Public finances*

General government budget

Another significant improvement in government finances in 2018 …

Germany's government finances are continuing to benefit from the highly favourable underlying conditions. A far larger general government surplus is on the cards this year (2017: +1.0% of gross domestic product (GDP)). In structural terms, too, i.e. factoring out cyclical and temporary effects, the budgetary situation is expected to see renewed improvement. The debt ratio is still on a downward path and could fall below the 60% threshold this year already. It had fallen to 61.5% by the middle of the year, down from 63.9% at the end of 2017.

… due to dynamic revenue growth amidst overall moderate rise in expenditure

Growth in revenue from taxes and social contributions remains strong this year. On the expenditure side, there is no nuclear fuel tax repayment to be made, unlike in 2017.[1] In addition, the strain on government coffers is being eased by falling unemployment and dwindling interest expenditure. These positive factors are outweighing the significant spending hikes in other areas. For example, fixed asset formation is rising sharply, while payments to the EU are up considerably (from an unusually low level last year).

Lower surplus in coming years due to fiscal loosening

As things stand, the framework conditions for government finances will remain favourable in the medium term. Positive economic and labour market developments are expected, though they are fraught with considerable uncertainty. In addition, interest expenditure is likely to further diminish in significance. The debt ratio will decline and the average rate of interest will probably also fall to a slightly lower level. At the same time, fiscal policy will be eased by stepping up expenditure and lowering taxes. The surplus is therefore likely to shrink markedly, particularly in structural but also in unadjusted terms. From the current perspective, fiscal policy is thus procyclical. However, the risk of this resulting in cyclical excesses and thereby also, for example, sending general price pressures soaring appears limited. This notwithstanding, government investment in construction, to give one example, will have to be monitored so that additional spending in view of high capacity utilisation is not swallowed up by price increases.

Spending increases in many areas as well as moderate tax cut

In view of the surpluses, a whole raft of budget-burdening measures are envisaged. Specifically, there are plans to expand benefits for pensions, healthcare and long-term care as of next year. In addition, central, state and local government intend to raise spending on childcare, education, transport, digital policy, internal security and defence. Under the measures specified so far, the burden of taxes and social contributions will remain largely unchanged over the medium term. First, this holds for social contributions – despite the still low level of demographic pressure and highly positive labour market performance. This is linked, amongst other things, to the benefit expansions. These mean that the contribution rate for the statutory pension insurance scheme is not set to decrease, while the rate for the public long-term care insurance scheme is to be raised significantly (by 0.5 percentage point). The envisaged reduction in the contribution rate for the unemployment insurance scheme (0.5 percentage point) merely offsets this.[2] Second, the income tax cuts specified so far will be offset by add-

* The section entitled "General government budget" relates to data from the national accounts and the Maastricht debt ratio. This is followed by more detailed reporting on budgetary developments (government finance statistics). As yet, there are no current quarterly data available for local government or the statutory health and public long-term care insurance schemes. These will be analysed in upcoming issues of the Monthly Report.

1 This absence is more important than the expected increase in temporary burdens resulting from calls on guarantees issued by Hamburg and Schleswig-Holstein in connection with the privatisation of HSH Nordbank.

2 Members of the statutory health insurance scheme will see their contributions go down on balance, as the supplementary contribution set by individual health insurance institutions will be financed equally by employer and employee in future. At the same time, however, this will place a corresponding financial strain on enterprises and the statutory pension insurance scheme.

itional revenue from progressive taxation. In 2021, the partial discontinuation of the solidarity surcharge – which has been announced, but not yet fleshed out – would reduce the tax burden to a more marked extent.[3] Viewed across the period since reunification, however, the tax ratio is still likely to be relatively high.

Demographic challenges for statutory pension insurance scheme, in particular

In view of the fact that government finances are in very good shape, it appears that longer-term challenges are, to some extent, being put on the back burner. These stem largely from demographic developments, which are accelerating the hike in spending on pensions, long-term care and healthcare while simultaneously putting the brakes on growth in tax and contribution receipts. In particular, the finances of the statutory pension insurance scheme will come under considerable pressure going forward. The latest pension package further increases the financial burden and will make it more difficult to ensure sustainability.[4]

Budgetary development of central, state and local government

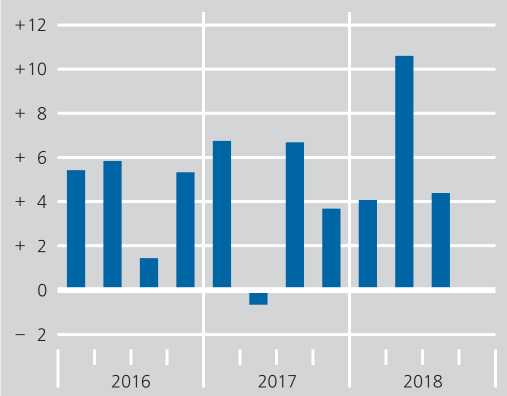
Tax revenue

Considerable growth in tax revenue in Q3

Tax revenue[5] was up by 4½% on the year in the third quarter of 2018 (see the chart above and the table on p. 56). On balance, this growth is almost entirely attributable to wage tax, turnover tax and corporation tax. Wage tax revenue was boosted by positive labour market and wage developments and the progressive tax scale. A smaller tax cut at the start of the year had a dampening effect.[6] The picture for profit-related taxes was mixed. Corporation tax revenue again rose sharply from last year's already high level. By contrast, assessed income tax revenue stagnated, and receipts from withholding tax on interest income and capital gains were down slightly. There was a significant decrease in revenue from non-assessed taxes on earnings, the main component of which is investment income tax on dividends.

Tax revenue*

Year-on-year percentage change, quarterly data



Source: Federal Ministry of Finance. * Including EU shares in German tax revenue but excluding receipts from local government taxes.

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This was expected following very strong growth in the second quarter and is probably due to the fact that a substantial share of profits were distributed earlier this year. There was a considerable pick-up in turnover tax, which fluctuates during the course of the year. Furthermore, there was no repeat of the previous year's nuclear fuel tax repayment.[7]

Tax estimate: dynamic growth in year as a whole

According to the latest official tax estimate, tax revenue (including local government taxes) will increase by 5½% in 2018 as a whole (for selected inputs for the estimate, see p. 58). Growth is thus higher than implied by the macroeconomic reference variables for tax rev-

3 For information on the solidarity surcharge, see p. 60.
4 For information on the statutory pension insurance scheme, see pp. 62 f.
5 Including tax revenue transferred to the EU. Receipts from local government taxes are not yet not known for the reporting quarter and are therefore not included.
6 The basic income tax allowance and child tax allowance were raised and the other tax brackets "shifted to the right" (specified tax rates only apply to higher taxable income). Child benefits were also increased. As these are set off against wage tax, revenue collected from wage tax is lower.
7 More specifically, interest payments of €1 billion were made to nuclear power plant operators in the third quarter of 2017. They were linked to a ruling of the Federal Constitutional Court which resulted in all nuclear fuel tax payments being refunded. Unlike in the national accounts, the nuclear fuel tax repayment is recorded in the government finance statistics as a deduction from revenue (negative tax revenue).

Tax revenue

Type of tax	Q1 to Q3				Estimate for 2018[1,2]	Q3			
	2017	2018				2017	2018		
	€ billion		Year-on-year change € billion	%	Year-on-year change %	€ billion		Year-on-year change € billion	%
Tax revenue, total[2]	492.3	523.4	+ 31.1	+ 6.3	+ 5.6	165.9	173.2	+ 7.3	+ 4.4
of which:									
Wage tax	140.8	149.8	+ 9.0	+ 6.4	+ 6.3	47.3	50.4	+ 3.1	+ 6.6
Profit-related taxes	89.6	96.3	+ 6.7	+ 7.5	+ 6.2	28.0	27.7	− 0.2	− 0.8
Assessed income tax[3]	44.6	45.2	+ 0.7	+ 1.5	+ 1.3	12.7	12.7	− 0.0	− 0.3
Corporation tax	22.4	25.9	+ 3.5	+ 15.6	+ 13.9	6.0	7.2	+ 1.2	+ 19.2
Investment income tax[4]	22.6	25.2	+ 2.6	+ 11.5	+ 8.6	9.2	7.9	− 1.3	− 14.6
Turnover taxes[5]	168.2	174.2	+ 6.0	+ 3.6	+ 3.7	56.5	59.2	+ 2.7	+ 4.8
Other consumption-related taxes[6]	64.6	64.9	+ 0.3	+ 0.5	+ 0.7	22.6	22.8	+ 0.2	+ 0.8

Sources: Federal Ministry of Finance and Bundesbank calculations. **1** According to official tax estimate of October 2018. **2** Including EU shares in German tax revenue but excluding receipts from local government taxes. **3** Employee refunds deducted from revenue. **4** Withholding tax on interest income and capital gains, non-assessed taxes on earnings. **5** Turnover tax and import turnover tax. **6** Taxes on energy, tobacco, insurance, motor vehicles, electricity, alcohol, air traffic, coffee, sparkling wine, intermediate products, alcopops, betting and lottery, beer, fire protection.

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enue and fiscal drag.[8] Specifically, 1 percentage point of the growth rate is due to the fact that there is no nuclear fuel tax repayment to be made, unlike in 2017. The projected increase is dampened, on balance, by legislative changes. By contrast, intra-year developments have a positive impact: in particular, revenue from corporation tax and non-assessed taxes on earnings has so far risen more rapidly than could be expected based on legislative changes and macroeconomic assumptions.

Robust revenue growth forecast up to 2023

Still, revenue growth of 4% is forecast for 2019. There are two main reasons for the slowdown compared to 2018. First, cash basis effects in relation to court rulings will serve to curb growth slightly rather than boosting it as in 2018. Second, it is expected that revenue from profit-related taxes will (only just) increase in line with the macroeconomic reference variables. A revenue increase of 4½% is then forecast for 2020, while the average annual growth rate will hit close to 4% in the medium term up to 2023. This is primarily based on the macroeconomic assumptions and fiscal drag. The tax ratio (as defined in the government finance statistics) is therefore projected to go up significantly to 23.4% by the end of the projection horizon (2017: 22.4%). In particular, the unbridled effects of the progressive income tax scale under current legislation will make themselves felt from 2019 onwards. However, the dynamic growth in profit-related taxes this year will also have a part to play.

Compared with the previous estimate in May, revenue expectations have been raised slightly

8 The progressive income tax scale has the effect of increasing the relative tax burden when (real and inflation-offsetting) income rises. In this context, bracket creep is defined as the share of the additional burden attributable to price changes. In the case of specific excise duties, price effects work in the opposite way: the revenue collected from these types of taxes is almost exclusively based on quantity. The relative burden therefore falls when prices rise (all other things being equal). In quantitative terms, however, the effect of the progressive income tax scale is far and away the dominant one.

Official tax estimate figures and the Federal Government's macroeconomic projection

Item	2018	2019	2020	2021	2022	2023
Tax revenue[1]						
€ billion	775.3	804.6	841.2	875.2	907.4	940.7
As % of GDP	22.9	22.9	23.0	23.2	23.3	23.4
Year-on-year change (%)	5.5	3.8	4.5	4.0	3.7	3.7
Revision of previous tax estimate (€ billion)	3.2	– 2.3	2.3	2.0	1.5	.
Real GDP growth (%)						
Autumn projection (October 2018)	1.8	1.8	1.8	1.3	1.3	1.3
Spring projection (April 2018)	2.3	2.1	1.4	1.4	1.4	.
Nominal GDP growth (%)						
Autumn projection (October 2018)	3.5	3.8	3.7	3.2	3.2	3.2
Spring projection (April 2018)	4.2	4.1	3.3	3.3	3.3	.

Sources: Working Party on Tax Revenue Estimates (October 2018) and the Federal Ministry of Economic Affairs and Energy. **1** Including EU shares in German tax revenue and receipts from local government taxes.
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Tax estimate forecasts slightly higher revenue than May estimate

overall. The downward revision of the macroeconomic assumptions and an administrative order in connection with a court ruling will make for lower revenue (see the technical comments on p. 58). However, the favourable development of profit-related taxes will have a positive impact this year. This will be carried forward into the subsequent years as a baseline effect. Expected shortfalls resulting from court rulings have been postponed, in part, from this year to next. All in all, this latest tax estimate envisages a €3 billion hike in revenue in the current year compared with the May estimate. By contrast, the projected amount for 2019 was lowered by €2½ billion. Increases in revenue of between €2½ billion and €1½ billion are expected for the years from 2020 onwards.

Moderate tax cuts foreseeable

Overall, however, tax revenue is expected to rise more slowly than indicated in the current estimate. The forecast is generally based on current legislation and therefore disregards tax cuts that have not yet been passed into law. Under the Family Relief Act *(Familienentlastungsgesetz)* passed by the Federal Cabinet, child benefits and income tax allowances are to be raised (the latter gradually). Furthermore, there is provision under the Act to offset the bracket creep of 2018 and 2019 by shifting the income tax scale in two stages. The revenue shortfall is expected to total around €4 billion in 2019 and to be in the order of €10 billion per year thereafter. The partial abolition of the solidarity surcharge planned for 2021 would then halve its revenue to just over €10 billion. With respect to revenue from profit-related taxes, there is the potential for setbacks following strong growth during the economic upturn of recent years. However, the strong momentum could also reflect structural factors, at least partly, such as the more effective curbing of tax evasion and avoidance.

Central government budget

Reduced deficit in Q3 despite high allocation to energy and climate fund

Central government posted a deficit of €4 billion in the third quarter of 2018. The result marked a €1 billion improvement on the year. Revenue rose by 3½%. On the one hand, tax revenue was pushed down by a greater number of contributions from gross revenue to the EU budget. On the other hand, the last part of the nuclear fuel tax repayment was paid in the third quarter of 2017. Expenditure grew moderately by 2½%. Unlike last year, Deutsche Bahn did not receive a capital injection, which had a dampening effect. In addition, interest expenditure declined. This was offset by a €3 billion increase in allocations to the energy and climate fund.

Selected technical information on the official tax estimate

Macroeconomic assumptions

The official tax estimate is based on the Federal Government's latest macroeconomic projection (see the table on p. 57). This comprises a short-term projection for the current year, the next year and (in the autumn) for the year after, as well as a medium-term projection covering the years subsequent to that. In the medium-term projection, it is assumed that any output gap existing at the end of the short-term projection horizon will be closed by the final year of the medium-term projection. Uniform rates of economic growth are applied for these years. The upward revision for 2020 is because that year now forms part of the short-term projection for the first time and favourable economic development is again expected then (growth slightly above potential). In spring, 2020 was still encompassed by the medium-term projection, with a growth rate below the potential rate so as to close a positive output gap.

Applicable tax law

The tax estimate is based on the tax legislation applicable at the time. This means, for example, that the revenue loss stemming from the Family Relief Act *(Familienentlastungsgesetz)* that has now been adopted by the Bundestag has not yet been factored in. By contrast, the estimate includes, in particular, an income tax cut this year which is partly intended to offset bracket creep caused by inflation last year. Furthermore, lapsing refunds of corporation tax credit play a major role, resulting in higher tax revenue from 2018 onwards.

Impact of court rulings

The tax estimate also factors in the impact of court rulings. These can have a significant effect on revenue growth and some were made quite some time ago. One ruling of the Federal Constitutional Court last year had particular repercussions; nuclear fuel tax was declared unconstitutional and was therefore paid back in full (with interest, in some cases) (€7½ billion). Revenue losses of this kind are recognised in the years of the projection as well, especially in the case of profit-related taxes. In addition, the current estimate takes into account revenue shortfalls stemming from an administrative order in connection with a decision on interest paid on tax arrears.[1]

In terms of statistical recording, the burdening effects of court rulings on government finances are reported in different ways in the financial statistics (on which the tax estimate is based) and the national accounts. In the financial statistics, they reduce tax revenue when the repayments are made (cash basis accounting). In the national accounts, however, they are recorded as government spending (capital transfers) as soon as the decision takes legal effect. This means that the point at which the effects are recorded in the national accounts sometimes lies well in advance of the cash outflow.

1 Letter of the Federal Ministry of Finance dated 14 June 2018 in conjunction with Federal Fiscal Court Decision IX B 21/18 of 25 April 2018.

Renewed significant surplus to be expected for 2018 budget outturn

After three quarters, the central government budget is on a much better footing than last year. The surplus climbed from €1½ billion to €14 billion. The budget plan finalised in the summer projected a significant deterioration in the outturn for 2018 as a whole (€7 billion decrease compared with the result in 2017). In a year-on-year comparison, there will be some additional burdens in the final quarter. For example, the new digitalisation fund is to receive €2½ billion. In addition, state and local governments are set to be reimbursed for spending on incoming refugees (€1½ billion). Nevertheless, rather than the projected deficit, there will probably be an even higher surplus at the end of the year compared with 2017. As a result, it will not be necessary to tap the refugee reserve in the amount of €1½ billion as was originally planned. It will probably be possible to continue topping it up much more, meaning that it could reach an amount in the order of €35 billion instead of the envisaged €22½ billion.[9]

Budget plan for 2019: government draft with marked deterioration in balance

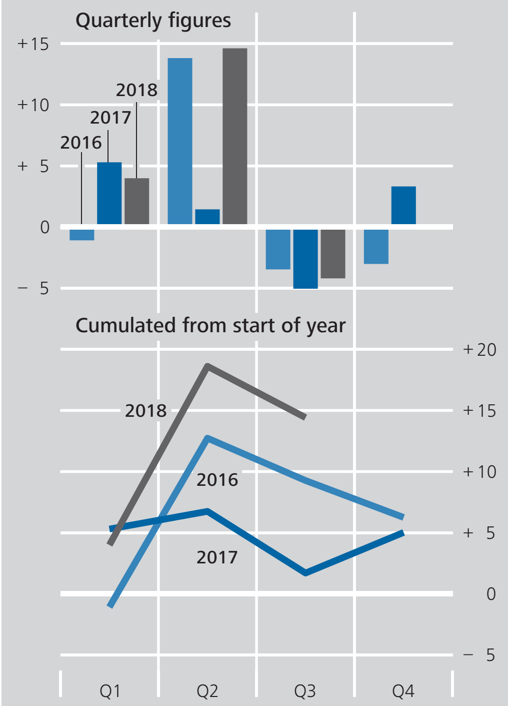
In early July, the Federal Cabinet presented a draft budget for 2019 with a deficit of €5½ billion.[10] The higher deficit compared with that envisaged for 2018 was the result not only of projects from the coalition agreement but also of further tax cuts to compensate for bracket creep. By way of precaution, an unexplained global revenue shortfall item of €7 billion was also included.

Budgetary burdens in aid of state and local government

In the meantime, various burdens have been agreed on, provision for which was made in the aforementioned global item. Next year, central government will transfer shares in turnover tax revenue in the total amount of €6½ billion to state and local government. In doing so, it will continue to cover a proportion of, inter alia, the financial burdens associated with refugee immigration. State government is also set to recover income from turnover tax now that the debts of the "German Unity Fund", which are serviced by central government, have been repaid in arithmetical terms. In addition, allocations of funds to improve child day care will play a smaller role.

Central government fiscal balance*

€ billion



Source: Bundesbank calculations based on data from the Federal Ministry of Finance. * Core budget excluding off-budget entities. Not adjusted for financial transactions or cyclical effects.

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Final deliberations make further use of fiscal space

The latest tax estimate, with revenue shortfalls of €½ billion, was also factored into the final deliberations of the Bundestag's Budget Committee. On the expenditure side, the agreement to continue assuming refugee costs was taken into account. Accordingly, the amounts budgeted for contributions to the accommodation costs of those receiving unemployment benefit II were raised significantly. The spending authorisations for the Federal Ministry of Interior (for information technology and internal security) as well as development aid were also expanded substantially. In addition, more funding was earmarked for regional aid, defence and transport (in particular, measures to address excessive emissions by diesel vehicles). In return, the precautionary global additional

9 For more details on reserves, see Deutsche Bundesbank, Excursus: the use of reserves and off-budget entities by central and state government, Monthly Report, August 2018, pp. 69 ff.
10 For more detailed information, see Deutsche Bundesbank, Public finances, Monthly Report, August 2018, pp. 61 f.

spending item previously included in the budget plans was eliminated. Furthermore, figures for interest expenditure and allocations to the energy and climate fund were lowered. On balance, the deficit is expected to increase by €½ billion to €6 billion. A slightly higher reserve withdrawal of €5½ billion and coin seigniorage will make it possible to continue avoiding net borrowing.

Clear structural deficit planned

Structural net borrowing is limited under the terms of the debt brake. Adjustments also have to be made for relief from the cyclical component (€4½ billion) and financial transactions (€½ billion). Furthermore, the structural deficit is to include the deficit of the relevant off-budget entities (€3 billion).[11] Structural net borrowing thus amounts to around €8 billion, with the total being capped at €11½ billion by the debt brake. Adherence to this ceiling is therefore only achieved with the planned withdrawal of funds from reserves.

Yet certain scope for additional expenditure or tax cuts still likely

However, overall, the central government budget should close the coming year, too, with a much better outturn than planned. As in the previous years, developments were far more favourable when implementing the 2018 budget and this is largely set to be carried forward as a baseline effect. Under the coalition agreement, any such additional financial scope would be predominantly used for defence and development aid. However, other measures – such as tax cuts – are also being discussed on a broader scale.[12]

Increasingly difficult to justify solidarity surcharge as add-on to income taxes for costs of unification

In addition to moderate income tax cuts, the coalition agreement already paves the way for a partial abolition of the solidarity surcharge. Since 1998, this add-on to income tax and corporation tax has amounted to 5.5%. It flows into the central government budget and, as an "add-on", is contingent on the existence of particular financing needs in this budget. It was originally justified by central government having to bear heavy financial burdens of German reunification. However, the special-need supplementary central government grants for reconstruction in eastern Germany paid by central government to state government will be discontinued at the end of 2019. Yet the solidarity surcharge is to continue and is likely to still be generating income of just over €20 billion in 2020. The coalition agreement envisages abolishing this surcharge for most taxpayers only as of 2021. But even after this date, corporations and persons with higher incomes are to continue paying. This is likely to still bring in income in excess of €10 billion.

Strengthen states' individual responsibility rather than increase mixed financing

During the period in which the solidarity surcharge is expected to still exist to a partial extent, central government intends to co-finance state government tasks (primarily education). This kind of return to larger-scale mixed financing would further blur responsibilities, with a presumable knock-on effect on the efficient use of funds. Instead, it would be worth strengthening states' individual responsibilities.

Consider abolishing solidarity surcharge entirely and instigating fundamental reform

An extensive effort at reform could ensure that government tasks and their financing are strictly assigned to the individual government levels. In this way, it would be possible to forgo the legally questionable (partial) continuation of the solidarity surcharge and avoid an increase in mixed financing. Objectives concerning tax revenue, burden-sharing among taxpayers and the distribution of taxes between the respective levels of government would

11 Figure taken from the draft finalised in the summer. No revision has yet been made.
12 Higher funds in the refugee reserve have also been seen as a source of fiscal policy scope to date. However, it does not seem advisable to plan a depletion of the reserve on a regular basis; see Deutsche Bundesbank, Excursus: the use of reserves and off-budget entities by central and state government, Monthly Report, August 2018, pp. 69 ff.

then, if necessary, have to be met by reforming the regular tax system.[13]

Off-budget entities record clear surplus …

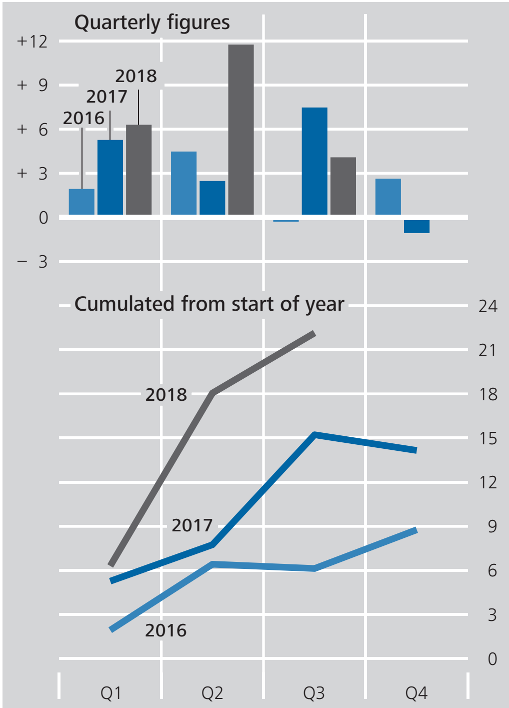
Central government's off-budget entities[14] recorded a surplus of €3 billion in the third quarter of 2018, compared with a balanced budget in the same period last year. This was driven by central government transfers to the energy and climate fund. In addition, the fund's revenue from CO_2 certificates grew because prices had gone up considerably. The new digitalisation fund will receive a €2½ billion transfer from central government by the end of the year. Overall, the surplus is expected to be higher than in 2017 (€3 billion).

… and prospects good for 2019, too

In the coming year, if certificate prices remain high, the energy and climate fund could post a notable surplus despite cuts in central government transfers. The repayment fund for inflation-linked Federal securities is not due to make any repayments and is thus also likely to record a marked surplus. By contrast, an increase in outflows from the fund to promote municipal investment could push up its deficit. Revenue from the mobile phone frequency auction scheduled for next spring is earmarked for the digitalisation fund. Whether the revenue of at least €10 billion assumed in the coalition agreement is actually generated also depends on the auction terms including the coverage requirements. Moreover, some of the proceeds will possibly not be received until a later date. However, the crucial point here should be to quickly ensure a good, cost-efficient provision of the relevant services throughout Germany. All in all, the off-budget entities are expected to run a clear surplus next year, too.

State government fiscal balance*

€ billion



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

State government budgets[15]

Q3 results strained by one-off effects

State government core budgets posted a surplus of €4 billion in the third quarter of 2018. The clear drop on the previous year (by €3½ billion) is predominantly due to one-off effects. As a result, revenue rose rather moderately on the whole (1½%). While tax revenue grew considerably (4%), there was no repeat of the €1 billion capital repayment from BayernLB as in the previous year. By contrast, expenditure shot up (5½%). This was evidently due to the state of North Rhine-Westphalia shifting the lion's share of payments to its higher education establishments into this reporting quarter. In the previous year, those establishments received

13 There may be concerns that higher income tax revenue received by state and local government could magnify the differences in financial capacity in Germany too strongly even under the revenue-sharing scheme. However, these could be countered by adjusting the various levels' tax revenue shares. For instance, a greater share of income tax could be assigned to central government, with state and local government receiving a higher share of turnover tax. State governments' individual responsibility could be strengthened by means of (limited) state-specific surcharges or discounts on income tax. See also Deutsche Bundesbank, State government finances: comparison of developments, debt brakes and fiscal surveillance, Monthly Report, October 2018, p. 38.
14 In line with the Federal Ministry of Finance's quarterly overviews. These notably do not include bad banks and other entities keeping commercial accounts.
15 The following results are based on the monthly cash statistics on the core budgets.

most of their transfers in the second quarter. There was also a surge in spending on investment. Personnel expenditure – a major component of state government spending – showed only muted growth as last year's level was elevated by back-payments for changes in wages and civil servant remuneration. Growth in other operating expenditure and transfers to local government was also no more than moderate.

Yet very large surplus on the cards for 2018 as a whole …

In the first three quarters taken together, the surplus climbed steeply by €7 billion to €22 billion. On the one hand, the states of Hamburg and Schleswig-Holstein are expecting another round of high, one-off burdens (€5 billion) before the year draws to a close as their guarantee will be called on when HSH Nordbank is privatised. On the other hand, the fine (just under €1 billion) from Audi in connection with emissions from diesel vehicles is having a positive impact. Another contributory factor is the turnover tax funds (€1½ billion) that central government is planning to transfer to state government to help relieve the strain of refugee-related expenses. All in all, the surplus for the year as a whole is likely to be higher even than last year (€14 billion) despite exceptional burdens.

… and medium-term outlook remains very positive

The medium-term outlook, too, remains very positive on the whole. According to the latest tax estimate, growth in tax revenue will dip only moderately in the period from 2019 to 2023 (to an average of 4%). But these figures do not factor in shortfalls due to planned changes in legislation, in particular the Family Relief Act. However, they will be offset by additional revenue from turnover tax as central government has ruled to continue providing funds for integration assistance. In addition, central government will transfer the turnover tax revenue that it received back to state government now that the debts of the "German Unity Fund" have been repaid in imputed terms. Given these overall exceptionally good general conditions, expenditure is also expected to rise dynamically. This is true, in particular, for personnel costs, other operating expenditure and spending on investment.[16]

Social security funds

Statutory pension insurance scheme

Deficit lower in Q3 due to sharp rise in contribution receipts

The finances of the statutory pension insurance scheme continued to develop favourably in the third quarter of 2018. At €1½ billion, the deficit was €1 billion lower than last year. Revenue soared (5%) due to very positive employment and wage growth. By contrast, expenditure rose at a much weaker rate (3½%). This amount is more or less in line with the average pension increase in Germany in the middle of the year. The rise in the number of pensions was again very limited.

Much better result expected for year as a whole, too

The positive trend is set to continue in the final quarter of 2018. The surplus for the year as a whole is thus expected to be much higher than last year (2017: €½ billion). As a result, the reserves are likely to rise accordingly and exceed the upper bound of the fluctuation band, or 1.5 times monthly expenditure, by an even greater margin.

No cut in contribution rate due to pension package

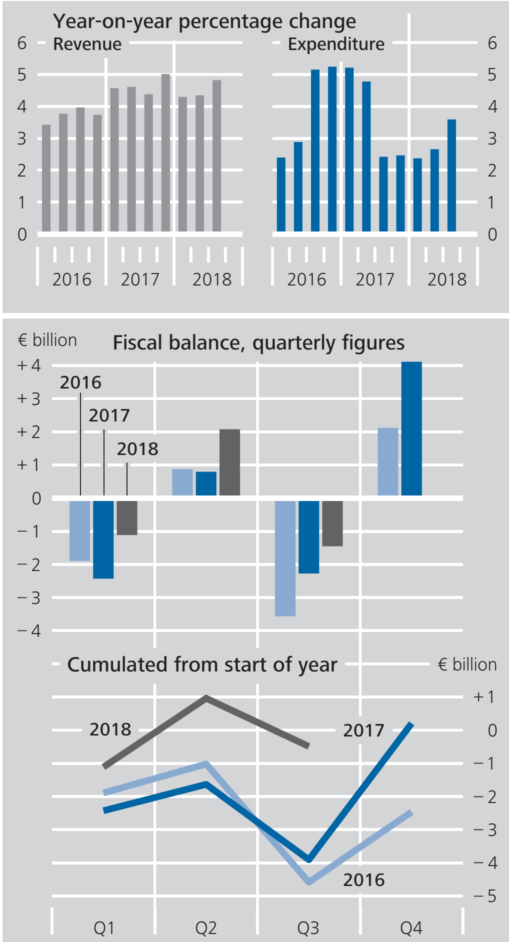
Without the agreed benefit expansions, the contribution rate would probably have been cut markedly at the start of 2019.[17] However, this cut will now no longer be implemented as the funds are required to finance the pension package (above all, "mothers' pensions"). As a result, there will be no relief for employees or enterprises and the pension adjustment in 2020 will also be lower accordingly.[18]

16 For more information on state government finances, see Deutsche Bundesbank, October 2018, op cit.
17 Deutsche Rentenversicherung recently estimated that the contribution rate could potentially be cut by 0.4 percentage point; see Deutscher Bundestag, Wortprotokoll der 25. Sitzung des Ausschusses für Arbeit und Soziales, Protokoll-Nr. 19/25.
18 For more information on the pension package, see Deutsche Bundesbank, Public finances, Monthly Report, August 2018, pp. 66 f.

Pension system finances hit by changes to contribution rates in other branches

The pension package also contains new limits for the pension level[19] and contribution rate up to the end of 2025. More specifically, the pension level may not fall below 48%, and the contribution rate is not to exceed 20%. However, due to the additional spending on mothers' pensions and pensions for persons with reduced earning capacity, which were resolved at the same time, these limits will be met earlier. The new limit for the pension level also means that the planned changes in contribution rates in other branches of the social security system will have a financial impact on the pension insurance scheme. For instance, the contribution rates for the public long-term care insurance scheme and the unemployment insurance scheme are set to be adjusted at the start of 2019 (+0.5 percentage point and -0.5 percentage point, respectively). The changes in contribution rates more or less equal themselves out for employees. However, pension recipients will feel the strain because they will be paying the higher contributions to the public long-term care insurance scheme on their own and not reaping the benefits from the cut in the rate for the unemployment insurance scheme. This will bring about an initial fall in the (relative) pension level. If, over the course of time, the corresponding limit takes effect, there will be greater adjustments to (gross) pensions to ensure that the limit is not undershot. As a result, more contribution receipts and central government funds will be needed.

Finances of the German statutory pension insurance scheme



Source: German statutory pension insurance scheme (Deutsche Rentenversicherung Bund). Preliminary quarterly figures. The final annual figures differ from the total of the reported preliminary quarterly figures as the latter are not revised subsequently.
Deutsche Bundesbank

Even more difficult to comply with longer-term ceiling for contribution rate up to 2030

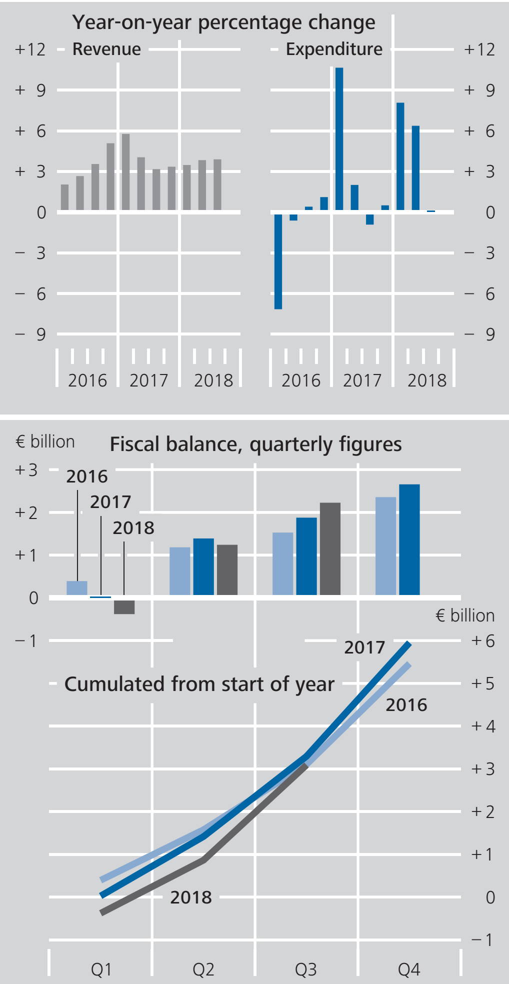
When, as of the mid-2020s, the baby boomer generation enters retirement, this will up the pressure on pension system finances. The previously agreed limits of 22% for the contribution rate and 43% for the pension level will continue to apply up to 2030. The latest pension package implies that the pension level and the contribution rates will also be higher post 2025. This will make it more difficult to comply with the contribution rate ceiling. At the end of November, central government will present its annual pension insurance report. If the mid-term outlook shows that the contribution rate is close to breaching the limit, the government will have to propose suitable measures to prevent this.

Longer-term decisions postponed

In the first instance, a pensions commission has been tasked with examining how the pension system finances are to be balanced in the longer term. By March 2020, this commission is to present proposals for reform for the period post 2025. Ultimately, the financial situation can only be sustainable if the central parameters are combined consistently. Besides the

19 The pension level is the standard pension benefit in relation to average earnings, in each case after deduction of social contributions.

Finances of the Federal Employment Agency*



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

pension level, contribution rates and central government grants, these parameters also include the statutory retirement age. In the long term, it would be a logical move to follow other countries and tether the statutory retirement age to expected changes in further life expectancy.[20] It would also be welcome for the pension level to take account of longer working lives. A final cause for concern is that central government grants will already increase sharply even before factoring in the pension package. Central government thus needs to mobilise substantial additional tax resources, and the financial contribution required of it will be inflated even further by the pension package. If an excessive levy burden is thus to be avoided, it is crucial to limit both social contributions and taxes.

Federal Employment Agency

Q3 surplus somewhat higher than last year

In the third quarter of 2018, the Federal Employment Agency posted a surplus of just over €2½ billion in the core budget.[21] This was €½ billion higher than last year. Revenue went up by 4%. The strong growth in contribution receipts was countered in particular by a fall in revenue from reduced insolvency benefit contributions. Expenditure stood at around the level of the previous year. Spending on unemployment benefits and the active labour market policy declined moderately. By contrast, administrative expenditure shot up. This was due to the negotiated pay increase in the public sector. As the agreement that was made in March 2018 was not implemented until August, back-payments were necessary.

Higher surplus and further growth in reserves likely for year as a whole

Thanks to the exceptionally good economic conditions, the Federal Employment Agency is likely to record a very high surplus for the year as a whole, and may even exceed the €6 billion mark attained last year even though special transfers to the civil servants' pension fund were €1½ billion higher in the first half of 2018.[22] The surplus would thus again be substantially above the budget estimate of €2½ billion. The free reserves, which are already at a high level, could continue to climb to around €23 billion (0.7% of GDP). The pension reserve is expected to grow considerably to around €8½ billion.

At the start of 2019, the contribution rate is initially to be cut by 0.5 percentage point to

20 See Deutsche Bundesbank, Excursus: longer-term pension developments, Monthly Report, August 2016, pp. 68 ff.
21 Excluding the civil servants' pension fund. Transfers to the fund are recorded as expenditure and thus reduce the core budget balance.
22 As a result, the future civil servant pension obligations should be covered earlier than originally planned.

Surpluses to persist despite considerable contribution rate cut in 2019

2.5% but will be fixed at 2.6% as of 2023. As of 2019, an additional amount of around €½ billion is to be earmarked annually for spending on advanced vocational training. Both measures appear manageable especially in light of the favourable medium-term outlook for the labour market. Further significant surpluses are even on the cards. There should be no difficulty complying with central government's target of maintaining a minimum level of 0.65% of GDP for the free reserves in good times.