

■ Public finances*

■ General government budget

2016: renewed surplus and ...

Germany's public finances are continuing to shape up well. Although the fiscal balance may dip slightly this year, it is set to remain in comfortably positive territory (2015: 0.7% of gross domestic product (GDP)). The country's fiscal stance is distinctly expansionary on the expenditure side, which is partially obscured by favourable cyclical factors and a further decline in interest expenditure. For example, spending on support for refugees has increased significantly on the year. This is largely due to the fact that the majority of asylum seekers did not arrive until autumn of last year, meaning that the costs incurred in 2015 as a whole were still comparatively low. In addition, expenditure by central, state and local government in areas such as child day care and transport infrastructure is rising, and the social security funds' expenditure on healthcare, pensions and long-term care is increasing markedly.

... receding debt ratio

The debt ratio stood at 70.1% at the end of the second quarter of 2016. The ratio's decline compared with the level recorded at the end of 2015 (71.2%) is solely attributable to growth in nominal GDP in the ratio's denominator. The gross debt level rose, however. While liabilities were reduced markedly at state government level,¹ central government liabilities increased significantly. Factors contributing to the latter development included mounting debt as a result of financing the accumulation of money market deposits and the provision of cash collateral for existing derivative transactions by its bad bank (FMS Wertmanagement). In the absence of further one-off effects, the debt ratio decline is set to accelerate as the year progresses.

Similar surplus and further fall in debt ratio in 2017

As things currently stand, it appears that the surplus will remain broadly unchanged and the debt ratio will continue to fall in the year ahead. Cyclical factors and further diminishing interest expenditure are likely to provide additional relief for public finances. Furthermore, the lion's share of

the proceeds from the frequency auction in summer 2015 will be recorded in the national accounts in 2017 (on an accrual basis as the frequency bands become available).² By contrast, the structural primary surplus is set to shrink once again, in an indication of ongoing moderately expansionary fiscal policy. On the revenue side, tax cuts should be more or less offset by fiscal drag³ and the raised contribution rate for the public long-term care insurance scheme. On the expenditure side, spending in connection with refugee migration may remain broadly stable: while, on the one hand, the level of assistance needed by refugees who are already in Germany is slowly tapering off, the relatively low number of (new) migrants generally expected would, on the other hand, entail only limited additional spending. However, significant expenditure hikes are expected in other areas, such as long-term care and pensions, in the coming year as well.⁴

* The section entitled "General government budget" relates to 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 finance statistics (which are generally in line with the budget accounts).

¹ The mid-year acquisition of HSH Nordbank's risk assets at the market price of €2½ billion (pushing up the debt level) is taken into account here. The haircut applied in connection with the transfer of a total of €2½ billion decreased state government's fiscal balance in the national accounts by €1½ billion due to recourse to the second loss guarantee. The loss retained by HSH Nordbank amounted to €1 billion.

² This will temporarily improve the balance by €4 billion.

³ In this context, the term "fiscal drag" encompasses the overall revenue effect of bracket creep in income taxation and the countervailing impact of the fact that specific excise duties are largely independent of prices.

⁴ Factors such as the United Kingdom's vote to leave the EU are causing uncertainty, although the short-term impact of this on Germany's public finances appears manageable. There are risks stemming from pending court proceedings in connection with the phasing-out of nuclear energy and in relation to the nuclear fuel tax. In addition, a federal foundation that is expected to be recorded in the general government sector is planned; this is to cover the future costs of radioactive waste disposal (see also footnote 32 on p 68). The transactions are unlikely to have an impact on general government's fiscal balance in the national accounts for the foreseeable future. The Maastricht debt level would fall if financial resources transferred to the fund were invested in German government bonds and thus consolidated in the general government sector.

Structural surpluses appropriate given demographic situation ...

Germany's general government budget has recorded a marked structural surplus in the past two years. The national fiscal framework reform in 2009 is likely to have contributed significantly to the fact that the highly favourable setting for Germany's public finances⁵ was utilised to achieve this sound budgetary position and thus, not least, to provide to some extent against foreseeable demographic burdens. In the light of the latest long-term sustainability analyses, a structural primary surplus matching the level recently achieved (and the associated rapid reduction of the debt ratio) does not appear overambitious by any means. In fact, the projections reveal that there is still a consolidation gap that will need to be closed at a later date.⁶

... and also advisable as safety margin below budget limits

Irrespective of this, it is still advisable for Germany to maintain moderate structural surpluses. As was demonstrated in 2015 when refugee migration spiked, safety margins below the budget ceilings make it possible to keep public finances on a steady course within stipulated borrowing limits, ie without the objectives of the budgetary rules being undermined by a purportedly inevitable need to water them down.⁷ By contrast, with respect to calls for Germany to provide additional fiscal stimulus with the particular aim of supporting the economies of other euro-area member states, it should be noted that the impact on these other states would likely be rather limited.⁸ Two much more crucial factors are structural reforms in individual euro-area countries – including Germany – and the stabilisation of the regulatory framework of European economic and monetary union.⁹ The latter point also covers binding fiscal rules, with Germany taking centre stage as a stability anchor.

Approaches to improving underlying conditions

There are various fiscal policy approaches that Germany could pursue to improve its economic framework conditions. For example, greater prominence could be given to areas of expenditure that boost growth and employment (such as infrastructure provision, education and child day care) and, in general, efficiency reserves

could be exploited. With respect to pensions, long-term care and healthcare, it is important to note that demographic change will give rise to long-term spending pressure. This should be taken into account when deciding on any further benefit increases, even if these can be temporarily covered by existing reserves – with the impact perhaps going virtually unnoticed at first – or if their effect will not be fully felt until further down the road. In the case of the statutory pension insurance scheme, due consideration has to be given to the long term. In this context, it is important to make reliable early policy decisions so that, if necessary, insured persons can secure a pension level that suits their wishes by building up a supplementary private pension. Further rises in the statutory retirement age in line with life expectancy should not be ruled out. Instead, they could make a key contribution to stabilising the provision of pensions via the statutory pension insurance scheme at a level deemed appropriate while keeping contribution increases within sustainable bounds.¹⁰

⁵ Despite the rise in the debt ratio, the interest expenditure ratio has dipped by around one percentage point over the last ten years owing to falling interest rates. The decline in structural unemployment has reduced labour market-related expenditure on a similar scale. Tax revenue has largely exceeded expectations perceptibly in recent years, with profit-related taxes rising especially sharply.

⁶ 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.

⁷ It is recommended that safety margins be maintained below the strict national budget limits, mainly in view of the considerable uncertainty in estimating the structural budget situation, which has seen some substantial downward revisions in the past. In the absence of any margin below the limit prior to such revisions, they may necessitate short-term and potentially procyclical consolidation measures. By contrast, if safety margins are factored in as a matter of course, these can be temporarily depleted in the event of unpleasant surprises so that the necessary adjustments can be spread over a longer period.

⁸ See also Deutsche Bundesbank, *The international spillover effects of an expansion of public investment in Germany*, Monthly Report, August 2016, pp 13-17.

⁹ See also Deutsche Bundesbank, *Approaches to strengthening the regulatory framework of European monetary union*, Monthly Report, March 2015, pp 15-39; and Deutsche Bundesbank, *Approaches to resolving sovereign debt crises in the euro area*, Monthly Report, July 2016, pp 41-62.

¹⁰ See also Deutsche Bundesbank, *Excursus: longer-term pension developments*, Monthly Report, August 2016, pp 68-77.

Reduce burden of taxes and social contributions

It is appropriate for the Federal Employment Agency to hold comparatively high reserves formed from surpluses built up during favourable economic periods in order to absorb the strong cyclical fluctuations in its finances. However, in view of the reserves now available, thought could be given to lowering the contribution rate in order to reduce expected further surpluses. Should central, state and local government be left with budgetary leeway after achieving the desired safety margins, it stands to reason that the tax burden be reduced. The tax ratio has once again reached the relatively high level recorded at the turn of the millennium. Against this background, it would be worth considering cutting income tax, not least the solidarity surcharge.¹¹

Budgetary development of central, state and local government

Tax revenue

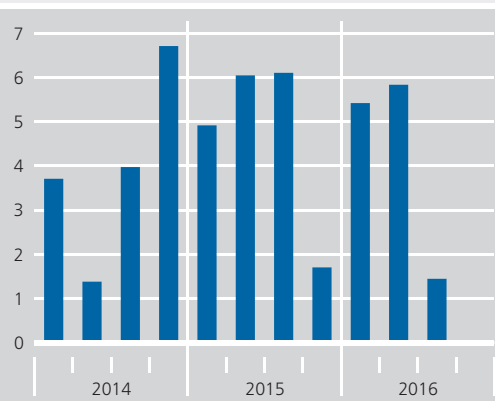
Subdued growth in Q3 ...

Year-on-year growth in tax revenue¹² in the third quarter of 2016 amounted to only 1½% and was thus distinctly weaker than in the first half of the year (see the adjacent chart and the table on page 64). This was attributable to shifted payments of non-assessed taxes on earnings (earlier distribution dates) during the year, as well as exceptional tobacco tax developments.¹³ Following strong growth in the first half of the year, revenue from both tax types subsequently fell. The increase in wage tax receipts was dampened year-on-year by a tax cut.¹⁴ Despite the aforementioned decline in tax payments on dividends, revenue from profit-related taxes climbed by 3%. In particular, high growth in revenue from corporation tax and assessed income tax continued unabated. By contrast, the rise in turnover tax revenue was markedly smaller: while developments over the course of the year are generally highly volatile, these were compounded by the negative impact of a one-off effect.

... owing mainly to expected one-off factors

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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According to the latest official tax estimate, tax revenue (including local government taxes) is forecast to rise by 3½% for the year as a whole. Given a favourable development in the macro-economic reference variables for tax revenue,¹⁵ this will be curbed by the fact that large-scale

Full-year revenue rise dampened by tax refunds and reductions

¹¹ As an add-on to income taxes imposed by central government, the solidarity surcharge is linked to the existence of particular financing needs and was (re)introduced in the mid-1990s to cover costs relating to reunification. Central government's special-purpose grants to the east German states for infrastructure reconstruction in eastern Germany will be discontinued at the end of 2019. Any undesirable distributional effects that arise as a result of phasing out the solidarity surcharge could be mitigated by making adjustments to income tax rates and child benefit.

¹² Including transfers to the EU budget – which are deducted from German tax revenue – but excluding receipts from local government taxes, which are not yet known for the quarter under review.

¹³ Tobacco companies have been required to print “shock images” on tobacco product packaging since 20 May 2016. In the run-up to this legislation being introduced, the pre-production and purchase of tax stamps was temporarily ramped up significantly.

¹⁴ At the beginning of the year, the basic tax allowance and child tax allowance were raised and the other income tax thresholds “shifted to the right” (specified tax rates only apply to higher taxable income). The simultaneous raising of child benefit, which is deducted from revenue, likewise reduces wage tax receipts in the government finance statistics.

¹⁵ This estimate is based on the Federal Government's current macroeconomic projection. According to this, GDP is expected to rise by 1.8% in real terms and 3.4% in nominal terms in 2016 (May: +1.7% and +3.6%, respectively). The corresponding growth rates for 2017 are 1.4% and 3.1% (May: +1.5% and +3.3%, respectively), while increases of 1.6% and 3.2% are assumed for 2018 (May: +1.5% and +3.2%, respectively). In the medium term, nominal growth of around 3% per annum is still forecast.

Tax revenue

Type of tax	Q1 to Q3				Estimate for 2016 ^{1,2}	Q3			
	2015		2016			2015		2016	
	€ billion		Year-on-year change € billion	%	Year-on-year change %	€ billion		Year-on-year change € billion	%
Tax revenue, total ²	453.4	472.5	+ 19.1	+ 4.2	+ 3.6	153.3	155.5	+ 2.2	+ 1.4
<i>of which</i>									
Wage tax	129.1	132.6	+ 3.5	+ 2.7	+ 3.0	43.3	44.7	+ 1.4	+ 3.2
Profit-related taxes ³	72.9	80.9	+ 8.0	+ 10.9	+ 7.4	22.8	23.5	+ 0.7	+ 3.2
Assessed income tax	36.1	39.4	+ 3.3	+ 9.1	+ 8.9	10.7	11.9	+ 1.2	+ 11.5
Corporation tax	15.7	21.3	+ 5.6	+ 35.4	+ 19.8	4.5	5.5	+ 1.1	+ 24.6
Investment income tax ⁴	21.0	20.1	- 0.9	- 4.2	- 4.5	7.6	6.0	- 1.6	- 21.0
Turnover taxes ⁵	155.8	161.0	+ 5.2	+ 3.3	+ 3.5	53.2	53.9	+ 0.7	+ 1.3
Energy tax	24.4	24.6	+ 0.3	+ 1.0	+ 1.0	10.2	10.1	- 0.0	- 0.1
Tobacco tax	9.9	9.9	- 0.0	- 0.2	- 2.5	4.0	3.0	- 1.0	- 24.4

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

tax refunds remain on the cards in the final quarter of 2016 owing to court rulings, some of which were made some time ago (mainly regarding corporation tax and local business tax).¹⁶ Furthermore, this will be accompanied by shortfalls resulting from amendments to tax legislation. The main change in this regard is the aforementioned cut in income tax. The gradual changeover to downstream taxation of pensions will also continue to cause revenue shortfalls to a limited extent.

Renewed rise in growth expected for 2017 and subsequent years

A renewed rise in tax revenue growth, amounting to 4%, is expected in 2017. While growth in the macroeconomic reference variables for tax revenue will fall somewhat compared with this year, it is assumed that the bulk of the significant strain placed on tax revenue by court rulings will be lifted.¹⁷ The impact of legislative changes will also reduce revenue growth a little less than in 2016.¹⁸ Average annual growth rates of 3½% are forecast for the years 2018 to 2021. The projected developments are shaped

primarily by macroeconomic growth assumptions and fiscal drag. Legislative changes that have already been approved will only slightly dampen the impact of fiscal drag over the remainder of the forecast horizon. The tax ratio (as defined in the government finance statistics) is therefore projected to increase significantly.

16 In 2016, these predominantly relate to the rulings by the Federal Fiscal Court of 25 June 2014 (IR 33/09) and of 30 July 2014 (IR 74/12) on section 40a of the Act on Asset Management Companies (Gesetz über Kapitalanlagegesellschaften) and STEKO (section 8b (3) of the Corporation Tax Act (Körperschaftsteuergesetz)) (see also Bundestags-Drucksache 18/5560) as well as the Federal Fiscal Court ruling of 17 December 2014 (IR 39/14). In the government finance statistics, these tax refunds reduce revenue at the time of payment. By contrast, they are recorded in the national accounts as government spending (capital transfers) at the time of the final ruling (accrual basis).

17 Most of the projected revenue shortfall in 2017 is attributable to only one court ruling – the European Court of Justice ruling of 20 October 2011 (C-284-09).

18 The Working Party on Tax Revenue Forecasting issues projections on the basis of current tax legislation. The income tax changes that are currently planned have therefore not yet been taken into account, but they will place only a fairly small strain on tax revenue growth, at least in the coming year.

cantly to 22.9% by the end of the forecast period in 2021 (2015: 22.2%).

Revenue expectations raised for 2016, confirmed for 2017 and revised downwards slightly for subsequent years

The May 2016 forecast has thus been revised upwards for the current year (+€4½ billion). The most significant factor in this is that tax revenue, particularly from profit-related taxes, has so far performed more favourably than expected in terms of cash receipts. The higher baseline is set to remain in place, to some extent, in the years to come. However, the impact of the macroeconomic setting's downward revision is of dominating relevance here. While the May forecast was largely confirmed for the coming year (+€½ billion), annual revenue shortfalls are anticipated as of 2018, which are expected to reach €1½ billion in 2020.

Central government budget

Slightly higher deficit in Q3 despite easing one-off effects

Central government posted a €3½ billion deficit in the third quarter of 2016 compared with a deficit of just over €3 billion one year previously. Revenue fell by 1% (€½ billion). This was mainly due to the decline in tax revenue, which, even after factoring out the €3 billion increase in transfers to the EU budget,¹⁹ failed to inch upwards. By contrast, relief was provided in the form of the scheduled one-off payment of €1½ billion from the flood relief fund, in particular, but also in the form of higher guarantee repayments. Decreasing by ½%, expenditure fell at a somewhat weaker pace than revenue. While significant growth was recorded, particularly for current transfers (+€3 billion),²⁰ this was once again counteracted by a marked decline in interest expenditure (just over -€1 billion, with higher premiums on new issues accounting for two-thirds thereof).²¹ In addition, €3½ billion was transferred to the fund to promote municipal investment last year, which was not repeated in the third quarter of 2016. Excluding this factor as well as the funds received from the flood relief fund and the one-off burdens arising in connection with EU transfers, the bal-

ance – at €2 billion – deteriorated to a somewhat greater degree.

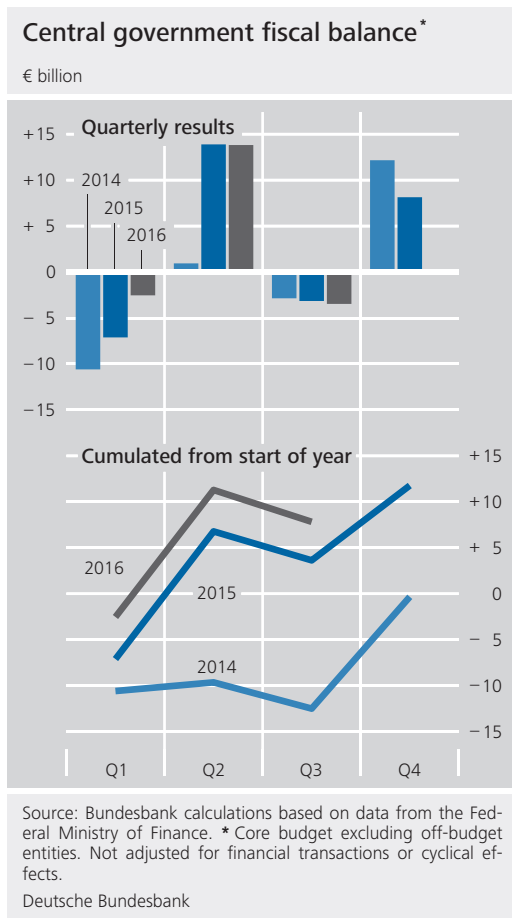
After three quarters, the central government budget is now running a surplus of almost €8 billion, marking a year-on-year improvement of no less than €4 billion. By contrast, a deficit of €6½ billion, and therefore a considerable deterioration of €18 billion compared with the actual result in 2015, was envisaged in the budget plan for 2016 as a whole. Taking the latest tax estimate as a basis and incorporating the transfer of turnover tax revenue to state government in the form of the flat immigrant integration payment (€2 billion) and the final settlement of the lump-sum refugee payments that is to be brought forward (€2½ billion), both of which have already been approved by the Federal Government, a €3 billion year-on-year reduction in tax revenue is on the cards in the final quarter. Higher transfers to the social security funds and state governments, in particular, are also likely to continue putting pressure on the budget. Furthermore, a supplementary budget is expected, enabling another round of pre-financing of the fund to promote municipal investment. Consequently, as things stand today, a negative result for the final quarter is possible (compared with a surplus of €8 billion one year previously, with a one-off transfer of €1½ billion to the energy and climate fund).

Marked surplus rather than planned deficit likely for year as a whole

¹⁹ Transfers to the EU reduce central government's tax revenue. In the first half of 2016, it had decreased by €5 billion on the year. Compared with the expectations outlined in the latest tax estimate (year as a whole: reduction of €2 billion compared with 2015), the developments in the third quarter are to be deemed a one-off equalising movement.

²⁰ Including, most notably, higher transfers to the health insurance fund and the statutory pension insurance scheme, state governments and – in connection with tackling the root causes of refugee migration, it would appear – foreign countries. By contrast, payments of unemployment benefit II (means-tested benefit) also contained here largely stagnated despite the higher number of recognised refugees, the majority of whom are presumably in need.

²¹ In the government finance statistics – unlike in the national accounts – premiums and discounts on the nominal value of government bond issues are recorded immediately in their full amount rather than on an accrual basis. This can result in substantial relief (€5½ billion so far in 2016) but also in corresponding burdens. It would appear advisable to harmonise the way in which such items are recorded with the method used in the national accounts.



That being said, it seems feasible that central government will run another marked surplus for the year as a whole. Pursuant to the Budget Act (*Haushaltsgesetz*), this is to be transferred to the refugee reserve, which is likely to grow to well over €15 billion as a result. According to the accounting practice selected by the Federal Ministry of Finance, the pending amount to be credited to the control account under the debt brake rules will be lowered accordingly.²²

Draft budget for 2017 with reserve-financed deficit expanded at early stage to include further burdens

At the beginning of July, the Federal Government adopted a draft 2017 budget with no net borrowing.²³ According to the draft, a deficit of €7 billion is to be financed by taking recourse to the arithmetical remainder of the refugee reserve. Later in July, a flat immigrant integration payment of €2 billion – which had not yet been factored into the draft budget – was earmarked for the state governments in 2017 as well. A tax reduction package was subsequently also put together and is set to place a €1 billion strain on the central government budget next

year. In addition, besides a dividend cut of €½ billion, Deutsche Bahn is to be granted a capital injection of €1 billion. Furthermore, additional financial assistance was pledged to other countries such as Afghanistan to tackle the root causes of refugee migration.

It was against this backdrop that the final deliberations of the German Bundestag's Budget Committee took place in mid-November. The decision to forgo any net borrowing was reaffirmed. Pursuant to the latest tax estimate, projected revenue was upped by €4 billion. However, the additional burdens – most of which have already been described – arising from legislative changes that have not yet been finalised (€4½ billion) and the lower dividend paid out by Deutsche Bahn were accompanied by the reversal of a global revenue shortfall item of €1½ billion,²⁴ meaning that estimated revenue was increased by €½ billion in net terms. Besides the additional outlays previously mentioned, one item to take a prominent position on the expenditure side is additional spending on internal security. Total additional expenditure is largely offset (but for €½ billion) by decreases in projected spending in connection with long-term unemployment and estimated global savings of €2 billion, in particular. The planned withdrawal from the refugee reserve was therefore not adjusted, resulting in an unchanged deficit of €7 billion.

Budget balanced in final deliberations, not least by means of global savings

With regard to the debt brake, the Federal Ministry of Finance estimates a cyclical burden of

²² Positive differences between the structural budget outturn and the constitutional borrowing limit (-€10 billion in 2016, including the relevant off-budget entities) are to be credited to the control account. In the event of unfavourable developments at the budget implementation stage, the limit can, under certain conditions, be exceeded to a limited extent and the control account debited accordingly. By contrast, it is not possible to cover structural financing gaps in regular budgetary planning by making withdrawals from the control account. This fundamental principle was bypassed by the reserve.

²³ See Deutsche Bundesbank, Public finances, Monthly Report, August 2016, pp 63-65.

²⁴ The primary aim of this was evidently to make provision for expenditure in connection with the lump-sum refugee payment (now €1 billion), which had not yet been specified in draft legislation in July.

Planned structural deficit with only moderate safety margin

€2 billion²⁵ and a deficit of €½ billion arising from financial transactions in the 2017 central government budget. The limit of -0.35% of GDP (-€10½ billion) also includes three off-budget entities – the flood relief fund, the fund to promote municipal investment, and the energy and climate fund – whose planned overall deficit appears to have been revised only slightly vis-à-vis the figure projected in the summer (€3½ billion). If the 2017 central government budget's structural result were, in the same way as the previous budget, calculated by including no net borrowing, but the planned recourse to the refugee reserve eased budgetary burdens, the updated draft central government budget would contain a structural minus of only €½ billion overall. By contrast, an approach based on EU fiscal rules would, in the case of the core budget as well, be linked to the fiscal balance (instead of net borrowing), which is unaffected in profit and loss terms by the withdrawal from the reserve.²⁶ The structural fiscal balance is therefore markedly less favourable than the indicator used by the Federal Ministry of Finance to assess compliance with the debt brake. Its target figure is -€7½ billion, which would leave only a moderate safety margin below the limit. Overall, however, developments could once again be significantly more favourable than estimated.²⁷

Worth considering dissolving refugee reserve for formal debt repayment

Central government now appears able to sufficiently gauge additional burdens in connection with the temporarily very high influx of refugees. Since it would also appear, all other things being equal, to be well absorbed within the budget, it would be worth considering dissolving the reserve in the near future. This precautionary item, which was established at the end of 2015 as a buffer for unforeseeable expenditure in connection with refugee migration, could then be used in the budget to repay a portion of central government's high debt.²⁸

Risk provisions in financial plan no longer sufficient to cover planned costs

In line with standard practice, central government's financial plan for the 2018 to 2020 period was not updated in the Budget Committee's final deliberations on the 2017 budget.

The €7 billion global revenue shortfalls budgeted as risk provisions for 2018 minus the revenue shortfalls of €2½ billion from the latest tax estimate may no longer be sufficient to cover the planned financial relief for local government, which, combined with the flat immigrant integration payment guaranteed until 2018 and the envisaged tax cut, will cost the central government budget €10 billion. Consequently, without recourse to the reserve mentioned above, a certain amount of borrowing would be necessary. In addition, relatively large global cost savings of €3 billion are still projected. For the final year of the financial plan (2020) too, factoring in the somewhat lower new tax estimate, the envisaged global revenue shortfalls are no longer sufficient to additionally cover the further funds (€9½ billion²⁹) pledged by central government for the new state government financial equalisation system.³⁰ However, in addition to the fact that leaving a safety margin as a buffer for unex-

²⁵ The determination that Germany will find itself in an unfavourable economic situation is consistent with the European Commission's assessment. However, the Bundesbank – much like the institutions involved in the Joint Economic Forecast, the German Council of Economic Experts, the IMF and the OECD – assumes that economic conditions will be favourable in the coming year, which would accordingly suggest cyclical relief for the central government budget.

²⁶ The national debt brake is designed to also ensure compliance with European fiscal rules. They relate to the fiscal balance in the national accounts – which is likewise unaffected by the withdrawal from the reserve.

²⁷ For instance, in the case of interest expenditure, a notable rebound compared with the projected result for 2016 is expected.

²⁸ For a critical evaluation of the reserve in the context of the debt brake, see also previous quarterly reports, eg Deutsche Bundesbank, Public finances, Monthly Report, November 2015, pp 64-66. According to the documents published as this report went to press, a provision was at least included in the final deliberations to allocate the portion of the Bundesbank's profit distribution that exceeds the budgeted amount to the investment and repayment fund (instead of to the reserve), which could then pay off debt.

²⁹ The financial plan already took account of the fact that the divestiture grants (€2½ billion, paid to the state governments as compensation for the 2006 agreement to end co-financing of several tasks) and the special-need supplementary central government grants for infrastructure reconstruction in eastern Germany (€2 billion) will both be discontinued in 2019.

³⁰ If central government continues to post better budget outturns, however, it is conceivable that these costs may still be absorbed.

pected burdens would be advisable, demographic developments and the extremely low interest rates both mean that it would in fact be sensible to better prepare for forthcoming burdens and aim to achieve a moderate structural surplus again.

Significantly worse outcome for off-budget entities in Q3 but balanced annual result possible

The aggregate result for central government's off-budget entities³¹ in the Federal Ministry of Finance's quarterly overviews was a deficit of €1½ billion in the third quarter of 2016, following a surplus of €4½ billion a year earlier. The surplus recorded a year previously was largely the result of a €3½ billion central government transfer to the fund to promote municipal investment. Outflows from this fund were still very limited at last report. Deutsche Pfandbriefbank's €1 billion repayment of a capital injection to the Financial Market Stabilisation Fund (SoFFin) in 2015 also had a negative impact on the year-on-year figure. In arithmetical terms, the deficit recorded for the third quarter of 2016 was due on balance to a scheduled one-off repayment of €1½ billion from the flood relief fund to the central government budget. The off-budget entities could achieve a roughly balanced budget for the year as a whole. Although there were already notable net outflows in the first half of the year, especially from the restructuring fund (because of revenue from 2015 being forwarded to the new single resolution fund (SRF) for banks) and from the fund created to cover additional repayment costs due to inflation-linked Federal securities. However, these deficits could be offset, alongside the surpluses likely to be posted by the off-budget entities set up to cover the costs of civil servant pensions, if prefinancing of the fund to promote municipal investment continues – as is apparently planned.

Another roughly balanced budget possible in 2017

Next year, the off-budget entities could record a similar result. Perceptible outflows are likely, not least from the fund to promote municipal investment. Nonetheless, the off-budget entities set up to cover the costs of civil servant pensions are set to continue posting surpluses, and – given that inflation is expected to rise and

transfers from the central government budget are thus likely to increase – the precautionary fund created to cover additional repayment costs due to inflation-linked Federal securities will probably also record a marked surplus.³²

State government budgets³³

State government's finances deteriorated in the third quarter. According to the monthly cash statistics, state government's core budgets were slightly in deficit (-€½ billion, compared with +€2 billion in the same period last year). Revenue rose by 2½% (€2 billion). Tax revenue growth (+3%) was significantly weaker than in the previous quarters, while the revenue received from public administrations (especially transfers from central government) saw a large increase (+6%). Expenditure expanded by just under 6% (or €4½ billion) and thus much more strongly than revenue. This was mainly due to the sharp increase in current transfers to local government (just under 12%, or just over €2 billion), which was apparently related, in particular, to support for refugees. The transfers from state government to the municipalities also included financial support forwarded from central government, which had been increased. The strong growth in other operating expenditure, which was likewise connected with the immigration of refugees, continued at a somewhat slower pace (+12%, or just under €1 billion). The rise in personnel expenditure remained moderate (+3%) in comparison.

Deterioration in 2016 Q3 amid strong expenditure growth

³¹ This notably does not include bad banks and entities keeping commercial accounts.

³² Under the Federal Government's draft legislation of 19 October 2016 on reforming responsibility for nuclear waste management, operators of nuclear power plants are to pay a basic fee of €17½ billion to a federal foundation (fund for financing nuclear waste disposal). Operators will be able to purchase an exemption from secondary liability by paying a surcharge totalling €6 billion. They will also have the option of paying in instalments subject to 4½% interest. However, the use of commercial double-entry bookkeeping makes it unlikely that the foundation will be included in this reporting group.

³³ The short articles in the Bundesbank's October 2016 Monthly Report contain a more detailed analysis of the development of local government finances in the second quarter of 2016. These are the most recent data available.

Reimbursements of refugee-related costs mean no deterioration in 2016 as a whole, and surpluses still likely thereafter

Thus far, the fiscal situation has generally been expected to worsen in the year as a whole. As recently as the Stability Council meeting in the early summer, state government was still expecting a core budget deficit of €9½ billion and thus a very clear deterioration on the previous year (surplus of just under €½ billion).³⁴ However, state government posted an improvement of €1 billion for the first three quarters of 2016. Burdens on the revenue side are still likely because of considerable tax refunds due to court rulings, yet the Federal Cabinet has now decided to bring forward the final settlement of the lump-sum refugee payments agreed from 2016 onwards. This back payment of €2½ billion means that state government finances should at least not deteriorate in 2016 as a whole. In the subsequent years, given marked increases in tax revenue,³⁵ a likely fall in payments related to the immigration of refugees and continued relief from low interest rates, state government as a whole can be expected to record ongoing surpluses.

Decision on the reform of central-state government financial relations from 2020 to the detriment of central government ...

In October, central government and the federal states agreed on key points for the reform of federal financial relations from 2020. The main focus is on abolishing the state government revenue-sharing scheme (narrowly defined) and thus putting an end to direct payments from financially strong to financially weak states (€9½ billion in 2015). Under these plans, differences in financial capacity will be evened out in future via distribution of the state government share in turnover tax revenue³⁶ – which is to be increased by €4 billion at the expense of central government – and via those supplementary central government grants which vary depending on a federal state's financial capacity and are due to rise from €4½ billion in 2019 to just over €7 billion (based on the regionalised tax estimate of May 2016). In addition, new supplementary central government grants totalling €1½ billion are to be introduced for federal states containing municipalities with particularly weak financial capacity (eastern Germany and Saarland). On the other hand, special assistance for infrastructure re-

construction in eastern Germany (€2 billion in 2019) and the divestiture funds³⁷ (€2½ billion), which are subject to separate rules, will both be discontinued. Under the new system, the existing transfers to address the higher cost of political administration in smaller states (€½ billion) and to offset burdens caused by long-term unemployment in eastern Germany (€¾ billion) will continue, and new central government transfers for states receiving below-average central government funding to promote research (€¼ billion) will be introduced. Moreover, budgetary restructuring assistance totalling €800 million per year is to be paid to Bremen and Saarland from 2020 onwards – apparently indefinitely.³⁸ The new financial equalisation system will apply indefinitely unless, after 2030, central government or at least three federal states call for a reform.³⁹

34 Whole-year data are derived from the results of the quarterly cash statistics. Unlike the monthly statistics, which showed a surplus of almost €3 billion, the year-end figures for 2015 apparently still included, most notably, transfers to off-budget entities which drove down the core budget balance.

35 The latest tax estimate, for example, puts growth in state government tax revenue for the 2017 to 2021 period at an average annual rate of 3½% and thus somewhat stronger than that in nominal GDP.

36 Two-thirds of the additional turnover tax funds will be granted as a fixed amount (fixed in nominal terms), the remaining third via a higher state government share (dynamically adjusted). In future, the state government share in turnover tax will essentially still be distributed among the states according to population size, but additional surcharges and discounts are to be applied, amounting to 63% of the deviation in financial capacity from the relevant reference value. When calculating this equalisation amount, the higher population weighting for the city-states and three sparsely populated non-city states will be maintained and the share of local government financial capacity to be taken into account will be raised from 64% to 75%.

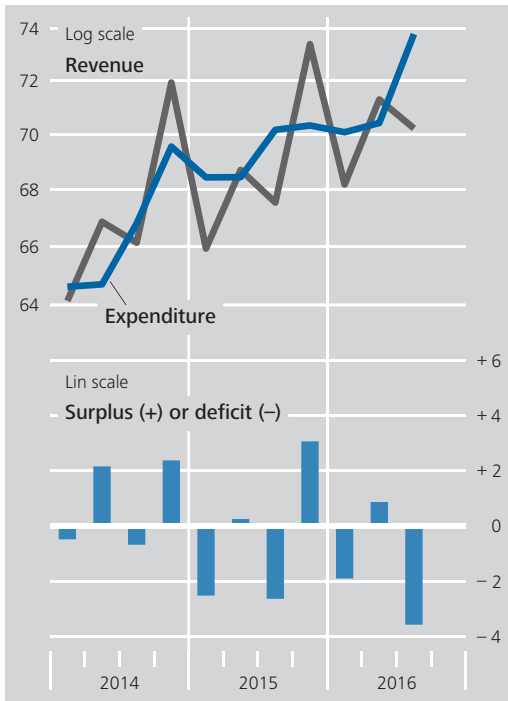
37 Since the 2006 federal structure reform, the divestiture funds have been paid as compensation for tasks previously co-financed by central government, such as university construction.

38 Under the existing arrangements, the two states are to receive temporary consolidation assistance totalling €560 million up to 2019, half of which is funded by state government as a whole. The precondition for this is that Bremen and Saarland meet their consolidation requirements. The intention was actually to achieve a structurally balanced budget from 2020 (the first year in which the debt brake will take full effect) and rule out any further need for special assistance.

39 In that case, the existing arrangements will continue to apply for no more than five years.

Finances of the German statutory pension insurance scheme

€ billion, quarterly data



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

... and does not strengthen states' individual responsibility

The decisions taken on the financial equalisation system are essentially in line with the proposal made by the state governments in December 2015 and will entail a considerable financial burden for central government (€9½ billion in 2020). The agreement should allow all states to comply with the debt brake from 2020 onwards.⁴⁰ However, a detailed assessment of the plans is not possible at present as many details have yet to be negotiated. Although the plans have the merit of simplifying the system to some degree, if the new, apparently discretionary central government grants are factored in, the proposed new arrangements are not significantly more transparent. They do not appear to substantially strengthen incentives for state governments to act on their own responsibility. The logic for maintaining and considerably increasing special assistance for Bremen and Saarland is not easy to follow unless this support is subject to a time limit and strict conditions, eg on debt repayment. All in all, the agreement represents a missed oppor-

tunity to fundamentally reform Germany's fiscal constitution. The option of extending state government tax-setting powers, eg to introduce income tax surcharges and discounts, would have been worthy of consideration, also with a view to ensuring compliance with the debt brake.⁴¹

In addition, the agreement envisages a stronger role for the Stability Council, which is to monitor central and state government compliance with the debt brake rules.⁴² Here, much will hinge on the detail of the Stability Council's powers, eg regarding penalties for infringements. Another crucial element will be to obtain a transparent and reproducible comparative overview of central government and individual state government budgetary developments and planning which factors in relevant burdens affecting off-budget entities and possibly also local governments. In addition to budget balances, this overview should show key revenue and expenditure categories (with separate recording of financial transactions, budgeted global spending cuts and global add-

Plans to strengthen role of the Stability Council ...

⁴⁰ According to the sample calculations (based on the regionalised result of the May 2016 tax estimate) in the annex to the decision, all states will achieve a significant improvement of at least around €80 per capita once the existing temporary special assistance has been discontinued, with the eastern German states – which will be particularly affected by this phase-out – faring noticeably better. Thanks to the budgetary restructuring assistance, Saarland and, above all, Bremen ultimately see a much stronger increase of €490 and €730 per capita, respectively. See Annex to press release No 369 from the Federal Government of Germany, 14 October 2016. The impression this gives is that the motivation behind the numerous transfers is not so much economic as the desire for a specific distribution of funds.

⁴¹ See Deutsche Bundesbank, The reform of financial relations in the German federal system, Monthly Report, September 2014, pp 33-52; and German Council of Economic Experts, Annual Report 2016/17, November 2016, p 35 f.

⁴² This monitoring is to be carried out using comparable data. It must also take account of European rules and procedures. This is welcome given that the aim of additionally safeguarding compliance with European budget rules by way of the national debt brake is enshrined in the German constitution. Should the European rules differ from the debt brake requirements, both limits would have to be met.

itional revenue) and deviations of budget estimates from the latest official tax estimate.⁴³

... and end state responsibility for motorway management are welcome, but specific arrangements important

Other important new rules concern the allocation of responsibilities within the federal system. On the one hand, the constitutional limit on central government investment grants to municipalities for education infrastructure is to be loosened. Additional investment may be required for schools, for example. However, primary responsibility for supporting municipalities with weak financial capacity lies with state government.⁴⁴ In addition, this would again result in a starker mismatch between responsibility for tasks and their funding, which should fundamentally be viewed critically. On the other hand, there are plans for central government, which provides most of the funding for motorways, to manage them too (planning, construction and operation) and to set up a private infrastructure company for that purpose. This could potentially address inefficiencies in planning and construction associated with the current arrangements, in which orders are managed by state government on behalf of central government. Even so, it should be ensured that central government's debt brake is not circumvented by hiving this area off from the government accounts.

In the first three quarters combined, the deficit was still slightly down on the year. In view of the large pension increase, however, expenditure is also set to grow strongly in the fourth quarter of 2016. The deficit for the year as a whole can thus be expected to be around €1 billion higher than in the previous year (2015: €1½ billion), although this would be significantly below the budgeted figure (€4½ billion), primarily because of better-than-expected revenue growth. The reserve is again likely to exceed the standard upper limit of 1.5 times the scheme's monthly expenditure at the end of the year, albeit only relatively moderately. Nonetheless, as the scheme is set to stay in deficit, also in the coming years, it is safe to assume that the reserve will increasingly be below the upper limit from 2017 onwards. Current projections by the statutory pension insurance estimators assume that the contribution rate will remain unchanged up to and including 2021, as the reserve is still unlikely to fall below the lower reserve limit of 0.2 times the scheme's monthly expenditure throughout that period.

Stronger expenditure growth leads to a somewhat higher deficit for year as a whole

According to the latest calculations, the pension-to-earnings ratio in the statutory pension insurance scheme after 45 contribution years⁴⁷ will remain broadly stable up to the end of the decade, at around 48%. As the "baby

Pension reform being debated given demographic adjustment pressures

■ Social security funds⁴⁵

Statutory pension insurance scheme

Significant deficit in Q3

In the third quarter of 2016, the statutory pension insurance scheme recorded a deficit of €3½ billion, which constituted a year-on-year deterioration of €1 billion. Revenue was up by 4% on the year. This was due to a significant increase in contribution receipts (+4½%), which primarily reflected ongoing favourable pay and employment trends. At 5%, growth in expenditure was even stronger, however. This was mainly attributable to the very large mid-year pension increase (4.25% in western Germany and 5.95% in eastern Germany),⁴⁶ which was a key factor in the rise of nearly 5½% in outlays on pensions.

⁴³ See also Deutsche Bundesbank, The role of the Stability Council, Monthly Report, October 2011, pp 20-23. The Independent Advisory Board of the Stability Council also pointed out the limited transparency regarding state and local government finances; see Independent Advisory Board of the Stability Council, Second statement, On compliance with the upper limit for the structural general government deficit pursuant to Section 51 (2) of the Budgetary Principles Act (HGrG), 8 December 2014.

⁴⁴ See Deutsche Bundesbank, Local government finances: development and selected aspects, Monthly Report, October 2016, pp 13-36.

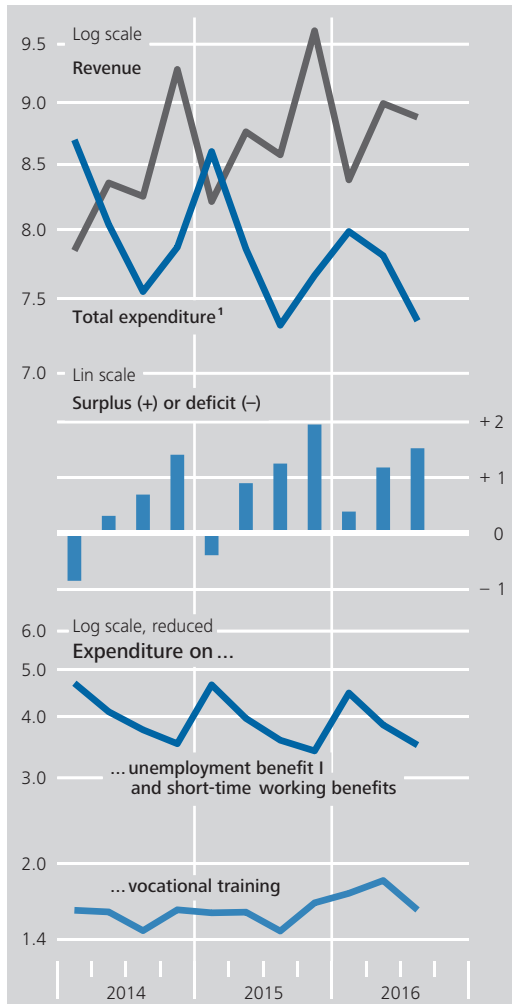
⁴⁵ The financial development of the public long-term care and statutory health insurance schemes in the second quarter of 2016 was discussed in the September Monthly Report. These are the most recent data available.

⁴⁶ The increase was driven up by a one-off factor, after being pushed down in mid-2015. See Deutsche Bundesbank, Public finances, Monthly Report, May 2016, p 72.

⁴⁷ The pension-to-earnings ratio in the statutory pension insurance scheme is the ratio of the standard pension (given average earnings over 45 contribution years) to average pay (before tax and less social contributions in both cases).

Finances of the Federal Employment Agency

€ billion, quarterly data



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

boomers" enter retirement from around the mid-2020s and life expectancy continues to rise, however, the pension-to-earnings ratio is set to fall in the years that follow. The long-term financial outlook for the statutory pension insurance scheme and the possibility of adjusting the contribution rate, pension-to-earnings ratio and statutory retirement age are currently being debated. Should the retirement age remain unchanged from 2030 onwards despite the fact that life expectancy is likely to go on rising, the phase in which pensions are drawn would grow increasingly longer while the number of working years would probably stay almost unchanged. This would place even

greater upward pressure on the contribution rate and/or downward pressure on the pension-to-earnings ratio.⁴⁸

Federal Employment Agency

The Federal Employment Agency (excluding the civil servants' pension fund) posted a surplus of €1½ billion in the third quarter of 2016. Compared with the same period last year, this constituted a further improvement of just under €½ billion. Revenue rose by 3½%. The strong growth in contribution receipts (+4½%) was countered by a fall in revenue from insolvency benefit contributions (the level of which was cut at the beginning of the year). The increase in total expenditure, at ½%, was significantly lower. Given a further decline in unemployment (also among contribution payers), outlays on unemployment benefit I (insurance-related benefit) continued to fall (-2%). In addition, less was spent on subsidised partial retirement, which is being phased out. By contrast, spending on active labour market policy measures grew strongly again (+10½%), probably mainly as a result of further marked increases in training for refugees.

Higher surplus in Q3, too

The positive trend is likely to continue in the final quarter of 2016. For the year as a whole, the surplus is set to increase significantly to €5 billion (2015: just over €3½ billion). It would thus again be substantially above the budget estimate (just under €2 billion). On both the revenue and expenditure sides, the Federal Employment Agency's finances are currently benefiting from favourable labour market developments. Its high surpluses, which are likely to continue, are probably partly cyclical and, as such, should not prompt any action. To limit the additional rise in the agency's reserves, the option of lowering the contribution rate should be considered.

Considerable surplus on horizon for year as a whole

⁴⁸ See Deutsche Bundesbank, Excursus: longer-term pension developments, Monthly Report, August 2016, pp 68-77.