

## Public finances\*

### General government budget

*Coronavirus crisis still impacting on government finances in 2021*

The coronavirus crisis is still impacting on government finances in 2021. While the budget burdens resulting from both the unfavourable state of the economy and the coronavirus response measures have already significantly diminished over the course of the year, they remain considerable when viewed in relation to the year as a whole. All in all, therefore, another large deficit is on the cards. This could be similar in size to last year's deficit (4.3% of gross domestic product (GDP)). The debt ratio is likely to edge further upwards still (2020: 68.7%).

*Easing in 2022 due to economic recovery and expiring coronavirus response measures*

The deficit is likely to fall sharply next year, as the expected economic recovery will also automatically ease the burden on government budgets. In particular, the latest tax estimate even puts tax revenue higher than projected before the crisis once adjusted for tax cuts implemented in the meantime (see pp. 66 f.). Moreover, based on the current legal situation, the coronavirus response measures creating these budget pressures will gradually come to an end. Disregarding new measures from the incoming Federal Government, the deficit ratio could fall back towards 1%. The consolidation required following the crisis would therefore be limited.

*Fiscal loosening mainly via comparatively high expenditure growth*

A moderate structural<sup>1</sup> deficit is expected for 2022, following the structural surpluses posted in the years prior to the coronavirus crisis. This reflects the fact that the underlying fiscal stance has been loosened. In particular, expenditure in various areas has risen dynamically in structural terms – especially social spending, but also spending in areas such as education, infrastructure and climate policy. Expenditure in the last of these areas is partly offset by revenue from CO<sub>2</sub> emission certificates. The structural expenditure ratio excluding interest expenditure is expected to be close to historic highs.<sup>2</sup>

The outlook for government finances depends, not least, on the fiscal policy adopted by the incoming Federal Government (with regard to central government finances, see p. 69). The outgoing Federal Government had been intending to continue application of the debt brake escape clause in 2022. The general escape clause of the Stability and Growth Pact will also remain in force. Despite this, there is good reason to believe that 2022 will not be a crisis year. This means that there should be, at most, comparatively little need for pandemic-related government expenditure. Moreover, there is a general expectation – also reflected in the latest government estimate – of normal economic conditions. As outlined above, after adjustment for changes in tax law, tax revenue will exceed pre-crisis expectations. All in all, therefore, recourse to the escape clause does not appear warranted as things currently stand. In any event, it would be extremely difficult to justify financing non-crisis-related budget burdens through borrowing made possible by the escape clause.

*Invoking escape clause in 2022 does not appear warranted*

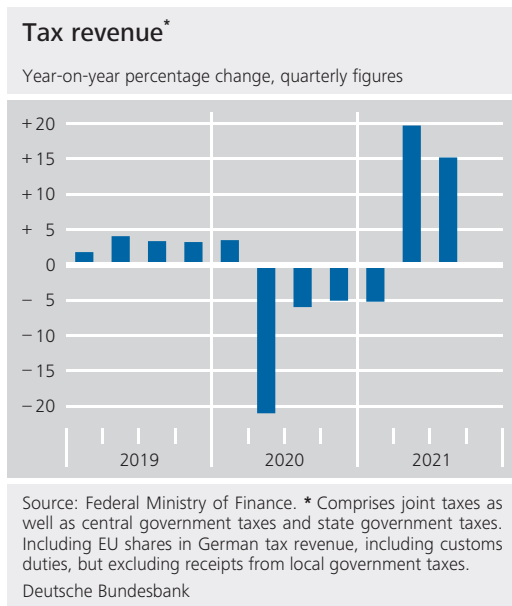
Financing pressure is building up in the health, pension and long-term care insurance schemes. Their expenditure is tending to grow faster than their revenue base. In 2022, central government will pay special grants of €14 billion to the health insurance institutions, and the social

*Need for action at social security funds*

\* 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 are yet available for local government or the statutory health and public long-term care insurance schemes for the reporting quarter. These will be analysed in the short commentaries in upcoming issues of the Monthly Report.

<sup>1</sup> Here, structural means excluding cyclical and special temporary effects. At present, the temporary effects are primarily the product of time-limited coronavirus response measures.

<sup>2</sup> See also Deutsche Bundesbank (2021a), p. 71. Expectations for 2021 are unchanged in qualitative terms. That said, the current assessment is that government finances are in better shape (in particular, tax revenue growth is stronger, and expenditure growth might also be slightly weaker).



fectiveness of the rules, reform is in order. Following a reform, the rules should then set out quantitative and binding upper limits defining the bounds within which national fiscal policy can operate. Compliance with these rules would need to be monitored in a transparent manner and, as a result, very high debt ratios, in particular, should fall reliably and markedly (for more details, see pp. 75 ff.).

## Budgetary development of central, state and local government

### Tax revenue

security funds will still be able to tap reserves. To address this financing pressure at its source, slower spending growth, higher contribution rates and/or continued higher grants from central government are needed. So far, there is no indication that a new Federal Government plans to tackle the expenditure issue. There is probably no leeway in the central government budget for additional grants without budget-alleviating measures elsewhere. Significant rises in contribution rates would therefore appear likely.

Tax revenue<sup>3</sup> continued to grow sharply in the third quarter of 2021 (by 15% on the year; see the adjacent chart and the table on p. 65). First and foremost, this reflects the economic recovery: for instance, advance payments of corporation tax and assessed income tax, a significant source of revenue, for the current year saw a strong increase. In addition, enterprises made less use of tax deferrals. The revenue from these taxes was therefore already markedly in excess of its pre-crisis level (third quarter of 2019). In the third quarter of 2021, wage tax benefited from the recovery of the labour market – in particular, there was a marked decline in short-time working.<sup>4</sup> Above all, however, the burdens stemming from the bonus child benefit payment in 2020 (around €3½ billion; deducted from tax revenue in the same way as regular child benefits) were absent from this year's third quarter revenue. But this contrasted with revenue shortfalls totalling €4 billion from various legislative changes at the start of 2021, when income tax allowances and the income tax scale were adjusted, the solidarity surcharge partly abolished and child benefits raised.<sup>5</sup> VAT

*Tax revenue grew sharply in Q3: economic recovery and discontinuation of support measures*

*Debate on reforming European fiscal rules*

Central government and state governments are subject to the debt brake (for more information, see also pp. 69 f. and p. 72). In addition, they are jointly responsible for complying with the European fiscal rules. Reforms of EU rules are currently being discussed, and it is a highly contentious topic: opinions range from stricter rules through to proposals to do away with quantitative requirements completely. Any further dilution of the binding effect of European rules would be a cause for concern, however. In addition to the fiscal rules, the Maastricht Treaty also relies on the disciplining effect of market reactions. Risk premia in the capital markets for governments independently borrowing are intended to create incentives for sound government finances. Both pillars have been weakened, though. To strengthen the ef-

<sup>3</sup> Including EU shares in German tax revenue but excluding receipts from local government taxes. These are not yet known for the quarter under review.

<sup>4</sup> Short-time working reduces wages, and short-time working benefits themselves are not taxed.

<sup>5</sup> See Deutsche Bundesbank (2021b), pp. 64 f.

Tax revenue									
Type of tax	Q1 to Q3				Estimate for 2021 <sup>1</sup>	Q3			
	2020	2021	Year-on-year change			2020	2021	Year-on-year change	
	€ billion		€ billion	%	Year-on-year change %	€ billion		€ billion	%
Tax revenue, total <sup>2</sup>	496.0	541.0	+ 45.0	+ 9.1	+ 9.1	168.3	193.9	+ 25.6	+ 15.2
of which:									
Wage tax <sup>3</sup>	151.6	155.5	+ 3.9	+ 2.6	+ 4.1	47.5	53.9	+ 6.4	+ 13.5
Profit-related taxes	80.1	106.0	+ 25.9	+ 32.4	+ 27.0	26.3	36.8	+ 10.5	+ 39.8
Assessed income tax <sup>4</sup>	42.8	50.1	+ 7.3	+ 17.1	+ 17.5	13.5	18.0	+ 4.5	+ 33.2
Corporation tax <sup>5</sup>	16.3	28.9	+ 12.7	+ 77.9	+ 60.3	5.4	9.9	+ 4.4	+ 82.1
Non-assessed taxes on earnings	15.9	19.5	+ 3.6	+ 22.8	+ 11.4	5.9	6.8	+ 0.8	+ 14.2
Withholding tax on interest income and capital gains	5.1	7.5	+ 2.3	+ 45.6	+ 40.5	1.5	2.2	+ 0.7	+ 48.0
VAT <sup>6</sup>	164.1	182.0	+ 17.8	+ 10.9	+ 12.3	59.8	69.5	+ 9.7	+ 16.2
Other consumption-related taxes <sup>7</sup>	62.7	62.8	+ 0.1	+ 0.2	+ 0.1	22.4	21.9	- 0.4	- 2.0

Sources: Federal Ministry of Finance, Working Party on Tax Revenue Estimates and Bundesbank calculations. **1** According to official tax estimate of November 2021. **2** Comprises joint taxes as well as central government taxes and state government taxes. Including EU shares in German tax revenue, including customs duties, but excluding receipts from local government taxes. **3** Child benefits and subsidies for supplementary private pension plans deducted from revenue. **4** Employee refunds and research grants deducted from revenue. **5** Research grants deducted from revenue. **6** VAT and import VAT. **7** Taxes on energy, tobacco, insurance, motor vehicles, electricity, alcohol, air traffic, coffee, sparkling wine, intermediate products, alcopops, betting and lottery, beer and fire protection.

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revenue rose significantly. This was partly due to a base effect: the temporary rate cut in place in the second half of 2020 no longer applied, which is likely to have resulted in additional receipts of around €3 billion. Revenue shortfalls at the same time last year were essentially recorded in September only. As VAT is usually paid with a lag of two months, it appears that July was not yet affected and August only to a minor extent. The fact that import VAT from the second quarter was booked with a time lag had a positive impact in this regard.

through channels such as progressive taxation. The second is the even greater increase in profit-related taxes. This expectation is based on the substantial receipts that these taxes have already brought in up to the end of October 2021. Tax measures are dampening the increase in total tax revenue. Revenue losses are primarily due to the partial abolition of the solidarity surcharge and adjustments to the income tax scale. Furthermore, firms are allowed to write off capital equipment faster, thus reducing revenue from profit-related taxes. In the case of VAT, tax measures will result in (for the most part, temporary) revenue shortfalls at a level comparable to the high shortfalls recorded in 2020. A strong revenue-increasing factor, on the other hand, is that the majority of the tax payments deferred in 2020 are now being made. This does not outweigh the aforementioned revenue-reducing effects, though.

*Tax revenue will see strong growth in 2021 as a whole and exceed level prior to coronavirus crisis*

According to the latest official tax estimate, general government tax revenue will rise by 10% on the year in 2021 (see also the table on p. 66). It would therefore already slightly exceed the level recorded in the pre-crisis year of 2019, despite sizeable tax cuts. There are two main reasons for this sharp increase. The first is dynamic growth in the nominal macroeconomic reference variables for tax revenue, bringing with it a corresponding rise in receipts

In 2022, revenue growth is expected to amount to 4½%. The pace at which the macroeco-

### Official tax estimate figures and the Federal Government's macroeconomic projections

Item	2021	2022	2023	2024	2025	2026
Tax revenue <sup>1</sup>						
€ billion	812.0	848.9	882.1	919.0	953.8	987.5
% of GDP	22.8	22.4	22.6	22.9	23.2	23.4
Year-on-year change (%)	9.8	4.5	3.9	4.2	3.8	3.5
Revision of tax estimate (€ billion)						
compared with May 2021	38.5	36.8	33.8	33.6	36.3	.
compared with November 2019	-33.2	-26.2	-22.7	-15.9	.	.
adjusted for legislative changes <sup>2</sup>	8.8	15.4	17.1	18.0	.	.
Real GDP growth (%)						
Autumn projection (October 2021)	2.6	4.1	1.6	0.8	0.8	0.8
Spring projection (April 2021)	3.5	3.6	1.1	1.1	1.1	.
Nominal GDP growth (%)						
Autumn projection (October 2021)	5.6	6.4	3.3	2.6	2.6	2.6
Spring projection (April 2021)	5.3	5.2	2.6	2.6	2.6	.

Sources: Working Party on Tax Revenue Estimates and Federal Ministry for Economic Affairs and Energy. <sup>1</sup> Including EU shares in German tax revenue, including customs duties, including receipts from local government taxes. <sup>2</sup> Interim changes in legislation as reported by the Working Party on Tax Revenue Estimates in Annex 2 of its press release on the results of the estimates of May 2020, September 2020, November 2020, May 2021 and November 2021.

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*Significant growth next year*

economic reference variables are rising will even pick up slightly, and progressive taxation will support growth somewhat more strongly than in 2021. However, the forecast indicates that profit-related taxes (before deducting shortfalls caused by legislative changes) will, starting from their high level in 2021, grow less sharply than macroeconomic profits. The recovery in employment will also bring with it higher employee refunds again. These are deducted from income tax revenue and thus dampen growth.

*Tax measures are a burden in net terms*

In addition, tax measures will curb the rise in revenue generated by profit-related taxes and wage tax in 2022. The most notable factors in this context are firms' aforementioned accelerated write-offs and the further adjustment step in the income tax scale. Furthermore, the back payments of deferred taxes will cease to affect the year-on-year figures. Meanwhile, significant additional revenue will be recorded in several other areas: the support measures in place for VAT will largely come to an end, tobacco tax rates will be raised and newer vaping products will be taxable for the first time. Following an order by the Federal Constitutional Court, some of interest payments to the tax authorities that had been temporarily suspended also now need to be made.<sup>6</sup>

In the subsequent years up to 2025, revenue is projected to rise by an average of 4%. The tax

estimate is based on the legal status quo, and legislation changes do not play a major role on balance. The forecast is therefore a fairly direct reflection of the assumptions regarding macroeconomic developments and progressive taxation. In actual fact, however, it stands to reason that raising income tax allowances will be necessary after 2022 as well. Risks also exist in connection with the solidarity surcharge, the constitutionality of which has been called into question for various reasons. In addition, the guidelines set out by the Federal Constitutional Court to prevent the foreseeable double taxation of future pensions need to be implemented.

Compared with the May tax estimate, there will be additional revenue to the tune of €38½ billion (1% of GDP) in 2021. This is primarily due to the fact that cash receipts up to October 2021 were very pleasantly surprising – especially with respect to profit-related taxes. That said, wage tax revenue growth has also

*Economic growth and progressive taxation will bring about significant growth in medium term, too*

*Strong upward revisions for all estimation years*

<sup>6</sup> In decisions by the Federal Fiscal Court, there had been doubts since 2018 regarding the constitutionality of the interest rates for back taxes and tax refunds. The tax authorities therefore granted a suspension of enforcement upon request. In an order published by the Federal Constitutional Court, it held that an interest rate of 6% per annum is applicable for interest periods up to 2018. As a result, payments of back taxes for previous years are now expected in 2022.

been stronger to date than indicated in the May tax estimate. In addition, the macroeconomic assumptions are more upbeat. This is because the tax estimate looks at nominal developments. High additional revenue compared with the May estimate is expected next year as well. This is mainly due to significantly more favourable overall economic development. In addition, the favourable cash balances will carry over in part into subsequent years. Growth will be bolstered by the court order on interest rates (in 2022 only) and the tobacco tax hike (also in the medium term). The Working Group is raising its projections for the following years to a similar extent and principally for the same reasons.

*Tax cuts push down revenue compared with pre-coronavirus outlook – but underlying trend is actually more favourable*

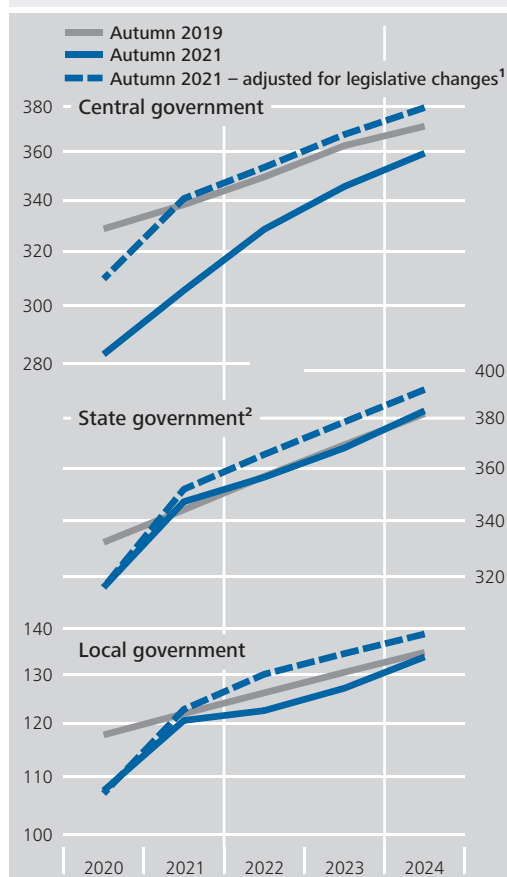
Tax developments are now estimated to be so favourable that their path adjusted for interim legislative changes even exceeds pre-crisis expectations. Compared with the last forecast prior to the coronavirus crisis (autumn 2019), revenue is lower, and the downward revision for 2021 is still €33 billion (1% of GDP). Thereafter, annual revenue shortfalls will decline to between €26 billion (2022) and €16 billion (2024). However, this reduction in revenue is solely due to sizeable shortfalls resulting from legislative changes made in the meantime. In 2022, legislative changes alone will give rise to revenue shortfalls of €42 billion: adjusted for these, tax revenue would have been €15 billion higher than the level expected before the coronavirus crisis.

*From 2021 onwards, state governments back on trajectory previously expected – revenue shortfalls at central government level*

Looking at the individual government levels, the picture is mixed (see the adjacent chart). The latest tax estimate sees state governments back on the revenue trajectory plotted in autumn 2019 this year already. Factoring out any legislative changes implemented in the meantime, their revenue trajectory would already markedly exceed their pre-pandemic trajectory. Meanwhile, the revenue trajectory for central government is still significantly below the one projected before the coronavirus crisis. Disregarding legislative changes, developments at the central government level would also be

### Official tax estimates: currently and prior to the coronavirus crisis

€ billion, log scale

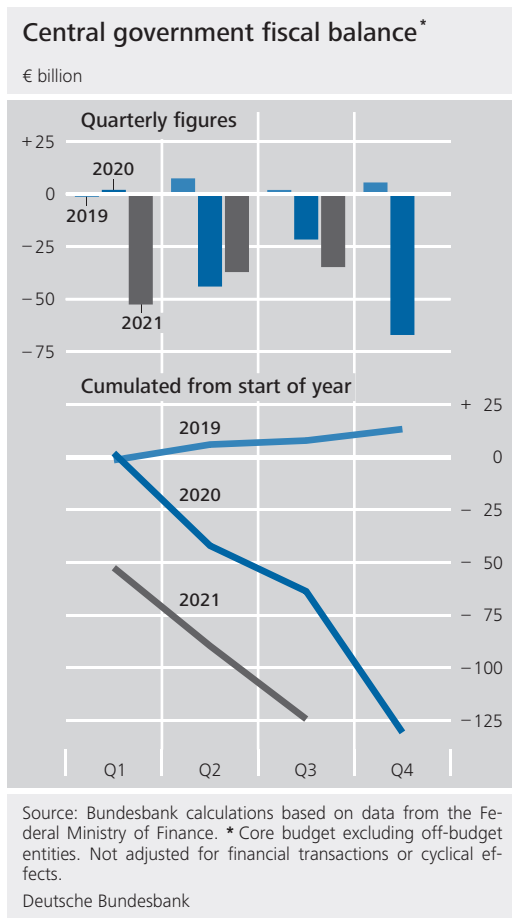


Source: Working Party on Tax Revenue Estimates. <sup>1</sup> Adjustment for interim changes in tax legislation pursuant to Annex 2 of the press release on the results of the estimates of May 2020, September 2020, November 2020, May 2021 and November 2021. <sup>2</sup> Excluding the local government taxes of the city states; after financial equalisation and supplementary grants.  
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more favourable than expected before the crisis: at this level, however, tax relief measures are leading to higher revenue shortfalls. For example, the partial abolition of the solidarity surcharge is making itself felt. In addition, central government is ceding tax revenue to the state governments.

### Central government budget

The central government budget recorded another large deficit in the third quarter. At €35 billion, it went so far as to exceed the prior-year figure by €13 billion. Revenue rose



*Significant increase in deficit in Q3 despite surge in tax receipts: pre-financed flood relief and coronavirus aid*

considerably, by 12% (+€10 billion). Tax revenue rose by 15% (+€11 billion), although transfers from this to the EU budget were €3 billion higher. Overall expenditure growth was far greater still (up by 22%, or €23 billion). One major reason for this was that central government pre-financed the new Flood Relief Fund to the tune of €16 billion. Furthermore, transfers to enterprises were €9½ billion higher than their prior-year figures, pushed up by bridging aid to compensate for lost revenue as a result of the pandemic. In quarter-on-quarter terms, however, the latter has already shrunk by €4 billion to €8 billion. Interest expenditure fell considerably on the year, by just under €1½ billion. This was primarily driven by higher premia on Federal securities. On balance, central government paid no interest in the reporting quarter – instead, it received interest income of just under €4½ billion.<sup>7</sup>

After three quarters, the deficit in the central government budget now stands at €124 bil-

lion. Last year, a very large deficit was recorded in the fourth quarter, with extensive burdens due to prefinancing of the Energy and Climate Fund, local government assistance, the VAT cut and assistance for the Federal Employment Agency. This year, the exceptional costs so far envisaged for the final quarter are considerably smaller. All in all, the deficit for the year as a whole could be far closer to the 2020 deficit of €131 billion than to the budget estimate (€240 billion).

*Deficit in year as a whole considerable smaller than planned*

Although the deficit will be far smaller than estimated, structural net borrowing will be well above the regular limit imposed by the debt brake. Appropriate repayments therefore need to be budgeted for in the future. These had been estimated to reach €13 billion per year from 2026 to 2042, but they will now be significantly lower due to more favourable budgetary performance. The following should be noted in this context:

*Future repayment burden also far smaller than planned*

- First, structural net borrowing in the core budget will be far lower than the amount budgeted. This borrowing includes the un-budgeted transfer of €16 billion to the new Flood Relief Fund. Furthermore, additional funds of more than €10 billion will probably be needed to offset the Federal Employment Agency’s deficit, plus a smaller cyclical burden will presumably also be deducted.<sup>8</sup> However, the substantial alleviating factors in budget implementation will outweigh these three negative factors quite considerably.

<sup>7</sup> When accounted for in the budget on a cash basis, premia are not recorded over the life of the relevant securities, which has various drawbacks. In particular, this makes interest expenditure highly volatile. For a proposal on recording premia on an accruals basis, thus eliminating this source of volatility, see Deutsche Bundesbank (2021c).

<sup>8</sup> According to the autumn projection, real GDP growth remains well below the figure estimated in the supplementary budget. However, higher inflation is causing nominal GDP (the relevant value here) to rise significantly more than expected back at that time. Based on these assumptions, the cyclical burden will be €9 billion lower than the budgeted figure, which will push up structural net borrowing accordingly.

- Second, it stands to reason that the fiscal balance of the new Flood Relief Fund will be included in the debt brake (this is normal procedure for new special funds that do not have their own borrowing authorisation).<sup>9</sup> The Flood Relief Fund will post a large surplus this year because most of the funds it is receiving from the core budget are unlikely to be released until a later date. In other words, the negative impact on the debt brake will ultimately not stem from central government's net borrowing to finance the transfer to the fund – it is the outflows of aid from the fund, which will be spread over several years, that will count towards it.
- Third, the Energy and Climate Fund can expect its deficit to be significantly smaller than the €14 billion figure included in the central government budget. This fund's fiscal balance is also included in the debt brake. The fund's outturn is likely to be more favourable due to revenue being higher than estimated. One reason for this is that the prices of European emission allowances have risen unexpectedly sharply. On top of the more favourable outturn, only slightly more than half of the fund's expenditure appropriation of €26 billion has been used up after three quarters. Spending is thus likely to be far lower than the budget estimate for the year as a whole (as in the previous year).

the loans as a financial transaction but to instead classify them as a grant item. The debt forgiveness would then be recorded as expenditure recognised in the budget, as is the case under European budget rules. This also makes more sense from an economic perspective and is in the spirit of the debt brake. It appears that a different approach is being taken for the loan claim for 2020. In this case, the intention is to forgive debt after the books have been closed and hence to apparently avoid a repayment obligation under the debt brake.

The existing fiscal plans for 2022 and the medium term will be taken up by the incoming government, but will then be revised in line with its own objectives. The main focus will be the funding of new projects. According to the exploratory paper, very extensive additional investments are planned for climate protection, amongst other things. Furthermore, the paper confirms the statutory pension level that is guaranteed at present and appears to rule out both cuts in benefits and a rise in the retirement age. A central government grant intended to partially fund the statutory pension insurance scheme was also announced. From 2022 onwards, a pension policy such as this would bring with it significant challenges for the central government budget.<sup>10</sup> If central government were to make a greater contribution to funding the statutory health and public long-term care insurance schemes in future, as has widely been encouraged of late, this would exacerbate the situation still further. Increases in joint taxes to cover additional burdens are ruled out. However, according to the latest tax estimate, significant additional tax revenue is to be expected (around +€13 billion each year from 2022 to 2025). It was also announced that environmentally harmful subsidies would be cut, but the timeframe and extent of these cuts remained unclear. All things considered, tax developments are making the budget plan-

*Exploratory paper implies new burdens on central government budget*

*From an economic perspective, debt forgiveness for Federal Employment Agency should count towards debt brake as transfer*

It still appears unclear whether the aforementioned net borrowing to offset the Federal Employment Agency's deficit will actually count towards repayment obligations. Until now, payments have been recorded as loans and thus as financial transactions outside the scope of the debt brake. The Budget Act (*Haushaltsgesetz*) stipulates that the loans should be converted into grants if the Federal Employment Agency's reserves are insufficient to cover the shortfall. Another condition is that, based on the figures, the remaining deficit is due to expenditure on short-time working. In the case of debt forgiveness of this nature, however, it would then be appropriate to no longer record

<sup>9</sup> See Federal Ministry of Finance (2021), p. 25.

<sup>10</sup> For information on the challenges facing the statutory pension insurance scheme, see Deutsche Bundesbank (2019a).

ning process markedly easier. In view of the extensive projects the next government has in mind, though, it will still face considerable fiscal policy challenges.

*Recourse to escape clause in 2022 seems questionable; topping-up of reserves particularly critical*

The outgoing government had planned to make recourse to the escape clause of the debt brake once more in 2022. However, the assumptions made regarding macroeconomic developments did not allude to any substantial remaining burdens from the pandemic. In its autumn forecast, the incumbent Federal Government assumes normal cyclical conditions. In 2022, central government tax revenue should be approaching the level expected prior to the crisis (tax estimate of autumn 2019, adjusted for central government provisions for planned legislative changes). Making recourse to the escape clause hardly seems justifiable, especially against the backdrop of very exhaustive reserves being available. Ultimately, the escape clause is based on a crisis situation outside the control of the state. If future expenditure were to be prefinanced by borrowing on the basis of the escape clause, this too would be incompatible with the objectives of the debt brake. This applies in particular to non-crisis measures.<sup>11</sup>

*Central government's off-budget entities should count towards the debt brake*

It would also be a questionable move to fund expenses outside of the debt brake if these are separated from the central government budget in formal terms only. This would be the case if central government continues to be instrumental in determining these expenses and thus ends up coming under financial pressure. In such an event, the measures to be funded would also fall under the European fiscal rules. This is because in the national accounts relevant for European budgetary surveillance, these items are counted as off-budget entities belonging to the government sector (accordingly, newly created special funds have also been included in the debt brake up to now). Public sector enterprises are only counted towards the corporate sector if they operate as independent economic entities. To qualify for this, they must have decision-making autonomy in respect of their principal function, in particu-

lar.<sup>12</sup> In addition, their goods or services must be supplied at economically significant prices; i.e. their prices should influence their supply. In concrete terms, at least one-half of their production and net interest costs must be covered by sales proceeds on the market. Equally, this output cannot primarily be sold to the government (unless the contracts were previously put out to tender).<sup>13</sup> Where public enterprises do not fulfil these criteria, they are attributed to general government in the national accounts.<sup>14</sup> Equally, specifically assigned business activities, such as the KfW banking group's coronavirus assistance loans, are assigned to the government sector, even if the enterprise belongs to the private sector.

The debt brake limits new projects that do not have counterfinancing. It is therefore essential to set priorities and to gain the general public's support for these. If, conversely, the debt brake is bypassed to avoid having to secure counterfinancing, one of its key functions may be lost: that of securing trust in government finances. This trust enables government debt to be financed without incurring larger risk premia, amongst other things. The importance of the debt brake also extends beyond Germany; it serves to anchor the EU's fiscal rules. These rules were passed with the particular aim of facilitating stability-oriented monetary policy. Against this backdrop, it is important that the binding effect of the debt brake, which has been strong up to now, is carefully guarded. This does not preclude a reform. However, to avoid violating the rules, any changes should be made transparently and with sufficient justification. In the same vein, it is essential that the rules continue to safeguard sound government finances, assure compliance with European provisions and clearly set new national boundaries.

*Uphold binding effect of debt brake*

<sup>11</sup> See Deutsche Bundesbank (2021d).

<sup>12</sup> See Eurostat (2014), point 2.12.

<sup>13</sup> See Eurostat (2014), points 20.19 ff.

<sup>14</sup> For instance, it is currently being assessed whether the DB Netz subsidiary of Deutsche Bahn still fulfils the criteria of a public enterprise.



*Central government's off-budget entities record large surplus in Q3 due to prefinancing of new Flood Relief Fund ...*

Central government's off-budget entities<sup>15</sup> recorded a large surplus of €15 billion in the third quarter, compared with a high deficit of €29 billion in the same period last year. At that time, the Economic Stabilisation Fund was providing very extensive funding for coronavirus assistance loans offered by the KfW banking group. This summer, return flows prevailed slightly, and the Economic Stabilisation Fund recorded a small surplus. Through extensive prefinancing, the Flood Relief Fund generated a surplus of €16 billion. This fund was started in September and recorded no outflows up to the end of the quarter. The Energy and Climate Fund, conversely, registered a deficit of €1 billion.

*... and high surplus also expected for 2021 as a whole*

The Flood Relief Fund is also set to record a high surplus for the year as a whole. Limited recourse is expected to be made to this fund up to the end of the year. In addition, the Economic Stabilisation Fund could record a surplus for the year as a whole, as further coronavirus loans and capital assistance are being paid back. To date, the Energy and Climate Fund has run up a deficit of €8 billion. In the final quarter, this is not set to rise substantially further, at least. Compared with earlier quarters, higher receipts from sales of emission allowances are foreseeable. Taken together, revenue and expenditure in the other entities factored in here could more or less offset each other. All in all, central government's off-budget entities can be expected to close 2021 with a high surplus. Although deficits are envisaged for the new Flood Relief Fund and the Energy and Climate Fund next year, coronavirus aid repayments to the Economic Stabilisation Fund could substantially outweigh these. Whether or not a surplus will be generated again also depends on how the incoming government deploys off-budget entities to carry out its projects.

## State government budgets<sup>16</sup>

The federal states' core budgets finished the third quarter of 2021 with a surplus of €6 bil-

lion. At the same time last year, they had posted a slight deficit of €½ billion. Revenue rose steeply, by 8% (+€9 billion) due to a sharp rise in tax receipts (+13%). By contrast, revenue from public administrations declined (-6%) on account of lower central government payments. Expenditure climbed less sharply, by 2% (+€2 billion). Just under one-quarter of this increase was attributable to immediate aid payments for flood damage. The results of the off-budget entities are also needed to assess the overall situation, as many federal states set up such entities and used them to group pandemic-related revenue and expenditure.<sup>17</sup> The financial relationships between these off-budget entities and the corresponding core budgets cannot be identified in the monthly cash statistics.

After three quarters, the federal states have recorded a surplus of €2 billion in their core budgets. All things considered, it appears that the coronavirus crisis is affecting the federal states considerably less in 2021 than was the case a year ago. Tax revenue, for instance, is set to see a large increase of 10%, according to the latest estimate. This will already put it slightly above the level expected for 2021 prior to the crisis (tax estimate of autumn 2019); indeed, excluding interim tax cuts, it would even have been somewhat higher. Last year, the state government deficit, including its off-budget entities, amounted to €34 billion.<sup>18</sup> This year, the deficit could decline to somewhere in the single-digit billions.

Next year, state government finances are expected to improve further. Tax revenue, for instance, is set to rise by 2½% from a recovered

*Surplus in Q3 due to strong upturn in tax revenue*

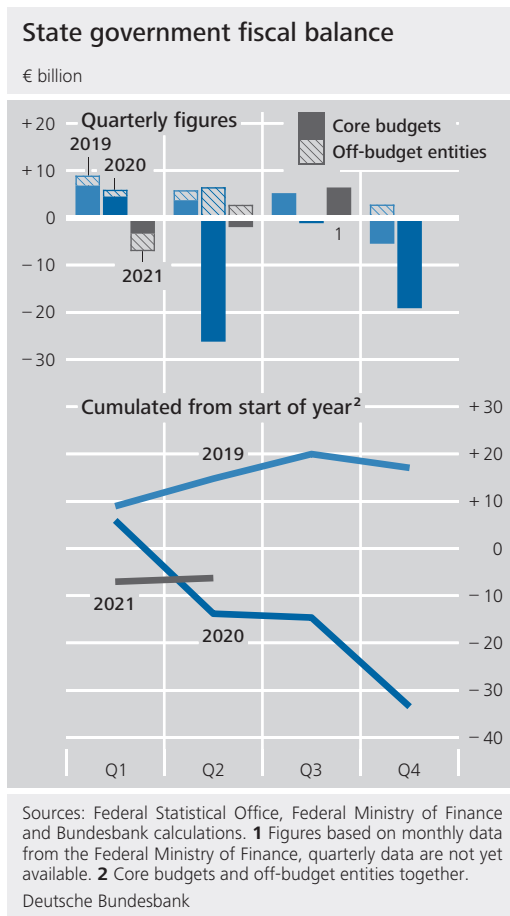
*Deficit for year as a whole considerably below previous year's figure*

<sup>15</sup> According to data from the Federal Ministry of Finance, i.e. excluding bad banks and other entities that use commercial double-entry bookkeeping. SoFFin's deficit is also factored out. It is based on funds transferred to refinance the bad bank FMSW.

<sup>16</sup> The data on state government budgets in the reporting quarter are based on the monthly cash statistics for the core budgets. Results for the off-budget entities are not yet available.

<sup>17</sup> For more on the role of off-budget entities, see Deutsche Bundesbank (2021a), p. 78.

<sup>18</sup> See Deutsche Bundesbank (2021d), pp. 16-19.



*Pandemic-induced burden on federal states likely to expire to a large extent in 2022*

baseline, bringing it to around its pre-crisis level. Expenditure-side coronavirus measures are equally likely to expire to a large extent if the pandemic peters out as assumed in most forecasts. It should then be possible to cover the bulk of any remaining coronavirus-related burdens using reserves.<sup>19</sup> In its autumn forecast, Federal Government anticipates that the economy will return to operating at near-normal capacity. Overall, as for central government, it would make sense for the federal states to stop using the escape clauses in their debt brakes, particularly if burdens remain manageable and reserves are available.<sup>20</sup>

*Federal states' structural situation as a whole not unfavourable*

It seems that in the wake of the coronavirus crisis, the structural situation of the federal states as a whole is not unfavourable. However, each of them now faces different fiscal challenges. Their respective structural budgetary positions are not the only factor here. Their stocks of reserves from the pre-crisis period and the design

of the state-specific debt brakes are just as relevant.<sup>21</sup>

In October, the Constitutional Court of Hesse ruled on important parts of the federal state's budgetary policy during the coronavirus crisis.<sup>22</sup> The Court deemed key areas of this policy to be incompatible with the state constitution and the debt brake enshrined within it. The newly created special fund, which is equipped with an exhaustive borrowing authorisation spanning several years, attracted particular criticism. This fund is thought to violate the principles of budgetary conformity and completeness, and to contravene the budgetary right of the state parliament. Although the ruling is based on constitutional rules that are specific to the state of Hesse, some key points could also be relevant to central government and to the other federal states.<sup>23</sup> The Constitutional Court ruled as follows:

*Court ruling on Hesse's coronavirus special fund highlights limits for escape clauses*

- Having a borrowing authorisation spanning several years “just in case” does not comply with the objectives of the debt brake concept.
- Should there be departures from the ban on new borrowing, the borrowing authorisation and any debt-financed measures must be suited to and necessary for combating the crisis, as well as being commensurate with the extent of the crisis. The legislator has not demonstrated this. Neither has it established a link between the need for new borrowing and the crisis situation.
- Finally, the legislator did not set out why no further funds from the federal state's general reserves were deployed in the first instance to combat the coronavirus pandemic.

<sup>19</sup> See Deutsche Bundesbank (2021d), pp. 33-35.

<sup>20</sup> See Deutsche Bundesbank (2021d), p. 38.

<sup>21</sup> See Deutsche Bundesbank (2020a).

<sup>22</sup> See Constitutional Court of Hesse (2021).

<sup>23</sup> Other legal proceedings are already underway in Baden-Württemberg, Mecklenburg-West Pomerania and Rhineland-Palatinate.

## ■ Social security funds

### Pension insurance scheme

*Deficit in Q3 considerably lower on the year due to subdued expenditure growth*

The statutory pension insurance scheme recorded a deficit of €1½ billion in the third quarter. This constitutes a year-on-year improvement of just over €2 billion. Total receipts increased by 3½%, which was slightly stronger than the rise in contribution receipts (+3%). Central government funds rose by just over 4½%; 1½ percentage points of this were attributable to funds for the basic pension. On the expenditure side, however, the new pension top-ups were not yet noticeable.<sup>24</sup> Expenditure saw weak growth of just over ½%. This was due to the very low pension adjustment of 0.2% on average across Germany (western Germany: 0.0%; eastern Germany: 0.7%). The number of pension recipients, too, rose only moderately, by ½%.

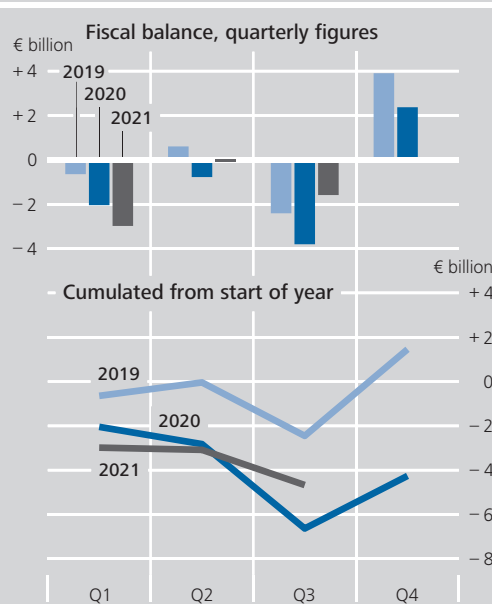
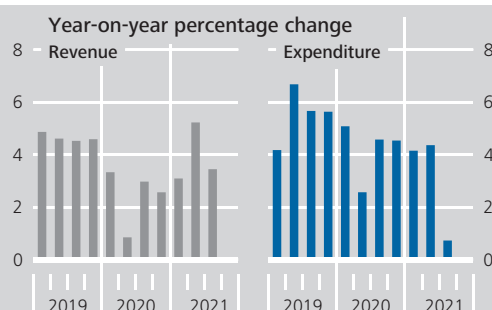
*Broadly balanced result possible for year as a whole*

Over the first three quarters of the year, the pension insurance scheme recorded a cumulated deficit of €4½ billion. In the final quarter, it is expected to see higher contribution receipts, as is usual for the time of year. On the expenditure side, the low pension adjustment

<sup>24</sup> The new basic pension was introduced at the start of 2021. Entitlements (estimated to be in the order of just over €100 million per month) have been accrued since January. However, those entitled to the new top-up payments only started to receive them in July (including back payments). The final basic pension payments from 2021 are not expected to be disbursed until the end of next year. Central government is therefore advancing funds, paying out the estimated higher pension amount in its entirety in the current year.

<sup>25</sup> The mid-2022 adjustment is based on wage growth for 2021, which was bolstered by the decline in short-time working. There is also likely to be a rather strong positive retrospective correction for developments in 2020: the relevant earnings subject to compulsory contributions for 2020 probably increased significantly more strongly than the wages that the 2021 pension adjustment was initially based on. The adjustment will be corrected accordingly. The weak wage growth seen in 2020 will also cause strong fluctuations in pension adjustments in 2023 and 2024 through the sustainability factor. As things currently stand, another very high adjustment is forecast for mid-2023 (around 5%). In 2024, the safeguard clause, which prevents a negative pension adjustment, could then be activated once more. Pensions are consequently only likely to rise slightly, at most. For more details, see Deutsche Bundesbank (2020b), p. 72.

#### Finances of the German statutory pension insurance scheme\*



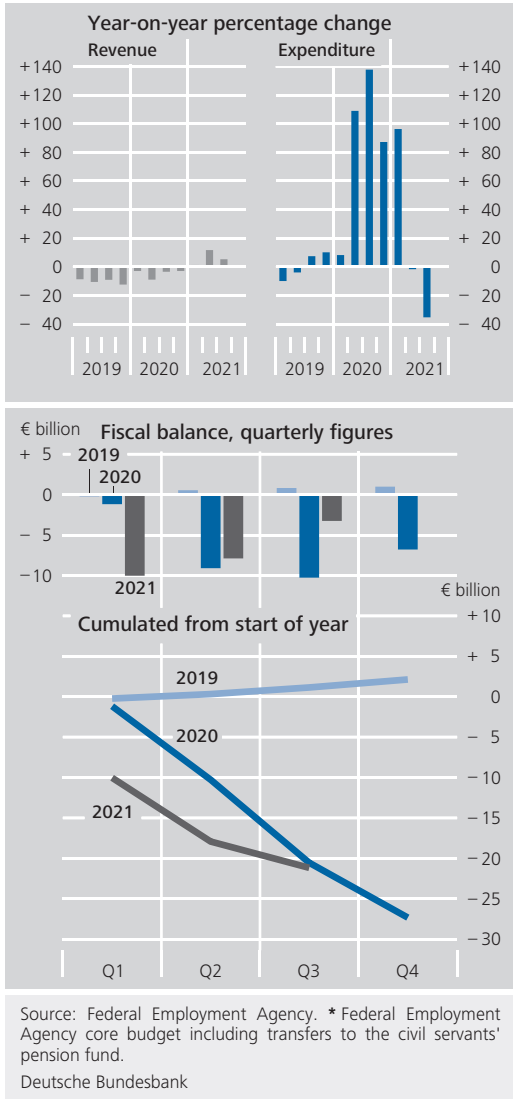
Source: German statutory pension insurance scheme (Deutsche Rentenversicherung Bund). \* Preliminary quarterly figures. The final annual figures differ from the total of the reported preliminary quarterly figures as the latter are not subsequently revised.  
 Deutsche Bundesbank

is slowing growth substantially. For the year as a whole, therefore, the budget could be broadly balanced (following a deficit of €4 billion the year before). The free reserves (sustainability reserve) would then be around €32 billion over the lower limit of 0.2 times the scheme's monthly expenditure.

Next year, however, a substantial deficit is likely to arise once more. On the expenditure side, higher pension benefits will have a burdening effect: by mid-2022, the pension adjustment could be rather high.<sup>25</sup> Compounding this are the current exhaustive basic pension top-ups for 2021, which are being paid out retroactively.

*Deficit expected again in 2022*

### Finances of the Federal Employment Agency\*



pecting the contribution rate to increase in 2024 – the first time since 2007.

## Federal Employment Agency

The Federal Employment Agency finished the third quarter with a substantial deficit of just over €3 billion in the core area.<sup>26</sup> This deficit was much higher last year, however, at €10 billion.

*Sharp decrease in quarterly deficit*

Revenue rose steeply, by almost 5½%. Furthermore, expenditure decreased significantly on the year (by 35%, or €6½ billion). However, it is still around 50% higher than in the third quarter of the pre-crisis year 2019. Payments for short-term work, in particular, have decreased sharply (-60%); in the third quarter, €3½ billion was disbursed (compared with €8½ billion a year earlier). In the quarter under review, €1½ billion of this was attributable to social contributions paid by the Federal Employment Agency to relieve enterprises during the pandemic. Expenditure on unemployment benefits also declined by almost €1½ billion on account of the improved labour market situation. Following an exceptional peak in the third quarter of 2020, insolvency benefit decreased very sharply, too, reaching its lowest quarterly level in over 20 years despite the fact that exemptions from the obligation to file for insolvency had expired by end-April.

*Steep rise in revenue and substantially lower expenditure due above all to sharp decline in short-time work*

On the revenue side, central government funds are seeing only subdued growth. This is primarily attributable to the weak wage development seen in 2020 – an item which is particularly important for forward projections.

*Demographics exacerbate funding pressure*

In the coming years, increasing numbers of baby boomers will be approaching retirement age. Funding pressure in the pension insurance scheme will gradually mount and deficits will rise. To prevent the reserve from undershooting its statutory minimum level, the contribution rate will then have to be gradually increased by a significant amount. According to press releases, the current Federal Government is ex-

At the end of the third quarter, the Federal Employment Agency recorded a deficit of €21 billion. This figure is likely to remain virtually unchanged up to the end of the year. Reserves of €6 billion and a central government grant of €3½ billion are earmarked for financing. Over the course of the year, central government plugs any remaining funding gaps with a loan, which is likely to be in the region of €13 billion at year's end. However, central government

*High deficit for year as a whole once more*

<sup>26</sup> Excluding the civil servants' pension fund. Transfers to the fund are recorded as expenditure, lowering the core budget balance. Transfers have been suspended until the end of 2021 on account of the coronavirus crisis.

## EU fiscal rules: current debate on reform

In February 2020, the European Commission opened a consultation process on reforming the fiscal rules. After being suspended on account of the coronavirus crisis, the process was relaunched in October 2021.

### Current basic quantitative requirements well suited

It is essential that any reform of the European budget rules upholds their main objective – to safeguard sound government finances. This includes, in particular, efforts to bring down high debt ratios. The basic quantitative requirements enshrined in the Stability and Growth Pact are well suited for this purpose.

De facto, the current rules base the reduction of the high debt ratios on the medium-term objective (MTO). The MTO is defined as a budget that is structurally close to balance or in surplus. In specific terms, this means that if the debt ratio is higher than 60%, the structural deficit may not exceed 0.5% of gross domestic product (GDP), and if the debt ratio is lower than 60%, the structural deficit may not exceed 1% of GDP. For the adjustment path towards the MTO, the benchmark for structural consolidation is 0.5% of GDP per year. This does not constitute excessively high consolidation.

For some time now, once a country has attained its MTO or adjusts sufficiently towards it, it has been regarded as complying with the debt criterion.<sup>1</sup> In such cases, high debt ratios are expected to fall below the reference value of 60% over time. The associated adjustment phases could well be very long. For instance, with an initial debt ratio

of 150%, a structural deficit of 0.5% of GDP and nominal GDP growth of 3%, it would take almost 40 years to reach the reference value of 60%.

In the past, countries often failed to meet the quantitative requirements for the structural balance. Prior to the coronavirus crisis, even countries with high debt ratios were actually drifting further from their MTO rather than approaching it. This was often largely due to the way in which the European Commission, in consultation with the European Council, interpreted the rules. Exceptions and scope for discretion enabled countries to deviate significantly from the basic quantitative requirements without being penalised. Furthermore, the implementation of the rules was complex, lacking in transparency and difficult to predict.

In the future, rules should define specific quantitative targets and these should be used to determine whether a country is compliant. Problems arise when fiscal limits are flexible and have no binding force. The fiscal course and evaluation of adherence to the rules should not be subject to political negotiations. Otherwise, neither governments nor the public will see the rules as a binding fiscal benchmark.

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<sup>1</sup> Consequently, the controversial  $\frac{1}{20}$  rule for the debt ratio has not yet been relevant in practice. Based on the debt criterion, an excessive deficit procedure (EDP) would ultimately only need to be launched if a country has a debt ratio of more than 60%, is in breach of the  $\frac{1}{20}$  rule as well as the MTO and its adjustment path, and the European Commission and the European Council have not identified any other exonerating factors. In an EDP, the European Commission and the European Council issue correction recommendations for the country in question. The benchmark is that a country should reduce its structural deficit by 0.5% of GDP per year.

### Approaches for moderate reform steps

The rules could be improved by making relatively moderate adjustments. The Bundesbank discussed such reform options in more detail in both the April 2019 and the December 2020 editions of its Monthly Report.<sup>2</sup> These proposals retain the MTO and its adjustment path as well as corrections of excessive deficits as a central anchor. However, the binding force of their basic quantitative requirements should be strengthened going forward. At the same time, the rules could provide room for fiscal stabilisation policy. It would also be possible to protect government investment. It would be essential to ensure that debt and deficits at the EU level feed into the rules. These key elements are summarised below.

#### Expenditure rule based on MTO to simplify budgetary surveillance

A frequent proposal in the current debate on reform is the option of using expenditure rules. The suitability of such rules hinges on the underlying fiscal target to be implemented via expenditure ceilings. Expenditure rules based on insufficiently ambitious or unspecific targets are not appropriate. Nor is it advisable to set expenditure ceilings for multiple years. Projections several years ahead are particularly uncertain and could routinely be overly optimistic. But if the underlying pace of revenue, for instance, is overestimated, deficits may be too high. Furthermore, if expenditure ceilings apply on average over several years, there is a risk that necessary consolidation may be postponed.

Basing an expenditure rule on the MTO would be a more appropriate option, enabling an annual quantitative requirement for the structural balance to be converted into a more practical ceiling for expenditure

growth.<sup>3</sup> Both budget plans and their execution could then be measured in terms of this predefined expenditure growth rate. Exceptions should only be made in times of crisis and no ad hoc discretionary scope should be granted. The rules would be much simpler if only this one indicator were used to determine compliance.

#### Control account to prevent any systematic failures

Combining an expenditure rule (or any other type of rule) with a control account would be a sensible move. The control account would be used to record – positive and negative – entries showing the amount by which a country missed its target structural position despite being on schedule with its implementation (projection error) and by how far it missed its expenditure ceiling. This does not mean that a country would be expected to respond immediately. Positive and negative deviations may cancel each other out over time. However, if it falls below a negative threshold, this should be corrected.<sup>4</sup>

#### National rainy day funds to enable greater stabilisation

The quantitative requirements of the European fiscal rules are sometimes criticised as being too narrow. There are often calls to

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<sup>2</sup> See Deutsche Bundesbank (2019b, 2020c).

<sup>3</sup> An estimate of potential output is essential to calculate the corresponding maximum expenditure growth (as an alternative, the trend and trend growth could be determined using a filter technique). Adjustment would need to be made for any measures on the revenue side (such as tax cuts or tax rises): e.g. tax cuts would have to be offset by a correspondingly more ambitious spending stance.

<sup>4</sup> The control account could also be used to record and, if necessary, correct situations where the cyclical components, calculated using the cyclical adjustment method, do not cancel each other out over the economic cycle. See Deutsche Bundesbank (2019b), pp. 81f.

allow greater scope for an active stabilisation policy, for example. In order to have a buffer even where limits are strict, national rainy day funds could be created and utilised.<sup>5</sup>

The basic idea behind this type of fund is to build up a financial buffer in good times in order to prepare for “rainy days” ahead. This could be added to the European fiscal rules without permitting additional debt over and above the target path. To this end, the rules would have to allow the fund to build up credit when the MTO is exceeded. This reserve would then free up room for manoeuvre: a country could fall short of its MTO by the amount that it has in credit in its reserve.

#### **Capped golden rule if particular protection for investment is desired**

Critics often argue that countries neglect investment expenditure in order to comply with deficit ceilings. This is judged as being in conflict with other political goals and also standing in the way of long-term sustainability. Golden rules give investment special treatment. They have both advantages and disadvantages.<sup>6</sup> The disadvantages were seen first hand in the Federal budget when Germany previously had a golden rule prior to being replaced by today’s debt brake.<sup>7</sup>

In order to limit the risks associated with the disadvantages, it would be important to link the golden rule to net investment. This means that write-downs would have to be deducted from gross investment so that additional debt could only be run up for net investment. One acceptable and pragmatic approach would be to use net government investment as defined in the national accounts. This is comparable throughout the EU.

It would also be wise to set a ceiling up to which net investment may be taken into account (capped golden rule). This would ensure that deficits and debt ratios remain limited, thus safeguarding the sustainability of government finances and mitigating any problems associated with defining and measuring net investment.

A capped golden rule could be integrated into the current MTO. For instance, a country with a debt ratio of over 60% could be required to provide a structural position that is at least balanced as a basis. Only if net investment was correspondingly high would it be possible to have a structural deficit of up to 0.5% of GDP. This would be in line with the current MTO but would also better protect net investment. The MTO of countries with less debt (debt ratio of below 60%), too, could be graduated as follows: starting from a deficit ratio of 0.5%, net investment of a corresponding size would allow for an additional deficit of 0.5% of GDP. This would resemble those countries’ current MTO. Furthermore, net investment could accordingly be factored into the adjustment path towards the MTO and corrections of excessive deficits. Protection would thus also be in place in the consolidation process.<sup>8</sup>

For debt ratios below the reference value of 60%, the option of easing the MTO could be considered. To this end, capped net investment could be taken into account in addition to the existing 1% limit. The overall structural deficit ceiling would then be 1.5% of GDP instead of 1% of GDP.

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<sup>5</sup> See Deutsche Bundesbank (2019b), pp. 82 f.

<sup>6</sup> See Deutsche Bundesbank (2019b), pp. 83 f.

<sup>7</sup> See Deutsche Bundesbank (2005).

<sup>8</sup> See Deutsche Bundesbank (2019b), pp. 85 f.

### **Incorporate European deficits and debt into the fiscal rules**

New common assistance was drawn up during the coronavirus crisis. The European level is to provide Member States with debt-financed funds up to 2026 (in addition to the regular contribution-funded EU budget), resulting in an accumulation of substantial debt at the European level. This debt is no longer funding just assistance loans but also extensive grants to Member States. As a consequence, notable deficits are being recorded at the European level for the first time.

Such EU debt and deficits mean that national debt and deficits are initially lower, as a Member State's expenditure is funded not by national borrowing but by debt-financed EU grants. While this improves the national indicators, Member States' financial positions are not any better overall. This is because European debt – on top of the national debt burden – will need to be serviced by taxpayers in the Member States at some point in the future. Instead of interest and principal payments on national debt, there will be larger contributions or tax payments to the EU budget.<sup>9</sup>

This runs the risk of hollowing out the existing fiscal rules that apply to official national budgetary indicators. The quantitative requirements would be futile if deficits and debts were simply transferred to a greater extent to the European level. For the quantitative limits to retain their force, it is vital, first, for the European Commission to collect statistics on government deficits and debt at the European level and disclose this information in a transparent manner. Second, this information should feed into the fiscal rules. To this end, European debt and deficits should be allocated to the Member States (not in the official national

accounts, but separately to ensure that the enhanced national indicators can be used in analyses and in the fiscal rules). This would require a distribution key to be established. A country's share of EU gross national income would appear suitable for this purpose, as this will probably continue to be the key metric for measuring a country's share of financing in the EU budget.<sup>10</sup>

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<sup>9</sup> In passing the Act on Own Resources (*Gesetz zum Eigenmittelbeschluss*), Germany has committed to providing financial contributions for debt servicing. It is envisaged that central government will service loans for grants (interest and repayments) in line with the German share of financing in the EU budget. This share broadly corresponds to relative economic output. Even if parts of the debt were to be repaid from new EU taxes, it would ultimately be taxpayers in the Member States who would foot the bill – or Member States would have to transfer sources of tax revenue to the EU. This would eat into the fiscal scope for national budgets.

<sup>10</sup> See Deutsche Bundesbank (2020c), p. 42.



*Greatly  
improved finan-  
cial situation  
next year*

loans for 2020 (€7 billion) and 2021 should then be waived.

The Federal Employment Agency's finances are likely to continue their robust recovery next year. Based on the current Federal Government's macroeconomic forecast and excluding significantly higher expenditure on active la-

bour market policy measures, a surplus is envisaged for the Federal Employment Agency's budget. For insolvency benefit contributions, the current contribution rate (0.12%) is also expected to yield another large surplus. It would therefore make sense to reduce the contribution rate to its pre-crisis level of 0.06%.

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