Free State of Bavaria

Rating Report

SCOPE AAA STABLE OUTLOOK

Credit strengths

- Low debt burden
- Excellent capital market access
- Ample liquidity
- Strong budgetary performance
- Wealthy economy
- Highly integrated institutional framework

Credit challenges

- Limited revenue flexibility
- High pension liabilities
- Sizeable, although largely low-risk, contingent liabilities

Rating rationale and Outlook

The AAA/Stable rating of the Free State of Bavaria (Bavaria) is driven by:

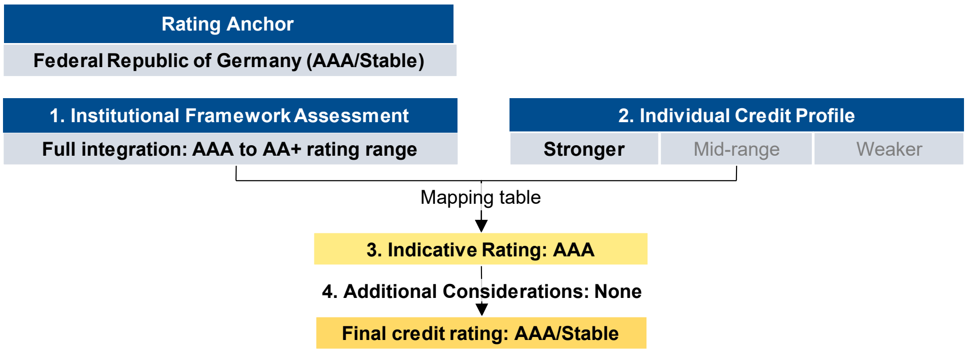
- **A highly integrated Institutional Framework**, resulting in a close alignment of German federal states' creditworthiness with the German central government's AAA/Stable rating. Key characteristics are a strong revenue equalisation system and the federal solidarity principle, among others.
- **A 'stronger' Individual Credit Profile:**

  Bavaria's credit strengths are: i) a low debt burden; ii) excellent capital market access; iii) ample liquidity; iv) strong budgetary performance; and v) a wealthy economy.

  Challenges are: i) limited revenue flexibility; ii) high pension liabilities that weigh on long-term expenditure flexibility; and iii) sizeable but manageable contingent liabilities.

  The Stable Outlook reflects our assessment that the risks Bavaria faces remain well balanced.

Our approach to rating Bavaria



Note: For further details, please see Scope's Sub-sovereigns Rating Methodology. Source: Scope Ratings

Positive rating-change drivers

- N/A

Negative rating-change drivers

- Downgrade of Germany's sovereign rating
- Changes in the institutional framework, resulting in weaker individual credit profile
- Individual credit profile weakens significantly and structurally

Ratings and Outlook

Foreign & local currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

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Institutional framework

Federal framework results in close rating alignment…

German Länder[1] benefit from a mature, highly predictable and integrated institutional framework. The key elements are: i) a strongly interconnected revenue equalisation mechanism enshrined in the constitution; ii) strict fiscal rules and monitoring, iii) wide-ranging participation and veto-rights of the federal states in the national legislation; iv) equal entitlement of federal states regarding negotiations on federal reforms; and v) a solidarity principle that ensures extraordinary system support during budgetary emergencies.

The federal system under which the Länder operate is the most integrated among the European sub-sovereign systems we cover. This is driven by our assessments of 'full integration' for extraordinary support and bailout practices, ordinary budgetary support and fiscal equalisation, fiscal rules and oversight, and revenue and spending powers. We assess funding practices as 'medium integration' (see Appendix I for an overview).

…with distance of up to one notch from sovereign rating.

The framework assessment for German Länder results in an **indicative downward rating adjustment of up to one notch** from Germany's AAA/Stable rating.

Extraordinary support and bail-out practices

Strong solidarity principle ensures extraordinary support

Our framework assessment acknowledges a record of extraordinary financial support. Länder have been granted exceptional financial support from the federal government in five instances: Bremen (1992, 2006), Saarland (1992, 2005) and Berlin (2002). The court approved claims on the grounds of the solidarity principle, or *Bundestreueprinzip*, under which the Länder and the federal government are required to support each other in the event of a budgetary emergency. A claim by Berlin was denied in 2006, with the court arguing that the city-state was not in an extreme budgetary situation. However, the judges noted that federal emergency support would still be possible as a last resort if the budget and/or debt situation were later assessed as extreme. We consider the *Bundestreueprinzip* to be an implicit bail-out rule, as it requires the provision of federal support in times of budgetary stress.

Federal government as shock absorber during recent crises

More recently, the federal government confirmed its role as a primary countercyclical shock absorber during the Covid-19 and energy crises in 2020-2023. Over these years, the federal government financed most anti-crisis measures and direct grants to the Länder to mitigate the impact on their finances. This led to federal budget deficits of an average 3.5% of GDP over 2020-2022, compared with an average deficit of the Länder of 0.14% over the same period.

Ordinary budgetary support and fiscal equalisation

Comprehensive fiscal equalisation system

The federal financial equalisation system aims to align different fiscal capacities across the Länder in an appropriate way. A reformed equalisation system took effect in 2020, with horizontal distributions made through deductions and top-ups to collected VAT, as well as supplemental vertical transfers from the federal government.

Bavaria is the largest contributor to the equalisation system

As in the previous system, Bavaria is the largest net contributor with deductions on its VAT revenue of around EUR 9.1bn in 2023. However, the net effect of the system change is positive for all Länder as contributions from the federal government are greater under the reformed system.

[1] We use the term 'Land' (or collectively 'Länder') and 'state' interchangeably to refer to German federal states.

Funding practices

Autonomous borrowing, access to shared liquidity

Länder governments have broad autonomy in their funding choices. There is no use of sovereign on-lending, and Länder can decide autonomously on their borrowing programmes within the framework of the debt brake. Short-term liquidity is available via access to shared liquidity among the Länder and the federal government, essentially eliminating liquidity risk. Basel III risk-weights for Länder debt securities are aligned at 0% with the central government. The Länder have a history of joint bond issuance, having issued such instruments on 64 occasions, although not all of the 16 Länder participated.

Fiscal rules and oversight

Debt brake anchors borrowing; stability council conducts oversight

Since 2020, the Länder have to comply with debt brakes under which they cannot run structural financing deficits unless, for example, hit by a severe economic downturn or a natural disaster.[2] The federal debt brake caps the structural annual deficit of the central government at 0.35% of GDP. The German federal parliament used the emergency clause of the debt brake in 2020-2023 in response to the Covid-19 and energy crises. Separately, Bavaria invoked the safeguard clause of its debt brake for 2020-2022 to implement support measures and credit authorisations to mitigate the impact of Covid-19. Borrowing under safeguard clauses comes with mandatory redemption rules.

Compliance with the debt brake and Länder finances are monitored by the Stability Council. The Council was established in 2010 to monitor restructuring programmes and compliance with budgetary targets and comprises the finance ministers of each Land and the federal ministers of finance and economic affairs. If the Council determines that a Land is threatened with a budgetary emergency, it agrees on a restructuring programme with the affected authority.

15 November 2023 constitutional court ruling with implications at federal level…

In late 2023, Germany's constitutional court ruled the Second Supplementary Budget Act 2021 of the federal government as unconstitutional and thus void. Crucially, the ruling also gives the constitutional court's broader interpretation of emergency budgetary practices under debt brake rules widely implemented by the federal and state governments since 2020. In the Budget Act, the federal government retroactively reallocated and repurposed funds initially raised via the emergency clause of the debt brake to address the Covid-19 crisis to its climate and transition fund for spending over coming years. The ruling has possible implications for Länder governments, as they employed similar budgetary practices of using emergency credit authorisations in a given year for budgetary reserves for spending in subsequent years.

…but no material repercussions expected for Bavaria.

The Bavarian Budget Act 2022 allowed for EUR 5.8bn in credit authorisations to cover pandemic-related costs and to fund the Hightech Agenda Plus, stating that credit authorisations can be transferred if the credit funds have not been taken out by the end of the 2022 financial year and are still required. While a court ruling was filed against the 2022 Budget, no material impact on Bavaria's finances is expected since the credit authorisations were not needed and spending needs were covered from the general budget.

Revenue and spending powers

Shared tax authority with the federal government

The Länder and the federal government share a taxation authority and jointly decide on rates and revenue distribution for high-revenue common taxes (income and VAT). The latest reform of federal financial relations (in 2017) took effect in 2020 and resulted in a higher share of VAT revenue being distributed among the Länder. The VAT distribution

[2] The debt brake is a legal framework that prohibits structural deficits for the Länder from 2020 onwards; article 109 (3) of the Basic Law stipulates that the Länder may incur deficits in a case of, for example, a recession or a natural disaster provided they pass respective legislation at the state level.

fully compensates for the variation in taxing powers, replacing the previous process of horizontal payments between the Länder. Alongside common taxes, the central government and the Länder have separate taxation authorities for lower revenue-generating taxes.

Federal reforms strengthen political coherence

Under the reform agreed in 2017, the Länder have assigned limited executive and legislative rights to the central government in certain policy areas, including physical and digital infrastructure and the higher education system, in return for higher payments from the equalisation system. In line with earlier reforms (*Föderalismusreformen II*), we observe that the higher the share of common national legislation (*konkurrierende Gesetzgebung*), the more integrated the system becomes.

Political coherence and multi-level governance

The German federal system is very predictable and supportive. Major reforms are discussed and agreed upon well in advance and in consultation with the Länder, which can directly influence national policymaking via the upper house of parliament.

Special role of Bavaria with regional party

Bavaria has a unique role in the political landscape. It is the only federal state with a separate party: the Christian Social Union (CSU). The CSU has been in power since 1957 under different coalitions but usually as a one-party government, and it has always appointed the state's prime minister. The party also has a long-standing agreement with the Christian Democrats to cooperate in federal and regional elections.

Individual credit profile (ICP)

Strongest individual credit profile among peers

We assess Bavaria's ICP as 'stronger' among German Länder. This places the Land's indicative rating at AAA, given our assessment of very close integration with the federal government and our mapping table, see Appendix II.

Bavaria's individual credit strengths are: i) low debt, ample liquidity, and excellent capital market access; ii) strong budgetary performance and above-average expenditure flexibility; iii) a wealthy and highly competitive economy; and iv) high quality of governance and strong commitment to fiscal prudence at the regional level.

Credit challenges are: i) limited revenue flexibility and high pension liabilities weighing on long-term expenditure flexibility; and ii) sizeable, yet manageable, contingent liabilities.

Bavaria is the second most populous federal state with about 13.4m residents (16% of the German total), and it has the country's second largest regional economy (19% of the total). Bavaria's main responsibilities include healthcare and education, which are financed predominantly via shared taxes and transfers.

Over 2020-2021, the Covid-19 pandemic led to moderately higher debt and a temporary budgetary deterioration due to additional expenditure, as well as tax revenue shortfalls in 2020. Budgetary reserves and prudent financial management compensated for the shock with budgetary performance recovering strongly in 2022 and we expect performance to remain robust in 2023 as lower tax revenues are offset by reduced operating expenditure as pandemic-related allocations and grants decline.

Debt burden and liquidity profile

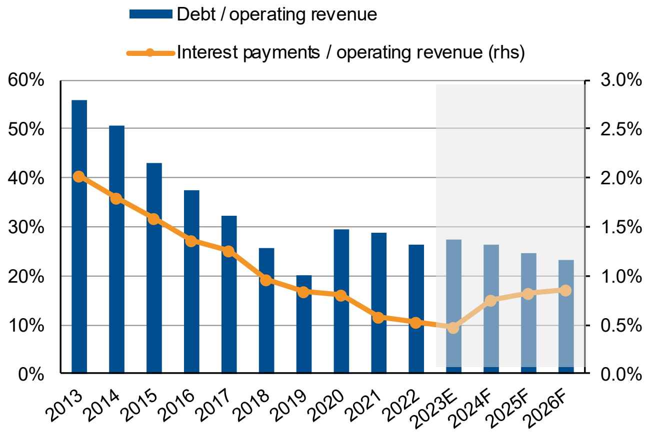
Low debt burden

Bavaria's credit profile benefits from a low debt burden in a national and international context. Before Covid-19, direct debt excluding guarantees had declined significantly from 56% of operating revenue in 2013 to 20% at end-2019 (**Figure 1**). By end-2021, due to pandemic-related borrowing, debt had increased to 29% of operating revenue (EUR 19.9bn).

Debt levels have since declined to EUR 19bn in 2022 and are expected to remain stable in 2023. We expect a moderate decrease in revenue to result in an increase of the debt/operating revenue ratio in 2023, before the ratio gradually declines in subsequent years as tax revenues start to recover. In line with previous years, Bavaria used cash to service its debt in 2022 and increased its postponed credit authorisations by EUR 882m to EUR 18.0bn[3].

Figure 1: Debt and interest burden

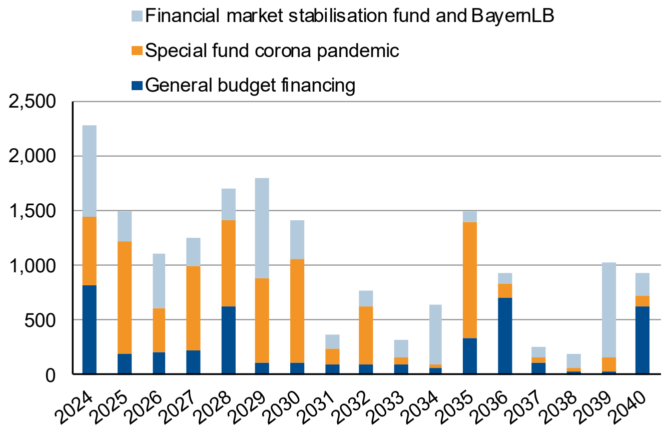
%



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Destatis, Scope Ratings

Figure 2: Debt service profile

EUR (m)



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings

Low interest-payment burden

Pre-pandemic debt reductions also contributed to a fall in Bavaria's interest payments relative to operating revenue, to 0.5% in 2022 from 2.0% in 2013, further bolstering its fiscal position. Even with the sharp rise in interest rates since 2022, we expect the interest payments-to-operating revenue ratio to increase only gradually and remain near pre-pandemic levels over the coming years. Based on recent Stability Council assessments, Bavaria will continue to outperform most German Länder in terms of fiscal indicators.

Significant increase but still low debt following the pandemic

In response to the Covid-19 crisis, Bavaria passed legislation to invoke the safeguard clause of its debt brake and adopted budgetary measures and credit authorisations of up to EUR 20bn of new debt in 2020, up to EUR 11.6bn in 2021 and EUR 5.8bn in 2022. In the 2023 budget, no new credit authorisations were included and a decrease in debt of EUR 50m has been budgeted.

Pandemic-related funds have been collected under a dedicated account (chapter 13 19 *Sonderfonds Corona-Pandemie*) in the Land's core budget created in 2020 to address the Covid-19 crisis. Bavaria's debt take-up has been significantly lower than credit authorisations over 2020-2022, and the volume of the 2020 authorisation of EUR 20bn was sufficient to cover funding over these three years, in line with the authorities' plans. At end-2022, debt taken up under chapter 13 19 amounted to EUR 10.21bn, significantly below the EUR 37.4bn authorised.

Debt service to rise modestly due to Covid debt repayment

Credit authorisations under the debt brake emergency clause come with a pre-defined redemption plan. Bavaria planned to amortise debt taken on under chapter 13 19 in annual instalments of 5% of the total amount incurred under the 2020 credit authorisation

[3] In view of Bavaria's high own cash holdings combined with the low interest rate environment, a major instrument for reducing cash holdings is the postponement of credit authorisations. This means that authorisations to accept debt for the repayment of due loans are unused and due loans are settled using existing cash holdings.

from 2024, and from 2025 for debt incurred under the 2021 credit authorisation. The draft Budget Act 2024/2025 limits planned repayments to EUR 50m in 2024 and the same amount in 2025 given the challenging short-term economic outlook. In addition, EUR 310.4m in 2024 and EUR 460.5m in 2025 will be allocated as a provision in the budget, which can then be used to cover any annual deficit or for further debt repayment. Any pandemic-related debt still outstanding at the end of 2025 will be repaid in equal instalments with the debt fully paid off by 2044. As actual take-up of debt was substantially lower than budgeted, mandatory redemptions should stay well below EUR 1bn per year. Thanks to favourable financing rates, we expect interest payments to stay below 1% of operating revenue over the coming years.

Sound debt management; excellent market access

As for all German Länder, we assess Bavaria's access to capital markets as excellent. This was observed during the Covid-19 crisis. Bavaria re-entered the bond markets for the first time since end-2014 in 2020, issuing EUR 7.2bn mostly at near-zero coupons. In 2021, Bavaria issued another EUR 3.4bn of debt. In 2022, Bavaria issued promissory notes amounting to EUR 338.5m, but did not tap public debt markets, indicating limited financing needs and reflecting volatile public capital markets as the ECB tightened monetary policy considerably. Similarly, public debt markets were not accessed in 2023, with EUR 1,315m issued through private placements and EUR 1,026m issued through promissory notes. Bavaria employs a conservative debt-management strategy with no foreign currency exposure and limited interest rate risks. Going forward, Bavaria's debt management strategy remains conservative and envisions: i) borrowing largely based on the liquidity profile; ii) depending on the steepness of the yield curve, a focus on longer maturities; and iii) a focus on achieving a balanced repayment structure, taking into account statutory repayment obligations related to the pandemic credit authorisations. Bavaria's debt service profile is balanced with around one-third of debt maturing in the next five years (**Figure 2**).

High own cash reserves

Bavaria benefits from ample liquidity. While cash holdings have declined over the past year, they remain sizeable compared to national peers, stemming from its sound budgetary and financial management. Bavaria's cash holdings comfortably cover debt service through to 2026.

Solid cash flow profile and conservative liquidity planning

Bavaria also benefits from highly predictable cash flow and prudent budgetary assumptions for liquidity planning. The state's cash flows, especially inflows, are prone to seasonal variations driven by the tax calendar. Like other Länder (excluding city-states), Bavaria's cash reserves tend to increase over the year, with peaks in mid-April, June, July and October followed by significant outflows at the end of October and in November. Moreover, the federal state accumulates the Bavarian municipalities' shares of taxes before distributing them to the municipalities every quarter. These factors partly explain the state's excess liquidity during the year.

Excellent access to external liquidity

Bavaria has excellent access to external funding, which strengthens its resilience to shocks. External liquidity, if required, is available at short notice via credit facilities from various major financial institutions. German Länder lend excess liquidity to each other via commercial cash transactions, generating another source of liquidity. Combined with Bavaria's own sizeable reserves, this makes the risk of a liquidity shortfall negligible.

Contractual guarantees exhibit low risks, very modest take-up of Covid-19 guarantees

Finally, contractual guarantees issued by Bavaria stood at EUR 11.2bn in 2022, up from about EUR 10.8bn in 2021, and remain overall moderate. The take-up of guarantees provided to Bavaria's regional development bank, LfA Förderbank Bayern (AAA/Stable), to facilitate lending to businesses hit by the Covid-19 pandemic and energy crisis remained modest at less than EUR 1bn out of a maximum envelope of EUR 12bn.

Other guarantees were issued mostly for social housing (EUR 2.6bn), as well as for individual authorisations (EUR 8.1bn) covering various areas, such as a local transport project in Munich. High property values make it less likely that Bavaria will need to honour guarantees relating to real estate transactions. In addition, guarantees for debt incurred by social housing associations are not relevant to the budget, because of the associations' stable rental income.

Materialisation of contingent liabilities in the financial sector unlikely

Bavaria's 75% shareholding in BayernLB (total assets of EUR 286bn as of September 2023) gives rise to some contingent liability risk, however much reduced after BayernLB repaid its state aid in full in 2017[4]. The repayment of Bavaria's capital contribution led to an early conclusion of related EU proceedings. The bank's balance sheet is strong with i) a solid capital base, reflected by a CET1 capital ratio of 18.2% in September 2023, well above the regulatory requirement (9.4% minimum for 2024); and ii) a low NPL ratio of 0.7%.

Solid management of major holdings

Bavaria's strong management of its major shareholdings is reflected in its robust financial performance, indicating a low risk of related contingent liabilities materialising. The total debt of entities in which Bavaria holds a majority share (excluding financial institutions) increased to around EUR 2.8bn in 2022. The Covid-19 crisis hindered the profitability of several holdings in 2020 and 2021, with Bavaria providing support via loans or capital injections. However, the reduction of pandemic restrictions resulted in substantial performance improvements, particularly for the Messe München GmbH due to a large increase in demand for trade fairs and conference events, and airports in Munich and Nuremberg saw a recovery in passenger numbers.

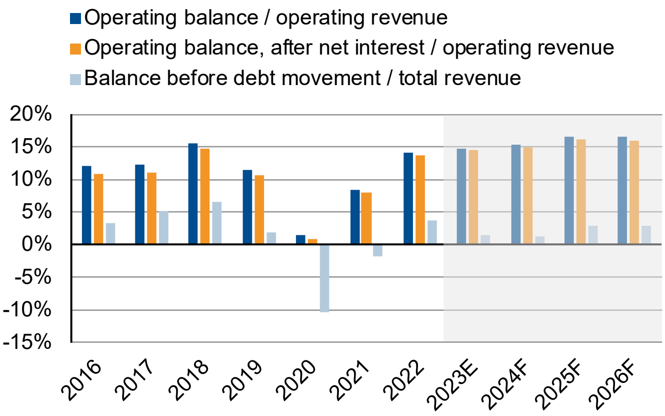
Budgetary performance and flexibility

Strong budgetary performance and flexibility

Bavaria displays a strong budgetary performance, with historically high operating surpluses averaging 12.9% of operating revenue in 2015-2019 (**Figure 3**). Bavaria's strong historical performance has been underpinned by strong growth in tax revenue, continuous cost control and conservative budgetary management, which have supported a substantial reduction in debt and a build-up of cash reserves.

Figure 3: Budgetary performance

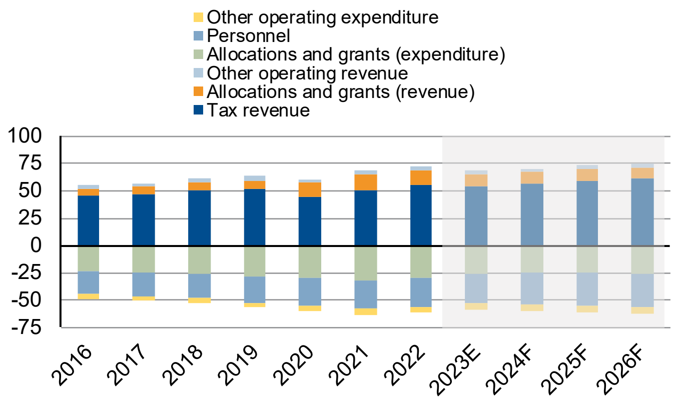
%



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings

Figure 4: Components of operating balance

EUR bn



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings

[4] In 2008/2009, Bavaria injected EUR 10bn of capital into the bank and issued EUR 4.8bn in guarantees for Bayern LB's structured finance portfolio. Under the EU state-aid proceedings, the European Commission scheduled a repayment of EUR 4.96bn until 31 December 2019 at the latest. With the repayment of EUR 1bn as of 30 June 2017, BayernLB has fully met the repayment obligation. The guarantees for the structured credit portfolio were terminated in 2014.

Bavaria's budgets impacted by the Covid-19 crisis

After years of budgetary surpluses and net debt reduction, budgetary results in 2020 and 2021 were driven by the Covid-19 pandemic. Due to greater uncertainty and efforts to increase operational flexibility, Bavaria passed one-year budgets for 2021, 2022 and 2023, instead of the usual two years being reintroduced for 2024/2025. Bavaria's financial results worsened from a surplus of around EUR 1.2bn in 2019, or 2% of total revenue, to deficits of 10.3% in 2020 and 1.7% in 2021.

A strong fiscal recovery in 2022

In 2022, the state posted strong results, ending the year with a EUR 2.8bn surplus before debt movements, or 3.7% of total revenue. Financial performance benefitted from strong nominal tax revenue, up 10% from 2021, primarily driven by robust growth in shared taxes. Operating expenditure decreased by 2.3% due to lower allocations and grant payments. The positive results allowed for the net credit authorisations remaining in the special coronavirus pandemic fund (chapter 13 19) at the end of 2022 to be fully withdrawn, in addition to debt repayments of EUR 100m related to the special fund for the financial market and BayernLB.

2023 budget expected to be balanced; increasing spending pressures

In line with its 2023 Budget, we expect that Bavaria did not require any new net borrowing in 2023 and that net debt decreased by EUR 50m. We also expect Bavaria to effectively absorb the adverse budgetary effects of the pandemic with debt metrics gradually improving over the coming years thanks to its: i) conservative budget management; ii) track record of commitment to fiscal consolidation; iii) ability to adjust budgets in view of the high investment levels; and iv) economic and demographic outperformance of national peers. Operating revenues are expected to decline in 2023 by 4.6% due to lower tax revenues. However, this decline is offset by operating expenditure also falling by around 5.2% as allocation and grant payments related to the pandemic decline. This helps balance some of the spending pressures from high inflation such as personnel costs that are expected to rise by 4% in 2023 and 6.5% in 2024.

No net borrowing and increased investment expected over the forecast horizon

Going forward, Bavaria will return to two-year budget plans. The planned 2024/2025 budget continues to adhere to the debt brake and therefore does not include any new debt. From 2024, the repayment of the debt taken on in the special pandemic fund in the years 2020 to 2022 will begin with repayments of EUR 50m in 2024 and in 2025. The balance before debt movement is expected to remain in surplus throughout our projection horizon until 2026. We expect the operating balance to remain slightly above pre-pandemic levels with operating revenues growing at around 3% per year as tax revenue growth returns following a decline of around 1.5% in 2023. Operating expenditure is expected to increase by around 2.6% per year, mainly driven by higher personnel costs. The conservative budget management is expected to allow for increased planned investment spending, with capital expenditure as a share of total expenditure rising to around 15%.

Above-average revenue flexibility

We assess Bavaria's revenue flexibility as moderate and above average compared with other Länder due to the state's lower dependency on transfers. Operating revenue is mostly comprised of taxes (**Figure 4**), most of which are shared taxes (personal income taxes, VAT and corporate taxes). Shared tax revenue is initially collected by Bavarian tax offices but later redistributed at the federal level in accordance with revenue-sharing agreements and additional transfer mechanisms. This weakens the link between the state's tax revenue and its economic performance.

Moderate expenditure flexibility

Relative to other Länder, Bavaria's expenditure flexibility is supported by a relatively high share of total expenditure on investments (12% on average over 2018-2022) and limited administrative costs (6.9%). Bavaria further has a record of fiscal consolidation and implementing cost cuts during economic downturns to offset budgetary shocks, which is reflected by a decline of 2.3% in operating expenditure in 2022 and a further decline expected in 2023. At the same time, Bavaria's operating expenditure structure is rigid, with large items relating to transfers and grants (42% of total expenditure in 2022) and elevated personnel costs (37%), of which around 60% is spent on education, science, research and culture, and 20% on security and legal protection.

Pension payments weigh on long-term budgetary flexibility…

Finally, pension expenditure will take up a growing share of Bavaria's budget. The number of eligible pensioners is set to rise to 185,000 in 2040 (up 18% from 2022), weighing on the state's long-term expenditure flexibility. According to Bavaria's report on future pension expenditure, which includes alternative assumptions on pension adjustments between 2.5%-3.5% yearly, the share of pension expenditure will rise steadily from 9.1% in 2018 to peak at: i) 11.1% in 2027 and then decline to 9.4% in 2050 (with a moderate growth rate of 2.5% p.a.); ii) 11.7% during 2033-36 (with a growth rate of 3% p.a.); or iii) 12.6% during 2037-43 (with a historically unlikely yearly growth rate of 3.5%).

… but provisions and annual contributions serve as buffers.

To ease the rising pressure from pension obligations, Bavaria has: i) implemented cost-saving measures; ii) pursued prudent fiscal policy and iii) created a pension fund. The capital stock of the pension fund stood at EUR 3.5bn at end-2022. In addition to the statutory annual fund inflows of EUR 110m until 2030, Bavaria contributes collected pension allowances (EUR 31.9m in 2023). Overall, the combined measures, including anticipated savings, will result in a moderate share of pension expenditure with a peak of 10%-12%, broadly in line with levels in 2018. For 2023, pay-outs from the fund were possible for the first time but were not taken. The pay-out plan from 19 September 2023 also indicates that no withdrawals are expected in 2024 and 2025.

Economy

Key economic region in Germany

Bavaria has a favourable socio-economic profile underpinned by a large, wealthy, well-diversified and highly competitive economy, resulting in a high regional growth potential and a strong ability to generate its own long-term revenue. Bavaria is a key economic region in Germany, contributing 19% of national GDP in 2022. The state is also one of the wealthiest regions in Europe, with a GDP per capita 17% above the German average and 52% above the EU average.

Robust economic growth and highly competitive economy

In the five years before the Covid-19 crisis, economic expansion was strong, although it had already started to slow. Average real GDP growth was 2% in 2015-2019, outperforming the German average of 1.7% (**Figure 5**).

Robust recovery from Covid-19 and Russia-Ukraine war

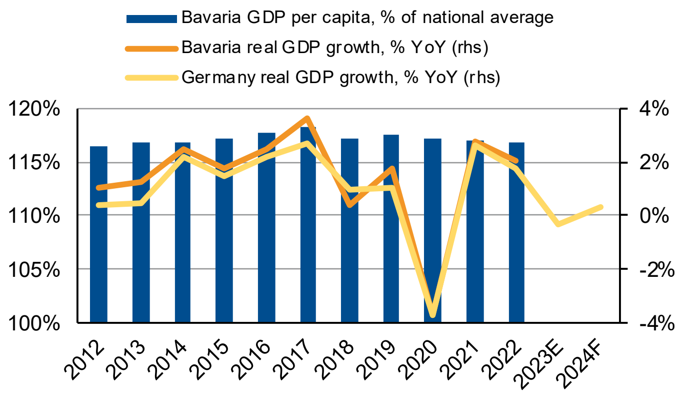
Bavaria's real GDP declined by 3.7% in 2020 due to the Covid-19 shock, in line with the German average. The economic recovery in 2021 and 2022 was robust and above the national average with 2.8% and 2.1% real GDP growth respectively. This was despite the impact of global supply chain disruptions, as well as high energy prices and other economic effects of the Russian invasion of Ukraine. While economic output in the German economy fell by 0.3% in 2023, we expect stronger results for Bavaria's economy given robust growth during the first half of the year.

Lowest unemployment in Germany

Bavaria enjoys favourable labour market characteristics, even though the Covid-19 shock caused the unemployment rate to increase to a high of 4.2% in February 2021, from 2.8% in December 2019. In January 2024, the unemployment rate stood at 3.9%, 1.1 pp above its 2019 level. Robust labour market outcomes over the course of the pandemic and energy shocks reflect the federal government's large discretionary support, e.g. in the form of a national furlough scheme, or *Kurzarbeit*. While the unemployment rate has started to increase in recent months amid a weakening economy, Bavaria has the lowest unemployment rate among all German Länder (**Figure 6**).

Figure 5: Real GDP growth

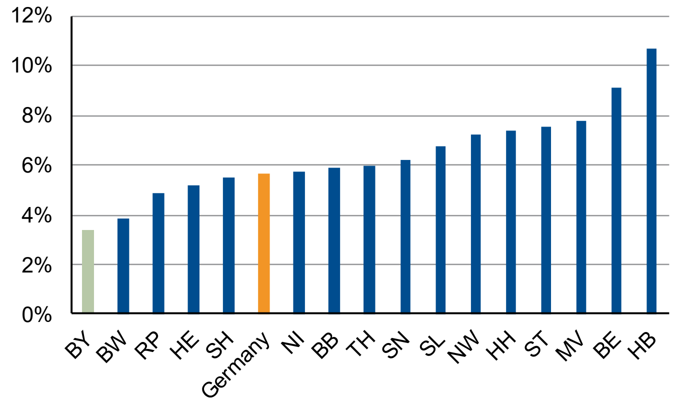
%



Source: Volkswirtschaftliche Gesamtrechnung der Länder, Scope Ratings

Figure 6: Unemployment ratio

% of total labour force, 2023



Source: Destatis, Scope Ratings

Relatively favourable demographic profile

Bavaria enjoys positive demographics compared to other Länder, supporting Bavaria's long-term growth and tax revenue potential. Bavaria's statistical office projects a 5.4% increase in total population from 2021 to 2041. At the same time, ageing will lead to an increase in the proportion of people aged 65 and over versus those aged 20-64, from 34.6% in 2021 to around 45.2% in 2041.

Quality of governance

Stable political environment

We assess Bavaria's quality of governance and financial management as strong. This is supported by the state's: i) record of nominal debt reduction; ii) regular fulfilment of policy objectives defined in strategic plans; and iii) ability to weather economic downturns by cutting costs to compensate for adverse budgetary developments.

Governing coalition of CSU/Free Voters

After losing its electoral majority in 2018, the CSU reached a coalition agreement with the smaller, conservative Free Voters party. The coalition remained in power following the October 2023 elections with the CSU winning 37% of the vote and the Free Voters 15.8%. CSU's Markus Söder is the region's president, while the Free Voters run four ministries: economy, environment, culture and digital.

Borrowing due to the pandemic; delay in debt reduction plans

The fiscal objective of continuously reducing Bavaria's debt is legally enshrined in the Bavarian budgetary laws (*Bayerische Haushaltordnung*). According to the coalition agreement, strategic priorities for the 2023-2028 administrative term include: i) balanced budgets without recourse to new debt; ii) compliance with the debt brake mechanism; iii) a gradual reduction of debt levels and repayment of pandemic-related debt starting from 2024; iv) a continued build-up of reserves; and v) increased investments. Bavaria's budgetary reaction to Covid-19 has delayed debt reduction plans, but debt take-up in 2020 and 2021 was overall moderate and well below credit authorisations.

Environmental and social considerations

Plan to become climate neutral by 2040

Bavaria's ambitious climate plan aims for a reduction in greenhouse gas emissions of 65% per inhabitant by 2030 and climate neutrality by 2040 at the latest. The Bavarian Climate Protection Act (BayKlimaG), which makes the basic targets legally binding and includes around 150 concrete measures adopted by the state government, accompanies the protection programme to achieve CO_2 reduction targets. While physical risks from climate change are relatively low, Bavaria was also affected by the large floodings in July 2021, although to a much lesser extent than North Rhine-Westphalia or Rhineland-Palatinate. With the establishment of a national Reconstruction Assistance fund

(Aufbauhilfe 2021), the federal government made up to EUR 30bn available to support reconstruction in the affected areas; Bavaria received 1% of the fund.

Relatively favourable demographics and educational attainments vs national average, but high cost of living

In terms of health and demographic indicators, Bavaria outperforms peers with an old-age dependency ratio of 32.1% versus 34.7% (national average). The state’s life expectancy is the second highest in Germany after Baden-Wurttemberg. Bavaria also outperforms peers in terms of education attainment as reflected by a higher-than-average share of graduates (34.5% versus 32.3% national average) and a lower share of young people neither in employment nor in education training (4.7% against the national average of 6.8%).

However, like many regions, Bavaria faces high housing costs in urban centres and an elevated cost of living compared with other states. This poses challenges to housing affordability, particularly for lower-income residents, compounding socio-economic disparities.

I. Institutional Framework Assessment

To assess the institutional framework, we apply a Qualitative Scorecard (QS1) centred around 6 components. We assess each analytical component on a five-point scale ranging from a score of 0 for 'low' integration to 100 for 'full' integration. The institutional framework score, ranging from 0 to 100, is calculated as a simple average of these assessments. The score is then used to determine a rating range from the rating anchor level, within which the sub-sovereign's rating can be positioned.

Our assessment of intergovernmental integration between the Länder and the Federal Republic of Germany (AAA/Stable) results in an indicative **downward rating range of up to one notch** from the German sovereign, within which the Länder can be positioned according to their individual credit strengths.

Institutional Framework scorecard (QS1)

Analytical components	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Extraordinary support and bailout practices	●	○	○	○	○
Ordinary budgetary support and fiscal equalisation	●	○	○	○	○
Funding practices	○	○	●	○	○
Fiscal rules and oversight	●	○	○	○	○
Revenue and spending powers	●	○	○	○	○
Political coherence and multi-level governance	●	○	○	○	○

Integration score	*92*
Downward rating range	***0-1***

Institutional framework score	100 > x≥ 90	90 > x≥ 80	80 > x≥ 70	70 > x≥ 60	60 > x≥ 50	50 > x≥ 40	40 > x≥ 30	30 > x≥ 20	20 > x≥ 10	10 > x≥ 0
Indicative rating range	0-1	0-2	0-3	0-4	0-5	0-6	0-7	0-8	0-9	0-10

II. Individual Credit Profile

To assess the ICP, we apply a Qualitative Scorecard 2 (QS2), centred around 10 components underpinned by peer benchmarking. We assess each analytical component on a three-point scale by benchmarking a sub-sovereign's performance and risk exposures to that of peers. Scores are 0 for 'weaker', 50 for 'mid-range', and 100 for 'stronger' for each component. The individual credit profile score, ranging from 0 to 100, is calculated as a simple average of these assessments. In addition, we make two additional assessments for environmental factors and resilience and social factors and resilience, which can lead to adjustments of the ICP score by up to +/- 10 points.

We assess the individual credit profile of Bavaria as **stronger** vis-à-vis peers, with a **score of 90 out of 100**.

Individual Credit Profile scorecard (QS2)

Risk pillar		Analytical components	Stronger (100)	Mid-range (50)	Weaker (0)
Debt and liquidity	40%	Debt burden & trajectory	◉	○	○
		Debt profile & affordability	◉	○	○
		Contingent liabilities	○	◉	○
		Liquidity position & funding flexibility	◉	○	○
Budget	30%	Budgetary performance & outlook	◉	○	○
		Revenue flexibility	◉	○	○
		Expenditure flexibility	○	◉	○
Economy	20%	Wealth levels & economic resilience	◉	○	○
		Economic sustainability	◉	○	○
Governance	10%	Governance & financial management quality	◉	○	○

Additional environmental and social factors	Positive impact (+5)	No impact (0)	Negative impact (-5)
Environmental factors and resilience	○	◉	○
Social factors and resilience	○	◉	○

ICP score	90
Indicative notching	***0***

III. Mapping Table

We derive the indicative sub-sovereign rating by mapping the result of the institutional framework assessment (i.e. the indicative rating range) to the ICP score.

For Bavaria, this results in an indicative rating aligned with the sovereign rating of AAA. No additional considerations apply.

Rating anchor	Institutional framework assessment		Individual credit profile score							
Federal Republic of Germany	Score	Downward rating range	100 > x ≥ 80	80 > x ≥ 70	70 > x ≥ 60	60 > x ≥ 50	50 > x ≥ 40	40 > x ≥ 30	30 > x ≥ 20	20 > x ≥ 0
AAA/Stable	100 > x ≥ 90	0-1	AAA	AAA	AAA	AAA	AAA	AAA	AA+	AA+
	90 > x ≥ 80	0-2	AAA	AAA	AA+	AA+	AA+	AA+	AA	AA
	80 > x ≥ 70	0-3	AAA	AA+	AA+	AA+	AA	AA	AA-	AA-
	70 > x ≥ 60	0-4	AAA	AA+	AA+	AA	AA	AA-	AA-	A+
	60 > x ≥ 50	0-5	AAA	AA+	AA+	AA	AA	AA-	A+	A
	50 > x ≥ 40	0-6	AAA	AA+	AA+/ AA	AA/ AA-	AA/ AA-	AA-/ A+	A+/ A	A-
	40 > x ≥ 30	0-7	AAA	AA+/ AA	AA+/ AA	AA/ AA-	AA-/ A+	A+/ A	A/ A-	BBB+
	30 > x ≥ 20	0-8	AAA	AA+/ AA	AA/ AA-	AA-/ A+	A+/ A	A/ A-	A-/ BBB+	BBB
	20 > x ≥ 10	0-9	AAA	AA+/ AA	AA/ AA-	AA-/ A+	A+/ A	A/ A-	BBB+/ BBB	BBB-
	10 > x ≥ 0	0-10	AAA	AA+/ AA	AA/ AA-	AA-/ A+	A/ A-	BBB+/ BBB	BBB-/ BB+	BB+

Note: Mapping table under section 4 of Scope's Sub-sovereigns Rating Methodology, as applied to the rating anchor's AAA-ratings.

IV. Statistical Overview

	2016	2017	2018	2019	2020	2021	2022	2023E	2024F	2025F	2026F
Budgetary Performance (EUR m)											
Operating revenue	55,355	57,178	61,979	63,817	60,529	69,175	71,962	68,656	70,433	73,272	75,121
Operating revenue growth, %	*5.6%*	*3.3%*	*8.4%*	*3.0%*	*-5.2%*	*14.3%*	*4.0%*	*-4.6%*	*2.6%*	*4.0%*	*2.5%*
Tax revenue	45,900	47,097	51,134	52,329	44,529	50,138	55,012	54,190	56,520	59,290	61,069
Allocations and grants	6,477	7,015	6,822	7,039	13,035	15,509	13,309	11,060	10,507	10,559	10,612
Other operating revenue	2,978	3,065	4,022	4,449	2,964	3,528	3,642	3,406	3,406	3,423	3,440
Operating expenditure	48,622	50,143	52,346	56,499	59,608	63,275	61,820	58,602	59,911	61,673	63,241
Operating expenditure growth, %	*6.9%*	*3.1%*	*4.4%*	*7.9%*	*5.5%*	*6.2%*	*-2.3%*	*-5.2%*	*2.2%*	*2.9%*	*2.5%*
Personnel	20,984	21,861	22,592	23,677	24,742	25,526	26,512	27,573	29,365	30,393	31,335
Allocations and grants	23,838	24,499	25,862	28,709	30,153	32,548	30,031	25,436	24,673	25,290	25,796
Other operating expenditure	3,800	3,783	3,892	4,113	4,714	5,201	5,277	5,594	5,873	5,991	6,110
Operating balance	6,734	7,035	9,633	7,318	920	5,900	10,142	10,054	10,522	11,599	11,880
Interest received	63	76	62	70	105	109	62	257	245	230	230
Interest paid	753	721	597	535	483	404	376	327	530	600	650
Net interest paid	690	645	535	465	378	295	314	70	285	370	420
Current balance	6,044	6,390	9,098	6,853	542	5,606	9,828	9,984	10,237	11,229	11,460
Capital balance	-4,113	-3,293	-4,874	-5,613	-6,975	-6,834	-7,381	-7,789	-8,278	-8,792	-9,332
Balance before debt movement	1,931	3,096	4,225	1,240	-6,433	-1,229	2,776	1,045	667	1,587	1,778
New borrowing (credit market)	1,020	1,370	1,220	1,370	7,208	3,428	339	3,831	1,394		
Debt redemption (credit market)	2,921	3,727	3,663	4,351	2,326	1,365	1,257	3,881	1,494		
Net borrowing	-1,901	-2,357	-2,443	-2,981	4,882	2,063	-919	-50	-100		
Debt (EUR m)											
Direct debt	20,728	18,370	15,927	12,947	17,829	19,892	18,973	18,923	18,563	18,048	17,548
Guarantees	8,247	10,105	11,048	13,978	16,254	17,079	17,961	17,961	18,141	18,322	18,506
Overall debt risk (direct debt plus guarantees)	28,975	28,475	26,975	26,925	34,083	36,971	36,935	36,885	36,704	36,371	36,054
Financial ratios											
Debt/operating revenue, %	37.4%	32.1%	25.7%	20.3%	29.5%	28.8%	26.4%	27.6%	26.4%	24.6%	23.4%
Debt/operating balance, years	3.1	2.6	1.7	1.8	19.4	3.4	1.9	1.9	1.8	1.6	1.5
Interest payments/operating revenue, %	1.4%	1.3%	1.0%	0.8%	0.8%	0.6%	0.5%	0.5%	0.8%	0.8%	0.9%
Implicit interest rate, %	3.6%	3.9%	3.7%	4.1%	2.7%	2.0%	2.0%	1.7%	2.9%	3.3%	3.7%
Operating balance/operating revenue, %	12.2%	12.3%	15.5%	11.5%	1.5%	8.5%	14.1%	14.6%	14.9%	15.8%	15.8%
Balance before debt movement/total revenue, %	3.4%	5.2%	6.6%	1.9%	-10.3%	-1.7%	3.7%	1.5%	0.9%	2.1%	2.3%
Transfers and grants/operating revenue, %	11.7%	12.3%	11.0%	11.0%	21.5%	22.4%	18.5%	16.1%	14.9%	14.4%	14.1%
Capital expenditure/total expenditure, %	10.3%	10.5%	11.2%	11.9%	12.4%	11.5%	13.0%	13.8%	14.7%	14.9%	15.2%
Economy and demographics											
Nominal GDP, EUR m	577,717	605,752	620,277	643,982	630,530	666,388	716,784				
GDP per capita, EUR	44,829	46,726	47,578	49,156	48,013	50,643	53,768				
GDP per capita, % of national GDP per capita	117.8%	118.2%	117.2%	117.6%	117.2%	117.0%	116.9%				
Real GDP growth, %	2.5%	3.7%	0.4%	1.8%	-3.7%	2.8%	2.1%				
Population, '000s	12,931	12,997	13,077	13,125	13,140	13,177	13,369				
Unemployment rate, % labour force	3.5%	3.2%	2.9%	2.8%	3.6%	3.5%	3.1%				

Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Federal Ministry of Finance, Federal Statistical Office, Scope Ratings

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