State government finances: comparison of developments, debt brakes and fiscal surveillance

German state government finances have improved considerably in the current decade. This has been driven mainly by strong growth in tax revenue and the extremely low interest rates. Almost all federal states (or Länder), including their local governments, achieved structural surpluses last year. Although there are still considerable differences, the various states' financial situations have converged over time. By contrast, debt levels have continued to move in different directions and now exhibit a large spread. This is currently less of an issue given the very low level of interest rates, and further savings will initially probably be possible as debt is rolled over. However, the current low interest rate environment should not be regarded as permanent. A normalisation has a particularly strong impact when debt levels are high. Highly indebted federal states, in particular, would therefore be well advised to pursue an ambitious budgetary policy.

The federal states' spending on civil servants' pensions will increase considerably for some time to come. As things currently stand, existing reserves for civil servants' pensions are not large enough to cover this. The size of both the financial burden and the provisions made differs from state to state. Hence, it would be desirable for all Länder to disclose details of both items regularly at certain dates in a transparent and harmonised manner. As is being discussed for the statutory pension insurance system, it would make sense to also gradually raise the retirement age for civil servants in the future in line with rising life expectancy.

Central government will make a larger contribution to the state government revenue-sharing scheme from 2020. In addition, it is to co-finance state government tasks on a much larger scale. Whereas the states' individual responsibility was strengthened in the last decade, responsibilities are now increasingly being blurred again. This would not appear to promote an efficient use of funds. What would, in fact, be important is a clear link between government tasks, spending and funding. By strengthening the responsibility of the individual state governments, it would also be easier to take account of different preferences in terms of the organisation and extent of government activity. Increased freedom of scope regarding some taxes and transparent comparisons of public services and their cost would strengthen federalism.

From 2020, the debt brake will apply to all federal states. In terms of its concrete implementation, the individual states are pursuing different approaches. What matters is that the concrete rules successfully guarantee that the objective of the debt brake is met: to ensure that there are no permanent deficits in the future. Alongside the national fiscal rules, the European rules, which target the general government deficit, must also be met. Here, stringent and transparent fiscal surveillance is of central importance. In this, the Stability Council has a key role. However, the information based on which budgetary surveillance takes place does not currently appear adequate. Significant improvements are needed in terms of the scope, information value and comparability of the information provided by the individual federal states.

Role of the federal states in the federal system

Federal states have special position in the federal system

The federal states have a special role to play within the federal system. The state governments have a say in national law-making through their representation in the Bundesrat. They are individually responsible for all areas not explicitly assigned to central government in Germany's Basic Law *(Grundgesetz)*. This includes, in particular, primary, secondary and tertiary education, general internal security, general legal protection and important parts of the public administration, such as the tax offices. The federal states are funded primarily through joint taxes raised uniformly at the national level, which they share with central government and (to a smaller extent) local government. A revenue-sharing scheme is in place to avoid excessive differences in terms of the financial capacities of the federal states and thus ultimately the public services they provide. Municipal tasks are the responsibility of local government, and are, in part, funded by local government taxes to which local multipliers apply. Nonetheless, the federal states are partly responsible for ensuring that their local governments have adequate funding and pursue sustainable fiscal policies.

Although the Basic Law strengthens individual responsibility of state governments, …

The federal states' individual responsibility has been strengthened over the past decade. Since the 2006 reform of the federal structure, for instance, the individual states have determined civil servants' pay and the real estate acquisition tax rate, amongst others. In addition, mixed financing, where central government co-finances certain state government projects, was reduced significantly.[1] This applies to the construction of social housing and of universities, say. The state governments are freer in terms of how they use the lump-sum payments they now receive. In addition, the debt brake was passed in 2009.

… mixed financing and blurred responsibilities are increasing again

In recent years, the state governments' individual responsibility in terms of resolving problems has taken something of a backseat, however. It is difficult, for instance, to make detailed comparisons of federal state outcomes, for example in education.[2] In addition, plans to increase the scope of decision-making on tax legislation were not pursued – say through state-specific surcharges or discounts on income tax. Instead, the state governments have repeatedly sought additional central government funds to finance their tasks.[3] In return, central government is demanding a greater say. Decisions are thus becoming increasingly centralised again and responsibilities are being blurred.

Development of state government finances – an overview[4]

Federal states as a whole with rising surpluses since 2014 following many years of budget deficits

Looking at the federal states in aggregate, budgets were almost continuously in deficit from reunification to 2013. In 2003, a year of economic weakness, the deficit peaked at €34½ billion (1½% of gross domestic product (GDP)) (see the chart on p. 15). In 2007, a surplus was achieved for the first time, partly as a result of the strong economy. However, the financial and economic crisis then resulted in considerable deficits again. This was partly due to the economic downturn as well as, not least, spending on economic stimulus packages. After that, the situation improved gradually, however. Since 2014, surpluses have been recorded and climbed to €8½ billion by last year.

1 Ultimately, any central government involvement in schools was even banned.
2 As a case in point, when the Pisa surveys were conducted, the state governments did not release more detailed datasets on the state results for publication.
3 One result was, for instance, the Federal Government's draft law intended to reform the Basic Law and expand mixed financing in education, in particular.
4 This overview is based on the national accounts. It includes not only core budgets, but also off-budget government entities such as the federal states' universities and construction agencies. By contrast, public enterprises such as university hospitals are not included in the government sector. The national accounts are better than the government financial statistics at ensuring a consistent comparison over time. For more on trends in the federal states' core budgets according to the government financial statistics in the period 2005 to 2011, see Deutsche Bundesbank, The development of state government finances in Germany since 2005, Monthly Report, October 2012, pp. 29-49.

This was ultimately primarily due to strong tax growth and the falling interest burden. Even after cyclical adjustment, a surplus has been recorded since 2014.[5] The fact that it has continued to rise in recent years is largely due to shrinking interest expenditure.

Spending trends

Clear increase in expenditure

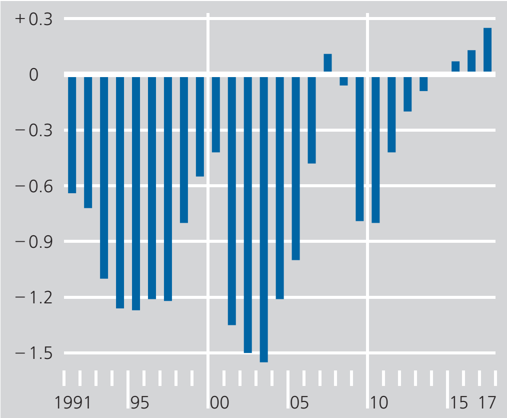
State governments account for just over one-third of spending by central, state and local government. In addition, they make large transfers to their local governments to help them fund the tasks conferred upon them. Since 2007, the year before the crisis, overall spending by the Länder has risen by 3½% a year on average (see the table on p. 16). The increase was therefore perceptibly more pronounced than in the preceding decade and also as compared to nominal GDP growth of just over 2½% a year. Primary expenditure – in other words, excluding interest spending – actually increased by almost 4% on average. There was relatively strong growth in spending on, for instance, civil servants' pensions, investment and intermediate consumption. In some instances, however, higher spending was also related to additional revenue already earmarked for this purpose. For example, there was a rise in the proportion of transfers to local government that were funded by central government. Additionally, television licence fees have, since 2013, been passed through the state government budgets for statistical purposes.[6] However, even excluding these two factors, primary expenditure still rose by a distinct 3½%.

Sharp decline in average interest rates lowers interest expenditure

Lower interest rates were a key factor in the favourable development in government finances (see the chart on p. 17). This is evident, for example, when one compares the average interest rate on state government debt in 2017 (2%) with the interest charged before the crisis. If the federal states had had to pay the average interest rate of 2007, namely just shy of 4½%, their interest expenditure would have been €13½ billion higher. Instead of a surplus, the Länder would have recorded a deficit of €5 billion last year. In actual fact, interest expenditure is less and less of a burden. Whereas interest spending accounted for 7% of overall expenditure in 2007, it represented a share of just 3% at last count. In relation to GDP, this translates into a halving to just under ½%.

The federal states' fiscal balance*

As a percentage of GDP



Sources: Federal Statistical Office and Bundesbank calculations. * National accounts data.
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Debt ratio has declined perceptibly since 2012 following previous rise

While average interest rates have been falling since as far back as 2008, debt initially continued to rise noticeably (as defined by the Maastricht Treaty, see the chart on p. 17). This was due both to the support provided to Landesbanken during the financial crisis[7] and to a spike in deficits. The state government debt

5 Cyclical adjustment is carried out based on the Bundesbank's estimate of May 2018 using the Bundesbank's disaggregated cyclical adjustment method. Cyclical effects for the individual taxes were allocated to the individual federal states based on their tax revenue shares.
6 In 2013, television licence fees were switched to a flat-rate fee per household. In the national accounts, they have since then been recorded as tax revenue of the federal states, which is transferred to the broadcasters on the expenditure side.
7 Several institutions – in particular BayernLB (which received €10 billion) – received capital injections. Others, such as LBBW, were additionally supported with a guarantee portfolio (€12½ billion), which pushed up debt. Spin-offs of portfolios guaranteed by state governments had the largest effect, accounting for more than €50 billion in total. These related to SachsenLB and WestLB and the latter's later bad bank, the First Winding-up Agency (Erste Abwicklungsanstalt). These debts have now been partially repaid, however.

Expenditure and revenue in federal states' budgets in the years 2007 to 2017

Item	2007	2010	2014	2015	2016	2017	Change
	€ bn						% p.a.
Revenue	309.3	317.8	383.2	399.8	423.7	436.7	3.5
of which:							
Sales	23.7	28.1	35.8	37.1	38.1	40.4	5.5
Taxes	205.2	193.8	244.9	259.1	279.3	289.8	3.5
Transfers (from general government)	44.3	54.7	55.8	57.7	59.3	61.4	3.3
Expenditure	306.4	338.4	383.1	397.6	419.5	428.4	3.4
of which:							
Intermediate consumption	29.7	36.3	43.9	47.0	48.6	48.4	5.0
Personnel expenditure	121.6	133.8	150.0	154.3	159.5	165.5	3.1
of which:							
Compensation of employees	100.0	108.6	119.3	121.8	125.2	129.3	2.6
Pension benefits	21.7	25.2	30.7	32.5	34.4	36.2	5.3
Interest	21.4	22.0	16.8	15.1	13.6	12.8	– 5.0
Social benefits[1]	20.5	23.5	23.5	24.1	27.2	26.7	2.7
Transfers (to general government)	65.2	69.7	84.9	91.8	100.5	104.5	4.8
Gross investment	13.9	17.8	20.0	22.3	23.5	24.9	6.0
Memo item: net investment	0.6	2.8	1.8	3.4	3.8	4.2	20.9
Memo item: primary expenditure[2]	285.0	316.4	366.3	382.5	405.9	415.5	3.8
Fiscal balance	2.8	– 20.6	0.1	2.2	4.2	8.3	
Structural balance[3]	– 1.2	– 16.8	1.7	4.0	5.0	7.6	
Memo item: incl. local government	3.4	– 23.6	2.4	9.0	10.3	16.7	
Structural primary balance[2]	20.2	5.2	18.6	19.1	18.5	20.5	
	As a percentage of GDP						Percentage points
Revenue	12.3	12.3	13.0	13.1	13.4	13.3	1.0
of which:							
Sales	0.9	1.1	1.2	1.2	1.2	1.2	0.3
Taxes	8.2	7.5	8.3	8.5	8.8	8.8	0.7
Transfers (from general government)	1.8	2.1	1.9	1.9	1.9	1.9	0.1
Expenditure	12.2	13.1	13.0	13.0	13.3	13.1	0.9
of which:							
Intermediate consumption	1.2	1.4	1.5	1.5	1.5	1.5	0.3
Personnel expenditure	4.8	5.2	5.1	5.1	5.0	5.1	0.2
of which:							
Compensation of employees	4.0	4.2	4.1	4.0	4.0	3.9	0.0
Pension benefits	0.9	1.0	1.0	1.1	1.1	1.1	0.2
Interest	0.9	0.9	0.6	0.5	0.4	0.4	– 0.5
Social benefits[1]	0.8	0.9	0.8	0.8	0.9	0.8	0.0
Transfers (to general government)	2.6	2.7	2.9	3.0	3.2	3.2	0.6
Gross investment	0.6	0.7	0.7	0.7	0.7	0.8	0.2
Memo item: net investment	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Memo item: primary expenditure[2]	11.3	12.3	12.5	12.5	12.8	12.7	1.3
Fiscal balance	0.1	– 0.8	0.0	0.1	0.1	0.3	0.1
Structural balance[3]	– 0.0	– 0.7	0.1	0.1	0.2	0.2	0.3
Memo item: incl. local government	0.1	– 0.9	0.1	0.3	0.3	0.5	0.4
Structural primary balance[2]	0.8	0.2	0.6	0.6	0.6	0.6	– 0.2

Sources: Federal Statistical Office, national accounts, as at August 2018. Bundesbank calculations. **1** Monetary social benefits (excluding civil servants' pensions and healthcare subsidies) as well as social transfers in kind. **2** After deduction of interest expenditure. **3** Fiscal balance adjusted for the calculated influence of cyclical factors on tax revenue (Bundesbank method, data as at May 2018).

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ratio rose from 20% in 2007 to almost 25% in 2012. Since then, it has fallen steadily to 18½% at the end of 2017 (€611 billion).

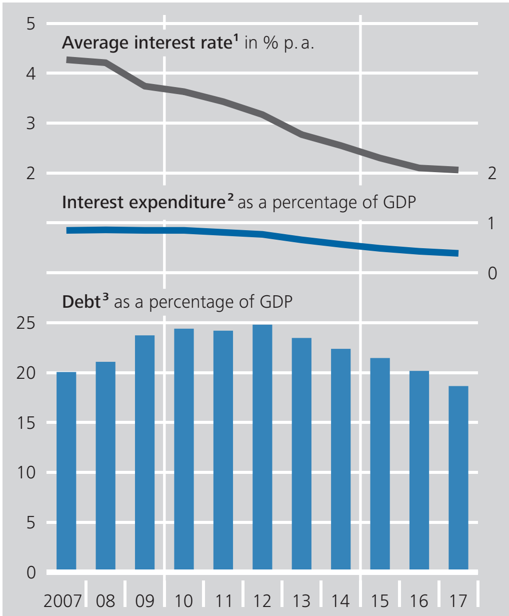
Moderate additional costs for current staff, but strong increase in civil servants' pensions

The federal states are responsible for particularly personnel-intensive functions of government. As a consequence, personnel expenditure accounts for by far the largest share of spending, at almost 40%. Spending on current salaried staff and civil servants has grown by an average of 2½% a year since 2007. Besides a slight increase in staffing levels, this mainly reflects changes in negotiated wages and civil servants' pay. Pay rises roughly matched the moderately increased negotiated wages in the economy as a whole. Spending on retired civil servants rose much more strongly (+5½% per year) as there was a sharp rise in the number of recipients.

Strong increase in transfers to local government supported by federal aid

The federal states make large current and capital transfers to other government levels, particularly local governments. Accounting for one-quarter of expenditure, the latter represent the second-largest expense item and exhibited above-average growth (+5% a year). Payments under the local government revenue-sharing scheme, which largely depend on how the states' tax revenue develops, grew considerably. However, the central government funds that flow to local governments through the federal state budgets grew much more still. For instance, central government has, since 2014, fully reimbursed the cost of the basic allowance for the elderly. In addition, it has incrementally increased how much it contributes to the accommodation costs of those receiving unemployment benefit II. Since 2015, central government has also made lump-sum payments to deal with the influx of refugees. Finally, federal funds for local government investment which pass through the federal states' budgets also rose. Alongside earlier economic stimulus packages, these include payments for the expansion of day care facilities for children and payments from the fund to promote municipal investment.

The federal states' debt and interest expenditure



Sources: Federal Statistical Office and Bundesbank calculations. **1** Interest expenditure (according to the national accounts) for the year under review in relation to mean Maastricht debt levels at the end of the reporting year and of the respective previous year. **2** As defined in the national accounts. **3** Maastricht debt.

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Similar increase in other operating expenditure

Intermediate consumption also grew strongly. This item includes, in particular, other operating expenditure such as the purchase of services and payment of rent. As a result of refugee migration, it temporarily increased particularly sharply. This is evident in high growth in 2015 and, more recently, a more muted development.

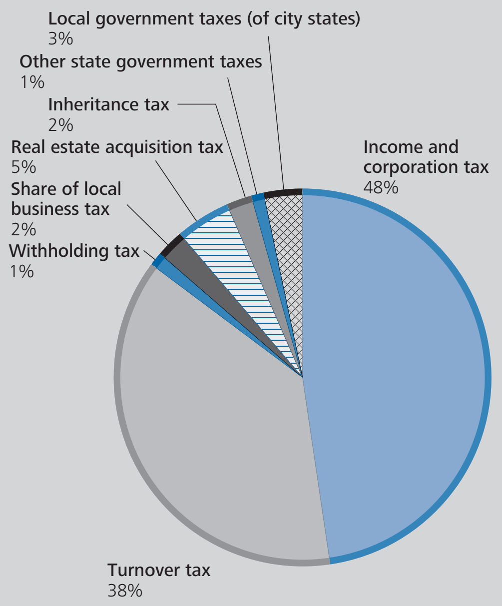
Strong expansion in investment

Investment expenditure by the state governments varied considerably. The strong overall increase (6% per year on average) reflects, in part, the favourable budgetary situation over the past few years. Net investment was positive throughout – in other words, investment expenditure exceeded depreciation.

Revenue trends

The federal states' revenue growth has slightly exceeded expenditure since 2007. Tax revenue expanded by 3½% a year on average, the same

The federal states' tax revenue in 2017 by type of tax*



Sources: Federal Statistical Office and Bundesbank calculations. * According to government finance statistics. Inheritance tax, which is recorded in the national accounts as a capital transfer, is included here, though the television licence fee, in particular, is not. In the government finance statistics (unlike in the national accounts), child benefits are deducted in full from tax revenue.
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Ample tax revenue meant revenue slightly outpaced expenditure growth

as total revenue, and made up two-thirds and thus the largest share of revenue. Although, the allocation or distribution of various taxes among central, state and local governments changed, the effects on state governments' tax revenue roughly cancelled each other out overall.[8] Changes in tax legislation dampened tax revenue in the first couple of years. Amongst other things, income tax cuts were introduced to cushion the effects of the financial crisis. In subsequent years, the strong underlying trend was the dominant factor, and clear revenue growth was recorded, particularly for profit-related taxes. Progressive taxation also had a markedly positive effect on revenue.

Bulk of tax revenue stems from joint taxes

Almost 90% of the federal states' tax revenue stems from joint taxes,[9] with income tax and corporation tax making the largest contribution ahead of turnover tax (see the chart above). In addition, federal states levy state government taxes.[10] These are largely regulated by national legislation, with the exception of real estate acquisition tax. Since the autumn of 2006, the individual states have set this tax rate autonomously. During the interim period, this rate has been raised in almost all states (except Bavaria and Saxony) – from originally 3.5% to up to 6.5%. The importance of this tax has thus increased, but it still represents just 4½% of the federal states' total tax revenue.

Clear increase in central government transfers

The second-largest revenue category are the transfers received from other public administrations, the vast majority from central government. These grew at a pace only slightly slower than tax revenue. This reflected the fact that additional federal funds were transferred to local government, as outlined above. Another significant factor was the transfer of funds from central government by way of compensation for motor vehicle tax, which has, since 2009, been passed to central government. These two items mask the fact that special-needs supplementary central government grants to help reconstruct the infrastructure in eastern Germany are gradually coming to an end.

Sharp increase in receipts from fees

There was significantly stronger growth in revenue from sales (+5½% per annum). This includes, in particular, receipts from fees, many of which are now received by off-budget entities. They fund public services for which staff and other operating costs, in particular, are generally incurred on the expenditure side. The federal states have meanwhile abolished the

8 In mid-2009, motor vehicle tax was transferred to central government. Since then, the federal states have received a transfer from central government (€9 billion a year) by way of compensation, which does not count as tax revenue. On top of that, the television licence fee has, since 2013, passed through the state government budgets for statistical purposes (€8 billion). In addition, central government ceded turnover tax funds to the federal states in connection with the spike in refugees entering the country.
9 For more information on the distribution of tax revenue, see Table X.6 in the Statistical Section of this report.
10 State government taxes comprise, first and foremost, real estate acquisition tax and inheritance tax. From 2013 onwards, they also include the television licence fee. However, in this definition, state government taxes also include local government taxes raised by the city states (where the local government level is not reported separately).

general tuition fees for students that many had previously introduced.

The budgetary situation of individual federal states

Methodological adjustments for better comparability

Enhancing the comparability of government financial statistics by …

The aggregate outcome for the federal states masks differences, in some cases large, between the individual federal states. Since the national accounts contain no individual state-level data, the government financial statistics are used here for a state-by-state breakdown. The available data material is further processed to ensure that key figures are as meaningful as possible.

… including off-budget entities …

The starting point for budgetary analyses is usually the core budget. However, in some federal states, the core budget does not include a large part of activities. Consequently, the federal states' off-budget entities included in the government sector are factored in – bringing the procedure more into line with the national accounts.[11] This neutralises the circumstance that some entities (such as universities) have, in many federal states, been moved off the core budgets and that reserves (such as pension funds) are used in different ways. For instance, high transfers to provisions weighed on the core budget in North Rhine-Westphalia in 2017. While the core budget had a deficit, this was balanced out by a surplus in the relevant off-budget entity. It is easier to compare the outcome for North Rhine-Westphalia with other federal states' results if the pension reserves and the core budget are analysed together.

… and local governments, …

Local governments are also included. This allows a comparison of non-city states with city states, which do not report local government-level data separately.[12] In addition, tasks are distributed differently between the federal state and the local government level in the non-city states. For a consolidated analysis, it would not matter if a federal state were to reduce its payments under the local government revenue-sharing scheme. This would merely shift the financial problems to the local governments, for which the federal state ultimately bears joint responsibility.[13]

… adjusting for financial transactions, …

As in the national accounts, financial transactions are also excluded.[14] These influence the fiscal balances recorded in the government financial statistics in individual federal states and years, significantly so in some cases. In principle, however, they merely reallocate financial assets. In a privatisation, for example, (net) financial assets remain unchanged: there is an inflow of cash, but equity holdings decline. By excluding transactions of this nature, the objective is to paint a more precise picture of the financial situation.

… recording the state government revenue-sharing scheme on an accruals basis, and …

In addition, payments under the state government revenue-sharing scheme are recorded on an accruals basis. Settlements that are not made and recorded in the government financial statistics until the following year are accounted for in the reporting year.[15]

… adjusting for cyclical effects

Finally, cyclical influences are stripped out in order to better depict the structural budgetary position. While these influences have a largely uniform impact on the individual federal states owing to the state government revenue-

11 The relevant entities are reported by the Federal Statistical Office: Liste der Extrahaushalte, 2018, available at www.destatis.de
12 The city states' population is given a 35% higher weighting in the state government revenue-sharing scheme in order to compensate for the fact that central areas have higher financial requirements than the surrounding areas.
13 See also Deutsche Bundesbank, Major budgetary differences between the federal states, Monthly Report, October 2012, pp. 36 ff.
14 However, adjustments are made in the national accounts if the budget shows a financial transaction but the national accounts criteria are not met. This would be the case, say, for an injection of capital without the prospect of profit distribution or to compensate for a loss. Such adjustments cannot be reconstructed for this article.
15 The adjustments incorporate the provisional annual settlement transactions for the reporting year and the preceding year.

Budgetary figures for the federal states (including local government) in 2017*

Item	BW	BY	BB	HE	MV	NI	NW	RP
Derivation of adjusted structural balances	in € million							
Fiscal balance (1)	1,377	5,571	908	1,585	1,062	1,851	2,683	1,527
Financial transactions (net) (2)	− 1,126	388	− 109	− 632	− 27	− 393	− 1,264	17
Settlement of payments under the state government revenue-sharing scheme (3)	163	345	− 22	183	− 6	91	109	− 355
Adjusted balance (4) = (1) − (2) + (3)	2,666	5,528	994	2,400	1,083	2,335	4,056	1,154
Cyclical component (5)	145	174	30	87	19	100	234	50
Adjusted structural balance (6) = (4) − (5)	2,521	5,354	964	2,313	1,063	2,235	3,822	1,104
Memo item: after deduction of consolidation assistance	.	.	.	.	.	.	.	.
Net interest burden[1] (7)	1,560	783	320	1,350	194	1,312	3,395	916
Adjusted structural primary balance (8) = (6) + (7)	4,081	6,136	1,284	3,663	1,258	3,547	7,217	2,020
	in € per inhabitant							
Fiscal balance (1)	125	429	363	254	659	232	150	375
Financial transactions (net) (2)	− 102	30	− 44	− 102	− 17	− 49	− 71	4
Settlement of payments under the state government revenue-sharing scheme (3)	15	27	− 9	29	− 4	11	6	− 87
Adjusted balance (4) = (1) − (2) + (3)	243	426	398	385	672	293	227	284
Cyclical component (5)	13	13	12	14	12	13	13	12
Adjusted structural balance (6) = (4) − (5)	229	413	386	371	660	281	214	271
Memo item: net of consolidation assistance	.	.	.	.	.	.	.	.
Net interest burden[1] (7)	142	60	128	217	121	165	190	225
Adjusted structural primary balance (8) = (6) + (7)	371	473	514	588	781	445	403	496
Expenditure, revenue and debt	in € per inhabitant							
Total expenditure	6,400	6,487	6,311	7,082	5,872	5,720	6,690	5,838
of which:								
Personnel expenditure	2,628	2,510	2,537	2,680	2,454	2,520	2,535	2,544
of which: pension benefits[2]	678	643	381	645	413	637	665	642
Other operating expenditure	1,041	1,035	1,208	1,348	1,224	979	1,489	1,225
Interest expenditure	168	83	145	241	168	199	250	284
Transfers to households	646	709	789	995	888	940	1,044	796
Fixed asset formation	693	734	395	407	535	371	316	371
Adjusted total expenditure[3]	6,010	5,922	6,134	6,491	5,463	5,640	6,517	5,744
Memo item: less fees	5,579	5,474	5,522	5,774	4,974	5,261	5,624	5,201
Memo item: less fees and interest expenditure	5,411	5,391	5,378	5,533	4,806	5,062	5,374	4,917
Total revenue	6,522	6,916	6,673	7,337	6,532	5,953	6,840	6,213
of which:								
Tax revenue[4]	4,742	4,739	4,375	4,910	4,326	4,401	4,691	4,524
Fees	432	448	612	717	490	379	893	544
Interest income	26	22	17	24	47	35	60	59
Transfers from central government[5]	379	396	949	509	1,011	443	472	433
Adjusted total revenue[3]	6,249	6,348	6,531	6,877	6,135	5,933	6,744	6,028
Memo item: less fees	5,818	5,900	5,919	6,160	5,646	5,554	5,850	5,484
Debt	5,400	2,442	7,818	9,988	7,210	9,567	13,209	12,825
Tax rates and multipliers								
Real estate acquisition tax (%)	5.0	3.5	6.5	6.0	5.0	5.0	6.5	5.0
Real estate tax B (%)[6]	396	392	406	470	424	427	567	400
Local business tax (%)[6]	368	373	321	410	377	403	452	382

Sources: Federal Statistical Office, quarterly cash statistics (including post-bookings); Bundesbank calculations. * Core budgets and off-budget entities. **1** Interest expenditure less interest income. **2** Including healthcare subsidies for civil servants and refunds to central government for legacy claims for pension benefits in eastern Germany. **3** Excluding financial transactions and payments under the state government revenue-sharing scheme made by states providing contributions. Payments under the state government revenue-sharing scheme are settled on the revenue side. **4** Taxes and compensation for motor vehicle tax, state government

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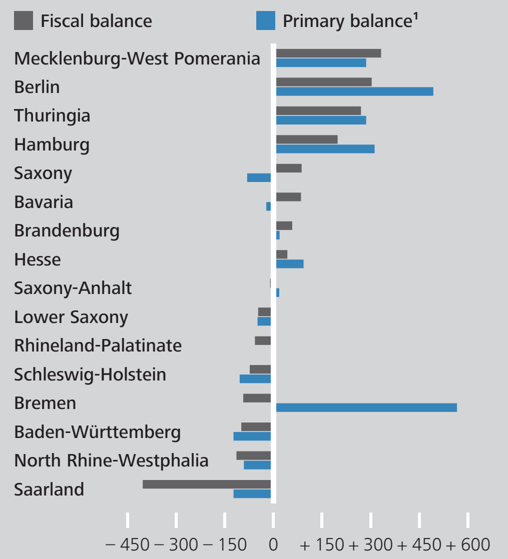
SL	SN	ST	SH	TH	BE	HB	HH	Total	Item
								in € million	**Derivation of adjusted structural balances**
– 90	1,136	680	– 106	1,324	2,437	83	74	22,101	Fiscal balance (1)
– 22	– 678	– 86	– 996	15	– 26	– 29	– 959	– 5,927	Financial transactions (net) (2)
5	– 73	– 29	– 117	4	– 136	59	– 42	174	Settlement of payments under the state government revenue-sharing scheme (3)
– 62	1,740	737	773	1,313	2,327	172	991	28,202	Adjusted balance (4) = (1) – (2) + (3)
12	49	27	36	26	60	12	33	1,097	Cyclical component (5)
– 75	1,691	709	736	1,287	2,267	160	958	27,106	Adjusted structural balance (6) = (4) – (5)
– 335	.	629	656	.	2,187	– 140	.	.	Memo item: after deduction of consolidation assistance
445	– 3	435	392	357	1,281	560	511	13,808	Net interest burden[1] (7)
370	1,689	1,144	1,128	1,644	3,548	720	1,469	40,914	Adjusted structural primary balance (8) = (6) + (7)
								in € per inhabitant	
– 90	279	305	– 37	615	679	123	41	267	Fiscal balance (1)
– 22	– 166	– 39	– 345	7	– 7	– 43	– 527	– 72	Financial transactions (net) (2)
5	– 18	– 13	– 41	2	– 38	87	– 23	2	Settlement of payments under the state government revenue-sharing scheme (3)
– 63	427	330	268	610	648	253	544	341	Adjusted balance (4) = (1) – (2) + (3)
12	12	12	13	12	17	18	18	13	Cyclical component (5)
– 75	415	318	255	598	631	235	526	328	Adjusted structural balance (6) = (4) – (5)
– 336	.	282	227	.	609	– 206	.	.	Memo item: net of consolidation assistance
447	– 1	195	136	166	357	825	281	167	Net interest burden[1] (7)
372	414	513	391	763	988	1,060	807	495	Adjusted structural primary balance (8) = (6) + (7)
								in € per inhabitant	**Expenditure, revenue and debt**
6,133	6,122	6,475	6,482	5,671	7,621	9,105	10,564	6,404	Total expenditure
									of which:
2,728	2,477	2,517	2,361	2,439	2,873	3,143	3,414	2,581	Personnel expenditure
759	350	400	612	367	667	867	963	622	of which: pension benefits[2]
1,359	1,097	1,492	1,013	981	2,389	2,147	3,096	1,301	Other operating expenditure
460	62	225	227	211	364	999	490	211	Interest expenditure
671	729	600	920	711	814	1,014	788	841	Transfers to households
307	574	398	471	448	205	400	1,062	489	Fixed asset formation
5,999	5,867	6,401	6,097	5,618	7,504	8,956	9,884	6,238	Adjusted total expenditure[3]
5,584	5,413	5,967	5,616	5,240	6,848	8,255	7,833	5,627	Memo item: less fees
5,123	5,352	5,742	5,389	5,030	6,484	7,255	7,343	5,416	Memo item: less fees and interest expenditure
6,042	6,395	6,780	6,445	6,286	8,299	9,228	10,605	6,670	Total revenue
									of which:
4,446	4,339	4,202	4,517	4,311	5,905	6,050	6,451	4,722	Tax revenue[4]
415	454	434	481	378	656	701	2,050	612	Fees
14	62	30	91	45	8	174	210	44	Interest income
774	795	1,263	611	863	956	1,166	662	558	Transfers from central government[5]
5,936	6,288	6,732	6,364	6,228	8,151	9,209	10,428	6,579	Adjusted total revenue[3]
5,521	5,834	6,298	5,883	5,850	7,495	8,508	8,377	5,967	Memo item: less fees
18,165	2,822	10,741	12,230	8,989	16,731	34,043	19,894	9,396	Debt
									Tax rates and multipliers
6.5	3.5	5.0	6.5	6.5	6.0	5.0	4.5	5.4	Real estate acquisition tax (%)
418	495	415	390	436	810	686	540	470	Real estate tax B (%)[6]
441	422	361	378	407	410	460	470	402	Local business tax (%)[6]

revenue-sharing scheme and general supplementary central government grants according to provisional figures. **5** Excluding general supplementary central government grants and compensation for motor vehicle tax. **6** Revenue-weighted average local government multipliers for 2017. Abbreviations: BW – Baden-Württemberg, BY – Bavaria, BB – Brandenburg, HE – Hesse, MV – Mecklenburg-West Pomerania, NI – Lower Saxony, NW – North Rhine-Westphalia, RP – Rhineland-Palatinate, SL – Saarland, SN – Saxony, ST – Saxony-Anhalt, SH – Schleswig-Holstein, TH – Thuringia, BE – Berlin, HB – Bremen, HH – Hamburg.

Deviation of adjusted structural balances of state and local governments from the national average*

Data in € per inhabitant in 2017



Sources: Federal Statistical Office and Bundesbank calculations. * Balances adjusted for financial transactions, calculated cyclical effects and settlement under the state government revenue-sharing scheme. Figures from the government financial statistics (cash statistics including post-bookings). **1** Additionally after deduction of net interest burden (interest expenditure less interest income).
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sharing scheme,[16] such an adjustment makes sense for a comparison over time.

The budget situation in 2017[17]

Structural surpluses virtually nationwide in 2017

The surpluses of the federal states as a whole climbed to an all-time high (€27 billion, or 0.8% of GDP) in 2017, even in terms of the methodological adjustments outlined above.[18] With the exception of Saarland, all federal states posted a surplus (see the table on pp. 20 and 21). Per capita, Mecklenburg-West Pomerania recorded the highest amount (€660), which was twice the national average.[19]

Major differences in debt level and interest expenditure, …

Debt servicing has a significant impact on the budget situation of the individual federal states (see the box on p. 23 focusing on Bremen and Saarland). This is predominantly due to different debt levels.[20] For instance, at the end of 2017, the per capita debt level in Bremen was more than three and a half times higher than the national reference figure (see the chart on p. 24). The level in Hamburg and Saarland was still around twice as high. As a result, per capita interest expenditure[21] was highest in Bremen – almost five times the national reference figure of €210 (see the chart on p. 26). But interest costs were also just over twice as high in Hamburg and Saarland. By contrast, Bavaria and Saxony recorded particularly low levels.

… but some large differences in interest income, too

However, in many cases, debt is also offset by sizeable financial assets.[22] These can be included in the calculations, at least in part, by deducting interest income from interest expenditure (net interest burden).[23] In these net terms, Saxony no longer had a burden and Hamburg's high interest costs fell by almost half. Bremen's interest income was also way above average.

16 The cyclical effect for the federal states as a whole (see footnote 5 on p. 15) is allocated to the individual federal states based on the previous year's tax revenue shares (as in the consolidation assistance procedure). The same is done for the local governments. The individual federal states apply various methods for their debt brakes, and the estimation results differ considerably in some cases.
17 To improve comparability among the federal states, the relevant figures are shown in relation to the population size (per capita analysis).
18 The surpluses thus significantly exceeded the cyclically adjusted national accounts balance of state government and local government combined (€16½ billion). One contributory factor was that the financial support provided by Hamburg and Schleswig-Holstein to HSH Nordbank is classed as a loan (financial transaction) in the government financial statistics. However, in the national accounts, it is booked as a capital transfer, thus lowering the surplus.
19 An average weighted by the share of the population is used for the national reference figure. Larger states thus have a greater impact.
20 This includes debt in the non-public and in the public sector. It is not possible to rule out errors in consolidation using the figures available for the individual federal states.
21 As with the similar definition of debt, this includes interest expenditure to areas of the non-public sector and other public sector entities.
22 According to the Federal Statistical Office's financial asset stock statistics, the total stock of state and local government financial assets amounted to €580 billion at the end of 2017. However, this figure has not been adjusted for loans to other public sector entities and is thus overstated. As a result, it is not directly comparable with the consolidated debt level of state and local government as defined under the Maastricht Treaty (around €760 billion at the end of 2017).
23 It is not possible to additionally adjust for profit distributions from equity holdings using the aggregated government financial statistics data available.

The significance of special assistance for Bremen and Saarland

With the debt brake, consolidation assistance was introduced for particularly highly indebted federal states. The costs are split between central government and state governments. An annual volume of €800 million has been earmarked for this purpose for the 2011 to 2019 fiscal years. The lion's share of this sum goes to two small states: Saarland (€260 million, or €260 per capita) and Bremen (€300 million, or €440 per capita).[1] The disbursement of assistance is conditional on progress in consolidation.[2] It has taken place every year thus far.

Last year, Bremen achieved an adjusted surplus (i.e. including interest burden and consolidation assistance) of €240.[3] Saarland, meanwhile, was still running a deficit (€70). Despite the extraordinarily low level of interest rates, high debt levels have still been weighing particularly heavily on both states: Saarland's net interest burden[4] was €280 higher than the national average, and that of Bremen €660 higher. This was partly compensated for by consolidation assistance, however, which nearly fully offset the additional burden in Saarland and knocked off as much as two-thirds of the additional burden in Bremen. Bremen's basic fiscal position (in turn, excluding net interest burden and consolidation assistance) was recently markedly better than the national average, whereas Saarland still fell perceptibly short of the national average.

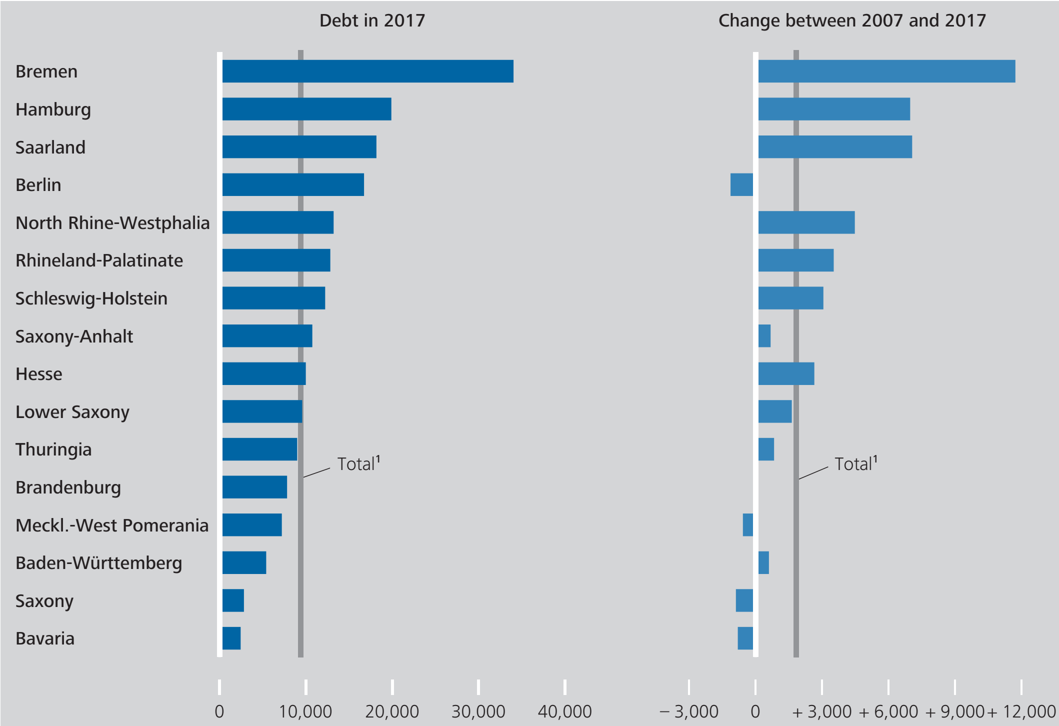
As from 2020, both states will receive new, higher special payments from central government. Each state will receive €400 million in budgetary recovery assistance annually (€400 per capita in Saarland and €590 per capita in Bremen). Based on figures for 2017, the funds almost completely cover Bremen's additional interest burden, while they even overcompensate Saarland's by a wide margin. This puts these two states in a better position than other states with above-average debt levels.

There is no formal time limit on the budgetary recovery assistance, which appears to be assured for well over a decade.[5] Virtually no repayment conditions are attached to these funds. This assistance is therefore not specifically pushing states to bring their budgetary outturns (net of the assistance) perceptibly closer to the federal state average. There is therefore a risk of structural dependency on budgetary recovery assistance. If efforts to scale back debt levels considerably do not succeed, both states will, in the medium to long term, also be more vulnerable to rising interest rates. It is therefore advisable to initially use only a smaller portion of the new funds for additional expenditure. A more expedient course of action would be to defuse the debt situation, something for which the henceforth expanded special assistance would provide a sound financial basis. That would help Bremen and Saarland, and not just in terms of complying with the debt brake. A federal structure which is based more strongly on individual responsibility of the federal states should then be seen as an opportunity.

1 In 1992, the Federal Constitutional Court ruled that these states were in extreme budgetary hardship. In order to overcome this state of affairs, they received extensive special assistance up until 2004, which was progressively reduced towards the end.
2 When identifying progress, no account is taken of this assistance, as the idea behind it is not to directly create any additional fiscal leeway. Instead, it is designed to ensure that a sound budgetary position is achieved and that the recipient can independently comply with the debt brake as of 2020.
3 The description below is based on adjusted data from the government finance statistics; the method used to calculate them (including cyclical adjustment) is described on p. 19. For ease of comparability, the data below, unless mentioned otherwise, are expressed in per capita terms and include consolidation assistance.
4 I.e. interest expenditure less interest income.
5 Pursuant to Article 143 f. of the Basic Law *(Grundgesetz)*, three or more federal states, for instance, can, as of 2031, jointly demand renegotiations on the revenue-sharing scheme and thus also on budgetary recovery assistance. The assistance would then expire unless new arrangements are agreed within five years.

Debt of state and local governments*

€ per inhabitant



Sources: Federal Statistical Office and Bundesbank calculations. * Figures from the government financial statistics. Debt in the non-public and the public sector (non-consolidated). **1** All state and local governments.

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Budget situation excluding net interest burden also shows larger differences

The budgetary position excluding the net interest burden (adjusted structural primary balance) was most favourable in the city states (see the chart on p. 27). Of the non-city states, Mecklenburg-West Pomerania and Thuringia recorded by far the highest surpluses. Without the net interest burden, Saarland, in particular, came much closer to the state average, closely followed by Baden-Württemberg.

Changes since 2007

Clear improvement in budget outturns since 2007 due to …

State governments' underlying budgetary position has improved immensely over the last ten years. The differences among the states have also eased considerably. In 2007, in addition to the five eastern states, only Bavaria, Baden-Württemberg and Hamburg had noteworthy surpluses (according to the definition and adjustments outlined above). Calculated in this way, the per capita deficits in 2007 were at their highest in Bremen (€1,250).

… fall in net interest burden and …

The favourable development is attributable, on the one hand, to the net interest burden, which has fallen significantly in all federal states, in particular due to the favourable borrowing conditions (see the chart on p. 26). Yet, there has been almost no change in the range of interest burdens among the federal states. The fall in interest rates provided particularly great relief for some highly indebted states, but it was largely outweighed by less favourable debt movements (see also the box on p. 25).

… improvement in structural budgetary position

On the other hand, the structural budgetary position (after deduction of the net interest burden) improved. This was due to extremely positive developments in those states that had been running a deficit at that time. By contrast, some states whose structural budgets were already in surplus eased their budgetary position. This was the case for Saxony, in particular, but also Baden-Württemberg and Saxony-Anhalt (see the chart on p. 27).

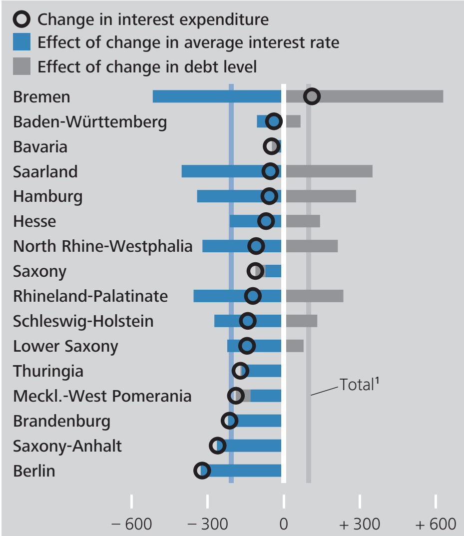
Interest expenditure: impact of debt levels and average interest rates

The amount of (gross) interest expenditure is determined by the level of debt and the average rate of interest. All the federal states have benefited from the dramatic improvement in borrowing conditions. For instance, the average interest rate calculated from the cash statistics for state government as a whole (including local government and off-budget entities) is half as high as it was in 2007, at just over 2%.[1] This decline has had a particularly positive effect on highly indebted federal states. On a national average, the receding average interest rates have translated into per capita relief of €210 compared with 2007 levels (€17 billion in total). Bremen and Saarland have benefited the most, their relief coming to €520 and €400 per capita, respectively.

Debt levels in the individual federal states have continued to diverge, not least on account of the varying budget outturns they have registered since 2007 (see the chart on p. 24).[2] They receded in the federal states of Bavaria, Berlin, Mecklenburg-West Pomerania and Saxony, but climbed elsewhere. Bremen experienced the strongest per capita growth, followed by Saarland and Hamburg some way behind. Interest expenditure contracted only marginally on balance in Saarland, and it even saw another increase in Bremen. In some cases, though, these contrasting fortunes have been driven in part by one-off factors. Furthermore, debt levels may have risen, but so, too, has the stock of financial assets and interest income.[3]

How state and local government interest expenditure evolved between 2007 and 2017*

Data in € per inhabitant in 2017



Sources: Federal Statistical Office (government financial statistics) and Bundesbank calculations. * Owing to gaps in the financial assets data, it is not possible to include the interest income offsetting some of the interest expenditure in the calculations of the average interest rate and the year-on-year comparison. **1** All state and local governments.

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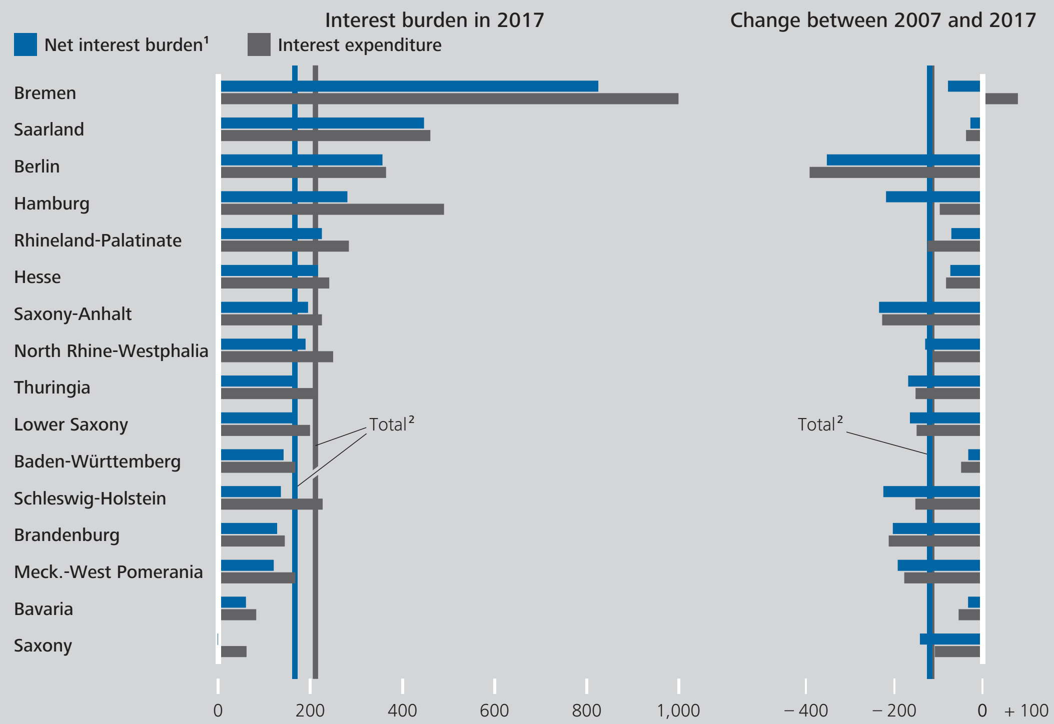
1 The average rate of interest is the reported interest expenditure as a percentage of the amount of debt at the end of the previous year. In some federal states, the average interest rate differs significantly from the figure stated due to the effects of interest rate hedges in particular.
2 The debt statistics for 2007 include only a small number of off-budget entities. However, it was only after that date that debt levels at these entities such as the bad banks began to rise significantly. Therefore, the comparison with the year 2017 should not be too distorted.
3 The data for North Rhine-Westphalia, for example, were affected by the establishment of the First Winding-up Agency (Erste Abwicklungsanstalt), the state-owned bad bank tasked with winding up the operations of WestLB. The debts managed by this Agency are offset by a stock of financial assets which are a source of interest income. By winding up these assets, the Agency expects to be able to scale back the debt level substantially over time. Bremen likewise saw its debt levels rise by far more than the deficits recorded in the core budget. The increase in interest expenditure was offset by strong growth in interest income during this period.

Interest burden of state and local governments*

€ per inhabitant



Sources: Federal Statistical Office and Bundesbank calculations. * Figures from the government financial statistics (cash statistics for 2017 including post-bookings). 1 Interest expenditure less interest income. 2 All state and local governments.
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Total revenue and total expenditure in 2017

Limited comparability of total revenue and expenditure: state government revenue-sharing scheme and …

The state government revenue-sharing scheme, for one, makes it difficult to compare total revenue and expenditure across the federal states. Federal states with a large financial capacity post "inflated" figures. They collect an above-average amount of tax revenue, part of which is dispensed again via payments into the state government revenue-sharing scheme. In order to neutralise this impact, payments under the revenue-sharing scheme made by the states providing contributions are recorded net; i.e. these payments are deducted from the total revenue and expenditure of the states in question.

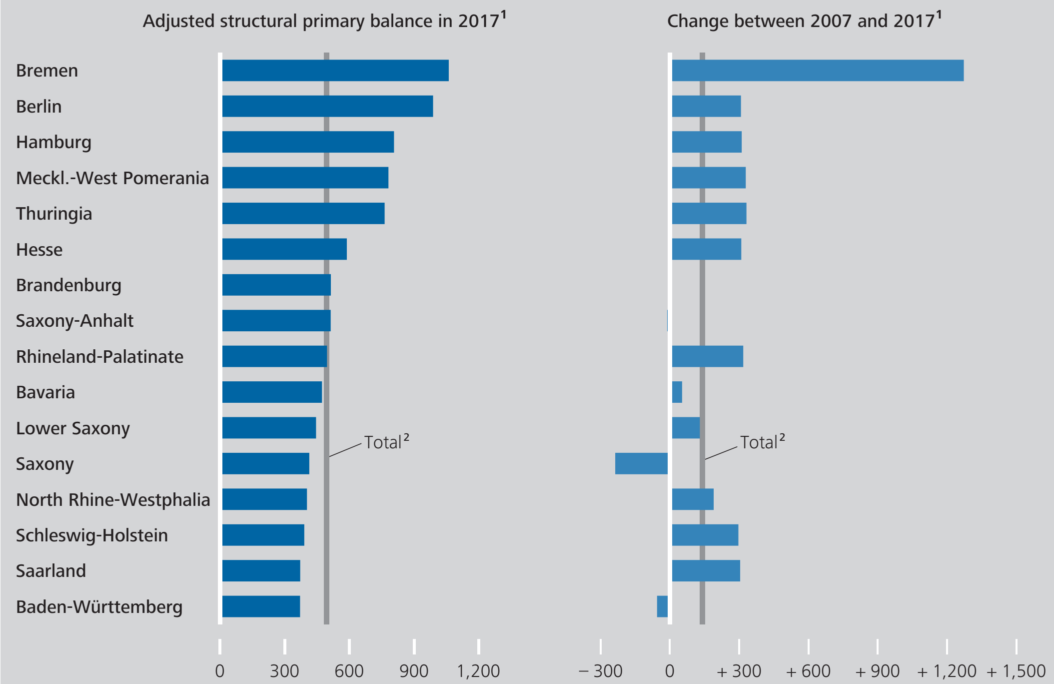
… receipts from fees recorded net

Furthermore, the individual states outsource a varying amount of tasks to private enterprises outside the government sector. Where tasks have been outsourced, government revenue and expenditure are lower. On the one hand, the corresponding receipts from fees, in particular, are no longer recorded on the revenue side. On the other hand, there is above all no personnel expenditure, other operating expenditure or spending on fixed asset formation on the expenditure side, respectively. Therefore, if a state records higher receipts from fees, this does not necessarily mean greater budgetary scope or higher burdens for the population than in other federal states. As a result, the particularly high level of receipts from fees recorded in Hamburg and partly in North Rhine-Westphalia is to be put into perspective, as is the higher level of spending observed in the corresponding categories in those states. In order to improve comparability of total revenue and total expenditure among federal states, receipts from fees are also recorded net here (i.e. deducted from total revenue and expenditure).

These adjustments considerably lowered the spread of total revenue and expenditure (see the table on pp. 20 and 21). The differences in

Primary balance of state and local governments*

€ per inhabitant



Sources: Federal Statistical Office and Bundesbank calculations. * Figures from the government financial statistics (cash statistics for 2017 including post-bookings). **1** After deduction of the net interest burden (interest expenditure less interest income). Balance adjusted for financial transactions, calculated cyclical effects and settlement under the state government revenue-sharing scheme. **2** All state and local governments.

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Higher expenditure, even after adjustment for interest burden, mostly covered by tax revenue capacity or transfers

interest expenditure outlined above can be seen on the expenditure side. Of the non-city states, Saxony-Anhalt recorded the highest level of other expenditure. However, this was offset by particularly high transfers from central government. Saxony-Anhalt was closely followed by Hesse which, at the same time, had a high level of tax revenue. Mecklenburg-West Pomerania was at the other end of the scale and also posted the highest surplus due to its relatively low level of expenditure. The values recorded by the city states were way above average: Hamburg recorded the highest level of other expenditure, closely followed by Bremen where tax revenue was much lower and the interest burden far higher.

Notes on selected expenditure categories

Staff costs are the largest expenditure item for all federal states. Expenditure for current staff per inhabitant is already very varied in the non-city states. For example, Brandenburg spent almost a quarter more on staff than Schleswig-Holstein. However, the largest amounts were recorded in the city states, especially Hamburg. Yet, caution should be exercised when interpreting these figures. Some federal states contract out public services outside the government budgets. One example is privately run institutions taking on childcare. The states' own staff costs are then lower, but grants to such institutions are higher.

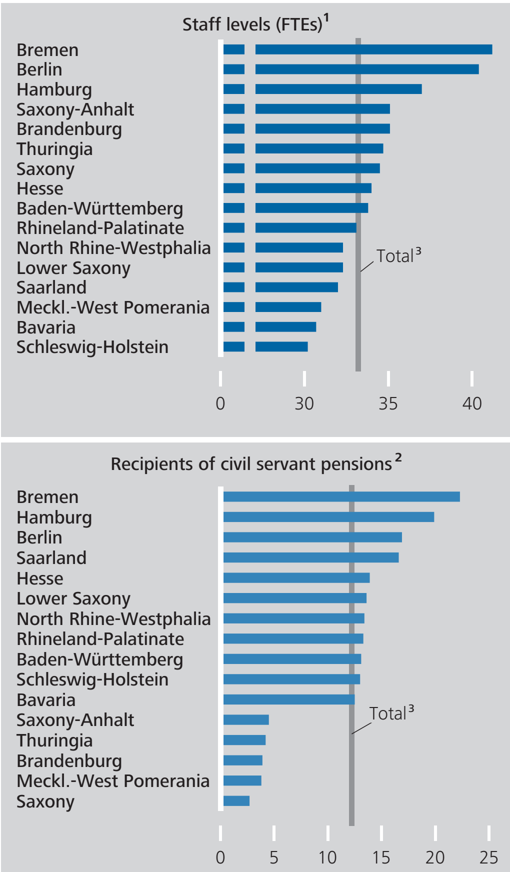
Personnel expenditure: marked differences in expenses for current staff …

A key factor behind staff costs is staff numbers. In the core government areas, staff numbers are again particularly high in the city states and, above all, in Bremen (see the chart on p. 28). But the eastern states, too – with the exception of Mecklenburg-West Pomerania – have staff levels that are way above average. The lowest levels are in Schleswig-Holstein and Bavaria.

… primarily due to staff numbers …

Staff levels and number of recipients of civil servant pensions in state and local governments in 2017

per 1,000 inhabitants



Sources: Federal Statistical Office and Bundesbank calculations. **1** Staff in public sector in state and local governments (in full-time equivalents) on 30 June 2017. Those areas where tasks do not usually belong to enterprises that are part of the government sector have been removed. **2** Recipients of civil servant pensions of state and local governments on 1 January 2017. **3** All state and local governments.

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… and differences in civil servant pay rates

Furthermore, pay rates differ from one federal state to the next. While negotiated rates of pay – with a few exceptions – have been collectively agreed throughout Germany, civil servant pay rates differ, in some cases considerably, among the federal states. There has been no national uniform legislation since the 2006 federal structure reform, with the result that Bavaria's annual gross civil servant pay rate in the final level of A 13 – the pay grade for a great many civil servants – was just over 6% higher than the average this year (see the chart on p. 29). Saarland recorded the lowest level.[24]

States have distinct scope when setting civil servant pay rates

In a ruling on judges' remuneration, the Federal Constitutional Court found no cause for concern if civil servant pay rates are up to one-tenth lower than the average. Furthermore, different costs of living could distort an economic assessment of the varying pay rates. If the costs of living are lower, real remuneration is correspondingly higher. This is likely to be the case in the eastern states.[25] There is also a certain degree of scope when assigning civil servants to various pay grades for certain functions. Official statistics do not contain any information on this, however. Overall, then, federal states do have ways in which to adjust these rates in order to meet state-specific consolidation requirements, for instance.

Vast differences in civil servant pensions, especially between eastern and western states

The spread for spending on civil servant pensions per inhabitant is even wider than it is for current personnel expenditure. This is predominantly attributable to lower numbers of recipients in the eastern states (see the adjacent chart). The eastern states make special payments to central government for special and supplementary pension payments made to former employees from the period prior to reunification. But even after factoring in these expenses, the eastern states reached, at most, two-thirds of the national result. Of the western German non-city states, Schleswig-Holstein was the only state below the national reference figure. Saarland exceeded the national reference figure by one-fifth, although the fact that population trends there have been weak for some time had an impact on per capita expenditure. The city states of Hamburg and Bremen have to foot an even heftier bill.

There are also substantial differences in transfers to households. North Rhine-Westphalia, Bremen and Hesse recorded the highest expenditure. It is the needs-based social benefits

24 The order of federal states is not the same for all pay grades and experience levels. For more information on the data, see DGB, Besoldungsreport 2018, April 2018.
25 For more information, see Deutsche Bundesbank, Personnel expenditure in the individual federal states, Monthly Report, October 2015, pp. 40-43.

Differences in transfers to households softened by central government contributions

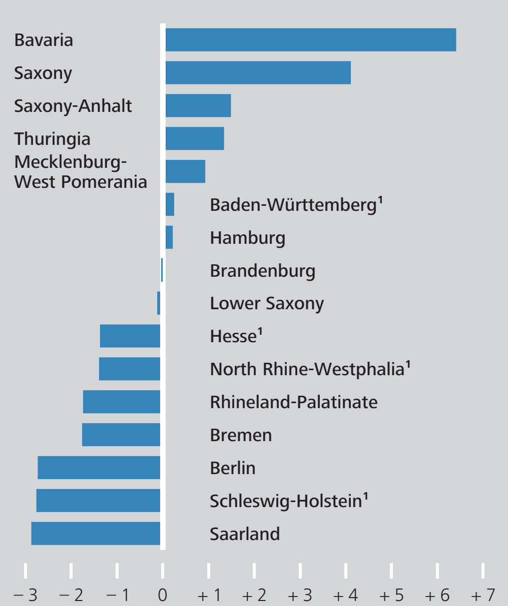
(such as basic allowance benefits), in particular, that have been driving up this item. Such benefits tend to be focused on regions where the population is denser or the economy weaker. Specific decisions regarding the division of responsibilities,[26] but also the range of benefits, are also likely to be a factor. It is difficult to derive from the government financial statistics the actual net burden on a state from social benefits. This is also because central government's contribution differs. For instance, central government grants towards the accommodation costs of recipients of unemployment benefit II, the full refund of basic allowances for the elderly as well as other cost reimbursements have varying effects from state to state.

Large deviations in other operating expenditure and fixed asset formation

Spending on other operating expenditure and fixed asset formation also varies considerably. Here, too, it is difficult to interpret the figures because tasks are outsourced to non-public sector entities to varying degrees. In both expenditure categories, comparison is distorted by the extremely high values recorded in Hamburg. The high levels of investment in Hamburg are mostly posted by off-budget entities. Bavaria and Baden-Württemberg are not far behind Hamburg, recording large volumes of investment, too. Bremen and, in particular, Saarland have below-average values but are still way ahead of Berlin. Past and present budgetary strains also ultimately have a negative impact on investment levels. A shortage of staff may currently also be holding back the implementation of investment projects. The government financial statistics do not contain investment in the form of public-private partnerships. Ultimately, in order to ensure that the comparison across states is meaningful, attention should be focused more on the public infrastructure provided than the level of expenditure. However, this information is not available.

A 13 annual gross civil servant pay in 2018*

Percentage deviation from the mean figure, as at April 2018



Sources: DGB Besoldungsreport 2018 and Bundesbank calculations. * Total of annual basic salary in the final level of the pay grade, general job-based allowance or structural allowance, special payment(s), assuming a 40-hour week. The A 13 pay grade particularly covers many school teachers. **1** Pay for a 41-hour week converted to 40 hours.

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Notes on selected revenue categories

Differences in tax revenue mainly equalised, …

The revenue-sharing scheme has greatly diminished the differences in tax revenue.[27] This scheme ensures that the federal states end up with at least 95% (or thereabouts) of the average financial capacity specified therein for each group of states (non-city states and city states).[28] One notable reason why actual rev-

26 The very low figure for Saxony-Anhalt is a result of a different division of responsibilities between state government and local government. In Saxony-Anhalt, the state – as the provider of certain social benefits – posts refunds to other areas (other operating expenditure) whereas, in other states, similar payments are included under social benefits via local government statistics. As a result, other operating expenditure is higher in Saxony-Anhalt than in most other states.
27 Taxes plus compensation for passing on motor vehicle tax to central government, the balance in the state government revenue-sharing scheme and general supplementary central government grants.
28 For more details, see Deutsche Bundesbank, The reform of financial relations in the German federal system, Monthly Report, September 2014, pp. 38-42.

enue differences turn out to be somewhat larger is that only just under two-thirds of local government tax revenue is taken into account in this scheme. In the original allocation of taxes (i.e. before turnover tax revenue is reallocated), the differences among states are more apparent. In many cases, shifts in the original allocation were strictly limited over the last decade. The development in North Rhine-Westphalia was striking. Its financial capacity in this regard has diminished more or less continuously. At last count, it was significantly lower than the average. Overall, in 2017, the spread of per capita tax revenue ranged from €6,450 in Hamburg to €4,200 in Saxony-Anhalt. The national average stood at €4,720 (non-city states: €4,610; city states: €6,080). Of the non-city states, Hesse recorded the highest amount (€4,910).[29]

… but differences of note in tax rates set decentrally

The taxes set autonomously by state or local governments vary greatly. The differences in real estate acquisition tax rates are considerable. Five states – including Saarland – now have a rate of 6.5%. By contrast, Bavaria and Saxony have kept their rate at the former uniform national level of 3.5%. In 2017, the city states tended to record the highest average rates for local government real estate tax B and local business tax. The multipliers for real estate tax B are the most widely scattered of these taxes. Berlin has the top position with 810%. Of the non-city states, local governments in North Rhine-Westphalia had the highest multipliers (570%) on average. Some local governments with a particularly tense budget situation recorded rates that were far higher than in Berlin. Schleswig-Holstein and Bavaria had the lowest average multipliers (390%). Local business tax rates were not spread quite so widely across the federal states. They ranged from 470% in Hamburg to 320% in Brandenburg. All in all, local government multipliers rose distinctly over the past decade, although local governments recently posted significant fiscal surpluses. Larger debt burdens and relatively unfavourable budget situations meant higher tax rates.[30]

Eastern states plus Bremen and Saarland with high revenue from other central government grants

In addition to tax revenue, central government transfers play a key role.[31] On average, these amounted to €560 per capita. But the eastern states recorded much higher levels. The special-needs supplementary central government grants for infrastructure reconstruction in eastern Germany and to offset the higher burdens caused by long-term unemployment still amounted to around €270 per capita in these states in 2017. Consolidation assistance did not have much of an impact in Berlin, Saxony-Anhalt and Schleswig-Holstein. However, it benefited Bremen and Saarland enormously.

More meaningful data on expenditure and performance items desirable for inter-state comparisons

All in all, there are special factors which make inter-state comparisons of individual revenue and expenditure items extremely difficult in some cases. There is no comprehensive, up-to-date set of data on revenue and expenditure broken down according to government functions. Some state governments and the local government level for the most part have introduced double-entry bookkeeping, which could additionally complicate the comparability of results from government financial statistics. Ideally, data – broken down by government function – would be published promptly, thus improving comparability across the board. This would enable the financial impact of policy decisions to be outlined more clearly and made more transparent for the general public. Meaningful budget data augmented by comparisons of the results, for instance as with the Pisa tests for schools, could generally help to better identify promising policy approaches. It therefore seems advisable to make reporting transparent and develop indicators suitable for comparison

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29 Bavaria recorded €4,740. The lower amount in comparison with Hesse is ultimately due to taxes that are set at state and local government-specific rates, and these are higher in Hesse. In the state government revenue-sharing scheme, Bavaria has a higher financial capacity because the calculations are based on normalised tax rates.
30 However, for local government multipliers, it is evidently also important how strictly the state government budgetary supervision implements the provisions governing a balanced budget.
31 The compensation for passing on motor vehicle tax and the general supplementary central government grants to further align financial capacities have already been included in tax revenue.

purposes. This could sustainably strengthen federalism in Germany as a whole.

Budgetary surveillance by the Stability Council

The tasks of the Stability Council

The tasks of the Stability Council: …

The Stability Council was established with the anchoring of the debt brake in Germany's Basic Law. Its members are the Federal Minister of Finance, the federal states' finance ministers and the Federal Minister for Economic Affairs and Energy. The Council is intended to play the central role in budgetary surveillance in Germany and has a variety of tasks.

… warning against impending budgetary hardship, …

First, the Council is there to monitor budgetary developments in central government and the individual federal states and warn against impending budgetary hardship. To do this, four predefined key figures were agreed, with two of them being ultimately based on the level of debt. Any budgetary recovery procedure depends on an irregularity being flagged by the majority of the key figures and is therefore likely to be triggered only at a very late stage. Overall, the key figures used so far have not been convincing.[32]

… monitoring compliance with the deficit reduction paths mapped out for federal states receiving consolidation assistance, …

Second, the Stability Council monitors progress made by the federal states which are receiving consolidation assistance: Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein. These federal states show particularly high levels of debt and, in 2011, agreed reduction paths for their structural budget deficits. If these are complied with, assistance payments totalling €800 million annually are pledged up to 2019. So far, the tests have invariably been positive. The chosen approach has not been convincing in this respect either. For example, major off-budget entities of individual federal states are left out if they do not have any borrowing authorisations. These include, say, pension reserves that can be structured flexibly and one large Berlin investment fund. Furthermore, the definition of the financial transactions that have been deducted is less than satisfactory. Moreover, the (per capita) cyclical components that have been included sometimes vary a great deal from one federal state to the next. This seems inappropriate, because the state government revenue-sharing scheme ought to largely offset cyclical developments specific to each federal state's economy.[33]

… safeguarding general government deficit limit, …

Third, the Stability Council monitors compliance with the EU requirements for budgetary discipline. In doing so, it is supported by an independent advisory board. In accordance with the European rules, the general government budget has to be close to balance in structural terms. For Germany, an upper limit of 0.5% applies to the structural deficit ratio. If there is a risk of the upper limit being exceeded, the Council is to recommend consolidation measures. Since this task was transferred to the Council in 2014, this limit has been complied with, as expected by the Council and its advisory board. However, it is likely that the safety margins will become smaller again in future, especially given instances of recourse to the extensive reserves. The latter, in particular, pose a challenge for monitoring (see the box on p. 32). Overall, the documentation submitted to the Council needs to be improved so that future developments can be estimated as reliably as possible.[34]

… and monitoring the implementation of the debt brake from 2020

Fourth, the Stability Council will, from 2020 onwards, assess whether central government and the individual federal states are complying with the debt brake. This was decided in 2017, when financial relations within Germany's federal system were restructured. For central government,

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32 For more details, see Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp. 20 ff.
33 Significant differences remain even after adjusting, say, for higher population growth rates (as suggested in Berlin's 2017 consolidation report).
34 See also Independent Advisory Board of the Stability Council, Neunte Stellungnahme zur Einhaltung der Obergrenzen für das strukturelle gesamtstaatliche Finanzierungsdefizit nach § 51 Abs. 2 HGrG, June 2018, pp. 17 f.

Reserves as a challenge for the European fiscal framework

Central, state and local governments as well as social security funds have built up sizeable reserves. In particular, the surpluses of recent years have often been used to form reserves and to prefinance off-budget entities. Sizeable funds can be withdrawn from these sources if required. The fact that provision is being made for future expenses is to be welcomed. Nevertheless, special requirements in terms of transparency and coordination should apply with regard to the European fiscal framework in the event of these funds being drawn on to a major extent. If reserves are drawn on, net borrowing in budgetary terms will be lower, and it will be easier to adhere to debt brakes that are linked to this item. However, the European fiscal framework relates to the deficit, which is not reduced by making withdrawals from reserves.[1] One major example of such reserves is central government's refugee reserve. This is set to be used up over the next few years to finance structural deficits. At the end of 2017, social security funds had free reserves in the amount of €88 billion. If more extensive use were to be made of such reserves to cover structural burdens – as will be the case in future with the statutory pension insurance scheme – the general government deficit ceiling might be exceeded even though there is no net borrowing. In this case, the Stability Council would have to recommend measures in order to maintain the deficit ceiling.

1 For more details, see Deutsche Bundesbank, Excursus: the use of reserves and off-budget entities by central and state government, Monthly Report, August 2018, pp. 69-73.

structural net borrowing since 2016 is limited to a maximum of 0.35% of GDP. The individual federal states will have to balance their budgets by 2020 at the latest without (structural) new net borrowing. If the Stability Council were to diagnose a breach of the rules, this would have no direct legal or financial consequences. It would, however, be a clear signal to the state government concerned and to the general public. This diagnosis might also be relevant in proceedings before a constitutional court.

Differences in the specific details of federal states' debt brakes

Many federal states still have not finalised the details of their debt brake. It would make the Stability Council's job easier if the rules were largely harmonised and geared to the European target variables. However, the current status shows that the approaches taken do differ quite substantially (see also the box on pp. 40 to 47). It is therefore all the more important to agree transparent monitoring procedures and have meaningful and comparable information available as soon as possible.

Requirements for budgetary surveillance

Independent boards of particular importance

Fiscal rules can play an important part in safeguarding sound public finances. Budgetary surveillance has a key role to play in this. It would seem prudent to make independent boards responsible for these activities.[35] This is also envisaged by the European fiscal rules for the national budgetary surveillance of the Member States. In Germany, this role is performed chiefly by the Stability Council. Thus, the Federal Ministry of Finance and the federal states' finance ministries are to monitor themselves via the Council. The independent advisory board mainly plays a part in monitoring the European rules for general government and is substantially dependent on the documentation provided by the Stability Council.

35 See Deutsche Bundesbank, Design and implementation of the European fiscal rules, Monthly Report, June 2017, pp. 29-44.

High degree of transparency essential for effective surveillance …

In order to ensure stringent budgetary surveillance in this approach, the procedures should be clearly structured and rule-bound. The general public should also be able to understand how the current situation looks and what risks exist in terms of failing to comply with national or European rules. Transparency is of key importance in this context. The budgetary key figures for central government and the individual federal states would have to be informative, up-to-date and comparable. In each instance, there would have to be an account of what effect the expected developments have with regard to the requirements of the respective debt brakes and the European rules. At present, only the rudimentary elements of this are in place.

… and information should already be available

The task of monitoring the debt brakes as from 2020 has considerably widened the Stability Council's mandate. This presents the opportunity to achieve a major advance in budgetary surveillance. It would be important to eliminate any grounds to suspect that the ministries of finance will take a lenient view of each other's books and are not interested in transparency. All things considered, this would not need to add substantially to the data collection workload. Responsible budgetary policy already implies comprehensive monitoring and planning systems. To a large extent, the pre-existing information from these systems would merely have to be harmonised, updated as necessary and then published.

Complying with debt rules stabilises debt and prevents budgetary hardship

Enhanced fiscal surveillance is yet to be given concrete form by the Stability Council. Assuming the debt brake is strictly adhered to, budgetary hardship should, by rights, be a thing of the past. If, from 2020, the federal states regularly achieve a structurally balanced budget with no net borrowing, a permanent rise in debt beyond the level then reached would be ruled out in principle. It would therefore be logical for the focus in future to be on monitoring compliance with the debt brakes. The current or medium-term threat of conflicts with constitutional requirements would have to be highlighted and suitable countermeasures recommended.

Enhanced monitoring of changes in debt and financial transactions an obvious thing to do

Nevertheless, the debt brakes also allow exceptions to the ban on new borrowing. Borrowing is permitted if this is for building up financial assets.[36] Cyclical developments or the exemption clause for emergency situations may also justify new borrowing temporarily. In the process, biases in the method of cyclical adjustment, utilised exemption clauses with repayment outstanding and assumptions of debt that are not taken into account may lead to a sustained build-up of debt. This would be contrary to the intention of the Basic Law, under which only a rising stock of financial assets would justify a structural build-up of debt. To allow for this in the budgetary surveillance process, it would be vital for the federal states, first, to give the Stability Council an account of the transaction-related change in their level of debt and their stock of financial assets since the introduction of the debt brake (including, in each case, the relevant off-budget entities). Second, the sum of the cyclical components taken into account and of the deviations from the structural annual upper limit in the budget outturn would also have to be stated. The Council could determine ex ante thresholds for the build-up of debt, from and above which it could call for a rule-based medium-term repayment.

Gearing to European requirements also needed

The information provided to the Council should, besides the debt brake, also make it verifiable whether there is a risk of breaching the European rules. To do this, the Stability Council, say, would also have to apply the European cyclical adjustment procedure to each of the expected budget outturns. Furthermore, the key figures should be brought more closely into line with the methodology and sectoral classification of the national accounts. This also includes the federal states submitting additional data and estimates and providing in-

36 Financial transactions are the point of reference. Reclassifications of previously acquired assets play no part in this.

Budgetary surveillance: good information basis is crucial

The Stability Council is responsible for monitoring compliance with the debt brakes of the individual federal states and the European fiscal rules for general government. To do this, sound and up-to-date basic information on the important factors has to be available. This is not sufficiently ensured at present.

General requirements[1]

The European rules are directed at general government deficits as defined in the national accounts. Budgetary surveillance therefore calls for a consistent and current estimate of the government account within the national accounts. This should be based on appropriate projections as defined in the budget accounts (government finance statistics) for central, state and local government and social security funds (and their main schemes). The focus should not only be on the core budgets, but also on the rest of the government sector included in the national accounts. The transition from the budgetary statistics to the national accounts should be clear in identifying the key ways in which it has been implemented. The fiscal estimates need to be based on a current macroeconomic projection. This is used to derive the estimated cyclical effects.

For monitoring the debt brakes, estimates for the relevant data from central and individual state governments have to be available. With regard to the general government deficit ceiling, the contributions of the individual federal states should also be made clear. Besides the off-budget entities, it would also be vital in this regard to have the best possible budget estimate for the local government level under their budgetary supervision.

Key figures

For appropriate, well-founded and transparent budgetary surveillance, central government and the individual state governments should provide a standardised overview of their current financial position and outlook.[2] Information that would appear necessary for such surveillance is shown on p. 36 for the Länder by way of an example. Corresponding information should also be provided by central government. It may be assumed that central and state governments already possess most of this information from their budget management and control. This basic information should be made available to the Stability Council in updated form at the time of auditing. There is no reason why this information should not be made accessible to the general public, too.

For the individual indicators, both the results for the past two years and the latest estimate for the current year and the medium term should be reported. This would represent a major advance on the data in the current stability reports on emergency prevention. At present these contain a compilation of budget planning information with very different data vintages in some instances. In many cases, for example, that data for the Länder have not been brought into line with the latest official tax estimate. In this respect, it is mostly not possible to

1 See also Independent Advisory Board to the Stability Council, Neunte Stellungnahme zur Einhaltung der Obergrenze für das strukturelle gesamtstaatliche Finanzierungsdefizit nach § 51 Absatz 2 HGrG, June 2018, pp. 17-18.
2 This is fundamentally envisaged for European budgetary surveillance, too. The individual Member States should submit updated and standardised forecasts about their own finances at specific points in time; these then undergo a rule-based evaluation.

discern the currently expected development.[3]

On the revenue side, taxes are the most important item. If a state government's forecast differs from the regionalisation (allocation between the Länder) of the last official tax estimate, this should be explained. Possible reasons might be an update by the state government in the interim, features that are specific to the given federal state such as an assumed divergence in economic or demographic development, or changes in tax legislation for which additional allowance has been made in the budget. Consideration should also be given to updated projections for the state government revenue-sharing scheme, the general supplementary central government grants and, where applicable, for the local government revenue-sharing scheme.

A key item on the expenditure side is personnel expenditure. Data on the expected development of staffing levels and the number of civil servant pension recipients are vital. Any planned decoupling of civil servant pay rates from national trends would also be relevant.

Further key items to be reported might include other operating expenditure and fixed asset formation.

In the case of interest expenditure, data on assumed interest rates would be essential. As defined in the budget, interest rates are heavily influenced by premiums, discounts and effects of derivatives positions. These items generally have no direct impact on national accounts results, however, and should therefore be shown.

If global items (for example, planned expenditure shortfalls or revenue windfalls) are included in the budget estimate, these should be listed.

Financial transactions have a different impact on the results in the budgets and in the national accounts. In order to assess such effects, these transactions should be shown on both the revenue and expenditure side. This should be based, as far as possible, on the strict requirements of the national accounts for financial transactions (acquisition or redemption of financial assets with genuine recoverable value): capital injections without a prospect of profit or for the purpose of offsetting losses should form as little a part of this as calls on guarantees.

Any reserve transactions affecting the budget, such as reserves or off-budget entities, should also be reported. Important examples are the use of "repealed" borrowing authorisations or withdrawals from the special funds for pension provisions. Although such transactions reduce net borrowing in budgetary terms, they do not improve the fiscal balance (which is consolidated with off-budget entities). They can be designed flexibly by the individual federal states and could conceal the structural budgetary position.

Where more significant one-off factors affect the budget outturn, it would be desirable to include a memorandum item. Examples are the fine paid by Volkswagen to the federal state of Lower Saxony in the current year or extensive sales of fixed assets. This would make it easier to assess the underlying budgetary position.

In addition to net borrowing and the fiscal balance according to the budget statistics, a balance consistent with the national accounts should also be shown. This should be adjusted for financial transactions as well as other known major adjustment

3 By contrast, the estimates of the Federal Ministry of Finance for the results of the state governments as a whole are updated in principle, but do not permit any analyses for individual Länder.

Key figures for budgetary surveillance for each federal state

Results t–2 and t–1, current estimate to t+4 (in € million and € per capita)

Core budget

- Total revenue
  - Taxes
    - If applicable, difference from last tax estimate stating reasons
  - Transfers from general government
    - Of which: From off-budget entities of the federal state
      - Of which: Pension reserves/funds
  - Financial transactions (excluding guarantees)
  - If applicable, global revenue increases/shortfalls
  - Other revenue affecting the fiscal balance
- Total expenditure
  - Personnel expenditure (excluding pension schemes)
    - Of which: Pensions and healthcare subsidies
    - Memo item: Development of active staff (full-time equivalent)
      Development of persons receiving pension benefits
      If applicable, state-specific details with relation to civil servant pay rate adjustments
  - Other operating expenditure
  - Interest expenditure
    - Here: Average interest rate for new borrowing
    - Of which: if applicable, premium/discount
    - Of which: if applicable, result from derivatives
  - Transfers to general government
    - Of which: To local government
    - Of which: Transferred by central government
    - Of which: Pension reserves and funds
    - Of which: Other provision funds
  - Current subsidies
  - Fixed asset formation
  - Financial transactions (excluding guarantees)
  - If applicable, global revenue increases/shortfalls
  - Other expenditure affecting the fiscal balance
- Net borrowing and balances
  - Net borrowing
  - Withdrawal from/transfer to reserves etc.
  - Fiscal balance
  - Balance of financial transactions
  - List of other major differences compared with national accounts (e.g. debt relief)
  - Fiscal balance consistent with national accounts

Budget consistent with national accounts (with off-budget entities und local governments)

- Fiscal balance core budget consistent with national accounts
- Fiscal balance off-budget entities (according to national accounts list)
- Balance off-budget entities consistent with national accounts
  - Of which: Off-budget entities considered in the debt brake
- Fiscal balance local governments
- Balance local government consistent with national accounts (similar methodology to that of the state governments)
- Total balance consistent with national accounts (with off-budget entities and local governments)
- Memo items:
- Key differences between national accounts and government finance statistics (list)
- One-off factors accounting for at least ½% of overall expenditure (list)

Information on budget rules

- EU rules
  - Total balance consistent with national accounts
  - Cyclical factor EU procedure
  - Total balance consistent with national accounts after cyclical adjustment
- Federal state’s debt brake
  - Deficit/borrowing ceiling (according to debt brake)
  - Deficit/borrowing
    - Of which: State-specific cyclical component
    - Memo item: Net effect, recourse to/filling reserves
  - Federal state’s debt level
  - Sum of the financial transactions deducted since 2020
  - Sum of the cyclical components since 2020 (cyclical control account)
  - Sum of the deviations from ceiling since 2020 (control account)
  - Reserve holdings to maintain the debt brake (e.g. budgetary reserves)
  - Additional information
    - Debt of off-budget entities which are not included
    - Debt of local governments
      - Of which: Cash advances

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items, such as debt assumptions and debt relief.

Results for the off-budget entities should be reported in accordance with the current list of such entities published by the Federal Statistical Office. Taking these into account brings the balance more closely into line with the national accounts and provides a more comprehensive picture.

The expected overall balances are significant for the local governments of a federal state. This concerns, first, their effect on the general government balance. Second, in combination with information on the volume of cash advances, an assessment can be made of whether a tense financial situation at local governments poses a risk for future state government budgets.

For the European rules, a federal state's expected contribution to the general government structural deficit as defined in the national accounts is important. Therefore, a structural balance that is consistent with the national accounts should also be reported for the individual states using the EU's cyclical adjustment method. The Federal Ministry of Finance could make the cyclical impact available on the basis of the method applied there. It would then be easier to assess whether the general government deficit might come into conflict with the structural ceiling of 0.5% of GDP.

In order to monitor compliance with the federal states' respective debt brake, the individual states would, as a rule, have to provide further supplementary information. This includes the expected margin to the state-specific debt brake ceiling. Data on the cyclical components considered would also be vital. This will make it possible to assess over the long term whether the symmetry requirement of the German Basic Law has been met.

formation for all their off-budget entities and the local governments. The box on pp. 34 to 37 contains an example of a set of vital basic information for effective fiscal surveillance.

Outlook and conclusions

Further convergence of fiscal positions of the individual federal states desirable

Following the favourable outturn in 2017, the positive development in state government finances is continuing. In the current year, the surplus adjusted for special factors is likely to increase further after the strong half-year result.[37] Even after adjustment for the positive economic situation, a marked surplus is in the offing. It is not possible to tell at present whether the disparity between federal states will narrow further. This would be desirable as the significant lingering differences make political decisions with a nationwide fiscal impact more difficult. For instance, in light of the favourable state of German public finances, there is talk of cutting national income tax rates. In some federal states, potential conflicts with the debt brake or short-term consolidation needs can be avoided once the fiscal positions are more closely converged.

Low interest rates not to be regarded as something that will go on for ever

An ambitious fiscal policy is advisable especially for highly indebted federal states. These are benefiting very strongly from the low funding costs in a low interest rate environment, which has made fiscal consolidation much easier in recent years. However, the extremely low interest rates should not be considered as something permanent. Although this relief is likely to continue for some time, not least in cases where longer average fixed-interest periods have been agreed, high levels of debt ultimately make it considerably more difficult to

37 Major negative special factors expected in the second half of the year are calls on guarantees in relation to the privatisation of HSH Nordbank and assumptions of debt by the state government of Hesse in favour of its local governments as part of the new "Hessenkasse" assistance programme.

combine sound fiscal policy with good public services as soon as monetary policy returns to normal.

More federal funds in future state government revenue-sharing scheme, yet different extent of relief with respect to present

In the medium term, the reform of the state government revenue-sharing scheme means that state government budgets will, from 2020 onwards, be significantly strengthened to the detriment of central government.[38] At the same time, however, the special funds for infrastructure reconstruction in eastern Germany and the funds paid by central government to offset the cutback in mixed financing in 2006 will be discontinued. Therefore, some federal states are likely to be in only a slightly better position than they are now.

Planned expansion of mixed financing questionable

However, the Federal Government is planning to transfer further funding to the federal states. The aim is to significantly increase mixed financing again. New grants are being earmarked for investment in schools, childcare, transport projects and social housing. Furthermore, central government is also promising to contribute financially to addressing the legacy debt problems of many local governments. The planned mixed financing obscures the link between public services and their actual costs. It is also becoming apparent that responsibility for public services and for any problems that may arise in this context is not clearly discernible. Experience has shown that such a situation is not conducive to an efficient use of funds and an effective performance of tasks.

Strengthening of individual responsibility more helpful

The new projects represent a departure again from the objectives of the reform of the financial constitution in 2006. The reform was designed to make state governments more self-reliant in their decision-making in terms of the services they provide and also force them to take greater account of the associated costs. This was intended to strengthen their individual responsibility. Suitable key figures would be important for a comparison of the different approaches adopted by the individual federal states. These are, in some cases, already available in the field of education, for example. For all their limitations, these indicators do provide additional, structured information for identifying promising approaches (best practices). This could enhance the efficiency of Germany's federal structure.

Strengthening revenue autonomy

It might also make sense to grant state governments greater discretionary powers on the revenue side as well. This might include, say, income tax surcharges that can be set individually at the state level.[39] To the extent that there are marked differences in preferences regarding the nature and scope of public services, state government policy can respond to them more precisely. The debt brake means that borrowing is not available as an option, and any need for adjustment falls largely on the expenditure side at present. Greater revenue autonomy would also make clear to the general public the connection between public services and their funding, while greater involvement of central government obscures it.

Longer-term challenges posed by demographic developments …

Looking ahead, demographic developments will place a further burden on state government budgets. For example, tax revenue will increase more slowly, while spending on civil servants' pension benefits will grow disproportionately, at least up to the middle of the next decade. This is due, in particular, to the fact that the number of civil servants was expanded significantly in the past, especially in the case of teachers in response to growing numbers of pupils. Furthermore, life expectancy is increasing, which means that civil servants will be drawing a pension for longer if the retirement

38 For more details, see Deutsche Bundesbank, Public finances, Monthly Report, November 2016, pp. 61-72. Relief for the federal states is also being afforded by the impending back-transfer of turnover tax funds by central government (just over €2 billion), as the debts of the "German Unity Fund" are fully funded in formal terms. The fact that the increased share of local business tax (€3½ billion) will no longer have to be transferred to western German state governments, on the other hand, will ease the burden on local government. Individual federal states could offset this to the benefit of their budgets.

39 For more detailed information on this topic, see Deutsche Bundesbank, The reform of financial relations in the German federal system, Monthly Report, September 2014, pp. 44-46.

age remains unchanged. There are parallels here with the statutory pension insurance scheme. It therefore appears appropriate to also link the retirement age of civil servants to increasing life expectancy levels. At the same time, this would at least go some way towards easing a situation where demographic developments are likely to make it more difficult to recruit new staff.

… only partially accounted for so far by the formation of reserves

To provide for the foreseeable large civil servant pension obligations, the federal states have been setting aside pension reserves and funds over the past two decades. In doing so, they pursued very different approaches. Generally speaking, it is appropriate to recognise the additional pension burdens associated with the employment of civil servants on an accruals basis in the current budgets. A systematic provision also seems prudent. Nevertheless, the accumulation of reserves of late has arguably been geared more to the current budgetary situation. The obligations which have already accrued are far from being covered. It is scarcely possible to estimate how far the earmarked funds are supposed to cover expenditure in individual years. To enhance transparency, regular harmonised civil servant pension reports would be desirable. These would need to be presented at agreed points in time. Of interest here are the expected future expenditure paths, as well as the financial provisions and their intended use.

Specific form the debt brake takes differs widely among federal states

Moreover, many federal states still have the implementation of the debt brake into state legislation on their agendas. The approaches specified so far differ quite considerably in some cases (see the box on pp. 40 to 47). Above all, there are major differences in terms of cyclical adjustment procedures, the inclusion of financial transactions and off-budget entities, as well as the point of reference (net borrowing or deficit).

Requirements for state debt brakes

In terms of design, the crucial factor is to effectively safeguard the constitutional objective of a consistent limit on debt and the European fiscal rules. It is therefore essential to take account of off-budget entities and remove financial transactions as defined in the national accounts. Where cyclical effects are left aside, the adjustment methods used must not allow any structural build-up of debt, as stipulated by the Basic Law. Exemptions for emergency situations would have to be defined as clearly as possible and backed by effective repayment rules. However, even if the debt brakes are designed quite strictly, it cannot be ruled out that debt will increase, contrary to the intention of the debt brakes, when the budget is implemented. In this case, there should be a requirement for state government to reduce any newly accrued debt according to a fixed set of rules if certain thresholds are exceeded. In any case, fiscal planning and developments should be modelled in such a way that allows compliance with the rules to be controlled effectively. To this end, the relevant calculations and key figures should be both comprehensible and presented transparently.

Significant expansion of budget information needed for the Stability Council

The Stability Council has a key role to play in budgetary surveillance. In addition to its existing tasks, it will examine compliance with the respective debt brakes in future. To achieve this, information which is more extensive than that available at present is necessary. This would also have to be published so that the general public can understand this surveillance process (see the box on pp. 34 to 37). At the time of auditing, central and state governments should present updated estimates for the current year and the medium term. These should contain the information needed to assess potential conflicts with the European or national rules.

Implementing the debt brake in the federal states

The debt brake limits structural new borrowing by central government to 0.35% of gross domestic product (GDP) in accordance with Article 115 of Germany's Basic Law *(Grundgesetz)*. Legislation implementing the debt brake entered into effect in the 2011 fiscal year. As for the state government budgets, Article 109(3) of the Basic Law generally prohibits the federal states from (structural) new borrowing as from the year 2020.[1] Any exceptions need to be addressed by state law, and they are not permitted to undermine the intention of the debt brake.

To date, the debt brake has been enshrined in the state constitutions of eight federal states (Bavaria, Bremen, Hamburg, Hesse, Mecklenburg-West Pomerania, Rhineland-Palatinate, Saxony and Schleswig-Holstein), though the relevant legislation does still need to be fleshed out in some instances. Five other states (Baden-Württemberg, Lower Saxony, North Rhine-Westphalia, Saxony-Anhalt and Thuringia) have not (yet) amended their constitutions, but they have updated their state budgetary acts. Here again, there are some states which have still not enacted any rules to implement the debt brake. Berlin, Saarland and Brandenburg have not made any arrangements under state law to date. That said, both Berlin and Saarland are currently subject to administrative agreements in connection with the consolidation assistance they are receiving.[2] These agreements are there to prepare Berlin and Saarland to comply with the debt brake as from 2020, and they were designed specifically with the debt brake in mind.

Target variable: new borrowing or fiscal balance

In the vast majority of cases, the debt rules which the federal states have implemented so far refer to net borrowing.[3] Only Schleswig-Holstein and – by virtue of the link to the administrative agreement in connection with the consolidation assistance running until the end of 2019 – Bremen and, up to the end of 2018, Rhineland-Palatinate have debt rules that are geared to the fiscal balance. Unlike net borrowing, the fiscal balance does not change when reserves are replenished or drawn down. This is consistent with the European fiscal rules, which use the fiscal balance as defined in the national accounts as their point of reference. What makes the debt brake more difficult to comply with in this case is that unused budgetary scope cannot be carried forward (in the form of reserves) to future periods.[4]

Reserves are becoming an increasingly important budgetary instrument for the state governments. Mecklenburg-West Pomerania reported the highest per capita stock of reserves, at almost €1,000 (see the overview on pp. 44 ff.).[5] The highest volume in absolute terms, meanwhile, was reported by Bavaria, at just over €6 billion, or €470 per capita. Other federal states such as North Rhine-Westphalia have no general reserves to speak of.[6]

1 Here, and in the remainder of this box, this means net new borrowing. Therefore, rolling over maturing debt instruments continues to be permitted.
2 Similar agreements are in place for Bremen, Saxony-Anhalt and Schleswig-Holstein.
3 At the central government level, net borrowing is considered for the core budget, and the fiscal balance for the off-budget entities consolidated under the debt brake.
4 See also the box on p. 32.
5 Information collected by a Bundesbank survey among the federal states' finance ministries.
6 The North Rhine-Westphalian state constitutional court curtailed the scope for creating and using such reserves by narrowly interpreting the state constitution.

Adjusting budgets for cyclically induced revenue growth

The Basic Law allows exceptions to be made from the debt ban, with the federal states having the scope to make their own individual arrangements. This includes the ability to adjust their budgets symmetrically to allow for cyclical effects. That is to say, they are permitted to borrow as a way of bridging cyclically induced deficits they incur during weak spells, provided similarly sized surpluses are generated when conditions improve to repay the debt. Thus far, cyclical adjustment methods have been adopted and published by eight federal states. One feature all these methods have in common is that they use tax revenue to measure cyclical effects. In other respects they vary substantially, so they each have their own set of advantages and drawbacks.[7]

Hesse and Schleswig-Holstein have opted for a method that is much like the one used by central government. Similar methods are used in connection with the consolidation assistance schemes, where an estimated aggregate output gap is the starting point used during budget planning to determine the cyclical component. When measuring this gap, it is assumed that the ratio to the cyclical component of tax revenue is fixed. Positive output gaps are an indication of good economic conditions (overutilisation), while negative gaps show that the situation is poor. If tax revenue deviates from the budgeted data over time right up to budget outturn, these deviations are also considered cyclical (except where they can be traced back to legislative changes). To ensure that positive and negative cyclical effects balance out over time, it makes sense to record all the cyclical effects identified on a cyclical control account, as is done in the state of Hesse, for instance. If the amount of debt posted on this account reaches a fairly high level over a longer period of time, the structural budgetary position was assessed as being better on average than it actually is. This happens because the debt which was thought to have been cyclically induced (and was thus allowed) was not automatically paid down out of cyclically induced surpluses. That is why a threshold value needs to be set for the cyclical control account above which debt reduction follows a rule-based procedure.

The federal states of Baden-Württemberg, Hamburg, Mecklenburg-West Pomerania, Rhineland-Palatinate, Saxony and Thuringia, meanwhile, have opted to apply tax-smoothing methods rather than a mechanism linked to the output gap. Under these methods, the cyclical component is the difference between tax revenue and a "normal level" of tax revenue. This normal level of tax revenue, which is adjusted for changes in legislation, is determined in different ways. Baden-Württemberg and Rhineland-Palatinate identify their normal values by selecting a starting year for which economic conditions were assumed to be normal. The tax revenue collected in this starting year is then carried forward at a trend growth rate which is updated annually. Hamburg determines its trend level using an econometric method which assumes a constant rate of trend growth (tax trend method group). Tax trend methods tend to generate smoother cyclically adjusted tax revenue levels than those linked to the output gap. However, if the actual rate of trend growth deteriorates, there is a risk that there might be no need for the state government to respond promptly. The danger then is that structural deficits might be permitted (wrongly) as cyclically induced developments, and an additional persistent debt might build up. Targeted trend adjustments would therefore appear to be necessary to address this problem. The essence of this idea is anchored in the method used in Rhineland-

7 For details, see Deutsche Bundesbank, Federal states' cyclical adjustment in the context of the debt brake, Monthly Report, March 2017, pp. 33 ff.

Palatinate, where the cyclical components are monitored on a control account. If the control account reaches substantial negative levels, there is a mechanism which automatically reduces the trend growth rates.

The tax-smoothing methods applied in Mecklenburg-West Pomerania, Saxony and Thuringia determine the normal level using the average level of tax revenue in multiple previous years (tax level method). However, if GDP and thus tax revenue increase over time (as they normally do), the use of past data as a point of reference will result in the normal levels determined being too low. As a result, for the most part, excessively high positive cyclical effects would be identified. These can be used for additional expenditure as long as they do not run up any debt, no repayments need to be made on loans borrowed earlier, and no reserves have to be replenished. High levels of reserves and safety margins are especially important under these methods because of the very tight constraints applied to cyclically induced borrowing.

Adjusting budgets for financial transactions

Transactions are deemed to be "financial transactions" when financial assets are realised or acquired. These transactions do not change the net stock of financial assets, nor do they accrue to the fiscal balance as defined in the national accounts, which is the point of reference for the European budgetary surveillance procedure. The state governments are free to choose whether and how they adjust their key budgetary position for the debt brake to allow for financial transactions.

To date, only Baden-Württemberg, Bremen, Hamburg, Hesse, Rhineland-Palatinate and Schleswig-Holstein make adjustments for financial transactions. For the most part, they make allowances for acquisitions and reductions of equity interests or loans as well as repayments and borrowing in the public sector. What this sometimes means, however, is that assumptions of losses and capital injections at enterprises with no prospect of distributing any profits in the future will also be included. These cases do not constitute financial transactions in the national accounts, however, and rightly so; instead, they are posted as capital transfers and thus affect the fiscal balance. The state governments ought to do likewise in order to comply with the objective of the debt brake, which is to avoid structural increases in debt without corresponding additions to the stock of financial assets. Starting in 2019, Rhineland-Palatinate will be following the approach used in the national accounts, at least in some respects (just like central government), in that drawn down guarantees will not be deducted as financial transactions. Like the national accounts, Hesse captures debt relief as regular expenditure items, with the result that the budgetary scope is reduced.

New borrowing in emergencies

Further exemptions from the debt brake rules are possible by adopting contingency clauses. These clauses can be activated in the event of natural disasters or exceptional emergency situations which escape government control and impact significantly on the state's financial situation. However, borrowing is only ever permitted in circumstances like these if it is linked to a repayment schedule.

The federal states' rules for contingency borrowing differ in a number of respects, including the voting majorities which are required in the state parliament.[8] These range from a simple majority of the votes cast

8 It does not seem appropriate here to modify the majority requirements enshrined in the state constitution by passing a set of sub-constitutional implementation acts.

(in North Rhine-Westphalia, Rhineland-Palatinate and Thuringia) to a two-thirds majority of mandates (in Hesse, Saxony and Schleswig-Holstein). In Mecklenburg-West Pomerania, a situation is only given emergency status above a specific threshold value. Yet, at less than 1% of the budget volume in recent years, this does appear to be a fairly low hurdle.[9] So far, Hesse, Saxony and Thuringia are the only federal states to articulate both an obligation and a clearer time schedule for scaling back funds raised under these contingency clauses.

Including off-budget entities

According to the wording of Article 109(3) of the Basic Law, the debt brake relates to borrowing by central and state government. The transitional provisions set forth in Article 143d make it clear, at least for central government, that its separate special funds (off-budget entities) also need to be included.[10] This arrangement does not apply as such to the state governments because they might still have the option of setting up off-budget entities equipped with borrowing authorisations during the transitional period. However, Article 109(2), which precedes the subsection anchoring the debt brake in the Basic Law, clearly states that the European fiscal rules must be complied with. It is reasonable to assume, then, that the state governments should likewise include their off-budget entities.[11]

The bulk of the federal states appear to have plans to stop granting borrowing authorisations to off-budget entities, in a move that is seen as satisfying the debt brake rule. This step does not suffice for the general government deficit ceiling, however – if off-budget entities are funded upfront, there is a possibility that the ceiling will be breached when the funds are drawn down at a later date.[12] The latter would be a case for including off-budget entities in the debt brake rules. But at a minimum, the balances of off-budget entities need to be added to the ongoing surveillance process.

Control account during budget execution

There is always a possibility that the debt brake will be adhered to during planning, but not in budget execution.[13] To prevent this from driving up debt levels, a number of federal states have set up control accounts (just like central government). This account shows how far net borrowing has deviated from the debt brake ceiling at budget outturn. If this account exceeds a threshold value, an adjustment will normally be made by lowering the borrowing ceiling in the next budget.[14] The federal states' control accounts differ primarily in terms of their threshold values. In Rhineland-Palatinate, the threshold is set at 15% of tax revenue in normal cyclical conditions, while in Hesse and Schleswig-Holstein it is 5%.

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9 However, what this also means in an emergency is that fiscal burdens of this amount or less cannot be covered by borrowing.
10 If at all, only borrowing authorisations issued before 2011 may still be used here.
11 Central government has been counting off-budget entities newly established since 2011 which are recipients of funding contributions from the core budget towards the debt brake. In compliance with the European fiscal rules, the fiscal balance is included for these entities. As a result, the advance funding does not curtail the budgetary scope under the debt brake rules, because the core budget is charged and the institution obtaining the funding receives the same amount of relief. Only when the funds flow out of the off-budget entity is the budgetary scope curtailed. Bearing this in mind, such pre-funded central government off-budget entities are viewed in a more positive light under the European fiscal rules than reserves.
12 See also the box on p. 32.
13 There is broader scope for borrowing during this phase, not only for central government.
14 In most cases, there is no need to reduce borrowing in adverse cyclical conditions, the idea here being to avoid any consolidation measures which have a procyclical effect.

Implementation of the debt brake pursuant to Article 109 III of the German Basic Law: current status*

Federal state	Legal basis	Point of reference	Deviations from debt ban for		
			Cyclical factors	Financial transactions[1]	Emergencies
Baden-Württemberg	Section 18 SBA; Reg on section 18 SBA	Net borrowing	Yes Tax trend method	Yes	Yes – Majority required: absolute majority. – Repayment schedule: within an appropriate period.
Bavaria	Recast Article 82 SC, Article 18(1) SBA	Net borrowing	No Option enshrined in SC unused.	No	Yes
Berlin[2]	No arrangements as yet.	–	–	–	–
Brandenburg	No arrangements as yet.	–	–	–	–
Bremen[2]	Article 131a SC; no IA as yet. Article 131b SC for a transitional period.	No arrangements as yet.	Yes Details unspecified as yet.	Yes Details unspecified as yet.	Yes – Majority required: absolute majority. – Repayment schedule: not specified.
Hamburg	Articles 72 and 72a SC, section 27 SBA, Act to strategically realign the budgetary framework of the Free and Hanseatic City of Hamburg	Net borrowing	Yes Tax trend method	Yes – Loans only if repayment is assured. – No securities carried as current assets	Yes – Majority required: two-thirds (simple). – Repayment schedule: within an appropriate period.
Hesse	Article 141 SC; IA for Article 141	Net borrowing	Yes Based on Federal Government's procedure with cyclical control account.	Yes Loan losses accounted for.	Yes – Majority required: two-thirds (absolute). – Repayment schedule: repayment in full, normally within seven years.
Lower Saxony	SBA; amendment of SC scheduled.	Net borrowing	Yes Details unspecified as yet.	Yes Details unspecified as yet.	Yes Details unspecified as yet.
Mecklenburg-West Pomerania	Article 65 SC, section 18 SBA, Act on the SF cyclical adjustment reserve of the Federal State of Mecklenburg-West Pomerania	Net borrowing	Yes Tax level method	No	Yes – Repayment schedule: not specified.

* Abbreviations: SC – state constitution, SBA – state budgetary act, IA – implementing act, Reg – regulation, SF – special fund. **1** In case of adjustment, the federal state's definition of financial transactions may deviate from the budgetary classification system used in the Federal Statistical Office's tables (SKF-3). **2** State subject to an administrative agreement for consolidation assistance.

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Off-budget entities included?	Control account in outturn	Selected key figures: 2017 budget as per debt brake	Selected key figures: Reserves for investment or to balance budget	Federal state
No	Yes Threshold value: 10% of trend tax revenue. Above that, mandatory reduction.	Net borrowing core budget (plan): -€410 million (repayment of implied debt after deducting €949 million in net borrowing permitted for a transitional period) Fin. transactions (net): -€153 million Cyclical component: €1,512 million	Calculated surplus from previous years: €1,962 million	Baden-Württemberg
No No off-budget entities with borrowing authorisation at present.	No	Net borrowing core budget (outturn): -€500 million Fin. transactions (net): -€188.1 million (memo item)	Reserve to rebalance the budget, strengthen cash resources and protect guarantees (end of 2016): €6,300 million	Bavaria
–	–	(Only data in consolidation report for 2017)	Off-budget entity SIWANA: out of 2015-17 surpluses: €3,109 million. Additionally €90 million. Outflows: €455 million. Buffer of €290 million.	Berlin[2]
–	–	–	No information.	Brandenburg
Details unspecified as yet.	Yes Details unspecified as yet.	(Only data in consolidation report for 2017)	–	Bremen[2]
Yes All state corporations, SFs and public higher education institutions.	No	Net borrowing core budget (outturn): -€644.8 million Net borrowing off-budget entities: €293.4 million Fin. transactions (net): -€64.1 million Cyclical component: €1,281.6 million	No single-entry reserves.	Hamburg
No Net borrowing only prohibited by law for state corporations, higher education institutions and SFs. Stock changes in pension reserve included.	Yes Threshold value: 5% of average tax revenue over past three years. Reduction mandatory if threshold value is exceeded.	Net borrowing core budget (outturn): -€200 million Net borrowing off-budget entities: none. Fin. transactions (net): €159 million Cyclical component: €617 million	Cyclical adjustment reserve (end of 2017): €450 million	Hesse
No arrangements as yet. No off-budget entities with borrowing authorisation at present.	Yes Details unspecified as yet.	No amounts under the debt brake reported as yet.	Reserves for investment etc. (end of 2017): €529 million General reserve (end of 2017): €1,505 million	Lower Saxony
No Borrowing not permitted for SFs.	No	No information.	Cyclical adjustment reserve: €300 million General reserve: €1,595.7 million	Mecklenburg-West Pomerania

Implementation of the debt brake pursuant to Article 109 III of the German Basic Law: current status* (cont'd)

Federal state	Legal basis	Point of reference	Deviations from debt ban for		
			Cyclical factors	Financial transactions[1]	Emergencies
North Rhine-Westphalia	Section 18 SBA; no IA as yet.	Net borrowing	Yes Details unspecified as yet.	Yes Details unspecified as yet.	Yes – Majority required: simple majority. – Repayment schedule: within an appropriate period.
Rhineland-Palatinate	Article 117 SC; section 18 SBA; IA for Article 117; Reg on the method used to determine the cyclical component	Up to 2019: fiscal balance As from 2019: net borrowing	Yes Tax trend method	Yes Up to 2019: incl. guarantees As from 2019: excl. guarantees	Yes – Majority required: simple majority. – Repayment schedule: reports to state parliament on repayments and outstanding balance; repayment cyclically appropriate.
Saarland[2]	No arrangements as yet.	–	–	–	–
Saxony	Article 95 SC; section 18 SBA	Net borrowing	Yes Tax level method (repayment within eight years)	No	Yes – Majority required: two-thirds (absolute). – Repayment schedule: within eight years.
Saxony-Anhalt[2]	Section 18 SBA; no IA as yet	Net borrowing	Yes Details unspecified as yet.	No	Yes – Majority required: no information. – Repayment schedule: within an appropriate period.
Schleswig-Holstein[2]	Article 61 SC; IA for Article 61 SC	Fiscal balance	Yes Based on Federal Government's procedure, with cyclical control account.	Yes	Yes – Majority required: two-thirds (absolute). – Repayment schedule: repayment reports to state parliament; repayment within an appropriate period.
Thuringia	Section 18 SBA; no IA	Net borrowing	Yes Tax level method	No	Yes – Majority required: simple majority. – Repayment reports to state parliament; repayment in five years (can be postponed in case of new borrowing).

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Off-budget entities included?	Control account in outturn	Selected key figures: 2017 budget as per debt brake	Selected key figures: Reserves for investment or to balance budget	Federal state
No arrangements as yet.	Yes Threshold value: 1% of state GDP. Above that, cyclically appropriate reduction is mandatory.	No amounts under the debt brake reported as yet.	No general reserves.	North Rhine-Westphalia
(Yes) Up to 2019: larger relevant off-budget entities included. As from 2019: no borrowing authorisation for state corporations and SFs.	Yes Threshold value: 15% of tax revenue in a cyclically normal situation. Cyclically appropriate reduction mandatory if threshold value is exceeded.	Net borrowing core budget (outturn): -€872.0 million Net borrowing off-budget entities: -€173.0 million Fin. transactions (net): -€127.0 million Cyclical component: €1,021.0 million	SF "Wissen schafft Zukunft": allocation in 2016: €118.7 million 2017: €7.1 million Stock of reserves at end of 2016: €2.0 million Residual borrowing authorisation: End of 2015: €3,334 million End of 2016: €2,036 million End of 2017: •	Rhineland-Palatinate
–	–	(Only data in consolidation report for 2017)	For investment: €265 million To balance the budget: €90 million	Saarland[2]
Yes All legally dependent SFs.	Yes Deviations to be offset no later than in the next budget plan.	Net borrowing core budget (outturn): -€75 million Net borrowing off-budget entities: 0 Fin. transactions (net): not relevant Cyclical component: €1,835 million (implied)	Reserve for investment etc. €3,940 million Reserve to balance the budget: €1,529 million	Saxony
No No off-budget entities with borrowing authorisation at present.	No	(Only consolidation report for 2017)	Tax fluctuation reserve: €500.5 million General reserve: €301.9 million	Saxony-Anhalt[2]
No	Yes Threshold value: 5% of prior-year tax revenue. Above that, cyclically appropriate reduction mandatory.	Net borrowing core budget (outturn): -€117 million Net borrowing off-budget entities: none Fin. transactions (net): -€32 million Cyclical component: €137 million	Allocations to provisions: €1 billion in 2016-17; disposals: €481 million Reserve to balance the budget: none	Schleswig-Holstein[2]
No	No	Net borrowing core budget (outturn): -€415.2 million Net borrowing off-budget entities: €29.1 million Fin. transactions (net): -€14.5 million Cyclical component: not reported.	Reserve to balance the budget: €1,366.8 million SF "Thüringer Wohnungsbauvermögen": €225 million	Thuringia