Deficit-limiting budgetary rules and a national stability pact in Germany

The public finance situation in Germany is marked by high deficits and sharply rising debt levels. The 3% European ceiling for the deficit ratio was overshot for the third year in succession in 2004. The debt ratio, at 66%, climbed even further above the 60% reference value. Central and state government, in particular, are recording large deficits. There have been numerous clashes with national budgetary rules.

If deficit-limiting rules are to be effective, it is essential that, as well as being stringent, they are transparent, comprehensible and unambiguous. Only then can the general public assess the budget plans and the fiscal outcome. This is not sufficiently the case in Germany. National and international rules are not aligned. In practice they have proved to be inadequate.

To ensure sound public finances a reform of the national budgetary rules would be necessary – not least in order to anchor more firmly the obligation to achieve structurally close-to-balance budgets. As part of a comprehensive revision of the fiscal constitution, the individual accountability of the different levels of government would need to be increased and the link between government expenditure and revenue more clearly emphasised.

Rules for limiting the government deficits in Germany

Budgetary rules to limit government indebtedness

Government can finance its expenditure directly using "regular" revenue (above all taxes and social security contributions). It can, however, also postpone the financial burden to a later date by financing expenditure through borrowing. Politico-economic analyses indicate that the latter alternative is particularly attractive to fiscal policy makers. To prevent the risk of excessive recourse to the capital markets, deficit-limiting budgetary rules have been established in Germany – as in most countries.

These include national rules which are part of the German fiscal constitution and are designed above all to restrict net borrowing by the individual levels of government. Then there are the European provisions laid down in the Maastricht Treaty and the Stability and Growth Pact designed to prevent excessive general government deficits and high debt ratios in the European Union and the euro area, in particular.

The national rules

Borrowing leeway

The German fiscal constitution allows extensive borrowing leeway in particular for central and state government, which enjoys extensive budgetary autonomy. By contrast, local government has comparatively narrow scope for borrowing owing to the more restrictive municipal budgetary rules. The social security funds are not permitted to finance their expenditure through debt. If deficits cannot be financed by depleting existing reserves, they have to be balanced by raising the contribution rate (or through Federal grants).[1]

Deficits and indebtedness by level of government

On balance, central government (including the off-budget special funds) has accounted for the lion's share of the general government deficit since 1970. State government has also recorded extensive deficits, whereas local government deficits have been relatively low and the social security funds have mostly generated a surplus.[2] This deficit pattern of the last few decades is similarly reflected in the breakdown of government debt (€1.4 trillion at the end of 2004). Central government's share amounted to just over 60%, while that of state and local government was almost 40% (see chart on page 25). However, per capita indebtedness varies considerably between the individual sates. In Baden-Württemberg, Bavaria and Saxony (including local government) it was well below the average level of the states, while in the city-states, in particular, the figures were much higher (see table on page 26). The east German states, which were mostly debt-free in 1990, are now – with the exception of Saxony – exceeding the average of the west German states.

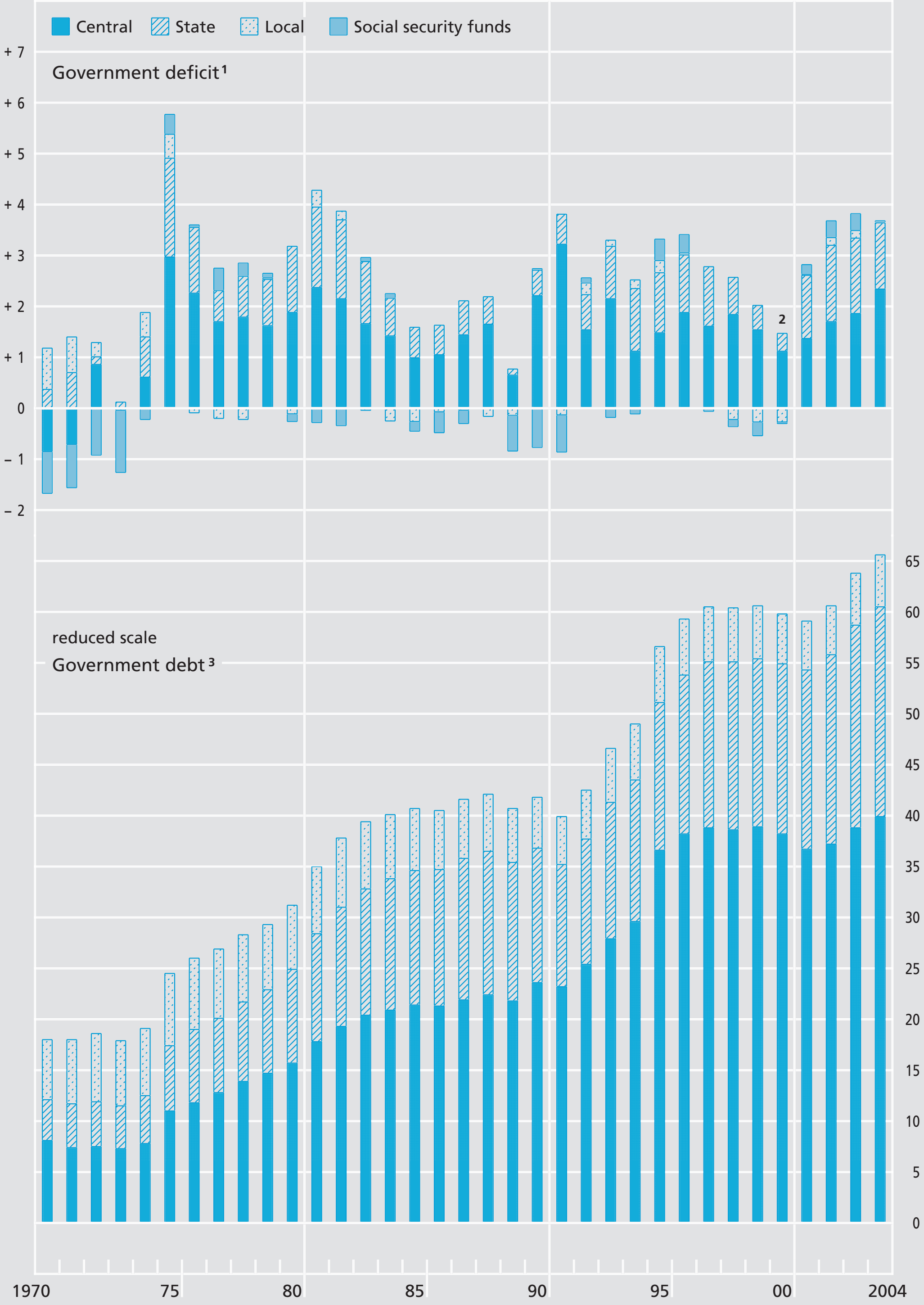
National budgetary law …

Central and state government's deficit-limiting budgetary rules are enshrined in article 115 of the German Basic Law *(Grundgesetz)*

[1] Nevertheless, the statutory health insurance institutions had accrued debts totalling just over €8 billion (gross) by the end of 2003. These must be redeemed by the end of 2007 at the latest.
[2] In all other euro-area countries the state and local government deficits are far smaller. Over the past ten years, they have amounted to less than ½% of GDP in all cases whereas a level of 1% was reached in Germany (according to the national accounts of each of the countries).

Deficit and debt by level of government

as % of GDP



1 As defined in the national accounts. — 2 Excluding UMTS proceeds (2½% of GDP). — 3 Central, state and local government according to the debt level statistics.

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Per capita indebtedness and deficit of state government (including local government)

	Indebtedness				Deficit [1]	
	€		as % of the average		€	as % of the average
State/group of states	1991	2004	1991	2004	2004	
Baden-Württemberg	2,779	4,302	92	63	190	53
Bavaria	1,994	3,134	66	46	95	26
Brandenburg	417	7,513	14	110	273	75
Hesse	3,881	6,578	129	96	461	127
Mecklenburg-West Pomerania	350	7,306	12	107	402	111
Lower Saxony	3,978	7,405	132	108	324	89
North Rhine-Westphalia	4,235	7,705	140	113	469	130
Rhineland-Palatinate	3,893	7,645	129	112	493	136
Saarland	7,028	8,860	233	130	536	148
Saxony	382	3,978	13	58	39	11
Saxony-Anhalt	375	8,727	12	128	530	146
Schleswig-Holstein	4,452	8,069	147	118	447	123
Thuringia	440	7,579	15	111	450	124
Berlin	2,323	16,333	77	239	872	241
Bremen	11,419	17,387	378	255	1,416	391
Hamburg	5,842	11,900	193	174	652	180
Average	3,020	6,826			362	
West German states	3,680	6,383	122	94	350	97
East German states	391	6,594	13	97	294	81
Berlin	2,323	16,333	77	239	872	241

[1] As defined in the government financial statistics, excluding transactions in loans and equity interests.

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and in the constitutions of the individual states. The details of the rules are defined in the Budget Principles Act *(Haushaltsgrundsätzegesetz)* and the respective budgetary regulations. It is laid down that borrowing shall be limited to the level of investment expenditure less any investment grants received. A (planned) overshooting of this ceiling is permitted only if it serves to avert a disruption of the overall economic equilibrium.[3]

... based on "golden rule"

These provisions basically follow the "golden rule" according to which a government deficit or the accumulation of government debt is acceptable only if accompanied by an increase in assets so that the government's net asset position does not deteriorate. This assumes that the future burden arising from the borrowing is offset by a corresponding benefit from the assets accumulated and that the government activities financed in this way will not result in an intertemporal redistribution of burdens.

Government investment can stimulate private investment and increase productivity. However, such effects are very difficult to quantify. They probably depend to a large degree on the type of investment and the existing level of capitalisation, among other things. But certain non-investment spending by government may also be regarded as an important requirement for growth (eg education expenditure, spending

[3] Although the individual state constitutions only partially reflect the wording of the amended article 115 of the Basic Law on the standard ceiling and exceptional cases, the state budgetary rules, which are in line with the provisions of section 18 of the Federal Budget Order, bind the state governments accordingly, see Piduch, *Bundeshaushaltsrecht, Artikel 115 Grundgesetz,* No 31a.

to achieve legal stability). Given the major methodological problems involved, however, there is a danger that a very broad definition of investment may prove far too elastic.

Even if the "golden rule" appears essentially plausible, serious reservations must be voiced, in particular with regard to its practical implementation within the framework of a binding budgetary rule – especially given its structure and implementation in Germany.[4]

Budgetary rules are linked to budget plans ...

The first problem is that the ceiling for new borrowing in Germany is, as a rule, based on budgeted figures and not the fiscal outcome. This creates up the possibility of extending the borrowing authorisation by overstating planned investment expenditure. If, in the course of implementing the budget, some flexible investment projects are cut, actual new borrowing may exceed the deficit ceiling specified by the "golden rule".

... and can be circumvented via off-budget vehicles

Burdens can also be shifted to off-budget special funds (or agencies and institutions outside the government sector), whose borrowing does not have to be restricted to the level of investment expenditure. If such debt is later incorporated into the government accounts, this leads to a rise in the debt level and the need to finance the debt servicing through the core budgets which is not counterbalanced by an increase in government assets. One example of this is the debt assumption following the reform of the German railways.

Extensive scope to exceed the ceilings

The exemption clause which permits net borrowing to exceed investment expenditure if this serves to avert a disruption of the overall economic equilibrium also offers considerable leeway. There is no requirement to offset such borrowing in times of favourable cyclical developments. Moreover, the current interpretation of the exemption clause encompasses a very broad definition of a disruption of the overall economic equilibrium. The scope for borrowing established by this has been exploited extensively in recent years, in particular.[5] Breaches of budgetary law also remain largely without consequence. Court rulings are not usually passed until years after a budget has been concluded. If a court rules that the budget was unlawful, this does not entail any direct consequences.

Definition of investment ...

One particularly problematic aspect of implementing the "golden rule" is the definition of the term investment. This is so broad in Germany that it does not accord with the basic idea underlying the rule. Investment covers the acquisition of non-financial assets (buildings and equipment) and financial assets (participating interests, loans), investment grants to the private and public sector, and guaran-

[4] See Deutsche Bundesbank, Development of public sector investment, and its financing, *Monthly Report,* April 1999, pp 29-45. The critics of the rules in Germany include the courts of auditors: Presidents of the courts of auditors of central and state government demanded an end to government debt in their press release of 7 May 2004, p 2.

[5] For example, between 2002 and 2004, central government had continuous recourse to this exemption clause at least in the supplementary budgets. In its latest report the German Council of Economic Experts expresses doubts about whether this was justified in 2004. See the Annual Report 2004/05 of the German Council of Economic Experts, *Bundestags-Drucksache* 15/4300, p 518 (full report available in German only). The opposition parties in the Bundestag have filed an action against the 2004 Federal budget claiming that it was unconstitutional.

tees granted and utilised.[6] As a rule, investment grants received from other levels of government or third parties are deducted.

... is problematic

Investment grants to the private sector lead to a decline in net government assets which at most may be accompanied by asset formation in other sectors and indirect revenue increases as a result of possibly higher tax receipts in the future. The possibility of simply rechannelling cannot be excluded and the subsidy nature of these grants means that there is a danger of resources being misallocated. In the case of credit-financed investment grants destined for recipients outside Germany – for example, within the framework of development aid – the resultant incurrence of debt is not accompanied by a corresponding increase in domestic assets. Essentially, there are strong incentives to label "current" payments as investment expenditure in order to extend the permitted borrowing limits.

Depreciation and asset disposals not taken into account

Moreover, no allowance is made for the depreciation of government tangible assets (or of the assets acquired in other sectors in connection with investment grants) through deductions from gross investment, nor are disinvestments resulting from asset disposals offset against new investments. Asset disposals include the sale of tangible assets, privatisations, repayments of loans and guarantees. This means that a loan (and the associated growth in assets) may currently be debt-financed, yet the repayment (or, if applicable, the waiver) of the loan does not entail the requirement to redeem the debt. In the case of tangible assets, replacement investments which serve merely to maintain the existing capital stock may also be used to justify additional borrowing. Consequently, the debt level may rise continuously without being accompanied by a corresponding growth in assets (some examples of problematic aspects of the way in which the budgetary rules are implemented in Germany are listed in the box on page 29).

Budgetary rules not preventing the depletion of government assets

Even if one only considers government fixed capital formation and the associated depreciation, the ongoing high level of new borrowing still breaches the "golden rule" in Germany on a major scale. As a simplified analysis within the framework of the national accounts shows, in the past thirty years government deficits often exceeded government gross fixed capital formation (see chart on page 30).[7] If the consumption of fixed capital is also taken into account, the discrepancy is even more starkly evident. For example, in 2004 a deficit of 3.7% of GDP was accompanied by negative net capital formation amounting to 0.2% of GDP. Over the past few decades, the stock of government assets in Germany has fallen considerably in relation to GDP.[8] While tangible fixed assets have de-

[6] In a ruling in 1989 the Federal Constitutional Court *(Bundesverfassungsgericht)* called for a more detailed definition of the term investment (see Bundesverfassungsgericht 79, 311). The expenditures listed correspond to the main categorises 7 and 8 in the common classification system for the budgets of central and state government.

[7] In the national accounts acquisitions and sales of financial assets are recorded as financial transactions that have no impact on the deficits, which means they are not included in this calculation.

[8] In accordance with a rule designed to keep the stock of net assets constant, the deficit may be slightly higher than net capital formation if the price level is rising because the value of the tangible assets recorded at replacement costs increases as prices rise, whereas the liabilities have a fixed nominal value.

Some problematic aspects of the way the budgetary rules are implemented in Germany

A mere glance at the key data of the Federal budget for 2005 reveals the problems involved in using a very broad definition of investment expenditure as the ceiling for government deficits. Planned net borrowing of €22 billion is accompanied by investment expenditure (calculated on the basis of classification numbers 7 and 8) of just over €22½ billion and thus the constitutional limit, which was inspired by the "golden rule" of matching assets and liabilities, is deemed to be observed. This definition of investment expenditure includes €7 billion in investment grants to the non-government sector, €2 billion of which relates to projects outside Germany. Furthermore, disinvestments of €21½ billion due to the sale of equity stakes, loan repayments and the disposal of tangible assets are not being deducted from the new investments. Moreover, on the expenditure side, temporary relief of €5½ billion is planned through the sale of Post Office pension fund claims. Finally, no allowance is made for the consumption of fixed capital, which really should be offset by a pro rata redemption of the loans used to finance the assets in question. According to the national accounts, last year, the depreciation of central government's tangible assets alone amounted to roughly €6½ billion.[1] Thus, overall, central government should be recording significant surpluses if the "golden rule" is applied consistently.

State government recorded a total deficit of just over €25 billion in 2004. This was partly matched by self-financed investment expenditure of 21½ billion. In addition, non-financial and financial assets to the tune of just over €3½ billion were sold to finance the state budgets. If the consumption of fixed capital (data from the national accounts) amounting to €6½ billion is also taken into account, state government's financing gap vis-à-vis the "golden rule" was wider still.

Even though the German budgetary rules already provide for considerable leeway with regard to incurring debt, this is being stretched even further in some cases. For example, investments are sometimes financed from transfers labelled as current revenue. When it comes to setting the ceiling for borrowing, current transfers, unlike investment grants, do not have to be offset against the investment expenditure which they are used to finance, and so the resulting extra credit facilities can be used to finance additional consumption expenditure. For example, state government in eastern Germany was given a considerably higher upper borrowing limit by recording as current income special supplementary Federal grants of €10½ billion, which were awarded primarily to finance the construction of the infrastructure. The policy objective behind this was not, however, to permit higher current expenditure whilst concurrently financing the improvement of the infrastructure in eastern Germany through new borrowing. Some state governments are also extending their borrowing limits by recording the subsidy repayments – which certain Landesbanks have been ordered to make by the European Commission – as current income while simultaneously classifying their recapitalisation of the Landesbanks in the same amount as investment. It is doubtful whether some of the payments which are defined as investment under budgetary law really merit that title. For example, in 2001, a grant of €½ billion awarded by Lower Saxony to EXPO Gesellschaft – which was in liquidation at the time – for the purpose of offsetting losses was declared as an acquisition of equity interests. In Berlin's state government budget, the entitlement to pay €300 million a year to Bankgesellschaft Berlin to avert risks as part of its restructuring is not recorded as loss offsetting but as (investment) calls on guarantees. A further example is the recording of shipyard subsidies as investment expenditure in the Schleswig-Holstein government budget, which was criticised by the state's Regional Court of Auditors back in 2002.

According to the current state of the budgetary plans for 2005, the Federal states of Berlin, Bremen, Hesse, Lower Saxony and Saarland will all exceed the upper borrowing limits (although a narrower definition of investment is applied in Hesse). Some of the other west German states are attempting to formally comply with the budgetary rules by stretching the limits or using the proceeds from asset disposals. The east German states (with the positive exception of Saxony) will probably manage to keep within the upper limit by virtue of recording the special supplementary Federal grants as current income. Despite the relatively favourable course of macroeconomic developments assumed in the November 2004 tax estimate, the state government budgets – like the Federal budget – remain structurally considerably underfinanced.

[1] Allowance should also be made for the depreciation of non-government assets relating to credit-financed investment grants if the latter are included in the definition of investment expenditure.

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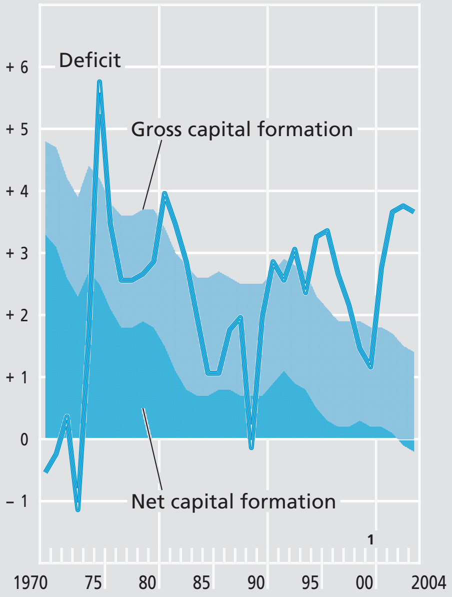
General government deficit and investment*

as % of GDP



* As defined in the national accounts. — 1 Excluding UMTS proceeds (2½% of GDP).

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clined in relation to GDP in recent years especially, the debt ratio has risen sharply (see chart on page 31).

"Golden rule" does not affect the need for consolidation in Germany

Thus, at the end of the day, the national budgetary rules have not been able to halt the depletion of government assets. The general government debt ratio has reached 66% without being accompanied by a corresponding increase in assets. Even an increase in government investment expenditure, which may be desirable, does not change the fact that under this approach there is still a comprehensive need to consolidate current expenditure or revenue.

Furthermore, quite apart from the numerous methodological problems involved, even if the "golden rule" were to be applied properly, it needs to be borne in mind that it relates only to part of the intergenerational redistribution of burdens. It does not take into account implicit liabilities in connection with the pay-as-you-go social security systems, which – given the demographic trend – suggest the need for a more ambitious fiscal policy stance. Moreover, a conflict may occur with regard to the sustainability of public finances if a high debt ratio associated with extensive government investment in the past leads to a risk that the high interest expenditure can no longer be financed.

The European rules

European rules restrict deficits and debt level

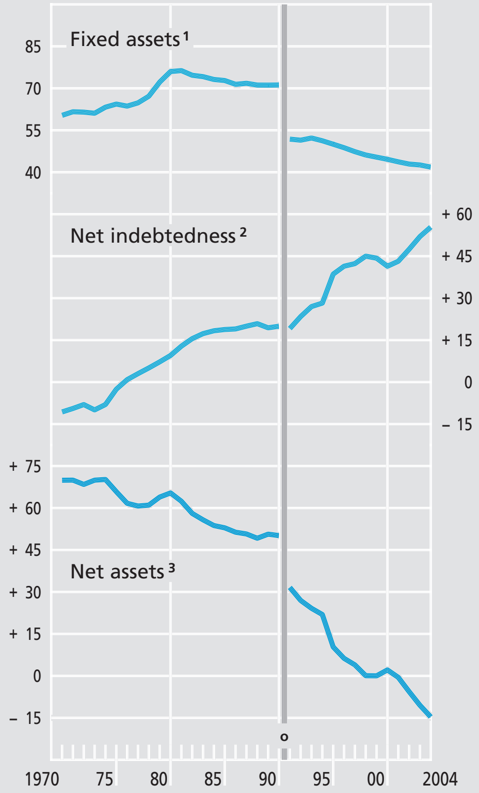
The budgetary rules agreed at the European level are laid down in the Maastricht Treaty and the European Stability and Growth Pact. The Maastricht Treaty sets ceilings for the general government deficit and debt ratios (essentially as defined in the national accounts) which may be exceeded only in exceptional cases. The excessive deficit procedure provided for in the Treaty specifies sanctions for the member state concerned in the event of an ongoing breach of the rules. The Stability and Growth Pact spells out the details of the rules and the surveillance procedure. An early warning system for undesirable fiscal developments has also been established. Under this, deficit goals for the medium term (ie over the economic cycle) were set for the individual EU states. Even after the amendments to the Stability and Growth Pact, at least in Germany's case, this means the obligation to achieve a structural general government budgetary position which is at least close to balance or in surplus in the medium term. Maintaining a balanced fiscal position allows budgetary flexibility over the economic cycle, also enabling other greater shocks to be absorbed without the absolute 3% ceiling for the unadjusted deficit ratio being exceeded.

Weakening the rules through reform

The lack of political determination to consistently apply the rules has ultimately led to the recently agreed reform of the Stability and Growth Pact. Formally, the reform makes little change to the targets and ceilings for the general government deficit and debt ratios. However, the envisaged extensive exemptions have severely weakened the pact's credibility and binding nature.[9] To ensure that the objectives of the European fiscal rules are nonetheless achieved, they should be firmly anchored in German budgetary legislation.

Assets and liabilities
of general government

as % of GDP, year-end figures



1 Net fixed assets at replacement costs except for underground and road construction from 1970 to 1990 which are gross fixed assets. Data for 2003 and 2004 estimated. — **2** Government debt less government financial assets pursuant to the financial accounts. — **3** Fixed assets less net indebtness. — **o** Methodological break owing to amended valuation of government underground and road construction assets (see footnote 1). From 1991 Germany as a whole, beforehand west Germany.

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The discussion on a national stability pact

Discussion on national stability pact ...

The implementation of the European budgetary rules raises considerable coordination problems in countries with a pronounced federal structure, where the subordinate levels of government also have extensive opportunities for borrowing. At the time the Maastricht Treaty was adopted, it had already been noted that there was a fundamental need for coordination between central and state government in Germany with regard to the general government deficit.[10] However, intensive discussions on a national stability pact only started in the mid-1990s when it became apparent that Germany would have considerable problems complying with the 3% ceiling for the government deficit in 1997, the year which was decisive for entry into monetary union. Particularly controversial issues were the legal implementation, the vertical allocation of the deficit ceilings to the government levels, the horizontal allocation to the individ-

[9] For the discussion on the reform of the Stability and Growth Pact see The changes to the Stability and Growth Pact in this *Monthly Report*, pp 15-21.
[10] See Article 2 of the Act concerning the Treaty on European Union of 7 February 1992 ("Act on the introduction of the Maastricht Treaty").

ual federal states and sanctions if the ceiling is breached.[11]

Compliance with budgetary discipline within the context of European economic and monetary union pursuant to section 51a of the Budget Principles Act

(1) The central and state governments shall assume their responsibility to uphold the stipulations laid down in Article 104 of the Treaty establishing the European Community and in the European Stability and Growth Pact and shall seek to reduce their net new borrowing with the objective of achieving a balanced budgetary position.

(2) Taking into consideration economic and financial factors, the Financial Planning Council shall make recommendations on budgetary discipline, in particular, on a common spending stance in the spirit of section 4 (3) of the Financial Specifications Act *(Massstäbegesetz).* On this basis, the Financial Planning Council shall discuss the compatibility of budgetary developments, particularly the expenditure and financial balances of the central and state governments including local government and local authority associations, with the provisions laid down in Article 104 of the Treaty establishing the European Community and in the European Stability and Growth Pact.

(3) If the budgetary discipline of central, state and local government does not sufficiently comply with the requirements pursuant to paragraphs 1 and 2, the Financial Planning Council shall discuss the reasons for this and make recommendations on restoring budgetary discipline.

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... initially fruitless

A national stability pact represents an encroachment on the existing budgetary autonomy of central and state government and calls for a statutory provision which requires the agreement of both government levels. However, despite several detailed proposals, no result was achieved at first, not least because there was also considerable disharmony among the state governments themselves concerning the specific shape of such a pact. Since central government is legally accountable to the EU for complying with the deficit ceilings, there was little incentive for state governments to restrict their own budgetary autonomy. Furthermore, given a deficit ratio of less than 1½% (excluding UMTS proceeds) and the expected continuation of the favourable macroeconomic development, the financial situation of general government appeared to be relaxed in 2000, so that the discussion on a national stability pact was initially discontinued.

Amending the Budget Principles Act

However, after the situation of public finances had worsened again dramatically in 2001 and the deficit edged dangerously close to the 3% ceiling once more, the discussion on anchoring the European rules at all budgetary levels was resumed. In March 2002 the Financial Planning Council proposed measures – often referred to as the "national stability

[11] See Advisory Board to the Federal Ministry of Finance (1994), *Zur Bedeutung der Maastricht-Kriterien für die Verschuldungsgrenzen von Bund und Ländern.* For a detailed overview, see Karsten Wendorff (2001), *The discussion on a national stability pact in Germany, Fiscal Rules,* Banca d'Italia, pp 677-712.

pact" – which were then adopted by parliament.[12] The measures notably included an amendment of the Budget Principles Act with the aim of reducing new borrowing by central and state government until a balanced budget is achieved. The Financial Planning Council – where the federal and state ministers of finance meet to coordinate their budgetary policies – is also to be given greater importance. Its recommendations on the development of expenditure and the deficit, in particular, are to be upgraded. Moreover, the various levels of government are obligated to comply with the European agreements (see box on page 32).

Minimal binding effect

Attempts to incorporate European budgetary provisions in German budgetary law and legally anchor the goal of balanced budgets for central and state government are to be welcomed. On the whole, however, the new provisions are largely ineffective. The provisions are at odds with the unchanged constitutional rules, the (inconsistent) implementation of which permits considerable borrowing. The cooperative approach adopted largely entails imprecise and non-binding obligations. For example, reference is made to an "objective" of balanced budgets which – except for the states of Bavaria and, to a certain extent, Saxony – no level of government has envisaged in its current medium-term budget plan. Even the planned reduction of net borrowing remains small in many cases and the budgetary goals are clearly oriented more to the constitutional limit. Even after

[12] See also Federal Ministry of Finance, German stability programme, updated version from December 2003, pp 36-37.

Selected agreements of the Financial Planning Council

2002:
The Council agrees to cut the general government deficit to below 3% of GDP in 2003.

All levels of government aim to achieve balanced budgets by 2006. Central and state government are to submit medium-term financial plans, in which they explain their strategy for achieving balanced budgets.

Central government is to reduce its spending in 2003 and 2004 by ½% on an annual average, while state and local government are to limit the average annual increase to 1%.

The deficit recorded by central government and the social security funds should not exceed 45% of the 3% limit (1.35% of GDP), while the share of state and local government deficits should not exceed 55% (1.65% of GDP).

2003:
The Council cannot agree on joint recommendations.

However, it reaffirms the objective of cutting the general government deficit ratio to below 3% in 2004.

2004:
The Council agrees to cut the deficit to below 3% of GDP in 2005.

The state and local government deficit is to remain below the agreed ceiling in the current year. Central government intends to reduce its deficit significantly.

The expenditure growth of central and state government is to remain limited to an annual average of 1% in 2004 and 2005.

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the amendment of the Budget Principles Act, the Financial Planning Council's recommendations regarding the deficit targets and balanced budgets have played only a limited role in the political process, although the unexpected tax revenue shortfalls also need to be taken into account. The regularly recommended expenditure ceilings were sometimes barely heeded and their binding character for individual states contested. The failure to achieve these targets resulted in neither sanctions nor an increased obligation to justify this failure. To date there is little sign of the Financial Planning Council enjoying a more prominent status or playing a more active role in fiscal policy discussions in Germany than in the past.

Principles of an effective national stability pact

Reform of national budgetary law necessary

In Germany there is a discrepancy between the European commitments to reduce the government deficit enshrined in the Maastricht Treaty and the Stability and Growth Pact, and national budgetary law. Not least, this impairs transparency and makes it harder for the general public to monitor the provisions – an important prerequisite for the binding effect of the rules. With regard to the obligations of general government, in particular, the respective responsibilities of the various levels of government are not clearly defined. In view of the insufficient national borrowing limits and the actual high deficits of central and state government, a fundamental reform of German budgetary law as part of an effective national stability pact appears to be necessary.

Amending the Budget Principles Act is a step in the right direction

In principle, central, state and local government have acknowledged their joint commitment to the European rules. The target of balanced budgets for central and state government included in the Budget Principles Act and the decision to give a more prominent status to the Financial Planning Council are also steps in the right direction. However, these objectives have not been rigorously implemented. Significantly more extensive steps appear to be necessary. Most of central government's proposals in this regard have been rejected by the state governments in the past.

Constitutional anchoring of structurally balanced budget

A systematic reform of national budgetary law would require a constitutional amendment. This would be in line with the European provisions if instead of the regulation anchored in Article 115 of the Basic Law – as also at state level – the requirement of achieving a structural budget position that is close to balance or in surplus were to be enshrined in the constitutions. This appears warranted not least in view of the – presumably long-term – increase in the private provision and financing of investment previously carried out by general government and of the demographic changes. On the basis of a sound budgetary position, the automatic stabilisers could then take full effect.[13]

More specific provisions

Such a fundamental decision would necessitate more specific implementation provisions

[13] Among the advocates of amending national budgetary law are the courts of auditors (see footnote 4) and the Advisory Board to the Federal Ministry of Finance, *Verbesserungsvorschläge für die Umsetzung des Deutschen Stabilitätspakts* (Suggestions for improving the implementation of the German stability pact) (2003).

for which the Budget Principles Act could be a suitable vehicle. It could define, in transparent and comprehensible form, the framework for taking account of cyclical influences. Furthermore, the individual levels of government should be committed to providing detailed evidence as to why they were unable to achieve a balanced budgetary position and how such a position can be reached again in the future. Not least in the light of past experience, it should be ensured that the plans are based on cautious macroeconomic assumptions.

Expenditure ceilings helpful but no substitute for deficit targets

Ceilings for expenditure growth can be an important component of a national consolidation strategy. However, they are no substitute for setting targets for the budget balance because sound public finances also depend crucially on developments on the revenue side. Medium-term expenditure goals must be adjusted if a persistently weaker revenue trend is evident and an increase in the structural deficit is to be prevented. There would be a need for adjustment, for example, in the case of tax cuts, a prolonged lowering of the tax assessment base or an ongoing decline in non-tax revenue.

Extensive evasion measures possible

Moreover, the accounting leeway for recorded expenditure is likely to be much more extensive than for deficits. For example, outsourcing parts of the budget (for example outsourcing of fee budgets or shifting activities off the main government budget) may lead to a decline in recorded expenditure without entailing any real consolidation progress. The same applies to replacing expenditures by tax relief measures (eg child benefit by the children’s tax allowance, the direct grant to home buyers by tax concessions) and intra-government transfers by shifting tax revenue.

Absolute deficit ceiling

If central and state government were to comply with the requirement to achieve a structural budgetary position which is close to balance or in surplus, the currently hotly disputed issue of how to apportion the deficit ceiling laid down in the Maastricht Treaty between the individual levels of government would lose much of its significance. Since there would then be a considerable safety margin below the 3% ceiling, cyclical fluctuations would not generally endanger its compliance. Irrespective of this, fixed nominal deficit ceilings are a necessary component of a set of national budgetary rules in order to offer a clear point of reference for possible sanctions as the ultimate disciplinary element. Any breaching of these limits (which are not to be misinterpreted as targets) by individual government entities would have to be limited to rare and unambiguously defined exceptional situations.

Vertical allocation

The (albeit not legally binding) breakdown of the deficit ceiling of 3% of GDP by allocating 45% to central government and the social security funds, and 55% to state and local government as decided by the Financial Planning Council for the years 2004 to 2006 appears to be inappropriate. It should be borne in mind that central government’s budget is more volatile than those of state and local government because, in addition to cyclical fluctuations in tax revenue, it is affected especially by the cyclical deficits of the Federal Employment Agency. Owing to this higher cyclical sensitivity, in principle a larger share of the deficit should therefore be allocated to central government. This should, however, be counterbalanced by a requirement to achieve correspondingly higher surpluses when the economic situation is more favourable.[14]

Allocation among federal states

At the state government level (including local government) a horizontal allocation according to the number of inhabitants seems to be appropriate, not least for pragmatic reasons. Whereas in the case of general government GDP is considered the relevant indicator of financial strength (and thus the ability to bear the future burdens arising from the deficits), this is currently not the case in Germany for state and local government. The intra-government allocation of taxes and the state government revenue-sharing scheme ensure a comparatively strong levelling of tax revenue per inhabitant, which means that the number of inhabitants is a better point of reference for the (potential) financial strength of the states and municipalities.

Importance of transparency and public accountability

The transparency and public accountability of budgetary plans and outturns on the basis of verifiable rules are extremely important for ensuring their binding effect. Progress towards achieving this goal could be made, for example, by upgrading the importance of the Financial Planning Council. Furthermore, clearer and stricter rules will make it easier for finance ministers to implement a sound budgetary strategy in the political process. One idea that could be considered is the introduction – on the lines of the European commitments – of standardised stability programmes for central government, each social security scheme and each state government (including local government) detailing the latest annual accounts, current developments and the medium-term plans. The Financial Planning Council could then verify compliance with the required goals and publish the results. The global findings and decisions of the Financial Planning Council should then be given particular consideration in the budget preparation process.

Fundamental reform of the fiscal constitution

The goal of ensuring that all levels of government are committed to achieving sound public finances according to budgetary law would be facilitated by a fundamental reform of the fiscal constitution in Germany. In this context, numerous calls have been made to modify the current provisions under which most laws require the approval of the Bundesrat (upper house of parliament) and to more clearly define the tasks of the individual levels of government, coupled with a respective allocation of revenue sources and accompanying legislative powers. This would give rise to regional distinctions and an increased responsibility of each individual level of government for the development of public finances in its respective area.

Income tax surcharge

For example, an income tax surcharge for the federal states is conceivable (without such revenue having to be included in the intrastate revenue-sharing scheme). This would give individual state governments the oppor-

[14] This should be based on fiscal balances – as is the case when assessing the structural budgetary position – that closely track the national accounts outturns (which are not available for individual states). In addition, financial asset transactions should be factored out of the relevant budget deficits.

tunity to make allowances for special preferences of their population on the expenditure side by introducing differing tax rates on the revenue side. In view of the mutual support obligation in place between the different levels of government ("federal principle"), it seems logical that if the deficit ceiling is overshot the relevant entity should be obliged to increase the income tax surcharge.[15] This would underline the direct link between expenditure and the need to ensure sound financing, particularly for the voters. It is crucial for fiscal discipline to avoid giving the impression that the government can provide benefits that entail no costs.

National stability pact as part of a reliable consolidation strategy

Public finances in Germany are in a critical situation. High structural deficits and sharply increasing debt levels necessitate comprehensive fiscal consolidation. Another requirement, given the likely demographic development, is to avoid burdening future generations further with an excessive level of government debt. A comprehensive reform of the national budgetary rules – which are manifestly too lax – as part of a national stability pact in connection with a reform of the fiscal constitution could be an integral part of a reliable consolidation strategy and thereby make an important contribution to resolving the budgetary problems.

[15] A restriction of budgetary autonomy at least in dire budgetary situations is also contemplated by the Advisory Board to the Federal Ministry of Finance (2005), in *Haushaltskrisen im Bundesstaat* (Budgetary crises in the federal state).