Public finances*

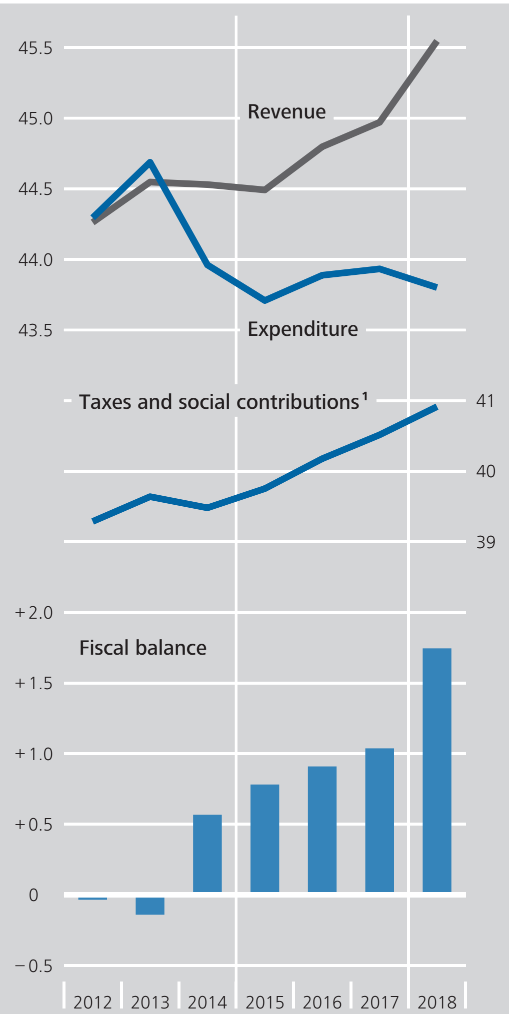
General government budget

Government budget ran high surplus in 2018

Germany's government finances improved significantly last year, with the surplus growing to 1.7% of gross domestic product (GDP), according to provisional data. The surplus posted by the social security funds rose again thanks to favourable developments in wages and the labour market. Moreover, central government did not have to repay nuclear fuel tax payments, unlike in the previous year. In addition, interest expenditure saw a renewed decline, and tax revenue continued to rise dynamically. Overall, these alleviating factors significantly outweighed the spending increases, some of which were sharp (see also pp. 59 f.). The debt ratio had declined to 61.0% by the end of the third quarter of 2018, down from 63.9% at the end of 2017.

General government fiscal ratios*

As a percentage of GDP



* As defined in the national accounts. **1** Taxes and social contributions plus customs duties and bank levies to the Single Resolution Fund.

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Shrinking surplus this year due to fiscal loosening

This year, the setting for government finances is expected to be advantageous. The Federal Government is anticipating weaker but still positive economic conditions. There are no notable temporary burdens on the horizon at present, and interest expenditure will continue to fall. All the same, the surplus is likely to shrink perceptibly. This is mainly due to markedly looser fiscal policy. The fiscal burden, measured as revenue from taxes and social contributions relative to GDP, will probably decline only a little. Tax cuts will be offset by additional revenue stemming from tax progression, and the overall lower contribution rates for employees by higher rates for enterprises. However, significant spending increases are planned in many areas, such as pensions, internal and external security, education and infrastructure.

Fiscal loosening in medium term, too, …

Fiscal policy is set to be loosened further in the medium term. In many cases, it is likely to take some time before the firmed-up projects affect expenditure more strongly. This is true of infrastructure expansion, for example, or increased staffing at schools and in police forces. Further measures have also been agreed upon. For example, the solidarity surcharge is to be partially abolished and all-day childcare for children of primary school age is to be boosted significantly. Moreover, given that budget outturns

* 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). No data for the fourth quarter of 2018 are yet 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.

The structural development of German public finances – results of the disaggregated framework for 2018*

Germany's general government budget recorded a surplus again in 2018. According to preliminary data, the surplus amounted to 1.7% of gross domestic product (GDP) and was far higher than in the previous year (1.0% of GDP). The role played by cyclical influences and major temporary effects is established using the disaggregated framework for analysing public finances. The framework also shows the determinants of any other changes – which are classified as structural – in the expenditure and revenue ratios.

In addition to reaping the benefits of a healthy economy, public finances also improved thanks to a decline in burdens stemming from one-off measures. There was a surge in calls on guarantees in the wake of HSH Nordbank's privatisation. However, there was no repeat of the nuclear fuel tax repayment made in 2017, and there were inflows of funds in connection with fines on emissions from diesel vehicles. All in all, the structural surplus ratio improved markedly, though to a far lesser extent than the unadjusted ratio.

On balance, the structural improvement can be fully explained by developments on the revenue side, particularly the high growth in profit-related taxes. Adjusted for legislative changes and the effects of tax progression, income growth was once again greater than can be accounted for by its macroeconomic reference variable of entrepreneurial and investment income. This can be discerned from the reported residual. Added to this was a revenue-rich growth structure. Gross wages and salaries, in particular, increased relatively sharply. Cuts in taxes and social contributions had the opposite effect, slightly overcompensating for fiscal drag[1] in net terms. While the cuts chiefly concerned income tax, contribution rates for social security funds were also affected. By contrast, corporation tax generated additional revenue due to the refunds of corporation tax credit stemming from the system switchover in 2001 coming to an end.

The structural expenditure ratio remained unchanged. The interest expenditure ratio did indeed dip slightly in view of continued highly favourable follow-up financing conditions and a decline in the debt ratio, but the ratio of other structural expenditure (primary expenditure) rose in equal measure. Above all, fixed asset formation recorded a sharp increase, and more funding – compared with the unusually low previous year's level – was allocated to the EU budget.

Overall, the German government budget has recorded a clear structural surplus since 2014. While pressure on the budget has been eased by dynamic growth in revenue from taxes and social contributions coupled with lower interest expenditure, structural primary expenditure has risen at a much faster rate than GDP.

* The analysis is based on national accounts data. Aside from data revisions, adjustments to the macroeconomic outlook may also result in changes. For methodological notes on the framework, see Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pp. 61-76.
1 The term "fiscal drag" encompasses the revenue effect of bracket creep in income taxation and the countervailing impact of the fact that specific excise duties are largely independent of prices.

Structural development of the government budget*

Year-on-year change in the ratio to nominal trend GDP in percentage points

Item	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total 2009 to 2018
Unadjusted fiscal balance[1]	– 3.1	– 1.0	3.3	0.9	– 0.1	0.7	0.2	0.1	0.1	0.7	1.9
Cyclical component[1]	– 1.6	0.2	0.8	0.0	– 0.5	– 0.0	0.0	0.2	0.2	0.1	– 0.6
Temporary effects[1]	0.2	– 1.0	1.1	– 0.1	0.1	– 0.3	0.3	– 0.1	– 0.2	0.2	0.2
Fiscal balance	– 1.4	– 0.3	1.3	1.0	0.3	1.1	– 0.2	0.0	0.2	0.4	2.4
Interest payable	– 0.2	– 0.1	0.1	– 0.2	– 0.3	– 0.4	– 0.2	– 0.2	– 0.1	– 0.1	– 1.8
Owing to change in average interest rate	– 0.3	– 0.3	– 0.1	– 0.2	– 0.3	– 0.3	– 0.1	– 0.1	– 0.1	[2] ...	– 2.0
Owing to change in debt level	0.1	0.3	0.2	– 0.0	0.0	– 0.1	– 0.1	– 0.1	– 0.1	[2] ...	0.1
Primary balance	– 1.7	– 0.4	1.4	0.8	– 0.0	0.7	– 0.4	– 0.2	0.0	0.3	0.5
Revenue	– 0.9	– 0.2	1.1	0.0	0.2	0.2	– 0.1	0.4	0.2	0.4	1.3
Taxes and social contributions	– 1.0	– 0.4	0.7	0.1	0.3	0.0	0.2	0.5	0.4	0.3	1.1
Fiscal drag[3]	0.1	– 0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8
Decoupling of macroeconomic reference variables from GDP	– 0.3	0.2	0.2	0.0	– 0.1	– 0.0	– 0.1	0.0	0.1	0.1	0.2
Legislative changes	– 0.3	– 0.6	0.2	– 0.1	– 0.2	– 0.1	– 0.0	– 0.1	– 0.1	– 0.2	– 1.4
Residual	– 0.6	0.0	0.2	0.2	0.5	0.0	0.2	0.4	0.3	0.3	1.5
of which: Profit-related taxes[4]	– 0.6	0.2	0.2	0.3	0.1	– 0.0	0.0	0.4	0.3	0.2	1.1
Non-tax revenue[5]	0.2	0.2	0.4	– 0.2	– 0.1	0.2	– 0.2	– 0.1	– 0.2	0.1	0.3
Primary expenditure	0.8	0.2	– 0.3	– 0.8	0.2	– 0.5	0.3	0.5	0.2	0.1	0.8
Social payments	0.1	– 0.0	– 0.3	– 0.4	– 0.3	0.0	0.2	0.4	0.2	– 0.1	– 0.2
Subsidies	0.3	– 0.1	– 0.1	– 0.1	0.0	– 0.0	0.0	– 0.0	– 0.0	– 0.1	– 0.2
Compensation of employees	0.1	0.1	0.0	– 0.1	– 0.1	– 0.0	– 0.1	0.0	0.0	0.0	– 0.0
Intermediate consumption	0.2	0.2	0.1	– 0.0	0.1	0.0	0.0	0.1	0.0	0.0	0.7
Gross fixed capital formation	0.1	0.0	0.0	– 0.1	– 0.1	– 0.1	0.0	0.1	0.1	0.1	0.2
Other expenditure[6]	– 0.1	0.1	0.0	– 0.1	0.6	– 0.4	0.2	0.0	– 0.1	0.1	0.3
Memo item:											
Pension expenditure[7]	– 0.1	0.0	– 0.1	– 0.2	– 0.3	– 0.0	0.1	0.1	0.1	– 0.0	– 0.5
Healthcare expenditure[8]	0.2	0.1	0.0	– 0.0	0.2	0.2	0.0	0.1	0.0	0.0	0.7
Labour market expenditure[9]	0.1	– 0.3	– 0.3	– 0.2	– 0.1	– 0.2	– 0.1	– 0.0	0.0	– 0.0	– 1.1
Long-term care expenditure[10]	0.0	0.0	– 0.0	0.0	0.0	0.0	0.1	0.0	0.2	0.0	0.4

* The structural figures are derived by adjusting for cyclical influences and specific temporary effects. **1** Year-on-year change in the ratio to nominal GDP. **2** The breakdown of the change in the interest expenditure ratio is not shown for 2018 as the debt ratio for the year's end is not yet available. **3** The term "fiscal drag" encompasses the revenue effect of bracket creep in income taxation and the countervailing impact of the fact that specific excise duties are largely independent of prices. **4** Assessed income tax, corporation tax, local business tax, investment income tax. **5** Other current transfers receivable, sales and total capital revenue. **6** Other current transfers payable, other net acquisitions of non-financial assets and capital transfers payable. **7** Spending by the statutory pension insurance scheme, spending on civil servant pensions as well as payments by the Post Office Pension Fund and the Federal Railways Fund. **8** Spending by the statutory health insurance scheme and assistance towards civil servants' healthcare costs. **9** Spending by the Federal Employment Agency (excluding the reintegration payment paid to central government (from 2009 to 2013)) and central government expenditure on unemployment benefit II and on labour market reintegration measures. **10** Spending by the public long-term care insurance scheme.

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were better than planned, additional measures can be expected. All in all, a shrinking surplus is on the cards in the coming years as well.

… but fiscal rules still met by some margin from today's perspective

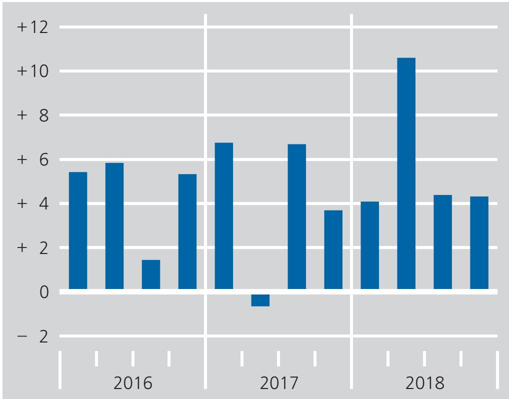
Nonetheless, structural surpluses are currently likely in the medium term, too, and the debt ratio should drop well below 60%.[1] Thus, the general government fiscal rules will be met by some margin despite the loose fiscal stance. Generally speaking, the rules permit unfavourable cyclical developments to have an impact on the budgets. However, flatter growth often leads to a reassessment of the structural budgetary situation, which may make fiscal policy corrections necessary. Buffers built up in good times therefore reduce the risk that procyclical consolidation will be needed in the event of an economic downturn.

Heed long-term challenges and make burden-sharing transparent

At the same time, given the current outlook, the debt burden will be reduced, thus making provision for the demographic challenges that lie ahead. What is problematic, however, is if new, permanent benefit commitments are funded by drawing exclusively on finite reserves and are therefore covered just temporarily.[2] The structural gaps this leaves then have to be plugged further down the line, when demographic burdens are simultaneously mounting. At the end of the day, sustainable public finances can only be secured if the long-term outlook is heeded as well. Greater transparency about the burdens and how they will be shared would be a welcome move. On that note, the pension package that came into force at the start of the year should be viewed critically. The statutory pension insurance scheme will be saddled with additional expenditure in good times, with no clarification as to how this will be financed in the long term.

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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Budgetary development of central, state and local government

Tax revenue

Dynamic rise in tax revenue in 2018

Tax revenue[3] rose by just under 6% in 2018 (see the above chart and the table on p. 62). This growth was driven by income-related taxes, with the dynamic increase in wage tax receipts chiefly reflecting positive employment and wage developments. A large part of the revenue increase stemming from bracket creep in income taxation was offset by shortfalls

1 The Federal Ministry of Finance also included this expectation in its projection for the Stability Council in December 2018. The Independent Advisory Board considers this projection to be acceptable; see Independent Advisory Board of the Stability Council, Tenth statement regarding compliance with the upper limit for the structural general government budget deficit pursuant to Section 51(2) of the Budgetary Principles Act (HGrG), December 2018. Given the slightly less favourable macroeconomic expectations, the Federal Government is likely to lower its fiscal projection somewhat, but, as things stand, there will be no substantial change in the budgetary situation.
2 See Deutsche Bundesbank, Excursus: the use of reserves and off-budget entities by central and state government, Monthly Report, August 2018, pp. 69 ff.
3 Including transfers to the EU budget – which are deducted from German tax revenue – but excluding receipts from local government taxes, which are not yet known for the quarter under review.

Tax revenue

Type of tax	Year as a whole 2017 € billion	2018 € billion	2018 Year-on-year change € billion	2018 Year-on-year change %	Estimate for 2018 as a whole[1,2] Year-on-year change %	Q4 2017 € billion	2018 € billion	2018 Year-on-year change € billion	2018 Year-on-year change %
Tax revenue, total[2]	674.6	713.6	+ 39.0	+ 5.8	+ 5.6	182.3	190.2	+ 7.9	+ 4.3
of which:									
Wage tax	195.5	208.2	+ 12.7	+ 6.5	+ 6.3	54.7	58.4	+ 3.7	+ 6.8
Profit-related taxes	116.9	123.9	+ 7.0	+ 6.0	+ 6.2	27.4	27.6	+ 0.2	+ 0.8
Assessed income tax[3]	59.4	60.4	+ 1.0	+ 1.7	+ 1.3	14.9	15.2	+ 0.3	+ 2.2
Corporation tax	29.3	33.4	+ 4.2	+ 14.2	+ 13.9	6.8	7.5	+ 0.7	+ 9.8
Investment income tax[4]	28.3	30.1	+ 1.8	+ 6.4	+ 8.6	5.7	4.9	− 0.8	− 13.8
Turnover taxes[5]	226.4	234.8	+ 8.4	+ 3.7	+ 3.7	58.1	60.6	+ 2.5	+ 4.2
Other consumption-related taxes[6]	92.2	92.7	+ 0.5	+ 0.5	+ 0.7	27.6	27.8	+ 0.2	+ 0.7

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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owing to legislative changes.[4] Revenue from profit-related taxes saw another dynamic rise (see also pp. 59 f.), with the exception of withholding tax on interest income and capital gains. Turnover tax revenue increased markedly in step with domestic demand. In addition, the lapsing repayment of nuclear fuel tax had a positive effect year on year.[5]

2018 revenue slightly higher than October estimate

Revenue was thus somewhat higher than projected in the last official estimate of October 2018 (+€1 billion). This was mainly thanks to wage tax. By contrast, receipts from withholding tax on interest income and capital gains were surprisingly poor. In particular, this could be down to a drop in capital gains in the quarter just ended (as against the same quarter of the previous year) amid stock market losses, some of them considerable.

The official estimate shows average revenue growth (including local government taxes) of around 4% this year and in the years thereafter. However, the Federal Government has since lowered its growth expectations slightly, primarily for 2019. Moreover, legislative changes agreed in the meantime will reduce the increase this year by ½ percentage point. Next year, this dampening effect will be somewhat stronger still. A notable factor here is the Family Relief Act *(Familienentlastungsgesetz)*, which entails income tax cuts applicable from the start of this year and of next year. This will increase the basic tax allowance and child tax allowance. The tax scale will also be adjusted with the intention of compensating for the effect of bracket creep attributable to inflation in the respective previous year. Child benefits will also go up in the middle of this year. As things now stand, revenue growth could thus be

Subdued revenue growth expected in 2019, picking up again in 2020

4 The basic tax allowance and child tax allowance as well as the other income tax brackets and child benefits were raised slightly.
5 In 2017, the Federal Government repaid all nuclear fuel tax receipts following a ruling by the Federal Constitutional Court (with interest: €7½ billion or 1% of total tax revenue).

dampened overall this year, but pick up again distinctly in 2020.

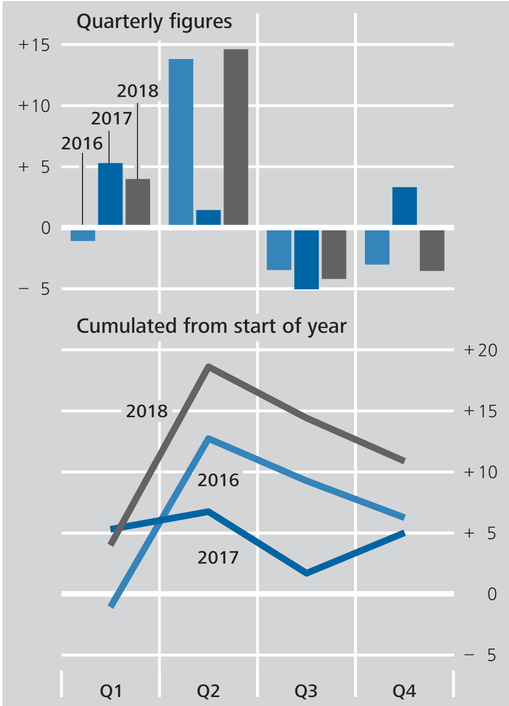
Central government budget

Significantly larger surplus in 2018

According to preliminary data, the central government budget recorded a surplus of €11 billion in 2018. This constitutes a significant improvement of €6 billion on 2017. Revenue rose by 4½%. Tax revenue grew at the somewhat weaker pace of 3½% (€12½ billion). The nuclear fuel tax repayment lapsed, but extra funds of a similar amount were transferred to the EU budget. There was a large increase of €4 billion in non-tax receipts. Alongside the higher Bundesbank profit distribution, this was not least attributable to additional receipts from the heavy goods vehicle toll, which was extended to all federal trunk roads in the middle of the year, and from loan repayments. At 3%, expenditure growth was much weaker than growth in revenue. A €1 billion drop in interest payments was the chief source of relief.

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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Result again much better than planned; worth examining purpose of reserve

The fiscal balance was therefore up by €13 billion on the budget plan just approved in July 2018. As in the previous two years, the envisaged withdrawal from the refugee reserve was not necessary. On the contrary, €11 billion was added to the reserve at budget outturn, taking the total to €35 billion. The Federal Court of Auditors criticised the repeated topping-up of the reserve, especially as it undermines the budgetary principle of annuality.[6] In reality, more or less free use is now made of this special reserve, which was originally created to cover refugee-related burdens. This harbours the risk of structural gaps being opened up, without it becoming sufficiently transparent. It would be worth considering setting aside a reserve exclusively to cover unexpected deteriorations in the budget position.[7]

Revenue significantly higher than budget estimates …

Revenue was €6 billion higher than planned (excluding the envisaged reserve withdrawals). Taxes contributed just €1 billion to this. However, the turnover tax revenue of €1½ billion that was transferred to state government to cover refugee-related expenses would have to be added to this figure. Provision was made for this in the budget with a global revenue shortfall item (i.e. a lump-sum reduction in non-tax receipts). The budget account therefore includes corresponding additional non-tax revenue. Furthermore, a sum larger than estimated was transferred from the EU, an unbudgeted dividend was distributed by Deutsche Bahn and more loans were repaid. Receipts from the resolution of the dispute over the delayed introduction of the heavy goods vehicle toll in 2005 probably also contributed to the increase.

… and expenditure lower

Expenditure was €7 billion lower than the amount envisaged in the budget. Interest ex-

6 See Bemerkungen 2018 des Bundesrechnungshofes zur Haushalts- und Wirtschaftsführung des Bundes, p. 108.
7 See Deutsche Bundesbank, Excursus: the use of reserves and off-budget entities by central and state government, op. cit.

Key central government budget data in connection with the debt brake*

€ billion

Item	2017 Actual	2018 Budget	2018 Provisional actual	2019 Budget
1. Fiscal balance	5.0	– 1.9	10.9	– 5.8
2. Coin seigniorage	0.3	0.3	0.3	0.3
3. Transfer to (–)/withdrawal from (+) reserves	– 5.3	1.6	– 11.2	5.5
4. Net borrowing (1.+2.+3.)	–	–	–	–
5. Balance of financial transactions	– 0.8	0.3	0.7	0.7
6. Cyclical component in the budget procedure	2.1	4.2	1 – 2.0	4.4
7. Balance of incorporated off-budget entities	– 1.4	0.9	4.0	– 3.6
Digitalisation fund (from 2018)	–	2.4	2.4	– 0.2
Energy and climate fund	– 0.2	0.0	2.9	– 0.7
Flood assistance fund	– 0.7	– 0.4	– 0.6	– 0.7
Fund to promote municipal investment	– 0.5	– 1.1	– 0.7	– 1.9
8. Structural net borrowing (4.–5.–6.+7.) (repayment: +; borrowing: –)	– 2.7	– 3.6	5.3	– 8.7
9. Structural balance (8.–2.–3.)	2.3	– 5.5	16.2	– 14.5
10. Structural balance adjusted for updated estimate of potential output2	– 1.6	– 7.0	8.5	– 12.9
11. Debt brake ceiling (–0.35% of GDP3)	– 10.6	– 11.4	– 11.4	– 11.5

* For more information, see Deutsche Bundesbank, Public finances, Monthly Report, February 2016, pp. 68 f. **1** Simplified procedure based on the national accounts figures published in February 2019. **2** Potential output and GDP based on Federal Government's 2019 Annual Economic Report. **3** Here, this refers to GDP in the year before the budget is prepared.

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penditure accounted for €1½ billion of this. On balance, this was attributable to the premiums (premiums on the sale price of Federal securities with coupons above the market interest rate) fully deducted from this item. These were again very extensive, at €3½ billion.[8] The rest of the difference was largely down to current grants. Investment spending was €1½ billion lower than estimated.

Debt brake: surplus and high credit entry on control account despite reserve top-up

The structural balance under the debt brake stands at almost +0.2% of GDP. The surplus in the core budget was neutralised by the reserve top-up (no net borrowing).[9] A minor surplus from financial transactions had to be deducted. However, because nominal GDP growth was lower than envisaged, a cyclical burden of sorts was determined in spite of the overall very favourable setting. Together with the surplus posted by the relevant off-budget entities, the overall outcome was +€5½ billion (budget estimate: -€3½ billion). There was thus a margin of ½% of GDP below the threshold of -0.35% of GDP. Despite the transfer to reserves, there will still be a high credit entry on the control account (€16½ billion).[10]

Improved starting position allows for better 2019 result than planned, despite slower growth

The 2019 Federal budget was adopted in November 2018, again with no authorisation for net borrowing. In its latest Annual Economic Report, the Federal Government projects somewhat weaker nominal GDP growth in 2019 than envisaged in the budget plan. The budget will thus come under pressure, but as things now stand, this burden will probably be far outweighed by the improved starting position.

8 For details of a less volatile accounting procedure that conforms with the national accounts, see Deutsche Bundesbank, Distortive accounting of premiums and discounts in the Federal budget, Monthly Report, July 2017, pp. 43 f.
9 The way in which changes in reserves are accounted for differs from the EU budget rules, compliance with which was intended to be ensured by means of the debt brake. Excluding the reserve top-up, the amount credited to the control account would have been correspondingly higher. Its use would be much more limited.
10 The provisional balance for the 2018 budget will be booked at the start of March. The balance (accrued from previous years) currently stands at €19 billion.

It therefore appears possible to achieve a balanced budget without the planned withdrawal from the reserve.

Benchmark figures again include fiscal space, but additional burdens foreseeable

In March, the Federal Government will adopt the benchmark figures for the 2020 budget and for the fiscal plan up to 2023. They will be based on a tax estimate updated in line with the Annual Economic Report. GDP growth is now considered to be weaker, but the reserve is €13 billion larger than previously planned, and the more favourable starting position will continue to make itself felt. According to the coalition agreements, additional fiscal space should be used to increase spending on the armed forces and development aid. On top of this, there are plans to continue compensating for bracket creep attributable to inflation and to use central government grants to cushion the exit from coal power. There are also discussions about abolishing the solidarity surcharge completely. This seems worthy of consideration, generally speaking; remaining financing needs could then be funded from regular tax revenue.[11] Looking ahead, however, central government's financial position will worsen considerably, as the central government grants to the statutory pension insurance scheme will increase sharply due to demographic developments alone.

Central government's off-budget entities record high surplus in 2018 …

Central government's off-budget entities (excluding bad banks and other entities that use commercial double-entry bookkeeping) concluded 2018 with a high surplus of €6 billion, compared with €3 billion in 2017. Some €2½ billion of this came from central government's transfer to prefinance the new digitalisation fund. The energy and climate fund benefited from both a much higher central government transfer than in the previous year and a very sharp rise in the prices of CO_2 certificates. By contrast, inflation compensation payments related to the repayment of an inflation-indexed seven-year Federal note (Bobl) (€1 billion) put noticeable pressure on the off-budget entities.

… and outlook is positive for 2019, too

The off-budget entities' surplus may be somewhat lower in 2019. While the precautionary fund for redemption payments for inflation-linked Federal securities is not due to make any repayments, and the energy and climate fund may benefit from higher CO_2 certificate prices on an annual average, the latter will receive lower central government transfers and will have to foot the bill for rising expenditure on its programme. A further dampening effect is likely to come from higher outflows from the fund to promote municipal investment, which has given advance notice of a large number of projects. In addition, the digitalisation fund will no longer be prefinanced by central government, and the first outflows are on the horizon. However, the auction of mobile phone frequencies planned for this year could enable the fund to generate a significant surplus again. This may even mean that the off-budget entities as a whole are able to improve their overall result.

State government budgets[12]

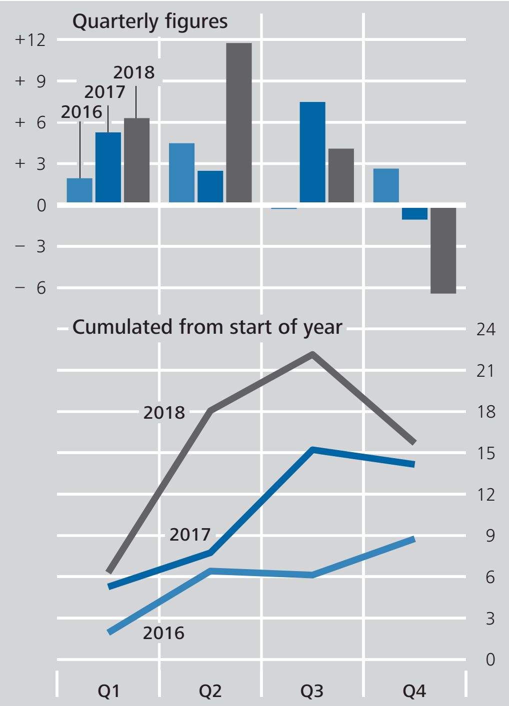
Higher surplus in 2018 despite one-off burden

State government finances improved in 2018, too. The surplus posted by the state government core budgets (before the closing entries) grew again, by €1½ billion to just over €15½ billion. Excluding the one-off burden in the fourth quarter stemming from settling guarantees in connection with the privatisation of HSH Nordbank (€5 billion), the result would have been even more favourable. Overall, revenue went up by 5½%. Tax revenue recorded dynamic growth (+6%), while growth in transfers from other administrations was only moderate. Of the other revenue, the absence of the capital repayment from Bayern LB recorded in 2017 was more than offset by fines from car manufacturers on emissions from diesel vehicles. As a result of the one-off burden relating to HSH Nordbank, expenditure rose almost

11 See also Deutsche Bundesbank, Public finances, Monthly Report, November 2018, p. 60.
12 The following figures are based on the monthly cash statistics on the core budgets.

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.

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as sharply as revenue on the whole. Staff costs and transfers to local government were up markedly. Fixed asset formation recorded far stronger growth, but it is a much smaller expenditure item. By contrast, interest expenditure continued to fall.

Positive outlook for current year and medium term

In the current year and the medium term, the outlook for state government as a whole remains positive. Tax revenue is forecast to grow markedly, even in the Federal Government's watered-down macroeconomic projection. The latest income tax cuts will be covered by progression-related increases. Furthermore, turnover tax revenue is no longer to be forwarded to central government to service the debts of the "German Unity Fund" now that they have been repaid in imputed terms. On top of this, additional revenue is expected as of 2020 from the reform of the federal financial equalisation scheme. However, expenditure will also be stepped up in areas such as childcare, education, internal security and the judicial system. As a result, transfers to local government as well as expenditure on staff, other operating expenditure and investment are set to increase considerably. As substantial growth in pension burdens is expected for a number of years yet, surpluses are likely to decline in the future.

Parliamentary mediation committee to debate reform of Germany's Basic Law with a view to increasing mixed financing

At the end of last year, the Bundestag ruled on a constitutional amendment to extend central government financial assistance, in particular for investment in education by state and local government. The Bundesrat referred the proposed amendment, including, not least, a greater financial contribution from state government, to the parliamentary mediation committee. In principle, stepping up mixed financing blurs the responsibilities of the various government levels and weakens federal states' individual responsibility. This may also increase the likelihood of funds being used inefficiently. In view of the high level of surpluses overall, most states are likely to have own funds available to allocate more funding to individual areas.[13] If additional central government funds do indeed seem to be necessary, it would be worth considering adjusting the distribution of revenue in the tax system. In any case, agreeing on common minimum standards and meaningful comparisons of performance is essential to let the federal states compete with each other for the best solutions in the area of education.[14]

13 Given the current cyclically driven increase in the degree of aggregate capacity utilisation, the unadjusted surplus overstates the financial scope. In the context of the debt brake, the federal states use different cyclical adjustment procedures, and the per capita cyclical components sometimes vary a great deal from one federal state to the next. This has an impact on their budgetary leeway.
14 See also Deutsche Bundesbank, State government finances: comparison of developments, debt brakes and fiscal surveillance, Monthly Report, October 2018, p. 38.

Local government finances[15]

Little change in surplus in Q3 2018

In the third quarter of 2018, the surplus of local government and its off-budget entities (just over €1½ billion) hardly changed compared with the same period of the year before. Revenue went up by 4½%, driven mainly by taxes (+7½%), particularly local business tax. However, at 5%, expenditure rose at a somewhat stronger pace than revenue. A major contribution was made by personnel expenditure (+7½%). This was chiefly due to the fact that the wage increases from spring were paid out at a later date, but probably also reflects a further rise in staffing levels. Growth in fixed asset formation (+13½%) and other operating expenditure (+5½%) was also high. Decreases were recorded for interest expenditure and, in particular, social benefits (-1½%). While spending on social assistance continued to increase, accommodation costs for recipients of unemployment benefit II and benefits for asylum seekers fell sharply.

Large surplus likely for 2018 as a whole, and prospects favourable in medium term, too

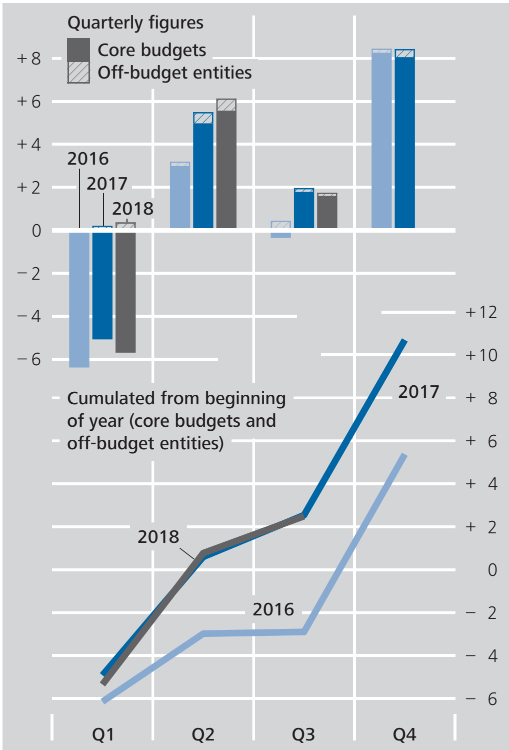
At the end of the first three quarters of 2018, the surplus stood at the same level as in the previous year (€2½ billion), and the result for the year as a whole is not expected to deviate significantly from that of the year before. As things currently stand, local government is expected to continue posting a marked rise in tax revenue for the current year and in the medium term. Once the increased share of local business tax will no longer have to be transferred to state government as of 2020, the burden on local government will ease by €4 billion. However, as in the case of state government, stronger increases in expenditure are expected. It is thus likely that the high surpluses will tail off for local government, too. Nevertheless, the local government budgetary rules are likely to require certain surpluses for a longer period.[16]

Local government debt fell sharply in Q3 2018 due to new "Hessenkasse" fund

At €5 billion, debt attributable to local government core budgets and off-budget entities fell sharply in the third quarter of 2018 compared with the end of June. Cash advances, which are actually only intended to bridge liquidity shortfalls over the course of the year, declined, in particular. The main reason for this was that the federal state of Hesse used its new "Hessenkasse" fund to assume the bulk of its local governments' cash advances (€3½ billion). In return, the local authorities are required to contribute to repayments, and the budgetary rules have been tightened in order to avoid higher outstanding cash advances in the future. Overall, local government debt in Germany amounted to €136½ billion at the end of September. Of this, €92½ billion is attributable to credit market debt, €40½ billion to cash ad-

Local government fiscal balance

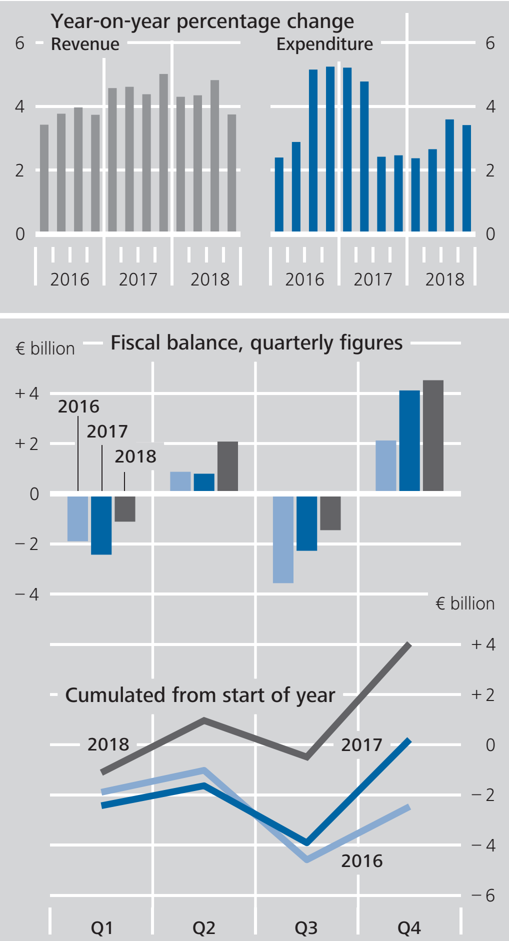
€ billion



Source: Federal Statistical Office.
Deutsche Bundesbank

15 This section describes the developments up to the third quarter of 2018; the figures were not available in time for the usual analysis in the January 2019 Monthly Report.
16 This also stems from the fact that the rules are often based on double-entry bookkeeping. In this type of bookkeeping, depreciation and new pension provisions are deducted from the result, whereas investment expenditure and pension entitlements are not. In many local governments, depreciation exceeds investment and new pension provisions exceed entitlements paid out. As a result, a balanced budget in the case of double-entry bookkeeping requires a surplus when recorded in the government finance statistics analysed in this article.

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

vances and €3½ billion to liabilities to the public sector. Adjusted for the "Hessenkasse", outstanding cash advances fell by just under €1 billion, mainly in North Rhine-Westphalia. Per capita, however, the level in that state, in Rhineland-Palatinate and, in particular, in Saarland is still very high.

Social security funds

Pension insurance scheme

Higher surplus in 2018

The finances of the statutory pension insurance scheme saw very favourable development in 2018. At €4 billion, the surplus was €3½ billion higher than in the previous year. In the final quarter of 2017, a slight deficit was still planned for 2018.

Considerable revenue growth with more moderate increase in expenditure

Revenue was up by 4%. Despite the slight cut in the contribution rate from 18.7% to 18.6% at the beginning of the year, contributions rose at a somewhat faster pace on the back of very favourable employment and wage developments. At 3%, expenditure growth was much weaker. This is due to an average annual pension increase of just over 2½%[17] and only a moderate increase in the number of pensions.

Result expected to be significantly lower in 2019

Despite very high reserves, the introduction of the new pension package[18] meant that the contribution rate was not lowered. In the current year, revenue is thus set to rise in parallel with employment and wages, which are both expected to continue faring well. However, growth in expenditure is likely to be much steeper, driven, above all, by the further extension of child-raising periods for children born before 1992 ("mothers' pensions"). Furthermore, the mid-year pension increase is also expected to make a marked contribution to this rise. Overall, therefore, despite favourable revenue growth, a deficit already looks likely.

Increasing financial pressure on scheme's finances

In the longer term, the funds needed by the statutory pension insurance scheme will grow at an increasingly faster pace. The deficits will rise until the reserve reaches its lower bound. The statutory pension insurance scheme will come under severe pressure when, as of the mid-2020s, the baby boomer generation enters retirement. According to the pension insurance report of November 2018, which includes the most recent benefit increases, the contribution rate is to jump by 1.3 percentage points to 19.9% in 2024. In 2025, it is forecast to reach the ceiling of 20% (which applies until that

17 This is made up of the average pension increases in Germany in the middle of 2017 (just over 2%) and 2018 (just over 3%).
18 For more details, see Deutsche Bundesbank, Public finances, Monthly Report, August 2018, pp. 66 f.

date). Larger central government special-purpose grants will be needed after that.

Announced pension reform must balance finances in long term

The guarantees for the pension level and contribution rate will come to an end in 2025. As the law stands, the central government budget will then no longer function as a temporary buffer. After that, the contribution rate would have to rise rapidly, which, together with the ever more unfavourable age structure, would rein in pension increases. A pensions commission has been appointed to put forward fundamental reform proposals by March 2020. It would be a logical move to consider longer life expectancy when defining the statutory retirement age. Tethering the retirement age to rising life expectancy is currently only the case until 2031, up to which point the retirement age is to be gradually put up to 67 years. Setting the retirement age higher provides scope to increase individual pension levels.[19]

Federal Employment Agency

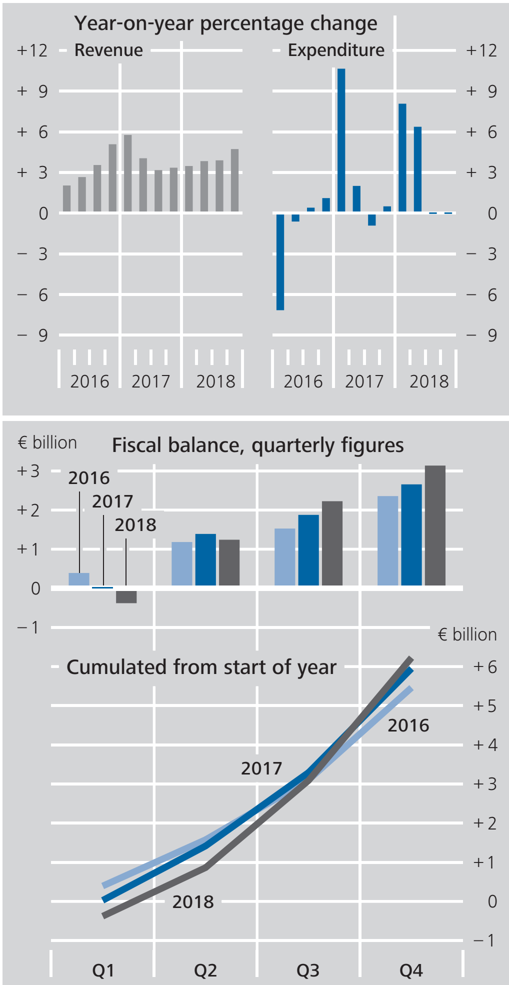
Surplus high again in 2018

In 2018, the Federal Employment Agency posted a surplus of just over €6 billion for its core budget.[20] Compared to the previous year, the result even picked up slightly, although more funds were again transferred to the civil servants' pension fund.[21] The budget target (surplus of €2½ billion) was again exceeded by a considerable margin. The reserve for the core budget stood at €23½ billion (0.7% of GDP) at the end of the year.[22]

Dynamic growth in revenue; expenditure grew only due to higher transfer to civil servants' pension fund

Revenue grew by 4% overall. Growth in contribution receipts was steeper (+5%), while revenue from insolvency benefit contributions fell somewhat as a result of cutting the contribution rate. Growth in expenditure was only slightly weaker. However, excluding the higher special transfer to the civil servants' pension fund, expenditure would have fallen by ½%. The most notable declines were recorded for expenditure on unemployment benefit (-2%) and on active labour market policy (-1½%).

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

Surplus expected to be much lower in 2019 due to cut in contribution rate

The Federal Employment Agency expects a much lower surplus of €½ billion for 2019. In its Annual Economic Report, the Federal Government has since lowered its growth forecast

19 See Deutsche Bundesbank, Excursus: longer-term pension developments, Monthly Report, August 2016, pp. 68 ff.
20 Excluding the civil servants' pension fund. Transfers to the fund are recorded as expenditure and thus reduce the core budget balance.
21 With a total of €2 billion, transfers were up by almost €1½ billion on the previous year. The aim of this special transfer is to ensure that future civil servant pension obligations are covered earlier than originally planned.
22 Further reserves include the insolvency benefit and winter compensation reserve (totalling just under €2½ billion) and a reserve of €8½ billion in the civil servants' pension fund.

somewhat; however, it made little change to its expectations for wages and employment. The report expects the contribution base to continue to develop favourably. The cut in the contribution rate from 3.0% to 2.5% at the beginning of the year, however, is likely to generate revenue shortfalls of around €6 billion. The number of benefit recipients upon which the budget plan is based roughly corresponds to the number recorded in 2018. As per capita benefit rates are rising roughly in line with remuneration, more funds have been earmarked for unemployment benefits in 2019. The figure budgeted for active labour market policy is almost one-third higher than in the previous year. Since there have not yet been any clear signs of a change in policy, this appears to be far too high. All in all, in 2019, the Federal Employment Agency's surplus is again expected to be much larger than planned.

Medium-term outlook is positive

In the medium term, too, the conditions for the Federal Employment Agency's finances appear favourable from today's perspective. According to the forecasts available, the unemployment rate is expected to fall somewhat further still. In spite of the lower contribution rate, significant surpluses are thus on the cards.