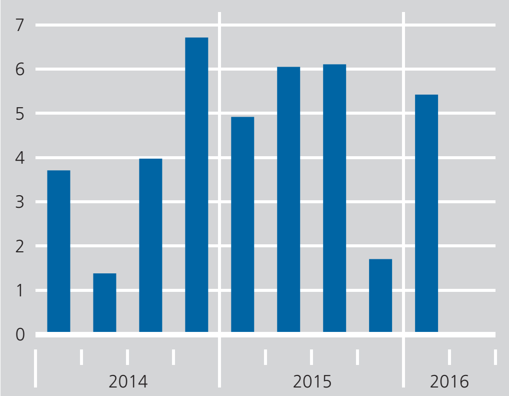
Central government budget

Central government posted a deficit of €2½ billion in the first quarter of 2016 compared with a deficit of €7 billion one year previously. Revenue rose very sharply (by 9%, or €6½ billion), primarily owing to higher tax receipts. However, half of the additional revenue of €6 billion was attributable to the relief provided by transfers to the EU budget, which are deducted from revenue.[14] Turning to other revenue items, various additional receipts – including the slight increase in the Bundesbank's profit distribution to just over €3 billion – outweighed a decline of almost €1 billion in revenue from asset sales.

Significant fall in deficit again at start of year supported by strong revenue growth and further decline in interest expenditure

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.
Deutsche Bundesbank

11 This pertains, first and foremost, to court rulings on section 40a of the Act on Asset Management Companies (Gesetz über Kapitalanlagegesellschaften) and STEKO (section 8b (3) of the Corporation Tax Act (Körperschaftsteuergesetz)) – Federal Fiscal Court rulings I R 33/09 and I R 74/12; see also Bundestags-Drucksache 18/5560. Moreover, shortfalls are expected as a result of the ruling by the European Court of Justice of 20 October 2011 on the taxation of dividends paid to EU/EEA companies (case C-284/09). The Federal Fiscal Court ruling I R 39/14 concerns local business tax receipts. Furthermore, shortfalls are likewise expected for turnover tax and assessed income tax. Unlike the cash receipt developments described here, the effect of these court rulings is recorded in the national accounts at the time of each of the rulings (2011, 2013 and 2014), increasing expenditure. Consequently, tax revenue will rise at a significantly sharper rate this year in the national accounts.
12 This means that, on balance, the end of nuclear fuel tax – which is expected to bring in €1 billion in revenue in 2016 – will also be far more than offset.
13 In this context, the term "fiscal drag" encompasses the overall revenue effect of bracket creep in income taxation and the impact of the fact that specific excise duties are largely independent of prices.
14 It appears that the bulk of the relief is attributable to refunds to compensate for the one-off higher transfers following the revision of the national accounts in summer 2014. In the national accounts, the transactions affected the balance in 2014.

Tax revenue

Type of tax	Q1 2015	Q1 2016		Estimate for 2016[1,2]
	€ billion		Year-on-year change %	Year-on-year change %
Tax revenue, total[2]	146.9	154.9	+ 5.4	+ 3.0
of which				
Wage tax	41.6	42.6	+ 2.5	+ 3.3
Profit-related taxes[3]	24.7	28.2	+ 14.3	+ 1.6
Assessed income tax	13.1	14.6	+ 10.9	+ 6.2
Corporation tax	5.4	8.4	+ 55.1	+ 5.3
Investment income tax[4]	6.1	5.2	− 14.6	− 9.6
Turnover taxes[5]	51.9	54.4	+ 4.9	+ 4.6
Energy tax	4.7	4.6	− 1.8	+ 1.0
Tobacco tax	2.2	2.7	+ 22.4	− 3.1

Sources: Federal Ministry of Finance and Bundesbank calculations. **1** According to official tax estimate of May 2016. **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.
Deutsche Bundesbank

On the expenditure side, a much more moderate overall increase of 2½% (€2 billion) was recorded. Factors such as higher payments to the social security funds (not least due to transfers to the health fund being restored to their normal level) and higher payments for capital transfers (also abroad) and military procurements placed a strain on the budget. However, this was partly offset by a further decline in the interest burden of just over €1 billion.

Considerable relief vis-à-vis 2016 budget estimates on the horizon

Compared with the actual figure recorded for 2015, the budget is expected to suffer a pronounced deterioration of €18 billion for the year as a whole, with a deficit of €6½ billion on the cards. However, following the favourable start to the year, there are already signs of a marked improvement compared with this estimate. Among the factors playing a minor role in this regard is the Bundesbank's profit distribution, which was just over €½ billion higher than estimated.[15] Furthermore, after the budget discussions had been concluded, the supplementary pension scheme of central and state government (*Versorgungsanstalt des Bundes und der Länder,* or VBL) announced that it would reimburse the additional payments charged between 2013 and 2015 to close an expected revenue gap[16] and significantly reduce this levy from 2016 onward. According to the latest tax estimate, tax revenue is set to provide further relief. Although, in contrast to the first quarter, the transfers to the EU linked to gross national income are not expected to decline for the year as a whole, the tax estimate envisages an overall improvement of €2 billion compared with the budget estimates. Interest expenditure developments are likely to have a somewhat greater impact still. Instead of the estimated renewed rise of €3 billion compared with the actual figure for 2015, a further decline seems plausible. It now looks likely that the number of persons granted refugee status will probably increase less strongly this year than had previously seemed plausible owing to the larger amount of time needed to process and reach a decision on asylum applications and the significantly lower influx of refugees of late. Therefore, from today's perspective, the calculated target figure for spending on unemployment benefit II (means-tested benefit), with only very modest growth, could perhaps even be adhered to or only moderately exceeded. Moreover, the budget appropriations should provide enough scope – not least given the sharp fall in the VBL recapitalisation levy – to finance the agreed rise in negotiated pay rates of 2.4% from March 2016 onward, even if this is also adopted in full for civil ser-

15 Although any profit exceeding €2½ billion is not used to directly finance the current central government budget but is rather to be transferred to the refugee reserve, the transfer to the reserve does not have an impact on the fiscal balance described here. The same applies symmetrically to the planned withdrawals from the reserve, which had been estimated at €6 billion for the current year.
16 Considerable funding gaps had previously been expected with regard to the supplementary pension provisions for salaried employees in the west German settlement group. However, these gaps have evidently turned out to be smaller than forecast, meaning that the additional levy of 2% on an extrapolated historical volume of salaries was not required. A rate of 0.14% applies from 2016 onward.

vants, despite the stated level of funds (€500 million) seeming to be somewhat on the tight side. Overall, the central government budget can thus be expected to record a significantly better than planned result, provided no unpleasant surprises occur. If this is the case, it might then be able to achieve its goal of no net borrowing in 2016 without having to draw on the reserves. Including the expected limited deficits for the off-budget entities included under the debt brake, the central government budget would thus comfortably comply with the upper limit for the structural balance of -0.35% of GDP (-€10 billion).[17]

Benchmark figures for upcoming budgets: need for action in 2018 and running-down of buffers

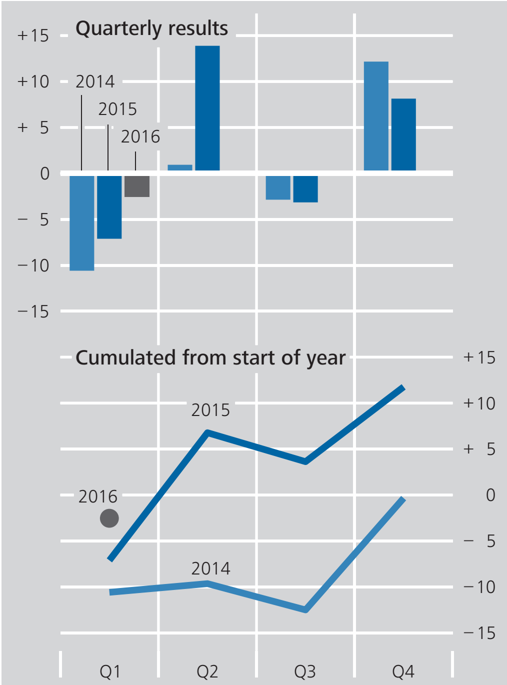
In March 2016, the Federal Cabinet adopted the benchmark figures for the 2017 budget and the fiscal planning up to 2020.[18] As in the medium-term fiscal planning of summer 2015, the government is still aiming to avoid net borrowing. With regard to the burdens stemming from refugee migration, the remaining reserve funds of €6½ billion based on the plans for 2016 are to be spent in 2017. For 2018, a global cut in expenditure in this amount – making up no less than 2% of the central government budget – is then envisaged. For the years thereafter, it appears that the high global revenue shortfalls previously factored in as safety margins have been correspondingly reduced. It is not clear from the publications what provisions are included regarding the promise made by central government in autumn 2015 to assume part of the refugee costs incurred by state government or regarding the envisaged additional payments by central government in connection with the 2020 reform of federal financial relations.

Expected relief for debt service payments to be spent

Even though it is likely that central government's financial situation in 2016 will develop significantly better than planned and the latest tax estimate suggests that tax revenue will be somewhat higher than presumed in the benchmark figures in the coming years, too, it seems that central government has limited room for manoeuvre in the medium term if it is to keep achieving a budget with no net borrowing.

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.

Deutsche Bundesbank

Compared with the last medium-term plan from summer 2015, the estimates for interest expenditure were reduced to an ever greater extent from one year to the next (it seems that, for 2019, it was reduced by almost €8 billion, or around three-tenths of the amount estimated back then). The amounts thus freed up have been earmarked, *inter alia*, to further increase defence expenditure. Furthermore, an additional benefits package was put together, which is estimated to total almost €2½ billion in 2017. This includes, in particular, an increase

17 For further information on the concepts and terms, see Deutsche Bundesbank, Key central government budget data in connection with the debt brake, Monthly Report, February 2016, pp 68-69. If the structural result deviates from the upper limit, this is recorded in the control account. In a welcome step, the extensive total balance for this account that was accrued during the transitional period from 2011 up to and including 2015 – not least on account of the starting figure for the deficit reduction path being set too high – was cancelled.

18 As in previous years, the published data permit only a rough analysis as key figures such as the balances of the financial transactions and the off-budget entities to be included have not been published.

in spending on labour market integration for persons entitled to unemployment benefit II as well as on housing construction subsidies.

Advisable to build up safety margins again

It appears advisable to place greater emphasis on building up safety margins vis-à-vis the deficit ceilings in the plans again in order to ensure that there is still budgetary leeway, even if any unpleasant surprises occur, and to make provision for the looming demographic burdens. If the refugee reserve – recourse to which, in any case, only affects net borrowing and not the deficit – is not needed to finance migration costs, it could be depleted and used to repay debts. This would ensure that a key intention of the debt brake, namely to ensure a structurally close-to-balance general government budget as required by the EU rules, would not be jeopardised by reserve movements. A more rapid reduction of the central government debt ratio induced by increased safety margins would also accommodate additional burdens in the event of future interest rate hikes.

Surplus of off-budget entities likely to turn into deficit in 2016

At the start of the year, the Federal Ministry of Finance recorded a deficit of €3½ billion for central government's off-budget entities that are recorded in the quarterly data,[19] following a surplus of €2½ billion one year previously. In particular, burdens of just over €2 billion from the repayment of a ten-year inflation-indexed Federal bond[20] and from passing on revenue that had been booked to the Restructuring Fund in the previous year had an impact. A marked deterioration is also on the cards for the year as a whole. For example, the Flood assistance fund is expected to see a significant acceleration in outflows in the next few quarters, not least owing to central government's plans to reclaim €1½ billion in funds that are no longer required. During the remainder of the year, the fact that central government made special transfers of €3½ billion to the Fund to promote municipal investment and €1½ billion to the Energy and climate fund in 2015 for the advance funding of future expenditure will also have a negative impact on the year-on-year comparison of results. Furthermore, the Restructuring Fund will cease to receive revenue of €1½ billion because, in future, it will no longer be used to forward the bank levy to the European fund. Lastly, no repayment of capital aid to SoFFin is expected in 2016. Overall, the surplus of €9 billion recorded in 2015 by the off-budget entities included in the data is expected to turn into a deficit in 2016.

State government budgets[21]

Marked surplus in 2016 Q1 thanks to high revenue growth

According to the monthly cash statistics, state government's core budgets recorded a surplus of €2 billion in the first quarter of 2016, following a broadly balanced result in the same period of 2015. Revenue rose significantly by 6% (€5 billion). This was mainly attributable to continued growth in tax revenue (+7½%, or €4½ billion). The upturn in current transfers from public administrations, including central government funds to be passed on to the municipalities, was somewhat more moderate (+3½%). On the expenditure side, an overall increase of 3½% (just under €3 billion) was recorded. As a result of expenditure overruns in connection with accommodating and additionally supporting refugees, other operating expenditure (+20%, or just under €1½ billion) and current transfers to municipalities (+8%, or €1½ billion) accounted for by far the highest rates of growth. In the case of personnel expenditure (+3%, or €1 billion), one particular factor that made itself felt – alongside the pay rises stemming from the 2015 pay round and the increases in civil servant pay that are mostly linked to this – was the additional ongoing strong rise in pension payments. The sharp de-

19 This notably does not include bad banks and other entities keeping commercial accounts. The results of the Postal workers' pension fund and the ERP special fund, which had recorded a total surplus of €1 billion one year previously, were not yet available.
20 In the national accounts, the burdens had already been recorded as interest expenditure for the respective period when the central government funds were transferred to the precautionary fund in question.
21 The development of local government finances in 2015 was analysed in greater detail in the short articles in the Bundesbank's April 2016 Monthly Report. These are the most recent data available.

cline in interest expenditure (-€1 billion) continued to provide relief.

Temporary budgetary deterioration in 2016

According to the latest tax estimate (which also reflects the impact of court rulings), growth in tax revenue is expected to wane during the remainder of the year (+3½% for the year as a whole, excluding local government tax receipts of the city states). At the same time, refugee-related spending is likely to be up significantly on the year despite the lower influx of refugees of late. However, the total figure for the state government budgets of around €20 billion, as recently given by state government representatives, cannot be derived directly from the budget plans. Based on standard cost rates, distinctly lower burdens appear plausible from today's perspective, even though it is likely that not all expenditure will be directly linked to the number of refugees to be provided for. Overall, state government could record a deficit again in 2016 after still achieving a surplus in 2015. However, from 2017 onward, stable growth in tax revenue should provide relief again and, at the same time, expenditure on support for refugees could decrease. This is because, for example, after being granted asylum status, the costs of supporting the refugees through means-tested benefits are borne by central government. Nevertheless, there are potential risks for state government if rejected asylum applicants do not leave the country quickly, as envisaged. The distribution of costs between central and state government is currently being renegotiated. However, even if this does not result in large-scale additional relief for state government, its financial situation is set to improve again from 2017 onward.

Fundamental strengthening of individual responsibility of federal states desirable

A fundamental reform of financial relations in the German federal system, including follow-up provisions for the financial equalisation system that will expire at the end of 2019, in particular, is still on the agenda. Above all, the state government proposal presented at the end of 2015 envisaged considerably higher central government funds (an additional €9½ billion) and evidently had a strong focus on the financial distribution effects between the federal states.[22] It would thus not offer any significant improvement in terms of greater transparency and less complexity, and the negative incentives associated with the large-scale levelling-out of differences in fiscal revenue would remain virtually unchanged. The opportunity for reform should be used to enhance the transparency of the financial equalisation system and to strengthen the federal states' individual financial responsibility. It appears advisable, not least with regard to the debt brake that will apply from 2020 onward, to extend the budgetary scope of the individual federal states. Limited surcharges or discounts on income tax appear important in this context, notably so that the citizens of the federal states can clearly see that the states have assumed individual responsibility – something that has quite rightly often been emphasised by state government.

Social security funds[23]

Statutory pension insurance scheme

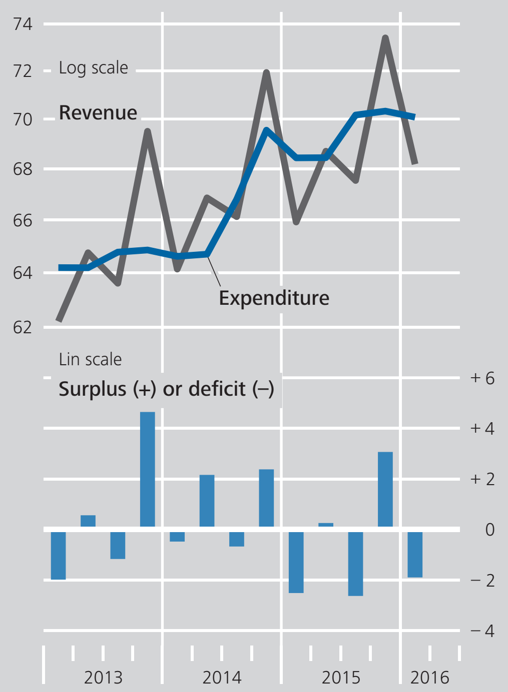
Somewhat lower deficit in 2016 Q1, but …

The statutory pension insurance scheme recorded a deficit of €2 billion in the first quarter of 2016. Compared with the same period last year, this constituted an improvement of €½ billion. Expenditure rose by 2½%. The pace of growth had already tapered off in the final quarter of 2015, having been significantly higher for a while due to the benefit increases under the pension benefits package (in particular, the mothers' pension and the full pension without actuarial deductions from the age of 63). At 3½%, revenue rose considerably more

22 For more information on this subject, see also Deutsche Bundesbank, Public finances, Monthly Report, February 2016, p 72. For an in-depth discussion on the topic, see Deutsche Bundesbank, The reform of financial relations in the German federal system, Monthly Report, September 2014, pp 33-52.
23 The financial development of the statutory health and public long-term care insurance schemes in 2015 was analysed in the short articles of the March 2016 and April 2016 Monthly Reports. These are the most recent data available.

Finances of the German statutory pension insurance scheme

€ billion, quarterly data



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

sharply in the first quarter, with contribution receipts increasing by as much as 4% owing to favourable employment and wage developments.

… significant burden due to high mid-year pension increase

In mid-2016, there will be a very sharp rise in pensions, of 4.25% in the west German states and 5.95% in the east German states. In addition to significant wage growth, the cut in the contribution rate last year (from 18.9% to 18.7%) also had a positive impact on the pension adjustment. Moreover, the sustainability factor means that the current decline in the pensioner ratio,[24] particularly owing to favourable employment developments, will likewise result in a stronger rise in pensions. Lastly, the correction of a statistical special effect will push up pensions by a further percentage point.[25] For the year as a whole, an increased deficit (2015: €2 billion, according to preliminary data) and thus a more rapid depletion of the reserves are on the cards in the wake of the particularly strong pension increase.

Looking ahead: rising contribution rates and falling pensions

Given the deficits generally envisaged for the coming years, the contribution rate will need to be raised again within a few years in order to comply with the statutory lower limit for the fluctuation reserve of 0.2 times the scheme's monthly expenditure. Looking ahead, once the "demographic lull" has come to an end, pensions will increase more slowly than average pay and the relative pension level will consequently fall – although a lower limit of 43% is to be maintained up until 2030.[26] The statutory retirement age will gradually be raised to 67 years by 2029, with no further increase planned as yet for the years thereafter.

Create transparency in current discussion on benefit increases

A political debate is currently taking place on changes to the statutory pension insurance scheme. In this context, it would be helpful for the Federal Government to present long-term projections in order to provide transparency regarding the developments that it expects. It is currently the case (and has been since the end of the 1980s) that projections in this regard have only been made for the period up to and including 2030. It is crucial that this forecast horizon be extended so as to reveal the financial outlook for state pensions in the light of demographic trends and to provide insured persons with as good a planning basis as possible.

24 The pensioner ratio is the number of "equivalent pensioners" (number of standard pensioners, calculated by dividing pension expenditure by the standard pension amount) relative to the number of "equivalent contribution payers" (number of average contribution payers, calculated by dividing the contribution receipts by the pension contribution of the average earner).
25 The revision of the national accounts in 2014 led to growth in gross wages and salaries being around 1 percentage point slower in 2015 (compared with the unrevised prior-year figure used to calculate the pension adjustment). In accordance with the pension formula, this automatically resulted in a corresponding pension decrease in mid-2015. This is now being corrected because the pension adjustment ultimately stays broadly in line with changes in the statutory pension insurance scheme's income subject to compulsory insurance contributions over time.
26 The lower limit refers to the pre-tax pension level, ie the ratio of the standard pension (given average earnings over 45 contribution years) less contributions to the health and long-term care insurance schemes to average pay less social contributions.

Pension-drawing period will automatically increase if statutory retirement age is not raised

The long-term financing of the statutory pension insurance scheme can ultimately be ensured through the three main levers of benefit level, contribution rate and statutory retirement age.[27] If the increase in the burden of contributions is to be kept in check and the pension level is to be reduced at least no more sharply than so far planned, a further increase in the statutory retirement age will be unavoidable. Otherwise, the continued expansion of individual pension-drawing periods in relation to previous contribution periods owing to increasing life expectancy would keep up the pressure to raise the contribution rate or further reduce the pension level. As its finances are still in good shape, measures placing substantial new burdens on the statutory pension insurance scheme were recently agreed. By contrast, some other countries have, for example, started indexing the statutory retirement age – including beyond 67 years of age – as a rule-based method of preventing relative pension-drawing periods from automatically increasing owing to longer life expectancy. Rules governing early retirement owing to incapacity for work are also important in this context – such rules are already in place at present, however.

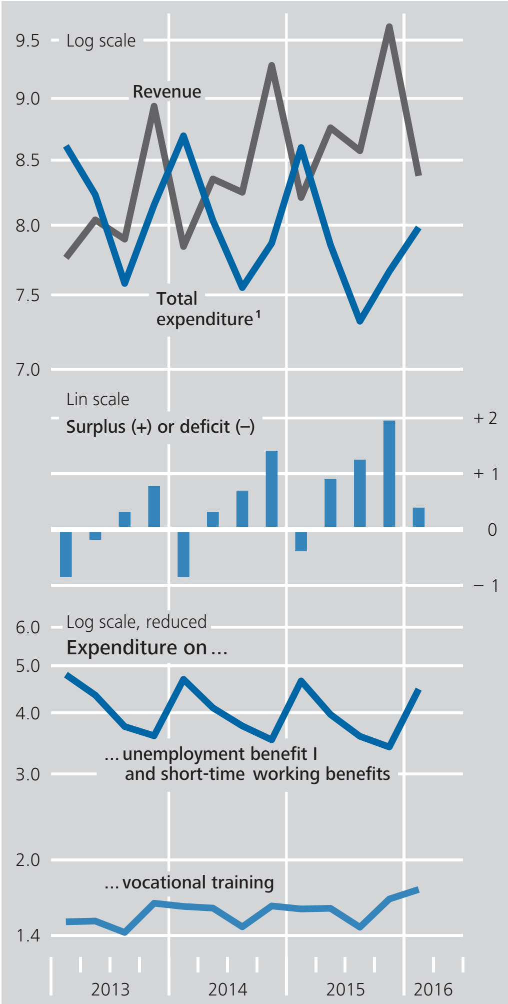
Federal Employment Agency

Further improvement in finances at start of year

In the first quarter of 2016, the Federal Employment Agency posted a surplus of €½ billion, which constituted a year-on-year improvement of almost €1 billion.[28] This is partly due to a one-off refund from the VBL, which reduced the Federal Employment Agency's administrative costs, in particular. The part attributable to the administration of unemployment benefit II payments ultimately benefits central government; its refunds of administrative costs in this regard were correspondingly lower in the first quarter. This contributed to revenue rising only moderately, by +2% overall. Furthermore, continued robust growth in contributions (almost 4½%) was set against revenue shortfalls resulting from the reduction in insolvency benefit contributions. On the expenditure side, in addition to the one-off effect in the case of administrative costs described above, lower expenditure on unemployment benefit I (insurance-related benefit; -4½%) and phased retirement subsidies (which are being discontinued; -68%) had an impact, in particular. By contrast, for the first time in a while there was once again significant growth in spending on active labour market policy measures (+9½%), two-thirds of

Finances of the Federal Employment Agency

€ billion, quarterly data



Source: Federal Employment Agency. **1** Including transfers to the civil servants' pension fund.
Deutsche Bundesbank

27 Furthermore, extensive central government grants are provided that should, however, only be used to finance non-insurance-related benefits.
28 The report refers to the operational area of the Federal Employment Agency, ie not including the Civil servant pension fund.

which was attributable to (one-off) additional expenditure on language courses for refugees. Overall, the Federal Employment Agency's expenditure decreased by just over 7% in the first quarter.

Rising surplus for year as a whole despite additional employment promotion benefits

Contribution receipts are also expected to continue to record strong growth for the year as a whole. The decline in spending on unemployment benefit I could likewise continue given the generally favourable developments anticipated in the labour market.[29] The Federal Employment Agency's budget envisages a marked increase in spending on active labour market policy measures owing to the influx of refugees, but this is set against sharp falls in subsidies for phased retirement, which are being discontinued. Overall, a higher year-on-year surplus (just over €3½ billion) is already on the cards.

Finance tasks facing society as a whole through tax revenue – consider contribution rate cut if any financial leeway

As a general rule, the Federal Employment Agency's non-insurance-related benefits should be financed through tax revenue, as tasks facing society as a whole would otherwise be financed solely by those whose income is subject to compulsory contributions (up to the maximum level of earnings subject to contributions). If, for example, the Federal Employment Agency were to assume the costs of integrating refugees, this would be at odds with this principle. Should the Federal Employment Agency identify any financial leeway, this should be used to the benefit of the contribution payers. Generally speaking, the Federal Employment Agency's budget is highly cyclical, and it thus makes sense to build up larger reserves when times are good. If it is assumed that the current extremely favourable labour market situation, with low unemployment figures among contribution payers, will prove sustainable, the option of cutting the contribution rate could, given the associated increase in reserves, be considered.

29 Persons granted asylum who are initially unemployed do not play a role in this context as they are not yet entitled to claim unemployment benefit I, which is financed by contributions.