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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Germany

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Germany

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1. INTRODUCTION

Germany has submitted its Draft Budgetary Plan for 2017 on 17 October 2016 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Germany is subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position, which ensures compliance with the medium term budgetary objective (MTO). As the debt ratio was 71.2% of GDP in 2015, Germany also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2016 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2016 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the SGP. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in the spring of 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the DBP for 2017 is based on the federal government's autumn projection published on 07 October 2016. The macroeconomic scenario underlying the DBP implies a continuation of moderate real GDP growth rates with slight uptick from 1.7% in 2015 to 1.8% in 2016 and a deceleration to 1.4% in 2017. Domestic demand is expected to remain the major growth driver. In 2017, private consumption expenditure and gross fixed capital formation are forecast to increase further on the back of a robust labour market and low interest rates. Annual potential growth is projected at 1.7% in 2015 and 1.4% in 2016. The GDP deflator is assumed to increase by 1.5% in 2016 and 1.7% in 2017. The macroeconomic scenario underlying the DBP is based on less optimistic growth but more optimistic employment assumptions than the scenario underlying the Stability Programme.

Overall, compared to the Commission 2016 autumn forecast, the DBP is based on a plausible macroeconomic scenario, assuming a slightly negative output gap over the forecast horizon, according to the values recalculated by the Commission. The Commission 2016 autumn forecast projects slightly higher GDP growth rates of 1.9% in 2016 and 1.5% in 2017, an equal increase of the GDP deflator of 1.5% in 2016 and a marginally weaker increase of 1.6% for 2017, compared to the DBP.

Box 1: The macro economic forecast underpinning the budget in Germany

The Commission Opinion on Germany's DBP for 2015 and 2016, among others, has pointed out that no independent body in charge of producing or endorsing macroeconomic forecasts has been put in place within the meaning of Regulation (EU) No 473/2013. This holds for the macroeconomic scenarios underlying both the DBP and the Stability Programme. The federal budget and fiscal projections at the level of general government are based on the federal government's own macroeconomic forecast, even though its preparation involves the Joint Economic Forecast *(Gemeinschaftsdiagnose)*. The Joint Economic Forecast is issued twice a year by leading research institutes shortly before the government's spring and autumn projections within the framework of research mandates awarded by the government through a call for tenders. Moreover, the Stability Programme is based on the government's January forecast published within the federal government's Annual Economic Report, which is usually prepared without using an updated Joint Economic Forecast as a benchmark. The Commission Opinion on Germany's 2015 DBP pointed to the fact that the DBP was based on the spring issue of the government's macroeconomic forecast, published in April, and could therefore not factor in the latest macroeconomic developments. To make progress on this issue, the publication of the autumn 2015 issues of both the Joint Economic Forecast and the federal government's macroeconomic projections was advanced by about a week to 8 and 14 October, respectively, and those projections were used for the first time as basis for the 2016 DBP.

Table 1. Comparison of macroeconomic developments and forecasts

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.7	1.7	1.8	1.9	1.5	1.4	1.5
Private consumption (% change)	2.0	1.9	1.7	1.7	1.5	1.3	1.4
Gross fixed capital formation (% change)	1.7	2.3	2.5	2.5	2.6	2.0	1.9
Exports of goods and services (% change)	5.2	3.2	2.3	2.6	4.3	2.1	2.8
Imports of goods and services (% change)	5.5	4.8	2.5	2.8	5.7	3.0	3.9
Contributions to real GDP growth:							
- Final domestic demand	2.0	2.1	2.1	2.2	1.8	1.5	1.6
- Change in inventories	-0.5	0.0	-0.4	-0.4	0.0	0.0	0.0
- Net exports	0.2	-0.4	0.1	0.2	-0.2	-0.1	-0.2
Output gap[1]	-0.2	-0.6	-0.1	0.0	-0.8	-0.5	-0.3
Employment (% change)	0.9	0.9	1.2	1.2	0.7	1.0	0.9
Unemployment rate (%)	4.6	4.5	4.0	4.4	5.0	4.0	4.3
Labour productivity (% change)	0.8	0.8	0.6	0.8	0.8	0.4	0.5
HICP inflation (%)	0.1			0.4			1.5
GDP deflator (% change)	2.0	1.7	1.5	1.5	1.8	1.7	1.6
Comp. of employees (per head, % change)	2.4	2.4	2.2	2.0	2.6	2.4	2.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	8.4	8.5	9.2	8.9	8.1	8.8	8.6

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP projects a general government budget surplus of ½% of GDP for 2016, compared to a balanced budget planned in the Stability Programme.[1] For 2017, this translates into a planned budget surplus for the general government of ¼% of GDP, compared to the Stability Programme's target of a balanced budget. The difference in the headline budget target for 2016 between the DBP and the Stability Programme is due to both higher-than-expected revenue and lower-than-expected expenditure. Total revenue has been revised up by ¼% of GDP, mainly because of higher revenue from taxes on income and wealth, while total expenditure is now planned to be lower by ¼% of GDP, notably due to lower-than-expected compensation of employees in the public sector, intermediate consumption and interest

[1] The Stability Programme (SP) and the Draft Budgetary Plan (DBP) report revenue and expenditure targets rounded to ¼ percentage point of GDP.

payments. In contrast to the Stability Programme, which projected a decrease of the structural balance in 2016-2017 from 0.8 to 0.3% of GDP in 2017, the DBP foresees a more gradual decrease in the (recalculated) structural balance[2] from 0.8% to 0.7% of GDP in 2016, followed by a further decrease to 0.5% of GDP in 2017, in line with the larger projected budgetary surplus in the DBP.

The DBP's projections for 2016 are broadly in line with the Commission 2016 autumn forecast, which projects headline and structural surpluses of 0.6% of GDP, respectively. The DBP projections for 2017 are also in line with Commission 2016 autumn forecast, which projects headline and structural surpluses of 0.4% of GDP, respectively.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Germany currently standing at 0.12%. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Germany is expected to fall from 1.6% of GDP in 2015 to 1¼ % in 2016 and 2017, well below the 2.3% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Germany's plans is broadly confirmed by the Commission 2016 autumn forecast.

Against the background of falling interest expenditure, the projected deterioration in the structural balance in 2016-17 (0.1% and 0.2% of GDP, respectively) is accompanied by a more pronounced deterioration in the structural primary balance (0.3% of GDP in both years).

[2] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the DBP, using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**44.7**	**44 ½**	***44¾***	**44.7**	**44 ½**	***44¾***	**44.8**	**1/4**
of which:								
- Taxes on production and imports	10.8	10 ¾	*10¾*	10.8	10 ½	*10¾*	10.7	0
- Current taxes on income, wealth, etc.	12.3	12.0	*12½*	12.4	12 ¼	*12½*	12.5	1/4
- Capital taxes	0.2	0.0	*0.0*	0.2	0.0	*0.0*	0.2	- 1/4
- Social contributions	16.5	16 ¾	*16¾*	16.6	16 ¾	*17.0*	16.7	1/2
- Other (residual)	4.9	n.a.	*n.a.*	4.8	n.a.	*n.a.*	4.7	- 1/4
Expenditure	**44.0**	**44 ½**	**44¼**	**44.1**	**44 ½**	**44½**	**44.4**	**1/2**
of which:								
- Primary expenditure	42.4	43.1	42.9	42.8	43.2	43.3	43.2	3/4
of which:								
Compensation of employees	7.5	7 ¾	7½	7.5	7 ½	7½	7.5	0
Intermediate consumption	4.6	5.0	4¾	4.7	5.0	5.0	4.8	1/4
Social payments	23.9	24 ¼	24¼	24.2	24 ½	24½	24.5	3/4
Subsidies	0.9	1.0	¾	0.9	1.0	¾	0.8	0
Gross fixed capital formation	2.1	2 ¼	2¼	2.2	2 ¼	2¼	2.2	0
Other (residual)	3.4	n.a.	42.9	3.3	n.a.	38.3	3.3	- 1/4
- Interest expenditure	1.6	1 ½	1¼	1.4	1 ¼	1¼	1.2	- 1/4
General government balance (GGB)	**0.7**	**0.0**	**½**	**0.6**	**0.0**	**¼**	**0.4**	**- 1/4**
Primary balance	**2.2**	**1 ¼**	**2.0**	**2.0**	**1 ¼**	**1½**	**1.6**	**- 3/4**
One-off and other temporary measures	0.0	0.0	-0.1	0.0	0.1	0.1	0.1	0
GGB excl. one-offs	**0.7**	**-0.1**	**0.6**	**0.6**	**-0.1**	**0.3**	**0.3**	**- 1/2**
Output gap[1]	-0.2	-0.6	-0.1	0.0	-0.8	-0.5	-0.3	- 1/2
Cyclically-adjusted balance[1]	0.8	0.2	0.7	0.6	0.4	0.7	0.6	0
Structural balance (SB)[2]	**0.8**	**0.2**	**0.7**	**0.6**	**0.3**	**0.5**	**0.4**	**- 1/4**
Structural primary balance[2]	2.4	1.6	2.1	2.0	1.6	1.8	1.7	- 1/2

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.2. Debt developments

The debt-to-GDP ratio decreased by 3.7% of GDP to 71.2% in 2015. The DBP projects a further diminishing debt-to-GDP ratio to 68¼% of GDP in 2016 and 66% in 2017, owing to the budget surplus and the positive denominator effect of nominal GDP growth. These projections largely confirm the debt level planned in the Stability Programme. The debt ratio planned by the DBP is also largely in line with the Commission 2016 autumn forecast for 2016 and 2017.

Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**71.2**	**68 ¼**	**68¼**	**68.1**	**65 ¾**	**66.0**	**65.7**
Change in the ratio	-3.7	-3.0	-2.8	-3.0	-2.4	-2.5	-2.5
Contributions [2] *:*							
1. Primary balance	**-2.2**	**-1.3**	**-1.9**	**-2.0**	**-1.2**	**-1.6**	**-1.6**
2. "Snow-ball" effect	**-1.1**	**-0.9**	**-1.0**	**-1.0**	**-0.9**	**-0.8**	**-0.8**
Of which:							
Interest expenditure	1.6	1.4	1.3	1.4	1.3	1.2	1.2
Growth effect	-1.2	-1.2	-1.2	-1.3	-1.0	-0.9	-1.0
Inflation effect	-1.4	-1.2	-1.1	-1.1	-1.2	-1.1	-1.1
3. Stock-flow adjustment	**-0.3**	**-0.7**	**0.1**	**0.0**	**-0.2**	**0.0**	**0.0**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The DBP includes on the revenue side increases in the basic personal allowance, the child exemption, child benefits, child complement and an adjustment of the personal income tax tariff, aiming at safeguarding the minimum subsistence income and compensating for fiscal drag. On the expenditure side, the DBP includes additional measures for accommodating refugees and asylum seekers, promoting social housing and expanding pre-school child care. Overall, the DBP reports a neutral budgetary impact of the discretionary measures in 2016 and a slightly expansionary effect in 2017. The estimates of the budgetary impact of the measures appear plausible.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP)		
	2016	2017	2018
Taxes on production and imports	0	0	
Current taxes on income, wealth, etc.	0	0	0
Capital taxes	0	0	
Social contributions	0	0	
Property income	0	0	
Other (residual)	0	0	0
Total	0	0	0

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP)		
	2016	2017	2018
Compensation of employees	0	0	0
Intermediate consumption	0	0	0
Social payments	0	0	0
Subsidies	0	0	0
Gross fixed capital formation	0	0	0
Capital transfers	0	0	0
Other (residual)	0	0	0
Total	0	0	0

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Germany is subject to the preventive arm of the SGP and the debt rule. Within the European Semester 2016, the Council did not address Country-Specific Recommendations related to the requirements of the SGP to Germany as full compliance with the rules was assessed. However, recommendations were issued concerning the broader area of public finances.

Box 2: Council recommendations addressed to Germany

On 12 July 2016, the Council addressed Country-Specific Recommendations (CSRs) to Germany in the context of the European Semester. In particular, in the area of public finances, the Council recommended to Germany to achieve a sustained upward trend in public investment, especially in infrastructure, education, research and innovation, while respecting the medium term objective; to improve the design of federal fiscal relations with a view to increasing public investment, especially at municipal level; to reduce inefficiencies in the tax system, in particular by reviewing corporate taxation and the local trade tax; to modernise the tax administration; to increase incentives for later retirement and reduce disincentives to work for second earners; to reduce the high tax wedge for low wage earners and facilitate the transition from mini-jobs to standard employment.

4.1. Compliance with the debt criterion

As the debt ratio was 71.2% of GDP in 2015, Germany needs to comply with the debt rule. The information provided in the DBP points to compliance with the debt rule both in 2016 and 2017. This is in line with the Commission 2016 autumn forecast.

Table 5. Compliance with the debt criterion*

	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	71,2	68 ¼	68¼	68,1	65 ¾	66,0	65,7
Gap to the debt benchmark [1,2]	-5,6	-5,5		-4,9	-5,7		-4,8

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

* An ex-ante assessment of planned compliance with the debt criterion can be based on the DBP only for the concerned countries providing extended data series (i.e. covering years up to t+4) in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September 2014 and reflected in the updated Code of Conduct of the two-pack.

4.2. Compliance with the MTO

Germany registered a structural surplus of 0.8% of GDP in 2015, well above its medium-term objective of a structural deficit not exceeding 0.5% of GDP. According to the information provided in the DBP, with a (recalculated) structural surplus of 0.7% and 0.5% of GDP, respectively, Germany is expected to remain above its medium-term objective also in 2016 and 2017, which is confirmed by the Commission 2016 autumn forecast.

The projected margin to the medium-term objective continues to provide scope to cover additional expenditure that may result in 2017 from the strong inflow of asylum seekers as well as to further increase public investment in infrastructure, education, research and innovation, as recommended by the Council in the context of the European Semester.

Table 6. Compliance with the requirements of the preventive arm

(% of GDP)	2015	2016		2017	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	0.8	0.6		0.4	
Structural balance based on freezing (COM)	1.0	0.6		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliant				
Required adjustment corrected[5]					
Change in structural balance[6]					
One-year deviation from the required adjustment[7]					
Two-year average deviation from the required adjustment[7]					
Expenditure benchmark pillar					
Applicable reference rate[8]					
One-year deviation[9]					
Two-year average deviation[9]					
Conclusion					
Conclusion over one year					
Conclusion over two years					

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The DBP includes measures taken in response to the Country-Specific Recommendations issued in the broader area of public finances. . In particular, a reform of fiscal relations has been agreed between the Federal Chancellor and the Minister-Presidents of the Länder which will take effect in 2020. Further, additional funds are planned to be provided as from 2017 for promoting social housing and expanding pre-school child care facilities. While these measures could further strengthen public investment, they are overall unlikely to change the investment backlog in public infrastructure.

Regarding the reduction of inefficiencies in the tax system, the investment tax reform act aims at simplifying the taxation of public investment funds and to close some tax planning loopholes. In the area of tax administration, the act to modernise taxation procedures aims at strengthening the automatic processing of tax returns and places more emphasis on audits based on risk management.

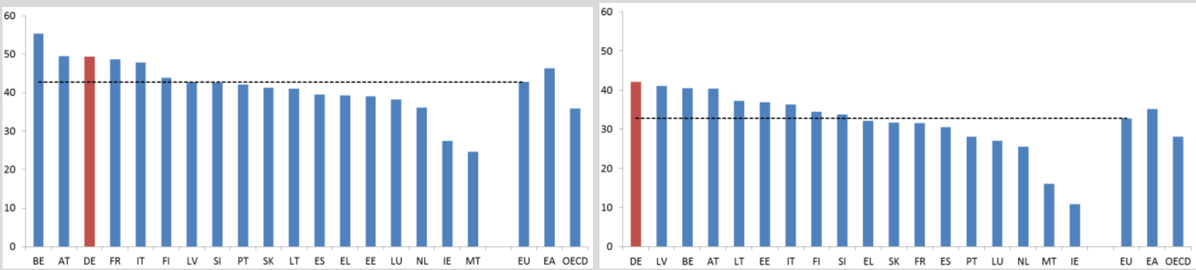
The tax wedge could be slightly reduced by increasing the basic personal allowance, the child tax exemption, the child benefit and the child supplement in 2017 and 2018 as well as a compensation for the impact of fiscal drag that has occurred over the last two years (see Box 3).

Box 3: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Germany for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Germany at the average wage and a low wage (2015)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2016 European Semester, Germany was issued the recommendation to "Reduce inefficiencies in the tax system, in particular by reviewing corporate taxation and the local trade tax, modernise the tax administration and review the regulatory framework for venture capital (…) and "Increase incentives for later retirement and reduce disincentives to work for second earners. Reduce the high tax wedge for low wage earners and facilitate the transition from mini jobs to standard employment."

Germany's DBP contains an increase in the basic personal allowance, the child tax exemption, the child benefit and the child supplement in 2017 and 2018 with a view to aligning the allowances with the adjusted subsistence level in line with existing law. At the same time, it was decided to adjust the income tax brackets to offset the impact of fiscal drag based on the tax progression report that is published every two years. Overall, this could slightly reduce the tax wedge.

6. OVERALL CONCLUSION

According to both the information provided in the DBP and the Commission 2016 autumn forecast, the structural balance will remain above the medium-term objective in 2016 and 2017. Based on both the DBP and the Commission 2016 autumn forecast, Germany will also meet the debt rule in both 2016 and 2017.