The development of state government finances in Germany since 2005

State government finances have undergone sharp fluctuations in recent years. Having temporarily achieved a balanced budget in the aggregate, state government saw its finances deteriorate considerably in 2009 following the financial and economic crisis. While the deficit of the 16 states has since declined significantly overall, state government is not expected to come close to balancing its budget until around the end of the fiscal planning period in 2016.

The current fiscal situation varies greatly across the individual states. Whereas some states already posted surpluses last year, others still had very high deficits. Although the interest burden stemming from high levels of debt was a key factor in many cases, revenue and other expenditure also partly differed considerably among the federal states.

In order to curb government debt, including that of the federal states, strict borrowing limits were enshrined in the German constitution (Basic Law, or Grundgesetz) in 2009. All states will have to balance their budgets (in structural terms) from 2020 onwards. However, some key details regarding the debt brake's design have been left to state legislators, and the transitional period specified in the national constitution seems very long for most of the states. Following amendments to some federal state constitutions, the first states have now passed implementing legislation. However, most have set only imprecise or unambitious requirements (to date) for the minimum deficit reductions during the transitional period. Like those that have not yet revised the requirements governing their borrowing limits, these states risk delaying necessary consolidation measures and ultimately encountering difficulties in achieving the budget targets. The later consolidation begins, the higher the future interest burden will be, distinctly narrowing the scope for other expenditure. It is particularly important for states with high starting deficits to take prompt action. Generally speaking, it makes sense to leave significant safety margins below the constitutional borrowing limits to avoid any need for short-term and potentially procyclical adjustments in the event of negative shocks. When preparing the reform of the state government revenue-sharing scheme, which is also scheduled to take effect by 2020, it would seem appropriate – not least in view of the differing starting positions of the individual federal states – to increase flexibility on the revenue side too, and to permit, for instance, state-specific surcharges or discounts on taxes raised jointly with other tiers of government.

Developments in state government budgets

Overview of the core budgets

Spin-offs from core budgets and creation of new special funds make analysis more difficult

State government finances have undergone sharp fluctuations in recent years. Given the trend towards spin-offs from core budgets and new off-budget entities, it is generally necessary to look beyond the core budgets in order to analyse developments in state government finances. However, statistical problems in the period under observation make this task more difficult. Germany's Federal Statistical Office has since expanded the reporting population beyond the core budgets for its quarterly cash statistics, which have included all government sector entities from the 2011 reporting year onwards. Developments in the preceding years are distorted by the fact that additional entities were successively added to the reporting population. This article therefore looks first at changes in the core budgets since 2005 before comparing the figures for 2011 from the narrower reporting group with those from the expanded group.

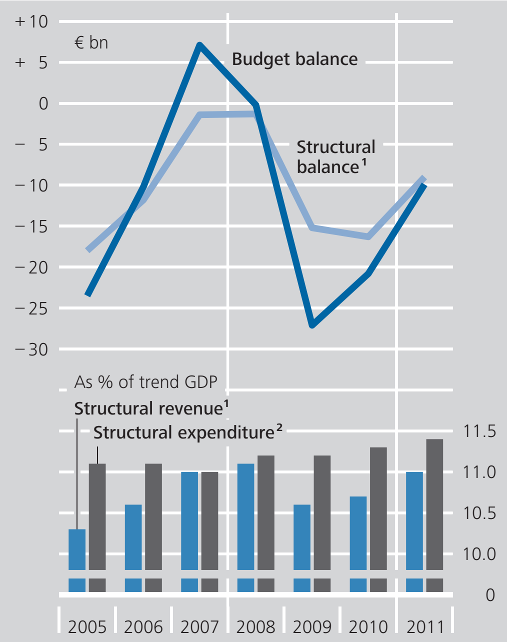
Deficit reduced on balance amid severe fluctuations, but no return to balanced budget yet

In 2005,[1] the first year in this analysis and one that saw relatively weak economic activity, the core state government budgets posted a very large deficit (€23½ billion). This shortfall dwindled rapidly during the subsequent upturn, and a clear surplus of €7 billion was recorded for one year only in 2007. Having balanced its books in 2008, state government then saw a dramatic deterioration in its finances during the financial and economic crisis; this resulted in a deficit of €27 billion in 2009, which had fallen to €10 billion again by 2011.

Structural position less volatile

After deducting the calculated impact of the business cycle[2] on tax revenue and adjusting for financial transactions,[3] which are generally excluded under the EU budgetary surveillance procedure and the debt brake, developments were much less volatile but somewhat less favourable on balance. In this structural analysis, the deficit was reduced continuously between 2005 and 2008, falling from €18 billion to €1 billion. It rose again to €17 billion in 2010 in the wake of the financial and economic crisis, before then declining to €9½ billion. The fact that this approach only partly factors out the high volatility of profit-related taxes across the business cycle – as is the case with any sche-

Budget balance and revenue and expenditure ratios for state government core budgets



1 Excluding financial transactions and excluding the cyclical effect on tax revenue estimated by the Bundesbank (data as at spring 2012). 2 Excluding financial transactions.
Deutsche Bundesbank

1 For information on developments in the preceding years, see Deutsche Bundesbank, State government finances in Germany, Monthly Report, July 2006, pp 29-50.
2 In this analysis, the cyclical components are calculated using the disaggregated framework applied as standard within the European System of Central Banks, based on data as at spring 2012. 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, for more information on this approach.
3 Expenditure and revenue associated with transactions in loans and equities do not change financial assets and therefore do not affect the Maastricht deficit. Financial transactions are factored out of central government's debt brake, and this principle has also been applied in all of the state government rules adopted to date. Significant transactions include the recapitalisations of Landesbanken in 2005, the proceeds of €4½ billion obtained in 2007 from the sale of Berlin's Landesbank, and capital injections totalling €10 billion into BayernLB in 2008 and 2009.

matic cyclical adjustment procedure – contributed to the fluctuations in the recorded structural balances.

Rise in structural revenue and expenditure ratios

As a ratio of trend gross domestic product (GDP), structural revenue grew by a total of 0.6 percentage point in the period under review. Tax bracket creep and, above all, the positive overall trend in profit-related taxes contributed to this rise. However, at last report, the structural revenue ratio was still 0.2 percentage point below its 2008 peak, despite the large investment grants that were received under central government's second economic stimulus package. In particular, this development reflects the fact that the tax increases applied up to 2007 were followed by a number of tax relief measures between 2008 and 2010. The structural expenditure ratio fell slightly until 2007 and rose gradually in the subsequent years. The 2011 expenditure ratio was 0.2 percentage point higher than in 2005, not least because of investment stemming from the economic stimulus packages. All in all, the rise in both the revenue and expenditure ratios was probably dampened by the numerous spin-offs from core state government budgets.

Revenue in the core budgets

Tax receipts played dominant role in revenue developments

Between 2005 and 2011, revenue increased by an annual average of just over 3% in total, while expenditure rose somewhat less sharply (by just over 2%). This growth in revenue was due to positive developments in tax receipts.[4] These fluctuated sharply over time, particularly owing to macroeconomic developments and the high volatility of profit-related taxes. Tax increases such as the 3 percentage point rise in the standard rate of VAT in 2007 (with state government participation of a third, currently almost €10 billion) also had an impact towards the beginning of the period, while the similarly extensive tax cuts between 2008 and 2010 affected revenue later on. Over the period under review, revenue developments were more favourable than would have been suggested by the estimated financial impact of legislative changes, movements in the key macroeconomic indicators for tax (gross wages and salaries, private consumption, entrepreneurial and investment income) and fiscal drag. All in all, tax revenue has thus made a significant contribution to the structural improvement in the state government budget.

Compensation for motor vehicle tax drove up current transfers

Revenue from current transfers (mainly from central government) increased, primarily because of the compensation paid to state government for ceding motor vehicle tax receipts (€9 billion per year) to central government. By contrast, the special supplementary central government grants to the east German states and Berlin were reduced by €¾ billion each year from 2009 onwards, as stipulated in the Revenue-Sharing Act *(Finanzausgleichsgesetz).* Meanwhile, however, there were higher central government compensation payments for costs incurred by local government in connection with long-term unemployment.

Receipts from investment grants strongly influenced by central government stimulus package

Before 2009, state government had receipts of around €7 billion per year from investment grants. During the 2008-09 financial and economic crisis, central government launched a €10 billion investment programme for state and local government via the Investment and Repayment Fund. Between 2009 and the end of 2011, refunds were available for measures taken under this programme. Despite the minimum target of €5 billion established by law for 2009, the volume of refunds actually disbursed that year amounted to only €1½ billion, before rising to €4 billion in 2010 and €4½ billion in 2011. The funds were thus paid out much later than planned, which would suggest that the stimulus also came later than originally intended. Excluding the Investment and Repayment Fund, the volume of investment grants

4 In mid-2009, motor vehicle tax was transferred to central government, which increased its transfers to state government by a lump sum to compensate for this loss in revenue. After adjustment for this effect, the rise in receipts is almost entirely attributable to tax revenue developments.

Developments in state government budgets (core budgets)*

€ bn

Item	2005	2006		2007		2008		2009		2010		2011	
Tax revenue	164.1	179.8	(9.5)	198.0	(10.1)	206.8	(4.5)	188.4	(– 8.9)	188.4	(0.0)	202.3	(7.4)
Transfers from public budgets													
Current	33.4	34.0	(1.7)	34.0	(–0.1)	34.1	(0.3)	38.2	(12.1)	42.5	(11.2)	44.5	(4.7)
Investment-related	7.1	7.2	(0.3)	7.4	(2.9)	7.0	(– 5.6)	8.6	(23.9)	11.0	(27.3)	11.3	(2.7)
Other revenue	31.1	28.0	(– 9.9)	32.6	(16.6)	27.1	(–16.9)	24.2	(–10.6)	24.0	(– 1.1)	27.4	(14.2)
Total revenue	235.7	248.9	(5.6)	271.9	(9.2)	274.9	(1.1)	259.5	(– 5.6)	265.9	(2.5)	285.4	(7.4)
Personnel expenditure	96.4	94.6	(– 1.8)	95.4	(0.8)	96.0	(0.7)	99.3	(3.4)	102.1	(2.8)	104.6	(2.5)
Other operating expenditure	22.1	21.9	(– 0.9)	23.1	(5.9)	24.5	(5.7)	24.7	(1.0)	25.6	(3.7)	26.2	(2.1)
Interest expenditure	20.8	21.3	(2.2)	21.1	(–0.7)	21.1	(– 0.1)	20.0	(– 5.2)	19.7	(– 1.5)	19.4	(–1.6)
Transfers to public budgets	59.4	60.8		65.8		69.5		71.3		72.2		76.3	
Current	49.0	50.0	(2.1)	54.6	(9.2)	58.3	(6.6)	59.3	(1.9)	58.2	(– 1.9)	62.5	(7.4)
Investment-related	10.4	10.7	(2.9)	11.1	(3.8)	11.2	(1.0)	11.9	(6.3)	13.9	(16.6)	13.7	(–1.4)
Real investment	6.2	6.3	(0.8)	6.2	(–1.9)	6.4	(4.4)	7.1	(10.0)	7.3	(3.8)	7.3	(–1.1)
Acquisitions of participating interests	5.0	1.4	(–71.5)	1.7	(21.1)	3.8	(120.9)	7.5	(96.6)	0.3	(–96.0)	0.8	(156.7)
Other expenditure	49.3	52.9	(7.3)	51.5	(–2.6)	53.8	(4.5)	56.7	(5.3)	59.5	(4.9)	60.8	(2.3)
Total expenditure	259.2	259.1	(0.0)	264.8	(2.2)	275.1	(3.9)	286.5	(4.2)	286.7	(0.0)	295.3	(3.0)
Budget balance	–23.5	–10.2		7.2		–0.2		–27.1		–20.8		–9.8	
Net financial transactions	– 4.1	– 0.8		4.4		–3.3		– 7.6		– 0.2		–0.1	
Cyclical component	– 1.4	2.5		4.1		4.4		– 4.3		– 4.3		–0.8	
Structural balance	–18.0	–11.8		–1.4		–1.3		–15.2		–16.3		–9.0	

* Figures in parentheses: year-on-year percentage change.
Deutsche Bundesbank

received by state government fell by €½ billion in the period under review.

Expenditure from the core budgets

Moderate rise in personnel expenditure but understated by spin-offs …

Personnel costs traditionally account for a large portion of state government expenditure (nearly two-fifths) given its key responsibilities in education, domestic security and the judicial system. These costs include wages for both salaried employees and civil servants, and spending on pensions and healthcare subsidies for civil servants. Moderate average growth of 1½% per year was recorded between 2005 and 2011. The bulk of this expansion took place in the last three years of the period under review; whereas a decline of almost 2% was recorded for 2006, for example. There were opposing factors at work in this context. On the one hand, collective wage agreements for non-civil servants and associated adjustments to civil servant salaries led to annual average growth of around 1% in the first half of the period under review, which accelerated significantly to around 2½% from 2009 onwards.[5] On the other, the number of employees included in the core budgets declined distinctly overall, dropping by just over 6½% between 2005 and 2011. However, this decrease is significantly overstated by spin-offs from state government budgets. Excluding the effects of spin-offs, the number of employees included in the core budgets probably fell by an estimated

5 It therefore seems that the federal states' entitlement to pass legislation setting civil servant salaries – over and above exceptional payments – independently, which was introduced during the first stage of the federal structure reform in 2006, has not yet led to lower wage adjustments on average. In many cases, wage increases have largely been copied – sometimes with a slight delay – from the collective wage agreements for non-civil servants, which are mostly uniform across Germany.

2½% overall.[6] This decline is likely to have been caused, in particular, by further adjustments in the east German states, which brought their staffing levels closer to those of west German states once negotiated wages had been aligned with those of western Germany. By contrast, increased efforts to expand education opportunities had the opposite effect.[7] After adjusting expenditure growth for the effect of spin-offs, the annual average rise in personnel expenditure came to an estimated 2%. There was a disproportionately large rise (an average of 4% per year) in payments for pensions and healthcare subsidies for civil servants, which made up an ever greater percentage of personnel expenditure (28½% at the end of the period under review). The salaries of staff still in active service ultimately accounted for only half of absolute expenditure growth.

… and concentrated on civil servant pension provisions

Clear rise in other operating expenditure

At an average of 3% per year, growth in other operating expenditure was stronger than that in personnel costs. However, there were noticeable spin-offs in this area too, which means that actual expansion in other operating expenditure is likely to have been understated by up to 1 percentage point per year.

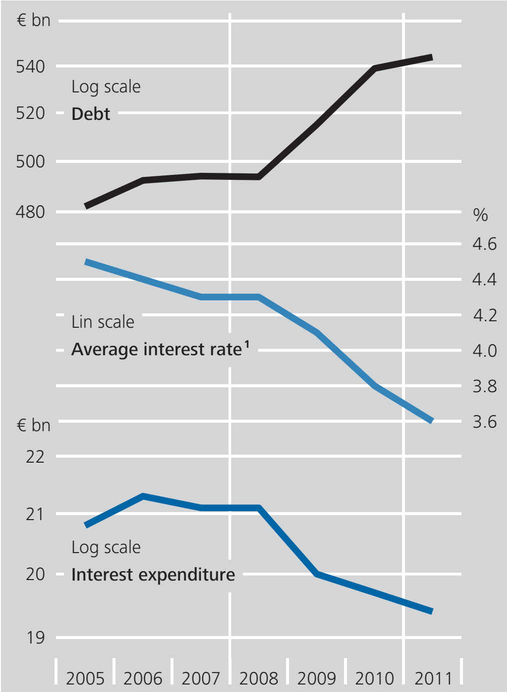
Decline in interest expenditure despite much higher debt

Developments in interest expenditure, which declined by an average of just over 1% per year, had a favourable impact on state government budgets. Although core budget debt in the form of credit market debt, cash advances and liabilities to public budgets grew by a fifth on aggregate, reaching nearly €550 billion by the end of 2011, interest expenditure only rose until 2006, falling steadily thereafter. The average interest rate, calculated as interest expenditure in relation to the debt level at the end of the preceding year, fell by 1 percentage point, reaching 3½% in 2011.

Transfers to local government: share in tax revenue and reimbursements

Current transfers to other budgets in the general government sector – mainly to local government – are a particularly important expenditure item for state government.[8] Under Article 106 VII of the German Basic Law, the federal states are obliged to make a certain proportion

Debt burden of state government core budgets



1 Interest expenditure for the reporting year divided by the debt level recorded at the end of the preceding year.
Deutsche Bundesbank

of their own tax revenue available to the municipalities in their state. In cases where local government tax receipts are additionally redistributed via the state government budget under the local government revenue-sharing scheme, this increases the volume of state government expenditure by that amount. Furthermore, under state constitutions, the federal states often have to pay municipalities compensation

6 Between 2006 and 2008, spin-offs reduced personnel expenditure by just over 3½% in total. See Federal Ministry of Finance, Einnahmen und Ausgaben der Länder im Jahr 2006, and the corresponding data for the following years at www.bundesfinanzministerium.de. It is assumed that salaries in the off-budget entities are at average levels and that there was a percentage change of the same size in staffing levels.
7 For the 2006-2011 period, the staffing levels – expressed as full-time equivalents – for the state government public sector (which also includes some entities outside the government sector) rose by 3% in schools and by 11% in universities and colleges of higher education. See Federal Statistical Office, Personal des öffentlichen Dienstes, Fachserie 14, Reihe 6, various years.
8 The east German states and Berlin also pay fairly large sums to central government for special and supplementary pensions for former employees (2011: €2½ billion).

for tasks allocated to them.[9] Moreover, in cases where central government pays a contribution towards municipalities' expenses – such as accommodation costs for the long-term unemployed – these funds flow through state government budgets. Changes in state government transfers to the municipalities may thus be attributable not only to developments in state government tax revenue and changes to the tasks assigned to the municipalities, but also to specific measures taken to correct local government finances.

Only temporary interruption of clear rise in current transfers

All in all, current transfers to other budgets in the general government sector increased by an average of 4% per year. They rose particularly sharply in 2007 and 2008, mainly as a result of favourable developments in state government tax revenue – partly because of legislative changes – and back payments relating to the unexpectedly strong growth in state government tax receipts in 2006. A clear countermovement began in 2010, when the tax cuts adopted between 2008 and 2010 had a particularly strong impact. The sharp rebound in current transfers in 2011 reflects not only the rise in tax revenue due to the macroeconomic recovery but also higher central government payments to municipalities in connection with long-term unemployment, which were channelled via state government budgets. At the same time, it was probably also partly due to the effect of rulings by constitutional courts in favour of the municipalities.[10] Active cuts to the revenue-sharing scheme for municipalities, eg in Hesse, were overcompensated. Alongside transfers to municipalities, payments to special funds, which hardly carried any weight at the beginning of the period under review, also grew strongly on balance, reaching as much as €2 billion in 2011. In many cases, the federal states are using these funds to make provisions, eg for growing civil servant pension payments or for liabilities to Landesbanken, tending to pay more into them when their budget situation is favourable.

Investment grants affected by economic stimulus packages

Investment grants to other budgets in the general government sector, which have a much smaller volume than current transfers, are likewise influenced by developments in state government tax revenue – part of which is transferred to local government for these purposes. Yet the economic stimulus package adopted by central government at the beginning of 2009 had a far greater impact on investment grants. This stimulus package was primarily targeted at local government investments, and its funds were to be increased by at least a third – a task mainly fulfilled by state government at first. Supplementary packages adopted by individual federal states, such as Hesse, boosted investment grants still further, substantially overcompensating for the cuts that would otherwise have been likely given a fall in tax revenue.

Acquisitions of participating interests: strong fluctuations and considerable gaps in reporting

There were particularly sharp fluctuations in spending on acquisitions of participating interests. State government made considerable payments in 2005, in particular to recapitalise Landesbanken – which, following an EU decision, had been obliged to compensate the federal states for having received capital too cheaply.[11] Spending on acquisitions of participating interests peaked again in 2008-09, when BayernLB received a capital injection totalling €10 billion from Bavaria's budget. While other Landesbanken also received substantial support from the federal states in which they are domiciled, these transactions are not recorded in the core budgets – although they are allocated to the government sector. The state of Baden-Württemberg injected capital of €2 billion into its Landesbank in 2009 (and also acquired a size-

9 Upon request, the constitutional court of the state in question can clarify whether the size of these compensation payments complies with the constitutional requirements. This can sometimes result in substantial back payments.
10 In its ruling on 12 October 2010 (VerfGH 12/09), the Constitutional Court of North Rhine-Westphalia decided that this federal state had to pay much higher compensation for tasks transferred to the municipalities under the Childcare Act (Kinderförderungsgesetz). Following this ruling, higher compensation payments were expected in other federal states, too.
11 Some of these refunds, which were classified as non-financial transactions, had already been paid in 2004.

able shareholding of €5 billion in a large energy provider in 2011) via a state government enterprise. The states of Hamburg and Schleswig-Holstein created a joint agency to finance a €3 billion capital injection into HSH Nordbank in 2009. Until the end of 2011, WestLB was recapitalised (by €3 billion) by the central government special fund SoFFin rather than North Rhine-Westphalia, its federal state of domicile. All in all, core budget figures provide a very incomplete picture of these financial transactions, which primarily arose in the wake of the financial crisis.

Core budgets and off-budget entities in 2011

Off-budget entities in 2011: substantial additional expenditure and limited deficits

Off-budget entities which had been newly created or spun-off from core budgets had a marked impact overall in 2011 and restrict the informative value of the recorded core budget developments. Broadening the analysis of the federal states' cash statistics – by including their off-budget entities which belong to the government sector – provides a better overview of state government finances in 2011.[12] The volume of expenditure in 2011 was €20 billion (or just over 6½%) higher in the broader analysis than that recorded in the core budgets alone. In absolute terms, the difference for personnel costs, at €15 billion (or a seventh), is particularly large. In the expanded reporting group, the figure for other operating expenditure was €10½ billion (around two-fifths) higher. As a number of construction companies had been spun off from core budgets, fixed asset formation was €4 billion (just over 50%) higher. By contrast, current and investment transfers to entities outside core government budgets were much lower, as a large proportion of them are included in the expanded reporting group and the relevant payment flows are netted against each other. The much higher consolidated aggregate expenditure in the expanded cash statistics was largely offset by additional revenue, eg from the user fees of the entities that were spun off from core budgets. On balance, however, the 2011 deficit was up to €1 billion higher for the expanded reporting group (despite the inclusion of civil servant pension reserves and respective special funds, which currently have clear structural surpluses). Confining the analyses or budgetary rules to the core budgets would allow a not insignificant and probably increasingly weighty share of the necessary consolidation to be factored out. From now on, the focus should therefore be on the expanded cash statistics, which will also be available for year-on-year comparisons in the future.

Large differences between federal states

In view of these circumstances, it is very difficult to compare the individual federal state budgets. Nevertheless, it is clear that there are large differences between the states even after adjustment for spin-offs, the various burdens shifted to local government level, financial transactions and payments made under the state government revenue-sharing scheme (see box from pages 36 to 41).

Implementing the debt brake and the Fiscal Compact

Implementing the debt brake at state government level

States initially took wait-and-see approach to including debt brake in their constitutions, …

A debt brake was enshrined in the German Basic Law in 2009,[13] introducing a general ban on borrowing for state government in Article 109. The states are permitted to adopt special provisions for budget burdens caused by cyclical developments, natural disasters and emergency situations. Article 143 d of the German Basic Law lays down provisions on the ban's

12 However, with regard to financial transactions conducted outside the core budgets, there are gaps in the cash statistics for off-budget entities, too. For example, they do not record acquisitions of participating interests and recapitalisations settled via state government enterprises which use commercial double-entry bookkeeping. The cash statistics thus ultimately provide an incomplete overview of the overall budget, too.

13 For a more detailed explanation, see Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, pp 15-40.

Major budgetary differences between the federal states

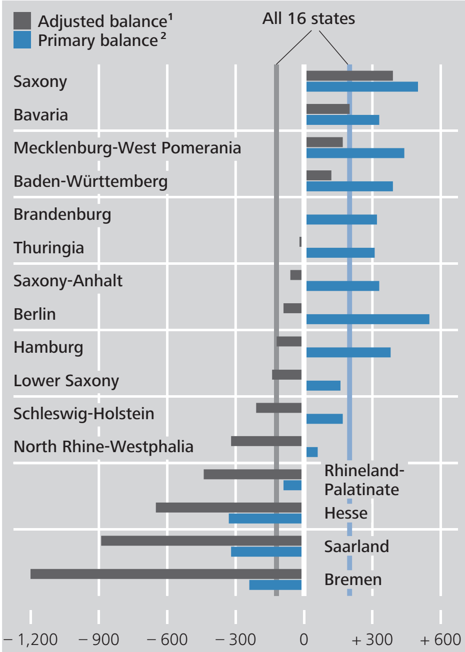
An overall view of state government finances masks major differences between the individual federal states. To ensure that comparisons are as meaningful as possible, this analysis draws on *per capita* budget figures from the 2011 cash statistics.[1] Because responsibilities and the associated expenditure are assigned differently between state and local government depending on the federal state in question, and consolidated data are available anyway for the city states, it makes sense to include the local authorities in the analysis. Using cash statistics which include government sector off-budget entities prevents any distortions arising from differences in spin-offs from the individual states' core budgets. However, because a full data set for this extended coverage is available only for last year, no comparisons may be drawn with previous years. In addition, it would appear useful to exclude financial transactions which purely involve a shifting of financial assets, as occurs under the European deficit rules and the debt brakes for which details have so far been drawn up in Germany. This also prevents sizeable one-off transactions from distorting the underlying picture.

Range of deficits

Under the definition outlined above, the *per capita* deficit averaged €120 across the federal states in 2011. However, there were extremely large differences between the individual states. Saxony, Bavaria, Mecklenburg-West Pomerania and Baden-Württemberg recorded surpluses of over €100. Brandenburg's revenue also exceeded its expenditure. The largest *per capita* deficit (€1,200) was registered in Bremen, while the figure for Saarland was also very high at almost €900. The ratio of these two deficits to expenditure (after adjustment as described above) was 15% and 17% respectively. Very unfavourable results were also recorded in Hesse with a figure of

Budget balances in 2011

€ per capita



1 After deduction of financial transactions and including preliminary settlement under revenue-sharing scheme. 2 Adjusted balance plus interest expenditure.
Deutsche Bundesbank

€650 and Rhineland-Palatinate with €440 (almost 11½% and 9% of expenditure respectively). Furthermore, in North Rhine-Westphalia, Germany's most populous state, the *per capita* deficit was almost three times the federal state average at €320 (6% of expenditure).

Significance of differing interest costs

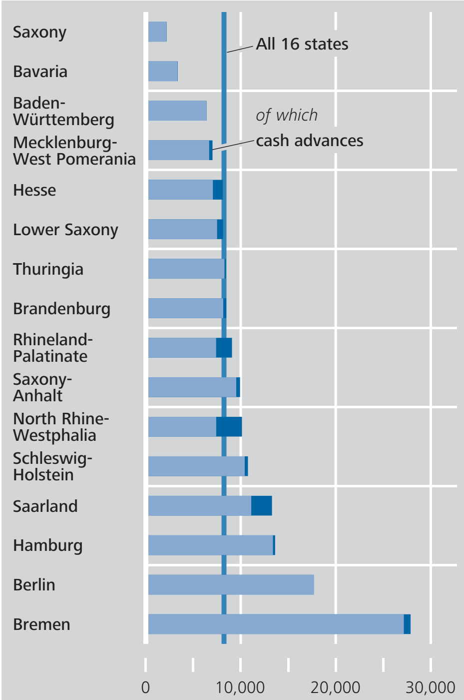
The debts accumulated through past deficits play an important part in explaining this wide range of budgetary positions, on account of the differing amounts of interest

1 The preliminary settlement under the state government revenue-sharing scheme, which is produced with a three-month time lag, has also been included in order to capture the structural position more precisely. In addition, charges required by federal law from donor states under the state government revenue-sharing scheme are deducted from expenditure and receipts.

the federal states have to pay as a result. Because the capital markets assume joint and several liability[2] within the German federation, there are no major yield differentials between the federal states. However, the states' debt levels vary very widely. While *per capita* credit market debt (including cash advances) averaged more than €9,100 across the federal states in 2011, Saxony and Bavaria were carrying the lightest debt burdens at just over €2,200 and €3,400 respectively. By contrast, Saarland – the most heavily indebted of the non-city states – and Bremen had totals of well above €15,000 and close to €29,000 respectively.[3] These differences have a direct effect on *per capita* interest costs. The interest burden ranged from somewhat in excess of €100 in Saxony and Bavaria to nearly €400 in almost all non-city states. Saarland alone had a figure close to €600. The cost came out higher still in the city states of Berlin and particularly Bremen, with the latter shouldering an interest burden of more than €950 *per capita*.

Credit market debt in 2011

€ per capita, as at year-end



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Varying interest payments account for a large proportion of the difference in the deficits. Adjustment for interest expenditure (ie looking at the primary budget balances) reduces the range of variation in states' *per capita* budget balances by more than half, and the rankings also change to a certain extent. However, it should be borne in mind that states which have accumulated relatively large debts in the past now require a more ambitious primary total if they are to balance their budgets. Whilst on average the states had a primary surplus of €200 *per capita*, Hesse and Saarland stand out with primary deficits well above €300. Bremen and Rhineland-Palatinate also recorded primary deficits (of €240 and €90 respectively). With a surplus of €550, Berlin came out top, followed by Saxony. However, even when interest payments are factored out, there are still large differences among the federal states between receipts and expenditure which do not balance out.

The revenue side

Taxes account for by far the largest share of receipts. This means that the multi-level state government revenue-sharing scheme – which is set to continue in its present form only until the end of 2019 – is also of crucial importance (see table on page 38). Before the distribution of turnover tax receipts, *per capita* financial strength in tax-

2 Ultimately, this assumption is based on Germany's federal system, which involves a mutual guarantee obligation. The Federal Constitutional Court upheld requests for assistance from the states of Bremen and Saarland in 1992. Although it rejected a similar request from Berlin in 2006, this was mainly because the court found that Berlin had further consolidation potential available to it; had the large deficits persisted once this potential had been exhausted, Berlin would probably also have been entitled to assistance.
3 It should be noted that higher debts are not generally associated with correspondingly larger asset totals. In fact, they often go hand in hand with below-average holdings of financial assets (as in the case of Saarland and Bremen). Thus, overall the states with higher debt levels usually also have a wider differential between interest expenditure and income on their assets.

Federal states' per capita financial strength before and after revenue-sharing in 2011*

As a percentage of the national average

State/group of states	Excluding turnover tax[1]	Before revenue-sharing[2]	After revenue-sharing	After general suppl central govt grants	After special suppl central govt grants[3]
Bavaria	127.9	112.0	102.6	101.5	97.8
Hesse	124.5	112.2	102.6	101.6	97.9
Baden-Württemberg	118.3	106.3	101.0	99.9	96.3
North Rhine-Westphalia	101.5	96.6	97.0	96.0	92.5
Rhineland-Palatinate	96.6	93.8	95.7	95.7	92.6
Schleswig-Holstein	95.5	94.8	96.2	95.8	93.0
Lower Saxony	83.9	95.7	96.6	95.9	92.4
Saarland	81.6	90.7	94.5	95.4	93.9
Western non-city states	108.7	102.4	99.1	98.3	94.8
Hamburg	155.6	133.9	132.8	131.5	126.7
Bremen	96.5	95.0	120.3	127.2	125.4
Berlin	85.5	91.0	119.4	127.0	136.4
City states	107.9	104.4	123.5	128.4	132.2
Brandenburg	62.4	88.7	94.4	95.9	109.7
Saxony-Anhalt	51.6	85.9	93.5	95.5	112.0
Saxony	51.4	86.0	93.2	95.1	109.9
Mecklenburg-West Pomerania	50.9	85.1	93.6	96.0	112.0
Thuringia	50.7	85.4	93.0	95.1	110.8
Eastern states	53.4	86.3	93.5	95.4	110.7

Source: Federal Ministry of Finance, Bundesbank calculations. ***** Provisional figures. **1** States' share in joint taxes (excluding turnover tax) and state taxes according to the revenue collected within the respective state. **2** After allocation of turnover tax receipts; including standardised local government tax receipts to be factored into the state government revenue-sharing scheme pursuant to section 8 of the Revenue-sharing Act; before state government revenue-sharing (under the narrower definition). **3** Special supplementary central government grants are paid to the eastern states and Berlin to cover extraordinary burdens from accumulated infrastructure modernisation needs, to balance out disproportionately low local government financial strength, and (except for Berlin) to cover extraordinary burdens resulting from structural unemployment in connection with Hartz IV, and are paid to small states to meet above-average costs for political administration.

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raising terms ranged from just over half the federal state average in the eastern states, to a quarter above the average in Baden-Württemberg, Hesse and Bavaria, to more than 50% above the average in Hamburg.

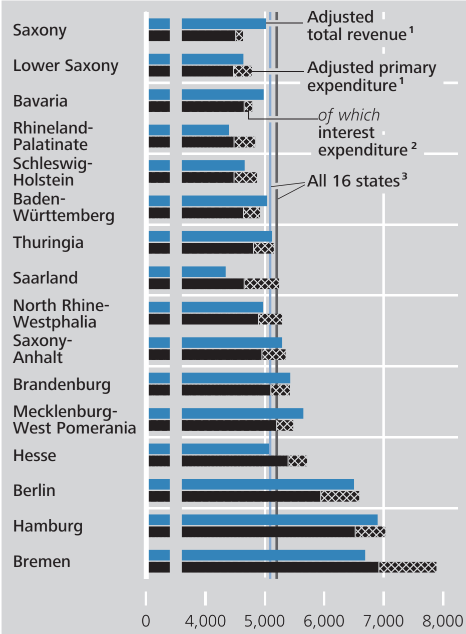
Even before the state government revenue-sharing scheme (under the narrower definition) is factored in, however, these differences were evened out to a considerable degree – in particular by the supplementary revenue shares granted to some states as part of the distribution of turnover tax receipts (totalling €11 billion in 2011). A further levelling effect was achieved by the state government revenue-sharing scheme under the narrower definition. Under the provisional settlement for 2011, this involved transfers of almost €7½ billion. Among the donor states, Bavaria paid the largest single contribution (€3½ billion). However, the share paid by Hesse was somewhat higher in *per capita* terms (€300). Berlin was granted the largest transfer (€3 billion), which equated to €870 *per capita*. Bremen received €780 *per capita* given that the financial needs of city states are weighted 35% higher across the board. The differences between the states were then reduced further still by general supplementary central government grants of €2½ billion. Special supplementary central government grants, usually involving tapered payments, are additionally awarded for legally defined exceptional burdens, and totalled €9½ billion in 2011. These special grants are intended to cushion the effect of above-average costs for political administration in smaller states, the relatively large burdens arising from long-term unemployment in the non-city states of eastern Germany and, above all, the consequences of a divided Germany in the five eastern states and Berlin.

Following all of these redistributions through revenue-sharing, Berlin had the greatest *per capita* financial strength at over a third above the federal state average, followed by Hamburg. The eastern states exceeded the average by more than 10%. Despite having the highest tax receipts within this group before distribution of turnover tax, Brandenburg was placed last, because the special supplementary central government grants are paid out according to fixed quotas, whilst population growth in this state has been far stronger. The states of Bavaria and Hesse, which originally had particularly high levels of financial strength, were now 2% below the average, but still more than 5% stronger than the weakest group, comprising Lower Saxony, North Rhine-Westphalia and Rhineland-Palatinate.[4]

Adjusted total receipts (ie not including proceeds from financial transactions and after deduction of any revenue-sharing charges) are also strongly affected by other factors in addition to the revenue-sharing scheme. For instance, the federal states receive substantial non-tax income (approximately half of tax receipts on average across the federal states) – not least from fees[5], principally at local government level, and other transfers. In this case, too, the results for different states varied considerably.[6] The federal state average for adjusted total revenue *per capita* was just short of €5,100 last year. The figures for Saarland (€4,340) and Rhineland-Palatinate (€4,400) were lowest, while Lower Saxony and Schleswig-Holstein were also well below average at around €4,650. Amongst the western non-city states, Hesse also came in slightly below average. Amongst the eastern states, Saxony recorded below-average revenue despite receiving special supplementary central government grants of more than €500 *per capita*, whilst Mecklenburg-West Pomerania had the highest receipts at €5,650. The city states achieved far higher levels. Berlin recorded the lowest result for a city state (€6,500) despite having the highest level of financial strength after revenue-sharing, whilst Hamburg had significantly more funds at its disposal with a figure of €6,900.

Revenue and expenditure in 2011

€ per capita



1 Results from cash statistics minus revenue-sharing charges and without financial transactions. Revenue-sharing as per preliminary settlement. **2** Interest expenditure outside the general government sector. **3** Expenditure including interest.

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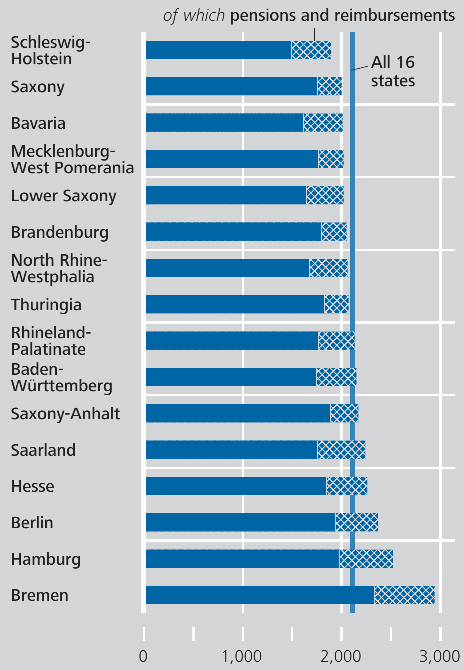
The (primary) expenditure side

As with the revenue analysis above, in the following comparison of expenditure adjusted for interest payments, charges arising

4 However, the differences arising in particular from the portion of local government tax receipts not included in the revenue-sharing scheme remain. Pursuant to section 8 of the Revenue-sharing Act *(Finanzausgleichsgesetz)*, only 64% of these tax receipts are included in the scheme. For real estate taxes and trade tax, it is not the actual development in states' receipts which is referred to, but an extrapolation using the distribution code derived from the previous year's revenue capacity.
5 In line with cost recovery rules, however, higher fee income is likely to go hand in hand with higher expenditure in many cases, which means that any effect on the budget balance will probably be limited overall (the same applies to reimbursements of costs).
6 For example, Bremen's other income per capita was around double that of Saarland. Nonetheless, 8 of the 13 non-city states were within a range of approximately €100 above or below the average.

Personnel expenditure in 2011*

€ per capita



* Excluding payments to pension reserves. Including reimbursements to central government for pension payments.

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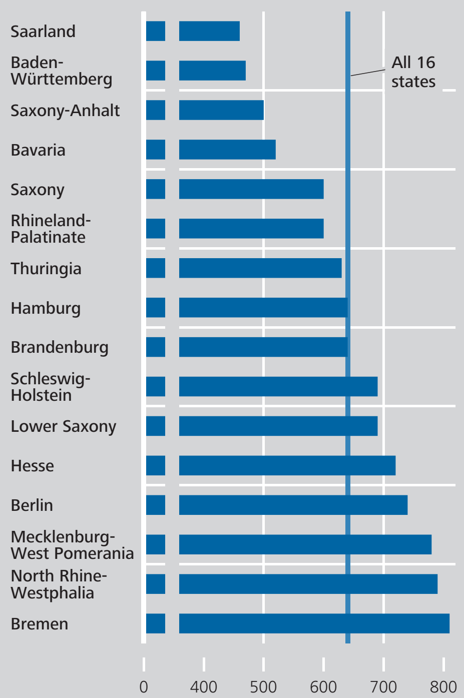
Transfers to households in 2011

€ per capita



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from the revenue-sharing scheme and from financial transactions are factored out. With an average of almost €4,900 for adjusted primary expenditure *per capita* across all the federal states, Lower Saxony, Rhineland-Palatinate, Schleswig-Holstein and Saxony had the lowest figures at around €4,500, whilst Hesse was at the top of the scale for non-city states with expenditure of €5,400. The levels of expenditure among the city states were significantly higher still. With a figure of more than €6,900, however, Bremen was still €400 above Hamburg, and exceeded Berlin's total by close to €1,000.

A breakdown of these adjusted primary spending totals shows that personnel expenditure – including pension payments – accounts for a substantial proportion (two-fifths).[7] In the eastern states and to a lesser extent in Berlin, transfers are also paid to central government in connection with the special and supplementary pension payments made to former employees from the period prior to reunification (a total of €2½ billion a year). These payments are comparable with pension payments in the western states and are therefore added to personnel expenditure in this analysis. Defined in this way, personnel expenditure averaged around €2,100 *per capita* across the federal states, with Schleswig-Holstein recording the lowest figure at just under €1,900, whilst Hesse and Saarland – which bears a particularly large pension burden – led the non-city states with totals of around €2,250. *Per capita* personnel expenditure in the city states was significantly higher still. Bremen posted by far the largest figure within this group (almost €2,950); reducing it to the level recorded in Berlin, for instance, would have approximately halved Bremen's deficit.

Transfers to households – which accounted for 13% of adjusted primary expenditure

7 It should be noted that this analysis, which includes off-budget entities, excludes transfers to pension reserves, which are booked differently from state to state.

across the federal states – also differed significantly from state to state. Whilst the average was €640 *per capita*, Saarland had the lowest figure at €460, just ahead of Baden-Württemberg, whilst North Rhine-Westphalia came out highest amongst the non-city states with a total of €790, only slightly below Bremen at €810.

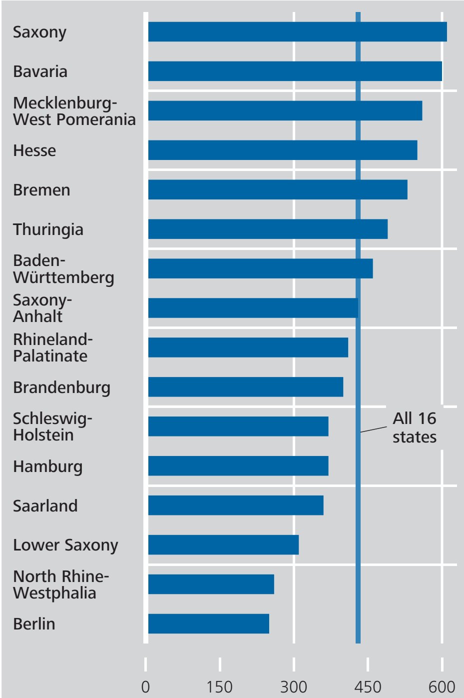
Real asset formation is largely carried out by local authorities, but the states also often contribute to its funding through investment grants. In 2011, the year under review, the 2009 central government investment programme with quotas for the individual states continued to affect real investment figures, as the states were still able to draw residual funds from the programme. Thus, where individual states had been slower than originally intended in implementing investment projects, this metric was higher in 2011 (which was also reflected in the associated revenue from grants). Overall, real asset formation accounted for almost 9% of adjusted primary expenditure in 2011. Average real asset formation amounted to €430 *per capita*. Saxony and Bavaria – both of which already had a budget surplus – surpassed this level particularly clearly (by €610 and €600 respectively), but it was also noticeably exceeded in western Germany by Hesse and Bremen (by more than €100). Despite the special assistance it received under the infrastructure reconstruction scheme in the eastern federal states *(Aufbau Ost)*, Berlin recorded the lowest value (€250), closely followed by North Rhine-Westphalia.

Outlook

The European fiscal rules and fiscal compact require that budget limits be made effective not only at central and state government level but also for the municipalities in order to achieve a close-to-balance general government budget. By 2020 at the latest, a constitutional general ban on borrowing will apply, which means that receipts will have to at least balance out expenditure (in

Real asset formation in 2011

€ per capita



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structural terms) in each federal state. If the new revenue-sharing arrangements from 2020 – which have yet to be decided upon – do not create a means of evening out the states' very varied budgetary situations, then the adjustments required in the individual states will differ greatly. In this case, particularly those states with below-average financial strength, larger debts and corresponding interest payments will either have to reduce their primary expenditure considerably further or utilise more of their own revenue-raising potential in order to achieve a (structurally) balanced budget. With this in mind, it may make sense to include a greater degree of flexibility in the upcoming reform of revenue-sharing arrangements, particularly on the revenue side, for instance through state-specific surtaxes.

entry into force in 2020. Until then, the federal states are allowed to continue borrowing to fund their budgets in accordance with state government rules. At central government level, the Basic Law and the implementing legislation passed at the same time promptly established more comprehensive provisions, eg regarding adjustment for financial transactions, cyclical adjustment, a control account and a structural deficit reduction path. For the individual federal state budgets, the specifics of how the debt brake is implemented – which are key to its effectiveness – were left to state government legislators, who initially took a wait-and-see approach. From summer 2010, the first federal states – starting with Schleswig-Holstein, followed by Rhineland-Palatinate, Hesse and Mecklenburg-West Pomerania – began to enshrine debt brakes in their state constitutions. Given that the ban on borrowing established in Article 109 of the German Basic Law is to take direct effect from 2020, the main focus was ultimately to have access to the exemptions offered in the national constitution.[14] In 2012, Hamburg and Bremen also included a debt brake in their constitutions.

… but six federal states have done so since summer 2010

State constitutions use entire transitional period, further exemption introduced

Overall, all of the amended constitutions make use of the entire transitional period despite the fact that state government was actually only given more time than central government because of the comparatively high adjustment burdens faced by some federal states and even though the direct burdens caused by the 2008-09 financial and economic crisis have proved to be considerably smaller than assumed when the debt brake was incorporated into the Basic Law. In addition, the deficit reduction requirements have often tended to be fairly lax. While the voting requirements to invoke exemptions for emergency situations are tougher in some federal states than at central government level, Rhineland-Palatinate and Bremen have both introduced an exemption for budget burdens not caused by state government legislation – such as substantial nationwide tax cuts or spending increases. It is worth noting that these are treated on a par with natural disasters and unavoidable, severe emergency situations despite the fact that the federal states are essentially in a position to influence such decisions in the upper house of parliament (Bundesrat).

Important details stipulated in implementing legislation

Alongside their constitutional provisions, the implementing legislation in the federal states is also important (see box from pages 43 to 45). If they do not stringently limit the possibilities for circumventing the rules – offered, say, by the definition of financial transactions or by cyclical adjustment procedures – they could fail to meet the objective enshrined in the Basic Law of curbing debt levels. By resolutely and rapidly cutting their deficits, however, the federal states can help to ensure that they comply with the borrowing limits, even in the event of negative shocks, without needing to introduce short-term consolidation measures (which often have a procyclical effect).

Developments in highly indebted federal states

Consolidation assistance up to 2019 tied to deficit reduction

To facilitate compliance with the debt brake, Article 143 d of the German Basic Law also provides for the possibility of the other members of the German federation granting the five particularly highly indebted federal states (Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein) transitional assistance totalling €800 million per year until 2019. These states' administrative agreements with central government specify conditions aimed at ensuring that they consolidate their budgets. To achieve this, a minimum reduction path was set for the structural deficits; their ceilings are lowered by a tenth of the 2010 starting value each year. Germany's new Stability Council is responsible for monitoring these federal states' compliance with the minimum reduction path.

14 See Deutsche Bundesbank, The debt brake in Germany – key aspects and implementation, Monthly Report, October 2011, p 32 ff.

The recent legislation implementing the debt brakes in Schleswig-Holstein and Rhineland-Palatinate

The specific implementation of the general ban on (structural) borrowing pursuant to Article 109 of the German constitution (Basic Law, or *Grundgesetz*) for the budgets of the individual federal states is the responsibility of federal state legislators. The first German states enshrined debt brakes in their constitutions in summer 2010. While the state parliament in Hesse had already reached a consensus on a number of key aspects of an implementation act, legislators in the other states had still not fleshed out any of the legislative details. Schleswig-Holstein enacted implementing legislation in spring 2012, notably including provisions on the obligation enshrined in the state constitution since 2011 to reduce the initial structural deficit – which had not been clearly defined hitherto – by a tenth per year. Rhineland-Palatinate followed suit by adopting legislation on specific details in summer 2012, although its state constitution only contains rather vague deficit reduction obligations.

Adjustments for financial transactions

Both sets of implementing legislation share one thing on common: the ban on borrowing is adjusted for net financial transactions, which are defined, like at central government level, on the basis of the classification scheme for public budgets. The European deficit rules, by contrast, apply the definitions used in the national accounts, which generally lay down strict profitability criteria for classification as a financial transaction, particularly for capital injections into public enterprises. Like at central government level, the implementing acts for Schleswig-Holstein and Rhineland-Palatinate do not set out any provisions for cases of debt relief, in which financial transactions are transformed into transfers. The intention of the debt brake is for these transactions to be counted towards the borrowing limit even if payment is not made in the year in question. One aspect of the legislation that appears to have been closely modelled on the EU deficit rules, however, is the requirement to adjust for movements in reserves, which means that, like financial transactions, additions to and withdrawals from reserves do not count towards the new borrowing limit. Reserves (formed out of borrowing authorisations not used for current budget funding) are traditionally used to bridge temporary budget shortfalls. Factoring movements in reserves out of the borrowing limit means that this option, like the use of privatisation proceeds to plug gaps in the budget, will no longer be available in the future. Under the terms of the debt brake, it will therefore no longer be possible to cover future pension payments using the reserves formed during the past decade or so. Expenditure resulting from the release of reserves will have to be fully counterfinanced in the current budget.

Cyclical adjustment

The implementing legislation also incorporates cyclical adjustment requirements. Unlike the central government procedure, which is largely based on the method applied for budgetary surveillance at European level, the legislation in Schleswig-Holstein and Rhineland-Palatinate requires the "normal tax revenue" to be approximated by extrapolating a past estimate using a typical rate of change. The precise calculation procedures still have to be specified in implementing regulations. Differences between actual and normal tax revenues are then treated as a cyclical effect and factored out of the structural balance.[1] The likely outcome for Schleswig-Holstein is that the budget ceiling under the state legislation implementing the debt brake will usually deviate from the budget ceiling determined under the administrative agreement with central government regarding the granting of consolidation aid. Generally speaking, employing different cyclical adjustment procedures makes it more difficult to coordinate budgetary policies within a federal system. However, the legislation for both Schleswig-Holstein and Rhineland-Palatinate reiterates a key provision of the German constitution, namely the requirement to avoid a systematic rise in debt resulting from a predominance of reported cyclical downswings – although both federal states will need to adopt a regulation to implement this requirement. A suitable corrective mechanism which takes account of negative deviations from the normal tax revenue would appear to be crucial in this respect. The growth rate of normal tax revenue should be determined on the basis of a reference period that includes full economic cycles wherever possible, and should not be influenced by past changes in tax legislation. The effects of any legislative changes during the planning period would then have to be classified as structural – as is the case in the implementing legislation in Rhineland-Palatinate – and the trend tax revenue adjusted accordingly.

Off-budget entities

Another important factor is how the scope of the debt brake is defined. Article 109 III of the German constitution refers only to central and state government budgets, meaning that exceptions for off-budget entities do not appear out of the question. However, the obligation stated in the preceding Article 109 II to comply with EU requirements (such as the objective enshrined in the Stability and Growth Pact to achieve at least close-to-balance or fully balanced general government budgets in the medium term) suggests that the strict constraints must also be applied to all entities outside the core budgets, provided they belong to the general government sector. The legislation in Schleswig-Holstein does not specify the scope of the debt brake. Yet the state's administrative agreement with central government on the granting of consolidation aid until the end of 2019 prevents the transfer of debt financing to off-budget entities. The Rhineland-Palatinate constitution, meanwhile, specifies that the borrowing limit should also include capital borrowed for state government-owned enterprises whose debts must be serviced by the state of Rhineland-Palatinate. The implementing legislation makes it clear that the road construction and real estate management enterprises which have hitherto been recipients of debt financing will therefore have to be taken into account as well. The fact that Rhineland-Palatinate has defined the scope of the debt brake so extensively and at such an early stage is to be welcomed as it will encourage a rapid and comprehensive consolidation of state government finances, as is generally required.[2]

1 This approach aims to ensure that, assuming tax legislation remains unchanged, the estimated structural revenue will develop more evenly than would be the case in the usual cyclical adjustment procedures, thereby permitting greater planning certainty. Given the high estimation uncertainty, however, regular reassessments of the structural budget situation will probably ultimately be unavoidable if the objective of curbing public debt stipulated in the German constitution is to be fulfilled.
2 By contrast, the relevant clause included in the decision by Hesse's state parliament to enact legislation implementing the debt brake contains loopholes. Although borrowing by special funds requires statutory authorisation, it will apparently not be included in the borrowing limit.

Control account

Both sets of implementing legislation also provide for the creation of a control account. Like those at central government level, the borrowing limits for Schleswig-Holstein and Rhineland-Palatinate apply to both budget planning and budget outturn. Any differences between the budget outturn and the budget target are posted to this account. While a negative balance of 5% of trend tax revenue is defined as the ceiling for this account in Schleswig-Holstein, in Rhineland-Palatinate, much like at central government level, it is as high as 15% and thus offers a much wider tolerance interval for budgetary deviations. As deviations between the actual and budgeted tax revenues are considered entirely cyclical under the cyclical adjustment procedure used here and thus exempted from the borrowing limit, the actual risk of the control account being debited on account of unforeseen developments is much lower, however. Against this backdrop, the option available to Rhineland-Palatinate, like central government, to take out structural borrowing amounting to 3% of trend tax revenue in supplementary budgets does not appear appropriate as it could encourage the state government to pass supplementary budgets which create deficits.

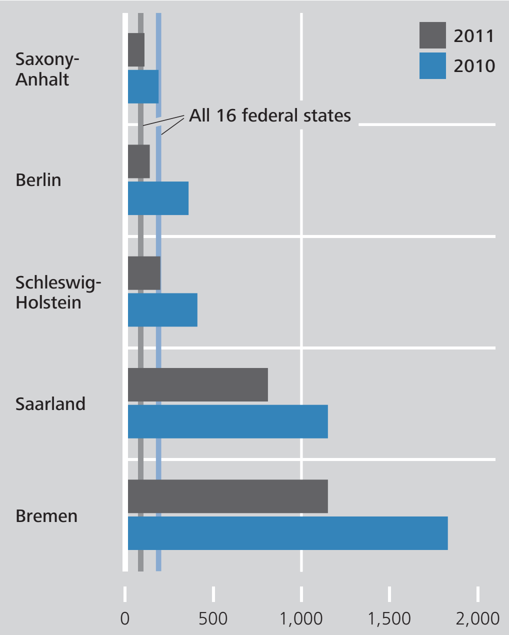
Repayment rules if targets are not met

The borrowing limit can be temporarily breached by invoking exemption clauses or, on a limited scale, if unexpected developments occur when the budget is being implemented. The repayment rules applicable in such cases might cause difficulties if they are not strict enough – a problem that could also beset central government. Particularly if repayment can be postponed with a vague reference to unfavourable macroeconomic developments, this could ultimately undermine the objective of curbing government debt (as occurred under the previous investment-related rule with its reference to averting a "disruption of the macroeconomic equilibrium"). For the exceptional case of budgetary burdens not caused by the federal state itself, the implementing legislation in Rhineland-Palatinate specifies that annual borrowing must be reduced in stages over four years and subsequently repaid in eight equal annual tranches. Repayment can be postponed if central government's Annual Economic Report expects real economic growth to be negative for the year in question. As a result, the scope for payment deferrals in such a case is governed by a clear set of rules and regulations.[3] As far as the other exceptional circumstances are concerned, the implementing legislation merely states that debt should be repaid in an unspecified, "cyclically appropriate" manner. The implementing act in Schleswig-Holstein provides for the possibility of deferring repayment on cyclical grounds, though only if the control account ceiling is breached. However, the constitutional rule governing the reduction of debts incurred when the exceptional clause is invoked is not specified in greater detail ("within an appropriate time frame"). Specifying a fixed repayment relative to the budget volume or to trend tax revenue is an option worth considering here.

3 The Annual Economic Report is not available until late January, ie after regular budgetary legislation has been passed, thus rendering budget planning somewhat more difficult.

Structural deficits of the federal states receiving consolidation assistance*

€ per capita



* Deficits as specified in the administrative agreements, cyclical effect replaced by estimate made using Bundesbank method (data as at spring 2012). Combined figure for all federal states estimated using cash statistics; includes off-budget entities minus revenue from transfers to pension reserves.

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Requirements for 2011 fulfilled but inflated starting deficits allow consolidation to be postponed

The Stability Council concluded in May 2012 that all five federal states receiving consolidation assistance had met their commitments in 2011.[15] However, the fact that the ceilings – like that for central government – were set on the basis of inflated starting deficits should be viewed critically. This has resulted in relatively unambitious reduction paths and opened up the problematic but politically attractive possibility of postponing the necessary overall consolidation.[16] Nonetheless, under the cyclical adjustment procedure which the Bundesbank applies to budgets in the general government sector, last year's structural developments were indeed favourable in the states receiving consolidation assistance (see chart above). The consolidation achieved by these states ranges in size from three-tenths of the 2010 structural deficit in Saarland to three-fifths in Berlin. However, it must be borne in mind that the conditions for reducing deficits were particularly good in 2011. The improvements were therefore due, not least, to very favourable tax revenue developments. In addition, the fact that the one-off burdens which had inflated the starting structural deficits, such as the crisis management measures in 2009-10, are now absent will probably make it much easier to meet the deficit reduction requirements in the first couple of years. Interest savings resulting from the very favourable refinancing conditions likewise had an impact. Despite the positive developments, the volatility of cyclically adjusted tax revenue means that there is by no means any room for complacency. Experience shows that, without substantial structural adjustment measures in the budget of the federal state concerned, a structural improvement should not simply be projected into the future.

Restructuring reports only offer very limited insight

In future, restructuring reports for the states of Berlin, Bremen, Saarland and Schleswig-Holstein, which the Stability Council classified in 2011 as being at risk of a budgetary emergency, must be compiled in order to provide more detailed information on the progress made in improving their finances through consolidation measures.[17] While the interim reports submitted by these federal states in May show that they made substantial efforts last year, the reports themselves leave something to be desired. Some of the required consolidation measures were not specified in detail and barely extend beyond 2012.[18] Bremen's report in particular does not contain many details.

15 Under the administrative agreements, structural deficits are calculated using a special approach, one consequence being that discrepancies between actual tax revenue and the values estimated when the budget was drawn up are classified as cyclically induced. See the relevant documents at www.stabilitaetsrat.de.
16 See Deutsche Bundesbank, German states receiving consolidation aid – initial deficit reduction requirements not very ambitious, Monthly Report, May 2011, pp 70-71.
17 One of the main responsibilities of the Stability Council, which was set up in 2010, is to review on an annual basis whether any of the 16 federal states or central government is in danger of experiencing a budgetary emergency. If such a danger is identified using a system of ratios with alert thresholds, the government entity in question must take measures to counter this danger as part of a restructuring programme.
18 Further criticism can be found in Federal Ministry of Finance, Konsolidierungsverpflichtungen der Länder Berlin, Bremen, Saarland, Sachsen-Anhalt und Schleswig-Holstein, Monthly Report, June 2012, p 45 ff.

Both the stated justification for this – that only non-specific deficit reduction objectives could be prescribed in view of the top-down budgeting approach which generally applies – and the report's reference to the efforts made by Bremen over many years to improve its finances are unconvincing given that this state faces a particularly pressing need for consolidation. In addition, the planning in the report appears to be based on relatively optimistic assumptions, not least regarding personnel expenditure. All in all, to ensure that the new surveillance procedure is successful, it is important to base the programmes on cautious assumptions and provide details right at the beginning of the programme on the consolidation measures required to plug the identified budget gap for the entire restructuring period.

Rigorously reduce deficit and plan in safety margin below ceilings

The fact that many of the federal states undergoing a restructuring programme have recorded safety margins below the deficit ceilings is a welcome development, not least in view of the considerable uncertainty regarding near-term macroeconomic developments and the course that the European sovereign debt crisis may take. Federal states would be well advised not to curtail consolidation efforts if developments in their budgets are temporarily more favourable than expected and to keep an eye on the gap between their deficits and the average of the other states, and not just focus on their own absolute deficit levels. Should the other states decide to take measures which create budget burdens – eg distinct tax cuts – because their financial situation is significantly better, there is a danger of state government falling considerably behind in the task of deficit reduction. It remains essential to critically assess the efficiency of all expenditure, including that in key areas of responsibility such as education and security. In addition, depending on the amount of consolidation required, it could become necessary to make full use of all potential avenues for boosting revenue above and beyond the increases in real estate purchase tax that have already been implemented. In particular, the degree to which fees cover costs or the possibility of extending user charges to further services could be key areas to look at.

Fiscal Compact

Concessions by central government in connection with Fiscal Compact

In addition to the consolidation requirements imposed through the debt brake, which have more of a long-term focus, the federal states were concerned that the ratification of the European Fiscal Compact would lead to an additional need for short-term adjustments. While the debt brake in the German Basic Law sets few requirements for the transitional period up to 2020, the Fiscal Compact ultimately obliges general government to achieve a close-to-balance budget in structural terms. As the social security schemes currently have considerable surpluses, which are likely to recede again in the foreseeable future, central, state and local government may have to reduce their deficits more rapidly than required by the national rules.[19] Central government made certain concessions in late June 2012 in return for the federal states approving the Fiscal Compact in the Bundesrat. It agreed to provide additional funds for childcare places for infants, bring forward its assumption of the costs incurred by municipalities for basic allowances for the elderly and the disabled and contribute to integration payments for the disabled. In addition, it was agreed that issuance of joint central and state government bonds would be permitted from 2013 onwards, although probably without joint and several liability. Nonetheless, given that there are only limited yield spreads between Federal securities and those of even highly indebted federal states, it is safe to assume that market participants generally already take it as read that the German federation

19 The draft Act concerning the implementation of the Fiscal Compact within Germany (Entwurf eines Gesetzes zur innerstaatlichen Umsetzung des Fiskalvertrages; Bundesrats-Drucksache 571/12) envisages a deficit ceiling for general government. As a general principle, the federal states appear to have accepted that the structurally balanced budget required of them will have to include the municipalities.

would step in if a budgetary emergency were to arise in one of the federal states. Finally, the Act governing contributions to sanction payments *(Sanktionszahlungs-Aufteilungsgesetz)* is to be amended so that central government will pay any sanctions applied up to 2020 as a result of the stricter requirements.

Outlook

Budget forecasts favourable overall but risks very high too

Following the clear decline in the deficit in 2011, the favourable developments in the federal states' core budgets continued up to the end of August 2012. The 4% year-on-year rise in revenue was still mainly attributable to the strong growth in tax receipts (+7½%). At 2%, the rise in expenditure was much slower in the first eight months of 2012, resulting in a year-on-year decrease of almost €3½ billion in the deficit. Stronger growth – mainly in current transfers to municipalities and personnel expenditure – contrasted with a clear decline in investment spending, primarily as a result of the expiry of the 2009 programmes. Although in the summer the Federal Ministry of Finance did not forecast any actual decline in the deficit for state government core budgets in 2012, it did predict that the deficit would fall continuously in the subsequent years (to €1 billion in 2016) provided that tax revenue continues to grow significantly by 4½% per year.[20] These figures already include the foreseeable burdens stemming from the reduction in the special supplementary central government grants for the east German states and Berlin – which currently fund as much as around a tenth of state and local government expenditure in these regions – and a steady rise in civil servant pension costs. However, projections of this kind which indicate that deficits will be reduced in the medium term have often been proved wrong in the past. In some cases the projected consolidation was not actually implemented, in others macroeconomic developments did not live up to expectations. Notably, near-term developments with regard to the European sovereign debt crisis hold substantial risks for state government finances, too.

Debt brake should be rapidly enshrined in state legislation and binding consolidation steps set

To ensure that their deficits are actually reduced, it would seem appropriate for the federal states to rapidly and rigorously enshrine the debt brake in their state legislation. They would be well advised to set binding minimum reduction paths which require the ceilings to be lowered steadily in equal steps, beginning with the budgetary *status quo* – which, at last report, was more favourable than forecast. As the budget burdens caused by the 2008-09 financial and economic crisis turned out to be smaller than initially expected, it would make sense, in the interests of limiting future debt servicing costs, for most states not to use all of the lengthy transitional period granted in the German Basic Law before the general borrowing ban comes into force. The states should use the favourable environment at present as an opportunity to take swift measures which have a lasting impact. This is especially important for states whose *per capita* deficit is still particularly high and which therefore still need to consolidate particularly extensively. Otherwise, they risk having to make substantial cuts shortly before the general borrowing ban comes into force – under intense time pressure and, potentially, in a more difficult macroeconomic setting.

Need for consolidation in states with high deficits should be considered when deciding on tax cuts

As the federal states are benefiting from distinctly higher tax revenue and lower interest rates than were expected when the new debt rules were adopted in 2009, the objective of ensuring a balanced budget – including safety margins below the limit – by 2020 should be achievable even for the states with high deficits. However, unlike states starting from a better position, these high-deficit states will have barely any room for notable tax cuts. To ensure that the debt brake requirements are met from 2020 onwards, it is therefore necessary, where

20 See Federal Ministry of Finance, Mittelfristige Projektion der öffentlichen Finanzen, Monthly Report, August 2012, p 10 ff.

tax cuts exceed the level deemed necessary in accordance with the German Basic Law, to either offset them on the revenue side or only allow states which already have sound finances to lower tax rates (eg through regional discounts).

Necessary to factor in safety margins

Given the uncertainty involved in estimating structural deficits, and the negative shocks which occur from time to time, it is also extremely important for all states to leave a distinct safety margin below their borrowing limits, at least when drawing up their budgets. Otherwise, they risk being forced to take procyclical measures in order to meet the requirements should developments take an unexpected turn for the worse. To obey the letter and spirit of the new budgetary rules, there ultimately needs to be a fundamental change in budgetary policy, which often still seems more focused on optimally exploiting the generally permissible borrowing leeway – and interpreting it loosely where necessary.

Off-budget entities must be included to fulfil letter and spirit of legislation

The administrative agreements for the states receiving consolidation assistance and the borrowing limit introduced in Rhineland-Palatinate explicitly include government sector off-budget entities in the debt rules. In view of the extensive spin-offs from core budgets, this is particularly important in order to limit the debt of all federal states effectively. Such an inclusion would be in keeping with the letter and spirit of the German Basic Law and would increase the likelihood of curtailing debt growth on a long-term basis. In this respect, strictly defined financial transactions can be factored out of the borrowing limit. Given the estimation uncertainty involved in cyclical adjustment, it is also important to have an effective means of ensuring that distortions in the cyclical components that are actually taken into account do not incrementally inflate the debt level (eg an additional control account).[21]

Reform of state government revenue-sharing scheme from 2020

Alongside the debt brake, the state government revenue-sharing scheme has also been the focus of growing attention. The rules adopted at the start of the previous decade will expire at the end of 2019, and the German Basic Law stipulates that follow-up provisions have to be adopted. It will also be necessary to clarify what differences in tax revenue capacity are compatible with the "equal living conditions throughout Germany" mentioned in the Basic Law. Given the regional price differences within Germany, which are usually also linked to the economic strength and population density of the areas concerned, a certain degree of divergence would seem justified. Under the existing rules, which largely even out differences in financial strength among the individual states and do not fully include local government taxes, a divergence of around 10% from the average is currently accepted in reality. To take account of differences on the revenue side, it would make sense for the federal states to systematically use the existing possibilities for creating regional differences in civil servant salaries and pensions. All in all, given their varying debt levels, the individual states will also need to compensate for substantial differences in interest expenditure in their budgets. Not least in view of this situation, and with an eye to setting the right incentives, it would be worth considering the option of giving individual states the right to introduce surcharges or discounts – on income tax for example – which would be included on a harmonised basis in the state government revenue-sharing scheme. In addition, this would allow greater account to be taken of divergences in public service preferences between the populations of different federal states.

21 See Deutsche Bundesbank, Some evidence on biased cyclical adjustment within fiscal rules, Monthly Report, August 2012, pp 68-70.