

## State government finances in Germany

Even though circumstances vary greatly from one Federal state to the next, the overall situation of state government finances is still extremely precarious. Although the deficits have fallen again recently after reaching record highs in 2003, many states are overshooting the constitutional borrowing limits by a considerable amount or are observing them only formally by means of asset disposals or the misapplication of central government funds earmarked for infrastructural reconstruction in eastern Germany. Three states believe that they will not be able to solve their financial problems by themselves in the medium term, either, and have filed an action for aid from the other government budgets. The current budgetary rules have not managed to prevent the critical status of many budgets. The binding nature of the rather generous borrowing ceilings appears limited given the – in some cases severely imbalanced – financial situation of state government. Moreover, state government now faces major challenges, not least because of the foreseeable strains caused by rising expenditure on pensions or the reduction of Federal grants to the east German states. It is therefore imperative that the incentives and institutional framework for sound public finances be improved perceptibly. Stricter budgetary rules, an effective budgetary surveillance procedure and greater individual responsibility – also with regard to taxation – could contribute towards such an improvement.

## Overall trend in state government finances

*Sharp rise in deficits after 2000*

All in all, the situation of state government finances remains extremely precarious despite the fact that the deficits have declined recently. The trend since 2000 mirrors the underlying pattern in general government finances in Germany.<sup>1</sup> After the state government deficits had declined significantly to just over €8 billion or 3½% of expenditure at the end of the 1990s,<sup>2</sup> partly owing to the favourable cyclical development and an unusually high increase in profit-related taxes, they increased very sharply after 2000 (see table on page 33 concerning the developments described below). In 2001, the previous record high of 1996 was surpassed slightly, with the deficit edging up to €24½ billion. By 2003, there had been a further increase to €30½ billion or just over 11½% of expenditure. While the deficits declined to €24 billion in 2004, hardly any further progress was achieved last year. Thus, state government debt has grown by roughly 40% in the past five years, reaching €482 billion at year-end 2005. The debt ratio to the annual volume of expenditure, which was 140% in 2000, rose to 185%.

*Weak development in tax revenue ...*

The sharp rise in the deficits, which persisted into 2003, was accompanied by a weak revenue trend. Total revenue in 2005 was down by €4 billion or just over 1½% on the level in 2000. This was largely due to the development in tax receipts. Having reached an exceptionally high level in 2000, in the period from 2001 to 2003 they fell by a total of €14 billion or 8% and rose only slightly in the following period. In addition to the comprehen-

sive income tax cuts – which were also approved by state government in the Bundesrat –, the weak overall economic growth of the previous years (including the muted development in gross wages and salaries) and sharp fluctuations in profit-related taxes took their toll.

A slight counterweight was provided by revenue from business activities which, following muted development in the preceding years, shot up by €2½ billion last year due to extensive subsidy repayments by Landesbanks. However, this was a one-off effect that has, in any case, been more or less offset by additional expenditure on recapitalisation. Furthermore, state government budgets have been increasingly financed by asset disposals. Proceeds from loan repayments and sales of participating interests and tangible assets rose from €3 billion in 2000 to €5 billion at the latest count. There was little change in transfers from other levels of government. The slight increase to €43½ billion is largely due to the rise in funds received from the EU. By contrast, transfers from central government dropped slightly in the period as a whole to €35½ billion at the end of 2005. Declining supplementary Federal grants were offset, in particular, by growing receipts in connection with the Hartz IV labour market reform; however, this revenue has to be forwarded to local

*... partly offset by repayment of subsidies and asset disposals*

<sup>1</sup> See Deutsche Bundesbank, A disaggregated framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, pp 61-76. While that article examines the financial situation according to the national accounts' methodology, this article focuses on budgetary developments.

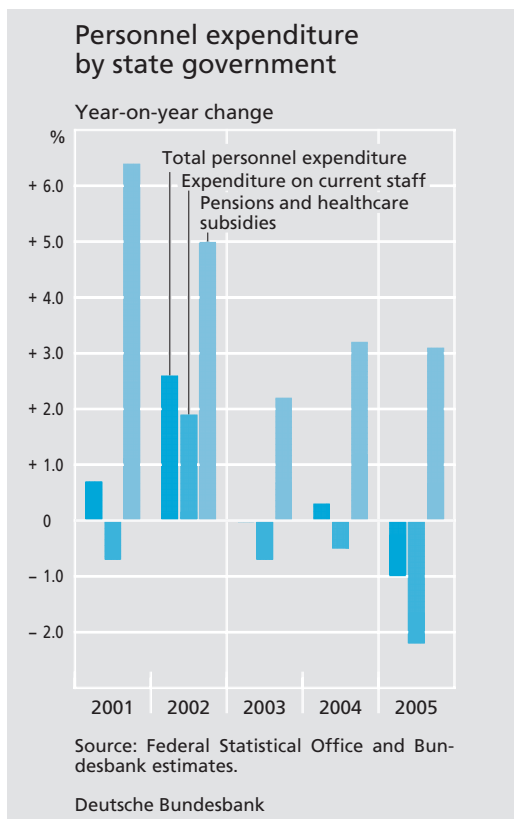
<sup>2</sup> See Deutsche Bundesbank, Trends in Länder Government finance since the mid-nineties, Monthly Report, June 2001, pp 57-74.

## State government revenue and expenditure

Item	2000	2001	2002	2003	2004 pe	2005 pe
	€ billion					
Revenue						
Taxes	174.8	164.5	161.0	160.6	163.3	163.9
Revenue from business activities	4.5	3.6	4.4	4.4	4.6	7.1
Revenue from asset disposals/investment grants	3.2	4.7	4.3	4.2	4.9	5.1
Grants from other public authorities	42.3	41.3	42.2	43.2	42.4	43.5
Other revenue	15.5	16.9	16.9	16.8	17.4	16.5
<b>Total revenue</b>	<b>240.4</b>	<b>230.9</b>	<b>228.8</b>	<b>229.2</b>	<b>232.6</b>	<b>236.2</b>
Expenditure						
Total personnel expenditure	94.7	95.3	97.8	97.8	98.1	97.1
Expenditure on current staff	75.3	74.8	76.2	75.7	75.3	73.7
Pensions and healthcare subsidies	19.3	20.5	21.6	22.1	22.8	23.5
Grants to other public authorities	56.5	54.9	56.8	57.7	56.0	59.8
Other operating expenditure	23.4	23.4	23.0	22.0	22.0	22.2
Interest expenditure	19.0	19.5	20.0	20.5	20.8	20.9
Current grants	31.9	35.1	37.6	39.1	39.5	36.4
Investment expenditure <sup>1</sup>	25.3	27.3	22.8	22.6	20.2	23.4
<b>Total expenditure</b>	<b>250.8</b>	<b>255.5</b>	<b>258.0</b>	<b>259.7</b>	<b>256.6</b>	<b>259.8</b>
Fiscal balance	- 10.4	- 24.6	- 29.2	- 30.5	- 24.0	- 23.6
	Year-on-year percentage change					
Revenue						
Taxes	2.8	- 5.9	- 2.1	- 0.2	1.7	0.4
Revenue from business activities	7.3	- 21.0	24.3	0.2	4.5	52.9
Revenue from asset disposals/investment grants	- 49.2	47.7	- 8.2	- 2.8	16.9	5.5
Grants from other public authorities	0.8	- 2.6	2.3	2.3	- 1.9	2.7
Other revenue	- 0.2	9.0	- 0.1	- 0.7	3.9	- 5.4
<b>Total revenue</b>	<b>0.9</b>	<b>- 3.9</b>	<b>- 0.9</b>	<b>0.2</b>	<b>1.5</b>	<b>1.5</b>
Expenditure						
Total personnel expenditure	0.8	0.7	2.6	0.0	0.3	- 1.0
Expenditure on current staff	- 0.2	- 0.7	1.9	- 0.7	- 0.5	- 2.2
Pensions and healthcare subsidies	4.9	6.4	5.0	2.2	3.2	3.1
Grants to other public authorities	4.6	- 2.9	3.5	1.6	- 2.9	6.7
Other operating expenditure	2.9	- 0.4	- 1.6	- 4.1	0.0	0.8
Interest expenditure	- 0.2	2.8	2.6	2.6	1.1	0.5
Current grants	0.8	10.3	7.1	3.9	1.1	- 7.8
Investment expenditure <sup>1</sup>	0.7	7.9	- 16.6	- 1.0	- 10.6	16.1
<b>Total expenditure</b>	<b>1.8</b>	<b>1.9</b>	<b>1.0</b>	<b>0.6</b>	<b>- 1.2</b>	<b>1.3</b>

Source: Federal Statistical Office, accounting results of the general government budget (until 2003), thereafter quar-

terly cash balances of general government — <sup>1</sup> Excluding investment grants to other public authorities.



government. On balance, the development in transfers placed a strain on state government.

*Overall restrained expenditure growth*

Since 2000, spending by state government has grown by a total of 3½%, around 1 percentage point of which is due to the one-off burden from the recapitalisation of the Landesbanks in 2005. While current expenditure increased by 6%, investment expenditure (including investment grants to local government, but excluding the recapitalisation of the Landesbanks) declined significantly by almost 15%. When analysing the rise in expenditure, it should be borne in mind that certain factors which curbed the revenue trend concurrently contributed to the restrained growth in expenditure. For example, moderate wage developments across the board were also reflected in public sector pay

and civil servant pension increases. Transfers to local government, which are linked to tax receipts, likewise fell in consequence of the decline in tax revenue. The analysis of state government's budget ratios is complicated by the fact that the spin-off of entities and activities from the core budgets significantly affects the development of expenditure and revenue as a whole and, above all, in specific categories (see box on page 33).

Personnel expenditure constitutes the largest expenditure item in the state government budgets. At €97 billion last year, it accounted for 37½% of total expenditure and was 2½% above the level in 2000 (see the chart on this page). The rise in spending on civil servants' (non-contributory) pensions and healthcare subsidies, at 21½%, was much greater. The main reason for this was the sharp rise in the number of pension recipients, which went up by one-sixth. By contrast, expenditure on current employees has been sharply restrained in the past few years. The government's financial statistics even show a decline of just over 2% in expenditure in 2005 vis-à-vis 2000. Although cuts in holiday and Christmas bonuses for civil servants (*Beamte*) and new employees with non-civil servant status (*Tarifbeschäftigte*), as well as a reduction in the overall number of employees through staff cuts, have provided some cost relief, the absolute decline in expenditure is primarily the result of outsourcing entities such as universities and enterprises from state government budgets.

*Personnel expenditure: increasing pension costs masked by spin-offs*

State government transfers to other levels of government are another major cost item. In

## Outsourcing of service entities from the core budgets

The strict provisions contained in both budgetary and civil service legislation are often criticised as excessively restricting flexibility and efficiency in the provision of public services. Since a complete withdrawal of government from many operational areas is rejected and may seem only partly feasible in the short term given existing structures, the outsourcing of service entities from the core budgets is suggested as a way of improving cost-effectiveness.

A case in point is the management of buildings and real estate. If these are made available to public authorities by outsourced entities for a fee, the total costs could be lower than when the provision of services is managed internally. A key consideration in this context seems to be that invoicing for services provided carries an incentive to critically assess the extent to which the services are really needed and to leave units no longer needed to other demanders. In the case of higher education, on the other hand, more weight is placed on autonomy in the use of funds. Universities that are completely incorporated into the state government accounts are given extensive instructions as to how they are to apply the funds. By contrast, if universities are outsourced and financed by means of a global budget provided by the state government, they can enjoy more autonomy in their management.

Outsourcing also makes it easier for state government to comply with expenditure ceilings if the outsourced entities generate own revenue that is then no longer channelled through the state government budget. Instead of the overall expenditure of these institutions, only a correspondingly smaller need for grants is disclosed in the budget. Hence, outsourcing may be used to show the expenditure trend in a more favourable light. But an even more problematic feature in this context is authorising outsourced entities to borrow. In this case, the core budgets provide only a limited picture of the true financial situation of state government. This option has indeed been exercised on some occasions in the past. For example, the Budget Acts of North-Rhine Westphalia and Rhineland-Palatinate allow construction and real estate enterprises as well as a road construction enterprise to finance expenditure by incurring debt. The Budget Act of Baden-Württemberg authorises an outsourced entity to pre-fund road construction expenditure of the state government by borrowing up to a pre-defined limit. Bremen maintains a general debt servicing fund for the pre-funding of state government expenditure with an annual borrowing authorisation. As is the case in Hamburg, Bremen also has an off-budget special fund that is allowed to finance harbour construction work by loans. By contrast, outsourced universities have evidently been authorised to take out loans only in very isolated cases to date, and subject to the condition that debt servicing must be assured.

Outsourcing deficits to subsidiary budgets is not a substitute for fiscal consolidation and must therefore be viewed very critically, not least against the background of the budget principles of clarity and completeness. Borrowing of outsourced entities carries the risk that the constitutional borrowing limits may ultimately prove completely ineffective if these entities incur losses which are in the end being assumed by government in addition to the regular new borrowing or are debt-financed by additional capital injections booked as investments.

Against the backdrop of stagnating revenue and the constraints imposed by civil service legislation and collective labour agreements in the public sector, it is imperative that state government curbs its personnel expenditure, which currently accounts on average for almost 40% of its overall expenditure. However, whenever a state government outsources certain services, it retains ultimate responsibility for their financing and, moreover, the labour and pay regulations governing public sector employees continue to apply initially, so that the possibilities for rapidly lowering costs are placed within narrow bounds. Personnel expenditure and other operating expenditure as well as investment is then just reclassified in the state government budgets as grants to enterprises.

Outsourcing considerably complicates a comparison of budget data over time as well as among the state governments. For the financial years 2001 to 2004, the Federal Ministry of Finance indicates outsourcing of personnel expenditure of over €2½ billion in the overviews of the final state government budgets outturns. In 2005 alone, this outsourcing effect (partly in connection with transferring certain tasks to local government) could have amounted to over €1 billion. Adjusted for this, average annual personnel expenditure growth (including expenditure on pensions) from 2001 to 2005 was not ½%, but rather almost 1½%. In 2006, state governments are apparently making even greater use of outsourcing. The effects on the recorded amount of other operating expenditure, however, are not clear-cut because rents or service charges are sometimes paid to the outsourced entities, which could outweigh the respective direct curbing impact of the outsourcing. Fixed capital expenditure recorded in the core budgets is lowered by outsourcing. In the year when construction services in Rhineland-Palatinate were outsourced, an especially strong impact was noted on the fixed capital expenditure of that state government with a decrease by almost three-fifths. Aggregating the figures of all state governments, outsourcing probably contributed to about one-fifth of the decrease in construction investment. However, to the extent that investment grants are subsequently paid to the outsourced entity, the constitutional borrowing limits in the budget are not tightened. Fixed capital expenditure is then simply replaced by grants.

*Only slight increase in transfers to local government*

2005, they accounted for €59½ billion or almost 23% of expenditure. This amounts to a rise of just over €3 billion on the level in 2000. Local government received €54 billion of this, which was €2 billion more than in 2000. However, this rise was due entirely to the Hartz IV reform. In addition to forwarding Federal funds, state government agreed that the savings which it made on housing allowances as a result of this reform would be passed on to local government in the form of higher transfers. Thus, last year a total of approximately €5 billion should have been transferred to local government in connection with this. Excluding this Hartz IV effect, transfers to local government have fallen considerably.

*Sharp rise in interest expenditure and current grants*

As far as its interest expenditure is concerned, state government benefited from the favourable financing conditions in the capital markets. If interest expenditure is measured against the debt level at the end of the previous year, the average rate of interest paid in 2005, at just over 4½%, was roughly 1 percentage point or almost one-fifth down on the level in 2000. However, this was accompanied by a notable increase in the volume of debt. Overall, state government's interest costs have grown by nearly 10% since 2000 to €21 billion or 8% of total expenditure. Current transfers to households and enterprises rose even more sharply by 14%. It is true that, owing to decreased expenditure on housing allowance in consequence of the Hartz IV reform, payments to households were €1 billion less in 2005 than in 2000. However, transfers to enterprises increased by just over 40% during this period to almost

€21 billion, not least as a result of spin-offs. More than half of this increase is likely to be due simply to the fact that personnel expenditure was replaced by grants to the out-sourced universities and institutions.

State government's investment in non-financial assets declined continuously. In 2005, at 6½ billion, it was down by €2 billion on the level in 2000. In addition to the cuts made to limit the deficits, this also reflects the spin-off of construction and real estate enterprises, whose investments are no longer captured in the state government budgets. There was also a significant reduction totalling €3½ billion in investment grants to enterprises and in loans. By contrast, there were sharp fluctuations in the acquisition of participating interests.<sup>3</sup> After adjustment for special effects, the level has remained practically unchanged. Thus, on balance, there was a notable decline in investments.

*Investment declining amid fluctuations*

### The financial situation in the individual states

The public finance situation varies greatly from one state to the next.<sup>4</sup> A comparison of

*Notable differences in deficits and ...*

<sup>3</sup> Peaks occurred in 2001, with the equity injection given to Bankgesellschaft Berlin and a substantial shareholder deposit to Landesbank Baden-Württemberg, and in 2005, in particular, as a result of the extensive recapitalisation of Landesbanks following the repayment of subsidies, as well as the topping up of the equity capital of two state-owned enterprises by North-Rhine/Westphalia.

<sup>4</sup> The figures for local government have been included in the state government comparison to enable an adequate assessment of the city-states and to exclude distortions resulting from differences in the extent to which Federal states pass on responsibilities to local government. As a rule, the figures are per capita, thus enabling a comparison between states of different sizes.

## Comparison of consolidated state and local government budget outturns for 2005

€ per capita

Item	West German non-city states	North-Rhine/Westphalia	Bavaria	Baden-Württemberg	Lower Saxony	Hesse	Rhine-land-Palatinate	Schleswig-Holstein	Saarland	All states
Debt 1	6,400	8,170	3,210	4,470	7,670	6,830	8,050	8,500	9,660	7,150
Fiscal balance	- 300	- 470	- 50	- 180	- 400	- 160	- 330	- 600	- 760	- 320
Adjusted fiscal balance 2	- 310	- 380	- 30	- 230	- 380	- 410	- 400	- 610	- 760	- 310
Adjusted total revenue 3	3,370	3,460	3,460	3,400	3,260	3,550	3,190	3,240	3,180	3,590
Adjusted total expenditure 4	3,680	3,840	3,490	3,630	3,640	3,960	3,590	3,850	3,930	3,900
<i>of which</i>										
adjusted current expenditure 5	3,320	3,570	3,040	3,240	3,360	3,580	3,250	3,440	3,570	3,480
interest expenditure	280	330	140	220	350	300	340	360	430	310
<i>Memo item</i>										
Personnel expenditure	1,680	1,680	1,700	1,770	1,530	1,690	1,650	1,650	1,710	1,660
<i>of which</i>										
expenditure on current employees 6	1,330	1,330	1,350	1,410	1,210	1,310	1,320	1,300	1,260	1,360
pensions 6	350	350	350	360	320	380	330	360	450	310
Acquisition of non-financial assets	290	210	390	330	210	350	270	300	250	300
	East German non-city states	Saxony	Brandenburg	Saxony-Anhalt	Thuringia	Mecklenburg-Western Pomerania	Berlin	Hamburg	Bremen	All states
Debt 1	6,870	4,020	7,700	9,390	7,940	7,660	17,270	12,420	18,960	7,150
Fiscal balance	- 200	20	- 160	- 460	- 330	- 230	- 940	- 210	- 1,730	- 320
Adjusted fiscal balance 2	- 120	120	- 120	- 360	- 250	- 200	- 800	- 410	- 1,750	- 310
Adjusted total revenue 3	4,220	4,260	4,170	4,280	3,990	4,410	4,780	4,800	4,410	3,590
Adjusted total expenditure 4	4,340	4,140	4,290	4,640	4,240	4,600	5,580	5,210	6,030	3,900
<i>of which</i>										
adjusted current expenditure 5	3,580	3,280	3,610	3,900	3,580	3,850	5,290	4,730	4,940	3,480
interest expenditure	310	190	340	420	360	340	710	580	760	310
<i>Memo item</i>										
Personnel expenditure	1,470	1,440	1,390	1,530	1,510	1,550	1,960	1,940	1,930	1,660
<i>of which</i>										
expenditure on current employees 6	1,430	1,400	1,350	1,470	1,470	1,510	1,580	1,370	1,390	1,360
pensions 6	40	30	40	60	40	40	370	570	540	310
Acquisition of non-financial assets	420	500	400	350	400	410	100	300	220	300

Source: Federal Statistical Office and Bundesbank calculations. — 1 Credit market debt in the broader sense, state government debt to central government and cash advances. — 2 Adjusted for asset acquisitions, disposals and related income and for subsidy repayments by Landesbanks. — 3 Excluding contributions made by payer states under the state government revenue-sharing scheme, and less receipts from fees, Landesbank subsidy repayments and

income related to asset disposals. — 4 Excluding expenditure by payer states under the state government revenue-sharing scheme and less receipts from fees and asset acquisitions. — 5 Excluding expenditure by payer states under the state government revenue-sharing scheme and less receipts from fees. — 6 Allocation of healthcare subsidies to current and retired civil servants estimated.

the fiscal balances recorded in the cash statistics shows that Saxony recorded a surplus last year and that Bavaria's deficit remained very limited. In North Rhine-Westphalia, Saxony-Anhalt, Schleswig-Holstein and, above all, in Saarland, the *per capita* deficit was well above average. In the city-states Berlin and especially Bremen, the situation was even more precarious. While the divergences in interest expenditure arising from the different debt levels explain a large part of the discrepancies, they were not the only factor. A somewhat different picture is presented if the deficits are adjusted for acquisitions and sales of assets (including loans) and the repayment of Landesbank subsidies in some states in order to factor out possible effects that may obscure the structural budgetary position (see table on page 35 and chart on page 37). After adjustment, the fiscal balance is poorer, in particular, in Hamburg, Hesse and Rhineland-Palatinate, while certain improvements can be seen, above all, in Berlin, North-Rhine/Westphalia and eastern Germany.

... indebtedness

Past fiscal policy is reflected in the debt levels of the individual states. Major divergences can be seen here, too. The spread ranged from €3,200 *per capita* in Bavaria to almost €19,000 in Bremen. While the liabilities of Bavaria, Saxony and Baden-Württemberg were considerably more than one-third below the state government average, indebtedness in all three city-states was more than two-thirds above the average. Among the non-city states, Saarland and Saxony-Anhalt exceeded this average by as much as one-third.

Recent years have witnessed a further increase in the spread of debt levels.

A comparison of (*per capita*) total revenue and expenditure across state government is far from straightforward. For example, payments made under the revenue-sharing scheme do not represent "real" expenditure-effective items in the state concerned. Thus, in this comparison, these payments have been subtracted from the revenue and expenditure figures shown in the cash statistics. In addition, state and local government have to varying degrees spun off entities which are partly financed by fees from their core budgets. As well as a possible impact on the total revenue and expenditure recorded in the budgets, this may lead to significant changes in the individual expenditure categories, which makes a comparison difficult. In order to neutralise as far as possible the effect on total revenue and expenditure, the remaining receipts from fees are shown net, ie deducted from the total revenue and expenditure of the individual states.<sup>5</sup> Asset acquisitions (including loans granted), which may mask the structural burden of expenditure, have also been factored out of total expenditure. Similarly, comparable proceeds from asset disposals have been factored out of revenue.

*State-by-state comparison of budget ratios involves difficulties*

On the revenue side it becomes clear that the state government revenue-sharing scheme significantly reduces differences with regard to tax revenue, whereas substantial differences in the states' capacity to raise taxes from regional activities remain. After includ-

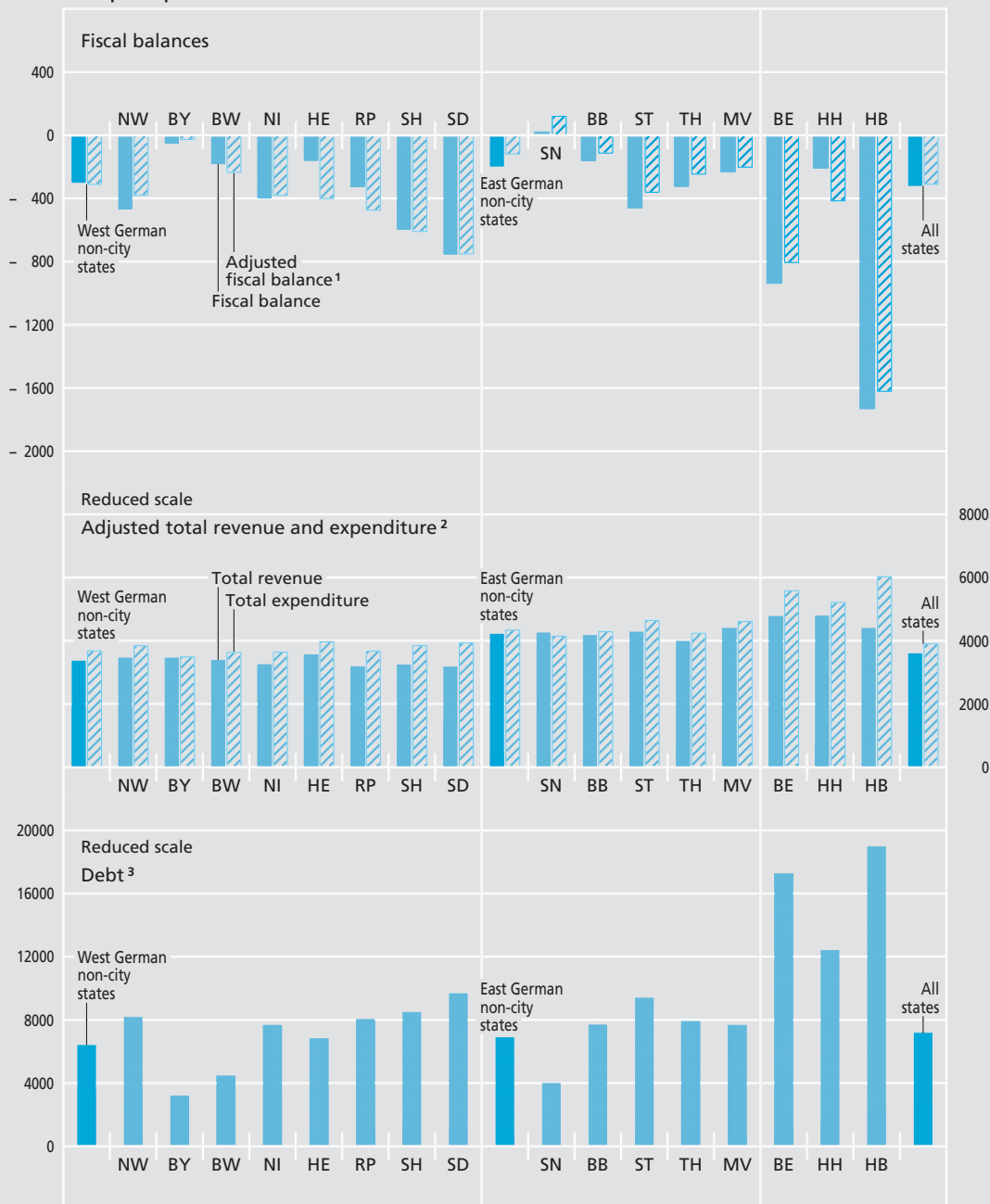
*Significant redistribution as a result of revenue-sharing scheme*

<sup>5</sup> A correction of each individual expenditure category was not performed owing to insufficient information.



### Budget ratios of state government \* (including local government) in 2005

Euro per capita



Source: Federal Statistical Office and Bundesbank calculations. — \* State abbreviations: NW=North-Rhine/Westphalia; BY=Bavaria; BW=Baden-Württemberg; NI=Lower Saxony; HE=Hesse; RP=Rhineland-Palatinate; SH=Schleswig-Holstein; SD=Saarland; SN=Saxony; BB=Brandenburg; ST=Saxony-Anhalt; TH=Thuringia; MV=Mecklenburg-Western Pomerania; BE=Berlin; HH=Hamburg; HB=Bremen. — 1 Adjusted for asset acquisitions and disposals and for Landesbank repayments. — 2 Adjusted revenue and expenditure less transfers under the revenue-sharing scheme by states required to make equalisation payments, and less all receipts from fees. In addition, asset disposals and Landesbank repayments have been subtracted from revenue, and asset acquisitions have been subtracted from expenditure. — 3 Credit market debt in the broader sense, state government debt to central government and cash advances.

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### Per capita financial strength in 2005 before and after revenue-sharing \*

As % of nationwide average

Item	Excluding VAT 1	Before revenue-sharing 2	After revenue-sharing	After general supplementary Federal grants	After special supplementary Federal grants 3
<b>West German non-city states</b>					
Hesse	129.1	113.6	102.6	101.3	95.5
Bavaria	124.3	109.0	101.5	100.2	94.5
Baden-Württemberg	123.2	110.6	101.9	100.6	94.8
North-Rhine/Westphalia	110.6	99.8	98.7	97.4	91.8
Rhineland-Palatinate	96.9	92.0	95.0	95.4	90.4
Schleswig-Holstein	92.9	93.4	95.5	95.5	90.7
Saarland	83.1	89.9	94.4	95.2	92.1
Lower Saxony	81.2	93.9	95.7	95.5	90.1
<b>City-states</b>					
Hamburg	179.0	145.8	136.7	135.0	127.2
Bremen	101.5	98.0	121.2	127.1	123.5
Berlin	86.5	88.5	118.8	126.6	143.0
<b>West German states altogether</b>	<b>111.8</b>	<b>103.4</b>	<b>101.5</b>	<b>101.0</b>	<b>96.5</b>
Brandenburg	45.0	83.4	92.9	95.3	116.7
Thuringia	40.1	81.8	92.1	94.7	118.3
Saxony	39.4	82.3	92.2	94.7	117.6
Mecklenburg-Western Pomerania	37.9	82.5	93.0	95.6	119.9
Saxony-Anhalt	33.1	82.8	92.6	95.1	119.6
<b>East German states altogether</b>	<b>39.2</b>	<b>82.6</b>	<b>92.5</b>	<b>95.0</b>	<b>118.2</b>

\* Provisional figures. Source: Federal Ministry of Finance and Bundesbank calculations. — 1 States' shares in joint taxes (excluding VAT) and state government taxes according to revenue accrued locally. — 2 After distribution of VAT revenue; including the normalised tax revenue of local government, which must be included at a rate of 64% pursuant to section 8 of the Fiscal Equalisation Act; before revenue-sharing among the states. — 3 Special supplementary Federal grants are paid to the east Ger-

man states (including Berlin) to cover special burdens arising from the need for infrastructural modernisation and to compensate for the below-average financial strength of local government in these states and the additional burdens as a result of structural unemployment in connection with the Hartz IV labour market reform (excluding Berlin), and to small states owing to higher-than-average costs of political administration.

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ing receipts from the revenue-sharing scheme and from supplementary Federal grants, the city-states and the east German states recorded tax-related revenue significantly above the average in 2005. This is due mainly to the higher population weighting of the city-states in the revenue-sharing scheme and to the special supplementary Federal grants (see table on this page). This also translated into above-average levels of total revenue.

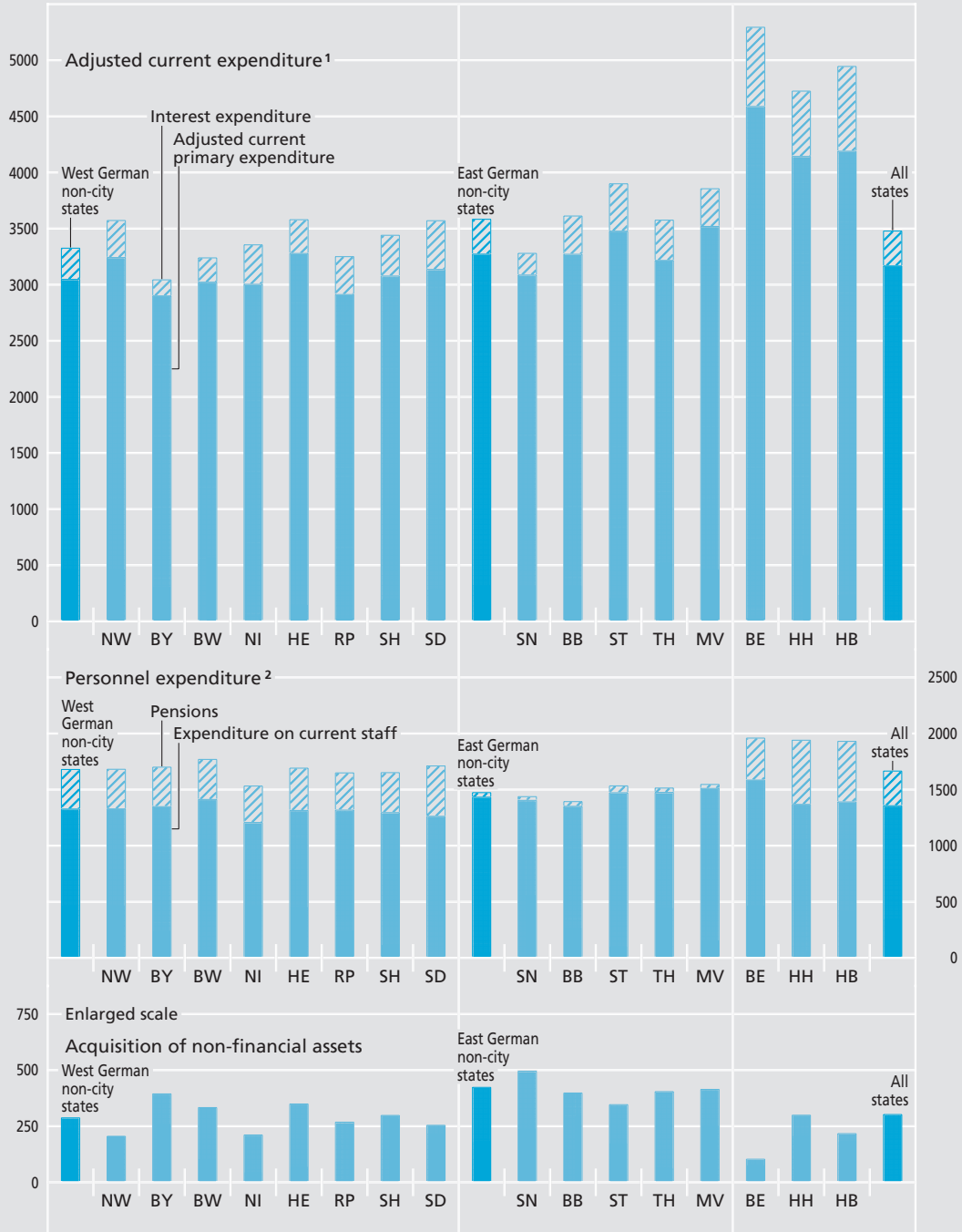
On the expenditure side, considerably higher *per capita* figures were recorded for current expenditure (excluding payments under the revenue-sharing scheme and after deduction of receipts from fees) especially in the city-states and – with the exception of Saxony – the east German states (see table on page 35 and chart on page 39). In the city-states, per-

sonnel expenditure was more than one-sixth above average, and the other expenditure items exceeded the average by an even greater degree. While the west German states recorded high outlays for civil servant pensions, above-average expenditure on current staff was incurred in eastern Germany. Despite lower pay levels, their expenditure was 8% higher on average than in the west German non-city states. Higher expenditure was also incurred in respect of transfers to other public authorities – including transfers for special and supplementary pension benefits for certain categories of retired employees in the former German Democratic Republic – and grants to enterprises, in particular. Moreover, there was a substantial spread within the individual state groups. For example, even after deduction of interest expenditure, adjusted

*Higher expenditure in the city-states and eastern Germany*

### Expenditure by state government \* (including local government) in 2005

Euro per capita



Source: Federal Statistical Office and Bundesbank calculations. — \* State abbreviations: NW=North-Rhine/Westphalia; BY=Bavaria; BW=Baden-Württemberg; NI=Lower Saxony; HE=Hesse; RP=Rhineland-Palatinate; SH=Schleswig-Holstein; SD=Saarland; SN=Saxony; BB=Brandenburg; ST=Saxony-Anhalt; TH=Thuringia; MV=Mecklenburg-Western Pomerania; BE=Berlin; HH=Hamburg; HB=Bremen. — 1 Excluding payments from payer states under the state government revenue-sharing scheme and less receipts from fees. — 2 Split of healthcare subsidies among current and retired civil servants estimated.

Deutsche Bundesbank

current expenditure in Saxony was roughly one-eighth less than in Mecklenburg-Western Pomerania and Saxony-Anhalt (all eastern states). In North-Rhine/Westphalia and Hesse it was more than 15% higher than in Bavaria and Rhineland-Palatinate (all western states). Investment in non-financial assets, most of which is undertaken by local government but is considerably dependent on transfers from state government, was clearly higher in the east German states, especially in Saxony. Among the west German states, investment in non-financial assets was highest in Bavaria. Berlin spent by far the least on non-financial assets – at barely more than one-third of the nationwide average.

### Compliance with the constitutional borrowing limits

*Fundamental problems concerning borrowing limits in Germany*

There is a widespread consensus concerning the need for strict legal limits on government borrowing, especially given the current political incentives for excessive use of this instrument by government and the negative consequences thereof. In Germany, both the Federal constitution (Article 115 of the Basic Law – *Grundgesetz*) and those of the individual states follow the golden rule that credit may be taken out essentially only to finance investments. The underlying aim of this rule is to ensure that the generation which profits from government spending must also take responsibility for financing it. However, this golden rule overlooks, among other things, the fact that future generations are not only burdened by explicit borrowings but also by implicit liabilities such as pension entitle-

ments, for example. Moreover, the underlying concept – that borrowing must be linked to the formation of assets – is not legally implemented in a consistent manner. For example, when determining the borrowing limit, proceeds from asset disposals and loan repayments are not deducted from investments even though they constitute disinvestments. Decreases in the value of assets as a result of depreciation are not deducted either. This makes it possible to increase the debt level even with stagnating or falling assets.<sup>6</sup> Furthermore, certain investment expenditure such as investment grants, do not constitute growth in the state's assets. Moreover, it also appears to be a problem that the constitutional borrowing limits are construed as binding only for budget planning but not for budget implementation.

Article 115 (1) second sentence of the Basic Law, which specifies the borrowing limits for central government, does not apply directly to state government budgets. However, the state government constitutions contain provisions which largely match the content of current Federal law. While there are sometimes deviations in the definition of exceptional circumstances justifying increased borrowing, Article 109 (2) of the Basic Law lays down a minimum norm by binding the budgets to the requirements of overall economic equilibrium.

*Borrowing limits prescribed by state constitutions ...*

<sup>6</sup> The courts of auditors also highlight these issues. See, for example, the findings of the conference of the presidents of the courts of auditors of central and state government of 7-9 May 2001. See also Deutsche Bundesbank, Deficit-limiting budgetary rules and a national stability pact in Germany, Monthly Report, April 2005, pp 23-37.

*... and their  
enforcement*

State governments vary in terms of the strictness with which they enforce the relevant constitutional provisions for limiting new borrowing. When determining the upper limits for new borrowing, usually only the investments financed by the state government's own funds are considered. These are generally defined as the expenditure recorded in the classification table under the main categories 7 (construction investment) and 8 (other expenditure on investment and investment-promoting measures) less funds collected under group 33 (investment grants received from other public authorities) and group 34 (contributions and other investment subsidies). However, there is no statutory obligation to deduct these items. Thus, the state of Berlin, for example, did not deduct investment revenue when calculating its borrowing limit. Similarly, practices in some states, such as using current Federal grants for regional railways to a significant degree for investment purposes and, thus, raising the borrowing ceiling by means of pre-financed expenditure, also led to an improper expansion of the borrowing limits.<sup>7</sup> By contrast, in Hesse a stricter interpretation of investment expenditure is applied than in the rest of the country. In this state, extensive investment grants paid within the framework of the tax-revenue-sharing arrangement with local government may not be used to justify borrowing.

*Structural  
breaching of  
constitutional  
provisions in  
most states*

In recent years the borrowing limits defined on the basis of the classification table have been exceeded by many states, in some cases significantly (see, for example, the table on page 42 regarding the budget estimates for 2005 and 2006). The 2005 budgets of Berlin,

Bremen, Hesse, Lower Saxony, North-Rhine/Westphalia, Saarland and Schleswig-Holstein foresaw an overshooting of the state-specific upper limits. Although Hesse managed to observe the borrowing limit in the course of implementing its budget, this was largely owing to extensive one-off proceeds from the sale of real estate. Similarly, Rhineland-Palatinate and the payer states within the revenue-sharing scheme, Baden-Württemberg and Hamburg, had recourse to sizeable asset disposals to observe their borrowing ceilings. While the east German states stayed within their constitutional borrowing limits, this was facilitated to a great degree by funds from central government to overcome the consequences of German partition (see box on pages 48 and 49). If one-off proceeds and special supplementary Federal grants to the east German states are factored out, only Bavaria remained clearly within the constitutional upper limits for new borrowing last year. This confirms the exceptionally precarious nature of the budgetary situation since 2002.

In recent years, there have been a number of court cases examining whether certain budget acts breach the constitution. The court rulings have, however, ultimately had very little impact on budgetary policy. For example, in 2003 the budgetary acts of North-Rhine/Westphalia for 2001 and 2002 were subsequently found to have breached the constitution because they foresaw the liquidation of loan-financed reserves in order to ob-

*Rulings by state  
constitutional  
courts on over-  
shooting of  
borrowing  
limits*

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<sup>7</sup> In this way, the borrowing ceiling in North-Rhine/Westphalia, for example, is extended by roughly €½ billion annually.

## Budget estimates for net borrowing and investments financed from own funds in 2005/2006

€ million

Item	Year	Baden- Würt- temberg	Bavaria	Branden- burg	Hesse	Mecklen- burg- West- Pomer- ania	Lower Saxony	North- Rhine/ West- phalia	Rhine- land- Palatin- ate
(1) Net borrowing (credit market) (group 32 less 59)	2005	1,990	1,338	971	959	583	2,149	7,520	1,024
	2006	1,935	0	826	1,346	400	1,800	5,726	885
(2) Investments financed from own funds (groups 7 and 8 less 33 and 34)	2005	2,006	3,139	1,142	1,151	670	865	5,964	1039
	2006	2,005	3,296	1,084	1,355	603	924	3,274	923
(3) Differential 1 [(2)-(1)]	2005	16	1,801	171	192	87	- 1,284	- 1,556	15
	2006	70	3,296	258	9	203	- 876	- 2,452	38
(4) Proceeds from sale of assets, capital repayments (group 13)	2005	457	0	18	849	10	649	11	168
	2006	305	0	17	923	14	859	16	139
(5) Loan repayments from the public sector and other sectors (groups 17 and 18)	2005	99	204	16	79	57	61	145	506
	2006	97	612	14	75	58	60	155	56
(6) Differential adjusted for asset disposals [(3)-(4)-(5)]	2005	- 541	1,597	136	- 737	21	- 1,994	- 1,712	- 659
	2006	- 331	2,684	227	- 989	130	- 1,794	- 2,623	- 157
(7) Net global increases (+) / cuts (-) in expenditure (group 97 less 37) <sup>2</sup>	2005	- 268	- 489	- 11	0	- 61	- 136	- 409	- 165
	2006	- 366	- 523	- 10	0	0	- 141	16	- 165
(8) Special supplementary Federal grants for reconstruction in eastern Germany	2005			1,509		1,110			
	2006			1,502		1,104			
	Year	Saarland	Saxony	Saxony- Anhalt	Schles- wig- Holstein	Thurin- gia	Berlin	Bremen	Ham- burg
(1) Net borrowing (credit market) (group 32 less 59)	2005	810	350	954	1,616	995	4,290	1,090	700
	2006	807	250	783	1,562	975	3,124	1,078	650
(2) Investments financed from own funds (groups 7 and 8 less 33 and 34)	2005	279	1,635	972	554	1,097	1,463	673	890
	2006	276	1,821	888	513	1,071	1,372	484	891
(3) Differential 1 [(2)-(1)]	2005	- 531	1,285	18	- 1,062	102	- 2,827	- 417	190
	2006	- 531	1,571	105	- 1,049	96	- 1,752	- 594	241
(4) Proceeds from sale of assets, capital repayments (group 13)	2005	2	1	49	4	17	183	64	11
	2006	10	1	34	4	78	148	2	57
(5) Loan repayments from the public sector and other sectors (groups 17 and 18)	2005	16	20	38	6	9	86	4	23
	2006	6	22	40	6	9	188	1	87
(6) Differential adjusted for asset disposals [(3)-(4)-(5)]	2005	- 549	1,264	- 69	- 1,072	76	- 3,095	- 485	156
	2006	- 547	1,548	31	- 1,059	9	- 2,088	- 597	98
(7) Net global increases (+) / cuts (-) in expenditure (group 97 less 37) <sup>2</sup>	2005	0	0	- 40	- 20	- 146	- 122	- 136	- 541
	2006	1	0	- 61	46	- 33	- 105	- 65	- 98
(8) Special supplementary Federal grants for reconstruction in eastern Germany	2005		2,746	1,657		1,507	2,003		
	2006		2,733	1,649		1,500	1,994		

Source: budgets including supplementary budgets, Bundesbank calculations based on classification table. In some cases, where the budget results for 2005 are not yet available or are only provisional, the budget plans have been evaluated. (Berlin: investments financed from own funds without risk provisions for Bankgesellschaft Berlin; Hesse: in 2005 revenue and investments financed from own funds before revisions from the supplementary budget; Bremen: in 2006 draft budgets.) — <sup>1</sup> The relevant consti-

tutional borrowing limits sometimes deviate from the calculations presented here. For example, in Berlin investments are not revised to take account of investment grants and in Hesse investments financed from the tax-sharing arrangement with local government are deducted. — <sup>2</sup> Global increases in revenue are treated as global cuts in expenditure here. — <sup>3</sup> Asset disposals totalling €661 million in 2005 and €183 billion in 2006 are included as global increases in revenue (see line 7).

serve the borrowing limits. Transactions of a very similar nature were also foreseen in Hamburg, Hesse, Lower Saxony and Schleswig-Holstein in 2001. The practical consequences of the ruling were limited as the reserves had been largely exhausted by that time. The State Constitutional Court of Mecklenburg-Western Pomerania found that the budgetary acts for 2003 to 2005 breached the constitution. However, this was mainly due to formal errors. While the structural underfunding was criticised, this was ultimately not a decisive factor. In its judgment delivered in December 2005 on the 2002 supplementary budget, the Constitutional Court of Hesse found that the high borrowing authorisation did not constitute a breach of the constitution. Accordingly, in certain circumstances, under a supplementary budget an unexpected shortfall may be plugged using borrowed funds. However, Hesse also exceeded the borrowing limit in the following years. Proceedings before the Federal Constitutional Court concerning the Schleswig-Holstein 2003 supplementary budget were dismissed because the plaintiffs withdrew their case after the election of a new government in 2005.

*Invoking  
budgetary  
hardship ...*

In the case of Berlin, the 2002 and 2003 budgetary acts were judged to be in breach of the constitution. The State Constitutional Court found that there was insufficient evidence to support the claim that an overshooting of the upper borrowing limit was necessary in order to avert a disruption to the overall economic equilibrium. However, the court granted the state the option of claiming it faced serious budgetary hardship and then

continuing to overshoot the borrowing limit once all potential cuts had been made. Berlin has exercised this option for its subsequent budgets even though doubts have been raised as to whether it is justified in doing so (see box on page 44). Besides Berlin, Bremen and Saarland – whose aid for amortisation of their excessive debts (which had amounted altogether to roughly €15 billion up to the end of 2004) expired after 11 years – filed actions with the Federal Constitutional Court for further special supplementary Federal grants on the grounds of ongoing drastic underfunding of their budgets. Such applications should be examined very critically given the very strained budgetary situation of central government and most of the other state governments and in view of the extremely worrying incentive effect on future fiscal discipline at state government level.

Lower Saxony, North-Rhine/Westphalia and Schleswig-Holstein, whose medium-term financial plans foresee an overshooting of the borrowing limits for several more years, do not invoke the argument of acute budgetary hardship. Instead, the introductory statements to their draft budgets declare that observance of the borrowing limits pursuant to state constitutional law is “objectively impossible”, at least in the short term, given other obligations of similar priority. For all that, the extent of the budget relief measures (for example, cuts in bonus payments to state employees) varies significantly from one state to the next.

*... and  
“objective  
impossibility” of  
observing  
borrowing  
limits*

For the future significance of the constitutional borrowing limits, a decision on the action

## Berlin's action for a declaratory judgment confirming the existence of extreme budgetary hardship

Three years ago, the state of Berlin commenced proceedings before the Federal Constitutional Court (*Bundesverfassungsgericht*) for a declaratory judgment confirming the existence of extreme budgetary hardship since 2002 and claiming the award of substantial supplementary Federal grants for the purposes of budget consolidation as the state sees itself unable to rectify the budgetary crisis – which it believes to have arisen through no fault of its own – by itself. The hearing was held before the Federal Constitutional Court in Karlsruhe at the end of April 2006. A judgment is expected before the end of the year.

The states of Bremen and Saarland submitted similar applications at the end of the 1980s. In 1992, the Federal Constitutional Court allowed these petitions and put the Federal Government under an obligation to provide extensive financial assistance.<sup>1</sup> This assistance expired in 2004. In delivering its judgment, the Court at the time compared the budgetary positions of the two states with the average position of all the states. The net borrowing requirement to expenditure ratio<sup>2</sup> and the ratio of interest to tax revenue<sup>3</sup> played a particularly important role in this comparison. Based on the observation that the former was twice as high in these two states and the latter was significantly higher than the benchmark figure, extreme budgetary hardship was assumed to exist and an obligation on the part of all other members of the German federation to provide financial assistance was declared. In return, the two states had to prove to the Financial Planning Council (*Finanzplanungsrat*) that they were endeavouring to keep the increase in their current expenditure  $\frac{1}{2}$  percentage point below the Council-agreed ceiling for such increases in all states. Furthermore, the Federal legislator was instructed – after examining the possibilities highlighted by the Federal Constitutional Court – to set in place arrangements which both counteract the emergence of budgetary hardship and can eliminate an emergency situation if one should occur. The legislator has failed to fulfil this mandate in the 14 years following delivery of the judgment, however. The Federal Constitutional Court's renewed dealings with this set of issues could now intensify the pressure to create clear rules to prevent budgetary crises.

1 See "Bundesverfassungsgerichtsentscheidungen" (decisions of the Federal Constitutional Court) 86, 148. — 2 Share of a financial year's expenditure which is financed by means of net borrowing. — 3 Ratio of a state's interest payments to its tax revenue including receipts from the state government revenue-sharing scheme and supplementary Federal grants to compensate for below-average

There is a key difference between the situation at that time and the current situation: whereas only the states of Saarland and Bremen were encountering continuous difficulties with the constitutional borrowing limits at the end of the 1980s, today most of the states and even the Federal Government are facing such serious structural financing problems. Nevertheless, there are still marked differences in the size of the budget deficits which, in the petitioners' view, could establish an obligation to assist Berlin (but probably also Bremen and Saarland). However, if virtually all levels of government are in such a difficult situation and are to be burdened further owing to the obligation to provide financial assistance, particularly good reasons for doing so must be given.<sup>4</sup> Against this background, too, it is essential that the states in question have themselves made all possible efforts to avert and alleviate extreme budgetary hardship.

It is disputed whether this has occurred in Berlin's case. The roots of Berlin's financial crisis lie in the restructuring of its budget financing following German reunification. The substantial Federal aid granted to the previously isolated state was phased out after four years in the expectation that the reunified capital city would grow rapidly and was replaced only partially by payments from the state government revenue-sharing scheme. Both economic and demographic developments remained exceedingly weak, however. The much-needed budgetary adjustment was not initiated in time and was not sufficiently extensive. As a result, the state's debt level was five times higher at the end of 2005 than it had been in 1991 and its budgetary leeway continued to dwindle. Although the current state government points out that it has noticeably reduced interest-adjusted expenditure *per capita* in comparison with the 1995 level not least through civil service cuts and termination of housing construction assistance, this primary expenditure is still structurally higher (more than 5%) than that of the economically strong state of Hamburg. In general, it seems questionable whether the maintenance of an above-average supply of public services can be reconciled with a claim for financial assistance from all other members of the German federation in an extreme emergency. On the revenue side, too, it should be examined whether all potential capacities are being resolutely utilised to the full.

financial capacity. — 4 For instance, in its judgment of 1992, the Federal Constitutional Court stipulated that the obligation to assist a state in financial distress must not lead to the Federal Government and the other states for their part losing the ability to fulfil their constitutional duties ("Bundesverfassungsgerichtsentscheidungen" 86, 148, [270]).



*Important  
decision by the  
Federal Consti-  
tutional Court*

filed by the former Bundestag opposition parties concerning the 2004 Federal Budget Act is particularly important. This could result in a tightening of the budgetary rules that would in future prevent any serious structural underfunding of budgets as is evident in some cases at present. The 1989 decision, which is often referred to in judgments by state constitutional courts, was only a small step in this direction. The decision called for more extensive justification for overshooting the borrowing limits; however, this has so far proved to be a largely ineffective hurdle.

#### **Outlook: marked need for fiscal consolidation**

*Medium-term  
financial plans  
envisage signifi-  
cant reduction  
of deficits*

State government's financial plans envisage a significant reduction in deficits in the coming years. The recently agreed tax increases provide a better foundation for these plans. According to the most recent tax estimate, state government's tax revenue will go up by 3¼% on average in each of the next four years as a result. Pursuant to the agreements reached in the Financial Planning Council, the average annual growth in expenditure is to be restricted to 1% in this period, resulting in notable consolidation. The medium-term expenditure growth of central, state and local government must remain around 2 percentage points below revenue growth, not least in order to fulfil the minimum criterion of the European Stability and Growth Pact, ie annual structural deficit reduction of at least ½% of GDP. However, this will require considerable effort on the part of state government as some expenditure categories (interest ex-

penditure, civil servant pensions) will increase automatically by far more than 1% per year unless additional fiscal consolidation measures are taken. Even if state government as a whole manages to reduce the deficit as planned, some of the states are likely to fail structurally to meet the stipulated borrowing ceilings right up to the end of the current financial planning period. The Budget Principles Act lays down the objective of a budget with no new net borrowing. So far, only Bavaria, whose budget regulations make this a requirement as of 2006, has managed to achieve this. Saxony is, however, already close to achieving this objective. As far as the other states are concerned, it remains to be seen whether the target paths, which extend into the next decade, really can be kept to.

The expected sharp growth in expenditure on civil servant pensions will prove a major financial burden for state government. In addition to a further rise in the life expectancy of retirees, another major factor is the foreseeable increase in the number of pension recipients owing to a recruitment boom that extended well into the 1970s. Central government's most recent civil servant pension report from 2005 identifies sharp growth in related expenditure – from €16½ billion in 2003 to €47½ billion in 2030.<sup>8</sup> While the second civil servant pension report from 2001 predicted a decline in the number of pension recipients after 2030, the number is now expected to continue rising until 2040 when it will stabilise at almost twice the current level.

*Major future  
burdens from  
pension  
expenditure*

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<sup>8</sup> In variant 2 of projected expenditure in the civil service pension report (annual pay increases of 2% less cuts which have already been agreed).

*State government should strive to set up pension reserves without increasing borrowing*

The civil servant pension reserves at central and state government level, which have been funded by lower pay and pension increases since 1999 and were designed to provide relief during a fifteen-year peak in the pension burden starting around 2018, will not achieve the desired objective. Further action is therefore needed. Consequently, some states have set up additional reserves. In Rhineland-Palatinate, an additional contribution – equivalent to up to 30% of current staff remuneration – has been set aside for new civil servants since October 1996. This is aimed at fully financing the related future budget burdens so that the real total costs of the civil servants currently employed by the state are made transparent. As a result, the costs of staffing decisions can be calculated with less distortion. According to the third civil servant pension report, Bremen, Hamburg, Hesse, North-Rhine/Westphalia and Saxony have also set up additional pension reserves although only some of these are aimed at full cost coverage. While these approaches are to be welcomed, it should be pointed out that reserves of this kind will bring about relief for future budgets only if they are not offset by increased net borrowing. Otherwise, implicit debt will merely be converted into explicit debt and long-term sustainability will not improve. Some relief for future budgets would be achieved if the cost-curbing measures adopted for the public pension scheme were to be applied equally to the civil servant pension scheme. One particular such measure is the increase in the official retirement age.

As they still have fewer than average civil servants, the east German states will see their

pension expenditure burden remain smaller, even though the relative rise in expenditure will be sharper because of their lower starting base. The phasing-out by 2019 of the supplementary Federal grants under Solidarity Pact II will have a far greater impact on the east German states' budgets. Given that large amounts of these funds are currently used by most east German states to cover current expenditure, considerable savings will be necessary to compensate for the decline without dramatically pushing up their deficits (see box on pages 48 and 49).

*East German states burdened by declining supplementary grants*

## Closing remarks

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All in all, state government's financial situation remains highly problematic. However, considerable differences can be seen between the individual states despite a significant redistribution of revenue owing to the split allocation of turnover tax receipts and the various levels of the revenue-sharing scheme, as well as numerous common nationwide requirements on the expenditure side.

*Problematic financial situation and big differences between states*

Existing national budget rules have proved ineffective. The practically uninterrupted growth in debt could not be prevented, the majority of the states are structurally failing to observe the constitutional borrowing limits by a significant degree without incurring any notable consequences in the short term, and no less than three states have filed actions for the receipt of financial assistance from the other public authorities on the grounds of supposedly facing acute budgetary hardship.

*Current budget rules place insufficient curbs on borrowing*

*Clearer demarcation of responsibilities under first stage of federalism reform*

The first stage of the reform of Germany's federal structure, which has since been adopted by parliament, focuses on a clearer demarcation of responsibilities between central and state government, with the latter gaining additional room for manoeuvre on the expenditure side, in particular, thanks to the transfer of legislative authority for state civil servants' pay. At the same time, their rights vested in the Bundesrat to influence national legislation have been reduced. Moreover, the range of cofinancing projects has been narrowed and a regulation has been agreed compelling state government to make a 35% contribution towards European fines that might be levied in the event of an ongoing excessive deficit. However, this legislation does not constitute a "real" national stability pact, which would significantly increase the pressure for sound budgetary management.

*Stage II of federalism reform: opportunity for stricter borrowing limits, ...*

The announced second stage of the reform of the federal structure presents the opportunity to make the constitutional borrowing limits more effective, to extend internal budgetary surveillance within the federal system and to further increase both the responsibility and the radius of action of the individual levels of government, in particular, by restructuring the fiscal constitution. Tightening the borrowing rules would appear eminently appropriate. This includes adjusting the very broad definition of investment as the upper borrowing limit. Deducting asset depreciation and asset disposals from investment when calculating the upper borrowing limit – which the courts of auditors are also calling for – would be an important step. Furthermore, a

more rigorous pursuit of the basic objective of a structurally close-to-balance budget, which is already anchored in the Budget Principles Act and in the European Stability and Growth Pact, should be aimed for.

The national budgetary surveillance procedure could also be strengthened. This would require greater transparency regarding financial developments and planning in the individual states. Along the lines of the European budgetary surveillance procedure, one possibility might be to produce regular harmonised stability programmes for the individual states and for central government and to appoint a competent body to assess the situation and outlook of public finances, both overall and at the individual government levels, using various standardised indicators, and to obtain recommendations for appropriate adjustments. In principle, the Financial Planning Council (FPC) could assume an important role here. At present, within the forum of the FPC a discussion is generally held between central and state government on a half-yearly basis concerning the development of public finances. Recommendations for budget planning are also made. However, in the past these have been of very limited significance, particularly in terms of their binding effect on the various levels of government.<sup>9</sup> Moreover, in the event of a serious misalignment following the overshooting of a critical limit, it might also make sense to restrict the budgetary autonomy of the government concerned – if the federal principle, involving the right to

*... national budgetary surveillance procedure ...*

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<sup>9</sup> See Deutsche Bundesbank, Deficit-limiting budgetary rules and a national stability pact in Germany, Monthly Report, April 2005, pp 33-37.

## Developments in the east German states

Although the east German states (*Länder*) excluding Berlin have only exceeded their constitutional ceilings for net borrowing sporadically in recent years, overall they still face major structural budgetary problems. The performance of the region's economy remains far below that of western Germany. Consequently, revenues *per capita* from taxes on income in the state government budgets in eastern Germany are only just over one-quarter of those in the west German non-city states (*Flächenländer*), ie excluding the city-states Berlin, Bremen and Hamburg. While the state government revenue-sharing scheme, including the advance equalisation in turnover tax distribution, brings about considerable convergence at state government level on the revenue side, it was designed far less to even out the below-average tax-generating power of local government.

By contrast, the east German state governments' current *per capita* expenditure exceeds the comparable figure for western Germany by one-eighth, even after factoring out the (far higher) transfers to local government. In addition to larger current grants to households and enterprises, another contributory factor are the staffing levels which are still higher. Progressive harmonisation with pay levels in the west German public sector means this will have an even greater impact in future unless countermeasures are taken. Moreover, pension payments will increase considerably in the long term, which will be offset only partly by a fall in special and sup-

plementary pension payments to certain former officials of the now defunct German Democratic Republic (GDR). Furthermore, interest payments per inhabitant in the east German non-city states were nearly one-fifth higher than those in the west German non-city states even though the east German states started on an almost debt-free basis in 1990. This trend is exacerbated by the fact that total population figures in the east German states are on the decline, while in western Germany they are still growing, albeit slightly. This puts additional pressure on the east German states to adapt, given the associated weakening of their regional tax-raising base and the fact that their revenue-sharing entitlement is determined according to the number of inhabitants.

Yet, the impending adjustments to financial aid measures beyond the general revenue-sharing arrangement are more serious still. For one thing, EU assistance for eastern Germany will be reduced as, post-enlargement, its economy will no longer be as weak compared with the new EU average. Far more significant is the agreement contained in Solidarity Pact II (which has been in effect since 2005) to gradually reduce the special supplementary Federal grants which the east German states receive pursuant to section 11 (3) of the Revenue-sharing Act (*Finanzausgleichsgesetz*) to ease the burdens resulting from the former partitioning of Germany, such as the costly need to improve the infrastructure in order to catch up with western Germany and

<sup>1</sup> In a comparison of east German states with the financially weak west German states as well as of Berlin with Bremen and Hamburg (excluding their ports), the German Institute for Economic Research (DIW) identified an infrastructure deficit of just over €80 billion. See D Vesper, Zum infrastrukturellen Nachholbedarf in Ostdeutschland, DIW-Wochenbericht, 20/01. It should be borne in mind, however, that this figure is subject to considerable valuation problems and that the implied requirement of equal infrastructure capital per capita is con-

tentious. For example, it does not appear necessary to achieve a comparable stock of capital in schools if, owing to the low birth rate in eastern Germany, the number of pupils is far lower. Concerning the traffic infrastructure, reachability indicators were analysed, too. While these were far less favourable for the east German states, the deficits are considerably mitigated when the geographical location and population density are also taken into account. See also Zweiter Fortschrittsbericht wirtschaftswissenschaftlicher Forschungsinstitute

compensate for their local governments' below-average tax-revenue capacity. The funds, which currently amount to just over €10½ billion annually, will be cut perceptibly from the end of the decade and cease altogether by the end of 2019. By that time, the east German states will have received just over €100 billion in supplementary Federal grants and the infrastructural deficits, which were calculated at the turn of the current decade using projected values for real capital stock per inhabitant, ought to have been eliminated once and for all.<sup>1</sup> In addition, the east German states were granted a second basket of additional funds worth just over €50 billion which is also likely to be paid on a gradually declining scale, thus ratcheting up the pressure on them to adapt.

Generally, the east German states receive the special supplementary Federal grants in the form of current transfers which, technically, they are free to use as they see fit. However, since 2002, when the €3½ billion of investment grants awarded under the Investment Promotion Act (*Investitionsförderungsgesetz*) were converted into current transfers, the east German states (including Berlin) have had to submit statements of accounts specifying how the money was used. Besides spending it to help narrow the infrastructure gap, which is confirmed by the fact that (except in Berlin) their *per capita* investment expenditure outstrips that in comparable west German states, the east German states must also provide evidence that they have not fi-

nanced the catching-up process via increased borrowing.

In recent years, however, only Saxony has been able to provide such evidence<sup>2</sup> (which also covers the local authorities with their relatively high investment expenditure and more limited borrowing capacity). In the other states, higher investment was accompanied by additional borrowing. This implies that – in breach of the agreements – a far greater proportion of Solidarity Pact funding was used for financing current expenditure than was necessary to achieve the envisaged appropriate levelling-up of the local governments' below-par tax-revenue capacity. According to provisional calculations based on data from cash statistics, just under two-fifths of the money granted to the east German states (excluding Berlin) in 2005 was used for purposes other than those intended.<sup>3</sup> This attests to the marked structural under-financing that characterises most of the eastern states' budgets. They, like many of their counterparts in western Germany, would be incapable of keeping below the constitutional ceiling for new borrowing without central government assistance. Even factoring in the additional revenue expected to accrue from recently approved tax increases, most east German states will probably not manage in 2007 either to submit a report showing that all central government transfers were used as agreed. This underscores the magnitude of the consolidation challenge which they face even in the short term.

über die wirtschaftliche Entwicklung in Ostdeutschland, Kiel Discussion Papers 406, 2003, p 13 f. — 2 New borrowing is deducted from self-financed investment in infrastructure (plus other self-financed investments, for which debt financing is generally permitted). The resources are considered to have been completely properly appropriated if the difference, plus the higher grants to local government to even out the below-average financial strength of the local author-

ities, matches or exceeds the amount of central government funding. — 3 See H Seitz (2006): SoBEZ-Verwendungsrechnung für 2005, working paper, p 2. The author states that only Saxony can demonstrate an appropriation of resources in full accord with the intended purpose, whereas the other east German states show misappropriations ranging from over 40% in Brandenburg to almost 80% in Saxony-Anhalt.



support from other government budgets in the event of budgetary hardship, is to be maintained. A possible option would be to specify binding ceilings for expenditure growth or state-specific tax surcharges.

*... and greater  
tax autonomy*

The planned reform of the fiscal constitution could also strengthen the tax autonomy of the individual states. The transfer of legislative authority for real estate transfer tax agreed under the first stage of the reform is an initial small step in this direction. After granting more extensive scope for expend-

iture management, one particular option would be to allow individual income tax surcharges. If providing additional services for citizens involves charging higher tax rates, there is a greater incentive to search for economic solutions and to examine more closely the benefits and costs of revenue and expenditure. This might at least weaken the present fiscal illusion created by shifting burdens to other public authorities under the revenue-sharing scheme or by passing on deficits to future tax payers.