Subnational Government Outlook 2025: Germany

Weak Growth Will Maintain Budgetary Pressure And Require New Borrowing

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S&P Global Ratings

This report does not constitute a rating action

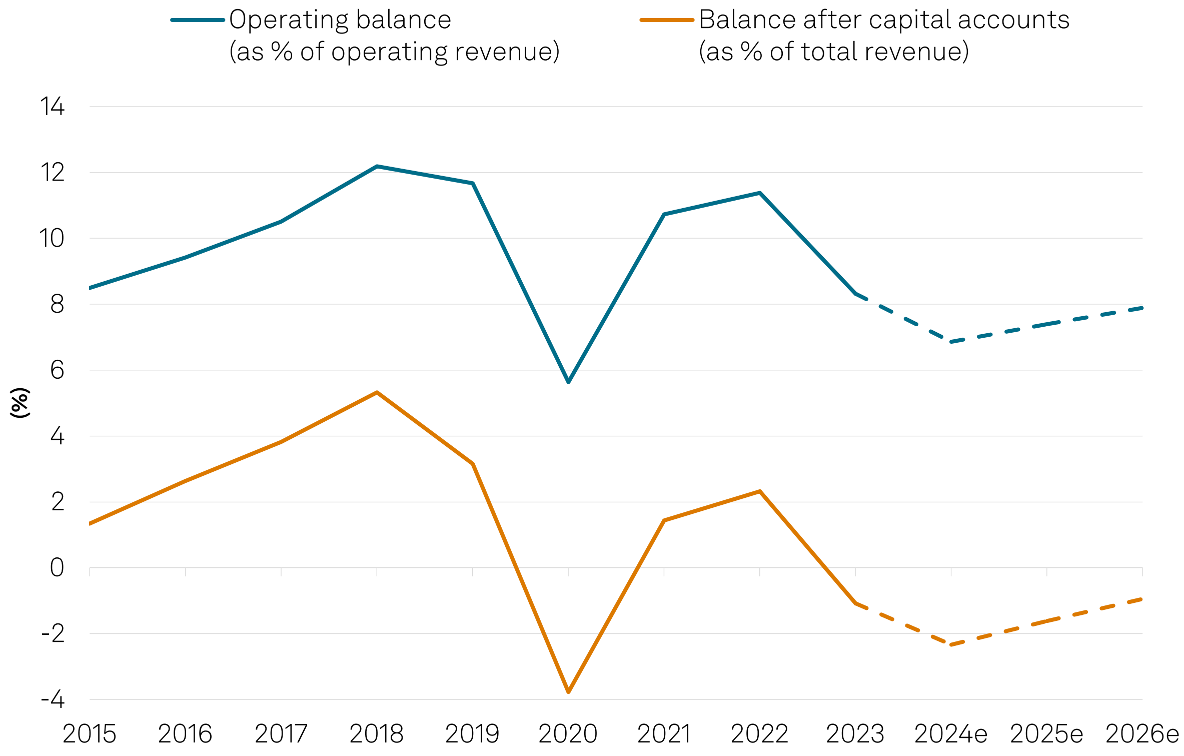
Key Takeaways

- Subdued tax revenue growth and rising operating expenditures (including due to increased staff compensation and social benefits), will maintain pressure on German local and regional government (LRG) budgets over 2025-2026.
- Deficits might have already peaked in 2024, but we expect them to abate only very slowly.
- Germany's debt brake, despite its balanced budgets principle, allows for limited LRG deficits in a cyclical downturn.
- Net new borrowing has driven annual bond issuance by German LRGs (including their auxiliary budgets) above €60 billion again in 2024 and could push the total outstanding volume of their debt (bonds and loans) towards €800 billion by 2026.
- However, continuing revenue growth should be sufficient to ensure the sector's aggregate tax-supported debt ratio (which we measure as the combined indebtedness of core and satellite budgets relative to operating revenue) remains stable at about 90%.
- A low share of variable-rate debt and LRG portfolios' longer tenors mean an increase in interest rates, observed since 2022, will only very slowly affect German LRGs' debt portfolios.
- Two negative rating outlooks (North Rhine-Westphalia and Saxony) and one positive one (Baden-Wuerttemberg), among the five states rated by S&P Global Ratings, reflect some uncertainty for LRGs, partially linked to Germany's economic position and (geo)political event risk.

We Anticipate Deficits For German LRGs Through 2026

Persistently weak economic growth and higher operating expenditure are the key drivers

German LRGs' balances



e--Estimate. Sources: Federal Statistics Office, S&P Global Ratings.

- About 70% of German state and municipal governments' revenue is derived from their own and shared taxes.
- Income streams from VAT, personal income tax, corporate tax, and municipal business tax are highly correlated with nominal economic growth.
- For Germany, we understand that real economic growth was -0.2% in 2024, and we project 0.9% for 2025, with inflation staying benign.
- Accordingly, revenue expansion for the country's LRGs will likely fall short of initial budgetary planning.
- Cost inflation (notably due to recent wage deals, rapid growth in healthcare costs borne by government employers, and growth in social transfers) exacerbates the situation.
- Compared to most prior years, this implies wider deficits for the German LRG sector, at least over 2024-2026.

Germany’s Debt Brake Does Not Fully Prevent LRG Deficits

States can rely on various, albeit limited, exemptions to the debt brake‘s balanced budget requirement (while municipalities are beyond its scope and subject to different rules)

Cyclical component

- In a cyclical downturn, Germany’s debt brake allows for limited net new borrowing.
- The additional borrowing allowance is sized to offset the downturn’s anticipated budgetary impact.
- Several German states relied on this in 2024 and will again in 2025.

Prior surpluses, reserves, and provisions

- Surpluses and budget reserves accumulated in prior periods can, if sufficient, be used to cover current deficits.
- This could carry several German states through 2024 and, presumably, 2025.

“Escape clause” for natural disasters

- In the event of a natural disaster or other emergency, state parliaments can temporarily suspend the debt brake rule and its balanced budget requirement.
- This occurred, for example, during COVID-19
- Selectively used in 2024 but not expected for 2025.

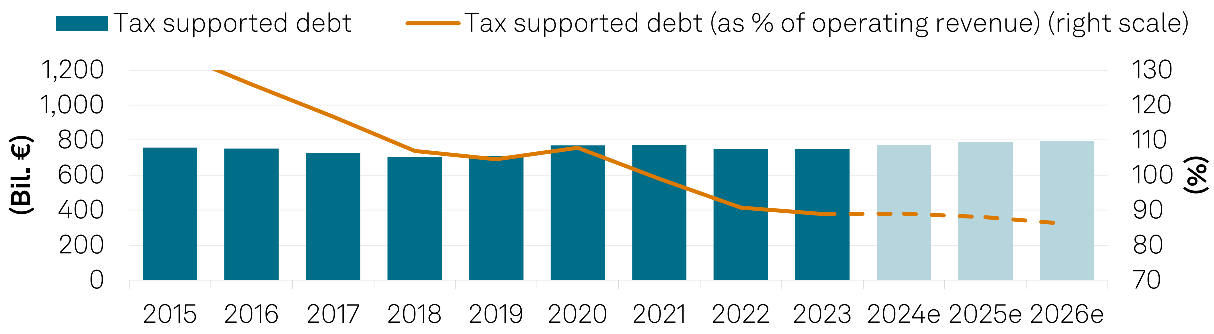
Financial transactions and “creative accounting”

- Purchasing shares in a company that then borrows to fund capex can be permitted.
- Other creative transactions that generate revenue, in a government accounting definition (even if non-cash), are evident in some states’ 2024 and 2025 budgets.

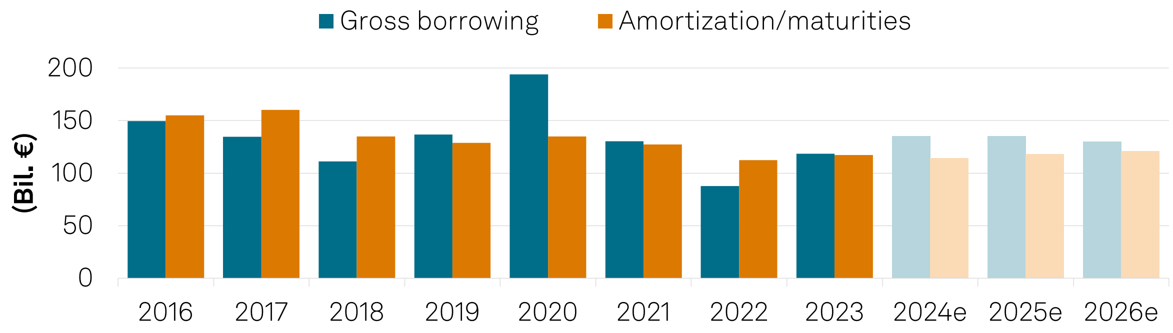
While Outstanding Debt Rises, The Relative Debt Burden Should Be Stable

We expect revenue growth will mitigate the impact of elevated net new borrowing on the LRGs' debt ratio

Tax supported debt of German LRGs



Gross borrowing and repayments by German LRGs



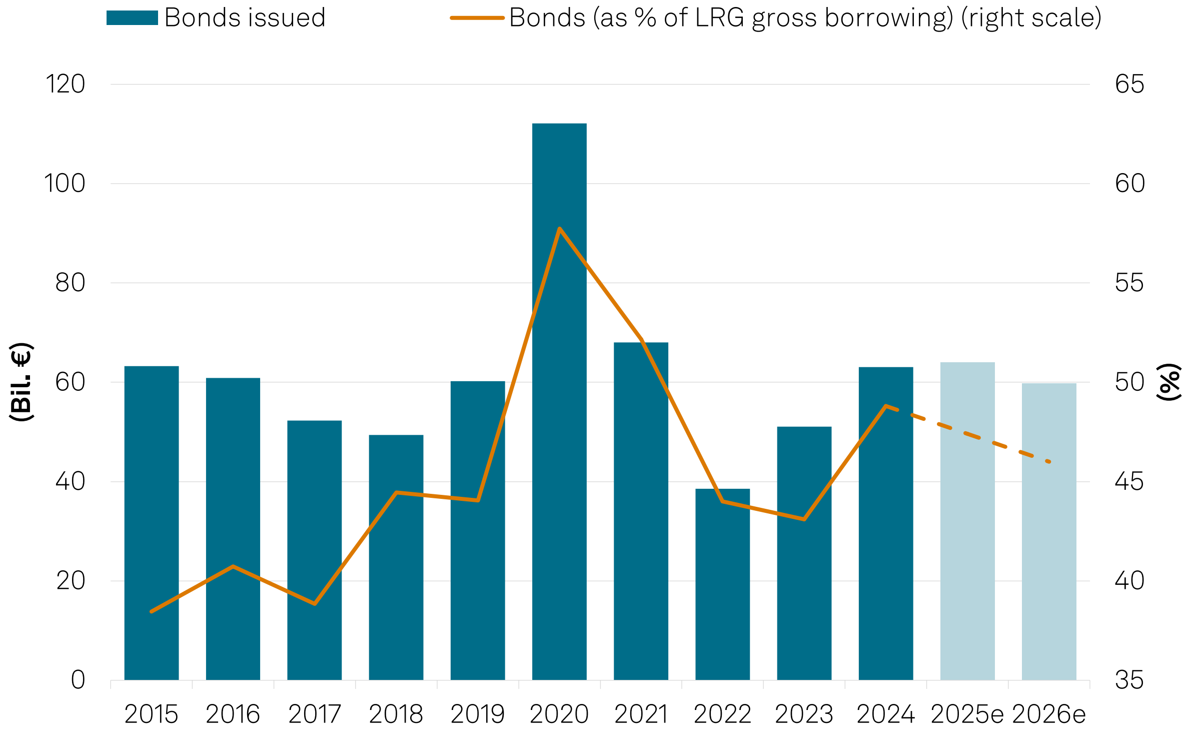
e--Estimate. Sources: Federal Statistics Office, S&P Global Ratings.

- Despite the return of material net new borrowing in 2024 and 2025, we forecast German LRGs' aggregated tax-supported debt ratio will remain broadly unchanged, at slightly below 90%.
  - Revenue growth should continue to mitigate the impact of higher outstanding debt for the calculation of our relative debt measure.
  - However, the rate at which German LRGs are increasing their absolute amount of outstanding debt has quickened.
- We predict the outstanding debt of German LRGs and auxiliary budgets will reach almost €800 billion by the end of 2026, reflecting:
  - Anticipated annual gross borrowing of €130 billion to €135 billion over 2024 to 2026, and repayment of €114 billion to €121 billion.
  - Anticipated annual net borrowing falling from €21 billion to €9 billon over 2024 to 2026.

Annual German LRG Bond Issuance Exceeds €60 Billion Again

Maturities and deficits indicate high new issue volumes on a sustained basis

Bond issuance by German LRGs



e--Estimate. Sources: Federal Statistics Office, S&P Global Ratings.

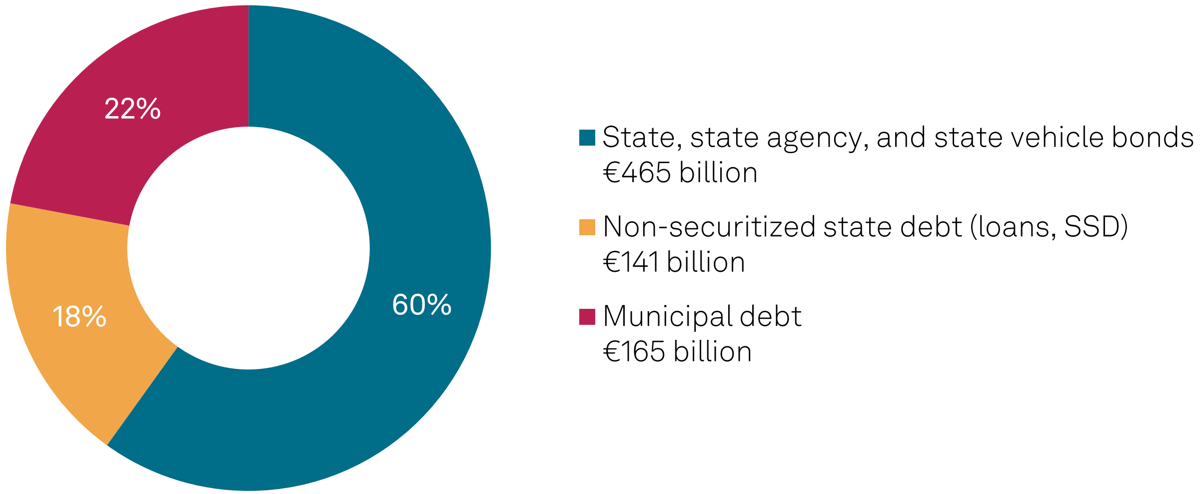
- Outstanding bonds issued by German LRGs and their auxiliary budgets exceeded €430 billion by December 31, 2024.
- This equals about 60% of LRGs' total debt.
- Weaker budgetary performance has driven LRG bond issuance much faster than expected.
- We believe that new issuance may have peaked in 2024 at clearly over €60 billion, but we do not expect a material decline over the next two years.
- Our prediction reflects:
  - Current pressures on LRGs' budgets which we assume will abate only slowly;
  - Our assumption that German states will predominantly finance in bond format, meaning that securitized debt will account for almost 50% of German LRG new gross borrowing.

The List Of Germany‘s Largest LRG Bond Issuers Remains Almost Unchanged

North Rhine-Westphalia (NRW) continues to lead issuance; Berlin and Lower Saxony switch positions

- Bond financing remains almost exclusively limited to German states, with municipal bond issuances a rare exception.
- Issuance of green and social bonds is more frequent, with many of the top issuers now regularly using these instruments.

2024 German LRG debt split



Sources: Federal Statistics Office, Bloomberg, S&P Global Ratings. SSD: “Schuldschein” loan certificates

Largest German LRG bond issuers

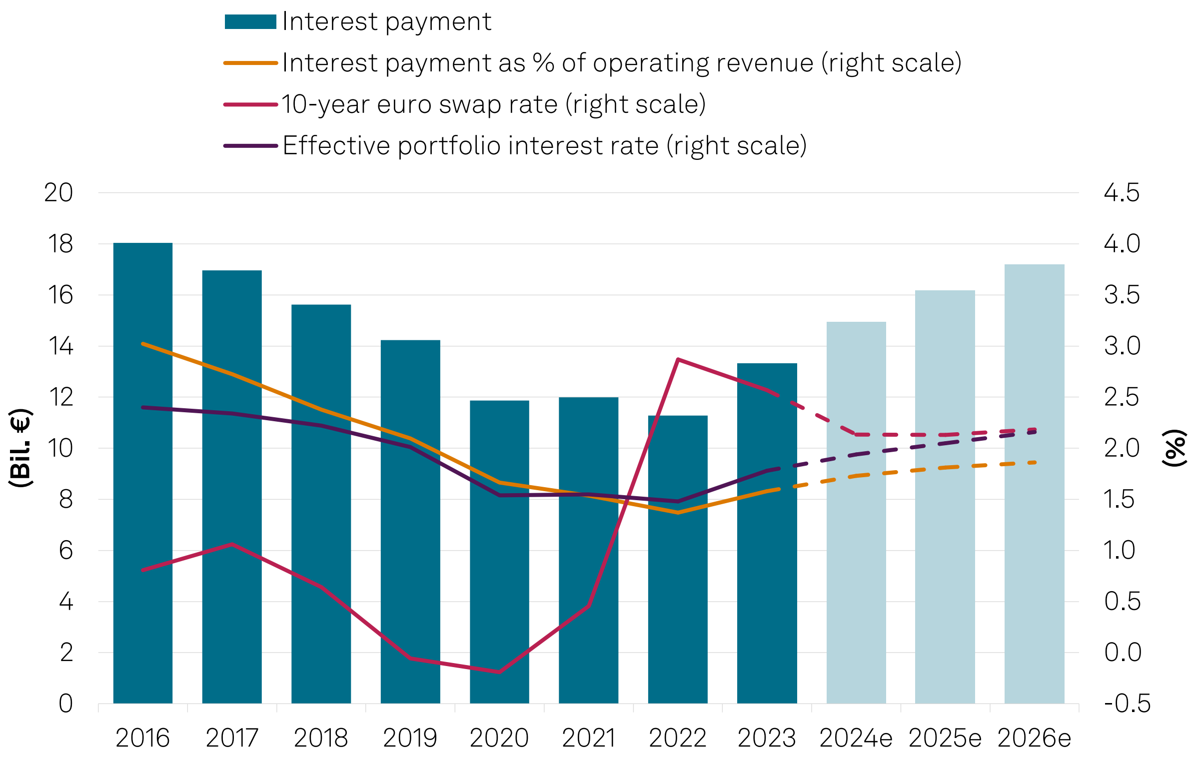
NRW	Bonds outstanding*: Bond issuance in 2024*: Estimated total borrowing§ 2025: S&P rating:	€129 billion €7.7 billion ~€15 billion AA/Negative/A-1+
Berlin	Bonds outstanding*: Bond issuance in 2024*: Estimated total borrowing§ 2025 S&P rating:	€48 billion €6.4 billion ~€6 billion Not rated
Lower Saxony	Bonds outstanding*: Bond issuance in 2024*: Estimated total borrowing§ 2025: S&P rating:	€44 billion €4.9 billion Not available Not rated
Hesse	Bonds outstanding*: Bond issuance in 2024*: Estimated total borrowing§ 2025: S&P rating:	€37 billion €9.3 billion ~€6 billion AA+/Stable/A-1+
Rhineland-Palatinate	Bonds outstanding*: Bond issuance in 2024*: Estimated total borrowing§ 2025: S&P rating:	€23 billion €6.0 billion Not available Not rated

*As of Dec. 31, 2024. §S&P estimate for bonds and loans together.

Slow Rise In Interest Burden Vindicates LRGs‘ Preference For Fixed-Rate Debt

Normalization of rates since 2022 is only slowly feeding into LRG debt portfolios

Interest cost of German LRGs



e--Estimate. Sources: Federal Statistics Office, S&P Global Ratings.

- Variable interest rate debt in German LRG portfolios is below 7%, according to German statistics office data compiled for year-end 2023.
- At that date, about 55% of outstanding LRG debt matured beyond five years, thereby limiting sudden repricing risks.
- That combination of factors underpins our prediction that the normalization of interest rates observed since 2022 will feed only very slowly into German LRG portfolios over 2024-2026.
- We still anticipate that the share of revenue LRGs will need to dedicate to interest expenditure will rise materially from its low point in 2021.
- In times of budgetary pressure, this constitutes an additional headwind.

(Geo) Political Event Risk Limits Visibility For 2025 And 2026

Events beyond the control of German LRGs‘ could materially affect budgets and are unpredictable in likelihood and effect

German national elections

- Elections are due in February, but a coalition government could take significantly longer to form.
- A delayed national budget for 2025 could jeopardize some transfers to LRGs.
- More importantly, a reform or partial suspension of limits imposed by Germany’s debt brake rule could be on the agenda post-election.

Escalation of international conflicts

- An escalation of the Russia-Ukraine war or more violence in the Middle East could require costly responses by German LRGs, including:
  – Economic stimulus, such as new tax breaks;
  – A surge in spending relating to refugees;
  – Higher federal defense spending that leaves less money for LRGs.

Disruption of international trade

- Germany’s export-oriented economy is exposed to trade disruptions and other restrictions that could weigh on LRGs’ budgetary performance
- Potential disruptions include:
  – The imposition of tariffs by the new U.S. administration;
  – Deterioration in EU-China trade relations;
  – Any public health-related trade restrictions.

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