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COMMISSION STAFF WORKING DOCUMENT

Analysis of the updated Draft Budgetary Plan of Germany

Accompanying the document

COMMISSION OPINION

on the updated Draft Budgetary Plan of Germany

{C(2018) 4064 final}

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COMMISSION STAFF WORKING DOCUMENT

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COMMISSION OPINION

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1. INTRODUCTION

Germany submitted its updated Draft Budgetary Plan (DBP) for 2018 on 5 June 2018. The update was prompted by the fact that the DBP submitted on 16 October 2017 in compliance with Regulation (EU) No 473/2013 reflected budgetary projections for 2018 on the basis of unchanged policies given the caretaker nature of the government in place at the time of submission. In comparison with the no-policy-change DBP submitted by the caretaker government on 16 October 2017, the updated DBP includes the measures that have been adopted since then and lists further planned but not yet adopted measures. Germany is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO). As the debt ratio was 68.2% of GDP in 2016, Germany also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the updated Draft Budgetary Plan and provides an assessment based on an ad-hoc Commission forecast. The following section presents the recent and planned fiscal developments, according to the updated Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission ad-hoc forecast. In particular, it also includes an assessment of the measures underpinning the updated Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of the composition of public finances and of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in July 2017, including reducing 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 assumes that the upswing of the German economy will continue in the next two years, driven by buoyant domestic and foreign demand. Employment growth is expected to continue, although dampened by tightening labour supply. The high labour demand is set to lead to higher wage growth. The measures of the coalition agreement are expected to additionally spur household incomes. As a result, private consumption is set to increase despite a rise in inflation. In addition, low interest rates are expected to stimulate investment in housing. Given rising foreign and domestic demand and already high capacity utilisation, business investment is seen to expand significantly.

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Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	CO	SP	DBP	CO	SP	DBP	CO
Real GDP (% change)	1.9	1.4	2.2	2.2	1.6	2.3	2.0
Private consumption (% change)	2.1	1.4	1.9	1.8	1.4	1.7	1.4
Gross fixed capital formation (% change)	3.1	1.7	3.3	3.3	2.8	3.7	3.2
Exports of goods and services (% change)	2.6	2.8	4.7	4.6	3.6	5.0	3.1
Imports of goods and services (% change)	3.9	3.8	5.1	5.2	4.3	5.8	3.3
Contributions to real GDP growth:							
- Final domestic demand	2.4	1.5	2.0	1.9	1.6	2.2	1.8
- Change in inventories	-0.2	0.0	0.1	0.2	0.0	0.0	0.0
- Net exports	-0.3	-0.1	0.2	0.2	0.0	0.1	0.2
Output gap[1]	-0.4	-0.2	0.2	0.2	-0.1	0.5	0.4
Employment (% change)	1.3	0.7	1.5	1.5	0.7	1.3	1.2
Unemployment rate (%)	4.1	3.8	3.5	3.8	3.8	3.1	3.4
Labour productivity (% change)	0.6	0.6	0.7	0.8	0.9	1.0	0.8
HICP inflation (%)	0.4			1.7			1.7
GDP deflator (% change)	1.3	1.4	1.5	1.5	1.6	1.9	1.7
Comp. of employees (per head, % change)	2.2	2.4	2.6	2.6	2.5	2.7	2.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	8.5	8.1	7.9	7.9	7.9	7.8	7.4

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 2017 (SP); Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 ad hoc forecast (COM); Commission calculations

The updated DBP is based on the Federal Government's Spring 2018 Projection which is broadly in line with the Commission's Spring 2018 Economic Forecast. There have been important data releases and developments since the cut-off dates of both forecasts. They include the reported national accounts data for the first quarter, various monthly statistical and survey data and forward-looking indicators, as well as geopolitical news. They suggest weaker than expected export and consumption dynamics and a possible slowing of equipment investment in view of cooling down of sentiment and seem to justify a downward revision of growth, in particular for 2018, but possibly also for 2019. Taking this into account, Commission staff have elaborated an ad-hoc forecast to inform this assessment of Germany's updated DBP. The updated DBP uses macroeconomic assumptions that are somewhat more optimistic than the Commission ad-hoc forecast and are thus subject to downside risk.

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

The Commission Opinions on Germany's DBPs have been pointing 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.

According to the Regulation on the Economic Projections of the Federal Government (*Vorausschätzungsverordnung*) passed by the Ministry of the Economy and Energy in agreement with the Ministry of Finance and effective from July 2018, the Joint Economic Forecast project group has been named as the independent body in charge of assessing and endorsing the economic projections underlying the Draft Budgetary Plans and the Stability Programmes within the meaning of the Law on the Economic Projections (*Vorausschätzungsgesetz*) codifying the procedure for producing the government's economic forecasts.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

As usual the updated DBP reports on the budgetary situation of the general government, which comprises the federal government, regional governments, municipalities and social security funds. The federal budget is expected to be adopted by the German parliament on 5 July 2018. The updated DBP reports a general government headline budget surplus of 1.3% of GDP for 2017 and projects 1¼% of GDP in 2018. This is above the projection from the 2017 Stability Programme, respectively ½% and ¼% of GDP.[1] The difference is mainly due to lower-than-expected expenditure and higher surpluses at the level of social security funds, but also methodological changes to the statistical recording of interest expenditure of about ¼% of GDP. Total revenue broadly remained stable, while total expenditure in the updated DBP is planned to be lower by about 1% of GDP, notably due to lower-than-expected social payments.

In contrast to the 2017 Stability Programme, which projected a decrease of the (recalculated) structural balance[2] from 0.5% of GDP in 2017 to 0.2% in 2018, the updated DBP forecasts an decrease of the (recalculated) structural balance from 1.5% of GDP in 2017 to 1.1% in 2018. The updated DBP's projections for 2018 are broadly in line with the Commission ad-hoc forecast, which expects headline and structural surpluses of 1.0% of GDP, respectively.

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

[2] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

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Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**45.0**	**45 ¼**	***45.2***	**45.2**	**45 ¼**	***44 ¾***	**45.0**	**0**
of which:								
- Taxes on production and imports	10.6	10 ¾	*10.6*	10.6	10 ¾	*10 ½*	10.4	-¼
- Current taxes on income, wealth, etc.	12.6	12 ¾	*12.9*	12.9	12 ¾	*13 ¼*	13.1	½
- Capital taxes	0.2	0	*0.0*	0.2	0	*0*	0.2	-¼
- Social contributions	16.7	17	*16.8*	16.8	17	*16 ¾*	16.7	0
- Other (residual)	4.8	4 ¾	*4.9*	4.7	4 ¾	*4 ½*	4.6	-¼
Expenditure	**44.0**	**44 ¾**	**43.9**	**43.9**	**45**	**43 ¾**	**44.0**	**-¼**
of which:								
- Primary expenditure	42.8	43 ½	42.9	42.9	43 ¾	42 ¾	43.0	-¼
of which:								
Compensation of employees	7.5	7 ½	7.6	7.6	7 ½	7 ½	7.6	0
Intermediate consumption	4.8	5	4.8	4.8	5	4 ¾	4.7	0
Social payments	24.0	24 ½	24.0	24.0	24 ½	23 ¾	24.0	-¼
Subsidies	0.9	¾	0.8	0.8	¾	¾	0.8	0
Gross fixed capital formation	2.1	2 ¼	2.2	2.2	2 ¼	2 ¼	2.2	0
Other (residual)	3.5	3 ½	3.5	3.5	3 ¾	3 ½	3.5	0
- Interest expenditure	1.1	1 ¼	1.1	1.1	1 ¼	1	1.0	0
General government balance (GGB)	**1.0**	**½**	**1.3**	**1.3**	**¼**	**1 ¼**	**1.0**	**¼**
Primary balance	**2.1**	**1 ¾**	**2.3**	**2.3**	**1 ¼**	**2¼**	**2.0**	**0**
One-off and other temporary measures	0.0	0	-0.3	-0.2	0	-¼	-0.2	-¼
GGB excl. one-offs	**1.0**	**½**	**1.6**	**1.5**	**¼**	**1 ¼**	**1.2**	**¼**
Output gap[1]	-0.4	-0.2	0.2	0.2	-0.1	0.5	0.4	0.9
Cyclically-adjusted balance[1]	1.2	0.5	1.2	1.1	0.2	0.9	0.8	-0.1
Structural balance (SB)[2]	**1.2**	**0.5**	**1.5**	**1.4**	**0.2**	**1.1**	**1.0**	**0.0**
Structural primary balance[2]	2.4	1.8	2.5	2.4	1.4	2.1	2.0	-0.2

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 2017 (SP); Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 ad hoc forecast (COM); Commission calculations

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Germany currently standing at 0.52%[3]. 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 updated Draft Budgetary Plan, interest expenditure in Germany is expected to

[3] 10-year bond yields average as of May 2018. Source: Bloomberg.

fall from 1.1% of GDP in 2016 and in 2017 to 1% of GDP in 2018. The picture stemming from Germany's plans is broadly in line with the Commission forecast.

Against the background of falling interest expenditure, the projected improvement and then deterioration in the structural balance in 2017 and 2018 (+0.3% and -0.4%, respectively) is accompanied by a less pronounced improvement in the structural primary balance (+0.1% and -0.4%, respectively).

3.2. Debt developments

The debt-to-GDP ratio decreased by 2.8% of GDP to 68.2% in 2016 and by 4.1% to 64.1% in 2017. The updated DBP projects the debt-to-GDP ratio to decline further to 61% of GDP in 2018, owing to the budget surplus and the positive denominator effect of nominal GDP growth. Those projections expect a lower debt ratio than the 2017 Stability Programme. Those differences disappear when looking at the 2018 Stability Programme, submitted in April 2018. At the same time, they are largely in line with the Commission ad-hoc forecast for 2018, which shows a slightly weaker decline of the debt ratio based on the no-policy-change assumption.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**68.2**	**66 ¼**	**64.1**	**64.1**	**64**	**61**	**61.1**
Change in the ratio	-2.8	-2	-4.1	-4.1	-2 ¼	-3 ¼	-3.0
Contributions[2]:							
1. Primary balance	**-2.1**	**-1 ¾**	**-2.3**	**-2.3**	**-1 ¼**	**-2 ¼**	**-2.0**
2. "Snow-ball" effect	**-1.1**	**-½**	**-1.4**	**-1.4**	**-¾**	**-1 ½**	**-1.3**
Of which:							
Interest expenditure	1.1	1 ¼	1.1	1.1	1 ¼	1	1.0
Growth effect	-1.3	-0.9	-1.5	-1.5	-1	-1 ½	-1.2
Inflation effect	-0.9	-0.9	-1.0	-1.0	-1	-1 ¼	-1.0
3. Stock-flow adjustment	**0.5**	**¼**	**-0.4**	**-0.4**	**0**	**½**	**0.3**

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 2017 (SP); Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 ad hoc forecast (COM); Commission calculations

Based on the updated DBP, Germany plans to comply with the requirements of the applicable national numerical fiscal rules, in particular with the constitutional 'debt brake' which provides that the federal budget as of 2016 must not exceed a deficit of 0.35% of GDP.[4] At its

[4] The constitutional 'debt brake' provides that as of 2016 the structural balance of the federal budget must not exceed a deficit of 0.35% of GDP, with a gradually decreasing ceiling along an agreed transition path in the preceding years. The federal states must have structurally balanced budgets as of 2020.

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16th meeting on 11 December 2017 the Fiscal Council (Stabilitätsrat) concluded that the federal government adhered to the national fiscal rules in the years 2015, 2016 and was expected to do so in 2017.[5]

3.3. Measures underpinning the draft budgetary plan

The updated DBP contains various discretionary measures on the expenditure and revenue side that show most of their impact as of 2019 and thereafter, whereas the overall impact in 2018 is negligible. This is partly due to the longer than usual process of forming a government and consequently the delay in implementing policy measures throughout the year. Those measures aim to strengthen potentail growth and investment in the areas of education, research, universities and digital technologies. Families and children are supported by better childcare facilities and social benefits and tax reliefs. Likewise the reduction of the solidarity surcharge is expected to benefit above all low- and medium-income earners. Increased investment grants targeting agriculture, transport, rural regions and local authorities are set to support equitable living conditions throughout the country. All those measures together are estimated to have a cumulative negative fiscal impact, totalling 1.9% of GDP over the period 2018 to 2022. Together with further planned but not yet adopted measures to reduce the contribution rate to the unemployment insurance, further increases in the basic subsistence allowance and the return to the equal funding of health care costs by employers and employees, the overall cumulative negative fiscal impact is expected to attain 2.8% of GDP over the period 2018 to 2022.

The country-specific recommendations issued by the Council on 11 July 2017 call on Germany to use fiscal and structural policies to support potential growth and domestic demand by accelerating public investment at all levels of government. The recommendation on the economic policy of the euro area, adopted by the Council on 14 May 2018[6], calls on Member States with large current-account surpluses to create the conditions to promote wage growth in a manner that respects the role of social partners and implement as a priority measures that foster investment and support domestic demand and growth potential, thereby also facilitating rebalancing in the euro area. The updated Draft Budgetary Plan shows increasing investment expenditure for digital and transport infrastructure as well as additional funds for education, research and universities. Those measures are expected to be beneficial for supporting potential growth and domestic demand. Measures to reduce the tax wedge, especially for families as well as low- and medium-income earners will benefit private consumption and further increase domestic demand. However, based on the updated Draft Budgetary Plan, public investment is expected to remain at 2¼% of GDP in 2018, the same level as in 2017. This compares to an average of 2¾% of GDP in 2017 in the rest of the euro area without Germany. Further efforts are thus needed to increase public investment in a sustained manner and clear the investment backlog, especially at municipal level. With the planned stable development of revenues and expenditures, the positive balance of public finances would allow for financing those measures.

[5] For the national stability report see:
http://www.stabilitaetsrat.de/SharedDocs/Downloads/DE/Haushaltsueberwachung/Kennziffern-und-Berichte/2017/Haushaltskennziffern_und_Stabilitaetsbericht_2017__Bund.pdf?__blob=publicationFile

[6] Council Recommendation of 14 May 2018 on the economic policy of the euro area, OJ C 179, 25.5.2018.

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

Germany is subject to the preventive arm of the Stability and Growth Pact and the debt reduction benchmark. Box 2 reports the latest country-specific recommendations in the area of public finances.

Box 2. Council Recommendations addressed to Germany

On 11 July 2017, the Council addressed recommendations to Germany in the context of the European Semester.[7] In particular, in the area of public finances the Council recommended that Germany, while respecting the medium-term objective, use fiscal and structural policies to support potential growth and domestic demand as well as to achieve a sustained upward trend in investment; accelerate public investment at all levels of government, especially in education, research and innovation, and address capacity and planning constraints for infrastructure investments; further improve the efficiency and investment-friendliness of the tax system.

4.1. Compliance with the debt criterion

As the debt ratio was 68.2% of GDP in 2016, Germany needs to comply with the debt reduction benchmark. The information provided in the updated DBP points to compliance with the debt reduction benchmark both in 2017 and 2018. This is in line with the Commission ad-hoc forecast.

Table 4. Compliance with the debt criterion

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	68.2	66 ¼	64.1	64.1	64	61	61.1
Gap to the debt benchmark [1,2]	-5.9	-4.1	-6.0	-6.0	-3.8	-6.0	-5.9

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 2017 (SP); Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 ad hoc forecast (COM); Commission calculations

4.2. Compliance with the MTO

Germany registered a structural surplus of 1.2% of GDP in 2016, well above its medium-term objective of a structural deficit not exceeding 0.5% of GDP. According to the information provided in the DBP also in 2017 and 2018 Germany is expected to remain above its MTO

[7] Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Germany and delivering a Council opinion on the 2017 Stability Programme of Germany, OJ C 261, 9.8.2017.

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with a (recalculated) structural surplus of 1.5% and 1.1% of GDP respectively, which is equally confirmed by the Commission ad-hoc forecast.

The projected margin to the MTO continues to provide scope to undertake additional expenditure for supporting potential growth and domestic demand, including through public investment in infrastructure, education, research and innovation, as recommended by the Council in the context of the European Semester.

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Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	1.2	1.4		1.0	
Structural balance based on freezing (COM)	1.2	1.4		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	**Compliance**				
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 adjusted for one-offs[9]					
Two-year average deviation adjusted for one-offs[9]					
PER MEMORIAM: One-year deviation[10]					
PER MEMORIAM: Two-year average deviation[10]					
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Compliance	Compliance
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance

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 38.).

[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 2016) was carried out on the basis of Commission 2017 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, revenue increases mandated by law and one-offs 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.

[10] 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:
Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 ad hoc forecast (COM); Commission calculations

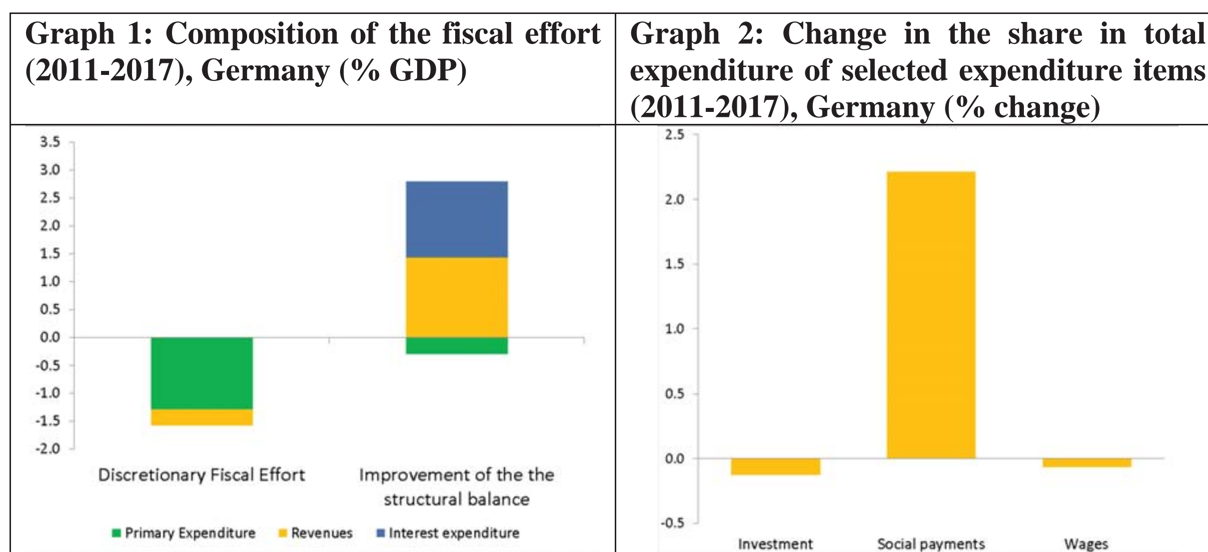
5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The updated DBP projects lower revenues and expenditures for 2018 at 44¾% and 43¾% of GDP respectivley compared to 2017 at 45.2% and 43.9% respectively. This can be partly explained by the longer than usual process of forming a government and consequently the postponement of policy measures that will thus show a noticeable effect only after 2018. Over 2011-2017 the discretionary fiscal effort (see graph 1) points to an expansionary fiscal policy, mainly due to primary expenditure increasing faster than medium-term growth and revenue decreasing measures. The structural balance nevertheless improved in that time because of strongly reduced interest expenditure as well as revenue windfalls.

Public investment is planned to remain overall stable at around 2¼% of GDP in 2018 as in the year before, which is in line with the long-term average. It is also reflected in the change of the share in total expenditure since 2011 (see graph 2), where expenditure for investment and wages did not change much, while by contrast for example expenditure for social payments (like pensions, social assistance, healthcare) increased markedly.

Graph 1: Composition of the fiscal effort (2011-2017), Germany (% GDP)

Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Germany (% change)



Source: Draft Budgetary Plans 2018, European Commission 2017 autumn forecast.

Note: Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3

http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

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 and is expected to help compliance with the national debt rule on all levels. Furthermore, from 2017 to 2022 additional funds will be provided for the modernisation and expansion of school buildings, including digital infrastructure. While those measures help to strengthen public investment, they are still insufficient to overcome the backlog in public infrastructure, especially at municipal level, that has accumulated over recent years.

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The taxation system is in general complex and could be simplified and improved to support investment and the business environment. Further measures to modernise taxation procedures aim at strengthening electronic communication with tax authorities and providing pre-filled tax returns.

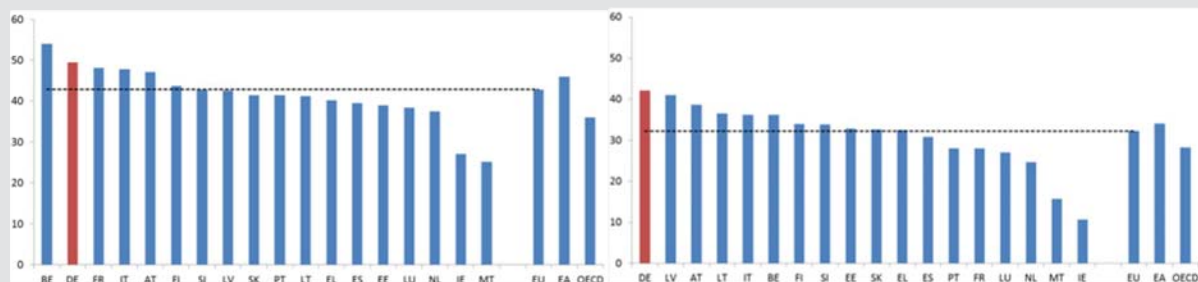
The tax burden on labour and the tax wedge are in general high in Germany, when placed in international comparison, which are driven to a large extent by social security contributions besides income tax. Measures increasing the basic personal allowance, the child benefit and tax-free child allowance as well as the planned reduction of the solidarity surcharge will benefit above all low- and middle-income earners (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 that 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 those 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 at low wage (2016)



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 2017 European Semester, Germany was issued the recommendation to "Reduce disincentives to work for second earners and facilitate transitions to standard employment. Reduce the high tax wedge for low wage earner."

Germany's updated Draft Budgetary Plan contains the following measures to reeduce the tax wedge on labour by increasing the basic personal tax-free allowance, the child benefit and tax-free child allowance as well as by the planned reduction of the solidarity surcharge. The announced reduction of the contributions to the unemployment insurance by 0.3 percentage point as well as the return to the equal funding by employers and employees of the health insurance system support the lowering of the

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tax wedge from the side of social security contributions. Overall, those measures are expected to positively contribute to growth and employment.

6. Overall conclusion

According to both the information provided in the updated DBP and the Commission ad-hoc forecast, the structural balance remained above the medium-term objective in 2017 and is projected to do so in 2018, and likewise the debt reduction benchmark was complied with in 2017 and is projected to be complied with in 2018.

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