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Public debt as an instrument of fiscal policy in Germany:

Basic conditions and current development

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Content

1 Context

1.1 Possible justification for the issuance of public debt

Originally, the only accepted reason for using public debt as a source of income was to use it as a subsidiary source of income in period of war and crisis. Now, things have changed: Today, there are two main approaches to justify public borrowing. On the one hand, public borrowing may be justified by the *object* to be financed by credits. This means public borrowing is related to the productive use of the capital. Here, the main focus is on objects, gaining interest and amortization by user fees and charges. On the other hand, the keynesian borrowing strategy is related to the *economic situation*. It introduces policy as an instrument to control the economic cycle.

It is accepted now that borrowing can serve different purposes, namely the stabilization of the national tax rates and to overcome sudden expenditure crises. Due to the economic cycle the tax income is smaller during recessions and higher during boom phases than the public expenditures in the equilibrium. Considering the postulate of balanced annual budgets, the state had to act pro-cyclically by increasing tax rates and lowering the expenditures in recessions and vice versa during economic upturn. As a consequence, this lowering of the overall economic demand would trigger an unwanted reinforcement of the undulation. The dilemma can be solved by introducing an anti-cyclical budget policy that increases credit funded spending in recession times and increases tax rates in boom times. The second function, the bypass function is intended to react to sudden expenditure increases due to exceptional political or economic events. Thus, welfare-reducing adjustment costs (e.g. by changes of law) are minimized and a more constant tax policy is carried out.

Besides the stabilization credits for the avoidance of pro-cyclic public spendingand the steadiness of the household load esp. from investments, there are a few other possible tasks for financing by borrowing, such as the short term reconciliation of income fluctuations (cash reinforcement credits) and preliminary financing of infrastructure projects, esp. within development processes.

Also, the reasons to explain the emergence and the growth of national debt are manifold and discussed extensively in the literature.[1] Thus, factors such as the ideology of the respective government and the system of government (majority government, coalition government) can play an important role for the development of the indebtedness of a country or a regional administrative body. Also the hypothesis of the fiscal illusion is always possible and probable fuelling indebtedness.[2] While this theory in connection with the political economic cycle will explain short term fluctuations in the output and national indebtedness as well as the long-term rise of the national indebtedness, the uncertainty about reasons for the differences in the developments of the national indebtedness of different countries and states still remains.[3]

1.2 Fiscal policy in Germany - Renaissance of discretionary fiscal policy?

Fiscal policy in the original sense of Keynes is not anymore applied in Germany: "the board of experts sees the likelihood of success of a discretionary economic policy skeptical. The automatic stabilizers should be sufficient. Thus, the financial policy can concentrate on the long-term task of creating favorable basic conditions for more employment and growth."[4]

However, the main reason for this refusal[5] is rather the limitation of the discretion over tax revenues and expenditures due to the struggle with the Maastricht and Stability and Growth Pact criteria.

Figure 1 shows the discretionary impulses of monetary and fiscal policy on the (cyclically) adjusted budget deficits from 2000 to 2003. Germany is together with Japan, the country with

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1 For a comprehensive overview see: Alesina, Alberto/ Perotti, Roberto (1995): The Political Economy of Budget Deficits", IMF Staff Papers 42, 1995.

2 The hypothesis of the fiscal illusion states that the present use of public expenditures is systematically overrated by the voter, while the future loss due to fiscal charges is underestimated. Since the public expenditures are financed by deficits and the tendency of politicians to act opportunistic due to their personal goal of re-election, deficit spending increases in particular before elections. Thus in times of recession the level of the public expenditures is kept appropriately high but at the same time is not decreased in boom times, since voters will not consider the intertemporal restriction of the budget. Consequently the volume of expenditure is far above the optimum entailing a gradually increasing debt.

3 Neck, Reinhard (2004): Staatsverschuldung aus politisch-ökonomischer Sicht: Theorie und österreichische Evidenz, 2004.

4 Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 2003/2004 "Staatsfinanzen konsolidieren - Steuersystem reformieren" S 393.

5 For a short description see also: Schettkat, Ronald (2004): Aggressive Geld- und Fiskalpolitik überwindet Rezession, Wirtschaftsdienst 2004, 3, 2004.

the least changes within the last three years. Changes in budget deficit though fiscal policy are recognizable only in the United Kingdom and the United States.

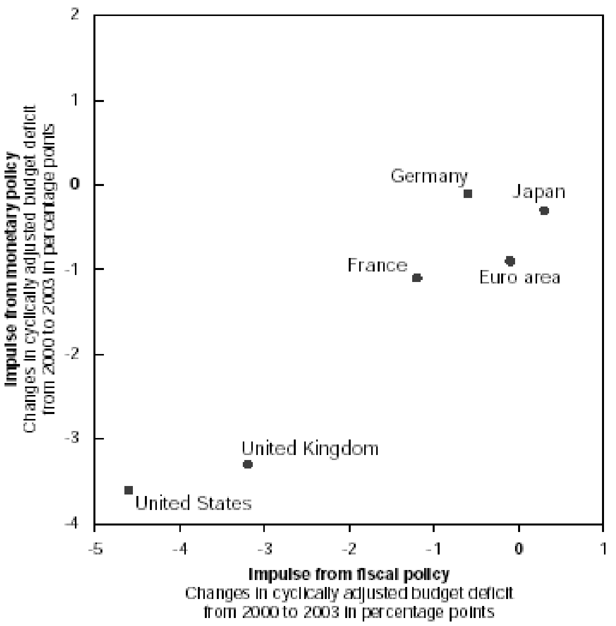

Figure 1: Discretionary impulses from monetary and fiscal policy since 2000

Source: German Council of Economic Experts (2004): Annual Report 2003/04: Consolidate public finances – reform the tax system, p. 10.

"The idea that the arsenal of fiscal policy instruments can and should be used to effectively counter the current cyclical slowdown has gained importance in recent years in Germany as elsewhere."[6] Through advancing the third stage of the tax reform, a tax relief will be triggered that will partly be financed by higher borrowing. Apparently, local governments do not know yet how to finance their share.

Also, the effect of the reforms may not necessarily be anti-cyclical. Due to the deferred reaction of consumers and industries, the effect on the economy could be too late and therefore pro-cyclical rather than anti-cyclical.

6 Sachverständigenrat: Jahresgutachten 2003/2004 l.c., p. 23f.

2 Indebtedness and limits of public debt

2.1 From political debt-abstinence to debt as an equal financing instrument – change of debt policies over time

Until the mid-60's a first phase of debt policy in Germany was characterized by avoiding public borrowing. This idea was manifested in the German Constitution of 1949, which states that the admission of public debt was "only with extraordinary need and generally only for expenditures for recruiting purposes" (art. 115 GG, old version). By contrast today's general rule is that the new credits must not exceed the sum of the expenditures for investments planned. Exceptions are permitted in order to protect the overall economic equilibrium against a disturbance. A second phase, which ended in 1970, introduced the use of anti-cyclical fiscal policy. Expenditure programs intended to fight recession were launched in 1966/67 and public credits rose. At the peak of this development, the Law for the promotion of stability and growth was enacted in 1967.

> EXCURSUS
>
> LAW OF PROMOTION OF STABILITY AND THE GROWTH OF THE ECONOMY (Stability and Growth Law, StWG) of 1967 embodied goals and instruments of an demand-oriented economic policy. In its first paragraph it determines, the overall economic goals:
>
> The stability of the price level, a high level of employment, a balanced account of payments (außenwirtschaftliches Gleichgewicht) and sustainable economic growth. In 1960's the general idea of global control was established. The goal was steady growth without larger fluctuations by employing political instruments to smooth those fluctuations that are caused by market conditions. The creation of an economic situation balance reserve[7], additional business-cycle-charge on the income tax and corporate income tax[8] and a medium-term financial plan and

[7] Herewith in times of boom a share of the revenues from taxes is kept aside to dissolved and use these reserves for demand programs in recession phases.

[8] In times of boom the taxes will be temporarily increased and in recession phases these funds will be repaid to the taxpayers.

the Finanzplanungsrat, a panel that was to give advice on financial matters and control the coordination of the expenditure plans were some of the Instruments of the StWG. Nowadays the StWG is scarcely put into action.

By the end of the recession at the beginning of the 1970's, public borrowing had become an instrument of allocation and distribution policies. Credits had reached the status of a regular financing instrument. In the budgetary law reform of 1969 the appropriation of public credits for federation and countries waived. As a result, public debt increased massively at the regional government level. This period ended in 1976/77 with first efforts of consolidation.

The fourth phase was characterized by consolidation. From 1978 there was a shift to raising foreign instead of national debt, which was politically motivated through the focus on a positive balance of payments. Between 1982 and 1989 Germany put some effort in the sustainable reduction of the net borrowing. The sixth, and still abiding phase started with the German reunification. It entailed extremely high financial requirements. In addition to this, old debts of the former German Democratic Republic (GDR) were taken over and in consequence the indebtedness of the Germany was soaring (see Figure 2).

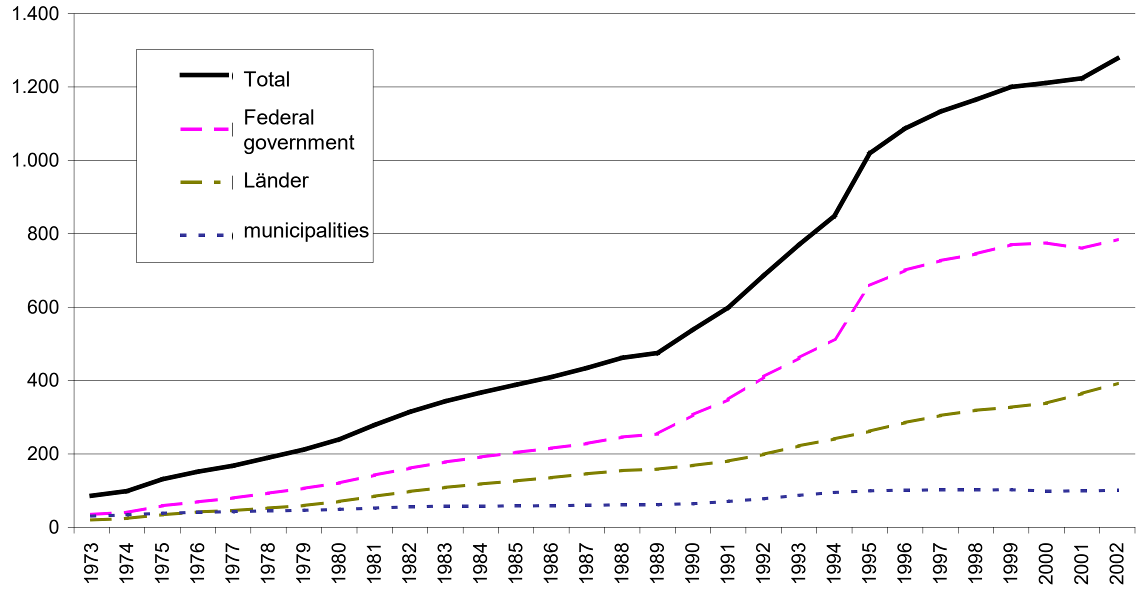

Figure 2: Debt conditions in billion euro

Source: Sachverständigenrat: Jahresgutachten 2003/2004 l.c.

2.2 The Effects of German reunification on the development of public debt

The reunification of the two German states entailed several historically unique challenges. Above all, within the financial sector the integration of the new Laender meant an enormous financial effort. The hope, that the new Laender would be within a few years more or less self-supporting, could not be fulfilled. As a result, the majority of financial activities were financed through credits, which could not be amortized yet. Therefor, the national debt increased substantially in the early nineties. The absorption of the old debts of the former GDR also led to a significant boost of debt and net borrowing. The ever growing volume of the public indebtedness was marked by two characteristics:

1. A concentration of public debt at the federal government level because of the German reunification (net borrowing of the federal government in 1991was nearly twice as high as the net borrowing of the German states).

2. The establishment of extra budget funds to carry out public borrowing (e.g. ERP-Sondervermögen, fund „Deutsche Einheit", credit fund, trust establishment). Eventually, the debt grew from 6.75 billion DM in the year 1989 to 294.9 billion DM in the year 1995 (more than 3,000 %).

2.3 The effects of debt on the structure of the public budget

The growing volume of public debt has had a tremendous effect on the structure of the public budget, most of all due to the rising interest payments. Figure 3 illustrates the dimension of this development.

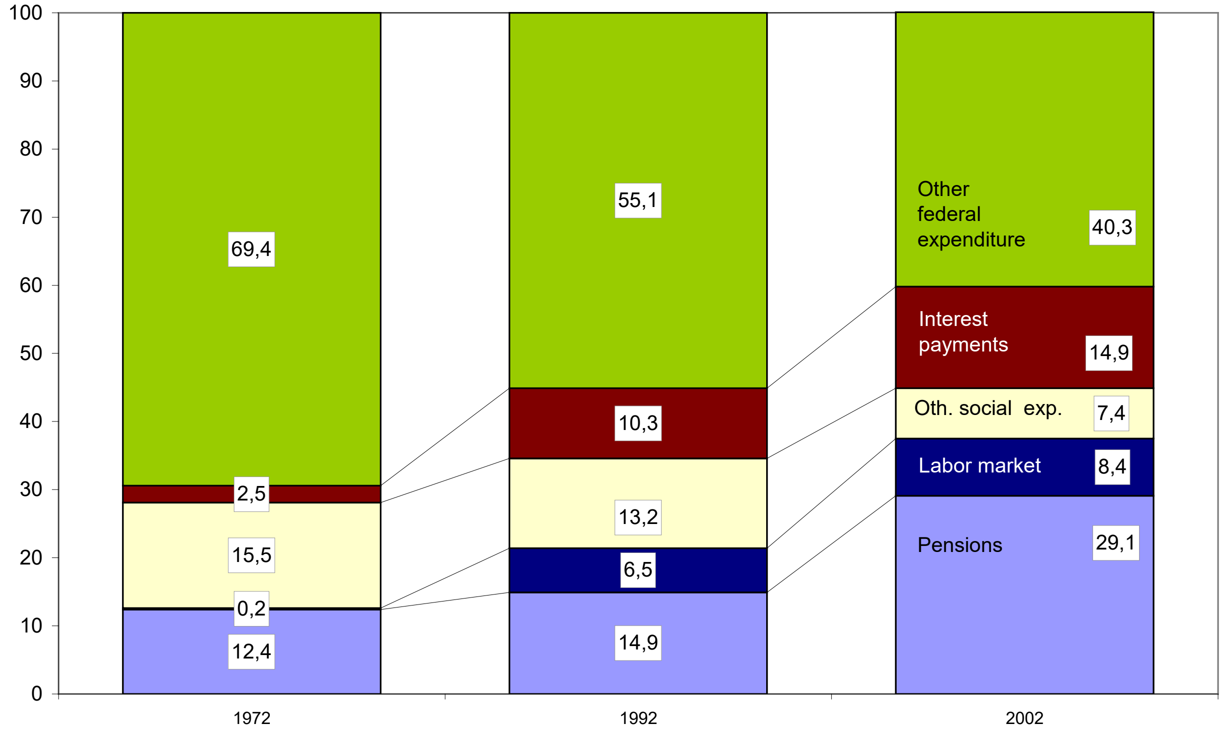

Figure 3: The structure of federal expenditures in 1972, 1992 and 2002, in %

Source: Federal Statistical Office.

2.4 Recent development of debt conditions and net borrowing

In 2003, after experiencing a deficit of more than 3 per cent in 2002, again the deficit ratio could not stay below the ceiling set by the Maastricht criteria. The Federal Government and the Laender run high deficits, but also the social security funds and municipalities also took part in this development.

	public debt	net borrowing	deficit spending quota	in % of GDP[1]
total	**1.239,8**	**45,5**	**7,0**	**58,8**
federal government	719,4	31,9	10,5	34,1
Sondervermögen	59,2	-7,8	-	2,8
Laender	384,8	20,6	7,1	18,3
municipalities	76,4	0,9	0,6	3,6

[1] according to the calculation of the financial statistic

Source: Deutschland in Zahlen 2003

Since net borrowing exceeded by far the planned investment spending and because of the existing legal limits of the public borrowing (article 115 para. 1 of the Basic Constitutional Law), the German government had to declare the disturbance of the overall economic equilibrium.

2.5 Current legal conditions and discretion in debt policies on different government levels

Despite the legal regulations, reality deviates from these restrictions. Thus general absolute limits of the public debt are hard to define, debt limits can be reached and exceeded whenever the goals of the economic policy are endangered. Therefore, the "debt optimum" may legally tenable as long as additional credit-financed expenditures altogether or in special form (e.g. public investments)

- lead to a better utilization of production factors,
- expand or improve the potential of economic production, or
- leave to expect a further approximation to the desired distribution

2.5.1 Adherence to the Maastricht criteria/ Stability and Growth Pact

2.5.1.1 The treaty of Maastricht[9]

The treaty of Maastricht involves five criteria of convergence. National governments have to comply with those criteria, if they want to join the 3. Stage of the European Monetary Union, which means introducing the Euro as national currency.

The criteria are the following:

- The rate of inflation lies at a maximum of 1.5 percentage points over those of the three most price stable countries of the monetary union.
- The long -term interest rate lies at a maximum of 2 percentage points over that of the three most price stable countries.

[9] To the rules and operating mode of the European Stability and Growth Pact see: Hefeker, Carsten (2002): Stabilitätspakt und glaubwürdige Fiskalpolitik, Wirtschaftsdienst 2002/ 3.

- The public deficit (net borrowing) does not exceed 3 per cent of the gross domestic product.

- Public debt does not exceed 60 per cent of the gross domestic product. Exceptions are made if public debt, exceeding the limit, approaches the reference value.

- The margin of the fluctuation of the rates of exchange permitted in the 2. Stage of the European monetary system was not exceeded for at least 2 years.

In 2003, the total of public debt was 62.7 per cent of the gross domestic product in the year 2003. The deficit ratio amounted to 3.7 per cent.

EU- member states are responsible for the deficits in the entire public sector (including the deficits of the regional and local authorities as well as the social security).

2.5.1.2 The Stability and Growth Pact

The Stability and Growth Pact is an agreement that which is to limit the issuance of new debt by the individual EU-member states.

In the Maastricht treaty of 1992 the members of the European Union agreed on the convergence criteria. On initiative of the German Minister of Financesome of these criteria were legally anchored in the Stability and Growth Pact also for those countries, which are members of the EC but did not enter the 3. stage yet. Stability and Growth Pact demands also an approximately balanced national budget, so that in economically unfavorable times there is still some discretion, to stabilize the economy by increasing public spending (new indebtedness at 3 per cent maximum of the gross domestic product).

2.5.1.3 Legal basis and procedure in Germany and on the problem of enforceability

Legally, the federal government is responsible for the obligations from the Stability and Growth Pact (HGrG § 51a). .

The deficit, as defined by the national accounting and relevant for the computation of any punishing payments, amounted to 4.1 % of the nominal gross domestic product in 2003. Thereof 3.8 % were of the jurisdictions and 0.3 % of the social security. Regarding the jurisdictions, the share of the federal government was 1.9 %, which was 0.3 % higher than in the previous year (1.6 %). The share of the Laender amounted to 1.8 % (after 1.5 % in the previous) and the municipal share was negligibly small with 0,1 % in both years."[10]

At first sight, it seems plausible that Laender and municipalities should also be obligated to the deficit criteria of the European Union and also take part in the payments to the European Union. But, contrary to the situation at the federal level, Laender and municipalities are not necessarily responsible for the causes of budgetary deficits. The Laender and municipalities have less budgetary discretion than the federal government. Their deficits can result from additional expenditures on the grounds of not sufficiently compensated new tasks delegated to the subnational level and decisions of the federal legislator over taxes.[11]

A goal of the Stability and Growth Pact is it to achieve and secure solid public finances in the economic and monetary union. The Deutsche Bundesbank states that "…the flexibility of financial policy of the member states is by no means limited by the pact over fee.[12] A budget, that is at least approximately balanced in the medium-term, provides the necessary conditions for the effect of the automatic stabilizers.[13] Solid public finances promote growth and employment and help to master the demographic challenges which will lead to a substantial burden of the social security systems. Healthy finances of the individual member states are an essential condition for the European system of the central banks to ensure price stability durably with a relatively low rate of interest."[14] In opposition to the just cited German Federal Bank Bofinger and others emphasizes that price stability in Germany is given despite the deficit.[15]

Since the Stability and Growth Pact is that controversial the enforceability of the Pact is tremendously weakened. It seems that the objectives are clear, but issue of the adequacy of the financial ratios applied is not solved yet.

In 2004, after a budget deficit of 4.1 per cent of the nominal GDP in 2003, Germany will exceed the deficit limit for the second consecutive year. Although the deficit is decreasing (but

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10 Sachverständigenrat: Jahresgutachten 2003/2004 l.c., p. 432.

11 Benz, Artur: Bundesstaatskommission, DrS 28 #16.

12 A clear contradiction a stated by: Bofinger, Peter (Würzburg University), in: Stabilitätspakt: Soll die Bundesregierung mehr sparen in Frankfurter Allgemeine Zeitung, 20.11.2003, Nr. 270/ page 15.

13 Also: Peffekoven, Rolf (Mainz University), in: Stabilitätspakt: Soll die Bundesregierung mehr sparen in Frankfurter Allgemeine Zeitung, 20.11.2003, Nr. 270/ page 15.

14 Deutsche Bundesbank, Auszüge aus Presseartikeln Nr. 38, 8. September 2004, p. 3.

15 According to Prof. Dr. Bofinger: Stabilitätspakt l.c.

still higher than 3 %) the German government is still far from achieving the medium-term objective of a balanced budget.

An excessive deficit procedure was initiated against Germany at the beginning of 2004. A similar procedure has also been initiated against France. The ECOFIN Council's decision at its meeting at the start of November to postpone a ruling on the European Commission's recommendations to France pursuant to Article 104 (9) of the EC Treaty has caused a controversial discussion. The European Commission's recommendation to tolerate France's overshooting of the 3 per cent ceiling up to 2005 in return for a promise to reduce the cyclically adjusted deficit ratio by 1 percentage point was a difficult move with consequences not be seen yet.

If the deficit limit is exceeded caused by a during a not excessively dramatic downswing of the business cycle - as in the case of Germany and France - this can only be explained by a failure to consolidate in the recent past. In this case there is indeed a conflict of aims between short-run anti-cyclical requirements and the deficit criteria prescribed by the Pact.

In order to bring government deficits below the 3 per cent ceiling two basic options to choose are left for the countries concerned: a pro-cyclical policy or the acceptance of an excessive deficit procedure together with its possible consequences.

Instead of discussing this conflict of aims openly the exceedance of the deficit limit without sanctions harms the Stability and Growth Pact, so it seem, even more. The decisions of the European Commission and of the Council of Ministers in the excessive deficit procedure must be viewed critically.

If a country does not manage to lower the deficit, the envisaged sanctions normally start with an unremunerated cash deposit. Only in the event of a continuing infringement would the cash deposit be converted into a fine.[16]

Within Germany the discussion is divers. The German Advisory Council at the Federal Ministry of Finance is in favor for a German Stability Pact that fixes the rules more effectively than the European one. On the 4th of July 2003 it demanded:

- the clarification of permissible discretion

[16] Sachverständigenrat: Jahresgutachten 2003/2004 l.c.

- a transparent monitoring device
- an improved availability of information to control
- sanction mechanisms in the federation land relationship
- improvement of the procedure to correct discrepancies (prognosis, tuning, actions)

In order to comply with the obligations of European Stability and Growth Pact the Financial Planning Council decided that the federal government has to decrease its expenditures on the average by 0.5 per cent per year between 2003 and 2004. States and municipalities are supposed to limit their annual growth in expenditures to 1 per cent per year. From these growth rates of expenditures in 2004 the shares of the expected deficit divide in 45 per cent for the subnational authorities and 55 per cent for the federal government and the social security funds. [17]

2.5.2 Federal government level

At the federal government level the issuance of credits is only possible within the limits provided by the German Constitution (art. 115 para. 1 GG).

This article implies that income gaps cannot be closed through credits. However, this authorization can also be too permissive, e.g. if more revenue from taxes is generated than expenditures estimated (which are then legally fixed). The budgetary surplus[18] should theoretically be used to repay credits. Practically though, because of the leeway through art. 115 para. 1 GG, the surplus is used to finance expenditures that exceed the previously fixed legal authorization[19].

Art. 115 para. 1 GG also leaves a variety of possible interpretations of the term *estimated investment* (delimitation of the public investments; gross or net investment). Art. 109 para. 2 GG. forms the first (and last) constitutional limit for issuing credits. The exception is (again) the overall economic equilibrium (accordingly: art. 18 para. 1 BHO). The result is the *situational covering principle*, also laid down in art. 1 StWG, which marks the limits to the endangerment

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[17] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 2002/2003 "Zwanzig Punkte für Beschäftigung und Wachstum", p. 541.

[18] The respective article of the German budget law is: BHO § 25 surplus, deficit (1) – (3).

[19] Dreißig, Wilhelmine (1981): Die Technik der Staatsverschuldung, in: HdF, Bd.III, 3.Aufl., 58.

of the overall economic equilibrium. The very broad interpretation of the latter term is very problematic.

Moreover, at the federal government level, a supervisory authority and usual licensing procedures as they exist at the local level is missing. The legal examination is possible only ex post. The question, whether or not the national budget is able to finance the national tasks in the long run, is not audited in the national budgetary law. Keeping this in mind it is not at all surprising, that the debt of the federal government (and Laender) rose significantly faster than the debt of municipalities.[20]

2.5.3 Regional government level

2.5.3.1 Different basic conditions and the financial equalization scheme between the Federal Government and the Laender

The investment behavior and indebtedness vary tremendously among the German States. It depends on

- the natural endowment and the history of economic development (e.g. industrial vs. agrarian etc.)
- the location (e.g. west or east German States)
- the population (e.g. necessary conversion or readjustment of urban sparsly populated areas))
- the regional state government and opposition
- possibly unusual conditions (metropolitan areas, ports etc.)

From different endowments result different financial needs. To create a similar financial starting point and to ensure comparable living conditions in all German states, the financial equalization scheme between the Federal Government and the Laender, is aimed at balancing the differences between the income from taxes etc. and the financial needs to a certain degree. Moreover, the scheme considers special needs, such as city states, ports, and sparsly populated areas. Thus, by considering special needs the financial equalization results indirectly in a significant decrease of the debt volume of the Laender.

[20] Schwarting, Gunnar (2002): Kampf gegen den Kollaps - Haushaltskonsolidierung in den Kommunen. In: bfd info, Dezember 2002 Nr. 6.

Problematic, of course is the incentive effect of the financial equalization. Since this is rather small for regional authorities to make a better use of their tax base. To solve this problem a Model of Premiums was developed.[21]

2.5.3.2 Legal and political limits of public debt

For the regional authorities the limitation of issuing debt to the volume of investments is not constitutional. It is regulated in state budget law.[22] The Laender also have to consider the goal of stability.[23] At the regional level, there is very little room for autonomous maneuver concerning consolidation measures on the expenditure side. Also, there are few possibilities to interfere on the revenue side, since the regional authorities draw their revenues mainly from joint taxes.

As a result, although the relative volume of the financial means per person in a regional authority is quite similar, the structure of revenues of the Laender regarding the main source of income (income from tax or assignments) is quite divers. The only limitation for credits is the volume of investments. Thus, there is a direct connection between investments and the new public debt and a decrease of the investment volume lowers the limit of debt.

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[21] On the effects of the model of premiums see: Lenk, Thomas/ Kaiser, Karolina (2003): Das Prämienmodell im Laenderfinanzausgleich - Anreiz- und Verteilungswirkungen, Diskussionsbeiträge der Wirtschaftswissenschaftlichen Fakultät, Nr. 42, Leipzig 2003.

[22] Dreißig, Wilhelmine (1981): Staatsverschuldung, l.c.

[23] Constitution of the **State of Saxony** from 27 May 1992 (SächsGVBl. p. 243) article 95: The admission of credits as well as each assumption of endorsements, warranties or other guarantees, which can lead to expenditures in future years, require an authorization by law. The incomes from credits may not exceed the sum of the expenditures for investments, estimated in the budget,; Exceptions are only permissible for the protection against a disturbance of the overall economic equilibrium. The details determine a law." **Baden-Wuerttemberg** article 84: the admission of credits as well as each assumption of endorsements, warranties or other guarantees require an authorization by law. The incomes from credits may not exceed the sum of the expenditures for investments, estimated in the budget; Exceptions are only permissible for the protection against a disturbance of the overall economic equilibrium. The details are regulated by law. **Berlin** article 87 (2) credits may be only taken up, if other means are missing for covering. The incomes from credits may not exceed the sum of the expenditures for investments, estimated in the budget; Exceptions are only permissible for the protection against a disturbance of the overall economic equilibrium. The details are regulated by law. **Likewise** Brandenburg, Bremen, Hessen, Mecklenburg-Western Pomerania, Lower Saxony, North Rhine-Westphalia, Rheinland-Pfalz, Saarland, Saxony, Saxony-Saxony-Anhalt, Schleswig-Holstein, Thuringia. **Modifications**: Hamburg article 72 [credits, securities, state property] for (1) only with extraordinary need and usually only for expenditures for recruiting purposes funds in the way of the credit may be procured; for this it requires a resolution of the citizenry.

2.5.4 Municipal level

2.5.4.1 Starting point of the municipalities and financial equalization at the local government level

The starting point for the municipalities is very similar to the one of the Laender: the endowment of the individual municipalities and the historical developments is quite divers. Again the very different primary revenue from taxes per capita is equalized to a certain degree in all regional states through the financial equalizations at the local level. Just like the financial endowment of the Laender, the financial endowment of the municipalities will be adjusted to the individual need, so that the relative[24] volume can be comparable, but the structure will still be distinctively different. One can notice a particularly big difference between the East and West German States regarding the structure of revenues, since the tax base in east Germany is still much weaker than in the old Laender (see Saxony as an example in Figure 4).

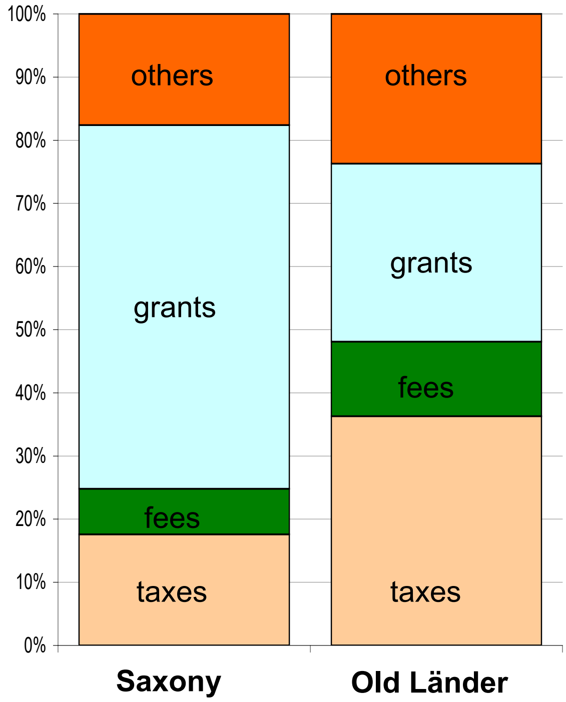

Figure 4: Revenues of the municipalities 2002 in per cent.

Source: Statistical office of Saxony.

[24] Relative to population and need, that is.

2.5.4.2 Legal basic conditions at the municipal level

At the local level, one can find the same conditions for credits as on the other administrative layers: The volume of new issued debt is here also connected to the expenditures on investment, only without the strong reference to the overall economic stability. Raising a credit requires permission through the supervisory authority of the respective regional authority.

The supervisory authority will not approve the credit, if the developing continuing burden (primarily the debt service) does not correlate with the continuing financial sustainability of the municipality. As an indicator the "*Freie Spitze*" is used, which is little different from the difference of net borrowing and regular repayment costs plus credit procurement costs.[25]

In order to determine the financial means necessary to maintain financial sustainability municipalities are supposed to provide a long-term budget plan (5 years).

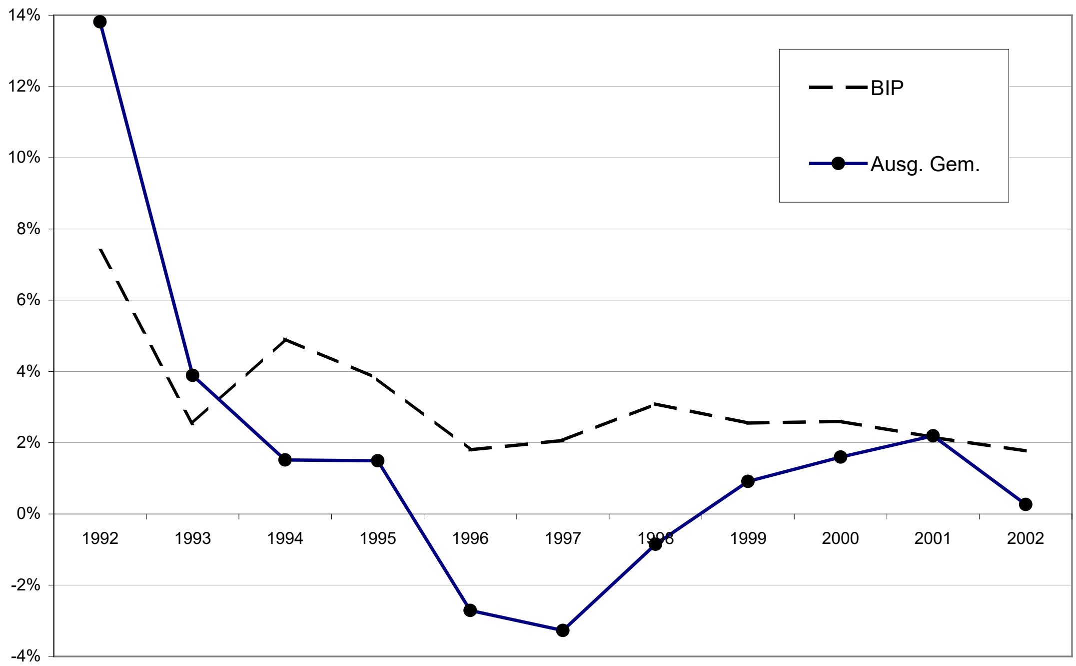

Figure 5: Growth rates of the gross domestic product and expenditures for the municipalities 1992 – 2002 compared to the previous year

Source: Sachverständigenrat: Jahresgutachten 2003/2004 l.c., S. 564f

[25] Grossekettler, Heinz (1999): Öffentliche Finanzen. In: Vahlens Kompendium der Wirtschaftstheorie und Wirtschaftspolitik. 7. Auflage, Vahlen, München 1999, S. 519-672.

2.5.4.3 Budgetary deficit and indebtedness – the situation at the municipal level

A balanced budget is defined over the ability to service the debt. The budget is legally balanced, if the current revenues are sufficient to cover the current expenditures including interest payment and the regular repayment.[26] Thus, one indicator of the financial health of a municipality is the ratio of the surplus of the current account to the repayment.[27]

1993 to 2003, there were in total five years (1995-1997, 2002, and 2003) that showed a negative ratio for the average local jurisdiction in the western part of Germany.[28] It is to be expected, that the municipalities in the eastern part of Germany hold a ratio even worse.[29] According to the currently planned budget of the individual municipalities, there would be no deficits in Baden-Wuerttemberg, Saxony, and Thuringia and very high deficits in Brandenburg, Hesse, Mecklenburg-Western Pomerania, Lower Saxony, North Rhine-Westphalia, Rhineland-Palatinate, and the Saarland.[30]

It is possible to finance deficits of the current period through *cash credits*. These credits are given to the municipalities to finance short-term deficits and unexpected costs. The rise of these credits that have high interest rates are legally only for the short-term use. Practically though, they are also used to fill long-term financial gaps. The rising volume of cash credits causes also the rise of the interest rate and the risk of financial default. [31]

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26 Schwarting, Gunnar (2003): Haushaltskonsolidierung in Kommunen : Leitfaden für Rat und Verwaltung, Erich Schmidt, Berlin 2003.

27 Zimmermann, Horst (1999): Kommunalfinanzen, 1. Aufl., Nomos Verl.-Ges., Baden-Baden 1999.

28 Schwarting, Gunnar (2004): Einige Gedanken zur fiskalischen Disziplin kommunaler Gebietskörperschaften in Deutschland, Beitrag im Finanzwissenschaftlichen Ausschuss VfSP 2004.

29 Bund der Steuerzahler: Each year in the spring the Bund der Steuerzahler accomplishes a local survey. Budgetary deficits, control items and tax receipts of the municipalities are queried. For the inquiry from the spring 2003 numbers from the current budgets were queried. Thus, it concerns data, with which the treasurers planned for the year 2003. Bund der Steuerzahler (2003): Kommunalumfrage in http://www.steuerzahler.de/inhalt/static.phtml?link=zahlen/staedtevergleich.htm (13.09.2004):

30 Whereby in some Laender it is fixed in the Constitution that the budgetary planning must set up a balanced budget. Consequently, the aimed budget plan of these regional authorities, e.g. Baden-Wuerttemberg and Thuringia, is not fully reliable.

31 Schwarting, Gunnar (2004): fiskalische Disziplin, l.c.

2.5.4.4 On the problem of the financial adhesion of the regional authorities

Art. 28 para. 2 GG guarantees general autonomy and in particular financial autonomy to local governments.[32] Although, *financial autonomy* is not clearly defined, it is explicitly laid down that financial autonomy includes financial self-responsibility.

The general local autonomy implies the right of local government to "regulate all affair of the local community". This requires that the necessary financial means are being provided. While the Federal Constitutional Court leaves the question open explicitly[33], The literature, the Laender constitutions and the Laender constitutional laws consent on the fact that one can derive a right of a minimum financial endowment of municipalities from art. 28 para. 2 GG in connection with the individual regional constitutions.[34] However, there is plenty of room for the interpretation of terms such as "*appropriately", "give up adequate", "financial minimum requirements", "viability*".[35] The claim could be regarded as justified, there share of obligatory tasks lays at approx. 90 per cent.[36] Moreover, the principle of connexity (Konnexitaetsprinzip[37]) is written down in most of the Laender constitutions. Also, the possibilities of shortening the public supply and consolidate the finances are relatively small.

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[32] Which is defined by the Federal Constitutional Court with the "Entitlement to full self-responsible decisions on income and expenditures in the context of a legal household".

[33] The Federal Constitutional Court in its decision of 15.10.1985 (BVerfGE 71, 25) deliberately did not deal with the question whether the municipalities are entitled to a minimum financial endowment based on art. 28 para. 2 GG. It explained, that the in art. 106 para. 5 GG guaranteed local tax participation must not to a fall below the "guaranteed total volume of the municipal financial endowment" as described in art. 28 para. 2 GG. According to the report of the *Gemeinsame Verfassungskommission* the Constitutional Law did explicitly not intend to lay down the right of financial provision for the municipalities in the Basic Constitutional Law, but define the financial responsibility as part of the autonomy of municipalities. (see also: Schoch, Friedrich/ Wieland, Joachim (1995): Finanzverantwortung für gesetzgeberisch veranlasste kommunale Aufgaben, p.. 182 f.; Scholz in Maunz, Theodor/ Düring, Thomas (1997): Grundgesetz, Kommentar, Roman Herzog/ Hans D. Klein/ Peter Lerche u.a. (Hrsg.), Stand: November 1997, München., Nr. 84 a, Ausführliche Darstellung der Entstehungsgeschichte bei Mückl, S. 67 ff.S.92f.; Schoch/how/as country, P. 182 f.; Scholz in Maunz/Duering, GG kind. 28 Rn 84 A, detailed description of the developing of the history with, Mückl, Stefan (1998): Finanzverfassungsrechtlicher Schutz der kommunalen Selbstverwaltung, Schriften zum deutschen und europäischen Kommunalrecht, Band 9, p. 67 et seqq.).

[34] 73 (1) Verf BW; 83 (2) S2 (4) s 4 Bay Verf; 99 (2) BraVerf; 137 (5) HessVerf; 73 (1, 2) Verf MV; 58 NdsVerf; 79 VerfNW; 49 (5) Verf RP; 119 (2) Verf Saar; 87 (1) SächsVerf; 88 (1) Verf LSA; 48, 49 (1) Verf SH; 93 (1) s 1 Thür Verf. Exemplarily shown from article 88 paragraph 1 Verf LSA: "the country ensures that the municipalities have the financial means for the appropriate fulfillment of their tasks." And article. 59 Nds. Verf: "the regional authority is committed to provide the necessary means to enable the municipalities to fulfill their tasks by the development of own tax sources … and through a financial equalization scheme on the local level.".

[35] For literature and court decisions see Engelsing, Felix (1999): Zahlungsunfähigkeit l.c., Fn 198.

[36] Schwarting, Gunnar (2004): fiskalische Disziplin, l.c.

[37] Basically, the *Konnexitätsprinzip* states, that the regional authority has to compensate local government for the costs caused by the fulfilment of tasks that are handed down from the regional to the local level.

Some kind of "dogmatic support" may be also found in Art. 155c para. 3 GG, which states that in the case of distress and defence the Laender have to maintain the viability of the municipal level. Some leading lawyers opt now for the reversal conclusion, saying that what is applicable in times of war has to be true also in times of peace. Therefore, Laender governments are responsible for the solvency of its municipalities.[38]

Nevertheless:

a) the claim of the municipality depends on the financial discretion of the Laender,[39] and

b) the endowment of the municipalities with a minimum of financial means requirements is not necessarily equivalent to the financial adhesion of the Laender for insolvent municipalities.

However, the main problem can be stated as follows: by the adhesion of the regional authorities and through grants, the so called *bailing out*, economically unreasonable incentives can be created. This way, failures in fiscal policy is accepted and the fiscal discipline weakened.

One possibility to solve the conflict is to make a distinction between externally or internally caused insolvency of a municipality[40]. To draw this kind of line would be quite important, in reality though it is hardly feasible. If the liquidity problem of the municipality is caused by factors that are not within the sphere of influence of the municipality (for example an overloading with tasks through the regional administration or changes in the federal law), art. 28 para. 2 GG and the Laender constitutions would request that the Laender governments provide financial support. On the other hand, if the deficit of the municipality is caused by inefficient fiscal policy within the municipality[41], there would be legally no right to claim financial support.[42]

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[38] See also: Kirchhof, Ferdinand (1995): Gemeinden und Kreise in der bundesstaatlichen Finanzverfassung, in: J. Ipsen (Hrsg.), Kommunale Aufgabenerfüllung im Zeichen der Finanzkrise, 1995, p. 59; Schoch, Friedrich (1997): Verfassungsrechtlicher Schutz der kommunalen Finanzautonomie: Darstellung am Beispiel saarländischer Kommunen, Schriften zum deutschen und europäischen Kommunalrecht ; Bd. 5, Stuttgart u.a. 1997., p. 153; Schwarz, Kyrill-Alexander (1998): Staatsgarantie l.c., p. 35.

[39] For decisions of Court of Justice see: Engelsing, Felix (1999): Zahlungsunfähigkeit l.c., Fn 224.

[40] According to Engelsing this decision is sensible but with the appliance of art. 28 para. 2 not necessary. Because from there a financial support of the provision of the local public service through the regional authority is derivable, independently from the fact whether the cause is to be searched with external factors or internal mismanagement.

[41] For possible causes see Schwarz, Kyrill-Alexander (1998): Staatsgarantie l.c., p. 37 f.

However, there is no legal procedure to satisfy creditors in case of local default in Germany.[43] Such procedure is ruled out by law. Creditors have to wait until the municipality is again solvent enough to satisfy their claims.[44]

An instrument to balance the budget expost are the so-called *Bedarfszuweisungen* in the financial equalization at the local government level. Those are grants to the municipalities if the primary income possibilities do not suffice to finance the tasks of the respective municipality. However, municipalities have no legal claim to those grants. The supervisory authority closely examines the situation of each individual municipality. If the municipality has exhausted all possibilities of cutting back expenditures and raising revenues, financial grants may be provided.[45] The financial means of the Bedarfszuweisungen are "… grants intended as assistance to self-assistance for budget consolidation only."[46] This assistance can also be interpreted as a form of bailing out.[47] In many municipalities the Bedarfszuweisungen may still be insufficient to finance the every day public service.

2.5.4.5 Automatic stabilizers at the district level and effects of Hartz IV

There are no automatic stabilizers at the local level. The income tax, that works against the economic cycle on the federal level, may provoke a pro-cyclical behavior of local governments. The municipalities in Germany have a share in the total revenue from income tax of 15 %. If this share of the income tax is not saved in boom phases, but immediately spent it fuels the overall economic demand.

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42 Meanwhile, some of the Laender use this argumentat in order to exclude themselves from the guarantee: "obligations, which from (credit) contracts between Saxonian municipalities and third result, are on level under private law locked contracts. They do not justify a legal relation with the State of Saxony… Therefore the Free State is not under private law obligated to take responsibility for liabilities of municipalities… public regulations or legal maxims, from which a direct beginning obligation could arise for the Free State e.g. for a credit with inability to pay of a municipality, exists." Answer of the Saxonian Department of State of the inside of 4.9.1996 on the small request of the delegate Heiko Hiller of 25.7.1996, LT Drs. 2/3666; see in addition also: RdErl. III NR. 89/1994 (payment obligation of municipalities) of the ministry of the Interior v. 2.12.1994, Abl. Brandenburg P. 1726.

43 as it is offered in Chapter 9 of the US insolvency law.

44 See for many other art. 77, para. 1 and 3 of the Bavarian *Gemeindeordnung*, Schwarting, Gunnar (2004): fiskalische Disziplin, l.c.

45 See also: Schwarting, Gunnar (2003): Haushaltskonsolidierung, l.c., S. 105f.

46 cp. Verwaltungsvorschrift des Sächsischen Staatsministeriums der Finanzen über das Antrags- und Bewilligungsverfahren sowie die Verteilung der Mittel für Bedarfszuweisungen und über die Verwendung der investiven Schlüsselzuweisungen zur außerordentlichen Kredittilgung nach dem Finanzausgleichsgesetz vom 25.4.2003, Abschnitt 0, Ziff.2.

47 *Bedarfszuweisungen* are in instrument that has to be considered very critically. However, they are justified as long as the respective municipality comes into a financial state of distress undeservedly. See: Schwarting, Gunnar (2004): fiskalische Disziplin, l.c.

In recent years and in the foreseeable future the high rate of unemployment and the demographic decline in Germany will raise the cost of social security, which is partly carried by the municipalities. The new law concerning the employment and social security system of the unemployed, *Hartz IV*, which originally meant to take off some of the financial burden of the municipalities, will have tremendous effects on the structure of the public budget. Some of the changes, such as the combination of *Arbeitslosengeld I* and *Arbeitslosengeld II* will presumably lead to an intensified debt problem in the future, others, above all the main goal to reduce unemployment could also have a positive effect on the municipal finances. Thus, the net effect is not predicable yet.

2.6 Instruments to control, cover and sanction debt on the individual levels

2.6.1 Instruments for controlling the Stability and Growth Pact at the federal government level

The conversion of the European Stability and Growth Pact into a domestic German Stability Pact that enforces the goals of the European Pact of the national level have not succeeded so far. The operability of the German Stability Pact, which is controversly discussed, is not yet satisfying. The instruments of the federal government level in Germany are few and weak.[48]

The Stability and Growth Pact was founded primarily to protect the sustainability of fiscal policy. According to Art. 121 (1) of the EC Treaty the member states are to achieve "the sustainability of the government financial position". Whether or not this goal is met is judged based on the fiscal balances and debt levels, despite the fact that these indicators do not fully mirror the economic situation of a federation.[49]

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[48] Bundesministerium für Finanzen (2004) (Hrsg.): Wissenschaftlicher Beirat beim Bundesministerium der Finanzen Stellungnahme, Verbesserungsvorschläge für die Umsetzung des Deutschen Stabilitätspaktes, Berlin, 4. Juli 2003.

[49] "Hence the two indicators fail to reflect the fact that, besides the securitised explicit government debt, a second form of government debt exists, namely the implicit liabilities. The latter arise as the difference between the future unsecuritised payment commitments based on current policy and the future revenue stream that must cover these obligations. Such unsecuritised future payment obligations are rooted above all in the benefit commitments of the social security funds, but also in government pension commitments to civil servants which must be honoured in the future. If future revenue - discounted to the present value - does not suffice to meet future payment commitments, an implicit debt exists. [...] The share of implicit debt in relation to nominal GDP in 2002 is several times higher than the explicit debt ratio of 60.8 per cent." (Sachverständigenrat: Jahresgutachten 2003/2004 l.c.).

In the German stability pact is no monitoring device, comparable to the commission and the ECOVIN council on the European Union level. The Financial Planning Council[50] is not a constant instrument, but rather a conference than a controlling institution. It meets usually only for a spring and an autumn meeting. The political status of the Financial Planning Council is still comparably small. It meets under the presidency of the Federal Minister of finances and under participation of a member of the board of directors of the German Federal Bank and resembles a working committee, which looks for compromises. The resolutions represent only approximate values, which are neither legally nor politically binding. The Financial Planning Council can seize no sanctions and its resolutions hardly find public attention.

The Federal Ministry of Finances, supported by the Lander Ministries of Finances[51], gathers and evaluates the information[52], which indicate deviations from the planned behavior. Also, the Federal Ministry of Finance receives reports on the debt conditions of the Laender four times a year. However, the data are announced in the definition of the financial statistics, which are not yet fully convertible to Maastricht criteria.

Instruments for sanctioning incorrect behavior are not laid down in the German stability pact. That is particularly important, since a procedure in the Federal Constitutional Court to enforce the compliance to the criteria would take too much time. In order to avoid a delay of Germany regarding art. 104 para. 9 EGV[53], it is necessary to implement a punctual and rapidly feasible discrepancy correction procedure for all administrative levels.

2.6.2 Instruments for fiscal control at regional government level

First of all, a financially distressed state has to consolidate the public finances by itself. If this is without success, technically, the federal government and the Laender have to provide financial support. This responsibility derives from the “federal principle” as defined by the German Constitution. However, this is only valid as long as the federal government and the Laender still can fulfill their own tasks despite the additional financial strain. To obtain financial support from the

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[50] HGrG § 51.

[51] Those report monthly the revenue and expenditures and the cash situation of the countries to the Federal Ministry of Finances.

[52] Monthly bulletins in the monthly report.

[53] Consolidated Version of the Treaty establishing the European community.

federal government or the Laender the respective regional government has to present a concept of consolidation, which explains and details the measures that are to be taken.

Another precondition for financial support is the exhaustion of all possible revenue sources such as the disposition of real estate and the full exploitation of the tax potential. To a certain extent, the budget deficit may be balanced through the so-called *Bundesergänzungszuweisungen*, which are paid to regional governments that are not able to finance their tasks.[54]

2.6.3 Instruments for fiscal control at the local government level

2.6.3.1 Market and regulation mechanisms at the local government level

Decisions by a politician on the local government level tend to be sanctioned by the voters more clearly. Thus, the danger of voice loss with the local election, the loss of capital and workers due to their mobility and the loss of credit givers due to a higher loss risk, can endanger the creation of a long term oriented budget policiy.

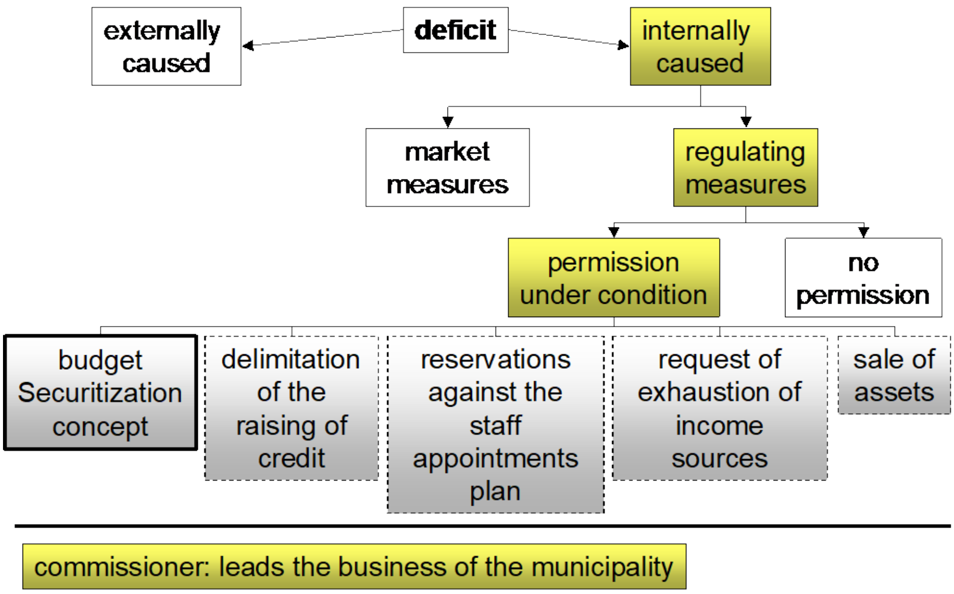

Figure 6: Deficits in the household of the municipality

Source: Own representation following Schwarting (2004) p. 6 - 11.

[54] Weiß, Reinhold/ Hofman, Kai/ Damm, Elmar (2003): Ein neues Notopfer Berlin? Konsequenzen einer Haushaltsnotlage, Justus-Liebig-Universität Giessen, Finanzwisschenschaftliche Arbeitspapiere Nr. 65 – 2003.

As regulating measure there is, above all, the authorization procedure of the budget. In principle not the entire household is subject to approval, but only certain parts. Beside the credit authorization and the commitment authorizations, the maximum amount of cash credits[55] and the staff appointment plan[56] can require a permission.

Fulfils the budget all requirements it will be approved. Likewise it will be permitted, if the requirements are not fulfilled in all points, but the imbalance appears unique and/or not particularly serious. In extreme cases the authorization is not given, which entails a revised version of the budget plan. However, this is very rare in practice.

The middle course between both extremes is the conditioned authorization. These conditions are binding, although neither the Laender nor the federation can put down direct obligatory requirements concerning individual expenditure positions or investments.

If a permission is attached at conditions, the respective municipality has to report in a budget securitization plan (*Haushaltssicherungskonzept*) how the budget reconciliation is supposed to be reached. The budget securitization plan is agreed on by the local council and is again subject to permission of the supervisory authority.

Beside the budget securitization plan the supervisory authority can also delimitate the raising of credits[57], hold reservations towards the staff appointment plan, request the exhaustion of potential revenues and the cutting of expenditures, demand a supplementary budget or the sale of assets.

If the budget can be balanced through these conditions, no further measures become necessary. However, is the acting mayor and/or local council not able or willing to enforce sufficient consolidation measures, the supervisory authority sends a commissioner, who leads the business of the municipality. Since the autonomy warranty is waived completely by this measure, this case does not occur very often in practice, and if, then only in smaller municipalities.

[55] not in Hessen, Mecklenburg-Western Pomerania, North Rhine-Westphalia and Rheinland-Pfalz.

[56] in Mecklenburg-Western Pomerania and Schleswig-Holstein.

[57] e.g. Complete interdiction, limitation on the redemption amount or temporary solutions.

2.6.3.2 Reasons for the failure of the regulating mechanisms

There are plenty of reasons to explain the failure of the regulating mechanisms at the local level. One of the main reasons is the influence of external factors on the local administrative body and its economy, such as economic crises, which are mostly not within the sphere of influense of the municipality and therefore hardly controllable through the local authority itself. On top of that around 90 % of the municipalities have very little discretion on their structure of expenditure due to the large share of obligatory tasks. Following the most typical requirements to reduce the deficit the effect is too small, the deficits are not solvable and the debt cannot be reduced.

Another problem is created through the principle of the equivalence of the living conditions (as stated in the German Consitutional Law), which requires an appropriate infrastructure in each municipality, which means that public services are not shortenable arbitrarily.

If the municipality has only little possibilities to control their own budget the regional authorities or the federal government should get involved. But because of the warranty of local autonomy, that covers also the financial autonomy [58] it is not possible for the higher level of government to interfere with the municipality's fiscal policy.

The supervising authorities that have to monitor the deficits of the municipalities are not able to cope with the large number of cases because of their personnel capacities.[59]

To solve the problem the suggestions range from simple concepts of reducing expenditure by cutting back the public services to complex solutions, implying a complete restructuring of local budgets through a municipal fiscal reform.

3 Summary

In Germany, on all government layers, several challenges exist regarding the assessment of the efficiency of financial planning and the mechanisms to control public debt. The only explicit legal limit, the volume of investment is not clearly defined and therefore of little use to enforce strict rules on the jurisdictions. Even worse is the fog around the term of the "disturbance of the

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[58] Art. 28 para. 2 GG.

overall economic equilibrium", which is theoretically a joint decision of the Minister of Finance, the German Federal Bank and the German Council of Economic Experts. Article 115 of the German Constitution applies only for the planned budget and not for the actual development. Thus, there are few consequences if net borrowing exceeds the volume of investment after the approval of the budget plan.

The central issue on all government levels is that politicians are biased in terms of reelection. The temptation to use revenues from taxes and grants not for the repayment of debts, but for new public expenditures is high during phases of economic recovery and sometimes in the long run economically irrational.

The very different situations among the individual regional authorities and municipalities make it quite difficult to find general applicable rules and restrictions applicable to all jurisdictions. A strong equalization is reached through the financial equalization scheme between the federal state, the Laender and on the local level. The role of the interdependences of the necessary financial endowment of the municipalities and the entailed incentive effects is complex and controversially discussed, especially with regard to the constitutional condition of the principle of the equivalence of the living conditions.

As to the future prospects it is to be said, that even if there was an economic upswing, it is not to be expected that the increase tax receipts and the lowering of the social transfers can outweigh the deficits. The municipal fiscal reform does not fulfill the expectations and so the opportunity to restructure the local budgets remains unused. It will take time to lower the fiscal burdens of municipalities. Also, the budgetary situation of the federal government and of the Laender is rather tense. One could not expect a lot of financial support via financial equalization at the local level. Finally, the overall political trend is to reduce the tax burdens of private industries and households. The result will be an ongoing reduction of public revenue. losses of income for the public sector. The backlog demand with local infrastructure of the rural areas, especially in the north-eastern states is still towering[60]. Also an adjustment of the infrastructure will be necessary because of the demographic decline, which will lead to simultaneous income losses and need increases.

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[59] Schwarting, Gunnar (2004): fiskalische Disziplin, l.c.

[60] Reidenbach, Michael (2002): Der kommunale Investitionsbedarf in Deutschland : eine Schätzung für die Jahre 2000 bis 2009, Difu-Beiträge zur Stadtforschung, 2002.

Other parameters are the intensified competition of local enterprises, including public enterprises, the modernization of the administration, tighter requirements on budget reconciliation through the introduction of the "double-entry accounting system (*Doppik*)"

The actual financial situation of the municipalities and their deficits has reached a point at which conventional consolidation methods are not sufficient any longer. The supervisory authorities are not sufficient in order to keep fiscal discipline.

New and improved instruments need to be implemented, such as the introduction of a risk management which can be organized by the municipalities themselves.

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