

Trends in local authority finance since the mid-nineties

The financial position of the local authorities underwent a reversal in the mid-nineties: whereas in the first half of the preceding decade the local authorities recorded large deficits,¹ they achieved surpluses in each of the last two years. However, since substantial differences continue to exist between the western and the eastern Länder, and between the individual municipalities of a single Land, the financial balance, which is positive on the whole, cannot be taken as representative of a generally relaxed budgetary situation. The following report analyses the trend in local authority finance, paying particular attention to the process of harmonisation between the local authorities in east and west Germany. Instructive commentary is made difficult by the fact that more and more amenities are being removed from local authority core budgets; as a result, the informative value of the corresponding financial statistics is quite limited. This is especially true of major receipts and expenditure items, whereas the financial balance is less vulnerable to distortions resulting from this trend. A separate section is given over to an in-depth analysis of the ensuing problems.

¹ For more details see Deutsche Bundesbank, Trends in local authority finance since the beginning of the nineties, Monthly Report, March 1994, pp. 19 ff.

Overall trend in local authority finance

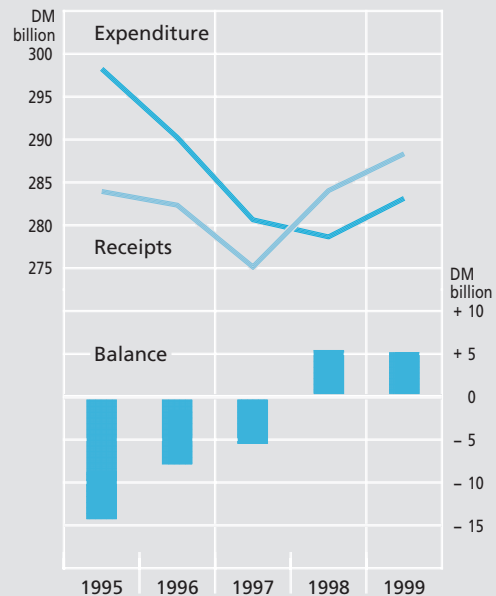
*Progress in
narrowing the
deficits*

In 1995 the budgets of the local authorities² were still showing a deficit – at that time amounting to DM 14 ½ billion – after expenditure had exceeded receipts by more than DM 10 billion in each of the preceding three years. Thus consolidation pressures had built up that were further aggravated in the next two years by a decline in receipts. As a result, the local authorities were obliged to adopt economising measures. Expenditure decreased in absolute terms and in 1999 was, at DM 283 ½ billion, 5 % less than in 1995 (although it should be borne in mind that the extent of the decrease is considerably overstated owing to the outsourcing of municipal amenities). As a result, the deficits had been narrowed rapidly. Indeed in each of the last two years an astonishingly large surplus of just over DM 5 billion was recorded. During those years receipts grew at an unexpectedly fast pace, given the decline of the preceding years. For all that, the total revenue figure for 1999 was only slightly larger than that for 1995, i.e. by just under 1 ½ %. (The various types of receipts and expenditure are listed individually in the table on page 47).

*Differences
between east
and west ...*

Still, the public finance trend for Germany as a whole gives only a general impression based on average values, which must be supplemented by the drawing of more subtle distinctions. The local authorities in western and eastern Germany, for example, did not reduce their deficits to the same extent. The old Länder showed significant improvement in their financial positions, having started with a deficit of just over DM 12 billion in 1995 and

Trends in local authority finances



Source: Federal Statistical Office. Figures for 1998 and 1999 partly estimated.

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having closed each of the last two years of the decade with surpluses of more than DM 5 billion. The budgetary situation of the local authorities in the new Länder also improved, but here the improvement was not as marked. As of last year, they were still running a deficit (approximately DM ½ billion) compared with a financing gap of DM 2 billion in 1995.

Not only do significant differences exist between east and west Germany but even within individual Länder the financial positions of the local authorities may vary considerably.

*... but also
within the
Länder*

² These include district-independent cities, districts, municipalities belonging to a district, and larger associations of municipalities such as the regional associations of North Rhine-Westphalia but not the municipal special-purpose associations. For statistical purposes, the municipal budgets of the city states are treated as belonging to the Länder government level.

Special features of local authority budget law

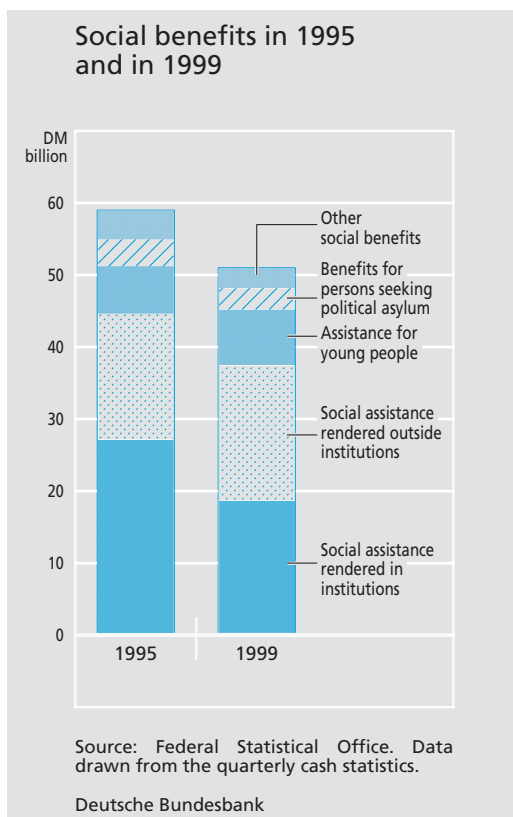
The budget plans of the local authorities discriminate more carefully between items relating to day-to-day operations and items relating to assets and liabilities than do the Federal or Länder budget plans. Current receipts and expenditure are shown in the administrative budget. It is here that receipts from taxes, fees and charges, and transfers from other levels of government that are not restricted to capital expenditure are recorded, as well as personnel expenditure, other operating expenditure, social benefits, other current grants and interest paid. Clearing items relating to capital budget entries and shortfalls in the administrative budgets of previous years are to be listed here, too. The capital budget, by contrast, consists of receipts and expenditure that affect the size of a municipality's assets or liabilities. These include, on the receipts side, investment grants from the Federal Government and the Länder Governments, road and connection contributions, asset sales, borrowing, and withdrawals from capital reserves as well as, on the expenditure side, capital formation, lending, investment grants, the acquisition of participating interests, and redemptions of outstanding debt. Items that are cleared against each other in the two budgets are to be posted in the capital budget as contra-entries to the entries appearing in the administrative budget.

Local authority budget law stipulates that the administrative budget show a surplus that is at least practically equivalent to the volume of funds required to redeem outstanding debt. This amount is to be transferred to the capital budget; borrowing is only possible within the latter's framework. Approval by the municipal supervisory board, which is mandatory in most Länder, presupposes confirmation that sufficient funds are available to finance debt service over the long term. If loans raised for investment purposes cannot be refinanced completely and direct through fees and charges or through contributions, the local authorities will often resort to certain "available financial balances". This term refers to the amounts by which net transfers from the administrative to the capital budget exceed the minimum transfer amount prescribed by budget law.

In the past few years, many district-independent cities have had difficulties in generating the amounts needed for minimum transfers to the capital budget on the basis of current receipts alone.¹ If this is not feasible, proceeds from asset sales and withdrawals from capital reserves may also be used for the purpose of restocking the administrative budget. Such transfers to the administrative budget may be construed as a sign of a difficult budgetary situation. If even these transactions fail to provide the administrative budget with the necessary funding, a shortfall must be shown in the annual accounts. If, in the course of drawing up the administrative budget, it already becomes apparent that the budget cannot be financed in the statutorily required way, this is a case of "uncovered expenditure". In most Länder, a budget that has been so designated will not receive the municipal supervisory board's approval or, if so, only on compliance with strict guidelines for budget management that have been set up by the board itself. Deficits in the administrative budget must not be financed by means of regular loans but must be bridged through cash advances. A shortfall in the administrative budget must be entered as a current expenditure item in the second budget following the shortfall, at the very latest, to ensure that it can be covered by normal receipts. Thus, through its restrictive provisions governing borrowing and the redemption of loans, local authority budget law imposes relatively severe constraints on the management of public funds.

The restrictive provisions of local authority budget law ensure that, in principle, loans taken up for the purpose of financing investment are repaid from ordinary receipts and thus prevent the kind of asset depletion that Federal Government and Länder Government budget law make possible by allowing for unlimited access to follow-up financing in the credit market. In so doing, local budget law also helps ensure that local authorities will realise the objective of the Stability and Growth Pact, which stipulates that, over the medium term, budgetary positions be close to balance or in surplus.

¹ An overview for the years 1998 and 1999 may be found in Karrenberg, H. and E. Münstermann, *Gemeindefinanzbericht 2000*, in: *der städtetag*, 4/2000, pp. 76 ff.



Whereas in Hesse, for example, the city of Frankfurt am Main was able to record a surplus of almost DM 900 million last year according to the quarterly cash statistics, other district-independent cities finished the year with deficits of up to DM 60 million. In numerous German municipalities, where trade tax receipts, in particular, have risen only negligibly over the last few years and social assistance benefits represent an above-average burden, the financial situation remains so critical that it is no longer possible for them to achieve the administrative budget surpluses mandated by local authority budget law. In such cases comprehensive consolidation measures continue to be necessary (see the explanation on page 45).

Still, the persistently unfavourable budgetary situation of numerous municipalities is, in itself, no reason to demand a broad-based improvement in the financial position of the local authorities. Instead, it would be more appropriate to consider whether additional funds should be granted to especially hard-hit municipalities as part of the municipal revenue equalisation scheme. Insofar as this would entail an increase in the funds available for revenue equalisation, it would have to be examined whether – apart from the Land involved – financially strong municipalities might not be able to contribute funding. The siphoning off of tax receipts involved in the equalisation scheme may, however, have the effect of weakening the municipalities' incentive to cultivate their own tax revenue sources. Thus such equalisation mechanisms are subject to relatively narrow limits.

Municipal revenue equalisation scheme has only limited effect

Several factors have contributed to the overall reversal in the financial position of the local authorities. A significant easing of the financial burden is attributable to the introduction of the statutory nursing care insurance scheme, which from July 1996 on also awards persons in need of institutional care a claim to financial assistance. The high costs associated with nursing home facilities had often exhausted the income of the persons affected, ultimately culminating in a claim to social assistance benefits that had to be redeemed by institutions funded mainly by the local authorities. Up until 1995, this expenditure item, in particular, had increased very sharply, with annual growth rates of usually more than 10%. When the nursing care insurance scheme began granting benefits, this

Improvement of financial position through ...

... relief in the field of social assistance, ...

trend could be reversed. This was the main reason that in 1999 expenditure on social assistance to persons living in institutions was, at DM 18 ½ billion, less than that in 1995 by more than DM 8 billion. This decline was, in turn, responsible for the fact that the local authorities' total expenditure on social benefits decreased significantly during this period.

Besides the decline in the number of persons seeking political asylum, this may also be attributed to the efforts of numerous local authorities to provide unemployed persons receiving social assistance with jobs which entitle them to payments from the Federal Labour Office. The result of these endeavours was a shift in the financing burden that benefited the local authorities. At the same time these projects also make it possible to target social assistance more effectively, especially if they succeed in offering the long-term unemployed an opportunity to re-integrate themselves into the regular labour market at a later point in time and reduce the number of persons able to work who receive social assistance.

... reduced
capital
formation, ...

Another important factor was the cut in investment expenditure, which was, in fact, larger than a mere totalling of the items outsourced might have suggested. The local authorities felt compelled to cut spending on investment anyway over the short term owing to the particular content of the applicable budget law. Rigidities, which were imposed on current expenditure not least by the requirements of higher government budget levels, made it impossible for the local authorities to economise there to the same degree.

Receipts, expenditure and indebtedness of the local authorities

DM billion					
Item	1995	1996	1997	1998 pe	1999 pe
Receipts	284.3	282.7	275.5	284.4	288.7
of which					
Taxes	86.0	86.0	87.5	95.5	100.0
of which					
Income tax shares	42.1	37.8	36.1	38.3	40.0
Trade tax (net) ¹	30.5	33.4	36.1	36.3	38.1
Tax on land and buildings	12.3	13.1	13.8	14.5	15.1
Shares in turnover tax revenue	–	–	–	4.8	5.2
Fees and charges	38.9	37.2	35.5	34.5	33.6
Current transfers ²	79.6	78.5	75.4	74.8	76.6
Investment grants ²	20.2	20.8	19.6	18.2	17.8
Expenditure	298.6	290.6	281.0	279.0	283.5
of which					
Personnel expenditure	71.9	70.3	68.4	68.3	68.8
Other operating expenditure	52.2	51.9	51.7	51.8	54.3
Social benefits	59.5	57.0	51.6	51.2	51.0
Other current grants	16.1	17.0	18.4	19.2	20.1
Interest paid	11.1	11.3	11.0	10.8	10.3
Capital formation	56.4	52.1	49.2	48.1	48.8
Financial aid ³	8.5	8.3	8.6	7.7	8.2
Financial balance	– 14.3	– 7.9	– 5.5	5.4	5.2
Total debt at the end of the year	171.7	175.5	178.4	177.9	175.9
Change from previous year in %					
Receipts	0.5	– 0.6	– 2.6	3.2	1.5
of which					
Taxes	– 1.9	0.0	1.7	9.2	4.7
of which					
Income tax shares	1.5	– 10.2	– 4.6	6.2	4.3
Trade tax (net) ¹	– 9.2	9.7	7.9	0.6	5.1
Tax on land and buildings	8.9	6.6	5.6	4.8	4.0
Shares in turnover tax revenue	–	–	–	–	7.1
Fees and charges	0.7	– 4.4	– 4.5	– 2.8	– 2.6
Current transfers ²	2.3	– 1.3	– 4.0	– 0.8	2.5
Investment grants ²	1.4	2.8	– 5.7	– 7.3	– 2.1
Expenditure	1.5	– 2.7	– 3.3	– 0.7	1.6
of which					
Personnel expenditure	2.0	– 1.7	– 2.1	0.1	1.0
Other operating expenditure	– 2.5	– 0.5	– 0.5	0.4	4.7
Social benefits	7.0	– 4.3	– 9.5	– 0.8	– 0.3
Other current grants	22.7	6.0	8.4	4.2	4.8
Interest paid	1.9	1.3	– 2.9	– 1.9	– 4.5
Capital formation	– 5.0	– 7.7	– 5.4	– 2.2	1.4
Financial aid ³	– 1.9	– 3.3	3.9	– 9.9	6.7

Sources: Federal Statistical Office and Bundesbank estimates. — ¹ After deduction of the levy on trade tax payable to the Federal and Länder governments. — ² From central and regional authorities. — ³ Loans, investment grants and acquisition of participating interests.

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Since the local authorities account for approximately three-fifths of all capital formation recorded in government budgets, their investment behaviour has had a significant effect on the construction sector, which had previously enlarged its capacity owing to pent-up demand in the new Länder.

While it is true that the public infrastructure of the western Länder is well-developed, the sustained decline in expenditure on capital formation may still lead to bottlenecks in some areas. Local authority expenditure on capital formation fell – partly due to outsourcing, as already pointed out – by one-quarter to just under DM 49 billion last year, compared with its 1992 level, which was the highest yet, owing not least to the exigencies of German unification. The surpluses of the past two years made a slight increase in capital formation expenditure possible again in the western Länder. However, initially, the primary beneficiaries of this rise were acquisition of land and investment in machinery and equipment. In the eastern Länder where the construction sector continues to play a significantly larger role than in the west and thus exerts a greater influence on the macroeconomic trend, capital formation expenditure continued to decline in 1999.

*... reduction in
personnel, ...*

The consolidation efforts of the local authorities were directed not only towards a reduction in investments but also towards a reduction in staffing levels. Between 1995 and 1998 the number of employed persons covered by the core budgets fell by 11 % to 1.16 million. The municipalities in the eastern Länder accounted for a larger portion of the

decline. Staffing levels, however, still remain above the west German average. This notwithstanding, the trend in personnel expenditure was strongly influenced by outsourcing as well.

The local authorities were also interested in improving their financial balances not only by selling off more land but especially through the sale of participating interests. In 1998, proceeds from the sale of participating interests reached a record level of DM 3 ½ billion. Last year receipts from the same source dropped to DM 2 ¼ billion. Generally speaking, there is still considerable revenue to be earned from selling participating interests, not least through the sale of local authority holdings in public utility companies. Taking a well-designed market economy as a criterion, it seems appropriate for the local authorities to divest themselves of corporate holdings, all the more so as the problems arising from natural monopolies have become less acute in many sectors.

*... and sale of
participating
interests*

By contrast, the fact that the local authorities were forced by the Federal Parliament in 1992 to guarantee the right of every child from three to six years of age to attend kindergarten from 1996 on has placed a strain on local authority finance. This regulation had the initial effect of confronting the local authorities with the need for additional investment in kindergarten facilities; according to the accounting results of the local authorities' budgets, the size of this extra investment expenditure lies, by some estimates, between DM ½ billion and DM 1 billion annually. It could not be recovered by means of addition-

*Larger kinder-
garten
capacities a
strain on
budget*

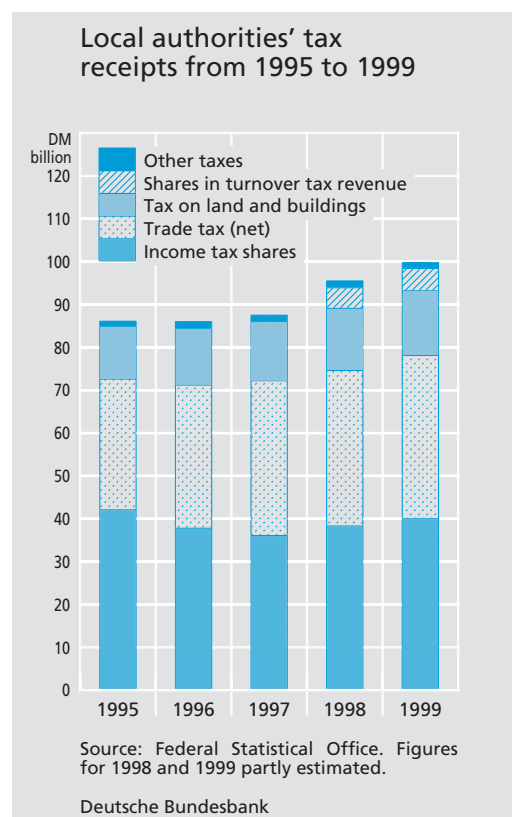
al investment grants from the other levels of government. An increase in the supply of kindergarten capacities implies at the same time, however, a considerable rise in related expenditure, i. e. in personnel and other operating expenditure, and in transfers to the owners of these institutions. A comparison of the accounting results of 1992 and 1997 suggests, after adjustment for a rise in receipts from fees and transfers, that this places an additional burden on the budget amounting to approximately DM 3 billion per year.

*Decline in
Länder
transfers*

The fact that Länder transfers, which account for approximately one-third of local authorities' total receipts, were DM 5 billion less than in 1995 also made itself felt. The decrease is partly attributable to the smaller size of payments within the general tax-sharing system. In addition, Länder transfers for local authority investment expenditure have become fewer; this both contributed to the latter's decline and was partly the result of this development. Finally, the decreasing number of fugitives and persons seeking political asylum, which provided the local authorities with some relief, also led to a decline in the reimbursements awarded by Länder for the corresponding services.

*Different trends
in tax receipts*

The trend in tax receipts was subject to opposing influences. Up to 1997 revenue from this source had remained at virtually the same level, thus placing a strain on local authority finances. A significant reason for the unchanging level of municipal tax revenue was the considerable decrease in receipts from assessed income tax, which was not least attributable to the generous special depreciation



facilities for investments in the eastern Länder. In addition, tax revenue at all levels of government was affected by a significant enlargement of the basic tax allowance from 1996 on, which had been mandated by a ruling of the Federal Constitutional Court. The new regulation governing the family allowance system, which entered into force in 1996, likewise had a negative effect on local authorities' shares in income tax revenue. Since then child benefits – which have in the meantime been raised several times – are booked to the detriment of wage tax revenue.³ However, in order to compensate for the loss in wage tax revenue that the regional

³ Under the old regulation, which is referred to as a "dual system", child benefits were paid by the Federal Government. The Länder and the local authorities only covered shortfalls which arose from additional tax allowances for children.

and local authorities suffer as a result, the Länder have been granted an additional share in turnover tax revenue, starting at 5½ percentage points.

In the last two years tax receipts have again increased substantially, thereby improving the budgetary situation. Thus, with receipts from assessed income tax on the rebound, local authorities' share in income tax revenue again rose considerably. At the same time the local authorities had been enjoying receipts from increasing turnover tax revenue since 1998; they had been given a share in turnover tax revenue amounting to 2.2%⁴ (1998: DM 4¾ billion) as recompense for the loss in revenue resulting from the repeal of the trade tax on business capital in the western Länder. Despite the abolition of this part of trade tax, which had been criticised for being a tax on real assets, receipts from trade tax altogether continued to grow at a surprisingly rapid rate in the last two years owing to extensive back-payments and larger advance payments, while collection multipliers remained mostly unchanged. The local authorities, however, had to transfer a larger share of these receipts than before to the Länder in the form of contribution levies.

Considerable differences between individual municipalities

Differences in the economic strength and collection multipliers of the various municipalities led to substantial differences in receipts from trade tax, which represents the most important revenue source, at least for the major cities. Taking the cities of North Rhine-Westphalia as an example, gross per capita trade tax revenue in Düsseldorf was DM 1,900 in 1998, while comparable revenue in Duisburg

amounted to less than a quarter of this figure, although the collection multiplier was only marginally lower. Average gross per capita trade tax revenue for North Rhine-Westphalia was equivalent to approximately DM 720.

Effects of outsourcing municipal amenities

The question may legitimately be raised, in keeping with free market principles, whether services to be offered by the public sector, and thus by the local authorities, cannot be provided more efficiently by private enterprises. If it proves inappropriate to engage a service provider from the private sector, the next step would be to choose an organisational form which would at least allow the state to perform the service efficiently. In the last few years, progress has been made, especially at the local authority level, both in limiting government involvement and in reorganising the form in which municipal amenities are offered.

Review of public sector operations

When deciding exactly how municipal duties are to be discharged, the local authorities are, in principle, free to choose among a variety of organisational forms besides the classical administrative one. Earlier the in-house services (*Regiebetrieb*) model had predominated; it is included in the local authority budget, together with all its receipts and ex-

Available organisational structures

⁴ This does not include the increase in revenue resulting from a rise in turnover tax by one percentage point in April 1998 to finance the statutory pension insurance scheme.

penditure, and is thus subject to governmental accounting rules. The concept of in-house services gave rise, however, to certain problems, especially with regard to the provision of public utility and waste disposal services. At all events, the latter items, which must cover their costs entirely through receipts from fees and charges, make it necessary to resort to elements of commercial accounting principles. Moreover, civil service legislation statutes, including those governing public sector salaries, sharply circumscribe the ability of institutions to adjust to changing needs.

In the case of financially autonomous, publicly owned enterprises (*Eigenbetriebe*), as opposed to in-house service providers, the only item that must be shown in the local authority core budget is the grant amount needed or the profit transferred. Nevertheless these institutions remain legally dependent entities and thus fall entirely within the compass of existing civil service legislation and wage settlements. By contrast, autonomous, publicly owned companies (*Eigengesellschaften*), such as the municipal private limited companies or municipal public limited companies, are independent entities from a legal standpoint. As such, they are free to diverge from the specific provisions of civil service law, a status which gives them greater economic flexibility.

The local authorities have been engaged for some time now in outsourcing municipal amenities; this process has had a substantial effect on local authority accounting and on the corresponding statistics. Receipts from fees and charges are particularly affected.

Since the mid-nineties, these receipts have fallen by more than 10 % after having sustained annual rises of over 5 %. The major factor in this development has probably been the conversion of in-house service providers into financially autonomous, publicly owned enterprises which remain legally dependent but which show their turnover in a separate profit and loss account rather than showing fees and charges in the core budgets. By contrast, when in-house service providers are converted into legally independent, autonomous, publicly owned companies, fees and charges usually continue to be entered into the core budgets as received and are then passed on.

Irrespective of the chosen form of organisation, outsourcing has led to a continuous decline in the personnel expenditure posted in the core budgets. How much of the reduction of staff levels of the last few years may be traced back to such outsourcing measures remains, however, an open question. Total personnel expenditure between 1995 and 1998 would probably show a rise rather than the posted decline, if the outsourced undertakings had been included in the core budgets. The effects of such outsourcing on other operating expenditure are ambiguous. If – as is often the case with autonomous companies – fees and charges continue to be booked on the receipts side of the core budget, the corresponding purchases of outsourced services by the local authorities must be shown on the expenditure side; the latter items are often significantly larger than the other operating expenditure which has been outsourced since they must also include the funding for per-

*... and on
current
expenditure*

*Effects on
receipts from
fees and
charges ...*

The effects of outsourcing municipal amenities on city finances, as exemplified by the city of Frankfurt am Main

In 1999 the city of Frankfurt adopted several major reorganising measures:

- The most significant transformation involved the municipal drainage system, which was outsourced as a financially autonomous, publicly owned enterprise. In the annual accounts for 1998, this institution was still listed as having earned revenue in fees and charges amounting to approximately DM 220 million. Since it was outsourced, the charges have no longer been routed through the municipal budget but have been booked directly with the municipality-owned enterprise as turnover. Similarly, personnel expenditure, which amounted to slightly over DM 30 million, administrative and operating expenses (slightly over DM 80 million) – the most important component of “other operating expenditure” – and imputed costs relating to depreciation and interest (almost DM 90 million) no longer appear in the budget. The quarterly cash statistics for 1999 set the value of such municipal investments at virtually zero, as opposed to approximately DM 70 million in 1998.
- Since 1999, Frankfurt’s evening school for adults (*Volkshochschule*) has likewise been run as a financially autonomous, publicly owned enterprise. As a result, receipts from fees and charges (more than DM 5 million), personnel expenditure (slightly over DM 15 million) and administrative and operating expenses (slightly under DM 10 million) have all disappeared from the budget. To compensate for the losses generated by the adult evening school, however, the budget plan has set aside approximately DM 15 million for a new subsidy item.
- The municipal assistance programme for children, adolescents and families was outsourced as well. Business documents relating to the new, financially autonomous but publicly owned enterprise, which were submitted along with the budget plan, indicate that receipts from fees and charges amounting to almost DM 15 million, personnel expenditure of just under DM 40 million and administrative and operating expenses amounting to around DM 20 million will be missing from the core budget. Additional room, however, has been reserved in the new budget for current grants amounting to slightly over DM 45 million.
- The city of Frankfurt turned over responsibility for collecting the fees charged by the waste disposal plants to the disposal company FES GmbH. As a result, revenue in the form of fees and charges has decreased by approximately DM 50 million on the receipts side of the budget whereas the expenditure side

has been short the same amount in administrative and operating expenses. The budget will continue to show the fees charged for waste collection.

Altogether, the outsourcing measures described above amount to a loss of almost DM 300 million in receipts from fees and charges. If this amount were included in the cash statistics for 1999, revenue in the form of fees and charges would not have declined by one-third but would actually have risen by around 5%. Similarly, the decline in the city’s personnel expenditure from 1998 to 1999, which was equivalent to DM 100 million or just under 10%, can largely be attributed to the aforementioned outsourcing activities. The decline in the number of staffed posts in the core budget by slightly more than 1,000 or almost 10% between 1997 and 1999, as attested by the budget plans, may be explained almost exclusively in terms of these outsourcing measures. These institutional outsourcing operations also account for a decrease in administrative and operating expenses of slightly more than DM 160 million. Since the cash statistics show only a decline of approximately DM 115 million, it is clear that the figures for these expenditure items, if adjusted accordingly, will point to a substantial rise in 1999. The conversion of the municipal drainage system into a financially autonomous, publicly owned enterprise, in particular, eased the financial burden which the servicing of the public debt had placed on the core budget. The transfer of assets meant that liabilities – equivalent to around DM 850 million – were also removed from the core budget, which was thereby relieved of interest payments amounting to around DM 50 million. This largely explains the fact that, according to the cash statistics, the interest paid by the city fell by almost DM 90 million. The outsourcing of the municipal drainage system also had a considerable impact on developments in construction investment. Adjusted for the effects of this measure, the decline in construction investment, which the cash statistics record as being almost 15%, becomes an increase of around 10%.

Even if the measures adopted by the city of Frankfurt in 1999 cannot be generalised, they demonstrate in an exemplary fashion how processes of outsourcing, which, from an economic standpoint, are to be welcomed in many cases, result in significant distortions at the statistical level, which must be taken into account when assessing and controlling municipal activities. Revenue and expenditure items are particularly vulnerable to such distortions. The financial balance is not as strongly affected since in most cases, outsourcing usually involves matching entries, which then disappear from both sides of the budget.

sonnel expenditure and the imputed costs involved in running the autonomous companies.⁵ If, however – as is usually the case with financially autonomous, publicly run enterprises – the local authority budget now shows only a clearing item corresponding to net income, the statistically recorded figure for other operating expenditure will also be smaller.

*Outsourcing
of capital
formation*

By contrast, outsourcing has exercised a definite dampening effect on the trend in the expenditure on capital formation. The water drainage sector has shown an especially pronounced decline in capital formation expenditure in the last few years, during which a series of organisational measures were implemented. Still, these changes only partly explain the marked decrease in local authority capital formation.⁶ The decline in capital formation brought about by the outsourcing of certain services, however, failed to result in a commensurate narrowing of budget deficits. In keeping with the cost recovery principle, depreciation allowances and imputed interest must also be financed solely on the basis of proceeds from fees and charges. Since these costs do not represent real outflows in revenue, the local authority budgets built up equivalent surpluses, which were credited to the outsourced units as part of the reorganisation process.

*Effect on the
trends in
indebtedness*

Outsourcing not only has the effect of reducing net borrowing; the accumulated debt which the institution being reorganised has incurred in financing its investments is often reassigned as well. While net borrowing by the local authorities amounted to approxi-

mately DM 22 billion between 1996 and 1999, their level of indebtedness rose by only DM 4 billion to DM 176 billion between the end of 1995 and the end of 1999. The reason for this discrepancy is to be found in the large entry for “other debt withdrawn” in the debt level statistics, which would appear to be comprised mainly of outsourcing.

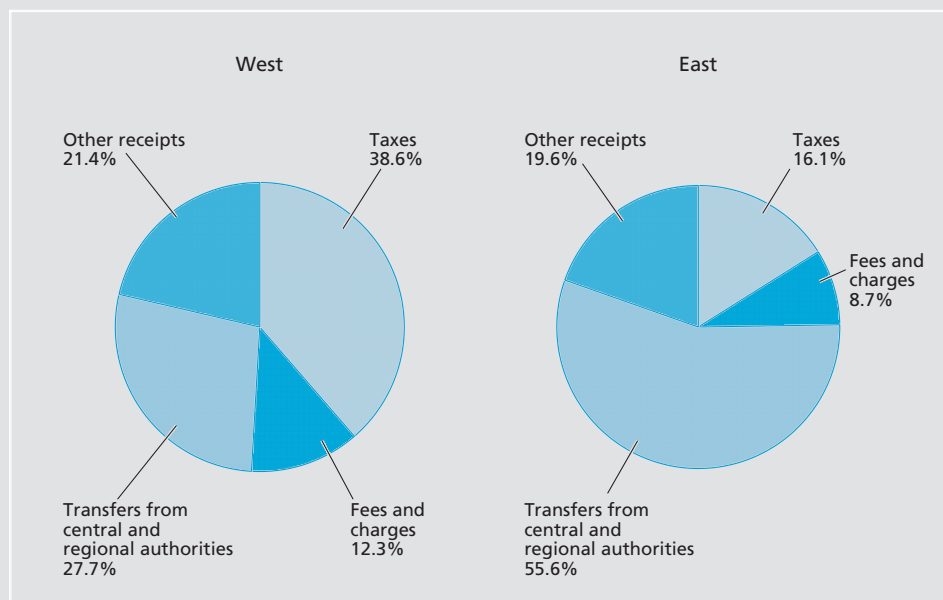
Generally speaking, outsourcing has made the evaluation of local authority finances considerably more difficult. In order to ensure an unbiased analysis – which would allow for a comparison with other levels of government as well – the responsible statistical agency would also have to collect data on the receipts and expenditure of (at least financially) autonomous but still municipally controlled institutions which could then be included in the budget data for the local authorities. At present, a rough idea of the extent to which local authority finance statistics have been distorted by outsourcing can be obtained only by consulting estimates and case studies. Thus, in order to show the extent of the distortions to which outsourcing may give rise, an overview of the problem, which takes the 1999 comparative figures for the city of Frankfurt am Main as an example, has been presented on page 52.

Analysis of aggregated data increasingly intractable

⁵ Thus, a large portion of the rise experienced by the local authorities in North Rhine-Westphalia in other operating expenditure – over 10 % last year – can probably be explained in this way.

⁶ According to the accounting results, institutions that were significantly affected by reorganisation measures (especially waste disposal institutions) account for approximately half of this decline.

Breakdown of local authorities' receipts in western and in eastern Germany in 1999



Source: Federal Statistical Office. Figures partly estimated.

Deutsche Bundesbank

The state of local authority finance in the eastern Länder

Still considerable differences between west and east

All in all, considerable differences still exist between the local authorities in the western and eastern Länder. It is true that in 1995 the "Solidarity Pact" significantly stepped up the amount of funding received by east German local authorities by including the eastern Länder in the general Länder revenue equalisation scheme and granting special requirement transfers and financial aid for investment expenditure from the Federal Government from 1995 on. This had the effect of reducing the deficit of the east German local authorities by DM 3 billion to DM 2 billion in 1995, which accounted for approximately one-seventh of the total local authority deficit in that year. In the following years, however, the east Ger-

man local authorities were far from being able to keep pace with improvements in the financial positions of the western Länder.

The main reason for this has been the negative trend in receipts. Since 1995, receipts have been declining continuously by a total of approximately 13% and in 1999 receipts were per capita almost 4% lower than the corresponding western figure; in 1995 they had still been hovering at 10% above the western level owing to the substantial size of the transfers involved (see the chart on page 55). The persistently low level of tax revenue in eastern Germany has exacerbated the strain on receipts. Whereas in 1999 the local authorities in the old Länder received almost DM 1,500 in taxes per inhabitant, the same figure for the eastern Länder came to a mere DM 600 at

Weak trend in receipts

best, or 40 % of the west German level. Since 1995, the gap has widened by an additional 1 ½ percentage points. Receipts from income and trade taxes are largely responsible for the comparatively meagre tax revenue; per capita taxes on land and buildings and local authority shares in turnover tax revenue bring in more than two-thirds of western levels.

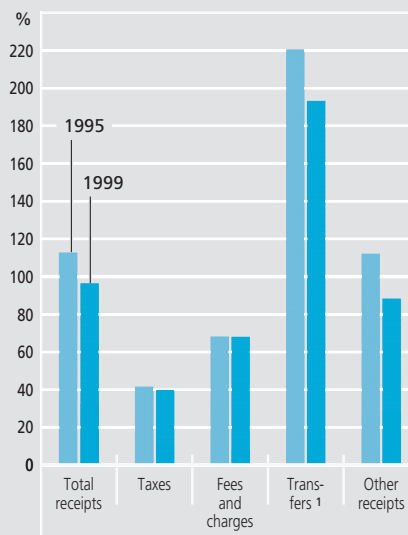
Scanty receipts from trade and income taxes place budgets under financial strain

Disregarding high unit labour costs, which have narrowed profits, it is the special concessions granted in connection with financial assistance to the east which have especially cut into revenue from trade tax and assessed income tax. The fact that the income level in the eastern Länder is lower also places a ceiling on the receipts that may be expected from local authority shares in income tax revenue. Similarly, child benefits have had a particularly negative impact on wage tax revenue from 1996 on since, relatively speaking, this deduction, which is unrelated to income level, affects east German revenue to a much greater degree. In 1999 total per capita receipts from income and trade taxes in the eastern local authorities amounted to slightly more than 30 % of the west German level.

Fewer transfers from the Länder and the Federal Government

Given that the tax receipts of the local authorities in the east are so low, their budgets are especially dependent on transfers from the Länder but also from the Federal Government. Thus total per capita receipts from the other levels of government were almost twice as high as those in the western Länder in 1999. This gap is, however, narrowing since the east German Länder have been substantially reducing their transfers from 1995 on in an effort to consolidate their budgets.

Receipts per inhabitant as a percentage of the west German level



Source: Federal Statistical Office. Figures for 1999 partly estimated. — 1 From central and regional authorities.

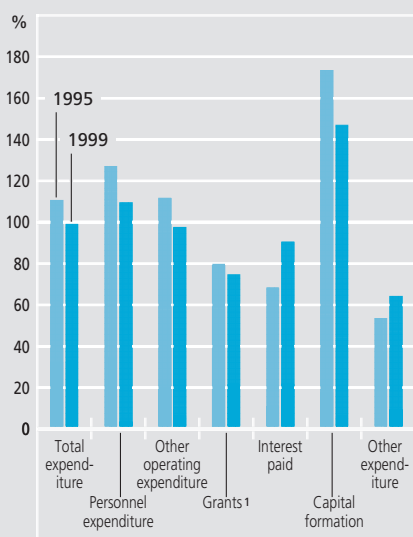
Deutsche Bundesbank

The local authorities have had to respond to this negative trend in receipts with reductions in expenditure, which are still far more extensive than comparable efforts in the west. While in 1995 local authority expenditure per inhabitant in eastern local authorities was still higher than the corresponding western level by one-tenth, it had fallen somewhat below that level by 1999 (see the chart on page 56).⁷ This reflects the fact that wage settlements, which had raised the salaries of public sector employees from 80 % of the western level (as of October 1994) to 86.5 % in 1999, had forced the local authorities there to come to grips with even larger financial burdens than

Reductions in expenditure

⁷ However, given that the duties assigned to the local authorities differ from one Land to another (among other reasons), any comparison of eastern and western levels of expenditure must be of strictly limited value.

Expenditure per inhabitant as a percentage of the west German level



Source: Federal Statistical Office. Figures for 1999 partly estimated. — ¹ Mainly social benefits paid to households.

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in the west. Thus, in an effort to curb personnel expenditure, the number of employees covered in the core budget was significantly reduced, an unavoidable measure considering the high levels of staffing. These economising measures notwithstanding, personnel expenditure per inhabitant in the east remained at 110 % of the western level (compared – it is true – with 127 % in 1995), although expenditure on old-age pensions and health care for civil servants has so far continued to be relatively low. Staffing levels corresponding to core budget items still exceeded per capita the western reference value by 40 % (it was two-thirds in 1995). If only fully employed persons are counted, the ratio becomes 25 % (compared with 60 % in 1995). This figure suggests the need for further

shedding of personnel in order to avoid over-taxing local authority budgets in the east.

Whereas the local authorities' level of indebtedness in the west – buoyed by a substantial improvement in their financial positions and by the outsourcing of public services – remained largely unchanged compared with 1995, the level of indebtedness in the east continued to rise owing to a persistent widening of local authority deficits. As a result, the local authorities in the east have now reached a level of indebtedness per inhabitant approaching that of the west.⁸ The interest paid per inhabitant is already equal to slightly more than 90 % of the western level (compared with two-thirds in 1995).

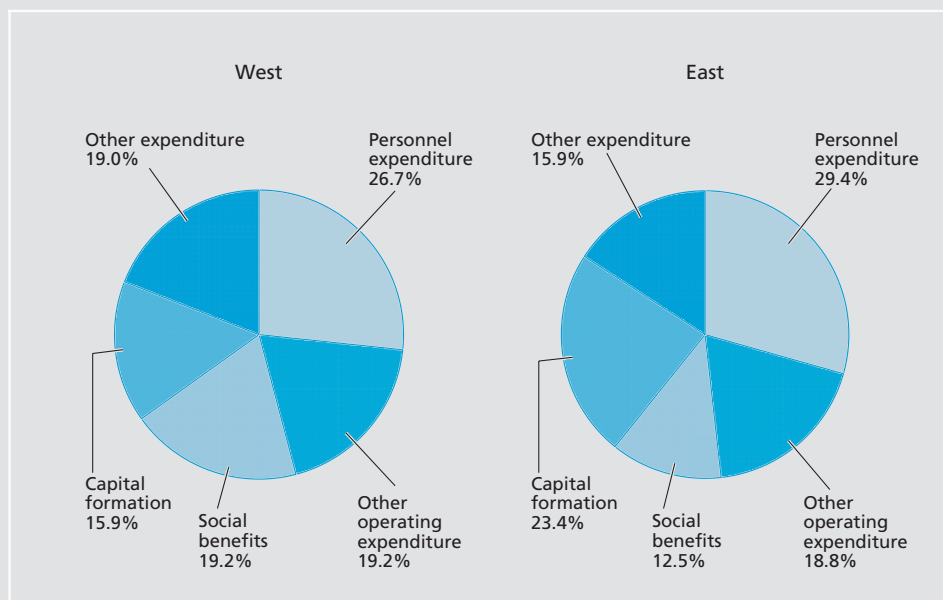
Interest paid per inhabitant already close to western level

By contrast, the local authorities in the eastern Länder have so far only had to spend per capita on social benefits approximately two-thirds of what the west spends. The main reason for this is probably that the lower costs of institutional care and the more extensive use of previous levels of the social security system help ease the financial strains placed on the local authority budget by social assistance. The latter plays a particularly important role in the case of social assistance awarded on the basis of unemployment. Moreover, the claims on pension benefits by women are higher than in west Germany owing to their greater participation in the labour force at the time of the German Democratic Republic.

Social benefits less of a burden on budgets

⁸ Since water drainage institutions have largely been outsourced from local authority core budgets in the east, the same comparison, undertaken after adjustment, might reveal that the debt burden per inhabitant is now larger than in the west.

Breakdown of local authorities' expenditure in western and in eastern Germany in 1999



Source: Federal Statistical Office. Figures partly estimated.

Deutsche Bundesbank

Capital formation even higher than in the west

Even disregarding the fact that the decline in expenditure on capital formation was much larger in east Germany, it still remains true that significantly more funds are spent per inhabitant for this purpose than in the west. In the mid-nineties per capita capital formation in the east still outstripped the western level of expenditure by three-quarters; by 1999 the east's lead had been narrowed to just under 50%. Although many problems affecting the infrastructure in the east have in the meantime been addressed, considerable shortcomings still remain in some areas that will have to be tended to in the coming years.

Current trends and problems

The trend in local authority finance this year will be characterised by at best marginal growth in total receipts and a somewhat more pronounced increase in expenditure. Capital formation expenditure for Germany as a whole is expected to rise further, although the local authorities in the east will be subject to continued pressure to consolidate and a renewed decline in capital formation expenditure is expected there. All things considered, the local authorities might still be able to achieve a financial surplus in 2000, as was the case in 1999. The budgetary situation next year, by contrast, will be dominated by the planned tax reductions, which make it seem more likely that the trend for 2001 will be towards deficits. Apart from

Financial outlook up to 2001

losses in the local authorities' share of income tax revenue, there may be sizeable cuts in transfers from the Länder under the general tax-sharing system, with the result that local authorities with weaker tax revenue will be particularly hard hit.

Effects of the liberalisation of public utility markets

The liberalisation of the public utility markets in the European Union might have a powerful effect on local authority finance. Disregarding the not yet foreseeable trend in licensing fees – up to now, the local authorities have received such licensing fees from utilities in exchange for road use and guaranteed monopoly status – the downward pressure being exerted on the profit margins of public utility enterprises, in particular, will probably increase. The loss in profits would also make it more difficult to continue the traditional cross-subsidising of municipal transport services, which have been running deficits. Despite all the problems which the liberalisation of utility markets poses for the local authorities, there is no reason to abandon deregulation, which is beneficial at a macroeconomic level.

Ongoing reform of local authority operations

On the contrary, the local authorities themselves derive efficiency benefits not only from the outsourcing of activities that had once belonged to the core budgets but also from the ongoing privatisation of marketable services. In the last few years, considerable progress has, in fact, been made in the privatisa-

tion of public services, a process which merits continuation. As for those services which are no longer recorded in the core budgets but which continue to be controlled by the local authorities, it is important that they be included in the local authority statistics; this ensures that public sector operations can be monitored in their entirety.

Even after all the foreseeable financial burdens of the years to come have been taken into account, it may reasonably be asserted that, among the different levels of government, the local authorities, taken together, will come nearest to attaining budget positions close to balance or in surplus, an objective specified in the European Stability and Growth Pact. The local authorities, as an aggregate, owe their sound financial position not least to the provisions of the applicable local authority budget law, which compelled them to adopt austerity measures – in large part to the detriment of capital formation, however – after the extraordinarily large deficits incurred up to the mid-nineties. The coming years will confront the local authorities not only with the fiscal policy task of averting another slide into deficit but also with that of maintaining an effective infrastructure consistent with the policy of “qualitative consolidation”. This presupposes continuing vigilance in holding down current expenditure, even in times of accelerating receipts.

Local authority budgets fulfil Stability Pact criteria