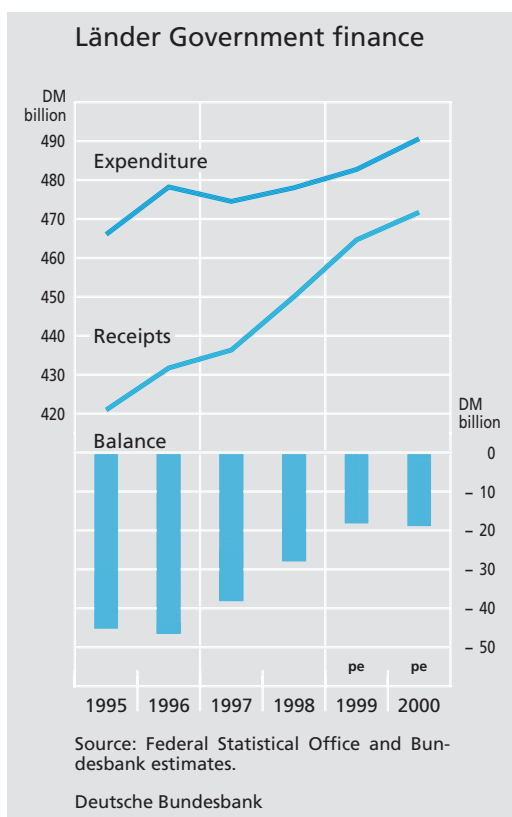


Trends in Länder Government finance since the mid-nineties

The financial position of the Länder improved considerably between the mid-nineties and last year. By the year 2000 the deficits, which had reached an all-time high of DM 46½ billion in 1996, had declined to DM 19 billion. This was mainly due to the recovery in tax revenue since 1998 as well as to the limitation on the growth in expenditure. The east German Länder have also been successful in reducing deficits. Owing to their persistently low tax potential, however, they continue to be dependent on large-scale transfers. Since the beginning of the current year the overall financial position of the Länder has again deteriorated significantly. This is essentially due to the large revenue shortfalls as a result of the tax reform. The sharply growing deficits highlight the need for continued retrenchment, especially as most of the Länder are endeavouring to achieve balanced budgets. This would be consistent with the objectives of the European Stability and Growth Pact, which requires general government to achieve a balanced budget in the medium term. The tax potential of the individual Länder varies considerably. This differential is largely levelled out, and in some cases the respective positions of the Länder were even reversed by the revenue-sharing scheme and supplementary Federal grants. This system has now to be revised following a ruling of the Federal Constitutional Court in November 1999.



Overall trends in Länder Government finance

Large deficits in mid-nineties

The Länder budgets ran large deficits in the middle of the nineties. An all-time high of DM 46½ billion was reached in 1996 when almost 10 % of total expenditure had to be covered by borrowing and reductions in reserves.¹ To prevent the level of debt and the resultant interest burden from getting out of hand significant and rapid reductions in the financial gap were urgently necessary. By the year 2000 it had been possible to reduce the deficits by more than one-half to DM 19 billion, or 4 % of expenditure.

Länder in both eastern and western Germany have been successful in reducing their deficits. Owing to their less favourable starting

point, however, the east German Länder (excluding Berlin) still cannot finance a much larger share of their expenditure, at just over 7 %, through “normal” receipts. Indeed, the differences between the individual Länder are even greater. Whereas preliminary data show that Bavaria, for example, was able to achieve a budget surplus in the year 2000, the deficits in Berlin, Hamburg, Mecklenburg-Western Pomerania, Saxony-Anhalt and Thuringia still amounted to much more than 6 % of their respective levels of expenditure.

Differential in Länder financial positions remains even after deficit reduction

One major reason for the advance made in consolidation was the limitation placed on the growth in expenditure. At the beginning of the nineties Länder expenditure had still been rising at an average annual rate of more than 5 %. As a result of the sharp deceleration in the increase in revenue, the Länder were compelled to make a dramatic cut in the growth of their expenditure. Between 1997 and 2000 the average increase was just a little more than ½ %. Thus, the recommendation from the Financial Planning Council to limit the annual growth in expenditure to a maximum of 2 % was also achieved.

Progress in consolidation as a result of limitation on expenditure growth

With a share of almost 40 %, total expenditure on staff is the most important category of expenditure in the Länder budgets. With the exception of 1995 and 1999 (when an increase in the rate of contributions to the supplementary pension funds for salary and wage earners had also to be covered) the negotiated wage settlements and the resultant

Strict limitation on growth in expenditure on current staff ...

¹ For details of the previous trends see Deutsche Bundesbank, The finances of the Länder Governments since unification, Monthly Report, April 1995, page 35 ff.

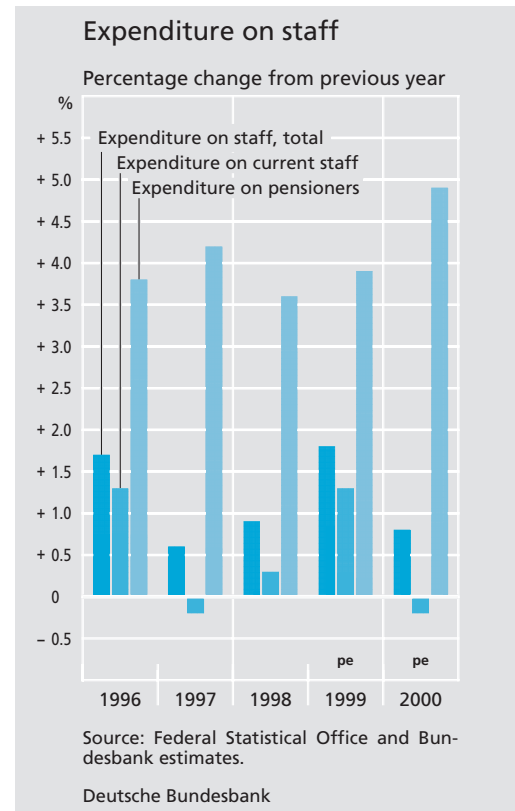
pay increases for civil servants remained moderate. This is especially true in the light of civil servants' compulsory working hours, which in some cases were extended. However, the limitation of the average annual increase in expenditure on current staff since 1995 to 1/2 % could be achieved only by reducing staff numbers by 1 1/2 % a year.² All major areas of activity were affected by this, albeit to varying degrees. Particularly in the past two years, however, there has again been an expansion in recruitment in the schools and to some extent in the police in many Länder. The reduction in staff has been slowed down as a result.

... but a substantial rise in expenditure on pensioners

Expenditure on pensioners has been growing at an annual average rate of just over 4 % since 1995 owing to the sharply rising number of pensioners. In 2000 they accounted for as much as one-fifth of total expenditure on staff, which, despite the savings made in the case of current employees, has thereby risen at an average annual rate of 1 1/4 %. As a result of the sharp increase in the number of pensioners, a significant long-term burden on Länder budgets is emerging. Although a reserve fund was founded in 1999 to finance this via contributions amounting to 0.2 percentage point of every increase in civil servants' pay and pensions until 2013, this measure can take account of only part of the extra burden.

Only slight rise in grants to other levels of government

The increase in grants to other public authorities, which account for just over one-fifth of Länder expenditure, has been checked even more than the increase in expenditure on staff. More than 90 % of these payments go to the municipalities. To a large extent they



are covered by the tax-sharing arrangements which the Länder have made with their municipalities, especially with respect to important shared taxes. As the shares in tax revenue can only be changed by legislation, the development of these grants depends on the respective trends in tax revenue, as a rule. Cuts have been made principally in the case of payments which – like the investment grants – are not subject to fixed rules of that kind. Although the Länder have been paying additional compensation to their municipalities for their loss of tax revenue (about DM 4 billion in the year 2000) since the change in the system of child benefit payments – since 1996 these payments have been offset

² However, part of this staff reduction was due to the removal of certain institutions from the core budgets of the Länder.

against wage tax – and although tax revenue has been rising more sharply again since 1998, total payments to other public authorities were only 1½ % larger last year than in 1995.

Growth in grants to private sector borne largely by Federal Government

Although grants by the Länder Governments to the private sector have grown at an annual average of 2½ % since 1995, this has hardly had a detrimental effect on Länder budgets on balance. The reason is that most of this rise is due to the transfer of responsibility for local passenger transport from the Federal Government to the Länder Governments as part of the 1996 reform of German railways. In compensation for this transfer of responsibility the Länder Governments receive a share of the Federal Government's revenue from mineral oil tax. This, together with additional – partly investible – funds for local public passenger transport, amounted to just over DM 13 billion in 2000. As there was almost no change to legislation on benefits, there was virtually no rise in current transfers to households, notably housing allowances, benefits paid under the Federal Act on the Promotion of Education and child maintenance advances, which are all co-financed by the Federal Government.

Restriction on investment expenditure

Investment expenditure (excluding investment grants to the municipalities) was actually reduced by 11½ % between 1996 and 1999. There was only a slight rise in this expenditure again last year. Consequently, its share of total expenditure declined by 1½ percentage points to just over 10 % compared with 1995. Although building expenditure reached the 1995 level, at DM 11½ billion, in-

vestment grants, notably to hospitals, educational establishments, house building companies and local rail transport, declined considerably (by DM 3 billion to DM 26 billion). There was likewise a decline in land acquisition. To a lesser extent, however, this was due to the removal of some building operations from the Land budgets.

The Land budgets were burdened by the rise in interest expenditure up to 1999. The average amount of interest paid on loans has been reduced by the low interest rate level during the past few years (just over 6½ % in 1995 falling to just over 5¾ % last year). However, the persistently sharp rise in debt has been undermining this effect with the result that interest expenditure increased by almost 4½ % a year until 1999.

Substantial rise in interest burden

Until 1997 the retrenchment on expenditure was almost offset by the fact that the tax revenue of the Länder stagnated for the most part. Following the changeover in the system of paying the (increased) child benefit to offsetting it against wage tax and the substantial rise in the basic allowance following a decision by the Federal Constitutional Court, the revenue of the Länder from wage tax actually fell considerably in 1996. As compensation for the loss of tax revenue resulting from the change in child benefit payments, however, the Federal Government granted the Länder a 5½ percentage point increase in their share of turnover tax. However, the local authorities also have to be compensated from this. In 1997 the persistently strong decline in assessed income tax played a role, not least as a result of the special depreciation allowances

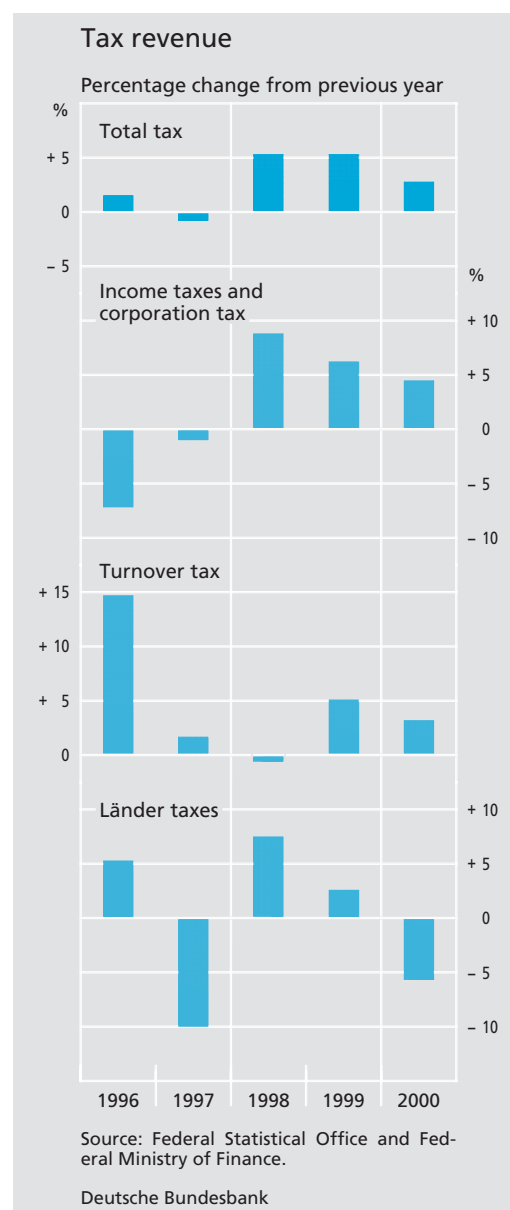
Weak trend in tax revenue until 1997

granted in eastern Germany. Furthermore, the abolition of wealth tax – following a decision by the Federal Constitutional Court – represented an additional burden (of almost DM 7½ billion) for the Länder. Some of the increases in the tax on the acquisition of land and buildings and in the inheritance tax that were conceived as compensation needed time to take effect and, initially, could therefore compensate for little more than one-third of the lost revenue in 1997.

Taxes yield more again from 1998

Tax revenue again increased strongly from 1998. On an average of the last three years it rose by almost 4½%. However, growth weakened again last year as a result of the cut in income taxation and a marked decline in revenue from the tax on the acquisition of land and buildings owing to the slowdown in the construction industry. The generally more favourable tendency in the last three years was due in the first instance to the gradual expiry of the special depreciation allowances for investment in eastern Germany and the improvement in corporate profits. Secondly, the Länder also obtained substantially larger receipts from turnover tax in the last two years. To a lesser extent, however, these were due in 2000 to the 25 basis point increase in the Länder share of this levy that was granted as compensation for the further rise in child benefit. It was not least as a result of their increasing participation in turnover tax that the Länder increased their share of total tax revenue somewhat compared with the mid-nineties (from 36.5% in 1995 to 37.4% in 2000³).

In view of the sluggish flow of tax revenue in the mid-nineties, some Länder tried to close



gaps in their budgets by selling participating interests. These sales reached a peak at almost DM 10½ billion in 1997, with Berlin and Hamburg alone receiving almost DM 6 billion and just under DM 2 billion, respectively. By the year 2000 the income from these sales had declined to just under DM 5½ billion. This in-

Sales of participating interests to close budgetary gaps

³ Excluding supplementary Federal grants and grants paid out of mineral oil tax but including the local authority taxes of the city states.

Receipts and expenditure of the Länder Governments

Item	1995	1996	1997	1998	1999 pe	2000 pe
	DM billion					
Receipts						
Taxes	298.1	302.6	300.0	316.0	332.7	341.9
of which						
Turnover tax	96.4	110.6	112.4	111.7	117.4	121.2
Wage tax	120.1	106.8	105.7	109.8	111.2	112.8
Assessed income tax	5.9	4.9	2.4	4.7	9.0	10.2
Corporate tax and non-assessed taxes on earnings	17.5	21.4	24.0	29.5	32.9	36.3
Länder taxes	36.6	38.5	34.7	37.3	38.3	36.1
of which						
Motor vehicle tax	13.8	13.7	14.4	15.2	13.8	13.7
Wealth tax	7.9	9.0	1.8	1.1	1.1	0.8
Inheritance tax	3.5	4.1	4.1	4.8	6.0	5.8
Tax on the acquisition of land and buildings	6.1	6.4	9.1	10.8	11.8	9.9
Disposal of participating interests	2.9	2.2	10.4	7.6	7.6	5.4
Grants from other public authorities	77.2	86.2	86.8	87.4	84.7	84.8
Other receipts	43.4	41.5	40.0	39.8	40.4	40.4
Total	421.7	432.5	437.1	450.8	465.4	472.5
Expenditure						
Expenditure on staff	174.5	177.5	178.7	180.4	183.6	185.1
Expenditure on current staff	143.6	145.5	145.2	145.7	147.6	147.4
Expenditure on pensioners	30.9	32.1	33.4	34.6	36.0	37.8
Other operating expenditure	42.5	43.7	42.7	43.9	44.9	45.8
Current grants	55.5	58.5	60.3	62.4	61.7	62.9
Interest expenditure	31.3	33.0	35.0	36.3	37.3	37.2
Investment expenditure (unless spent on other public authorities)	54.3	55.8	52.9	52.1	49.4	50.1
of which: expenditure on buildings	11.6	11.6	11.2	11.1	11.1	11.4
Grants to other public authorities	108.7	110.6	105.7	103.6	106.6	110.3
of which: investment grants	25.1	26.0	24.3	23.9	23.1	23.9
Total	466.8	479.0	475.3	478.8	483.5	491.4
Financial balance	- 45.1	- 46.6	- 38.2	- 28.0	- 18.1	- 18.9
	Percentage change from previous year					
Receipts	10.1	1.5	- 0.8	5.3	5.3	2.8
Taxes						
of which						
Turnover tax	32.8	14.7	1.7	- 0.6	5.1	3.2
Wage tax	6.1	- 11.1	- 1.0	3.9	1.3	1.4
Assessed income tax	- 45.1	- 17.0	- 50.4	92.9	91.6	12.3
Corporate tax and non-assessed taxes on earnings	- 6.1	22.1	12.1	22.9	11.7	10.2
Länder taxes	0.1	5.3	- 10.0	7.5	2.6	- 5.7
of which						
Motor vehicle tax	- 2.6	- 0.5	4.9	5.2	- 9.3	- 0.3
Wealth tax	18.5	15.0	- 80.6	- 39.5	- 1.1	- 19.3
Inheritance tax	2.0	14.2	0.2	18.5	24.3	- 2.4
Tax on the acquisition of land and buildings	- 13.7	5.3	42.8	17.9	10.1	- 16.1
Disposal of participating interests	- 19.7	- 23.8	365.8	- 27.1	0.6	- 29.1
Grants from other public authorities	- 20.1	11.6	0.7	0.7	- 3.0	0.1
Other receipts	17.2	- 4.3	- 3.7	- 0.3	1.3	0.1
Total	3.3	2.6	1.1	3.1	3.2	1.5
Expenditure						
Expenditure on staff	4.2	1.7	0.6	0.9	1.8	0.8
Expenditure on current staff	4.0	1.3	- 0.2	0.3	1.3	- 0.2
Expenditure on pensioners	5.4	3.8	4.2	3.6	3.9	4.9
Other operating expenditure	0.5	2.7	- 2.1	2.8	2.3	2.1
Current grants	0.6	5.4	3.2	3.6	- 1.1	1.8
Interest expenditure	5.2	5.3	6.2	3.7	2.6	- 0.2
Investment expenditure (unless spent on other public authorities)	3.2	2.8	- 5.2	- 1.5	- 5.2	1.4
of which: expenditure on buildings	2.4	- 0.3	- 2.7	- 1.5	- 0.1	3.5
Grants to other public authorities	2.9	1.7	- 4.4	- 2.0	2.8	3.5
of which: investment grants	3.8	3.5	- 6.5	- 1.6	- 3.2	3.2
Total	3.1	2.6	- 0.8	0.7	1.0	1.6

Source: Federal Statistical Office, accounting results of the public authorities, tax budget. Federal Ministry of Finance.

come continues to be of particular importance to the city state of Berlin, which has experienced serious budgetary problems since the reduction in its extensive financial assistance from the Federal Government following reunification. The Länder still hold extensive participating interests. If a well-designed market economy is taken as a criterion, further sales are advisable. However, the proceeds should not be used to finance additional expenditure but, instead, to reduce the debt burden.

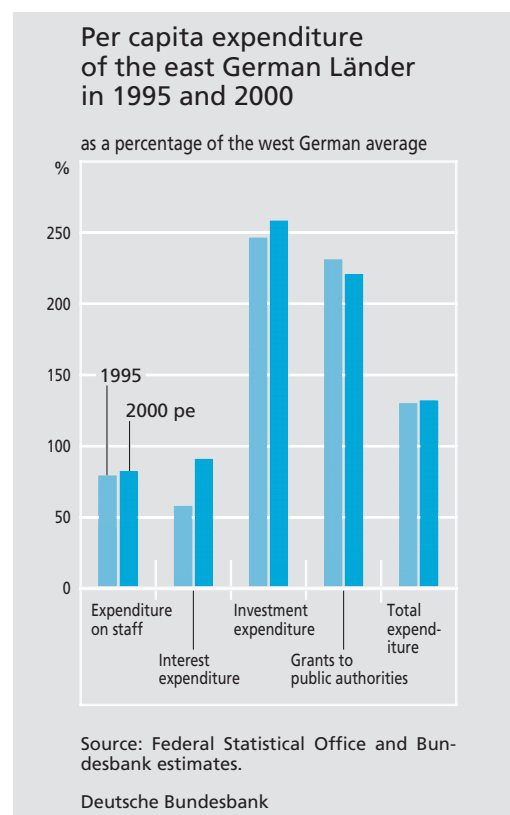
Budgetary position of Länder in eastern Germany

Larger deficits remain even after inclusion in revenue-sharing scheme

The Länder in eastern Germany⁴ have been fully integrated into the framework governing tax distribution and revenue sharing since 1995. The resultant annual receipts substantially exceeded the payments made from the "German Unity" Fund, which were discontinued at the end of 1994. Although part of the additional receipts was passed on to the east German local authorities, it was possible to reduce the deficit by DM 4½ billion to DM 12 billion in 1995. Despite the progress made in reducing the deficit in the following few years, the shortfall in cover, at almost DM 550 per inhabitant, was still about three times as high as in western Germany in the year 2000. Even so, there are marked differences from one Land to another in the east of the country, too. For example, Saxony is actually still far below the west German average.

Per capita expenditure much greater

Total expenditure per inhabitant has exceeded the level in western Germany by one-third since the mid-nineties. However, this



ratio is distorted by the substantial grants which are made – to a large extent financed by the Federal Government – to the east German municipalities, which generate little tax revenue.⁵ If payments to other public authorities are excluded, per capita expenditure in eastern Germany was recently just under 10% more than in western Germany.⁶

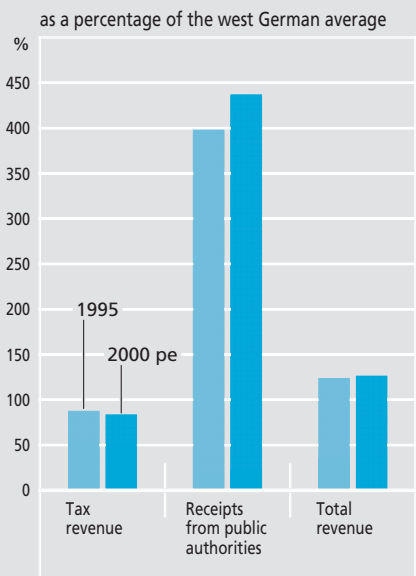
Per capita expenditure on staff recently amounted to just over four-fifths of the level in western Germany. This was principally due

⁴ Berlin is treated as part of western Germany for the purposes of this report.

⁵ Per capita grants to the municipalities were recently more than twice as large as in the west.

⁶ It must always be remembered in the case of the revenue and expenditure levels of the core budgets that they may be distorted by the shifting of tasks to the local authorities (which, in the case of the city states, are fully attributed to the Länder Governments) or to the corporate sector, which differs from Land to Land.

Per capita receipts of the east German Länder in 1995 and 2000



Source: Federal Statistical Office and Bundesbank estimates.

Deutsche Bundesbank

Lower total expenditure on staff due to payments to pensioners

to the still very low payments to retired civil servants.⁷ It is true that the Länder in eastern Germany also enjoy relief from the fact that pay rates are still lower than in the west (about 13 % lower on an annual average in the year 2000). Even so, per capita expenditure on employed persons (i.e. excluding payments to pensioners) has risen more sharply than in the west since the mid-nineties and recently actually exceeded the western level by 6 %. The sharper rises in income could not be offset by the reduction in staff, which, at an annual average of just under 2 ½ %, was almost twice as fast as in western Germany. The number of persons employed by the Länder Governments per inhabitant is still one-seventh above the comparable figure for western Germany⁸ and will probably be a place for further retrenchment.

Although investment expenditure per inhabitant (excluding the investment grants to the municipalities) was somewhat lower in 2000 than in 1995, it was still two and a half times as high as in western Germany. A large proportion of the payments is used for investment grants. Considerable importance is attached to supporting business investment considered as regional aid. Investment grants for hospitals and housing are also important although the special needs of these areas will probably become gradually less acute considering the level of provision that has now been reached. However, gaps in infrastructure, especially transport, are still having a detrimental effect on the economic development of eastern Germany.

Investment still important

The interest burden per inhabitant is now just over 90 % of the level in western Germany compared with just under 60 % in 1995. This increase is due to the generally greater weight of borrowing in the east German Länder, which in 1991 had virtually no debt. In 2000, per capita debt in the east had reached almost the same level as in the west.

Interest expenditure almost at western level

At DM 7,000, receipts per inhabitant likewise exceeded the comparable level in the west recently – by just over one-quarter, in fact. This was due to extensive transfers from the Fed-

Greater receipts as a result of transfers

⁷ However, the Länder in eastern Germany must make payments to the Federal Government for pensioners covered by the special and supplementary pension systems in the former East Germany. If these payments are added to the actual pensions paid, per capita expenditure in 1999 amounted to just over 45 % of the western level instead of the 5 % shown in the financial statistics.

⁸ East Berlin is regarded as part of eastern Germany in the statistics on staff. As the ratio of part-time employees in the Länder Governments in eastern Germany is about 10 percentage points lower than in the west, the difference in staff numbers is actually understated in this comparison.

eral Government, which, together with the payments from the west German Länder, account for almost 45 % of receipts and have been initially fixed only until the end of 2004.

Regional tax potential still very low

In 2000, tax revenue per inhabitant amounted to almost DM 3,600, or 84 % of the western level. However, the figure greatly overstates the tax potential inherent in the regional economy because that figure comprises both the general allocation of turnover tax based on the number of inhabitants and the advance equalising transfers made with respect to this particular tax. Last year both components, taken together, resulted in receipts of DM 2,750 per inhabitant. If the tax-raising potential is measured in terms of income taxes and corporate tax alone,⁹ the ratio is decidedly less favourable. Given per capita revenue of just over DM 650, only one-quarter of the level in the west German Länder was achieved in 2000. The corresponding figure in 1995 was just over 30 %. This means that the region's own tax-raising power has not improved in the past few years, not least because of the unfavourable employment trend. The east German Länder will therefore continue to be dependent on substantial transfers even after 2004.

The Länder's revenue-sharing scheme

Revenue sharing to limit differences in living standards

The German system of public finance does not provide the Länder Governments with the possibility of adjusting their taxes to match their respective financial needs. At the same time, the Basic Law mentions uniform living standards as a fundamental criterion.

Given these underlying conditions, it may be necessary to give financial assistance to "poor" Länder so that they can provide their residents with public services of a similar standard to those afforded by the "rich" Länder. This regional redistribution of funds is achieved in Germany by means of a multi-tier revenue-sharing scheme.

The revenue-sharing scheme in its broader sense, which has been practised in its present form since 1995, adjusts the respective financial resources of the Länder in three steps. The first step comprises the advance equalisation in turnover tax distribution, which had a transfer volume of DM 17 billion in 2000. This is used to bring the tax revenue of Länder which fail to raise at least 92 % of average tax receipts (excluding turnover tax and local authority taxes) per inhabitant up to this level. Up to one-quarter of the Länder's total share of turnover tax is reserved for this equalisation arrangement before the residual amount is distributed among the individual Länder according to the respective number of residents – a process which also encompasses a redistribution from the place where the receipts were generated.¹⁰ In the subsequent

Various steps in revenue-sharing scheme

⁹ The local revenue from wage tax before the deduction of child benefit has been taken as a base. Refunds have been included in the case of assessed income tax, non-assessed taxes on earnings and corporation tax. The redistribution of tax revenue from its place of origin to the recipient authorities according to tax distribution rules (a process called *Steuerzerlegung*) has been taken into account in the case of interest income and corporation tax.

¹⁰ There is also a redistribution of local revenue as part of the breakdown of taxes (*Steuerzerlegung*). Whereas the redistribution of wage tax is based on the domicile of the tax payer and, to that extent, may differ from the place where the income concerned was generated, the redistribution of corporation tax and trade tax is based on the location of the operating plant and thus on the original economic potential.

Financial capacity of the Länder before and after revenue sharing in 2000 *

%

Land	Excluding turnover tax ¹	Before revenue sharing ²	After revenue sharing	After shortfall-related supplementary Federal grants	After special-requirement-related supplementary Federal grants ³
West German states (Flächenländer)					
Hesse	142.9	122.4	103.8	101.9	97.3
Baden-Württemberg	121.2	109.1	101.3	99.5	95.0
Bavaria	120.9	107.4	100.9	99.1	94.6
North Rhine-Westphalia	113.7	102.9	100.4	98.5	94.1
Schleswig-Holstein	93.3	90.2	93.0	95.1	92.7
Rhineland-Palatinate	92.9	88.8	92.8	95.5	93.3
Lower Saxony	86.8	89.8	92.8	95.4	91.7
Saarland	77.4	86.6	93.0	95.7	114.3
City states					
Hamburg	184.2	149.9	136.4	133.9	127.9
Bremen	103.2	95.1	122.8	125.7	172.6
Berlin	93.9	89.4	123.7	127.2	138.3
Western Germany, total	113.7	103.7	101.5	100.9	98.3
Brandenburg	37.2	82.2	92.4	95.0	107.0
Mecklenburg-Western Pomerania	35.0	81.1	92.7	95.3	109.1
Saxony	33.9	82.1	93.1	95.7	107.6
Thuringia	30.4	81.4	92.7	95.4	108.6
Saxony-Anhalt	29.6	81.8	93.0	95.7	109.1
Eastern Germany, total	33.2	81.8	92.8	95.5	108.2
Grand total	100	100	100	100	100

Source: Federal Ministry of Finance and the Bundesbank's own calculations. — * Per capita financial capacity as a percentage of the total German average. The scale used in the revenue-sharing scheme gives a greater weight, for example, to the inhabitants of the city states as well as to those of the larger local authorities in the *Flächenländer* (a process known as *Einwohnerveredelung*). In terms of the actual number of inhabitants in the respective states, differences in financial capacity between the recipient Länder continue to exist even after the revenue-sharing scheme has been applied. — ¹ Länder shares of joint taxes (excluding turnover tax) and of Länder taxes in terms of

local origin. — ² After distribution of revenue from turnover tax, including the share of municipalities' tax receipts to be included in the revenue-sharing scheme, but before the implementation of that scheme among the Länder. — ³ Special-requirement-related supplementary Federal grants are paid to the Länder in eastern Germany (including Berlin), to small Länder owing to the relatively higher cost of political administration, to those west German Länder that were considered to be financially weak prior to reunification and to Bremen and the Saarland as assistance for amortisation of their excessive debt.

Deutsche Bundesbank

step of the revenue-sharing scheme in the narrower sense tax revenue (including turnover tax and one-half of the local authority taxes adjusted mainly by the multiplier differential to take account of differences in the tax rates) that falls below the average amount is topped up to 95 % of the average, which is the compensation coefficient. (The volume in 2000 was just over DM 16 billion.) In the process revenue arising from mining royalties is added to the tax receipts and a lump sum to cover the cost of seaports is deducted. Furthermore, a concession is granted to the city states in that their financial needs per citizen is considered to be 35 % higher than elsewhere. The equalisation tariff provides for an increase in the marginal absorption rates for Länder of above-average tax potential to 80 % as soon as the compensatory

coefficient is exceeded by 10 %. Finally, in a third step, there is a vertical revenue-sharing arrangement. Here, the Federal Government pays the "financially weak" Länder shortfall-related supplementary Federal grants with the result that the revenue of these Länder is raised to 99.5 % of the compensatory coefficient, i.e. to almost the Länder average. In addition, there are Federal grants to cover a variety of special needs (special-requirement-related supplementary Federal grants), as a result of which the position of the Länder with respect to their financial capacity may actually be reversed (total volume in the third stage just over DM 26 billion in 2000).

The present Tax Equalisation Act can now be applied for only a limited period following the ruling of November 1999 by the Federal Con-

Need for reform after constitutional court ruling

stitutional Court because it does not define with sufficient precision the legal terms which have not been specified in the Basic Law. Only if legislation on standards, which closes these gaps, is passed by the end of 2002 can the present regulations continue to apply until the end of 2004. A new Tax Equalisation Act will then have to be submitted by the end of 2004. However, a reorganisation of the contents of the revenue-sharing scheme has not been explicitly demanded.

*Possible points
for reform:
limited
equalisation ...*

The most important shortcoming of the present equalisation mechanism is the almost complete levelling of differences in tax yields. This undermines the incentives for both the donor Länder and the beneficiary Länder to increase their economic and tax-yielding potential through their own efforts and to exploit all the sources of tax available to them. Any reform of the revenue-sharing scheme, which would have to aim under Federal efficiency aspects at increasing the individual public authorities' own level of responsibility, should therefore focus on substantially reducing the equalisation tariff and dispensing with minimum replenishment levels of any sort. The draft legislation submitted by the Federal Government is directed along these lines. However, the flexibility of the Länder budgets on the expenditure side is relatively limited in the short term with the result that changes in the transfer volume would have to be extended over a longer period of time.

*... taking
account of local
authority
taxes ...*

A particularly controversial point is the degree to which local authority tax revenue should be taken into account. As the Länder Governments have to provide a reasonable level of

funding for their local authorities through the local authority revenue-sharing scheme, it appears to be justifiable, in principle, to include local authority tax revenue to a greater extent in the Länder revenue-sharing scheme. Admittedly, this would increase the intensity of the equalisation scheme even more. If the marginal absorption rates remained high, there would be a growing risk that, in net terms, additional income from, say, wage tax would actually have a detrimental effect on the Länder budgets unless this were offset by making changes to the local authority revenue-sharing scheme. To reduce the present undesirable incentives it would be all the more important in the event of a greater amount of local authority tax revenue being included to lower the marginal burden discernibly by means of the equalisation tariff.

The greater needs of the city states over the other states (*Flächenländer*) – which are far larger in terms of area (*Fläche*) – are justified by the fact that the city states provide major centrally located amenities which are enjoyed by people living in the surrounding towns and villages but, as a result of the distribution of wage tax according to the taxpayer's place of residence, a considerable portion of the city states' tax revenue is lost to these surrounding communities. A higher population weighting is one possible way of compensating for these effects.¹¹ However, the size of this weighting element is controversial; at all events, following the ruling of the Federal Constitutional Court, the present population

*... examining
additional
needs*

¹¹ A more appropriate alternative might be to base the distribution of wage tax not only on domicile but also on the location of the taxpayer's place of work.

Länder fiscal indicators according to quarterly cash statistics in 2000

DM thousand per inhabitant

	Baden- Württem- berg	Bavaria	Branden- burg	Hesse	Mecklen- burg- Western Pomerania	Lower Saxony	North Rhine- Westphalia	Rhineland- Palatinate	Saarland
Revenue-sharing scheme	-0.37	-0.31	0.49	-0.88	0.55	0.14	-0.12	0.19	0.31
Balance of Länder budgets	-0.13	0.15	-0.34	-0.14	-0.70	-0.23	-0.24	-0.23	0.20
including municipalities	0.02	0.17	-0.36	0.07	-0.65	-0.20	-0.21	-0.31	0.01
Total receipts	5.51	5.35	6.95	5.74	7.10	4.91	4.78	5.21	6.17
including municipalities	7.89	8.07	8.61	8.89	8.71	7.16	7.73	7.11	7.89
Total expenditure	5.64	5.20	7.29	5.88	7.80	5.14	5.02	5.45	5.97
including municipalities	7.87	7.90	8.97	8.81	9.36	7.36	7.94	7.42	7.89
Expenditure on staff	2.21	2.14	1.81	2.25	2.08	2.12	2.06	2.21	2.35
including municipalities	3.19	3.08	2.96	3.29	3.11	3.06	3.17	3.09	3.25
Interest expenditure	0.30	0.16	0.51	0.41	0.48	0.51	0.47	0.50	0.73
including municipalities	0.37	0.27	0.59	0.58	0.60	0.65	0.64	0.64	0.88
Investment	0.42	0.54	0.84	0.33	1.23	0.40	0.30	0.40	0.57
including municipalities	1.25	1.54	1.81	0.97	2.08	0.96	0.84	1.04	0.88
Debt	5.50	2.88	9.92	7.25	8.56	8.57	8.33	8.93	11.24
including municipalities	6.81	4.87	11.00	9.51	10.47	10.44	11.06	10.96	13.14
Memo item: million inhabitants ¹	10.5	12.2	2.6	6.1	1.8	7.9	18.0	4.0	1.1
	Saxony	Saxony- Anhalt	Schleswig- Holstein	Thuringia	States (Flächen- länder), total	Berlin	Bremen	Hamburg	Germany, total
Revenue-sharing scheme	0.52	0.53	0.13	0.54	-0.07	1.63	1.32	-0.64	0.00
Balance of Länder budgets	-0.11	-0.63	-0.25	-0.59	-0.18	-1.48	-0.43	-0.78	-0.20
including municipalities	-0.08	-0.63	-0.23	-0.55	-0.13	-1.48	-0.43	-0.78	-0.20
Total receipts	6.99	7.13	5.06	7.17	5.53	10.60	11.76	10.33	8.14
including municipalities	8.58	8.58	7.28	8.46	7.95	10.60	11.76	10.33	8.14
Total expenditure	7.10	7.76	5.31	7.76	5.71	12.08	12.19	11.12	8.34
including municipalities	8.66	9.21	7.51	9.01	8.08	12.08	12.19	11.12	8.34
Expenditure on staff	1.79	2.07	2.11	1.95	2.10	4.13	3.89	3.67	3.17
including municipalities	2.78	3.26	3.05	2.93	3.11	4.13	3.89	3.67	3.17
Interest expenditure	0.25	0.52	0.63	0.45	0.40	1.12	1.51	1.11	0.57
including municipalities	0.38	0.65	0.72	0.58	0.53	1.12	1.51	1.11	0.57
Investment	1.34	1.15	0.31	1.19	0.54	1.28	1.85	1.11	1.27
including municipalities	2.19	2.07	0.97	1.99	1.26	1.28	1.85	1.11	1.27
Debt	4.43	10.08	10.89	8.87	7.09	19.34	25.19	19.03	9.92
including municipalities	6.87	12.47	12.49	11.10	9.17	19.34	25.19	19.03	9.92
Memo item: million inhabitants ¹	4.4	2.6	2.8	2.4	76.4	3.4	0.7	1.7	82.2

¹ June 30, 2000. Source: Federal Statistical Office.

Deutsche Bundesbank

weighting has to be reviewed. This also applies to other possible structural additional needs such as those in particularly sparsely populated regions. In principle, a very restrictive yardstick ought to be used here because the acknowledgement of a greater need can easily result in other claims being made of special circumstances that require compensation. There would then be the risk that the revenue-sharing scheme would become increasingly arbitrary and less transparent.

*Reorganisation
also in case of
Federal aid*

The Federal Constitutional Court has demanded a substantial reduction in the redistribution volume relating to supplementary Federal grants. Despite the secondary function of these payments, the redistribution volume far exceeds the volume of the revenue-sharing scheme in the narrower sense. This disproportion can be justified by the burdens resulting from reunification only for a limited period. In principle, a substantial reduction in the shortfall-related supplementary Federal grants seems necessary. Moreover, it is only where individual Länder are carrying serious special burdens which have to be proved in detail that an increase in their finances through special-requirement-related supplementary grants can be justified. The exceptional character of these grants should be emphasised by setting especially strict conditions, a limitation on the length of time over which they are paid and a gradual reduction in their volume over that period. The draft legislation submitted by the Federal Government goes along these lines. The present system of transfers to offset the higher cost per inhabitant of political management in the smaller Länder is one of the special forms of

Federal grant which appears to be problematical. It is difficult to explain the fact that more than one-half of the Länder benefit from these grants and that the sum paid actually increases in line with the size of the Land concerned. The aid for amortisation of excessive debt which the Federal Government grants to Bremen and the Saarland following a ruling by the Federal Constitutional Court in 1992 that these two Länder were facing a budgetary emergency is also worth investigating from an incentive point of view. At least, these payments taper off over time and – like the transitional grants to some financially weak west German Länder – expire at the end of 2004.

The experience gained over the past few decades has shown that the dominance of the tax-sharing arrangements and the considerable importance of mixed forms of funding have blurred the responsibilities of the various public authorities. For that reason it would be advisable to aim for the reinstatement of a more clear-cut distribution of responsibilities, allocating them to the lowest possible level of government along the lines of the subsidiarity principle. It also seems sensible to grant the Länder a limited degree of tax autonomy, for example, the right to raise a supplementary levy on joint taxes or the legislative power for the Länder taxes. Generally speaking, the aim should be to boost the individual public authorities' own level of responsibility to such an extent that the public again have a clearer conception of the relationship between government functions and the tax burden. This would promote a more economical use of public funds.

*Comprehensive
reforms
desirable*

The financial position of the individual Länder

Position in the revenue-sharing scheme

There are considerable differences in the current financial position of the Länder despite the great extent to which their tax revenues have been brought into line. If their position in the revenue-sharing scheme is taken as a yardstick, the donor Länder of Hesse, Hamburg, Baden-Württemberg, Bavaria and North Rhine-Westphalia have to be classified as financially strong, at least before the effects of the equalisation scheme. By contrast, the other 11 Länder received payments and, consequently, would have to be regarded as financially weak. However, the position of a Land in the revenue-sharing scheme, which is based on tax-raising potential, still does not provide sufficient information on the relative level of deficits, total receipts and expenditure.

Deficits and receipts

For example, the beneficiary Land of Saxony recently had deficits per inhabitant which were more or less as low as those of the donor Länder of Baden-Württemberg and Hesse. The Länder with above-average deficits include some which have to make payments into the revenue-sharing scheme (see also the table of page 68). The total receipts of Länder entitled to equalisation payments are not always below the level of the donor Länder. This situation is partly due to the income which arises from the sales of assets and from fees and charges, as these receipts are not included in the revenue-sharing scheme. Even more important are the supplementary Federal grants, which create an advantage for some Länder, especially in eastern

Germany. The main reason for the special position of the city states is that in the revenue-sharing scheme a special weighting factor is applied to the number of their citizens. If in the case of the other states (*Flächenländer*) the receipts of the local authorities are taken into consideration, the city states still have a total of one-third more income than these *Flächenländer*.

In the case of total per capita expenditure the clear lead of the city states, which only partly diminishes when the local authorities of the other Länder are included in the calculation, is likewise apparent. The centrally located amenities and expenditure on social benefits, which is far above average, play a role here. The city states also record the highest figures for expenditure on staff.¹² The level of expenditure of the east German Länder is likewise very high, the main reason being the grants to the local authorities. It is remarkable in the case of the *Flächenländer* in western Germany that per capita expenditure in most beneficiary Länder is greater than in the donor Länder provided the donor Länder's equalisation payments are deducted.

Expenditure

There are also considerable differences in interest expenditure. Expenditure by the city states on this is likewise far above the Federal average. Despite the aid paid since 1994 for the amortisation of its excessive debt, Bremen's interest payments in 2000 were still

¹² For example, in 1998 expenditure on social benefits represented an additional burden of just over DM 4 ½ billion for the city state of Berlin compared with the Länder average (including local authorities). In the case of total expenditure on staff the difference recently amounted to just over DM 3 billion.

“Modernising” Länder administrations

Many municipalities introduced reforms at the beginning of the nineties in an effort to increase the cost-effectiveness of the services they provide. Now, some of the Länder Governments are trying to do the same. The basic thinking behind these new management models is to move away from the traditional method of steering administrations, which was to allocate funds that had been agreed in detail centrally (“input management”), and, instead, to concentrate on setting targets for the services that are to be provided (“output management”). Decisions on the precise allocation of the funds provided to achieve these aims have then to be taken on a decentralised basis because the persons concerned know best where potential savings can be made and are likely to be resolute in their pursuit of cost-saving policies if their units get a share of the savings made. If the cost of providing services can be made transparent, areas where savings can be made will be revealed simply by comparisons with the other Länder.

However, there are often problems in definition, especially with respect to the quality of the services to be provided. For example, it is not easy to assess the output of an educational institution. Even so, there are promising signs that the very introduction of parts of the reform models such as the decentralisation of decisions concerning the allocation of funds is resulting in increased efficiency.

Such reforms have already been implemented in the personnel field in some Länder or they have at least been tried out. According to interim reports, substantial savings appear to have been achieved in Hesse during the first year of implementation. A further increase in savings is expected in the next few years.

Cost calculations are also being increasingly applied. The aim here is to make the cost-

effectiveness of the authorities’ activities more transparent and to improve it. In an even more radical step Hesse and Bremen are introducing commercial accounting. When the changeover is complete, this will show their respective assets and liabilities positions, which means that, in the event of bad management, reductions in net assets will be revealed. If, however, a detailed overall picture of public finance is to be obtained from the statistics in future, too, it will still be necessary for these two Länder to report data which can be integrated into the various subdivisions of the governmental accounting system still used by the majority of the Länder.

It is also becoming increasingly common to remove certain operations from the core budgets. The main aim of these measures is to promote cost-cutting attitudes. At the beginning of 2001, for example, North Rhine-Westphalia removed its building department along with the latter’s buildings and land from the Land budget. The various Land institutions must now pay cost-covering rents to this enterprise, which, in turn, pays interest reimbursements to the state of North Rhine-Westphalia for its borrowing in previous years. However, the greater efficiency achieved by this also poses some problems. For example, re-organisational measures of this nature impair the comparability of budget figures over time and also their comparability with other individual Länder. There is also the danger that shadow budgets could arise and that loans would be taken up to finance them off the core budget. However, the Land would ultimately have to assume liability for them. Another factor is that, where there is a growing number of public enterprises, care must be taken to ensure that there is adequate control. On the whole, it would be advisable to privatise such outsourced undertakings, where possible.

more than DM ½ billion above the German average (the local authorities included). The equivalent figure for Hamburg amounted to almost DM 1 billion and for Berlin just under DM 2 billion. On the other hand, Bavaria, owing to its low debt level, had savings of about DM 3 billion on interest payments compared with the national average.

In order to satisfy pent-up demand the east German Länder have been very much in the lead when it comes to investment expenditure. Of the west German *Flächenländer* only Bavaria, owing to its low debt level, and the Saarland, which benefits from the Federal Government's grants to assist it in amortising its excessive debt, have been achieving the overall national average of the Länder.

Conclusion

If, by way of a summary, an attempt were made to put the current budget positions of the individual Länder into some kind of order, it would emerge that the city states are under the most financial strain. Although they have the highest level of receipts, their expenditure exceeds the Länder average by an even greater margin. This applies to Berlin in particular. A very high structural expenditure level is evident here, and the budgetary situation has deteriorated even further compared with 2000 as a result of the enormous burden arising from participating interests. All in all, the financial situation of the east German *Flächenländer* is less favourable than in the west. Yet substantial differences emerge here, too. One striking feature is the comparatively favourable position in Saxony, which is primarily due to the relatively low level of expenditure there. Regarding the

budgetary position, Bavaria comes off best among the Länder. It is among the states with the lowest expenditure per inhabitant, not least because of its small interest burden, and last year it ran a budget surplus. Bavaria is also the only Land which has succeeded in "graduating" permanently from a beneficiary Land to a donor Land under the revenue-sharing scheme. The situation in both Hesse and Baden-Württemberg must also be deemed to be relatively favourable, particularly with respect to the budget balance in 2000. The Saarland likewise had a favourable financial balance, but that was the result of the large aforementioned grants from the Federal Government.

Outlook

Following the earlier progress made in reducing Länder budget deficits, these will increase substantially again in the current year. The shortfall in revenue resulting from the Tax Reduction Act is being estimated at DM 19 billion, or 4% of the total expenditure volume, for 2001. Given their expenditure structure, the Länder have difficulty in achieving the necessary short-term savings to compensate for these shortfalls. However, many Länder had used the unexpectedly large tax revenues during the past few years to create reserves to enable them to offset lower receipts without incurring larger amounts of new borrowing. Just over DM 7 billion of such reserve funds have been earmarked in the budgets for this year. However, like sales of assets, which in the original budget estimates were likewise intended, at almost

*Tax reform
demands
restrictions on
expenditure*

Limitations on new borrowing

The constitutions of the Länder contain provisions which govern the limitations on new borrowing and which, as a rule, are consistent with the provisions laid down in Article 115 of the German Constitution. Accordingly, the upper limit on new borrowing under normal cyclical conditions is the sum of investment expenditure in budgetary terms. This includes expenditure on building and other investments. The acquisition of fixed assets and participating interests, loans granted and investment grants to both the public and private sectors belong to the second category. As these grants do not increase the Land's primary assets, financing them via loans ultimately impairs the Land's assets and liabilities position. Furthermore, when the upper limit for net borrowing is being determined, depreciations, sales of assets or reductions in reserves are not deducted from the volume of investment. Sometimes this can also result in a Land not maintaining its net assets and liabilities position even when the limits on new borrowing are observed. As a rule, however, investment grants received from other levels of government and contributions from the private sector to finance investment are deducted. In Hesse, in particular, the limit on new borrowing is much stricter still because, for example, investment grants financed via the tax-sharing arrangement with the municipalities may not be used to justify borrowing.

However, the upper limits on new borrowing apply only for the purpose of drawing up the budget. In the course of implementing the budget borrowing may exceed the investment volume if investments are not carried

out as planned or there are still unused credit authorisations from previous years.

In view of the large shortfalls in revenue following the introduction of the tax reform which was also endorsed by a majority of the Länder Governments, many Länder came close to their constitutional limits on debt when drafting their budgets. If it had not been for – in some cases very extensive – withdrawals from reserves, asset sales, estimates of just vaguely predictable savings in the form of global cuts in expenditure which are not yet specified and the use of a very broad definition of investment,¹ numerous Länder would have been unable to observe these limits.

The Maastricht Treaty limits the general government deficit (as defined in the national accounts) to a maximum of 3% of GDP. Four years ago, at the insistence of Germany, in particular, the member states of the European Union committed themselves in the Stability and Growth Pact to achieving the medium-term objective of budgetary positions close to balance or in surplus in order to ensure a sustainable government financial position and to prevent conflicts of interest between monetary and fiscal policy. However, the deficit ratio of 1½% targeted for the current year in the German stability programme of October 2000 does not yet meet this goal. If this is to be implemented on a federal basis, all levels of government should strive for a balanced budget. Considerable efforts are therefore still necessary on the part of the Länder, too, if the European commitments are to be fulfilled.

¹ For example, Lower Saxony is treating its payments to offset the Expo deficit not as a current grant but as the acquisition of a participating interest.

DM 10 billion, to make a large contribution to limiting new borrowing, such receipts are available only once. They can conceal the need for permanent restrictions on expenditure only in the short term. Efforts to improve the economic efficiency of Länder services could help to achieve such restrictions (see the overview on page 71).

Constitutional limits on new borrowing within reach

In spite of the withdrawals from reserves, sales of assets and the budgeting of global cuts in expenditure not yet specified, the level of net borrowing scheduled in the current budgets of numerous Länder is only just below the constitutionally prescribed ceilings (see the overview on this issue on page 73). In the case of Berlin this threshold has been exceeded since 1993 in the opinion of the Land Court of Auditors. The financial problems posed by the participating interests of the Land are increasing the gravity of the budgetary situation even more. The Länder's

overall financial position in the current year is very strained. In the next few years additional financial burdens will arise as a result of the further tax reductions already agreed, the measures to promote private old-age provision and the planned increase in child benefit.

Despite the foreseeable difficulties, most Länder aimed in their medium-term financial planning last year to reduce net borrowing substantially in the next few years. Like the Federal Government, numerous Länder are trying to dispense with new borrowing from 2006. The achievement of balanced budgets might also be promoted if – as in the case of Bavaria with its budget system that will come into force in 2006 – statutory legislation increased the pressure to consolidate. The need for a substantial reduction in expenditure in the Länder budgets is obvious.

Longer-term consolidation aims increase in importance