

Trends in local government finances since 2000

At first glance, the budgetary situation of local government in Germany currently appears to be significantly better than that of central and state government. 2006 closed with a local government budget surplus. Nevertheless, amid sharp divergences between individual local governments, in many cases a considerable need for fiscal consolidation persists in order to comply with the more rigorous local government budgetary rules. Thus concepts to safeguard budgetary stringency often have to be submitted, while high outstanding cash advances are placing severe restrictions on budgetary leeway.

Overall, the outsourcing of entities and the emergence of public-private partnerships has made it more difficult to assess fiscal developments. It is particularly important that this does not give rise to any incalculable risks which ultimately have to be borne by the public sector. The changeover from cameralistic cash-based accounting to commercial accounting, which has been set in train, should simplify the assessment process provided that activities are recorded in a uniform and transparent way. The availability of consolidated data on local government yields and costs, including outsourced entities, will at least generally make it easier to improve efficiency and to focus government activities on specific aims as well as to aid budgetary consolidation.

Overall financial situation of local government

Fiscal balance increasingly improved following large deficit in 2003

The budgetary development of local government¹ has varied considerably over the past few years, which was mainly attributable to large fluctuations in tax revenue (see also table on page 34). In 2000 – as in the two previous years – the budgets had a positive fiscal balance (+€2 billion). However, in the following year, local government began recording a deficit and this grew to €8 billion in 2003, thereby almost matching the peak of the early 1990s. The financial situation then improved gradually again and last year, at €3 billion, a marked surplus was achieved.

Nevertheless, budgetary situation of many local governments still tense

In spite of this recent favourable development, the budgetary situation of a number of local governments remains highly tense. While the fiscal balance is a key target variable for central and state government, the situation for local government is more complex, especially owing to special budgetary rules.² Thus, in most states, approval must be obtained from a supervisory body for budgetary borrowing that is intended for the long-term financing of expected deficits (ie over a period of decades) as a result of investment expenditure. However, this is usually only granted if the local government in question is likely to generate enough revenue to cover this additional incurrence of debt. In the cameralistic system, the benchmark for assessing this is the capability of generating the surpluses stipulated in the administrative budget, that is the budget in which current revenue and expenditure is recorded. The minimum surplus to be generated is mainly

calculated from the scheduled repayments of maturing loans. Given financing based on matching maturities, the repayment of credit thus mirrors the ongoing consumption of fixed assets. If a local government cannot demonstrate the required revenue-earning capacity, its scope for budgetary borrowing is thus extremely limited. It then has to forgo planned investments if it is unable to finance these investments itself from, say, revenue from fees. Therefore, even if a local government has a financial surplus, this does not necessarily mean that its budgetary situation is free of tension or that it enjoys a large degree of budgetary leeway.

The overall development of cash advances reveals the actual tension in local government finances. These loans, which were originally only intended to bridge short-term liquidity shortages, are now being used in many cases to bridge funding gaps in current expenditure for longer periods of time. At the end of 1999, local government reported outstanding cash advances of €6 billion. At the end of 2002, this figure had risen to €10½ billion. In the following years, the increase accelerated sharply to reach over €27½ billion by mid-2006. Although, according to the quarterly cash statistics, the total volume did not grow any further up to the end of last year, the

Big jump in cash advances indicates difficulties in balancing administrative budgets

¹ This includes independently administered cities, district authorities, municipalities belonging to a district as well as superordinated municipal associations, such as regional associations in North Rhine-Westphalia but not the municipal special-purpose associations. The city-states Berlin, Bremen and Hamburg are generally assigned to the state government level in the cash and accounting results statistics.

² See Deutsche Bundesbank, Trends in local authority finance since the mid-nineties, Monthly Report, June 2000, p 45.

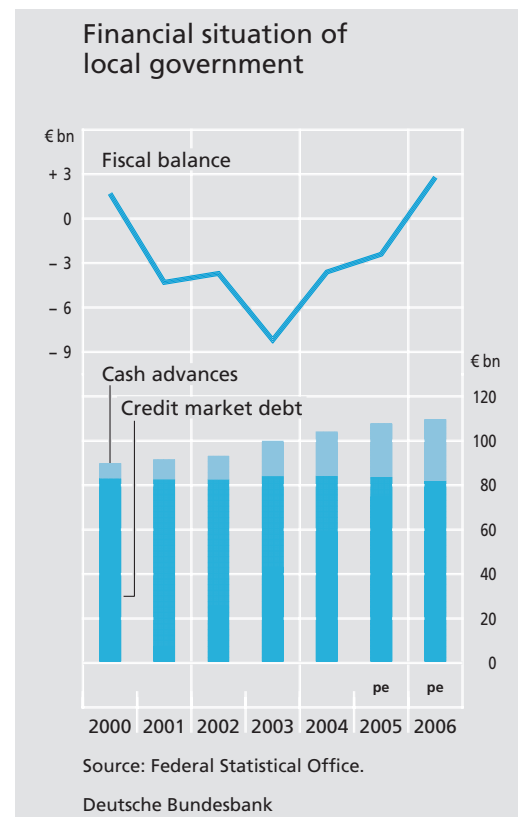
large variation in financial developments in the individual local governments implies that the situation may have deteriorated further in some cases.

Restrictions in case of unbalanced administrative budget

As a rule, when preparing the annual administrative budgets, local governments must ensure that budgets remain balanced after deduction of the required minimum surpluses. If they do not conform to this, then they must submit a concept to safeguard budgetary stringency showing how they intend to achieve a balanced administrative budget, at least in the mid-term. If this proves to be out of reach, the regional supervisory authority is generally obliged to withhold approval. The municipalities in question are thereafter in a state of preliminary budget management and are essentially allowed to expend money only on activities to which they are obligated. A large number of local governments are currently in this position.³

Link between cash advances and fiscal balances points to regional problems

The amount of debt incurred *per capita* as a result of cash advances varies greatly, however. The highest amounts were recorded by local government in Saarland, Rhineland-Palatinate and North Rhine-Westphalia at the end of 2006. Moreover, their fiscal balances were also still negative and their state government budgets recorded above-average deficits. At the other end of the scale, the lowest bridging loans on average were reported by local government in Baden-Württemberg, Bavaria, Saxony and Thuringia, where the unadjusted fiscal balances were also more positive than the average and the situation of state government finances was more favourable. This link between cash advances and fis-

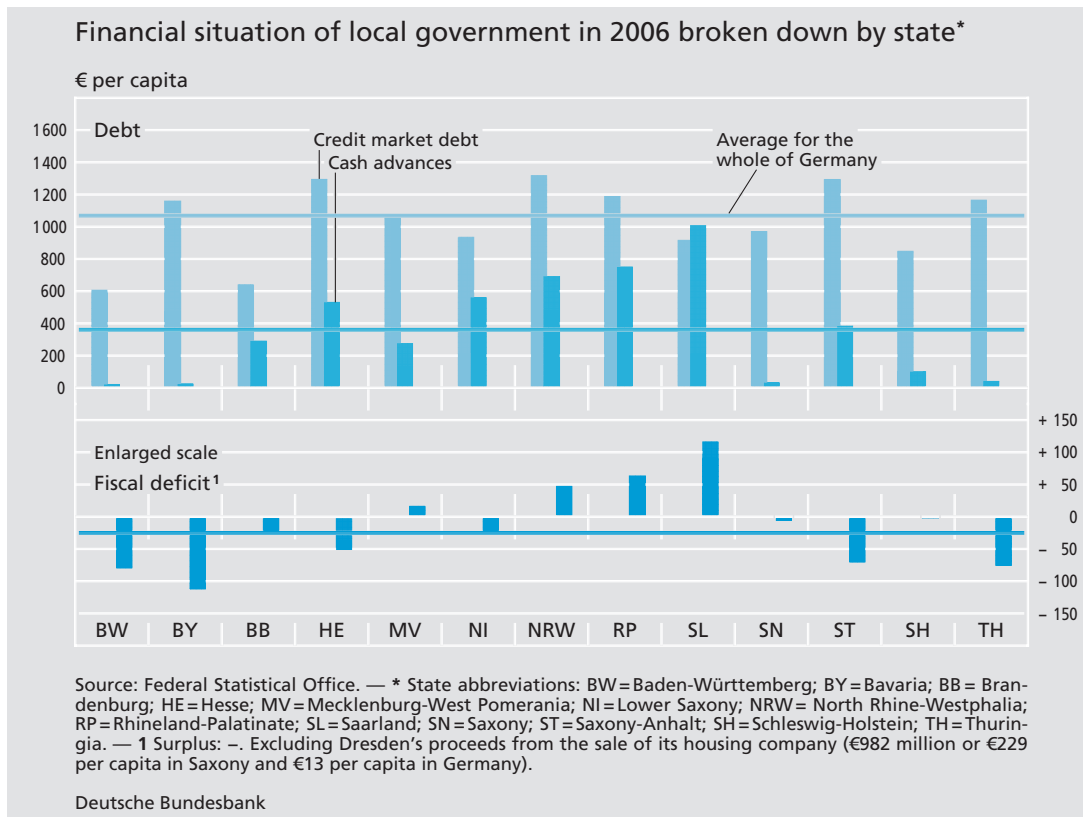


cal balances may be coincidental but it highlights regional problems. However, there are also considerable variations within individual states, predominantly owing to sometimes massive differences in the *per capita* tax-raising potential.

While the amount of cash advances gives an indication of the local government budgetary situation, the extent of credit market debt is not suitable for this purpose. This is due not only to the approval preconditions by the

Core budget debt does not present a complete picture

³ For example, in North Rhine-Westphalia, the number of local governments with such serious budget problems apparently rose further last year. At the end of 2006, 198 of the 427 municipalities in this state had to submit concepts to safeguard budgetary stringency, whereby 115 of these failed to win the approval of the supervisory body. See Innenministerium des Landes Nordrhein-Westfalen, Kommunalfinanzbericht May 2007, p 11 (available in German only).



supervisory body, which can lead to local governments with greater financial strength being more highly indebted, but also to the greatly varying degree to which service entities have been outsourced from the core budgets. If the service entities in question were also assigned liabilities, these are no longer recorded automatically in the financial statistics for local government budgets at the current end, even if local governments manage the outsourced entities directly and are ultimately responsible for the liabilities of these entities. The challenge is to incorporate those outsourced entities which still belong to the government sector. Simply adding on the debts of all local government holdings may well overstate the burdens on future budgets.⁴

While central and state government are now again largely managing to adhere to the prescribed borrowing limits following the extraordinarily sharp growth of tax revenue, many local governments still have to repay the cash advances that they have accumulated over the last few years. This has a knock-on short-term effect of noticeably restricting their budgetary leeway even though local governments as a whole are currently generating surpluses. In the final analysis, however, local

Local government budgetary rules counteract overindebtedness

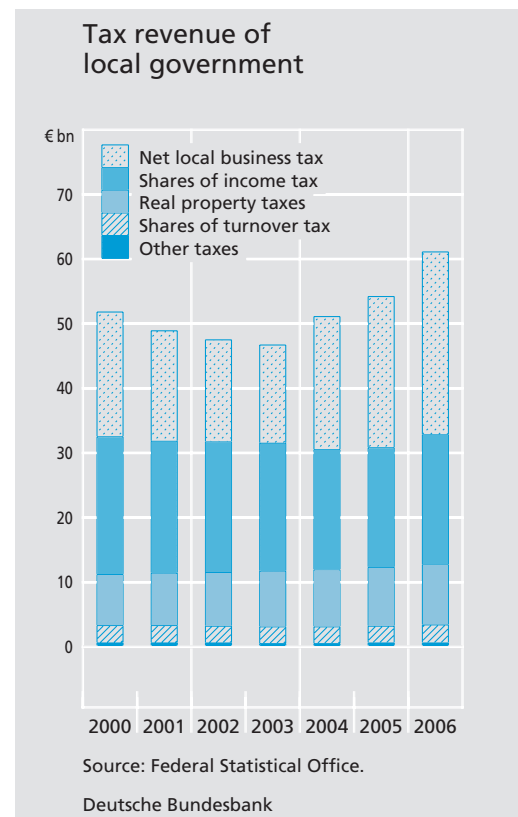
⁴ One study shows that including legally-dependent publicly owned and operated enterprises, public funds, institutions and enterprises (which, of course, also include profit-making corporations such as many of the municipal utilities) in the statistics, means a mark-up of approximately 100% on the core budgets' total debt on a national average. Considerable differences in the extent of outsourcing in various states caused the states' per capita debt ranking to be reversed in part. See M Junkerheinrich (2007): Kommunaler Gesamtschuldenmonitor, <http://www.bertelsmann-stiftung.de> (available in German only).

government budgetary rules are far better suited to averting a long-term overburdening of the budget by debt servicing than are the current provisions for central and state government because they more effectively constrain wealth consumption. While interest expenditure only accounted for 3% of total expenditure by local government in 2006, central and state government recorded much higher values at 13% and 8% respectively. The obligation to offset an overshooting of budgetary limits using surpluses in subsequent years and ultimately also to take due account of the consumption of fixed assets has contributed to keeping local government debt within far narrower bounds.

Development of revenue

Sharp increase following decrease up to 2003

Over the past few years the financial development of local government has been largely determined by influences from the revenue side. Between 2000 and 2003, revenue decreased by €6 billion or an annual average of 1½%. In the following three years, it rose continuously by almost €18 billion or 4% each year. This was predominantly due to tax revenue (see chart on this page) and to state government transfers, which are mainly linked to revenue from joint taxes. At over €61 billion or two-fifths of the total proceeds for 2006, tax receipts were the most significant source of revenue for local government. Up until 2003, there was an initial notable decline in tax revenue but this has since grown at a much stronger pace by an annual average of 9½%.



Revenue from local business tax in particular has proved to be very volatile in spite of the fact that the tax rate multipliers set by local governments were broadly stable. In 2000, after deduction of the local business tax shares transferable to central and state government, local government was left with €19½ billion. Three years later, this figure amounted to only €15 billion. This was partly due to the decision to raise the transfer shares as part of the tax reform in 2000, which meant that the actual amount payable to central and state government went up by 9 percentage points.⁵ Owing to the strained state of local government finances, the trans-

Large fluctuations in revenue from local business tax

⁵ On the development of the share of local business tax revenue to be transferred to central and state government see H Karrenberg and E Münstermann, *Gemeindefinanzbericht 2006*, in: *der städtetag*, 5/2006, p 99 (available in German only).

Volatility of local government tax revenue

Revenue from local government taxes is subject to sharp fluctuations which are due primarily to the large share of revenue from local business tax, which is very volatile. This share has actually increased in recent years. In order to stabilise the revenue from local government taxes, it is sometimes suggested that the relative weight of local business tax should be reduced in favour of other types of tax with a more stable revenue development. A reweighting of this nature is, however, associated with various complications. For example, in addition to the overall effect on local government tax revenue, the influence on the individual local government budgets also has to be taken into consideration. Furthermore, according to the constitution, local government self-regulation notably comprises a source of tax revenue for the municipalities, including the right to adjust local tax rate multipliers, based on the economic performance of local trade and industry (Article 28 (2) of the Basic Law).¹

Nevertheless, to give an idea of the intensity of fluctuation of local government tax revenue and of the contribution of local business tax to the volatility, two computations are made here. Firstly, the temporary influences on the growth of local government tax revenue are roughly estimated and, secondly, a hypothetical shift away from local business tax towards more stable types of tax is calculated for local government as a whole. These computations were based on the period from 1997 to 2006, which appears to approximately encompass a revenue cycle. It was also assumed that, given the sharp growth in recent years, the income raised from local business tax in 2006 was higher than its medium-term level.

To assess the scale of the temporary fluctuations in local government tax revenue, cyclical components can be determined for the individual types of taxes. There were also very significant fluctuations in the revenue from local business tax over the past few years which could not be explained by the trend in entrepreneurial and property income, which is used as a standardised assessment base in the cyclical adjustment process, or by legislative changes.

¹ One concept for replacing local business tax was proposed by the Stiftung Marktwirtschaft, for example: Tax Legislation Committee (Kommission "Steuergesetzbuch") – fiscal policy programme, 30 January 2006. Misgivings about such a change were expressed, inter alia, by a national organisation of municipalities (Deutscher Städtetag) in its Executive Committee resolution of 20 September 2005. — ² For cyclical adjustment and the disaggregated approach see: Deutsche Bundesbank, A disaggregated

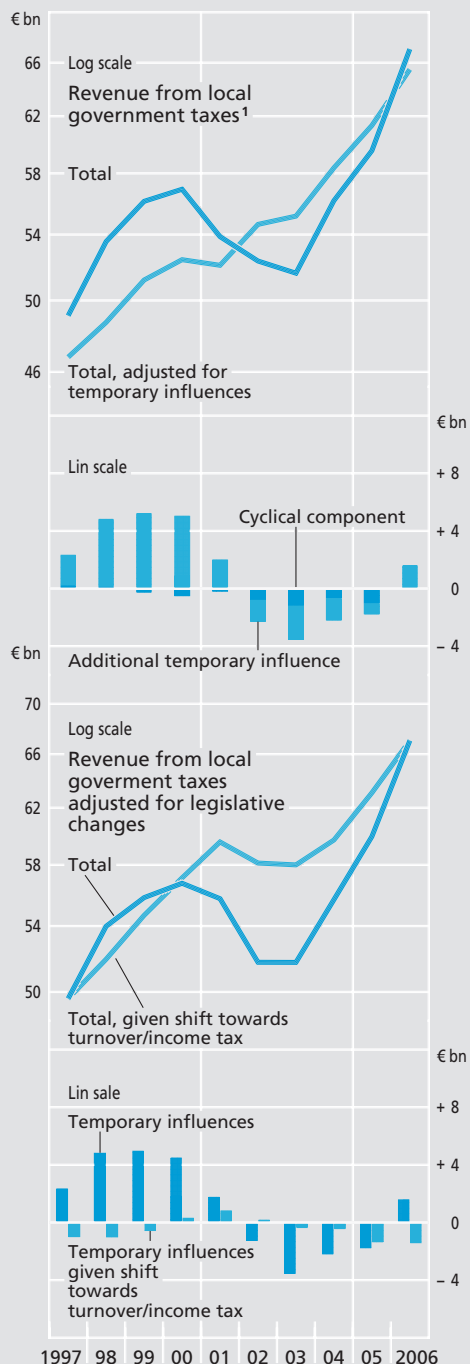
The bulk of these fluctuations appear to be temporary deviations from a medium-term trend which are not captured as a cyclical influence using standardised procedures. These temporary deviations are reflected in the residuals of the disaggregated framework for analysing public finances which was developed by the European System of Central Banks. On the basis of these deviations, an additional temporary influence on local government revenue can be determined which significantly exceeds the influence of the cyclical component (see chart on page 31).²

In order to assess the stabilising effect which a reweighting towards other types of tax would have had and to illustrate the relative volatility of local business tax, the revenue raised from local business tax is hypothetically replaced by greater shares of turnover tax and income tax. Turnover and income tax shares were selected in such a way that, in 2006, tax revenue was equal to the *status quo* and the growth in revenue from local government taxes over the period from 1997 to 2006 was retained after adjustment for legislative changes. The shares are currently around 2% of turnover tax, 15% of wage and assessed income tax and 12% of withholding tax on income. The hypothetical shares account for around 10% of turnover tax and 28½% of the different types of income taxes.

It turns out that under such a reweighting, tax revenues would have flowed much more steadily after adjustment for legislative changes and, in particular, the sharp drop in the years 2000 to 2003 would have been milder (see chart on page 31). Under the *status quo* scenario, the overall temporary influences reached a high of €5 billion in 1999 before falling by around €8½ billion and reaching a low in 2003. This corresponds to a significant part of the deterioration of the local government fiscal balance from €2.2 billion in 1999 to -€8 billion in 2003. By contrast, the temporary influences in the hypothetical scenario of a shift towards turnover tax and income tax results in a significantly narrower fluctuation band of between +€1 billion and -€1½ billion.

framework for analysing public finances: Germany's fiscal track record between 2000 and 2005, Monthly Report, March 2006, p 61 ff. The additional temporary effect is derived by adding up the share of local authorities in the residuals. A medium-term standard level has to be defined (partly founded on expectations of future developments). Its choice, however, has no influence on the fluctuations and their range.

Volatility of local government tax revenue



1 As defined by the Federal Ministry of Finance. Unlike the data from the Federal Statistical Office, this includes the revenue of the city-states Berlin, Bremen and Hamburg.

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fer shares were, however, brought back down to below the 2000 level from 2004 onwards. The €5½ billion upsurge in net revenue that year, however, was only partly attributable to this and to the effect of legislative changes (in particular, reducing the ability to offset losses for tax purposes), which caused revenue to rise on balance. The robust revenue growth continued until 2006 and most recently resulted in net revenue of €28½ billion, which clearly surpassed not only the low of 2003 but also the previous peak from the change of the millennium. The fluctuations in net revenue described above and the sharp average increase were predominantly triggered by the development of gross revenue from local business tax. According to central government estimates, the effect of legislative changes on gross revenue was almost always positive for the years between 2000 and 2006 and *per se* explains an average annual increase in revenue of 3% for this period (ie half of the total growth in the same period). From 2000 to 2003 actual gross revenue, after adjustment for legislative changes, developed at a far weaker pace than entrepreneurial and property income, which is generally used as an indicator for the tax assessment base. Since 2004, however, revenue has enjoyed much stronger growth.⁶ Given the considerable fluctuations in revenue from local business tax, local governments need to build up reserves from surpluses during more favourable phases to be able to cope with subsequent weaker phases without having to take major procyclical countermeasures (see box on page 30). How-

6 See Deutsche Bundesbank, The development of profit-related taxes, Monthly Report, November 2006, p 55.

ever, past experience has shown that this has only been done in exceptional cases. Therefore, the idea of replacing local business tax with a less volatile levy, which has been repeatedly discussed, appears a promising avenue.

Income tax share also volatile ...

The proceeds from local government's share of income tax also initially suffered a clear decline. After €21½ billion in 2000, only €18½ billion was recorded in 2005, primarily owing to successive tax cuts. Last year this revenue grew again and reached €20 billion, mainly as a result of the sharp increase in revenue from assessed income tax. In contrast, proceeds from real property taxes rose relatively steadily from €8 billion in 2000 to €9½ billion in 2006. Approximately half of the annual 2½% increase is accounted for by the development of the average tax rate multipliers for tax on land and buildings not used for agricultural purposes (*Grundsteuer B*), which rose by a total of 25 points to 392% in the period between 2000 and 2005.⁷ With revenue of approximately €2½ billion, local government's share of just over 2% in the proceeds from turnover tax, introduced in 1998 to compensate for abolishing local tax on business capital, showed hardly any growth. Other municipal taxes, such as dog tax and hunting tax, generated only low levels of revenue.

... but other local government taxes fairly stable

State government transfers increased solely due to 2005 labour market reform

As was the case with local government's tax revenue, state government transfers – which largely track the development of revenue from joint taxes – likewise initially declined during the period under review. Starting at €52 billion in 2000, these transfers fell significantly to €49 billion by 2003 while revenue

from joint taxes decreased by almost twice as much. The contribution of state transfers towards stabilising local government finances, however, was still rather limited on the whole (see box on page 33). By 2006, the total amount had climbed back up to €55 billion mainly because, from 2005, the share of accommodation costs for benefit recipients taken on by central government as part of the amalgamation of unemployment assistance and social assistance⁸ was paid to local government via the state government budgets. In addition to these funds, which amounted to a total of €4 billion at the end of the reporting period (including payments of over €½ billion to the city-states), state government has committed itself to passing on to local government any savings made in the area of housing allowances as a result of the reform, which are estimated to total approximately €2 billion per year.⁹ If these special factors are excluded, state government transfers declined by approximately €2½ billion over the period from 2000 to 2006.

At €43½ billion in 2006, other revenue collected by local government from fees, asset realisations (in particular, sale of building land), business activities (in particular, licence fees from public utilities) and other sources (for example, refunds of social benefits, fines and interest income) was €1 billion lower

Overall slight decline in other revenue

⁷ See Federal Statistical Office, Realsteuervergleich 2005, Fachserie 14, Reihe 10.1 (available in German only).

⁸ See Deutsche Bundesbank, The evolution of labour market-related expenditure, Monthly Report, September 2006, pp 65ff.

⁹ A portion of this amount is used by state government to finance the agreed equalisation payments of €1 billion for higher costs for local governments in eastern Germany as a result of the reform.

than in 2000. This is largely attributable to an almost continuous decline in revenue from fees. At €16 billion in 2006, this type of revenue was over €1 billion lower than in 2000. In times when the financial situation is tense, local governments are generally obliged to levy fees to cover their costs and thus pass on any cost increases to the users. However, any such increases in fees were more than offset by outsourcing service entities from core local government budgets.¹⁰ The financial statistics do not show the extent to which the closure of fee-levying entities requiring grants, such as swimming pools and libraries, eg as part of concepts to safeguard budgetary stringency, has contributed to this decline.

Development of expenditure

Accelerated expenditure growth following 2005 labour market reform

Total local government expenditure rose by less than 1% per year on average from 2000 to 2004. However, in 2005, the pace of growth accelerated to almost 3% before slowing to 1½% last year. The recent larger increases were triggered by the effects of the 2005 labour market reform but these were counterbalanced by additional transfers received of around 3% of local government expenditure on balance. The fact that the increase in expenditure was nevertheless still moderate on the whole is explained not only by the relatively strict provisions for local government budgets but also by the outsourcing of service entities from the core budgets. As

¹⁰ For the effects of outsourcing on the results of the financial statistics, see Deutsche Bundesbank, Trends in local authority finance since the mid-nineties, Monthly Report, June 2000, pp 50ff.

Stabilisation of revenue through transfers from state government

For the funding of local government, alongside the revenue from non-personal taxes and a share in the proceeds from turnover tax and income tax, Article 106 of the Basic Law also envisages a proportion of state government revenue from taxes raised jointly with central government, which is set by the state parliament. In addition, state taxes can also be included in the tax-revenue-sharing schemes with local government and, for instance, for the purpose of revenue-sharing, levies imposed on the non-personal tax revenue and revenue from local government shares in income tax and turnover tax. The municipalities receive resources linked to the level of tax revenue, in particular, in the form of transfers reflecting local revenue capacity shortcomings (*Schlüsselzuweisungen*). Differences between the disbursement of the transfers on the basis of tax estimates and the amount actually payable according to the final tax revenue outturn are normally settled in subsequent years. Rhineland-Palatinate guarantees its local governments certain minimum transfers irrespective of the development of its tax revenue. Any transfers over and above the payments from the tax revenue-sharing scheme are only granted as a loan and are later offset against higher tax revenue. Such an additional stabilising mechanism is advantageous for local government, as this means that a procyclical policy can be more easily avoided. However, if state government borrows credit to grant loans and does not redeem this credit when the account is later settled with local government, the level of debt is systematically increased.

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Local government revenue and expenditure *

Item	2000	2001	2002	2003	2004	2005 pe	2006 pe
	€ billion						
Revenue	148.0	144.2	147.0	142.1	147.0	152.3	159.9
<i>of which</i>							
Taxes	51.9	49.0	47.5	46.9	51.3	54.4	61.1
State government transfers	51.8	50.6	50.3	49.1	50.0	54.0	55.1
Other	44.3	44.6	49.1	46.1	45.7	43.9	43.6
<i>of which</i>							
Charges and fees	17.1	16.7	16.2	16.3	16.3	16.1	16.0
Expenditure	146.1	148.3	150.4	150.1	150.4	154.6	156.9
<i>of which</i>							
Personnel expenditure	39.5	39.4	40.0	40.5	40.5	40.9	40.6
Expenditure on current staff	35.1	34.8	35.2	35.4	35.2	35.4	35.0
Pensions and healthcare subsidies	4.4	4.6	4.8	5.2	5.3	5.6	5.6
Other operating expenditure	28.2	28.8	29.4	29.4	29.7	30.9	31.8
Current grants	37.2	38.5	40.3	42.4	44.7	48.5	49.7
Investment in fixed assets	24.7	24.3	23.7	21.5	19.8	18.7	19.2
Other	16.4	17.3	17.0	16.3	15.7	15.6	15.7
Surplus/deficit	1.9	-4.1	-3.5	-8.0	-3.4	-2.2	3.0
	Year-on-year percentage change						
Revenue	1.4	-2.5	1.9	-3.3	3.5	3.6	5.0
<i>of which</i>							
Taxes	2.0	-5.6	-3.1	-1.4	9.5	6.1	12.3
State government transfers	4.1	-2.4	-0.5	-2.4	1.8	8.0	2.1
Other	-2.2	0.8	10.1	-6.1	-0.9	-4.0	-0.6
<i>of which</i>							
Charges and fees	-0.5	-2.5	-2.9	0.7	-0.3	-1.2	-0.5
Expenditure	1.6	1.5	1.4	-0.2	0.2	2.8	1.5
<i>of which</i>							
Personnel expenditure	0.9	-0.4	1.6	1.4	-0.2	1.1	-0.9
Expenditure on current staff	0.5	-1.0	1.2	0.6	-0.5	0.5	-1.0
Pensions and healthcare subsidies	4.4	4.1	4.6	7.3	2.3	4.7	0.2
Other operating expenditure	2.9	2.0	2.1	-0.2	1.0	4.1	3.0
Current grants	2.8	3.6	4.6	5.2	5.4	8.3	2.6
Investment in fixed assets	0.5	-1.7	-2.4	-9.4	-7.7	-5.5	2.4
Other	0.2	5.8	-1.9	-4.3	-3.5	-0.6	0.7
	Percentage share in total revenue/expenditure						
Revenue							
Taxes	35.1	34.0	32.3	33.0	34.9	35.7	38.2
State government transfers	35.0	35.1	34.2	34.6	34.0	35.4	34.5
Other	29.9	31.0	33.4	32.5	31.1	28.8	27.3
<i>of which</i>							
Charges and fees	11.6	11.6	11.0	11.5	11.1	10.5	10.0
Expenditure							
<i>of which</i>							
Personnel expenditure	27.1	26.6	26.6	27.0	26.9	26.5	25.9
Expenditure on current staff	24.0	23.4	23.4	23.6	23.4	22.9	22.3
Pensions and healthcare subsidies	3.0	3.1	3.2	3.5	3.5	3.6	3.5
Other operating expenditure	19.3	19.4	19.6	19.6	19.7	20.0	20.3
Current grants	25.5	26.0	26.8	28.3	29.7	31.3	31.7
Investment in fixed assets	16.9	16.4	15.8	14.3	13.2	12.1	12.2
Other	11.2	11.7	11.3	10.8	10.4	10.1	10.0

* Source: Federal Statistical Office.

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only the need for grants is still being budgeted for, the volume of expenditure is reduced by the amount of revenue that the outsourced entities generate themselves. Assuming revenue from fees grows in line with the price development for public services only, annual growth in expenditure would have been 0.4 percentage point higher on average.

Personnel expenditure stabilised but other operating expenditure further increased perceptibly

Personnel expenditure by local government increased by an annual average of ½% between 2000 and 2006 to €40½ billion. This increase resulted purely from payments for civil servant pensions, supplementary pension schemes for salaried employees and civil servant healthcare subsidies. Despite somewhat higher social contributions and additional cost burdens from pay rises by an average of 1½% per year, expenditure for current staff decreased slightly. This is attributable to significant staff cuts (in full-time equivalents) by an annual average of 2½% (up to 2005). However, this is not due to greater productivity and reductions in the scope of activities alone but also reflects the outsourcing of entities whose personnel expenditure has been rebooked in the financial statistics under transfers to enterprises (which rose by 6½% per year between 2000 and 2006) or purchases of services. No doubt partly because of this, other operating expenditure also increased at an above-average rate of 2% per year to €32 billion over the same period. Higher prices for energy and a greater recourse to so-called public-private partnerships (PPP) have probably also had a part to play in this development. Under PPP schemes, private entities generally take on the operation, building as well as the credit financing of es-

entially local government entities, meaning that current expenditure on services may also replace investment expenditure and interest payments.

Up until the end of 2004, local government expenditure on social benefits notably included payments pursuant to the Federal Act on Social Assistance (*Bundessozialhilfegesetz*), which comprised subsistence benefits, assistance granted in particular circumstances,¹¹ assistance for young people in and outside of institutions as well as benefits for war victims and benefits granted to persons seeking asylum. From 2003, the Act stipulating a needs-based basic allowance for elderly persons and for people with reduced earning capacity (*Gesetz über eine bedarfsorientierte Grundsicherung im Alter und bei Erwerbsminderung*) established a new, independent social benefit provided by local government entailing additional cost burdens of around €½ billion per year, which is, by and large, the same as subsistence benefit but is granted with fewer restrictions.

Local government's social benefits prior to the 2005 labour market reform ...

Local government expenditure on social benefits went up over the period from 2000 to 2004 from €26½ billion to €32 billion (+5% on annual average).¹² Broken down ac-

... increased strongly

¹¹ Subsistence benefits comprise ongoing benefits as well as measures promoting a return to work (grants to employers and employees, public work schemes and reintegration measures). Assistance granted in particular circumstances is made up of nursing assistance, reintegration assistance for disabled people, assistance in the case of illness and other forms of assistance.

¹² After deducting refunds, the increase amounted to over €4½ billion (+4½% pa). Refunds comprise receipts from other social service providers (statutory health, long-term care, old-age pension and unemployment insurance schemes) as well as transferred claims on persons liable to pay maintenance under civil law.

Local government social benefits from 2000 to 2006 *

€ billion

Item	2000	2001	2002	2003	2004	2005	2006
Expenditure	26.3	26.9	28.1	30.4	32.2	35.5	36.6
<i>of which</i>							
Benefits as a result of labour market reform ¹	–	–	–	–	–	10.6	11.8
Social assistance outside of institutions	9.5	9.5	9.8	10.0	10.3	3.4	3.3
Social assistance in institutions	10.0	10.5	10.8	11.6	12.3	12.3	12.3
Benefits for war victims etc	0.6	0.7	0.6	0.6	0.6	0.6	0.6
Assistance for young people outside of institutions	1.6	1.7	1.8	1.9	2.0	2.1	2.1
Assistance for young people in institutions	2.6	2.7	2.9	3.0	3.0	3.0	2.9
Benefits granted to persons seeking asylum	1.5	1.3	1.2	1.1	1.0	1.0	0.9
Other ²	0.5	0.6	1.0	2.2	3.0	2.6	2.7
Revenue	3.0	3.2	3.3	3.7	4.2	7.2	7.8
<i>of which</i>							
Revenue as a result of labour market reform	–	–	–	–	–	4.3	5.0
Refunds of social benefits	3.0	3.2	3.3	3.7	4.2	3.0	2.7
Net expenditure	23.3	23.8	24.8	26.7	28.0	28.2	28.9

Source: Federal Statistical Office, accounting results for local authorities, from 2005 quarterly cash statistics. — * Social benefits include expenditure recorded under the classification numbers 73-79 and, from 2005, also those under classification numbers 691-693; excluding the city-states Berlin, Bremen and Hamburg. — ¹ Excluding unemployment benefit II completely refunded by central

government in those municipalities having separate responsibility for the unemployed. — ² From 2003 including basic allowance for elderly persons and for persons with reduced earning capacity. According to the cash statistics, these accounted for approximately €1.7 billion each year between 2004 and 2006.

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According to benefit components, sharp increases were recorded for payments for social assistance in institutions (from €10 billion to €12½ billion or +5 % pa) and for assistance for young people outside of institutions (to €2 billion or +6 % pa). Expenditure on social assistance outside of institutions grew in proportion to the increase in the number of recipients by 2 % on average per year (from €9½ billion to €10½ billion). However, after taking account of the basic allowance for elderly persons and for people with reduced earning capacity that was introduced in 2003, for which over €1½ billion was paid in 2004, the increase was only slightly smaller than that of social assistance in institutions. Only expenditure on persons seeking asylum recorded a perceptible decline (to €1 billion).

Following the labour market reform in 2005, local government, either together with the local employment agencies or on its own, took on responsibility for recipients of the new unemployment benefit II who had previously received mainly unemployment assistance or social assistance. Local government became responsible, in particular, for the costs of accommodation and heating which were previously paid as part of social assistance or, in part, as statutory housing allowances.¹³ Central government contributes to the accommodation costs to fulfil its promise to ease the burden on local government by

*Changes due to
labour market
reform*

¹³ Several local governments were also given the opportunity to take over the remaining tasks with regards to the labour market reform, such as paying unemployment benefit II and carrying out reintegration measures (municipalities with separate responsibility for the unemployed). However, central government refunded this expenditure in full and booked it on its own accounts.

€2½ billion per year. Initially a contribution share of 29.1% was set for this which was then raised to an average of 31.8% for 2007 and scaled according to state.¹⁴ In addition to the contribution from central government, it has been agreed that the states will pass on any savings that they make as a result of the reform to local government.

Expenditure surge following labour market reform, but subdued increase on balance

Owing to the amalgamation of unemployment and social assistance for persons able to work, local government expenditure on social benefits initially shot up by €3½ billion to €35½ billion (+10%) in 2005 and by a further €1 billion in 2006. Adjusted for the new refunds from central and state government and other (declining) revenue for other social benefits, this resulted on balance in a total additional cost burden for social benefits of €1 billion compared to 2004. Taking into account the probably substantial net cost relief for personnel and administration and comparing the result with the estimated development had the previous legal *status quo* persisted, this is likely to have resulted in considerable cost relief for local government overall.¹⁵

Investment in fixed assets fell markedly up to 2005 due to tense budgetary situation

The development of investment expenditure over the last few years was shaped by the tense budgetary situation in many local governments. With a total volume of €18½ billion, payments for investment in fixed assets in 2005 were €6 billion lower than in 2000, which corresponds to an average annual decline of 5½%. Evidently, many local governments were not able to provide the proof that their revenue-generating ability was sufficient. This proof is required under budgetary

rules in almost all states before taking up additional loans for investment purposes. However, with some marked budgetary surpluses, local governments, especially those in south German states, were able to significantly augment their investments in fixed assets last year, resulting in a nationwide increase of 2½%. The decrease in local government investment over the past few years was, however, probably noticeably overstated owing to the outsourcing mentioned above.¹⁶ Public-private partnerships have also played a role in this of late. In the case of such PPPs, prior local government investment is reclassified as private investment (hence not being recorded in the budgets) which is then used by local government for a fee.

Developments in the east German federal states

While state budgets in eastern Germany have far greater *per capita* revenue than those in western Germany, on account of the special

Per capita revenue still slightly lower

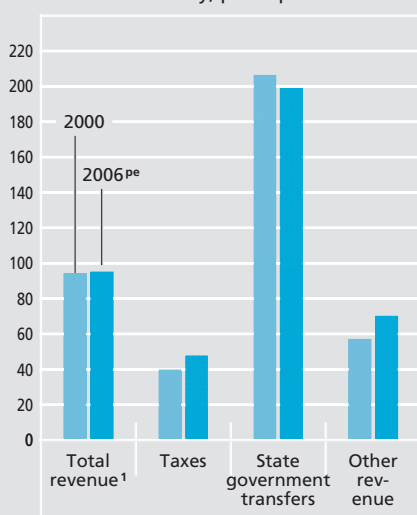
¹⁴ In 2007, central government is contributing 35.2% towards accommodation costs in Baden-Württemberg, 41.2% in Rhineland-Palatinate and 31.2% in the other states. This scaling of payments is intended to help correct the larger-than-average burdens on local government in these two federal states. Up until 2010, adjustments are only to be made based on formulas.

¹⁵ For detailed comments see Deutsche Bundesbank, The evolution of labour market-related expenditure, Monthly Report, September 2006, pp 72-73.

¹⁶ It has been established for the municipalities in North Rhine-Westphalia that in 2003 enterprises and off-budget institutions managed by local government alone financed approximately three-quarters of the volume of investment in fixed assets in the core budgets. Including investment by municipally owned enterprises, this almost matched the volume in the core budgets. See M Junkerheinrich (2007), loc cit. As no information is currently available about the development over time, however, it is not possible to estimate the contribution made by outsourcing to the decline in investment in fixed assets reported by local government.

Local government revenue in eastern Germany

as a percentage of the level in western Germany, per capita



Source: Federal Statistical Office. — 1 Excluding Dresden's proceeds from the sale of its housing company in 2006 (€982 million or 3.6% of the level in western Germany).

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supplementary Federal grants, local governments in eastern Germany currently do not have this kind of advantage. If the one-off proceeds from the sale of the Dresden housing company (€1 billion), which were posted last year, are stripped out, *per capita* revenue and expenditure were both around 95 % of the level in western Germany. The ratio for revenue was thus 1 percentage point higher than in 2000. However, it cannot be inferred from this comparative gap that the financial position of east German municipalities really was more strained than that of their west German counterparts, mainly because both the distribution of tasks between state and local government and the outsourcing of entities from core budgets differs from state to state. It should also be taken into consideration on the expenditure side that, overall,

the price level (for example, for wage costs or service charges) is likely to be lower on average in eastern Germany.

Local government tax revenue (*per capita*) has increased at a somewhat faster pace in eastern Germany than in western Germany. Whereas in 2000, eastern Germany recorded only 40 % of the level in western Germany, this had increased to 48 % in 2006. While the gap is still very wide, it is more than evened out by *per capita* state government transfers that are almost twice as high.

Relative tax-generating potential on the rise but gap still needs to be closed

In terms of expenditure, personnel costs *per capita* were reduced significantly compared with moderate growth in staff costs in western Germany. This had the effect of lowering the *per capita* expenditure for the period from 2000 to 2006 from 106½% to 97 % of the average amount in western Germany. However, the higher level of civil servant pensions in west German municipalities also has to be taken into consideration in this context. The comparable figure for current staff was still surpassed by 8½% in eastern Germany (after +20½% six years previously). Between 2000 and 2005, the headcount was reduced by an annual average of 6½%, while local government jobs were cut at an annual rate of 1½% in western Germany. At the same time, pay scales were raised further towards the west German level. While in 2000 only 86½% of the west German level was paid, since July 2006 this figure has been at 95½%. As the municipal workforce *per capita*, expressed in full-time equivalents, was still 13½% above the average in western Germany in mid-2005, there may well still be

Despite cuts more staff than in western Germany

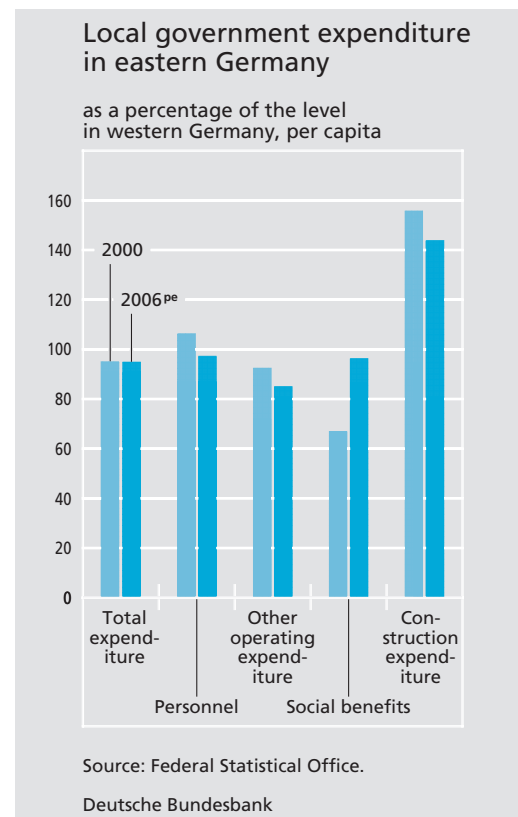
a need for further adjustment in this area, especially so as to avoid east German local government budgets being overburdened by the continuing alignment of pay scales. There are, of course, differences between the individual east German states, although these may, in part, be a result of the varying distribution of tasks between state and local government. Local governments in Saxony-Anhalt and Brandenburg, in particular, have a sizeable workforce. By contrast, Saxony and Thuringia are much closer to the west German reference figures.

Relative rise in cost burden due to social benefits offset by equalisation payments

While east German local governments recorded increasingly lower *per capita* other operating expenditure compared to western Germany, the increase in social benefits has been much stronger in eastern Germany over the last few years. The 2005 labour market reform is likely to have been the chief cause of this. Taking on responsibility for costs of accommodation and heating also for those people entitled to claim the former unemployment assistance has placed a particularly heavy burden on local government in eastern Germany. However, a special payment of €1 billion per year to east German states was agreed as part of the reform, which comes near to offsetting the additional costs that these states have to bear vis-à-vis west German municipalities.

Construction investment still clearly higher but lead diminishing

However, the fact that *per capita* investment in fixed assets by local government is still noticeably higher in eastern Germany indicates that further progress was achieved in catching-up with regards to the provision of infrastructure over the last few years. Neverthe-



less, expenditure in eastern Germany is now not as far ahead of western Germany as it was six years ago. Thus whereas construction investment was 56 % ahead of western Germany in 2000, this figure had narrowed to 44 % in 2006, with a large portion of this probably due to measures taken to overcome the flood damage caused in summer 2002. The procurement of movable assets and, above all, the acquisition of real estate was, however, much lower than by local government in western Germany, with the result that overall investment in fixed assets in 2006 was 22½% higher than in western Germany (after 32 % in 2000). From 2009, the special supplementary Federal grants paid to east German states, part of which they pass on to local government, will be reduced more perceptibly. East German municipalities will be

Extension and funding of child day care

Recently, the issue of additional day care places for children under three years old and the funding for this has been the subject of heated debate. Child day care is, as part of public assistance for young people pursuant to the Eighth Book of the Social Security Code, a duty of state and local government, which they are also responsible for funding. Day care facilities are provided, on the one hand, by churches and religious groups and welfare associations (independent providers) and, on the other hand, by district authorities, independently administered cities and – if decreed by the state legislation – also municipalities belonging to a district and regional authorities like the state youth welfare offices (public providers).

Since 1996, children have had the right to a place in a child day care facility from when they have reached the age of three until they start school (section 24 (1) of the Eighth Book of the Social Security Code), and the available capacity has been correspondingly increased. However, for children under three, particularly in western Germany, considerably less capacity is offered. Under the Act on extending child day care provision (*Tagesbetreuungs- ausbaugesetz*), which came into force in 2005, in addition to the 100,000 places that existed in western Germany at the end of 2002, a further 230,000 child care places for infants are to be created by the end of 2010. The investment required was estimated at €2½ billion and the annual running costs from 2011 were estimated at €1¾ billion. €1½ billion of the €2½ billion promised to relieve local government budgets in the 2005 labour market reform should, in the long term, be invested for these purposes.

In contrast to western Germany, in eastern Germany the strong decline in the birth rate, in particular, has for years considerably reduced the demand and thus, given the comprehensive care capacity that already existed there, the expenditure. Overall, however, there were considerable differences between individual state governments regarding expenditure, which, in particular, reflected the different scope of day care facilities that was offered. The proportion of children under three who attended a day care facility in 2006 varied from 50% in Saxony-Anhalt in eastern Germany to 5% in Lower Saxony in western Germany.

In April 2007, central government, the state governments and the central organisations representing local government agreed to extend the number of day care places for children under three to such an extent, that in 2013, on average, 35% of children in this age group will be offered a place. To this end, the number of places throughout Germany is to almost treble, from 285,000 in March 2006 to around 750,000 places. It is understood that then children are to have a right to a day care place once they have reached the age of one. However, the level of costs and the contribution of central government to the funding are the subject of dispute. While the Federal Government estimates the investment costs for an additional 300,000 places vis-à-vis the provision envisaged in the Act on extending child day care provision will amount to €3½ billion and the later additional annual running costs to €2 billion, local governments expect a greater burden

(€5 billion with regards to investment and €3 billion for running costs). The Federal Government intends to make a contribution of one-third of the additional expenditure which it estimates will, in total, be €12 billion up until 2013. For the time thereafter, it declared its intention to continue to assume a share of the additional running costs, without being more specific.

In general, an assumption of part of the costs by central government is made more difficult by the fact that the constitutional framework of the German public finance system does not allow direct financial relations between central government and local government. In accordance with the reform of the federal structure, which did not come into force until September 2006, in addition, central government may no longer assign tasks to local government (Article 84 (1) seventh sentence of the Basic Law). Only state governments have the right to do this and then, in accordance with the respective connectivity rules, they must also refund the costs. In this respect, the possibility of central government assistance towards financing the extension of day care provision is restricted to the granting of temporary investment subsidies to state government, pursuant to Article 104b of the Basic Law, for the purpose of promoting economic growth. In the case of such mixed financing, however, the incentive effects have to be taken into account. The granting of central government aid to cover a proportion of the investment costs seems unlikely to be conducive towards achieving a cost-effective implementation of the planned extensions in capacity at local level. Alternatively, assigning additional shares in turnover tax revenue to state government would appear to be a promising idea. In this way, the higher current running costs could also be offset. State government would have to use these financial resources to cover its cost compensation obligations where state law obliges local government to provide the day care places necessary to meet the entitlement to day care.

By contrast, the Federal Ministry of Finance is planning to set up a capital-consuming special fund, funded out of the current higher tax revenue, to finance the extension of day nurseries. In addition, issuing parents with care vouchers is being considered as a possible central government grant for the additional running costs, although these vouchers would only cover a small part of the total costs. Vouchers could, as a general rule, have a positive steering effect, as experience in some municipalities and abroad shows. However, owing to state government opposition to such a model, in the meantime, reallocating turnover tax revenue from central government to state government is also being considered. However, it appears that no agreement has yet been reached which gives state government the freedom of scope required under constitutional law with regard to refunding local government outlays. In addition, advance funding of central government's contribution from the present higher tax revenue by means of a special fund – regardless of the aims of the revised rules on the constitutional framework of the German public finance system – is not without problems, particularly in view of the budgetary principles of unity and transparency.

confronted with an extensive need for adjustment if this cannot be offset by further increasing their tax-generating potential.

Outlook

Overall budgetary surplus also expected for 2007

The currently favourable macroeconomic setting is having a positive effect on local government finances, too. This takes the form of a further clear increase in revenue from income tax shares in 2007 as well as robust growth in revenue-linked transfers from state government, which *inter alia* will pass on a portion of its additional revenue from raising the standard rate of turnover tax.¹⁷ The May tax estimate predicts that income from local business tax, following the upsurge in the past few years, will still show a slight improvement despite the denting effect on revenue of the temporary extension of the applicable degressive depreciation method. On the spending side, personnel expenditure may well decrease slightly owing to expected ongoing staff cuts and to moderate pay rises overall. The significant reduction in the number of persons unemployed and benefit restrictions in connection with unemployment benefit II are likely to curb spending on social benefits and thus provide a counterweight to the aspired extension of childcare for infants (see box on page 40). Expenditure for investment in fixed assets is expected to grow more strongly owing to the improvement in the overall financial situation of local government, but also to the extra cost resulting from the rise in the standard rate of turnover tax and to current sharp increases in net construction prices. On the whole, local govern-

ment budgets are expected to conclude 2007 with a positive fiscal balance. However, it may well be some time before the deficits in the administrative budgets, which have accumulated in numerous local governments over the course of the past few years, have been offset in line with the legal requirement.

In view of the significant financing surplus expected, the solution agreed upon for the 2008 business tax reform of limiting revenue shortfalls for local government to just under €1 billion in the first year appears to be financially viable, even if repercussions from the tax revenue-sharing agreement with state government may cause the cost burden to increase somewhat. In the mid-term, additional revenue is actually expected for local government. The large estimation risk with regard to the exact impact on revenue must be taken into account, however. The accompanying structural vulnerability of local business tax proceeds could be mitigated by a switch from including half of the interest on long-term debt to including a more broadly defined range of debt financing costs, which would have almost no effect on revenue. However, the underlying problem of the extreme fluctuations in local government revenue, in particular as a result of the dependency on volatile revenue from local business tax (see box on page 30) has not been resolved. Past experience has shown that investments in the public infrastructure, which are predominantly financed from local government budgets, are greatly affected by these fluctuations in

Business tax reform does not resolve problem of extremely volatile local government revenue

¹⁷ See also the short article on trends in local government finances in the first quarter of 2007 in this Monthly Report, p 8-9.

Changeover to double-entry bookkeeping

In November 2003, the state government interior ministers adopted guidelines for the changeover of local government budgets to a commercial double-entry bookkeeping system. The concrete implementation of the new accounting system is the responsibility of each state parliament. North Rhine-Westphalia is taking the lead in this respect; the Act introducing the new local government financial management system (*Gesetz zur Einführung des Neuen Kommunalen Finanzmanagements für Gemeinden*) passed by this state at the end of 2004 stipulates that the switch must be complete by 2009. In some other federal states, the changeover may take place much later; in Bavaria, which has many quite small municipalities, even an option to continue using the current cameralistic budget management system was granted. In order to take the European and national reporting requirements into account and to be able to aggregate the results of the different accounting systems – including during the transitional period – the statistical offices were involved in defining new standard products and accounts. However, the provisions since passed by the state parliaments partly differ considerably from this standard. There is therefore a danger that the financial statistics data for local government will become significantly less meaningful overall.

The cameralistic accounting system focuses on payment flows and thus tends to conceal, in particular, costs that do not result in outgoing payments until later reporting periods. By contrast, in the double-entry bookkeeping system, all

yields and costs that are attributable to a given period must be recorded in the crucial profit and loss account. One key difference for local government in terms of the budget management requirements is that it is no longer necessary for due redemptions, which can be steered through the choice of loan maturities, to be financed from regular revenue. Rather the actual resources consumed in a given period as mirrored by depreciation have to be matched by yields. Furthermore, in the case of staffing costs, it is no longer pension payments but the additional provisions for current staff that must be covered. Pension payments are now redemptions and are not to be recorded as a cost item.

Whether the requirements for a balanced budget are stricter than in the cameralistic system depends largely on whether depreciation and increases in provisions are greater than redemption commitments and pension payments. Alongside possible maturity mismatches concerning credit-financed investments, it should be noted that a significant proportion of assets, such as real property and participating interests, are not usually subject to depreciation charges but can be credit-financed and associated with redemption commitments. Fears on the part of many local authorities that their radius of budgetary action will be narrowed may prove unfounded.

The details of the accounting rules, which differ from state to state, also have a bearing on this. If valuation of assets at fair value is permitted,

the balance sheet values and the associated depreciation charges in double-entry bookkeeping typically exceed those based on historical acquisition costs. By contrast, achieving a balanced budget is made easier if, alongside regular yields, proceeds from the realisation of hidden reserves through asset disposals can be used to cover costs. In addition, North Rhine-Westphalia has also introduced an offsetting reserve. One-third of the equity capital (up to one-third of annual tax revenue plus transfers received) can be placed in this reserve, from which deficits may be financed without further restrictions with regards to preserving the equity base. With these regulations, North Rhine-Westphalia is easing the changeover to the new accounting system for those municipalities that are facing a tight financial situation. However, to a certain degree this conflicts with the aim of protecting the interests of future generations through a commitment to offset all current costs. This will also be reflected on the balance sheet, where not only assets but also liabilities and equity capital have to be valued. Overall, it is expected that the municipalities' opening balance sheets will record sizeable amounts of equity capital. In the event of lax budgetary rules under the system of double-entry bookkeeping, the depletion of the capital base could even be made easier.

One frequently perceived important advantage of double-entry bookkeeping is that the process of consolidating the results of core budgets and their participating interests, eg in the form of municipally owned enterprises, is made consid-

erably easier through the use of a uniform accounting system. It is hoped that this will also lead to improved management of the portfolio of participating interests, which has become increasingly opaque over the past few years owing to the hiving-off of entities from the balance sheet. From a statistical perspective, it is important to achieve a correct demarcation in the consolidation process between government entities and market-oriented enterprises. A crucial criterion in this respect, besides the degree of cost recovery through charges, is decision-making autonomy of the entities concerned.

However, the management of core budgets is also to be improved. While, in the cameralistic system, attempts are made to achieve political aims by allocating funds to individual budget items, in double-entry bookkeeping, products are defined whose production costs have to be calculated. The scope of supply must then be determined by the local parliament. The funding required is authorised in the budget. This provides a clear picture for politicians and the general public alike of the costs associated with the desired volume of services. This facilitates comparisons of cost efficiency between fiscal years and also between individual local authorities and can help to contain costs. Although in many cases improvements in management operations will, on their own, fall a long way short of providing a rapid solution to the continuing budgetary problems experienced by many local authorities, the remaining consolidation potential should be easier to identify and exploit.

revenue. As the proposal to replace local business tax with, say, shares in income tax and corporation tax, with a surcharge option, are meeting with stiff political resistance, it may be worth considering at least steadying the level of state government transfers so as to shift the impact of cyclical swings to a higher level.¹⁸ Easing the local government debt incurrence rules certainly offers no solution to the problem. The curbing of the interest burden which was achieved over the last few decades, also as a result of the relatively strict rules, has in fact opened up long-term budgetary leeway and lessened incentive problems, which it was feared would arise if excessive debt could be shifted to other government entities. To tighten the link between local government services and the financing of these services, it appears worthwhile to consider giving local government greater scope to set different tax rates, which would then have to be justified by the local government in question.

Changeover of accounting and investment activities requires clear legal framework

The changeover of local government budgets to double-entry bookkeeping shifts the focus to maintaining wealth and ensuring that the management of authorities heads for performance objectives. Costs associated with the changeover could essentially soon be balanced out by a more efficient provision of services. However, it is important that when es-

tablishing the legal framework, state parliaments take account of these aims and also the need for well-defined statistical information (see box on pages 42 and 43 on the introduction of double-entry bookkeeping). The same is also true for public-private partnerships. Without details about the scope of these agreements, it is much more difficult to make statements about the development of public infrastructure. Basically, PPPs can be a promising way of improving infrastructure – initial reports indicate cost savings of more than one-tenth in some cases and faster project completion than under conventional approaches. However, it must be made clear which risks remain with the public sector. The long-term nature of the contractual specifications is another factor that has to be taken into consideration. The regional supervisory body faces the challenge of preventing a potential misuse of such models to bypass borrowing limits. Finally, it is crucial that, in the context of the emerging changes in accounting methods and financing forms, local government's activities and obligations are transparent, comprehensible and manageable.

¹⁸ Despite numerous demands to abolish local business tax and replace it with a standard company tax, this was not taken on board in the latest reform of business taxation. Steadying the revenue flow by expanding business tax elements which are unrelated to earnings is problematic both in terms of tax principle and also with regard to the likely implications for investment decisions.