Subsidy trends in Germany since the start of the nineties

The purpose of state subsidies is to remedy the outcomes of market processes. In a market economy such intervention has to be continually justified and critically examined. Not only considerations of institutional policy but also the ongoing constraints on public finance and the high level of taxes and social security contributions make it imperative to grant such aid as restrictively as possible. In principle, this need for fiscal policy discipline is widely recognised. Yet the attempts to implement it are met with resistance. The situation is made even more difficult by the fact that there is no clear definition of the term *subsidy*. Depending on the definition used, there are not only differences in the levels of subsidies granted but also in the scope for their reduction. Monitoring the effectiveness of subsidies is hampered by the large variety of instruments deployed and the differences in their impact, which is sometimes difficult to quantify. This issue is analysed in the following article, which also outlines the impact that the trends in state financial aid and tax concessions have had on public finance since reunification.

Defining the term subsidy

Definitions vary ...

Basically, the term *subsidy* implies that some economic sectors and regions are treated more favourably than others, which are regarded as "normal" and therefore serve as the benchmark, in that the favoured sectors and regions receive state aid in order to promote economic activity. Despite debate over decades, however, there is no standard definition of the term. For example, a rather narrow definition is used in the Subsidy Reports, which the Federal Government has to publish every two years in accordance with section 12 of the Stability and Growth Act and which, in essence, serve as a basis for this article. By contrast, the Kiel Institute of World Economics, to take another example, puts the volume of subsidies granted much higher (for details see the box on page 17 as well as the chart on this page).

... according to the type of benefit ...

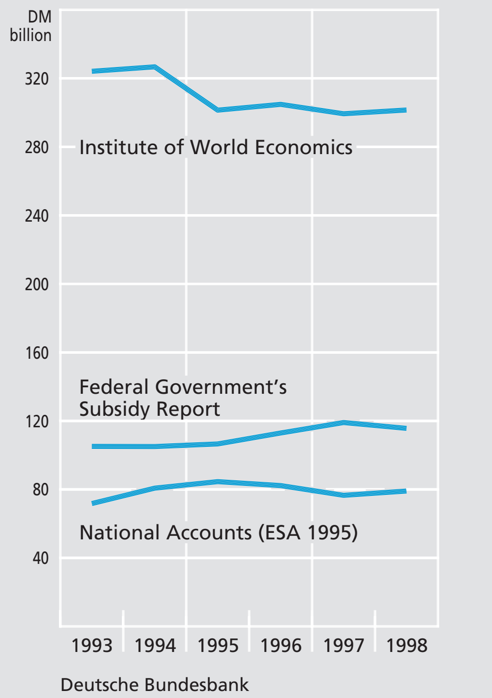
Problems of definition arise in the first place because state aid is provided not only in the form of grants and tax concessions – the two most important types of subsidy. In principle, it also covers soft loans, other revenue forgone, guarantees and regulatory measures.[1] State shareholdings in enterprises, where the government forgoes a customary market return on its invested capital, are not the least important of these. In contrast to the Federal Government's Subsidy Reports the European Commission, when monitoring subsidies in accordance with the EU Treaty, regards such capital injections – as in the case of Westdeutsche Landesbank – as aid.

... and the recipient

Further problems arise with respect to defining subsidy recipients. Subsidies are aimed at the business sector. Naturally, there are also state benefits which are granted to households to lower the cost of acquiring certain goods. Grants of this nature likewise have an effect on the sectors concerned and consequently are ultimately comparable to direct payments to enterprises. One example is the tax grant for home buyers, which benefits persons who are building or purchasing accommodation for their own use. The granting of housing allowances, too, might ultimately be seen as an indirect subsidy to the housing sector, but in this case the social purpose behind the benefit is even more important. However, this example shows that the distinction between subsidies and other forms of expenditure – such as payments for social purposes – is not clear-cut.

Finally, differentiating between the private sector and the core public sector also presents

Subsidies as variously defined



1 See Deutsche Bundesbank, The price effects of deregulation and privatisation in the product markets, Monthly Report, December 2000, page 31 ff.

The term *subsidy* is variously defined

Special concessions which the Federal Government grants to various sectors or regions in order to influence their economic activity are the subject of the **Federal Government's Subsidy Reports.** Government responsibilities such as social policy and the improvement of the infrastructure are not taken into account here. Not only private enterprises are considered, in principle, as possible recipients of subsidies but also individuals if the benefit is aimed directly at influencing part of the economy. The tax grant for home owners, for example, is included. However, housing allowances, which are considered to be a social benefit, are not. Federal enterprises and the Treuhand agency are not included in the Subsidy Reports because these are not bodies outside the Federal administration for whose subsidisation the Federal Government is accountable, pursuant to section 12 (2) of the Stability and Growth Act. The subsidy aggregate comprises tax concessions and financial assistance. The latter includes loans, which are listed with the respective amounts of the outlay involved in each case. In its Subsidy Reports the Federal Government concentrates on measures affecting its budget. The value of subsidies has been put at just over DM 41 billion for 1998. In addition, the Federal Government records tax concessions to Länder Governments and local authorities and shows, by way of information, the comparably defined financial assistance given by the Länder Governments and the subsidies provided by the local authorities and the European Union. The loans granted by the ERP Special Fund are also included in the subsidy aggregate even though the interest rate subsidies to the fund are already recorded as a subsidy in the Federal budget. In 1998 total subsidies as defined here amounted to just over DM 117 billion, or 3.1 % of GDP.

The definition of the term *subsidy* used in the **National Accounts** is generally somewhat narrower. Only "current unrequited payments which general government or the Institutions of the European Union make to resident producers" [1] are recorded in this case. This means that some of the current grants to hospitals and expenditure by the Federal Labour Office on job creation measures, which are not included in the Federal Government Subsidy Reports, are posted here as subsidies. [2] However, tax concessions and benefits paid to individuals are not taken into account. The exclusion of investment grants as capital transfers (DM 54 billion) is also significant. Loans are recorded in the national accounts as financial transactions instead of as expenditure and are therefore not deemed to be assistance. The total volume of subsidies as defined in the national accounts amounted to DM 80.8 billion, or 2.1 % of GDP, in 1998.

The **Kiel Institute of World Economics** probably uses the term *subsidy* in the widest sense of all. [3] In principle, the institute defines as subsidy recipients not only the group of beneficiaries recorded in the Federal Government's Subsidy Reports but also all state providers of marketable services which do not cover their expenditure fully by charging specific fees. Owing to the repayment requirement, however, loans granted by the ERP Special Fund are not included in the subsidy aggregate. The Treuhand agency is included. The tax concessions are taken from the Subsidy Reports and – with the exception of the savers' tax allowance, in particular – are augmented by the items which, owing especially to the size of the group of recipients, the Federal Government has shown in a separate annex since the sixth Subsidy Report instead of including them as subsidies. The exemption of medical services from turnover tax and the special allowance for church tax payments are of particular importance here. When so defined, the tax concessions amounted to just under DM 74 billion in 1998 compared with almost DM 45 billion as defined in the Federal Government Subsidy Report. Notably as a result of the extended inclusion of state-owned service providers ranging from the railways to hospitals, not to mention the active labour market policy of the Federal Labour Office and the housing allowances, financial assistance amounted to just over DM 229 billion in 1998 with the result that the total volume of subsidies, using this broad definition, came to DM 303 billion, or 8 % of GDP.

1 Eurostat (1996), European System of Accounts. ESA 1995, Luxembourg, page 69 (4.30). — **2** See Essig, H. and N. Hartmann (1999), *Revision der Volkswirtschaftlichen Gesamtrechnungen 1991 bis 1998* in Wirtschaft und Statistik, 6/1999, page 477. — **3** Compare the approach described and the data in Boss, A. and A. Rosenschon (2000), *Subventionen in Deutschland: Eine Aktualisierung,* Kieler Diskussionsbeiträge 356, Kiel.

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problems. Financial assistance to public corporations and other public organisations is widespread. Where these undertakings are in competition with private enterprises, such payments have likewise to be seen as aid. Consequently, the European Commission includes public enterprises in its subsidy controls as a matter of principle. The Institute of World Economics records grants to theatres and museums as subsidies, too.

Establishing the subsidy element

The actual extent of benefits can diverge significantly from the payment flows recorded in the public budget. While it is still relatively easy to determine the subsidy element in the case of grants and tax concessions, this is more difficult in the case of, say, special depreciation allowances, loans, guarantees, particularly lucrative public contracts and regulatory measures which provide protection against competitors and have therefore likewise to be seen as preferential treatment. An effort is made in the case of subsidised loans, for example, to record a fixed portion of the total volume as aid.[2]

Budgetary cost

Determining the effective budgetary cost of subsidies is not unproblematical either. While the recording of grants is straightforward, estimates are necessary in the case of tax revenue lost as a result of granting tax concessions. When loans are granted, the final outlay incurred is unknown. Loan repayments would have to be offset against the borrowed sum, but these are to be regarded as "old" cases and therefore do not affect the subsidy policy of the reporting period.[3] Loans from public institutions such as the Kreditanstalt für Wiederaufbau (KfW) that are outside the core budgets are recorded in the Federal Government's Subsidy Reports only via interest rate subsidies. This makes it clear that the officially declared subsidy amounts can reflect a very varied degree of promotional assistance. In contrast to their treatment in the Federal Government's Subsidy Reports, loans are therefore not included as subsidies in what follows but are simply shown as memo items.

Subsidy providers

The Federal and Länder Governments are the main providers of subsidies, but local authorities provide subsidies, too. The European Union also grants financial aid although, with the exception of expenditure in the context of agricultural market regulation, this aid is recorded in the Federal and Länder budgets. In addition, public promotional banks, notably the KfW, grant subsidised loans. In the first half of the nineties the Treuhand agency also disbursed large amounts of funds to foster the restructuring of the east German economy.

Justifying subsidies

Specific reasons essential

State aid in a market economy always has to be specially justified because it may lead to changes in relative prices which have a distorting effect on the economy as a whole. Granting subsidies is justifiable only if un-

2 For example, in its eighth survey on state aid in the European Union, which appeared this year, the European Commission fixed the aid element of amounts lent at 15 %. Before 1995 the aid element had been set at 33 % owing to the higher interest rate level. In actual fact it is the difference between the subsidised interest rate and the normal market rate that ought to be recorded in each case.
3 This is also a major problem in the case of special depreciation allowances and the utilisation of guarantees.

desirable market outcomes regarding resource allocation or income distribution might arise unless the state intervenes.

Arguments in favour of subsidies: positive external effects, ...

Market failure is to be expected, for example, in the case of those services that bring positive external benefits beyond their market value. As no one can be excluded from enjoying these external benefits, it is impossible to levy a charge that would cover the cost of providing them. Preservation of the countryside is a case in point.

... cushioning regional shocks ...

Bearing in mind both the public and private costs caused by massive and permanent shifts in demand or shocks on the supply side, it may be desirable to cushion the pressure to adjust in regions that are badly affected. For example, there could be a large-scale exodus of labour and firms if absorption capacity is exhausted owing to a localised concentration of crisis-ridden sectors and the downturn ultimately threatens to escalate. Regional aid may help to prevent this "de-industrialisation by default". However, the pressure to adjust can only be cushioned in such crises, and therefore aid must always be restricted to a limited period and gradually reduced over the allotted time. If not, there is a risk that the region's own ability to overcome future crises could be diminished. In that case it could become permanently dependent on subsidies.

... and start-up aid

Frequently, subsidies are also justified as "start-up aid". For example, special problems in opening up new markets may be cited because sufficient capital cannot be raised owing to the uncertainty surrounding sales opportunities. However, it is doubtful whether the state is better than a profit-oriented investor at recognising the potential success of a new product and therefore the wisdom of providing initial funding. Moreover, the rapidly expanding market for venture capital already constitutes a market-based source of assistance in this area. In the case of young firms, however, acquiring funds remains a problem especially as a result of their lack of collateral. Limited state aid could help to overcome such teething troubles.[4]

Effectiveness of subsidies needs to be monitored continuously

If for the reasons mentioned a subsidy is considered to be essential, its aims have to be precisely defined so that it is possible to monitor its effectiveness. Such controls are necessary to enable a constant check to be made on whether the subsidies are still justified or whether alternative measures with a better cost-benefit ratio are called for. If such controls are not made with sufficient care, there is a danger that aid will continue to be provided even though there is no longer any justification for it.

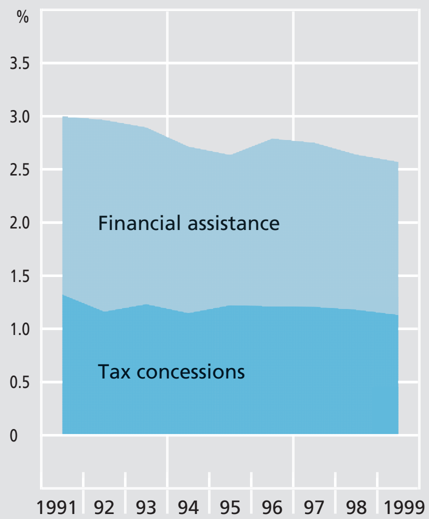
Subsidy trends

Trend in overall volume

In terms of the definition used in the Federal Government's Subsidy Reports (but excluding the loans that are recorded there) and in the comments below, the aggregate aid which was granted by the Federal and Länder Governments, the local authorities and the EU in 1991 in the form of financial assistance and tax concessions amounted to DM 88 billion,

4 For details see Deutsche Bundesbank, The market for venture capital in Germany, Monthly Report, October 2000, page 15 ff.

Subsidies in relation to gross domestic product



Source: Federal Government Subsidy Reports and Bundesbank calculations. Subsidies by the Federal Government, Länder Governments and local authorities as well as by the EU, excluding loans. Data for 1999 are planned values.

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or 3.0 % of GDP.[5] These figures include aid for eastern Germany,[6] which was increased substantially in subsequent years. By 1993 aid had grown to almost DM 94 billion. It then declined slightly to DM 93 billion in 1995 in view of the reduction in the promotional measures in force for western Germany.[7] In 1996 the total rose sharply to DM 100 billion although this was due to the fact that, following a ruling of the Federal Constitutional Court, the aid granted by a special fund to promote the use of coal for generating electricity could no longer be financed through a special levy on electricity consumers (the "coal penny" levy). Instead, grants, initially of DM 7.5 billion, are now paid out of the Federal budget and have been shown ever since in the Federal Government's Subsidy Reports. The main reasons for the further increase in aid to DM 101 billion in 1997 are revised estimates made in the Subsidy Report and a substantial increase in the assistance provided for housing. By 1999 the subsidy volume had fallen slightly to just under DM 100 billion. Although it had been greater over the entire period than in 1991,[8] its share of GDP declined by ½ percentage point to 2 ½ %.

Inclusion of Treuhand agency modifies overall picture

If the aid given by the Treuhand agency[9] to enterprises in eastern Germany and the payments made by the Federal Government for the agency's successor organisations are also taken into account, the aid granted rose from DM 104 billion in 1991 to almost DM 124 billion in 1994. After the Treuhand agency had been dissolved at the end of 1994, payments made to finance its work were reduced from almost DM 32 billion to about DM 1 billion. In 1999 the subsidy total as so defined was DM 101 billion.

Fall in partition-related subsidies in western Germany from 1991

An east-west breakdown of the subsidies (excluding the payments made by the Treuhand agency and the regionally unclassifiable EU

5 Various sectors also received loans of just over DM 3 billion from the budgets of these bodies. Additionally, the ERP Special Fund granted loans of DM 11 billion, and the KfW authorised loans of DM 30 billion.
6 In 1989 the volume of subsidies had amounted to DM 70 billion. The ratio to GDP, however, remained virtually unchanged.
7 Even so, the trend was distorted by a change in the recording method in 1995. In the case of financial assistance, payments for regional economic support and for transport were reclassified. A substantial part of the reduction of almost DM 3 billion in financial assistance from the Länder Governments in that year was probably due to this and therefore does not imply a reduction in subsidies.
8 This is true even after the adjustment to include the promotion of coal to generate electricity.
9 Total expenditure on the "core" business of the Treuhand agency is included here even though social transfers accounted for part of the outlay. Interest payments as well as overhead costs and other commitments have not been taken into account.

Subsidies by sector *

DM billion

Sectors	1991	1992	1993	1994	1995	1996	1997	1998	1999 1
Trade and industry (excluding transport)									
Financial assistance	14.6	15.5	18.6	16.3	14.1	7 21.7	22.2	21.4	20.7
of which									
Federal grants to promote the sale of coal 2	2.6	2.5	2.4	2.0	1.8	7 9.1	8.3	8.1	8.0
Tax concessions	22.3	20.3	20.0	17.7	22.2	21.1	17.6	15.4	13.4
of which									
Regional promotional measures for Berlin (West) and the zonal border area	13.5	8.3	5.3	3.5	2.7	2.1	1.2	0.7	0.4
of which									
Turnover tax concession for Berlin (West)	3.0	1.7	0.4	.	.	.	.	.	.
Tax grant for employed persons in Berlin (West)	3.4	2.4	1.6	0.8	0.1	.	.	.	.
Regional promotional measures for eastern Germany including Berlin	4.5	8.6	11.7	11.2	14.4	14.0	10.6	8.8	3.0
of which									
Special depreciation facilities for business investment	1.5	1.6	3.9	4.8	8.8	9.1	5.8	5.6	1.0
Investment tax grants	1.0	4.3	5.2	4.4	3.6	2.5	1.8	1.3	1.3
Tax rate limit on business earnings	.	.	.	.	1.7	1.5	2.5	2.6	4.2
"Ecology tax" exemptions	.	.	.	.	.	.	.	.	3.1
Total	37.0	35.8	38.6	34.0	36.3	42.8	39.8	36.9	34.1
Food, agriculture and forestry									
Financial assistance	21.6	27.1	22.0	19.9	19.6	19.4	18.5	18.1	19.5
of which									
EU expenditure on market guarantees	10.5	15.5	12.7	11.3	11.4	11.5	11.0	11.2	12.2
Tax concessions	2.9	1.4	1.0	0.9	0.9	1.0	1.0	1.0	0.9
Total	24.5	28.5	23.0	20.8	20.5	20.4	19.4	19.1	20.4
Housing									
Financial assistance	7.0	8.5	6.6	9.6	10.0	9.3	9.3	8.9	8.9
of which									
Federal grants for the construction of flats for low-income groups	1.5	1.8	1.6	2.0	2.1	2.5	2.5	2.4	2.0
Tax concessions	7.3	8.4	10.7	12.1	12.2	13.4	16.7	18.8	19.2
of which									
Sections 7b and 10e (incl. 34f) of the Income Tax Act	5.7	6.7	9.0	10.4	11.2	11.5	10.0	8.7	7.2
Tax grant for home owners (incl. tax grant for children)	.	.	.	.	.	0.5	3.5	7.0	10.2
Total	14.3	16.8	17.3	21.7	22.2	22.7	25.9	27.7	28.1
Transport									
Financial assistance	2.5	2.2	2.6	3.2	2.6	2.6	2.8	2.8	2.5
Tax concessions	1.8	2.0	2.2	2.1	2.1	2.1	2.1	2.2	2.4
Total	4.3	4.2	4.8	5.3	4.7	4.7	5.0	5.0	5.0
Other assistance									
Financial assistance	0.6	0.6	0.6	0.5	0.4	0.3	0.5	0.6	0.9
Tax concessions	4.6	5.0	6.1	6.2	5.7	5.9	6.9	7.3	7.8
of which									
Tax exemption for bonuses for night work *inter alia*	1.2	1.3	1.8	1.8	2.3	2.3	3.4	3.5	3.6
Turnover tax concessions	1.9	2.2	2.8	3.0	2.9	3.0	3.1	3.4	3.5
Total	5.2	5.6	6.6	6.7	6.1	6.2	7.3	8.0	8.7
All sectors 3									
Financial assistance	49.2	56.8	53.7	53.1	49.7	56.5	56.5	55.1	55.7
Tax concessions	38.9	36.7	39.9	39.0	43.1	43.5	44.3	44.7	43.9
Total	88.1	93.5	93.6	92.1	92.8	100.0	100.8	99.8	99.6
Memo items									
Treuhand agency 4	15.6	23.0	28.7	31.6	1.1	0.5	0.5	1.0	1.1
Federal and Länder Government loans	3.4	3.5	4.3	4.3	4.0	3.8	3.4	3.0	3.0
ERP loans	10.8	11.5	9.0	10.5	11.5	11.0	13.3	12.9	13.0
Loans promised by the KfW 5	29.8	27.3	19.8	29.5	23.8	27.2	32.7	40.1	54.7
Federal Government guarantees 6	191.8	202.2	214.7	223.5	238.3	252.3	267.7	268.1	272.9

* Breakdown of financial assistance by sector excluding local authority subsidies. Loans have been excluded. The trend in tax concessions is also affected by methodological changes and changes in estimates. Source: Federal Government Subsidy Reports and the Bundesbank's own calculations. — **1** Target figures. — **2** Including assistance to close mines. — **3** Including local authority subsidies. — **4** Expenditure by the Treuhand agency on "core" business and Federal Government payments to successor organisations. — **5** Only to the housing sector and to trade and industry. — **6** Data as at June 30 in each case. Guarantees for exports, other domestic trade and successor organisations to the Treuhand agency. — **7** From 1996 including subsidies for the use of coal to generate electricity amounting initially to DM 7.5 billion.

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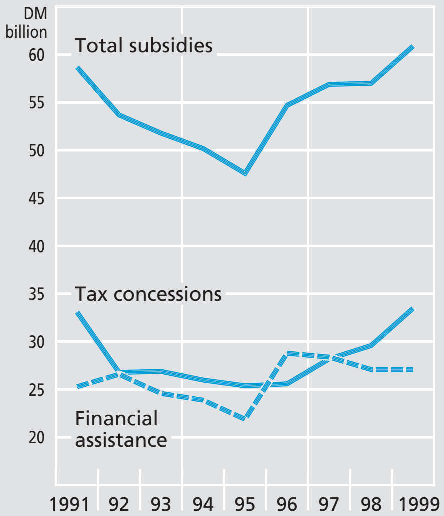
Subsidies in western Germany



Source: Federal Government Subsidy Reports and Bundesbank estimates. Subsidies by the Federal Government, Länder Governments and local authorities, excluding loans. Western Germany including Berlin (West). Data for 1999 are planned values.

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expenditure on market guarantees) reveals the shifts between western Germany including Berlin (West) and eastern Germany. Subsidies paid in western Germany were reduced from DM 59 billion to DM 48 billion between 1991 and 1995 primarily as a result of the expiry following reunification of the promotional measures for the areas bordering the former East Germany and of the substantial aid for Berlin (West). This notably entailed the gradual reduction of the grant paid to employed persons in Berlin (West) up to the end of 1994 and the reduction of the turnover tax concession there up to the end of 1993 as each of these fiscal measures had resulted in lost tax revenue of DM 3 billion in 1991. In other areas, by contrast, there was no appreciable reduction in subsidies on the whole despite the serious funding problems following reunification.

Sharp rise in tax concessions since 1996

Aid began to grow again in western Germany in the second half of the nineties, rising to DM 61 billion by 1999. This was due not only to the inclusion of the coal subsidy but also to a sharp rise of almost DM 8 billion in tax concessions, notably those to promote housing construction, to finance exemptions from the "ecology tax" and to limit the income tax rate on business earnings. Financial assistance, by contrast, declined by just under DM 2 billion although this was due in part to the transfer of financial items from the government core budgets to off-budget accounts.[10]

Considerable increase in eastern Germany up to 1996

Two distinct periods can likewise be seen in the trend in regionally classifiable subsidies in eastern Germany. Aid rose sharply until 1996 (from just under DM 19 billion in 1991 to almost DM 34 billion). Tax concessions, which consisted primarily of grants and special depreciation allowances for investment in the east, accounted for the bulk of this rise. As a result of this massive investment promotion, concession-related shortfalls in tax revenue

10 In its 12th Subsidy Report Hesse, for example, points out that since 1999 the grants for the construction of flats for low-income groups have been almost fully met from a special off-budgetary fund. In 1998 financial assistance (including loans) of just over DM 450 million had been recorded under this item. In its financial assistance reports for the years 1996 to 1999 Rhineland-Palatinate, too, mentions the outsourcing of functions, which probably explains the reduction in housing aid in that state by just over DM 200 million in 1999. There has also been a further reduction of just over DM 400 million since 1997 through shifting the capital aid programme to budding entrepreneurs from the Federal Government to the ERP Special Fund.

tripled to almost DM 18 billion between 1991 and 1996.

Significant decline since 1997

Since 1997, by contrast, aid has declined significantly (to DM 26 billion in 1999), primarily as a result of the diminishing importance of tax concessions. The progressive curtailment of special depreciation allowances up to the end of 1998 was the major factor here. Even so, this entailed only a partial real reduction in the investment incentives applying to eastern Germany because the special depreciation allowances were replaced by investment grants. On balance, these have been providing more or less the same degree of incentive but with far smaller short-term tax shortfalls because, in contrast to what happened in the case of special depreciation allowances, enterprises no longer have to bear additional burdens at a later date. Another reason for the decline in tax concessions was that wealth tax was abolished in western Germany in 1997 and trade capital tax a year later. Neither of these had been levied in eastern Germany, and so this had been tantamount to a subsidy there.

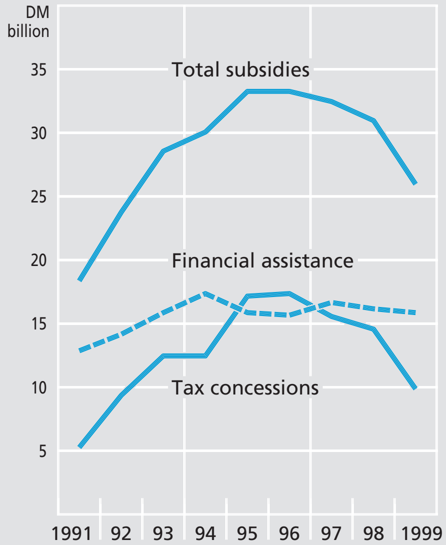
Pronounced sectoral concentration of aid

A sectoral breakdown of the subsidies granted by the Federal and Länder Governments and by the EU shows that these are concentrated heavily on agriculture, housing, transport and coal mining. Between them, these sectors received about two-thirds of the aid granted in 1999.

EU aid to agriculture particularly extensive

Food, agriculture and forestry received aid amounting to almost DM 25 billion in 1991. With the inclusion of eastern Germany in the EU's agricultural market regulation scheme, the volume rose appreciably to just over DM 28 billion in the following year but subsequently declined again and has been stable at approximately DM 20 billion since 1994. In 1999 the EU's expenditure on market guarantees predominated, at just over DM 12 billion. This expenditure is now primarily an incomes subsidy and varies according to the size of the agricultural business. It is paid as compensation for income losses arising from price reductions which had been implemented from 1992 to curb production incentives and thereby check existing surpluses of many products. Expenditure on export subsidies and storage also plays a role here. The main reason for this expenditure is that the guaranteed minimum prices of many agricultural products are still above world market prices.

Subsidies in eastern Germany



Source: Federal Government Subsidy Reports and Bundesbank estimates. Subsidies by the Federal Government, Länder Governments and local authorities, excluding loans. Eastern Germany including Berlin (East). Data for 1999 are planned values.

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As in the case of national aid, there is considerable need for reform here.

Other agricultural aid from Federal and Länder Governments

Agricultural subsidies include aid for the purchase of diesel fuel amounting to almost DM 1 billion a year. Supplementary assistance is also paid to farmers working less favoured areas such as mountainous regions. The EU pays a grant, which is topped up by the Länder Governments, for this purpose. In addition, the Federal Government makes a grant towards farmers' accident insurance. This amounts to just over DM ½ billion and holds down their insurance premiums. However, the other aspects of agricultural social policy,[11] which include, above all, grants to the farmers' pension and health insurance schemes and which, in the end, likewise bring financial relief to agricultural businesses, are not shown in the Subsidy Reports. This additional expenditure amounted to just over DM 7 billion in 1999.

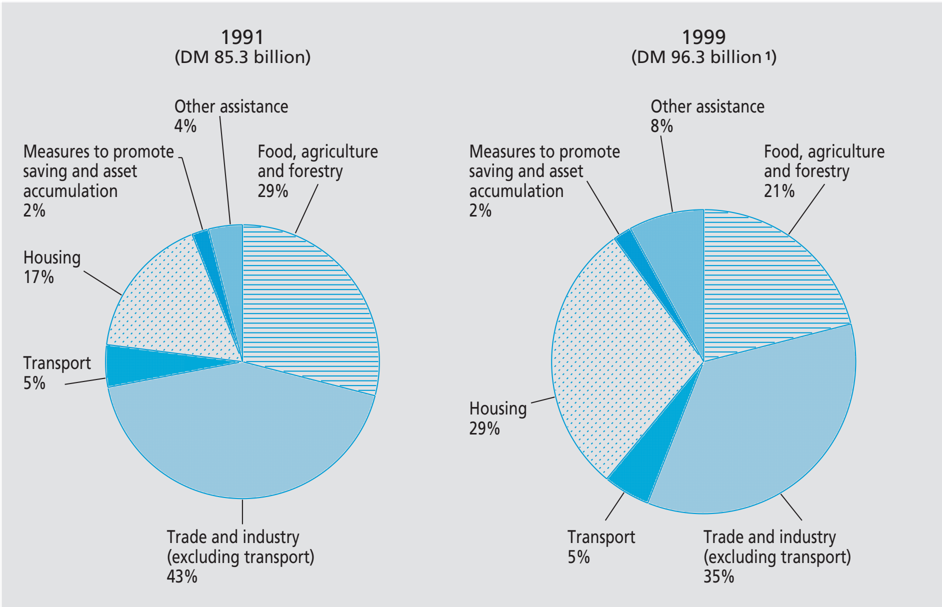
Sharp rise in housing subsidies

Housing subsidies[12] grew fastest by far in the nineties. These benefits doubled from just over DM 14 billion in 1991 to DM 28 billion in 1999. The increase was primarily due to the tax concessions which were granted to home buyers and which grew from just over DM 7 billion to more than DM 19 billion. Until 1996 this sharp rise had mainly taken the form of growing tax shortfalls as a result of the special allowance under section 10e of the Income Tax Act. The effective level of this allowance depended on the marginal tax rate of the respective home buyer. The loss of revenue associated with this tax break increased with the sharply rising level of investment in housing until the mid-nineties, a trend that was partly due to reunification. A flat-rate tax grant for home owners, which is deducted from the beneficiary's income tax liability and is independent of his individual tax rate, replaced the special allowance for new applications from 1996. In principle, this change should have had a largely neutral effect on tax revenue. Even so, tax shortfalls caused by the promotion of home ownership continued to grow, mainly because the volume of investment began to expand again from 1997. A contributory factor, in addition to the declining interest rates until 1999, could be that the positive stimuli on the lower-income groups and families with children which resulted from the change in the form of the promotion scheme had a greater effect than the negative impact in the upper income segment where greater use had been made of the previous assistance scheme for home buyers. Growth levelled out again last year owing to the abolition of the deduction to cover preliminary expenses.[13] Since the year 2000 tax shortfalls have been checked by the lowering of the income tax threshold for qualifying for the tax grant for home owners, which came into force at the beginning of 2000, and by the downturn in construction.

Financial assistance for housing ceased to expand so sharply and amounted to just under

11 The Federal Government refers explicitly to the agricultural report, which lists "grants that are similar in nature to subsidies".
12 Excluding the fiscal promotion of investment in rented accommodation in eastern Germany, including Berlin (West), which is shown under Trade and industry (excluding transport).
13 Up to the end of 1998 the purchaser of a property for owner-occupation could offset expenditure incurred for renovation work prior to occupation against tax as special costs.

Subsidies by sector



Source: Federal Government Subsidy Reports and Bundesbank calculations. Subsidies by the Federal Government, Länder Governments and the EU, excluding loans. — **1** Budget target values.

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DM 9 billion at the end of the nineties. A large part of these funds is used for building public housing estates. In 1999 the Federal Government alone spent DM 2 billion on this. It also grants interest subsidies to the KfW, which uses these funds to encourage borrowing to modernise dwellings and reduce heating costs.[14]

Transport

Throughout the period under review subsidies amounting to approximately DM 5 billion a year were granted to the transport sector. The turnover tax concession which is granted to regional public transport played an important role in this. In addition, the Länder Governments provided financial assistance to the cost of travel for schoolchildren and students. Transport subsidies do not include Federal Government aid to rail transport in the form of investment grants or interest-free loans, payments to maintain regional public transport and the grants to the Federal Railways Fund, which uses most of the money to finance former railway officials' non-contributory pensions. At almost DM 30 billion, these benefits far exceeded the volume of subsidies officially recorded in 1999.

Assistance for coal-mining

Of the many subsidies paid to the remaining sectors of trade and industry, not only the measures to encourage investment in eastern Germany but also the financial assistance to coal-mining are of considerable importance. Expenditure by the Federal Government on

14 In 1999 the KfW approved loans to the housing sector totalling almost DM 22 billion. The Federal and Länder Governments also granted loans for house-building. Almost DM 3 billion was earmarked for these purposes in their budgets in 1999.

the latter[15] declined by DM 1 billion to DM 2 ½ billion between 1991 and 1995. The coking grant, which reduces the price the steel industry pays for domestic coal to that of imported coal, accounts for the largest share of this subsidy by far. In 1996 the coal subsidies paid out of the Federal budget increased to just under DM 10 billion as a result of the aforementioned inclusion of the assistance granted to promote the use of coal for generating electricity. They then began to decline slightly, amounting to DM 8.5 billion by 1999. This was partly influenced by the "coal compromise" which was agreed in 1997 and which sets fixed promotional budgets until 2005, by which time these, in the case of the Federal Government, are to fall to just under DM 4 billion. As a result of pressure from the EU to restructure the support schemes, assistance to enable mines to close will play a greater role in the next few years.

Declining subsidies to aircraft and shipbuilding industries

Other trade and industry sectors still receiving large subsidies at the beginning of the nineties were the aircraft industry and shipbuilding. In 1991, for example, subsidies paid out of the Federal budget for aircraft manufacture amounted to almost DM 1.4 billion. In view of the increasing success in selling Airbus aircraft, aid for the sector had been virtually discontinued by 1998. Federal aid for shipbuilding has also been significantly reduced. At the end of the period under review it amounted to just under DM 0.3 billion, which was one-half of the subsidy level in 1991.

New subsidies through "ecology tax" exemptions ...

The exemptions from the extension of energy tax and its progressive increase since April 1999 will have a relatively strong impact on the overall trend in subsidies for trade and industry in the next few years. Prominent examples are tax concessions for the producing sector and for agriculture, which have to pay only 20 % of the normal rate of electricity tax and of the increase in mineral oil tax rates for heating purposes. The aim of these measures is to safeguard the competitiveness of energy-intensive sectors in Germany and, consequently, to avoid the transfer of production abroad. In 1999 exemption arrangements probably resulted in tax revenue losses amounting to approximately DM 3 billion.[16] There is likely to be an almost three-fold rise in this amount by 2003 as a result of the future increases already approved.

... and the tax rate limit on business earnings

The tax rate limit on business earnings introduced in 1994 also played an important role, leading to tax shortfalls of just over DM 4 billion in 1999. To limit the additional burden that the trade tax is having on such earnings the top rate of income tax has been reduced by 8 percentage points. In 2001 this measure will be replaced by the off-setting of trade tax against the income tax liability. This reform will result in a further sharp rise in tax revenue losses. Considered strictly in income tax terms, this measure is tantamount to a concession, but looking at the total tax burden on business profits, it may be regarded as a

15 This aid is not shown separately for the Länder in the Federal Government's Subsidy Reports. According to data in its 16th Subsidy Report, North Rhine-Westphalia, the most important state concerned, currently pays out about DM 1.2 billion in aid to the coal industry each year.
16 The subsidy volume does not include the additional tax refund claimable by enterprises whose "ecology tax" burden is over 1.2 times greater than the relief they have been granted on pension insurance contributions.

reduction in the additional tax burden compared with other forms of income.

Other aid

Regarding the other forms of aid, the tax exemption on wage and salary increments for working on Sundays, public holidays and at night is of particular importance. It is estimated that tax shortfalls as a result of this privilege totalled about DM 3.5 billion in 1999. Turnover tax concessions due to a lower levy on certain goods and services are another major factor in this category.[17]

Problems of subsidy controls, and outlook

The Federal Government's Subsidy Reports list the aims of the subsidies but do not define them precisely enough to enable a sufficiently accurate analysis to be made of the effectiveness of their application. This makes it difficult to evaluate their cost-effectiveness.[18]

General trend towards spread of subsidies

If the effectiveness of subsidies is inadequately monitored, there is a general danger that the use of subsidies could spread. Recipient groups benefit greatly from the aid granted and resist any attempt to reduce it. As long as the unproductiveness of a form of aid cannot be unequivocally proven, those vested interests dominate the political process at the expense of the majority, who, individually, are only marginally affected by the additional levy burden resulting from a specific subsidy. This set of circumstances encourages the expansion of aid. This leads to a rise in the general levy burden, which, in turn, curbs economic growth. The strict monitoring of subsidies is therefore essential because of the associated pressure to justify measures. However, this monitoring should not only cover the degree of success in achieving objectives but should also take account of the funds applied and the negative macroeconomic repercussions associated with the subsidies.

Increasing pressure from aid monitoring by European Commission

In view of the desired reduction in subsidies, the monitoring of aid by the European Commission is growing in importance. The authority granted by the EU Treaty to avert impediments to economic transactions between member states is being interpreted increasingly more liberally so that it now puts further limits on the granting of aid. Not only private enterprises are being monitored; capital investment and the offsetting of losses by public corporations are also being scrutinised. Aid which does not conform to EU norms has to be refunded with interest by the beneficiaries (see the box showing the European Commission's subsidy controls on page 28). This could lead to the recipients of subsidies losing interest in grants and allowances that were dubious under European law, thus encouraging the reduction of subsidies.

17 In this context it is difficult to understand the definition used in the Subsidy Reports. While, for example, the reduced VAT rate for cultural and entertainment services as well as for technical services in dentistry is recorded as aid, other concessions are not taken into account. This applies both to other tax concessions (on, for example, food) and to all special tax exemptions. These are either not recorded at all (for example, tax exemptions on housing rents and on banking services) in the Subsidy Reports or are shown only as a memo item (Annex 3). While individual EU member states are free to decide whether they take advantage of the concessionary options laid down in the Sixth EC directive on value added tax harmonisation, the tax exemptions allowed can be reduced only by an amendment to the directive.
18 The Federal Court of Auditors referred to this in its remarks on financial management as far back as 1996. See Bundestags-Drucksache 13/5700, page 45 ff.

Subsidy controls by the European Commission

Subsidy controls by the European Commission make considerable inroads into the economic policy sovereignty of the EU member states. These controls are part and parcel of the Commission's task, in its capacity as the guardian of the treaties, to safeguard the orderly functioning of the single market. Accordingly, far-reaching powers in the fields of cartel law, merger control and state aid (subsidies) are assigned to it in the section of the EU Treaty on competition. According to Article 87 (1), state aid which favours certain undertakings or the production of certain goods is forbidden, in principle, insofar as it affects trade between member states. This applies regardless of the type of subsidy or of whether a favoured enterprise is participating in intra-Community trade. It is sufficient for there to be an economic advantage which would entail a competitive disadvantage for enterprises domiciled in other member states. The Commission is not required to quantify the distorting effects on competition in individual cases but, instead, can use the general characteristics of state aid programmes as a basis for its decisions. [1]

A number of exceptions restrict the significance of this subsidy ban, however. Agriculture is virtually exempt from the rules on competition (Article 36). Among other permissible exemptions are subsidies aimed at assisting economically disadvantaged regions as well as those for promoting culture, small and medium-sized businesses, research and development, employment and education as well as the environment and restructuring. Public or publicly controlled enterprises which provide services of general interest likewise enjoy a special position (Article 86 (2)).

Under the control procedure (Article 88) the member states are required to inform the Commission before granting any new aid or reorganising existing aid (notification). The measure must not be implemented until it has been approved by the Commission or until the (relatively short) period allowed for its rejection has expired. If the Commission has doubts about the legality of a subsidy, it institutes the major investigation procedure set forth in Article 88 (2), which encompasses opinions from those directly involved and from other parties. The Commission's final decision consists in either discontinuing the procedure or in pronouncing a negative verdict which declares the aid to be unlawful. The member state concerned is required to recall any unlawful aid already granted (including interest from the time it was granted) from the beneficiary enterprise. An appeal to the European Court of Justice against the Commission's decision is possible. However, this has no postponing effect on the obligation on the part of the member state concerned to retrieve the aid paid. Even if the decisions taken by the Court of Justice do not always favour the Commission, the Court tends to support the Commission's stance on subsidy restriction.

It is important for the effectiveness of subsidy control that third parties – as a rule non-beneficiary competitors – can also ask the Commission to investigate state aid or seek an injunction directly in the national courts.

Decisions taken by the European Commission and directly affecting Germany include those against subsidies for production plant owned by Volkswagen in Saxony [2] and the capital injections made by the state of North Rhine-Westphalia to Westdeutsche Landesbank. [3] In the first case, only part of the aid was unlawful because, in principle, aid granted to compensate for the economic disadvantages caused by the division of Germany is permissible. The extent of the increase in production capacity thereby assisted, however, was seen as distorting competition in the light of total production capacity in the European car industry. In the second case, the Commission held that North Rhine-Westphalia, as the creditor, was not charging a market-related rate of interest, and this was considered to be giving Westdeutsche Landesbank, owing to the significant improvement in its own capital base, an inadmissible competitive advantage over other banks.

1 See, for example, the judgement of the Court of Justice of the European Communities of June 17, 1999 (Kingdom of Belgium versus European Commission, "Maribel" scheme). — **2** Decision of the Commission of June 26, 1996, Official Journal of the European Communities, No. L 308 of November 29, 1996. — **3** Decision of the Commission of July 8, 1999, Official Journal of the European Communities, No. L 150 of June 23, 2000.

Deutsche Bundesbank

Consolidation requirements curb subsidies

General fiscal policy requirements are also tending to reduce the volume of subsidies. Despite the achievements over the past few years, there is still enormous pressure on general government to consolidate its budgets. If governments are to meet their obligation under the European Stability and Growth Pact to achieve a budget close to balance or in surplus in the medium term and, in addition, to lower rates of tax and other levies, public expenditure must be strictly controlled and tax concessions reduced. The strict criteria which should apply to granting subsidies, as discussed above, are another reason why the call for a vigorous reduction, especially in the principal recipient areas, remains on the fiscal policy agenda. The coal compromise of March 1997 is a major step in the right direction. According to its medium-term fiscal plans, the Federal Government intends to reduce its total financial aid to approximately DM 13 billion by the year 2004 (compared with just over DM 21 billion in 1999). By contrast, there could be a rise in the volume of tax concessions, partly because of the growing importance of exemptions from energy taxation which is to continue rising until 2003.