Public finances*

General government budget

Continued marked surplus on cards for 2017

Despite the fiscal policy stance being expansionary overall, German public finances are still in good shape. The surplus for 2016 came to 0.8% of gross domestic product (GDP). However, it may shrink somewhat this year, although economic developments and a further decline in interest expenditure will ease the pressure on public coffers. This is being driven by relatively sharp hikes in expenditure, particularly on child day care, education, transport infrastructure and the armed forces. Furthermore, the social security funds' spending on healthcare and long-term care will gain momentum in the wake of new benefit expansions, while pension expenditure will rise significantly once again owing to the high mid-2016 pension increase. On the revenue side, the effect of bracket creep in income taxation[1] will be broadly offset by income tax cuts. The increase in the contribution rate to long-term care insurance will give revenue a boost, while growth in revenue from profit-related taxes will remain dynamic. However, other sources of government revenue, such as the Bundesbank's profit distribution, are lower.[2]

Under current policy, surpluses over next few years, but new fiscal measures could be adopted after Germany's general election

Debt ratio continuing to fall

Under the current policy, there looks set to be no major change to the fiscal balance over the next few years, thus implying further marked surpluses overall. However, new fiscal policy measures could be adopted following Germany's general election, which means that the outlook is fraught with uncertainty. As things currently stand, the debt ratio, which had fallen to 68.3% by the end of 2016, will remain on its downward trajectory. The ongoing winding-up of government-owned bad banks is also likely to contribute to the medium-term decline. According to the Federal Government's updated stability programme, which is based on the budget from mid-April, the general government surplus will hover at between ¼% and ½% of GDP up to 2021. Furthermore, in 2020, the debt ratio should be back below the 60% mark again for the first time since 2002.

Demographically driven rise in social contribution rates, but also potential for relief

Conditions for public finances have been highly favourable for some time. Against this backdrop, structural surpluses recorded since 2014 have been rather marked. In the past two years, falling financing costs, the positive labour market situation and the surging growth in tax revenue have masked what is essentially expansionary spending. While the latter was chiefly attributable to expenditure on refugees, spending on pensions, healthcare and long-term care, in particular, also rose significantly – not least on account of various benefit expansions. As a result of demographic change, the social security funds are set to feel the squeeze more acutely in the future. If benefits are expanded again, contribution rates will in any case need to be raised sooner and more sharply than anticipated. In the long term, further rises in the statutory retirement age in line with increasing life expectancy could curb the hike in the contribution rate and shore up pension levels.[3] In the statutory health insurance scheme, it may be possible to rein in continued strong expenditure growth by placing greater

---

* The section entitled "General government budget" relates to data from the national accounts and the Maastricht debt ratio. The subsequent more detailed reporting on the budgets of central, state and local government and of the social security funds pursuant to available data is based on the figures as defined in the government finance statistics (which are generally in line with the budget accounts).

1 In arithmetical terms, this is calculated as the rise in the revenue ratio resulting from the combination of the progressive tax scale and growth in (average) nominal income per capita. In other words, both growth offsetting general inflation and real growth are factored in.

2 More tangible risks to public finances are posed by ongoing proceedings before the Federal Constitutional Court concerning nuclear fuel tax. Furthermore, additional strains relating to HSH Nordbank could make themselves felt this year already. Overall, state government guarantees were issued to the bank in the amount of €10 billion, of which around €2 billion was called on last year already.

3 The positive impact on growth potential would also give a boost to central, state and local government tax revenue. See also Deutsche Bundesbank, Excursus: longer-term pension developments, Monthly Report, August 2016, pp 68-77.

Key data of the Federal Government's updated stability programme

Item	2016	2017	2018	2019	2020	2021
Real GDP growth (%)						
Stability programme April 2017	1.9	1.4	1.6	1.5	1.5	1.5
Stability programme April 2016	1.7	1.5	1.6	1.6	1.6	.
General government fiscal balance (% of GDP)						
Stability programme April 2017	0.8	½	¼	¼	½	½
Stability programme April 2016	0	0	0	0	0	.
Structural fiscal balance (% of GDP)						
Stability programme April 2017	0.8	½	¼	¼	½	½
Stability programme April 2016	0	0	0	0	0	.
Debt level (% of GDP)						
Stability programme April 2017	68.3	66¼	64	61¾	59¾	57
Stability programme April 2016	68¼	65¾	63½	61¼	59½	.

Source: Federal Ministry of Finance.
Deutsche Bundesbank

emphasis on improving cost-effectiveness.[4] Looking at the Federal Employment Agency, it would be worth considering lowering the contribution rate given its exceptionally good financial situation and the positive labour market outlook, thus limiting the further increase in reserves. This would be a way of easing the burden on employees and enterprises alike.

Moderate structural surpluses appropriate for central, state and local governments

Central, state and local governments have likewise recorded marked structural surpluses over the past three years. These surpluses can be used to reduce debt and lower interest expenditure, even if this is unlikely to have much of an effect on the budgets in the short term given the extremely favourable financing conditions. However, central, state and local governments are also set to be saddled with considerable burdens as a result of demographic change. On the expenditure side, these will be reflected largely in a rise in civil servants' pension benefits and the central government grant to the statutory pension insurance scheme. On the revenue side, the pace of tax revenue growth is likely to diminish on account of lower GDP trend growth and of social contributions placing a greater strain on the tax base. Bringing down the debt ratio rapidly is a key component in preparing for these challenges in the context of a fiscal policy oriented towards the longer term. It would also be advisable to factor structural surpluses into fiscal plans as this would allow their budgets to absorb temporarily unexpected shocks – the recent influx of refugees being one such example – without bending or breaching the budgetary rules. With this in mind, the surpluses mapped out in the stability programme appear appropriate overall.

Budgetary development of central, state and local government

Tax revenue

Dynamic growth in tax revenue in 2017 Q1

Year-on-year growth in tax revenue[5] came to 7% in the first quarter of 2017 (see the chart on page 63 and the table on page 64). At 6½%, growth in wage tax receipts was strong. However, this was partly attributable to the fact that the wage tax level was driven down (by around €0.7 billion) in January 2016 by the tax cut retroactively applied for 2015 as a whole. In view of the further tax cut implemented at the

4 See also Deutsche Bundesbank, Germany's statutory health insurance scheme: past developments and future challenges, Monthly Report, July 2014, pp 29-50.
5 Including EU shares in German tax revenue but excluding receipts from local government taxes, which are not yet known for the quarter under review.

Current fiscal developments in the euro area

2016: deficit decreases due to favourable economic developments and declining interest burden

Last year, the general government deficit ratio in the euro area fell from 2.1% to 1.5%. According to calculations by the European Commission, this was as a result of the positive impact of economic developments and low interest rates. The underlying fiscal stance (ie the change in the cyclically adjusted primary balance) was thus neutral. Factoring out burdens arising from bank support measures (2015: 0.2% of gross domestic product (GDP)), the stance was actually slightly expansionary. The debt ratio contracted from 92.6% to 91.4%. This was primarily driven by growth in nominal GDP (denominator effect). Given the deficits, debt rose, with interest expenditure of 2.2% of GDP being offset by a primary surplus of 0.7% of GDP.

No structural improvement on the horizon for coming years either

The European Commission expects only a marginal decline in the deficit ratio this year (to 1.4%). A slight loosening of the fiscal stance is being overshadowed by positive cyclical factors and relief from interest expenditure. The loosening is expected to be more pronounced in 2018; however, the national budgetary plans for that year have yet to be finalised. With economic developments[1] and interest expenditure remaining favourable, the deficit ratio is once again to contract slightly (to 1.3% of GDP). The debt ratio is set to continue the moderate decline that began in 2015 and fall to 89.0% by 2018.

Greek assistance programme remains topic of debate

Greece is the only euro-area country still in a European Stability Mechanism (ESM) programme. Fiscal developments there are thus to be assessed based on the targets for the assistance programme, rather than according to the European fiscal rules. The fiscal target of a primary surplus[2] of 0.5% of GDP agreed between the institutions involved (ESM, ECB, European Commission, International Monetary Fund (IMF)) and Greece was significantly exceeded in 2016 (by 3½% of GDP), though this was also due to temporary effects. According to the Commission's forecast, sufficient measures have been taken and planned to ensure that the primary surplus targets for 2017 (1.75% of GDP) and 2018 (3.5% of GDP) are met. However, the various institutions differed in opinion regarding the likelihood of achieving the targets. This, coupled with the fact that a need was seen to improve Greece's structural reforms, is delaying the second review of the current assistance programme. In the past, fundamental structural reforms were repeatedly found to have been insufficiently implemented.[3] To enable the review of the programme to be concluded successfully, measures have been agreed for 2018, 2019 and 2020, with measures for the latter two years primarily concerning taxes and pensions. On this

1 According to the Commission's forecast, the output gap will total only -½% in 2017 and close in 2018.
2 Under the assistance programme, the targets concern the general government primary balance, which deviates from the usual ESA definition in that, in particular, it does not include expenditure related to support for the banking sector or revenue from transfers in connection with the Eurosystem's SMP/ANFA transactions. There was no notable difference in 2016; the ESA primary balance amounted to 3.9% of GDP.
3 See 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 2017						Deadline for correcting excessive deficit
	Budget balance as a percentage of GDP			Government debt as a percentage of GDP			
	2016	2017	2018	2016	2017	2018	
Austria	− 1.6	− 1.3	− 1.0	84.6	82.8	81.2	–
Belgium	− 2.6	− 1.9	− 2.0	105.9	105.6	105.1	–
Cyprus	0.4	0.2	0.7	107.8	103.4	99.8	–
Estonia	0.3	− 0.3	− 0.5	9.5	9.5	9.6	–
Finland	− 1.9	− 2.2	− 1.8	63.6	65.5	66.2	–
France	− 3.4	− 3.0	− 3.2	96.0	96.4	96.7	2017
Germany	0.8	0.5	0.3	68.3	65.8	63.3	–
Greece	0.7	− 1.2	0.6	179.0	178.8	174.6	2016
Ireland	− 0.6	− 0.5	− 0.3	75.4	73.5	72.7	–
Italy	− 2.4	− 2.2	− 2.3	132.6	133.1	132.5	–
Latvia	0.0	− 0.8	− 1.8	40.1	38.5	36.0	–
Lithuania	0.3	− 0.4	− 0.2	40.2	42.4	38.9	–
Luxembourg	1.6	0.2	0.3	20.0	22.0	22.3	–
Malta	1.0	0.5	0.8	58.3	55.8	52.5	–
Netherlands	0.4	0.5	0.8	62.3	59.8	57.2	–
Portugal	− 2.0	− 1.8	− 1.9	130.4	128.5	126.2	2016
Slovakia	− 1.7	− 1.3	− 0.6	51.9	51.5	49.8	–
Slovenia	− 1.8	− 1.4	− 1.2	79.7	77.8	75.5	–
Spain	− 4.5	− 3.2	− 2.6	99.4	99.2	98.5	2018
Euro area	− 1.5	− 1.4	− 1.3	91.3	90.3	89.0	–

Source: European Commission.
Deutsche Bundesbank

basis, deficit-increasing measures will be accepted in the future under the proviso that these measures still enable the primary surplus targets to be achieved according to the forecast.

The IMF does not believe that Greece will be able to maintain the agreed target of a primary surplus of 3.5% of GDP beyond 2021. At the same time, with a lower surplus, it deems Greece's public finances unsustainable and is thus calling on European public lenders to grant substantial further debt relief before it will contribute financially to the current programme.

In May 2016, the Eurogroup had indeed held out the possibility of granting further debt relief by means of extending the repayment period and lowering interest rates after the third programme had been successfully concluded. At the same time, however, analyses conducted by the European institutions found that, if the agreed targets were maintained, there would be no need for a haircut on debt and the situation would be deemed sustainable.

There is no reason why a primary surplus of 3.5% of GDP cannot be maintained in the longer term. In fact, following the successful implementation of a fundamental reform process, this is especially likely to be the case. In the past, some countries have also managed to achieve similar or, in some cases, even higher primary surpluses for extended periods of time (Belgium, Finland and Italy). Moreover, the European fiscal rules, which will apply again once the programme comes to an end, stipulate structurally close-to-balance budgets. These provisions require more ambitious primary surpluses when debt levels are higher or interest rates are rising.[4] When the debt ratio

4 A ceiling of 3.5% (or lower) for the primary surplus would imply that the target anchored in the Stability and Growth Pact of a structurally close-to-balance budget no longer needs to be observed when debt ratios (and thus interest expenditure ratios) are high. This would fundamentally undermine the European fiscal rules.

falls, these levels can be reduced again. The current programme targets for Greece's primary surplus are thus in no way too tough and it would not be appropriate to ease them. It is essential to avoid giving the impression that the conditionality attached to fiscal programmes can be diluted if it is politically inopportune. Debt relief would also undermine the credibility of programme agreements and weaken the responsibility of the programme country, not least with regard to implementing reforms. Irrespective of this, an agreement may be reached to continue providing transfers due to other political considerations. However, the argument that sustainability cannot be achieved without debt relief is not a convincing one. If the programme were to be implemented in full and the fiscal targets reached, this would bring about a continuous decline in the debt ratio and thus re-establish sustainability.

As of 2017, hardly any infringements of 3% deficit ceiling but debt ratio still high in many cases

Portugal met its correction deadline (which had been extended a number of times) in 2016 with a deficit ratio of well under 3%. While France is expected to comply with the reference value on schedule in 2017 (after likewise having been granted a number of extensions), it is likely to breach the ceiling again in 2018 if no additional measures are taken. Spain is also on track to remain below the reference value by 2018 (here again following a number of extensions). Deficit ratios are falling in many of the other euro-area countries, too.

Yet given the fiscal rules, expected developments are unsatisfactory in many countries. Insufficient structural improvements are often masked by economic recovery and interest relief. In 2016, 11 member states either did not achieve their structural medium-term objective (MTO) and/or were subject to an excessive deficit procedure. Nonetheless, structural improvements, in both 2017 and 2018 in most cases, will fall short of the general requirement of 0.5% of GDP.[5] In 2017 and 2018, the structural deficit ratio is actually expected to increase in eight countries that still require fiscal consolidation even though the interest expenditure ratio will continue to fall. In 2018, only seven euro-area countries (Cyprus, Germany, Greece, Ireland, Luxembourg, Malta and the Netherlands) are set to attain the agreed MTO of a structural deficit of no more than 0.5% of GDP.

It is in precisely those countries that have a particularly high debt ratio that the debt ratio's trajectory leaves much to be desired. Based on a debt ratio of over 90% at the end of 2016, Belgium, Spain, France, Greece, Italy and Portugal are not likely to be able to reduce the distance to the 60% reference value by an average annual rate of one-twentieth by the end of 2018 as agreed in the rules.[6] In France and Italy, the debt ratio is actually set to increase on the 2016 level.[7] According to the Commission's forecast, Greece will have the highest debt ratio by far in 2018 (over 170%). But in Italy, Portugal and Belgium as well as Cyprus, Spain and France, too, the debt ratio will

5 As a general rule, both the preventive and the corrective arm of the Stability and Growth Pact prescribe structural improvements of 0.5% of GDP per annum. However, country-specific recommendations may deviate from this in both processes.
6 Future debt developments are thus not in line with the narrow definition of the debt rule. This requires that any debt exceeding the reference value of 60% of GDP has fallen at an average annual rate of one-twentieth in the previous three years. If this condition is deemed not to have been met ex post, one way in which this can be rectified is if it is expected to be met going forward. Furthermore, transitional provisions exist for those countries that were subject to an excessive deficit procedure at the time that this debt criterion was operationalised (November 2011). These provisions are valid for three years after the deficit procedure has come to a close.
7 The debt ratio is forecast to rise in Finland, too, climbing to 66% by 2018.

still be very high, at over or very close to 100%.

Calls for tighter fiscal fine-tuning not convincing

In order to safeguard the sustainability of public finances, euro-area fiscal rules stipulate deficit and debt ceilings as well as minimum consolidation requirements. Compliance with these rules enables the automatic stabilisers to take full effect, and exceptions are possible should a severe economic downturn arise. Maintaining an appropriate margin to the deficit and debt ceilings generally creates scope for a country to implement a nationally desired stabilisation policy. However, in recent years, the European Commission, among others, has steered the focus towards an attempt at fiscal fine-tuning and is increasingly applying the fiscal rules to this effect.

To avoid a continued rise in debt, active stabilisation policy must be used symmetrically, ie it must be just as often expansionary as it is contractionary and to the same degree of intensity. However, the trend is for the current situation to often be identified as a cyclical lull. For instance, in each of its autumn forecasts since 2002, the European Commission has predicted that around 90% of the EU-15 countries would have a negative output gap in the following year. This assessment was often revised upwards at a later date.[8] According to the Commission's current calculations (as well as those from autumn 2016), the euro area's overall capacity in 2017 is likely to be only moderately underutilised and the output gap is set to be more or less closed in 2018. Next to no negative gaps are expected in the individual euro-area countries either. Nevertheless, there have still been calls to make fiscal policy more expansionary overall and, if necessary, to delay consolidation, even if the European fiscal rules indicate otherwise.[9] Instead, in view of the continued very high debt ratios in some cases and the impending challenges posed by demographic trends, it would be advisable to strengthen the credibility of the European fiscal rules and to opt for a strict interpretation of the provisions.

In general, fiscal stimulus may be appropriate in times of severe economic crisis. However, in all other situations, the many and fundamental methodological and practical problems associated with attempts at economic fine-tuning serve as a warning to exercise restraint.[10] These problems do not become any less relevant in the case of a centralised management approach, such as a European facility to stabilise economic development, the establishment of which is regularly proposed. It would be worrying if this were to give rise to additional borrowing opportunities at the European level which would further undermine existing rules.

8 See also G Kempkes, Cyclical adjustment in fiscal rules: some evidence on real-time bias for EU-15 countries, Finanzarchiv 70 (2), pp 278-315. The EU-15 includes those countries that were members of the EU prior to the 2004 enlargement: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. A positive output gap was reported in only around 10% of cases for euro-area countries.
9 See Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Towards a positive fiscal stance for the euro area, Brussels, 16 November 2016, COM (2016) 727 final. Against the backdrop of a similar situation and developments in overall capacity utilisation, the European Commission called for additional fiscal easing for the euro area compared with national plans. The Commission itself noted that this was only "broadly compatible with the objective of fiscal sustainability". Compliance with the provisions of the Stability and Growth Pact would then be sidelined in favour of attempts at economic fine-tuning.
10 In addition to severe measurement and identification difficulties, not least with a view to the cyclical position, there is also uncertainty with regard to the effect of individual fiscal measures and, as a rule, considerable delays in the implementation thereof. Moreover, in the past, structurally low growth has often been mistaken for a slowdown in economic activity, with the result that fiscal easing, rather than solving the problem, actually led to a structural increase in government debt.

start of this year[6] as well, weaker growth is envisaged for 2017 as a whole. At 12½%, the pick-up in profit-related taxes was strong and broadly based across the different tax types. Only revenue from corporation tax stagnated. However, it had already reached a particularly high level in 2016. Revenue from non-assessed taxes on earnings, resulting mainly from investment income tax payments on dividends, rose especially steeply. This is probably due not least to shifted dividend payments during the year. Turnover tax revenue also increased relatively sharply (+5½%) but is generally rather volatile over the course of the year.

Weaker growth anticipated for year as whole

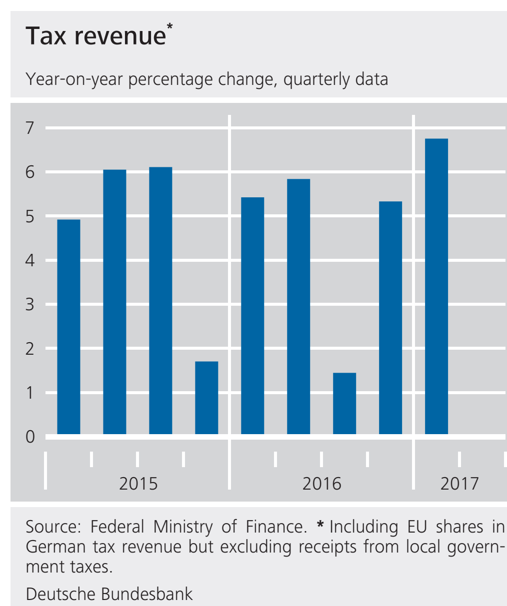
The latest official tax estimate expects revenue growth (including local government taxes) of 4% for 2017 as a whole. One contributing factor here is growth in the macroeconomic reference variables for tax revenue[7] being forecast as solid, while the second is the expected rise in profit-related tax revenue going significantly beyond what would be envisaged solely on the basis of these assumptions and the financial impact of changes in tax legislation and court rulings. This is due to favourable developments in the first quarter. However, growth will be markedly curbed by sizeable scheduled tax refunds owing to court rulings, some of which were made some time ago. Above all, this concerns revenue from profit-related taxes, particularly corporation tax, local business tax and non-assessed taxes on earnings.[8] Legislative changes are expected to reduce revenue growth distinctly, especially on account of the aforementioned income tax relief measures.

Similar revenue increases expected in years to come

At 3½%, somewhat lower tax revenue growth is forecast for the year ahead. The main reason for this is that there is not expected to be any renewed boost in profit-related taxes. Growth will be bolstered because the payments arising from court rulings are assumed to be lower than in the current year. Legislative changes are set to have less of a diminishing effect. Revenue growth of 4% is expected for the subsequent years up to 2021. Developments will primarily be determined by growth assumptions and fiscal drag. Tax cuts will curb growth only slightly. The tax ratio (as defined in the government finance statistics) is projected to increase significantly to 23.3% by the end of the forecast period (2016: 22.5%).

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

Revenue expectations up significantly overall

Compared with the November 2016 forecast, the budgeted figures have been revised upwards by €8 billion for 2017. This is due not

6 Income tax allowances were raised and income tax brackets shifted to the right with the primary aim of offsetting the fiscal drag stemming from the previous year's inflation. Child benefit, which is deducted from revenue, was likewise raised. The shortfalls for 2017 will amount to around €2 billion.

7 This estimate is based on central government's current macroeconomic projection from the end of April 2017. According to this, GDP is expected to rise by 1.5% in real terms and 3.0% in nominal terms in 2017 (November: 1.4% and 3.1%, respectively). GDP growth for 2018 is forecast to be 1.6% in real terms and 3.1% in nominal terms (November: 1.6% and 3.2%, respectively). In the medium term, nominal growth of around 3% per annum is still forecast.

8 This pertains, first and foremost, to court rulings (Federal Fiscal Court rulings I R 33/09 and I R 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. Moreover, shortfalls are expected as a result of a ruling by the European Court of Justice on the taxation of dividends paid to EU/EEA companies (case C-284/09) and owing to various other rulings. 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, 2014 and 2016), increasing expenditure. Consequently, tax revenue will rise at a sharper rate this year in the national accounts than in the government finance statistics.

Tax revenue

Type of tax	Q1 2016	Q1 2017		Estimate for 2017[1,2]
	€ billion		Year-on-year change %	Year-on-year change %
Tax revenue, total[2]	154.9	165.4	+ 6.8	+ 3.9
of which				
Wage tax	42.6	45.3	+ 6.4	+ 5.1
Profit-related taxes[3]	28.2	31.7	+ 12.3	+ 3.7
Assessed income tax	14.6	17.0	+ 16.7	+ 6.8
Corporation tax	8.4	8.5	+ 0.9	− 1.3
Investment income tax[4]	5.2	6.2	+ 18.4	+ 2.4
Turnover taxes[5]	54.4	57.5	+ 5.7	+ 4.8
Energy tax	4.6	4.8	+ 4.2	+ 0.3
Tobacco tax	2.7	2.6	− 3.1	+ 0.0

Sources: Federal Ministry of Finance and Bundesbank calculations. **1** According to official tax estimate of May 2017. **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

only to the annual result for 2016 being better than expected in November but also to the now significantly more optimistic outlook for profit-related taxes. By contrast, lower revenue will result from both new and expected, delayed shortfalls stemming from court rulings, additional legislative changes and a slight downward revision of macroeconomic assumptions. Estimates were raised, initially by a somewhat lesser amount for 2018 (+€5½ billion) and culminating in an increase of €16½ billion by 2021. Next year, adjustments in connection with the impact of court rulings will have a renewed, marked dampening effect on the upward revision, while the burdens arising from new legislative changes will also increase compared with the current year.

Central government budget

Surplus at start of year thanks to extraordinary rise in tax revenue and declining interest expenditure

Central government recorded a surplus of €3½ billion in the first quarter of 2017 compared with a deficit of €2½ billion one year previously. Revenue rose very sharply by 8½% (€7 billion). This was mainly due to an abrupt rise in tax receipts (+15½%, or €11 billion). Even if the transfers to the EU budget, which were reduced by €6½ billion, are factored out, revenue growth remains strong. By contrast, other income fell considerably, primarily because the Bundesbank's profit distribution was down by almost €3 billion. On the expenditure side, overall growth was very muted at 1% (€1 billion). While payments to the social security funds, in particular, were once again higher, interest expenditure dropped considerably once more on account of favourable refinancing in 2016 (almost -€1½ billion).

Budget outturn could be significantly better than planned; …

This year's budget plan runs a deficit of €7 billion.[9] Compared with the previous year's actual budget outturn, this would mark a pronounced deterioration of almost €13½ billion. However, as in preceding years, developments are set to be more favourable than planned. That said, the figures for the first quarter overstate the underlying trend, not least because high drawdowns of funds to the EU budget are still outstanding. According to the May tax estimate, central government is nevertheless expected to record additional revenue of €7 billion compared with the budget estimate. Interest expenditure could also prove more favourable, having been estimated as being €1 billion up on the previous year. There will be considerable savings due to lower refinancing costs, while there has, to date, been no decline in the very high premium payments observed last year. What can be described overall as imminent relief compared with the budget plan will significantly outstrip the global spending cuts[10] of €3 billion and the burden resulting from the Bun-

9 A €6½ billion withdrawal from the refugee reserve and coin seigniorage are planned to fund this without new borrowing (maintaining a "black zero", ie a balanced budget). Even in the absence of this withdrawal, which is included to provide budget relief, compliance with the debt brake would still be ensured.
10 Budgeting for global spending cuts means that cost savings in this amount must be made in the course of implementing the budget (which were not divided between the individual expenditure item entitlements).

desbank's profit, which was €2 billion lower than forecast. Overall, the budget could actually remain in surplus. This would mean that the refugee reserve, which was set up at the end of 2015 in response to the strong influx of refugees and now contains an already elevated total of €18½ billion, would grow further. It would still appear to make sense to dissolve this reserve in a timely manner by budgeting for debt repayment. It is clear that refugee immigration can be financed without making use of the reserve. If temporary withdrawals from the reserve were interpreted as a source for funding permanent spending, this would generate a risk of budget shortfalls in the medium term. Besides, such withdrawals would not be recognised as reducing the deficit under the European fiscal framework. Dissolving reserves to pay down debt envisaged in the budget would therefore also prevent a potential conflict with the European fiscal rules.[11]

… it would make sense to dissolve reserves to pay down debt

Budget benchmark figures show need for action in 2018 and full depletion of refugee reserve in 2019

In the benchmark figures adopted in mid-March for the 2018 budget and the financial plan up to 2021, the Federal Government maintains its goal of refraining from net new borrowing throughout the entire period. However, the figures do not indicate a structural balance, even though the associated deficit limit of 0.35% of GDP represents the linchpin of central government's debt brake.[12] Compared with the medium-term financial plan drawn up in summer 2016, the transfer of turnover tax revenue to state government in the form of a flat immigrant integration payment up to 2018, which has been adopted in the meantime, and the permanent municipal relief package of €5 billion per year from 2018 onwards were specifically incorporated. The same applies to the reform of federal financial relations from 2020 onwards due to soon be passed by the German parliament, which ultimately envisages a transfer of tax revenue, initially of €9½ billion, to state government. Moreover, the expenditure framework was expanded. As well as increasing defence spending, additional funds have been earmarked for internal security and economic cooperation, in particular. Unlike in previous years, there was no downward revision of estimated interest expenditure to create additional scope for spending. Instead, estimates for individual years were increased compared with previous financial plans. As a result, considerable shortfalls need to be plugged in order to achieve a balanced budget with no net borrowing. It is intended to partially close these gaps using funds that, in line with the planned 2017 budget deficit, will be left over in the refugee reserve (€8 billion in 2018 and €4 billion in the following year). Furthermore, an additional high global spending cut of €5 billion was included for 2018 in order to reach the target.

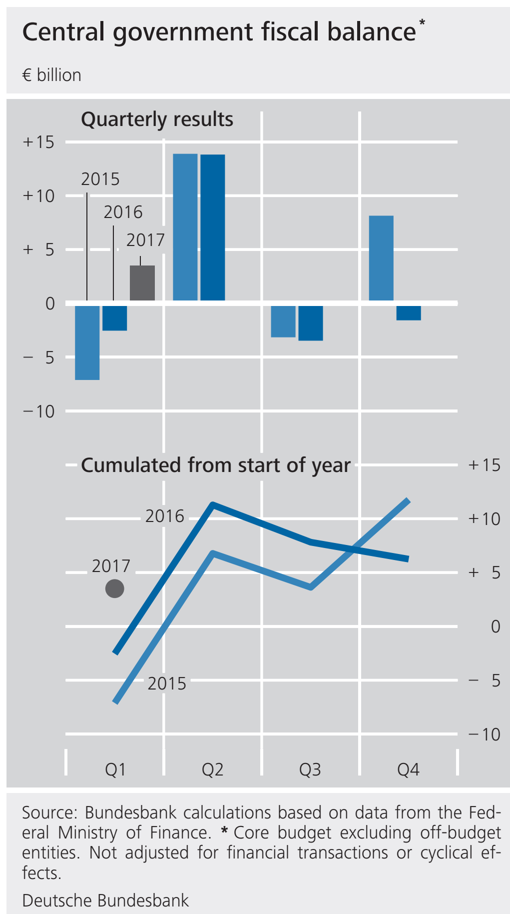
Marked safety margins still advisable

Only in 2021 do the benchmark figures appear to include a certain buffer to attain a balanced budget without net borrowing again. Revenue developments then lag behind the projected growth in tax receipts, probably due to an estimated global shortfall. According to the latest tax estimate, additional revenue is now expected to rise from €3 billion in 2018 to €7 billion in 2021 vis-à-vis the benchmark figures, resulting in a significant easing of the fiscal situation. However, it does not seem appropriate to fully use these or any other sources of relief to fund new budgetary burdens. There are significant uncertainties in terms of the plans. With regard to future macroeconomic developments and interest rates, these uncertainties refer not least to the international level. Overall, greater budgetary burdens – a lower profit distribution from the Bundesbank, for example – are also possible. In addition, the ratio of defence ministry expenditure to GDP is intended to remain virtually unchanged until 2021, whereas the NATO agreement could give rise to more stringent requirements. With this in mind, cautious planning seems appropriate overall. Generally speaking, it would make sense to plan moderate structural surpluses

11 See Deutsche Bundesbank, Public finances, Monthly Report, August 2016, pp 63-65.
12 As in previous years, there are no data on the balances arising from financial transactions and of the off-budget entities to be included.

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

and therefore safety margins with respect to the ceiling as defined in the debt brake rules. This would allow a short-term and potentially procyclical need for correction in the wake of negative surprises to be avoided. The imminent demographic strains highlight the need to aim for moderate surpluses, thereby limiting spending on servicing debt in a sustainable manner – also as a precautionary measure for future interest rate rises.

Significantly improved result from off-budget entities at start of 2017 …

Central government's off-budget entities[13] recorded a surplus of €½ billion at the start of the year, compared with a deficit of €3½ billion in the same period last year. At that time, the redemption of an inflation-linked Federal bond and the transmission of funds collected in the previous year from the bank levy to the new European resolution authority in particular had a negative effect. The surplus this year is ultimately attributable to pension-related entities whose revenues from transfers currently still significantly exceed the outflows. The deficits of the fund to promote municipal investment, recently raised to €7 billion, of the flood relief fund, established in 2013, and of the energy and climate fund remained low (€¼ billion in total). For the year as a whole, net expenditure from these three off-budget entities that are included in the debt brake could considerably lag behind the amount of just over €3 billion planned for in the central government budget. Given the expected surpluses for pension-related entities, overall the off-budget entities would thus record a slightly higher surplus than in the previous year (€½ billion).[14]

… and surplus anticipated once more for year as whole

State government budgets[15]

Higher surplus in Q1 due to substantially increased tax revenue and transfers with moderately increased spending

The positive development in the state government budgets continued in the first quarter of the current year. The surplus increased by €3½ billion on the year to €5½ billion. The strong growth in revenue (6½%, or €5½ billion) was primarily due to the development of tax revenue (+6½%, or €4½ billion) but current transfers from public administration also played a role (+13%). However, the latter also include central government funds which are to be forwarded to municipalities. This also applies to the increased contribution to accommodation costs for recipients of unemployment benefit II. Overall, increases in expenditure were considerably

13 The off-budget entities discussed here are those that are included in the Federal Ministry of Finance's quarterly data. This notably does not take into account bad banks and other entities keeping commercial accounts.
14 With the 2016 supplementary budget finally approved in the spring of 2017, a further transfer of €3½ billion was made to the fund to promote municipal investment, where the amount was also assigned to 2016. This transfer had not yet been booked when the Monthly Report for February 2017 went to press. It is possible that a new off-budget entity funding the final disposal of nuclear waste will be included in the reporting group going forward. Cash revenue of some €24 billion is expected from power plant associations in the current year following proof of compatibility with the EU rules on state aid. This will not affect the general government's national accounts balance.
15 The development of local government finances in 2016 was analysed in greater detail in the short articles in the April 2017 Monthly Report. These are the most recent data available. The data on state government budgets are based on the monthly cash statistics on the core budgets. For results including off-budget entities, see the statistical section of this report.

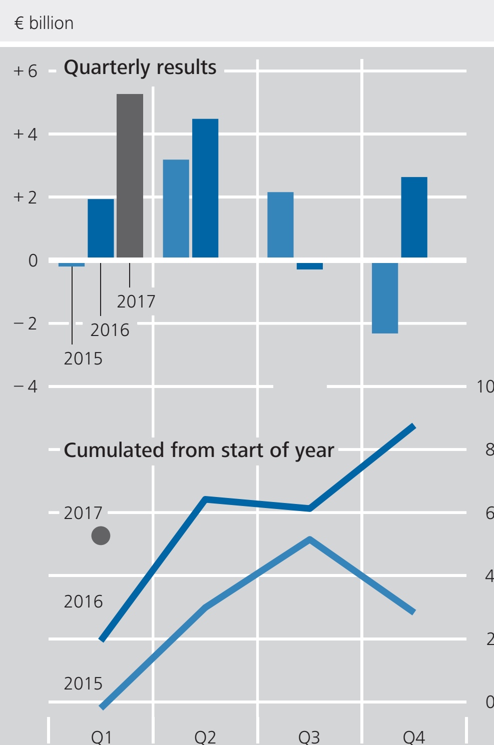
weaker at 2½%, or €2 billion. Stronger growth was recorded in current transfers to the municipalities (+8½%) and personnel expenditure (+4%), in particular. Other operating expenditure, by contrast, declined (-2½%), having been particularly high at the beginning of 2016 owing to the initial provision of support for refugees. Interest expenditure also continued to fall.

Slowdown as year progresses

The balance improvement at the beginning of the year is unlikely to continue into the following quarters. Although, according to the latest tax estimate from May, a revenue increase of €6½ billion in comparison with the November 2016 estimate is expected, growth on the year remains limited to 2%,[16] which is also due to the fact that refunds resulting from earlier court rulings are expected to be made at a later point in time. By contrast, as the year progresses, expenditure growth will probably become stronger, even though the overall increase of almost 4½% budgeted for in the state government plans seems rather high. All things considered, a marked surplus is likely to be recorded once more, although it could be somewhat lower than that of the previous year.

Marked surpluses expected in medium term

Looking ahead, stronger tax growth can be expected once again, and the tax estimate reports considerable additional revenue for the state governments compared with the November 2016 estimate. Although refugee-related increases in central government funds will be phased out at the end of 2018, burdens in this area also look set to decrease, as things currently stand. The additional central government contributions planned from 2020 for the reformed financial equalisation scheme are more significant. Overall, marked surpluses in the state government budgets are thus also envisaged in the medium term. As in the case of central government, it seems completely appropriate to factor in certain surpluses with a view to ensuring compliance with the debt brake, which requires the federal states to have (structurally) balanced budgets from 2020, but also in order to prepare for civil servant pension costs, which are still increasing markedly.



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

Further specification of debt brakes

Most of the federal states have adopted initial regulations for the implementation of the debt brake enshrined in Germany's Basic Law *(Grundgesetz)* from 2020 onwards.[17] Like Baden-Württemberg, Lower Saxony, Saxony-Anhalt and Thuringia, North Rhine-Westphalia has also merely adjusted its state budgetary rules to this end in the past month. However, such exclusively non-constitutional rules may be temporarily suspended with a mere budgetary act[18] and do not allow for a review before

16 The divergent allocation of the city states' local government tax receipts at the local government level in these figures is of only minor importance.
17 See also Deutsche Bundesbank, Federal states' cyclical adjustment in the context of the debt brake, Monthly Report, March 2017, p 34.
18 Bavaria made use of this option to finance a capital contribution of €10 billion to Bayern LB in 2008 and 2009 and suspended the ban on new borrowing which had existed in its state budgetary rules since 2006. Going one step further, in the face of a strained budgetary situation, Baden-Württemberg's 2012 reform act replaced the general ban on new borrowing in its state budgetary rules, which had been in place since 2008, with staggered declining upper limits on new borrowing.

the state constitutional court, for example. Should a federal state debt brake only apply to the core budget, it would also be possible to increase borrowing via off-budget entities. As the national debt brake also seeks to comply with European regulations, it would be advisable to expand the curbing of debt by applying the debt brake to such entities as well.

Restructuring reports: critical examination of off-budget entities and financial transactions, too

At the end of April, the federal states in receipt of consolidation assistance were required to state the extent to which they had adhered to the agreed reduction path for their structural deficits of 2016. According to the data available, the provisions were adhered to, but only by a slight margin in some cases. It is, in principle, a welcome development that Bremen was able to completely avoid net new borrowing whilst executing its budget, and that it did not have to invoke the exemption clause which it had been granted.[19] According to Bremen's report, the margin to the limit amounted to just over €30 million, with a €65 million surplus from the off-budget entity for Bremen's general debt servicing fund having an alleviating effect. The other off-budget entities, by contrast, were not taken into account. According to the quarterly cash statistics of the Federal Statistical Office,[20] off-budget entities in Bremen recorded a deficit of almost €90 million overall (adjusted for financial transactions). A comprehensive analysis ensuring compatibility with the definition of the government sector in the national accounts, which is relevant for the European rules, would result in a much less favourable overall picture. In principle, it also seems appropriate to examine, within the framework of fiscal surveillance, whether the financial transactions reported in the cash statistics results have in fact left financial assets unaffected (ie that they have not been used to offset losses, for example). Only then could they ultimately be recorded with a neutral balance effect, as is the case in the national accounts. It would not be advisable to exclude regular capital injections to some cultural institutions, for instance, in the case of Saarland, or else calls on guarantees via off-budget entities in connection with support for HSH Nordbank, in the case of Schleswig-Holstein, from the agreed limits.

Social security funds[21]

Statutory pension insurance scheme

Q1 deficit slightly higher

In the first quarter of 2017, the statutory pension insurance scheme recorded a deficit of €2½ billion. The deficit – usual for this time of year – expanded by €½ billion in year-on-year terms. The rise in expenditure was robust at just over 5%, which is still largely attributable to the high pension adjustments of July 2016 (+4.25% in western Germany and +5.95% in eastern Germany). The strain on the balance was eased by just under €½ billion because the general central government grant will be paid back in full from this year onwards.

Pension expenditure expected to increase as strongly as in 2016

In mid-2017, pensions will be raised by 1.90% in western Germany and 3.59% in eastern Germany, reflecting in particular the wage developments of the past year. The adjustment is significantly higher in eastern Germany because the average gross wages and salaries have risen more strongly here. This was partly due to the introduction of the statutory minimum wage in 2015, which also led to higher wage adjustments in eastern Germany in 2016.[22] A correction factor belatedly used to adjust the pension adjustment to the relevant development of

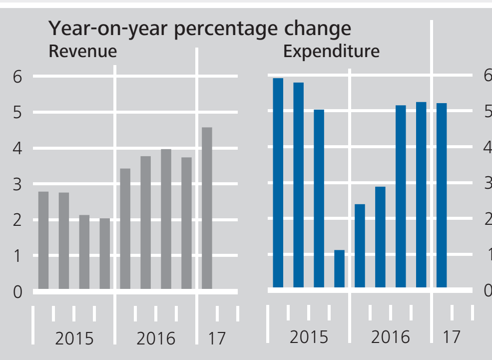
19 For more on budget planning in Bremen, see also Deutsche Bundesbank, Public finances, Monthly Report, August 2016, p 66.
20 Data from the periods of lag are not included here.
21 The financial development of the public long-term care and statutory health insurance schemes in 2016 was analysed in the short articles of the March 2017 Monthly Report. These are the most recent data available.
22 The statutory minimum wage was only implemented across the board after a certain delay. In accordance with this, more wages were adjusted upwards within existing wage structures, particularly in eastern Germany.

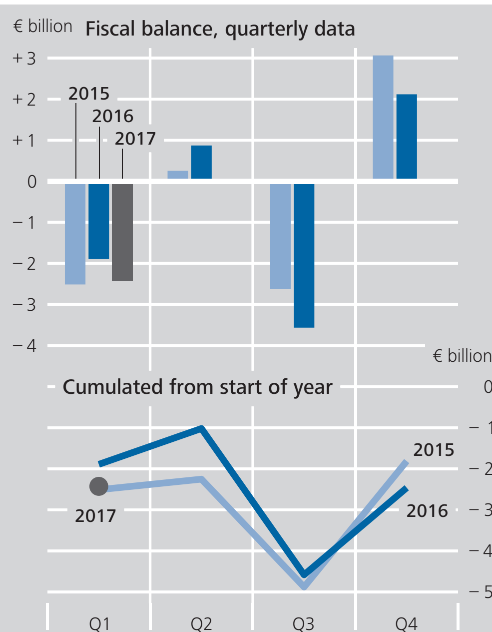
compulsory contributions[23] increases the difference further still. On an annual average, the national pension increase in 2017 matches the level of the previous year at 3½%. Total pension expenditure should also increase at a similar rate to last year (+4% in 2016).

Improved result in current year but statutory pension insurance scheme finances to face considerable pressure in future

For the year as a whole, however, the result of the statutory pension insurance scheme is likely to improve compared with 2016 (deficit of €2½ billion) essentially because the reduction factor of just over €1 billion in the central government grant will no longer apply. Contribution receipts are likely to increase as strongly as pension expenditure. In the absence of new measures that have a detrimental impact and assuming that positive development on the labour market continues, the financial situation could improve somewhat more on a temporary basis and lower the deficit further still. However, statutory pension insurance scheme finances are merely experiencing an interim peak, as demographic pressure is set to increase in the future. The high level of reserves will thus be gradually depleted and substantial increases in the contribution rate are envisaged for the longer term. This will need to be taken into account when considering further reforms in the area of pensions.[24]

Finances of the German statutory pension insurance scheme





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

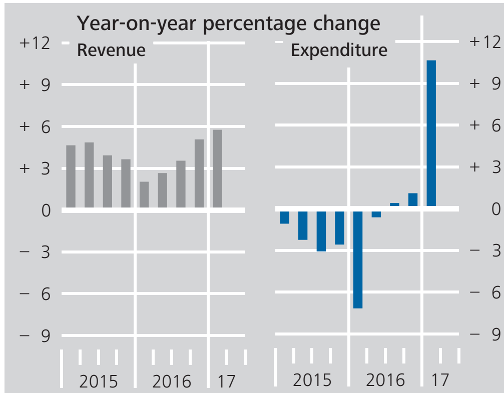
Federal Employment Agency

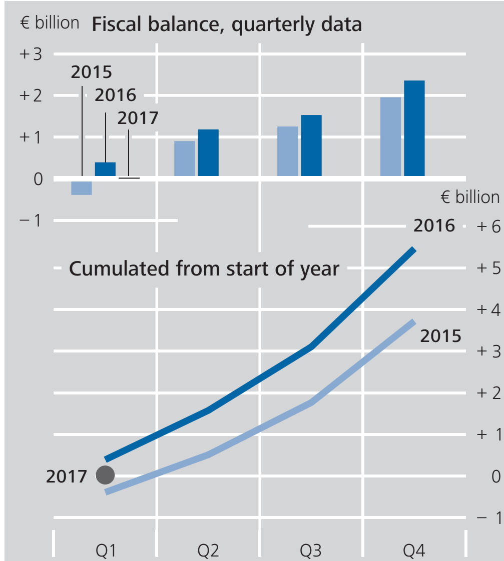
Balance depressed by one-off effect in Q1 …

The Federal Employment Agency recorded a balanced core budget (excluding the civil servants' pension fund) for the first quarter of 2017. The result was depressed by a special allocation of €½ billion to the civil servants' pension fund.[25] A decline of €½ billion was therefore recorded in comparison with the previous year. However, the result in the same quarter of the previous year was also boosted by a positive one-off effect to the tune of €½ billion.[26] Without these one-off factors, there would

23 The data on the development of average income subject to compulsory contributions are only available with a delay of just over one year. Therefore the inflation rate of average gross wages and salaries from the national accounts of the previous year is used for the respective midyear pension adjustment. Once the data on earlier developments in average compulsory contributions are available, the figures are then belatedly adjusted by means of a correction factor during the next pension adjustment (wage correction).
24 For more on the outlook, see Deutsche Bundesbank, Excursus: longer-term pension developments, Monthly Report, August 2016, pp 68-77.
25 The special allocation is linked to the low interest rates; see Deutsche Bundesbank, Public finances, Monthly Report, February 2017, p 68.
26 Here, the supplementary pension scheme of central and state government (Versorgungsanstalt des Bundes und der Länder, or VBL) had reimbursed the additional payments charged between 2013 and 2015. This resulted in subdued administrative expenditure by the Federal Employment Agency, as well as (to a lesser extent) reduced receipts from refunds of administrative costs by central government. See Deutsche Bundesbank, Public finances, Monthly Report, May 2016, p 68 and p 73.

Finances of the Federal Employment Agency*





Source: Federal Employment Agency. * Federal Employment Agency core budget including transfers to the civil servants' pension fund.
Deutsche Bundesbank

have been an improvement in the balance of €½ billion on the year.

… but positive underlying developments

Contribution receipts increased by 4% against a backdrop of ongoing favourable developments in wages and employment. The positive development on the labour market is reflected in core expenditure, particularly on unemployment benefit. The substantial increase in total expenditure (+10½%) was driven by the one-off effects mentioned above. After adjustment for these, expenditure would have fallen by ½%.

Considerable surplus expected again for year as whole

Dynamic growth in contribution receipts and a decline in unemployment benefit are also to be expected for the year as a whole. The surplus (€5½ billion in 2016) is only expected to fall if there is a very sharp rise in spending on active labour market policy measures. The budget estimate of €1½ billion is therefore likely to be significantly exceeded once more.

Reduce taxpayer burdens by lowering contribution rate

According to current forecasts, favourable developments are also expected on the labour market in future. Surpluses, many of which are likely to be structural, should therefore also continue to rise. All things considered, a reduction in the Federal Employment Agency's contribution rate would seem appropriate. This would allow the burden of taxes and social security contributions on employees and enterprises to be eased somewhat. Surpluses could still be achieved in the medium term even with a lower contribution rate and the reserves would be at a level which could also accommodate a sharper downturn.