

THE DISCUSSION ON A NATIONAL STABILITY PACT IN GERMANY

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1. Introduction

As the name suggests, the Federal Republic of Germany is characterised by a strongly pronounced federal structure. Each level of government has its own important state-related tasks to fulfil. However, the most important areas of legislation are characterised by uniformity, and, when taking major political decisions, it often proves necessary to establish a consensus among the central (Bund) and regional (Länder) authorities. In taking their budgetary decisions the different levels of government enjoy, in principle, a broad degree of autonomy. But, when it comes to the provision of public goods, the German constitution emphasises the uniformity of living conditions throughout the country, and, therefore, the system of public finances is characterised by strong links between different government levels. In addition, the “confederate principle”, derived from the German Constitution, means that the central, regional and local authorities all vouch for one another so that in the event of a budgetary emergency a bail-out is ultimately required.

This system of “cooperative federalism“ finds itself challenged by the requirements of the Maastricht Treaty and of the European Stability and Growth Pact, which accentuates those “Maastricht requirements” that relate to public finance criteria. Thus, on the one hand, decisions affecting new borrowing at the individual levels of government are taken in a decentralised manner. The statutory restrictions on borrowing are usually tied to the amount of government investment and are not very restrictive, when viewed as a whole. On the other hand, Germany’s pan-European obligations require that the general government budget be close to balance or in surplus over the medium term. In addition, failure to comply with the Maastricht criteria applying to the general government may result in the imposition of considerable financial sanctions.

* Deutsche Bundesbank. The ideas expressed below represent the author’s personal opinions and do not necessarily reflect the views of the Deutsche Bundesbank.

Approval of the European Stability and Growth Pact, coupled with the likelihood that Germany's government deficit ratio in 1997 would, at best, just narrowly fall below the prescribed 3%-ceiling, which was required for entry into European monetary union, gave rise to a fairly intense debate in Germany on the benefits of a so-called "national stability pact". By this means, compliance with the Maastricht criteria was to be anchored in the federal system itself and a breakdown given of the financial sanctions to be imposed, if any. Corresponding proposals were made and discussed by the Bund, the Länder and relevant third parties. In the Länder, in particular, it proved difficult to reach a consensus on major issues, with the result that no national stability pact has so far been adopted.

The present paper begins with a brief survey of the federalist structure in Germany and of the statutory regulations limiting public borrowing. This will be followed by a discussion of the debate surrounding a "national stability pact". In the final chapter, conclusions will be drawn and elaborated on.

2. The public finance system in Germany

"Cooperative federalism"

In Germany most important areas of legislation, including the tax system, exhibit a relatively strong degree of uniformity and in the past, the Federal Government has increasingly assumed greater legislative responsibility. However, the performance and provision of public services are largely relegated to the lower levels of government. Since the Länder (and the respective municipalities) are involved in carrying out most of these tasks and Federal legislation often impinges on Länder matters, the Länder exercise, through the upper house of Parliament (the *Bundesrat*¹), extensive decision-making powers and a right of veto in the legislative process. This makes the wide-ranging coordination and reconciliation of policies between the Federal Government and the Länder necessary².

¹ The Länder Governments directly appoint their representatives to the Bundesrat. These representatives are bound in their decisions by the opinions of their government.

² The Financial Planning Council plays a key role with respect to coordinating public finance planning. This body, which usually meets twice a year and which is composed of Federal and Länder finance ministers and of local authority officials (Deutsche Bundesbank acting in an (continues)

The public finance system is an outgrowth of the “cooperative federalism” practised in Germany³. Although, theoretically, the different levels of government manage their budgets independently of one another⁴, a close financial relationship exists at the same time between the central, regional and local authorities. The “confederate” principle guarantees that the central, regional and local authorities ultimately have a claim to financial support in budgetary emergencies⁵. The negative sides of the “cooperative federalism” practiced in Germany are the virtually never-ending dispute over the allocation of government (tax) revenue at the different levels and between these levels and the - for the most part - rather rigid public finance system characterised by its relatively “heavy” reform-processes.

Significant role played by the regional and local government levels in the performance and provision of public goods and services

Public finance in Germany may be divided into central, regional and local authorities, on the one hand, and social security services, on the other. The central, regional and local authorities comprise the Federal Government, the 16 Länder and some 15,000 municipalities. Social security funds consist of the statutory pension insurance scheme, the unemployment insurance fund, the statutory health insurance system, the social security scheme to finance nursing care for the aged and handicapped and the statutory accident insurance scheme; in particular, the statutory health insurance system encompasses a variety of funds (350).

advisory capacity) analyses the current state of public finance and discusses future developments at different government levels. The most important function of this body is to enunciate proposals for coordinating financial planning at the different budgetary levels based on a consistent set of economic and fiscal assumptions. Its original purpose was to coordinate a “Keynesian” fiscal policy. However, this aspect is no longer of great relevance today.

³ For a more comprehensive (English) description see: Spahn/Föttinger (1997).

⁴ Article 109 (1) of the Constitution.

⁵ For example, in 1992, the Federal Constitutional Court declared budgetary emergencies in the Länder Bremen and Saarland owing to their very high level of indebtedness and large interest burden. The other levels of government were required to assist. As a result, the Federal Government offered what are known as supplementary Federal grants. At the same time the beneficiary Länder were obliged to present consolidation plans in which they were to lay down their own consolidation efforts.

Table 1**Expenditure and personnel of different levels of government in 1999**

	Expenditure		Expenditure excl. payments to other level of government		Personnel	
	bn DM	in % ³⁾	bn DM	in % ³⁾	in 1000	in % ³⁾
Bund ¹⁾	543	41%	338	34%	510	12%
Länder	482	37%	375	38%	2314	52%
Local authorities	284	22%	271	27%	1610	36%
Social security funds	830					
<i>of which</i>						
<i>pension insurance</i>	404					
<i>health insurance</i>	256					
<i>unemployment insurance</i>	101					
<i>nursing care insurance</i>	32					
1) Incl. federal special funds.						
2) Excl. payments to social security funds.						
3) Excl. social security funds.						

Table 1 shows that public expenditure is broadly distributed across the central, regional and local authorities. The data, once adjusted for transfers to other government levels, indicate that the Länder and municipalities are much more strongly represented than the Federal Government, the reason being that, in keeping with German federalism, public services should be provided in a decentralised manner⁶. Whereas defence and unemployment expenditure⁷ account for much of the costs at the Federal government level (apart from interest payments), the Länder bear the costs of education (schools and universities) and of internal security (police and legal system), in particular. The expenses of municipalities centre around the local infrastructure and administrations and the various forms of subsidiary welfare (social assistance). The large role played by the Länder and municipalities in performing government tasks is evidenced in their respective staffing levels (Table 1). Thus the Federal Government accounts for no more than just under 12% of all

⁶ Article 83 of the Constitution.

⁷ The risk of employees' becoming temporarily unemployed is basically covered by the statutory pay-as-you-go unemployment insurance fund. By contrast, the Federal Government defrays a large portion of the costs of long-term unemployment through unemployment assistance; the municipalities are called upon as well to contribute through social assistance. In the nineties, contribution receipts from unemployment insurance did not suffice to cover their expenditure, although the contribution rates had been raised significantly; the shortfall was made up with grants from the Federal budget. The unemployment insurance is not expected to show a balanced budget again until 2002.

personnel employed by the central, regional and local authorities. The statutory pension insurance scheme and the statutory health insurance system are the most important social security services.

Shared taxes dominant – Exclusive taxes of limited importance

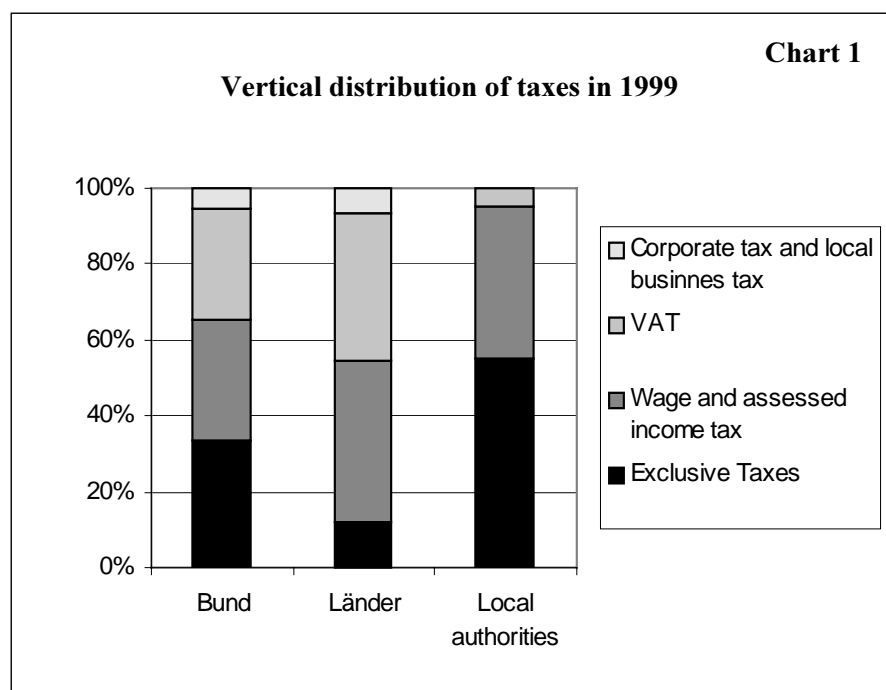
The cooperative aspect is emphasised in the vertical tax distribution (see Chart 1). Thus “shared taxes”, whose revenue is allocated among several levels, comprise the largest percentage of taxes (1999: 71%)⁸. “Exclusive” tax revenue sources, which may be individually controlled by varying the tax rate or assessment basis, are of less importance⁹. The allocation of turnover tax receipts is intended to achieve the “fine-tuning” necessary for an “appropriate” distribution of tax revenue between the Federal Government and the Länder¹⁰, and changes in borrowing needs at the individual levels of government are supposed to be offset through a reallocation of turnover tax shares. The result, however, has been that the distribution of turnover tax revenue regularly becomes a bone of contention¹¹. In principle, the horizontal tax distribution between regions follows the residence principle. However, in the case of VAT – derived from the principle of uniform living conditions – the goal of equalising different Länder governments revenue dominates. Thus, 75% of VAT is distributed on a per capita basis; the remaining 25% is used for the express purpose of smoothing regional disparities in Länder tax revenue.

⁸ Wage and assessed income tax (32% of tax revenue in 1999), corporation tax (5%) and turnover tax (30%) are distributed virtually equally between the Federal Government and the Länder, the local authorities receiving 15% of income tax revenue from the very outset. The distribution of income tax and corporation tax revenue are determined by the Constitution (Art. 106). The distribution of turnover tax revenue is subject to Federal law with the approval of the Länder.

⁹ Especially important in this connection is the revenue which the local authorities receive: local business tax which is based on the profits of the local enterprises and property tax revenue. Major sources of revenue at the Federal level include the “solidarity surcharge” (on wage and assessed income tax, corporation tax) and excises (especially the energy taxes). The Länder receive the proceeds from the inheritance tax and motor vehicle tax, *inter alia*, but have no means of shaping the tax rate or the assessment basis on their own.

¹⁰ See Article 106 of the Constitution, where it says that the Federal Government and the Länder have an equal claim to cover their necessary expenditure from current receipts and that the financing needs of the Federal Government and the Länder are to be reconciled with one another in such a way that an equitable distribution is reached, an excessive burdening of the taxpayer is avoided, and the uniformity of living conditions in the Federal territory is preserved.

¹¹ In the Nineties, the distribution of turnover tax revenue among the Federal Government and the Länder was changed 5 times.

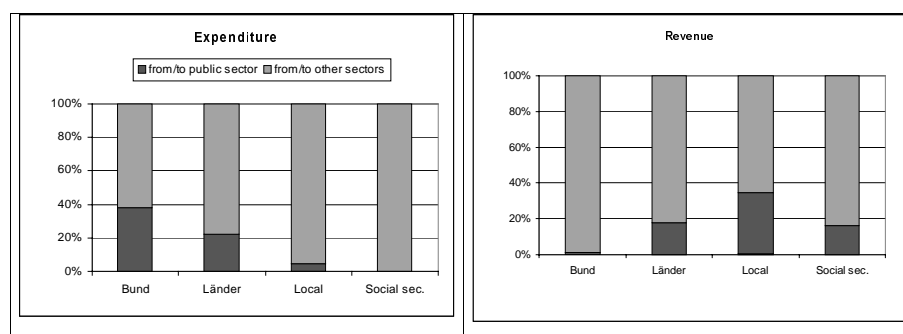


Important intergovernmental transfers

The budgets of individual levels of government are closely interlinked owing to intergovernmental transfers (see Chart 2). Thus the Federal Government makes substantial payments to the social security services (especially to the pension insurance scheme) and to the Länder – transfers to eastern Germany accounting for a large portion of these payments. Moreover, important funds flow between the Länder within the framework of the “inter-Länder equalisation scheme” and from the Länder to the local authorities in the form of current transfers - typically connected to the development of the Länder tax receipts - and investment grants. The vast majority of intergovernmental transfers are executed on the basis of fixed statutory regulations. Sometimes - as is the case with investment grants from the Länder to the local authorities - they are left more or less to the payer’s discretion.

Chart 2

The weight of intergovernmental transfers in 1999



The principle of uniform living conditions also has a major impact on how the system of intergovernmental transfers is organised. Thus, payments within the framework of the “inter-Länder equalisation scheme” further reduce differences in the financial strengths of Länder Governments (after VAT had already levelled the initial differences significantly). Moreover, the Bund provides important general Federal grants (to all “weak” Länder) and specific Federal grants (to individual Länder with “exceptional needs”). The system of intergovernmental transfers greatly affects the relative financial strength of the individual Länder (see Table 2).

In addition, the Bund contributes within a comprehensive framework of cofinancing to expenditure programmes of individual Länder. The justification for these Federal payments is also derived from the principle of meeting the additional financing needs of relatively “weak” regions (i.e. “weak” as compared with the rest of the country).

Intergovernmental equalisation schemes criticised – Increase of individual governments responsibilities warranted

For years the German public finance system has been criticised on several points¹². The key criticisms of the existing public finance system are:

¹² See *inter alia*: Baretto et al (2000), Homburg (1994), Peffekoven (1998, 1994, 1987), Sachverständigenrat (2000,1997), Wissenschaftlicher Beirat beim Bundesfinanzministerium (1997, 1992).

Table 2**Changes in the fiscal strengt indicators of the Länder via inter-Länder revenue equalisation and federal supplementary grants in 1999¹⁾**

	before distribution of VAT ²⁾	before inter-Länder equalisation ³⁾	after inter-Länder equalisation ⁴⁾	after general federal supplementary equalisation grants ⁵⁾	after special federal supplementary grants ⁶⁾
North Rhine-Westphalia	113,1	103,6	100,5	98,8	94,1
Bavaria	117,5	106,5	100,8	99,1	94,4
Baden-Württemberg	119,5	108,3	101,2	99,5	94,8
Lower Saxony	89,9	90,2	93,0	95,7	91,9
Hesse	138,5	120,2	103,2	101,5	96,7
Rhineland-Palatinate	97,4	92,2	94,3	95,7	93,6
Schleswig-Holstein	97,4	93,8	95,1	95,5	93,2
Saarland	76,2	86,9	92,8	95,6	117,5
Hamburg	173,3	142,7	134,3	132,0	125,7
Bremen	112,2	101,7	123,3	125,6	179,6
Western Länder	113,8	104,4	100,4	98,7	96,3
Saxony	39,5	82,3	92,7	95,4	107,4
Saxony-Anhalt	34,0	81,9	92,5	95,2	108,7
Thuringia	35,9	81,7	92,4	95,2	108,5
Brandenburg	41,0	82,8	92,4	95,1	107,4
Mecklenburg-West Pomerania	36,8	81,3	92,4	95,1	109,1
Eastern Länder	37,8	82,1	92,5	90,9	108,0
Berlin	92,9	89,7	123,6	127,2	138,3
Altogether	100,0	100,0	100,0	100,0	100,0

1) Fiscal capacity per inhabitant as a percentage of German average.

2) Shares of the Länder in shared taxes (except VAT) plus Länder taxes according to their local origin. Sum of these revenues nearly DM 202 bn.

3) After distribution of VAT revenues, figures include parts of local authority taxes, before inter-Länder revenue equalisation. Sum of revenues DM 380 bn.

4) Inter-Länder equalisation (DM 14.8 bn) aims at bringing fiscal capacity relatively close to the "equalisation standard", which gives a higher weight to inhabitants of "citystates" as Berlin, Hamburg and Bremen.

5) General federal supplementary equalisation grants (DM 6.5 bn) are paid by the federal government and aim at reducing remaining deficiencies in fiscal capacity nearly completely.

6) Special federal supplementary equalisation grants (DM 19.3 bn) are paid by the federal government for special needs of individual Länder (e.g. to the Eastern Länder, to small Länder in order to compensate their higher costs of government per inhabitant, to Western Länder rated "weak" before unification, to Bremen and Saarland for amortisation of their excessive debt.)

- The Länder whose tax revenue derives almost entirely from “shared taxes” (without them having the ability to levy an individual surcharge) possess almost no exclusive taxes and have no means of shaping their tax revenue on an individual basis. The result has largely been to prevent them from achieving greater autonomy, which would be desirable from the standpoint of a more efficient provision of public goods and which would mean greater fiscal equivalence for citizens.
- The current federal equalisation scheme is complicated and opaque. The effect of the intergovernment compensatory mechanisms has largely been to level out regional differences in financial strength and has even changed the “Länder league table” for financial strength (see Table 2). As a result, incentives for the regions to cultivate their own tax revenue sources are virtually non-existent from a financial perspective. The “inter-Länder equalisation scheme” should be simplified and the compensatory rates reduced. Federal equalisation grants, which the Federal Government pays to the Länder, should represent a clearly defined exception and should, to the extent possible, be provided in a “degressive” manner over time. At a more fundamental level, it is worth considering whether the Länder should be restructured, a solution which might defuse some of the conflicts currently arising within the revenue-sharing scheme.
- The result of “cofinancing” several public tasks is that responsibility for function and expenditure no longer coincide in full and the principle of “connexity” is violated. Consequently, competences overlap and the respective priorities of the central, regional and local authorities become blurred. Thus the Federal Government is involved in various Länder expenditure programmes. To ensure a more efficient use of resources, cofinancing should be curtailed.

Essentially, the critique points to the fact that the cooperative and reallocate aspects are given too much weight in the current system of public finances in Germany and hinder the more efficient performance of government activities. Future reforms should place greater emphasis on competitiveness and on the individual responsibility of the central, regional and local authorities.

After the opportunity for more wide-ranging reform afforded by the integration of the new Länder in the public finance system had gone

unexploited, the Federal Constitutional Court issued a ruling in 1999, which stated that the existing federal equalisation scheme would have to be revised by the end of 2004 or, at the very least, that the existing regulations would have to be reconsidered and justified more clearly¹³. The new regulations would have to arise out of a consensus between the Federal Government and the Länder. However, the current discussion, in which the different parties (the Federal Government, fiscally strong Länder, and fiscally weak Länder) are exhibiting their typical interests, makes it seem likely that, again, at best minor changes will be made in the current system. Precisely because the Federal Constitutional Court has offered no guidelines for determining where the “golden mean” between individual responsibility and support from the Federal system as a community of solidarity lies, no legal impetus exists for a “massive” reform.

3. Current regulations limiting the size of government deficits in Germany

The budgetary autonomy of the individual levels of government, as enshrined in the German constitution, means that the Länder are fundamentally entitled to finance their expenditure through borrowing (without violating their respective constitutions). Generally speaking, a “vague” restriction on new borrowing may be derived from the “confederate” principle insofar as a public authority is called upon, in the exercise of its function, to take into account the “well-being” of other government adjuncts; in the end, however, this fails to pose an effective constraint on general government indebtedness¹⁴. Moreover, the German system of public finance contains statutory provisions, which are based, in principle, on the “golden rule”. According to this rule, the amount of new borrowing should generally be less than investment expenditure.

¹³ Or, more in keeping with the actual wording of the Constitutional Court’s decision, given a justification by means of which the legislature provides itself and the general public with an account, ensures the transparency of fund distribution in accordance with the rule of law, and makes possible the budgetary planning and predictability needed to secure the basis of the Federal Government’s and each Land’s financial autonomy. Bundesverfassungsgericht (1999).

¹⁴ On the contrary, the “confederate” principle and the associated “bailout” probably may provide an incentive to increase borrowing, as long as a public authority is entitled to assume that other Länder or the Federal Government will be involved in financing the debt-related burdens as well.

Only weak legal restrictions on new borrowing by the Bund

At the Federal level, the new borrowing provided for in the budgetary plan is limited by Article 115 (1) of the Constitution to the planned amount of investment. Changes in the business cycle are accommodated to the extent that it is permissible to disregard this limit if the Federal Government determines that the national economic equilibrium has been disrupted¹⁵. However, the current interpretation of this regulation by the Bund does not effectively limit its borrowing ability. For example, the provision applies only to the planning stage, with the result that the actual execution of the budget may deviate from the initial plan. But, even more importantly the definition of investment is extraordinarily broad¹⁶. It includes not only fixed capital expenditure but also the acquisition of financial assets (participating interests, loan awards) and capital transfers to other levels of government and to third parties (for example, to foreign countries). At the same time, investment grants received are deducted. By contrast, loan repayments, disposals of participating interests and sales of fixed assets are not set off but nevertheless reduce new borrowing in the budget, which is the category restricted by the constitution. Depreciations are not included either when calculating the upper limit of new borrowing¹⁷. Finally, the regulation applies only to the Federal budget and may therefore be circumvented by borrowing via a special funds or via an off-budget vehicle¹⁸.

¹⁵ The notion of national economic equilibrium is not explained at greater length in the Constitution. Section 1 of the Stability and Growth Act adopted in 1967 cites a stable price level, a high level of employment and an external economic equilibrium accompanied by continuous and appropriate economic growth as overall economic objectives. This enumeration, however, does not really help, if the actual overall economic situation is to be assessed. Thus the government has considerable leeway in its interpretation of the overall economic situation.

¹⁶ In a 1989 decision, the Federal Constitutional Court called on the legislature to specify and delimit what is meant by the term "investment". This request, however, was fulfilled only to the extent that individual budgetary categories were enumerated. This measure does not seem to reflect adequately the Constitutional Court's intentions. See also: Karl-Bräuer-Institut (1997) p.21.

¹⁷ For a critical discussion, see *inter alia* : Deutsche Bundesbank (1999) pp. 42-45, Bundesrechnungshof (1999) p. 12; Wissenschaftlicher Beirat beim Bundesfinanzministerium (1980) p. 42ff.

¹⁸ Thus German reunification was largely financed through federal special funds such as the "German Unity" Fund, the Debt-Processing Fund and the Treuhand agency.

Only weak legal restrictions on Länder borrowing but a strong ruling at local level

The Länder are largely subject to provisions modelled on Federal Government regulations and involving investment expenditure; these provisions are to be found in the respective Länder constitutions or in the Länder budget statutes¹⁹. The existing statutory provisions generally place only weak constraints on the borrowing options of the Länder, as is also the case with the Federal Government²⁰. By contrast, the regulations governing the local authorities are comparatively “hard”. As a matter of principle, borrowing is envisaged as a secondary instrument to be used by municipal budgets, which are subject to authorisation by the Länder, only if another means of financing is not possible or appropriate. The “golden rule” which is present here as well in nuce appeals to a notion of investment which is more narrowly defined than that used in connection with the Federal Government and the Länder. Moreover, the legal framework limits the ability of the local authorities to refinance maturing debt via new borrowing²¹.

The social security services have, in principle, no access to borrowing facilities. Deficits in the unemployment insurance fund, if they arise, are covered annually by transfers from the Federal budget. The statutory pension insurance scheme and the statutory health insurance scheme are pay-as-you-go systems, which, in principle, reconcile receipts with expenditure through corresponding adjustments in the contribution rates. They also have certain reserves with which they may cushion fluctuations in their financial position – especially ones occurring during the year. Given the existence of these reserves it is also possible in isolated years to build temporary deficits, however they must be compensated in the following year²².

¹⁹ Some Länder constitutions explicitly sanction borrowing in cases of “exceptional need”. This regulation has been interpreted by some of the Länder concerned as an even more generous form of borrowing authorisation rather than as a regulation based on investment.

²⁰ See Schemmel (1997) p. 20, Fürst (1997) p. 230.

²¹ See Fürst (1997) p.230, Deutsche Bundesbank (2000a) p. 47.

²² In the early nineties, the asset reserves of the statutory pension insurance and health insurance schemes were still so abundant that considerable deficits were sometimes incurred during the decade, without this leading to further debt. Now, however, these reserves have diminished to such an extent that fairly large shortfalls can no longer be tolerated and must necessarily be compensated in the following year.

Table 3**Public Debt**

Year	Debt at the end of the year				
	General Government	Bund and Special Funds	Länder	Local authorities	
	bn DM	as a % of GDP			
1970	125,9	18,6	8,6	4,1	6,0
1975	256,4	25,0	11,2	6,5	7,2
1980	468,6	31,8	16,0	9,4	6,5
1985	760,2	41,7	21,9	13,6	6,2
1990	1.053,5	43,4	24,7	13,6	5,2
1991	1.171,0	39,9	23,2	12,0	4,7
1992	1.342,5	42,5	25,4	12,3	4,8
1993	1.506,4	46,6	27,9	13,4	5,3
1994	1.659,6	48,9	29,6	13,9	5,5
1995	1.993,5	56,6	36,6	14,5	5,5
1996	2.126,3	59,3	38,2	15,6	5,5
1997	2.215,9	60,4	38,8	16,2	5,4
1998	2.280,2	60,3	38,5	16,5	5,3
1999	2.346,9	60,5	38,9	16,5	5,2

Marked increase in public debt in the past

The trend in general government debt makes it evident that existing regulations are unable to curtail government borrowing. As Table 3 illustrates, public debt (and the debt to GDP ratio) in Germany has grown almost without interruption since the early seventies. The trend was especially dramatic in the nineties, although it was decisively influenced by an unusual event in the guise of German reunification. The burdens associated with reunification were reflected, above all, in the debt recorded by the Federal Government and its special funds²³. Even so, the level of debt also rose significantly at the Länder and local levels. However, the indebtedness of individual regions differs considerably. The per capita debt of the east German Länder and municipalities, which were still debt-free at the time of reunification, now stands largely at the level of the west German Länder (see Table 4).

²³ See Deutsche Bundesbank (1997).

Table 4

Per-capita indebtedness of the Länder (incl. local authorities)

DM, per-capita									
Year	1991	1992	1993	1994	1995	1996	1997	1998	1999
Baden-Württemberg	5.435	5.675	5.860	6.018	6.202	6.469	6.570	6.699	6.711
Bavaria	3.899	4.057	4.155	4.066	4.128	4.601	4.885	4.980	4.942
Brandenburg	815	2.636	4.769	6.572	7.658	8.877	9.638	10.169	10.406
Hesse	7.591	7.862	8.264	8.674	9.004	9.115	9.569	9.693	9.459
Mecklenburg-West Pomerania	684	1.562	3.133	4.377	6.072	7.319	8.459	9.371	9.961
Lower Saxony	7.780	8.136	8.708	9.168	9.546	9.904	10.224	10.389	10.350
North Rhine-Westphalia	8.282	8.465	8.841	9.030	9.606	9.977	10.451	10.741	10.858
Rhineland-Palatinate	7.615	7.923	8.174	8.554	8.901	9.465	9.998	10.391	10.707
Saarland	13.745	14.736	15.675	15.138	14.788	14.510	13.995	13.601	13.550
Saxony	748	1.904	3.310	4.204	5.211	5.833	6.329	6.669	7.149
Saxony-Anhalt	733	2.683	4.556	5.796	7.061	8.804	9.842	10.864	11.754
Schleswig-Holstein	8.707	9.086	9.766	10.106	10.721	11.192	11.670	11.947	12.224
Thuringia	861	2.180	3.803	5.695	6.828	7.875	8.801	9.677	10.454
Berlin	4.543	5.896	7.637	9.059	12.144	14.043	15.390	16.839	18.161
Bremen	22.334	23.988	25.086	24.760	24.798	24.547	25.068	24.769	23.740
Hamburg	11.425	12.036	13.426	14.667	15.305	16.385	16.763	17.168	18.002
All Länder	5.906	6.453	7.123	7.590	8.193	8.750	9.212	9.533	9.689
West Länder	7.198	7.466	7.831	8.041	8.379	8.739	9.079	9.265	9.300
East Länder	765	2.189	3.869	5.218	6.394	7.505	8.317	8.989	9.433
Berlin	4.543	5.896	7.637	9.059	12.144	14.043	15.390	16.839	18.161

“Golden rule” almost always violated in last 20 years

The inadequacy of the legal restrictions on governmental borrowing also becomes evident if compliance with the “golden rule” is used as a criterion for evaluating the existing legal framework - at least if the golden rule is understood in a narrower sense rather than the very “lax” interpretation given to it by the Federal Government and the Länder²⁴.

²⁴ In its recent publication “Guiding principles of fiscal policies” (Bundesministerium der Finanzen (2000a)), the Federal Ministry of Finance announced that it intends to apply more stringent criteria in future to the financing of investment through new borrowing. Loans to finance investment should be redeemed during the lifetime of the relevant asset. In this way, depreciations would be taken into account.

Table 5

Public deficit, investment and the golden rule

as a % of GDP					
	Deficit	Gross Investment	Depreciation	Net-Investment	Fulfilment of Golden Rule
1980	-2,9%	3,6%	1,7%	1,9%	-1,0%
1981	-3,7%	3,3%	1,8%	1,4%	-2,3%
1982	-3,3%	2,9%	1,9%	0,9%	-2,4%
1983	-2,6%	2,5%	1,9%	0,6%	-1,9%
1984	-1,9%	2,4%	1,9%	0,5%	-1,4%
1985	-1,2%	2,4%	1,9%	0,5%	-0,7%
1986	-1,3%	2,5%	1,9%	0,6%	-0,7%
1987	-1,9%	2,4%	1,9%	0,5%	-1,4%
1988	-2,2%	2,3%	1,8%	0,5%	-1,7%
1989	0,1%	2,4%	1,8%	0,5%	0,6%
1990	-2,1%	2,3%	1,8%	0,5%	-1,6%
1991	-3,0%	2,8%	1,9%	0,9%	-2,1%
1992	-2,6%	2,9%	1,9%	1,1%	-1,5%
1993	-3,2%	2,8%	1,9%	0,9%	-2,3%
1994	-2,5%	2,6%	1,9%	0,8%	-1,7%
1995	-3,2%	2,3%	1,9%	0,4%	-2,8%
1996	-3,5%	2,1%	1,8%	0,3%	-3,2%
1997	-2,7%	1,8%	1,8%	0,1%	-2,7%
1998	-2,1%	1,7%	1,7%	0,0%	-2,0%
1999	-1,4%	1,8%	1,7%	0,1%	-1,3%
Avg. 1980-1999	-2,4%	2,5%	1,8%	0,6%	-1,7%
Avg. 1991-1999	-2,7%	2,3%	1,8%	0,5%	-2,2%
1980-1990: ESA 79. Depreciation according to ESA 95 methodology - own estimates.					
1991-1999: ESA 95.					

In Table 5 investment, as derived from the national accounts and adjusted for depreciation, is contrasted with the actual national accounts deficit²⁵. On the one hand, this includes depreciations; on the other hand, it ignores financial transactions – such as the sale or acquisition of participating interests, loan awards or repayments. As it turns out, the golden rule, so constructed, has been followed in only one year since the

²⁵ This does not include actual investment grants (capital transfers) made. If investment grants are paid to state-owned enterprises, it may be the case that, through this omission, asset accumulation on the part of the state has been undervalued. On the other hand, the depreciations on these investments would also have to be taken into account, with the result that the net effect would likely not be all that pronounced.

beginning of the eighties, namely in 1989. As a result, the state's loss of net wealth amounted to more than 1½% of GDP as an annual average over the past 20 years and more than 2% as an annual average during the nineties. The trend is still greatly underrecorded since the off-budget activities of the Treuhand agency, which was heavily involved in funding the financial burden resulting from unification, have not been included here. Treuhand agency debt assumed by the Federal Government came to 6.8% of GDP in 1995, but, in keeping with an Eurostat decision, this was not treated as a transaction which would increase the "Maastricht deficit".

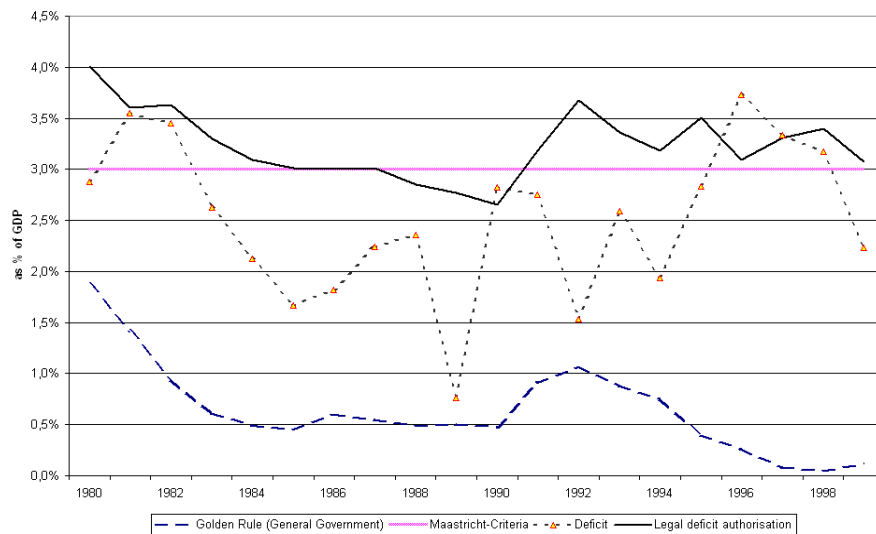
Legal restrictions on public deficits not strong enough by far

A rough impression of the difference between the previously defined and rather strict "golden rule" and the existing statutory deficit-restricting regulations may be gained by examining Chart 3. Here the Federal Government's interpretation of the corresponding provision in constitutional law is applied to the Federal Government and the Länder, and this legal authorisation – which centres on new borrowing – is transformed into the national accounts methodology. This means that investment, investment grants (capital transfers) and the room to manoeuvre gained from the sale of participating interests and loan repayments as well are regarded as setting a deficit ceiling²⁶. This legal upper limit for deficits is compared with general government net investments derived from the national accounts. As it turns out, statutory authorisations are, as an annual average over the last 20 years, 3% of GDP larger than the level allowed by the strict "golden rule". As already mentioned, it is also possible to exceed this limit during the actual implementation of the budget or to justify an excess amount by declaring a disruption in the national economy or to take up loans via special funds. In short, the legal restrictions on governmental borrowing in Germany are not strong enough by far.

²⁶ Acquisition of participating interests and loan awards, by contrast, are not taken into account because these financial transactions do not affect the deficit in the national accounts methodology. The general government's actual ability, as prescribed by law, to take up loans is understated here, because local authorities have a certain legal ability to run deficits as well. Moreover, special funds, whose borrowing is not subject to legal constraints, may also incur deficits.

Chart 3

**Bund and Länder: Legal deficit authorisation,
Maastricht-criteria, actual deficit and Golden Rule
(National accounts methodology)**



4. Debate on a national stability pact in Germany

Pending monetary union initiated discussion on a national stability pact

Given the Maastricht Treaty requirements and the European Stability and Growth Pact, which defines these requirements more precisely, Germany's distinct federalistic structure and the considerable regional and local authority deficits incurred in the past made the notion of a national stability pact appear especially appropriate to the German situation²⁷. Thus, in the nineties, the aggregate (national accounts) deficits of the regional and local authorities amounted, on average, to slightly over 1.0% of GDP (see table 6); these regional deficits were therefore greater than comparable deficits in every other country of the European Union.

²⁷ Article 3 of the protocol on the excessive deficit procedure states that, ultimately, the central governments of the individual countries are responsible for compliance with the Maastricht criteria. The member states are required to establish intergovernmental procedures which ensure that the Maastricht Treaty requirements are fulfilled and which enforce the consequences of non-compliance.

Table 6

Public deficit ratios¹⁾

as a % of GDP					
	General government	Bund	Länder	Local authorities	social security funds
1980	-2,9%	-1,7%	-1,2%	-0,3%	0,3%
1981	-3,7%	-2,1%	-1,4%	-0,5%	0,4%
1982	-3,3%	-2,1%	-1,4%	-0,3%	0,5%
1983	-2,6%	-1,6%	-1,1%	0,1%	0,0%
1984	-1,9%	-1,3%	-0,8%	0,2%	0,0%
1985	-1,2%	-0,9%	-0,7%	0,2%	0,3%
1986	-1,3%	-1,0%	-0,8%	0,0%	0,5%
1987	-1,9%	-1,4%	-0,8%	0,0%	0,3%
1988	-2,2%	-1,6%	-0,7%	0,1%	0,1%
1989	0,1%	-0,5%	-0,2%	0,1%	0,8%
1990	-2,1%	-2,2%	-0,6%	-0,1%	0,8%
1991	-3,0%	-3,3%	-0,6%	0,1%	0,7%
1992	-2,6%	-1,6%	-0,7%	-0,2%	-0,1%
1993	-3,2%	-2,2%	-1,0%	-0,1%	0,2%
1994	-2,5%	-1,1%	-1,3%	-0,2%	0,1%
1995	-3,2%	-8,3%	-1,2%	-0,2%	-0,4%
1996	-3,5%	-1,9%	-1,2%	0,0%	-0,4%
1997	-2,7%	-1,6%	-1,2%	0,0%	0,1%
1998	-2,1%	-1,7%	-0,8%	0,3%	0,1%
1999	-1,4%	-1,6%	-0,5%	0,3%	0,3%

1) 1980-1990: ESA 79. 1991-1999: ESA 95.

The “Act on the Treaty on European Union of February 7, 1992”, which was passed by the Bundestag and Bundesrat on December 28, 1992, states that *obligations arising for the Federal Republic of Germany from the legal instruments of the European Union in compliance with Article 104c of the EU Treaty are to be fulfilled on the basis of an agreement between the Federal Government and the Länder*. However, the existing deficit-dampening regulations in Germany are not sufficient in themselves to guarantee that the 3% reference value for the deficit ratio is not exceeded. Thus Chart 3 shows that most of the peak values for legal deficit allowances by the Federal Government and by the Länder (these values being based on investments in the budget) lay significantly above the

Maastricht criterion of 3% of GDP in most of the years. In addition, the prerequisites for an exceptional violation of this limit based on “disruptions in national economic activity”, as laid down in the German public finance system, are significantly less restrictive than those specified in the Maastricht treaty and the European Stability and Growth Pact. Finally, not only the Bund and the Länder but also the local authorities and the special funds may incur deficits.

In the course of 1996, it became clear that the deficit ratio in Germany would amount to more than 3% and that “narrow” compliance was to be expected in 1997, the crucial year for entry into European monetary union. After informal negotiations between the Federal Government and the Länder failed to yield any result, the Federal Government presented its own proposal for a national stability pact²⁸. The Länder, too, recognised, in principle, the necessity of an intergovernmental implementation of pan-European obligations²⁹. Controversy arose, however, among the various Länder as to possible formats and finally in 1997 various Länder launched different proposals. In addition, a national stability pact was discussed by third parties in several publications³⁰.

Most of the proposals concerning a national stability pact for Germany have adopted the Maastricht Treaty’s 3% criterion as a ceiling for new public borrowing. The primary goal of the national pact was to “allocate” this “deficit authorisation” across individual levels of government. There are basically four major problem areas to be clarified:

- legal implementation,
- criteria for a vertical distribution of deficit authorisations across individual levels of government,
- criteria for a horizontal distribution of deficit authorisations within a single government level,
- imposition of possible sanctions against the respective authorities.

²⁸ See the Federal Ministry of Finance (*Bundesministerium der Finanzen*, 1996a). As early as 1994, the Economic Advisory Council of the Federal Minister of Finance had presented a study, many aspects of which found their way into the subsequent proposal from the Bund. Beirat beim Bundesministerium der Finanzen (1994).

²⁹ See *Frankfurter Allgemeine Zeitung (FAZ)* (1997).

³⁰ See *inter alia*: Fürst (1997), Sachverständigenrat (1996), Schemmel (1997), Snelting (1997), Söllner (2000), Sturm (1998), Vesper (1997 and 1999), Windels (1997).

Legal implementation

One important question to be addressed is that of the *legal form* of a national stability pact, although that will be treated only briefly in this paper. Here it is especially important to determine whether this pact should take the form of constitutional amendments or supplements, Federal or Länder acts or decrees not yet promulgated, a “Federal treaty” between the Federal Government and the Länder, or a more informal type of cooperation conducted in the absence of statutory regulations. In view of the complexity of the procedure, the Federal Government’s proposal³¹ envisages no constitutional amendment. Instead, the pact should be implemented by means of a Federal act and decrees, which are to be passed jointly by the Federal Government and the Länder. The Financial Planning Council as the coordinating body would have an important function here³². By contrast, some Länder and many authors consider a constitutional amendment³³ or “Federal treaty³⁴” to be reasonable and even necessary. However, other Länder³⁵ reject precisely this type of firm commitment and support instead a “looser” (case by case) arrangement between the central, regional and local authorities. In general, the constitutional approach appears to be appropriate, especially if the intergovernmental imposition of sanctions based on the “excessive deficit procedure” is to be treated as binding. Otherwise, the danger exists that the national stability pact, which would necessarily restrict the budgetary autonomy of the Länder, would be constitutionally unsound and, if worst came to worst, would entail long, drawn-out proceedings before the Federal Constitutional Court. More informal ad hoc agreements, to be implemented when the 3% limit is expected to be surpassed, should be regarded sceptically. Given the discord in the public finance system during the past few years, not only between the Federal Government and the Länder but also between the Länder themselves, it is to be feared that distribution battles would be a permanent

³¹ See Bundesministerium der Finanzen (1996a) and especially Bundesministerium der Finanzen (1996b).

³² The Federal Government argues that the constitution is not at odds with such a limitation on the budgetary autonomy of the Länder (with respect to borrowing). This position is shared, for example, by Hartmann (1996).

³³ See *inter alia*: Fürst (1997), Schemmel (1997) p. 74ff, Wissenschaftlicher Beirat beim Bundesfinanzministerium (1994) p. 48, Hellermann (2000) p. 41 sowie tendenziell Thuringia und North Rhine-Westfalia.

³⁴ *Inter alia*: Bavaria and Sachverständigenrat (1996) p. 191.

³⁵ *Inter alia*: Bremen, Lower Saxony, Schleswig-Holstein.

occurrence. The Länder would have more leverage initially since the Federal Government would vouch directly for pan-European obligations.

Vertical distribution of deficit authorisations

When fixing the *vertical distribution* of new borrowing ceilings in the national stability pact, it would first be necessary to determine how much deficit financing is to be authorised for each level of government. In most proposals, the Federal Government and social security funds are grouped together on the one side and the Länder and municipalities, on the other. This is appropriate. Thus the financial position of social security services is decisively influenced by the Federal legislature and by Federal Government transfers, although – as mentioned above – social security services, under normal circumstances, show a balanced budget. The local authorities' budgets are subject to direct financial surveillance by the Länder. Moreover, since Länder transfers are critical to municipal finances, the Länder as a whole exert a direct and marked influence on the development of the local authorities' financial position.

Since most authors favour a fifty-fifty distribution of the “deficit authorisation” between the Federal Government/social security funds, on the one hand, and the Länder/municipalities, on the other³⁶, each of the two blocks would have 1.5% of GDP available as latitude for new debt. According to the Advisory Council at the Federal Ministry of Finance, such a distribution results - according to one rough assessment - from “the combination of several indicators” (*inter alia* the volume of the budget and the deficit in preceding years), with the pragmatic charm of a 1:1 solution playing also an important role³⁷. Over and above that, however, the Federal Government, which also advocates a fifty-fifty distribution for “normal situations”, exacts an “advance charge” in the event of an unfavourable

³⁶ See *inter alia*: Bundesministerium der Finanzen (1996a), Beirat beim Bundesministerium der Finanzen (1994) p. 33, Söllner (2000), Karl-Bräuer-Institut (1997), p. 66, Snelting (1997), p. 4.

³⁷ A fifty-fifty approach also roughly results if “self-financed” investments (gross fixed capital investment+capital transfers paid to the public sector – capital transfers received from the public sector) is taken into account. In the second half of the nineties, the Bund's share was 46%, the Länder's 23% and the municipalities 31%.

economic situation³⁸. The Federal budget's greater sensitivity to economic upturns and downturns is given as a reason³⁹. Not only do tax revenue losses resulting from changes in the business cycle place a strain on the Federal budget; the increase in expenditure which is caused by rising unemployment and losses in unemployment insurance contribution receipts which is to be financed through the federal budget does so, too. By contrast, the Länder, which were at least unanimous on *this* point, demanded a distribution of 60:40 in their "favour". The argument was put forward that the Federal budget would show significantly greater flexibility than would the rather rigid Länder budgets, which are characterised, above all, by a large share of personnel expenditure⁴⁰. On this view, the Federal Government can absorb unexpected shocks considerably better than the Länder, for which short-term borrowing plays a major role as buffer. In addition, the local authorities have in the local business tax, which is based on enterprises' profits, one of the most economically sensitive tax revenue sources in the entire German tax system. The Länder also argued that the Federal Government is endowed with more wide-ranging powers than the Länder are to vary their tax receipts by modifying tax law or tax rates⁴¹. Although the positions of the Federal Government and of the Länder differed on the question of a vertical distribution, it would probably have been possible, theoretically, to have reached a consensus on this point. Such a consensus might, finally, have been possible with a fifty-fifty distribution. However, such a solution would have placed no strong constraint on borrowing by the Länder and municipalities on average. Thus, their national accounts deficits in the preceding 20 years have exceeded 1.5% of GDP only twice (in 1981 and in 1982). A 60% share for the Länder would have been tantamount to issuing them a blank cheque.

³⁸ In 1996, the Federal Finance Ministry set as its primary overall public sector goal a deficit ratio of 1%. This was in keeping with the then current "Waigel proposal" for a European Stability Pact. The Bund has suggested that the decision on deficit ceilings for individual governments should only be taken if the danger exists that the Maastricht criterion of 3% might be exceeded. According to the Bund's proposal, the increase in the Bund's borrowing authorisation due to cyclical reasons would have to be approved by agreement between the Federal Government and the Länder on a case-by-case basis.

³⁹ A reason also accepted by Wissenschaftlichen Beirat beim Bundesfinanzministerium (1994), Snelting (1997) p. 5, Sturm (1997) p. 108, DIW (2000) p. 619, Vesper (1999) p. 197.

⁴⁰ See Senator für Finanzen der Hansestadt Bremen (1997).

⁴¹ Thus, by modifying excises (especially the mineral oil tax) or supplementary surcharge on income tax and on corporation tax, the Federal Government has the means to adjust its tax revenue without the prior approval of the Länder.

Horizontal distribution within the Länder

It is considerably more difficult to reach a consensus on the issue of a *horizontal distribution* of deficit authorisations among the Länder (including the corresponding municipalities in each case). The Federal Government⁴², some Länder and many of the other commentators⁴³ have argued, in principle, in favour of a distribution based on population size. This would have been a convincing solution. Thus, the Länder Government revenue-sharing scheme ensures that per capita tax receipts do not vary strongly from one Land to another (apart from the “city-states”, and east German Länder, which have higher revenues due to federal supplementary grants). As a result, a Land’s ability to repay, or at least carry, its debt (in other words, its potential tax receipts) would be measured not in terms of its actual tax base but in terms of its population size. This is in marked contrast to the situation within the EU. Whereas the Maastricht criteria are rightly tied to national gross domestic product, which, in the final analysis, constitutes the assessment basis for national tax receipts, the “inter-Länder equalisation scheme” results, to a great extent, in a decoupling of tax receipts from regional gross domestic product. For this reason, the arguments advanced by some commentators that those Maastricht Treaty regulations which refer to GDP in this connection be applied to a horizontal distribution as part of a national stability pact⁴⁴ carry little conviction. A distribution based in population size has another, crucial advantage in that it may be justified relatively easily and in a non-controversial manner. A regionalisation of GDP is not attempted in the “official national accounts” and entails considerable statistical difficulties⁴⁵. If it should ever come that far, major political confrontations may be expected as to the precise method of calculation to be used.

⁴² The Federal Government position as regards the horizontal distribution of revenue among the Länder was not very rigid. As an alternative to the above-mentioned principle, it proposed a distribution in line with deficits incurred in the preceding years. Moreover, the Federal Government thought it possible to take into account the special burdens of individual Länder.

⁴³ *Inter alia* : Sturm (1997) p. 109, Fürst (1997), Wissenschaftlicher Beirat beim Bundesfinanzministerium (1994), Karl-Bräuer-Institut (1997), p. 68, Schemmel (1997) p. 50, Sachverständigenrat (1996) p. 193.

⁴⁴ See Beirat beim Bundesministerium der Finanzen (1994) p. 36.

⁴⁵ Although the Working Group “Regionalisation of the national accounts” attempts to break gross domestic product down by region, these figures do not form part of the official national accounts issued by the Federal Statistical Office. The figures should be regarded as providing only a rough guideline. At the present time, they have no major political impact.

Many Länder, however, have rejected a distribution based on population size⁴⁶. Especially financially weak Länder with relatively large deficits stated that they were incapable of consolidating their budgets to the required extent over the short term⁴⁷. Table 7 makes it clear that, with a fifty-fifty distribution between the Federal Government and the Länder, the east German Länder, in particular, showed considerably larger deficits in 1996 than would have been permitted by the national stability pact in the case of a per-capita distribution of the deficit allowance⁴⁸. As a result, these Länder have insisted that the initial situation, and especially those deficits incurred in the preceding years, be included when determining “deficit authorisations”. The argument, however, seems implausible, at least if considered over the middle and longer term. It might be viewed almost as a “reward” for deficits previously incurred, and it would encourage individual Länder to engage in strategic manoeuvring. At the same time, allowing some parts of the country to roll forward their currently large deficits would show up unfavourably differences in the long-term sustainability of public finance systems in different regions (similar problems attach to the attempt to build on past Länder expenditure). Using investment expenditure as a criterion would appear, at first glance, to offer an incomparably more attractive prospect⁴⁹. This would make it possible – so the argument runs – to attach due weight to catching up on investment, especially in the east German Länder. This may be countered, however, with an appeal to past experience which shows reliance on public investment to be extremely problematic, especially with regard to the definitional difficulties it raises⁵⁰. In the case of the new Länder, whose per capita debt has already reached west German levels (see Table 5), an increase in deficit-financed investment does not seem well-suited to improving their locational advantages⁵¹.

⁴⁶ See Finanzsenator der Stadt Bremen (1997).

⁴⁷ See Finanzsenator der Stadt Bremen (1997).

⁴⁸ For a comprehensive comparison of the numeric outcomes for different criteria for the horizontal distribution of deficit allowances for the year 1995, see Windels (1997).

⁴⁹ See *inter alia* DIW (2000), Snelting (1997), Vesper (1999).

⁵⁰ See *inter alia* Wrede (1999) p. 217.

⁵¹ The auction of “debt certificates” was also discussed by some authors (Fürst (1997) p. 237, Beirat beim Bundesministerium der Finanzen (1994), Söllner (2000)). However, this option was ultimately considered impractical by most of them (with the exception of Söllner, who was willing to allocate deficit allowances by way of an auction while distributing the substance of them in a mechanical manner).

Table 7

Horizontal distribution of deficit ceilings¹⁾

in bn DM	Deficit			Upper deficit limit according to:					Deficit (national accounts) - upper deficit limit ²⁾			
	National ac. ²⁾	Budget. stat.	National ac. ²⁾	Per Capita	Avg. deficit last 2 years	Avg. deficit last 5 years	0.5* (Per-Capita+Def)	Per Capita	Avg. deficit last 2 years	Avg. deficit last 5 years	0.5* (Per-Capita+Def)	
	1996	1999	1999									
Baden-Württemberg	-3608	2299	2658	-7356	-1026	-2633	-4995	10014	3684	5291	7653	
Bavaria	-3078	948	1603	-8529	-2111	-1709	-5119	10132	3714	3312	6722	
Brandenburg	-2637	-1546	-1655	-1825	-3085	-3457	-2641	170	1430	1802	966	
Hesse	-2418	632	96	-4254	-2602	-3069	-3661	4352	2900	3167	3759	
Mecklenburg-West Pomm.	-1999	-1120	-755	-1263	-1796	-2095	-1679	508	1041	1340	924	
Lower Saxony	-4306	-1768	-1907	-5545	-4316	-5046	-5296	3638	2409	3139	3389	
North Rhine-Westphalia	-8528	-3989	-4174	-12658	-13131	-10851	-11754	8484	8957	6677	7580	
Rhineland-Palatinate	-2101	-1413	-1607	-2635	-3621	-2502	-2869	1228	2014	895	1062	
Saarland	295	92	26	755	553	381	-187	783	-525	-353	215	
Saxony	-2868	-18	360	-3151	-1442	-3119	-3195	3511	1802	3479	3495	
Saxony-Anhalt	-2607	-1657	-1650	-1875	-4571	-3888	-2881	225	2921	2238	1231	
Schleswig-Holstein	-1952	-769	-987	-1950	-1715	-1895	-1922	963	728	908	935	
Thuringia	-2426	-1930	-1727	-1729	-2896	-3030	-2379	2	1159	1303	652	
Fiscchenländer	-38233	-10249	-9715	-53725	-41947	-42911	-48318	44010	32232	33196	38603	
Berlin	-9721	-3627	-5555	-2388	-10901	-11178	-6783	-3167	5346	5623	1228	
Bremen	75	562	126	469	475	60	-264	595	601	186	390	
Hamburg	-3353	-1172	-1451	-1198	-4458	-3632	-2415	-253	3007	2181	964	
"City states"	-12999	-4237	-6880	-4055	-15834	-14870	-9463	-2625	8954	7990	2583	
Länder as a whole	-51232	-14486	-16595	-57781	-57781	-57781	-57781	41186	41186	41186	41186	
West Länder	-28974	-4578	-5613	-45549	-33101	-31014	-38282	39936	27488	25401	32669	
East Länder	-12537	-6281	-5427	-9843	-13778	-15588	-12715	4416	8351	10161	7288	
Berlin	-9721	-3627	-5555	-2388	-10901	-11178	-6783	-3167	5346	5623	1228	

1) Länder (incl. local authorities). Assumption of a fifty-fifty distribution between Bund/Social security funds and Länder/local authorities.

2) Budgetary statistics without taking into account acquisition and sale of participating interest and loan awards and repayments.

Given the differences in the fiscal histories of individual Länder, a mixed system might have been acceptable (as an interim solution), as was, in fact, proposed by the Bund and some of the Länder⁵². Thus debt authorisation based on population size might have been left as an objective to be attained over the medium term while, over the short term, during an adjustment period, the deficits incurred in preceding years might also have been taken into account. In the meantime the financial position of the Länder has improved as well. In both 1999 and 2000 the deficits run by most Länder would appear to have remained below what a deficit ceiling based on population size would have indicated (see Table 7). In 2001, however, the financial position of the Länder will again deteriorate considerably, in view of the large falls in tax revenue associated with the recent tax reform.

Distribution of sanctions

The Länder were equally unable to reach a consensus concerning the imposition of *sanctions* in connection with the excessive deficit procedure.

⁵² See Vesper (1999) p. 202, Sturm (1998), North Rhine Westphalia und Lower Saxony. The proposals differ considerably, however, in their formulation.

The initial Federal Government's proposal envisaged a strict "perpetrator principle". However, the Federal Government proposed later on a diluted form⁵³. Sanctions amounting to 0.2% of GDP would be carried by the overall public sector (fifty-fifty between the Federal Government and the Länder). Länder which exceeded the deficit-financing ceilings (established by decree according to the prescribed criteria) would be subject to a penalty equivalent to the variable portion of the sanction and would have to allocate this among their municipalities in accordance with their own criteria. In the eventuality that each level of government were to remain below its appointed deficit ceiling but a pecuniary punishment were still exacted⁵⁴, the Federal Government's model provided for an allocation of the penalty in keeping with the formula for distributing "deficit authorisations". The Länder differed widely in their views on how possible sanctions might be allocated. Whereas financially stronger Länder such as Bavaria and Baden-Württemberg espoused a diluted form of the "perpetrator principle", other Länder (for example, Lower Saxony) rejected any attempt to regulate the distribution of sanctions on the grounds that they did not consider it to be practically feasible. A fundamental argument put forward against the strict "perpetrator principle" was that a Land or, even worse, a municipality could by no means afford to pay a penalty based on national GDP and that the German constitution, at least in its present form, which includes the "confederate" principle, would not permit the imposition of such a heavy and unusual financing burden⁵⁵. Moreover, since regionalised national accounts deficits were not available, the intergovernmental implementation of a stability pact would have to be based, in the final analysis, on budgetary figures. Although the national accounts results might be approximated by summing up specific budgetary categories, it would at the same time be necessary to tolerate a considerable degree of ambiguity, which could be expected to give rise to political infighting. Finally, the question would have to be addressed as to which government the actual perpetrator of the punishable offence was. The European Stability and Growth Pact envisages payment of a non-interest-bearing deposit on the initial violation of the deficit limit. A non-recoverable penalty fee is imposed only later if the excessive deficit has not been reduced. Now, how should a situation be handled in which different

⁵³ See Sturm (1997).

⁵⁴ This could happen, for example, if GDP is lower than expected and the deficit ratio increases as a result. The national accounts deficit could also deviate from the budgetary deficits.

⁵⁵ A penalty amounting to 0.2% of Germany's GDP would, for example, be almost equivalent to the total budget volume of Saarland and its municipalities.

public authorities were responsible in different years for exceeding the deficit ceiling? Those Länder critical of the perpetrator principle suggested that the hypothetical penalty be paid by the Federal Government initially. The latter would then have the opportunity to refinance itself through a corresponding change in the allocation of turnover tax revenue in its favour. The problem with this proposal, however, is that such a reallocation also requires the approval of the Länder, which in individual cases might not be forthcoming.

In the end no consensus on a national stability pact

In the end, no consensus was finally reached on a national stability pact in Germany because the line between the constitutionally guaranteed autonomy of the Länder and the fixing of workable criteria impinging on that autonomy was too thin to secure consensus. Since the Federal Government is dependent on the approval of the Länder to implement a national stability pact, and the latter could not agree on crucial points, no national pact was adopted. This shows that the Länder have, in certain respects, a very limited interest in legally binding solutions since they do not offer any advantages for them. This is all the more true given the fact that, in the absence of a national stability pact, the Federal Government remains primarily responsible for compliance with the criteria and for the payment of any penalties incurred. Since, at the present time, the public deficit ratio appears to offer a comfortable safety margin with regard to the 3% reference value, the national stability pact is not considered an urgent fiscal policy matter.

5. Concluding remarks

Maastricht treaty and European Stability and Growth Pact

The purpose of the Maastricht Treaty was to ensure the long-term sustainability of public finances in the European Union and to defuse, from the outset, a potential conflict between monetary and fiscal policy within European monetary union. A public deficit ratio of 3% and a debt ratio of 60% were fixed as ceilings, which could only be exceeded in exceptional cases. The European Stability and Growth Pact specified, in particular, the sanctions which would follow on violation of Maastricht Treaty criteria and the criteria applicable to exceptional cases which would justify a

violation of the 3% limit. In addition, participants in monetary union committed themselves to pursuing a budgetary position which was in a medium perspective almost balanced or in surplus. Public finances were to be so conducted as to allow for safety margins that would ensure compliance with Maastricht criteria in the face of unfavourable economic conditions or possible unexpected shocks⁵⁶. Moreover, the fundamental goal of achieving at least an almost balanced budgetary position over the medium term was to be pursued.

The “Federal implementation” of European agreements: “Balanced budget rules” for the Bund and Länder

Germany’s failure to implement a national stability pact is, in the end, attributed to the varied and specific interests of the central and regional authorities. The conflict between budgetary autonomy and Länder and municipality identity, on the one hand, and joint responsibility for complying with general government obligations, on the other, was not resolved. However, the author feels that the usual approach to drafting a nation-wide agreement was, by virtue of its very conception, ill-suited to accommodate Maastricht Treaty requirements and the European Stability and Growth Pact. The guiding principle was to cement the status of Maastricht’s 3% deficit ratio ceiling as a fiscal reference point at the national level by distributing the deficit allowed by the Treaty to different levels of government. At the same time, the impression was often given that the larger the deficit authorisations assigned to different regions, the greater the advantages accruing to them. In point of fact, it was the politicians who were more likely to have profited from this privilege – namely, the postponement of a fiscal burden – rather than the actual inhabitants of a region. In the end the procedures proposed were relatively complicated, more or less transparent, but always extremely controversial.

It would have been more straightforward and adequate if the European Stability and Growth Pact, which had been approved in mid-1997 had been taken literally. Federal implementation of the Pact’s intentions would result in the Federal Government and the Länder committing themselves to achieving at least a balanced budget over the

⁵⁶ Moreover, Länder with large debt ratios should show more ambitious budgetary items which ensure a rapid decline in the debt ratio.

medium term⁵⁷. A balanced budget rule could be implemented without recourse to complicated intergovernmental rules for the assignment of deficit ceilings and would simultaneously - i.e. automatically - guarantee an adequate safety margin in view of the overall public sector deficit ratio of 3%. While the existing budgetary regulations for the Federal Government and the Länder which are based on investment would be replaced by the stipulation of a balanced budgetary position, the statutory constraints already in place for the local authorities could be retained. Indeed, on an annual average over the past 20 years, the deficits of the local authorities were, in the budgetary definition, 0.2% of GDP and, in the ESA, 0.1% of GDP. Supplementary regulations would also prove unnecessary for social security services since the existing regulations prescribe that they be, for the most part, structurally balanced⁵⁸.

“Balanced budget rules” not contradicted by the “Golden Rule”

The current statutory framework restricting government borrowing proved incapable of effectively halting the rise in government debt. However attractive a regulation based on the “golden rule” may appear, in theory, its practical implementation has turned out to be problematic. In the process, the definition of investment has revealed itself to be an enduringly controversial and, ultimately, malleable quantity. The problem of depreciations, in particular, was not taken into account (and might, in general, prove difficult to take into account adequately). Beyond that, it may be assumed that in the future the volume of government investment will be less than it has been in the past since many types of investment that had previously been the province of the public sector are now being assumed by the private sector⁵⁹. Moreover, most public sector investment seems to consist of capital expenditure on replacement, which – even if the golden rule is followed – is not intended to justify borrowing anyway. Thus, in the second half of the nineties, government investment adjusted for depreciations in Germany was on average only 0.2% of GDP, and in the past 20 years it amounted, on average, to roughly ½% of GDP (see

⁵⁷ This was also proposed by Schemmel (1997), who advocates a structurally balanced general government budget (p. 27ff), and Fürst (1997) p. 234.

⁵⁸ Under current legislation, any deficits are only temporary and must be offset by adjusting the contribution rates in subsequent years.

⁵⁹ Most of the investment in telecommunications and postal services, utilities and waste disposal has been assumed by the private sector. In future, large segments of the remaining public sector investment in construction are likely to be hived off from government budgets.

Table 5)⁶⁰. Finally, given the demographic trend and the burdens arising for future generations, it again appears appropriate to have recourse to regulations which would have the effect of imposing rather strong limits on the government's ability to borrow.

Cyclical effects to be taken into account but automatic stabilisers rather weak in Germany

As for how a "balanced budget rule" might be formulated, the Federal Government and the Länder should be placed under a strong obligation to indicate their reasons for planning or incurring deficits; the deficits should be offset by surpluses in other years. As a matter of policy, the sole justification that should be given at first are cyclical reasons. This rationale should – in the case of the Länder as well - concentrate on the overall economic situation in Germany since the system of tax revenue allocation in Germany strongly dilutes (indeed at the present time almost completely annuls) different cyclical developments in specific regions⁶¹. It should be evident from the individual public authorities' financial plans that cyclical deficits and surpluses will cancel out over time.

On the whole, cyclical government deficits and surpluses will probably be rather restrained in Germany given that the effect of automatic stabilisers is rather limited⁶². The cyclical impact, especially on the Länder budgets, is not expected to be strong. Although these budgets will be subject to cyclical fluctuations in tax revenue, they will be partly offset on the expenditure side since expenditure on personnel, which makes up a significant part of Länder budgets, and transfers to the local authorities,

⁶⁰ According to ESA 95. The corresponding data, especially the depreciations, are, of course, subject to a high degree of uncertainty. Still, they may be used to provide a rough basis of comparison.

⁶¹ The Financial Planning Council could assume a role in this context. Here the overall economic situation could be discussed and its effect on public finance be evaluated. The Working Group on Tax Estimates might also be consulted when assessing economic or other important temporary influences on tax revenue, which have played a major role in past years. The Working Group on Tax Estimates consists of representatives from the Federal Government, the Länder, the municipalities, the Deutsche Bundesbank, the National statistical institute, the council of economic advisers and the economic research institutes. It convenes twice a year as a rule and forecasts the trend in tax receipts on the basis of current taxation law. The budget plan and the medium-term financial planning of the Federal Government is based on Working Group estimates and these estimates are basically the ones adopted by the Länder as well, albeit in a derivative form owing to their regional adaptation.

⁶² See Deutsche Bundesbank (2000a).

which are based on tax revenue of the Länder, tend to respond procyclically.

The public authority concerned should explain in full other short-term – non-cyclical – shocks, which might justify deficits at that level of government over the short term, and the medium-term compensation for the deficits incurred by the public authority budgets should be specified. In this context, the granting of degressive provisional transfers from other government authorities may be worth considering. However, exceptional shocks which affect the budgets of individual Länder are likely to be rare. These are more likely to pose a problem for local authority budgets, whose receipts (in the form of local business tax) and expenditure (in the form of subsidiary welfare) are both very susceptible to special trends at the regional level⁶³.

The Federal Government and some Länder Governments intend to achieve balanced budgets in future

At the present time, the fundamental objective of achieving balanced budgets over the medium term has also become increasingly important in the political discussion. Thus, at the close of its last meeting in November, the Financial Planning Council observed that balanced budgets over the medium term were necessary, not least if the pan-European requirements were to be met⁶⁴. In its guidelines for a fiscal policy for the future, published in November 2000, the Federal Government affirmed its commitment to the objective of a balanced budget. It is intended to reach surpluses for the Federal Government and for general government as a whole and to redeem public debt. A surplus of 1% of GDP is to be attained for the overall public sector. Although the Federal Government is, accordingly, no longer interested in pursuing a formal national stability pact, in the Financial Planning Council it intends to convince the Länder of the sense of its fiscal policy guidelines⁶⁵. Some Länder recently published their plans for the future in which they envisage balanced budgets. One of the Länder, Bavaria, has committed itself through its budget statutes to achieving a fundamentally balanced budget starting from 2006.

⁶³ See Fürst (1997) p. 234.

⁶⁴ See Bundesministerium der Finanzen (2000b).

⁶⁵ See Bundesministerium der Finanzen (2000a) p. 19.

Amendment of the constitution necessary – incorporation in a structural reform of the public finance system

The implementation of a balanced budget rule should, in the end, be part of a more fundamental reform of the German public finance system. This presupposes an amendment to the German constitution insofar as the existing regulations concerning Federal Government and Länder borrowing would have to be replaced and the budgetary autonomy associated with them curtailed. In order to guarantee sufficient flexibility of the Länder budgets, these balanced budget rules should be included in a more comprehensive reform of the system of public finances. The main aim of such a reform should be to achieve a more concerted disentangling of the fiscal relationships between levels of government and to grant individual public authorities greater responsibility in determining the form their own activities and revenue take.

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