FISCAL INSTITUTIONS AND SUSTAINABILITY OF PUBLIC DEBT IN GERMANY

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Introduction

Safeguarding the sustainability of public finances is one of the key challenges for fiscal policy makers in the coming years. The stock of public debt that has been accumulated over the last decades has reached high levels in many countries and the process of ageing poses a significant risk to the sustainability of public finances in the majority of industrialised countries. Devising policy concepts that tackle these challenges is one of the main tasks for current fiscal and economic policy makers and advisors. The academic literature on the analysis of fiscal sustainability and possible remedies is therefore huge and diverse. Altogether this literature shows clearly that the problem is a multidimensional one and therefore can only be solved in a joint and coordinated attempt of fiscal, economic and social policy. Besides, reforms to strengthen economic growth and employment, far-reaching reforms of the social security system (and, in particular, of the pension system) and of the labour market are without doubt at the core of the agenda.

In the present paper we try to shed some light on a different issue that is yet closely connected to the issue of sustainable public finances. An interesting and still growing political economy literature has emphasised the importance of adequate fiscal or budgetary institutions for safeguarding sound public finances in the long run. Fiscal institutions in this context are understood as the entirety of formal and informal institutions that govern the decision-making process over public spending and revenues of a country. With this perspective in mind, we want to focus more closely on the "fiscalist" aspect of the problem of sustainability and pose the question of what the finance minister, in a more narrow view as being responsible for the budget, can contribute to a coherent political strategy to secure the long-run viability of public finances.

The present paper is divided into two main sections. Section 1 presents the past development of public debt in Germany as well as an outlook on the challenges that lay ahead due to the ageing of the population. In section 2 we discuss, from an applied perspective and quite selectively, existing fiscal institutions in Germany that are targeted at securing sound public finances and discuss approaches to improve these institutions.

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The authors present their personal opinions and not necessarily the opinion of the German Federal Ministry of Finance.

1. Public debt in Germany: the evidence

1.1 Look in the past: debt development in Germany

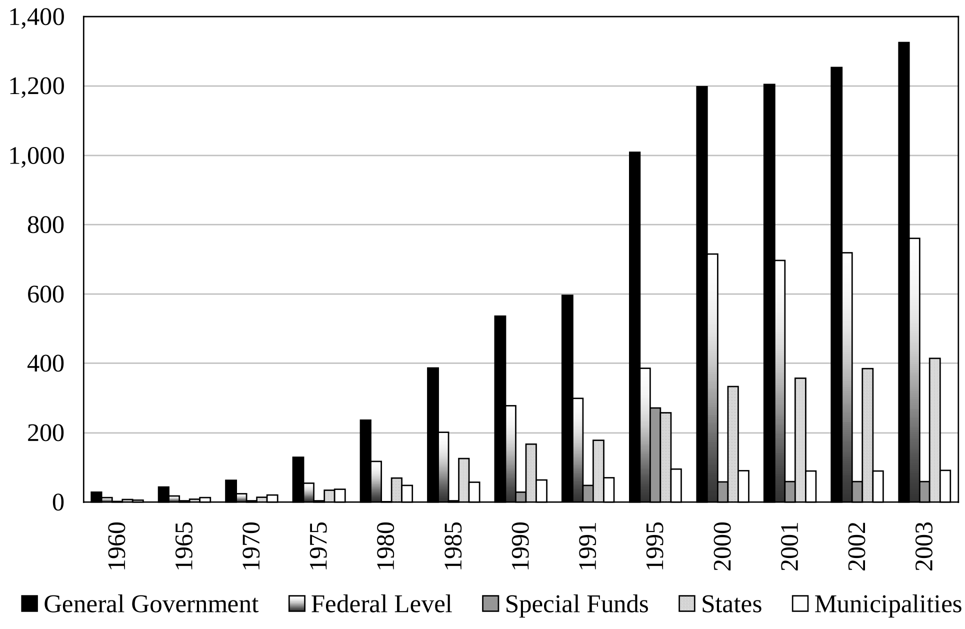
When analysing the development of public debt in Germany, it has to be taken into account that Germany is a federal state, consisting of the Federal level, the states (Länder) and the municipalities (Städte and Gemeinden). Every level of the federal republic has the right of issuing debt (for details see below under 3) and thereby contributes to the overall general government level of debt. Note that, associated with the federal level, are several "special funds", the most important ones being the German Unity Fund, the Equalisations of Burdens Fund and the ERP Special Fund.

Up to 1970, public debt remained at a rather low level, while from 1970 until today general government debt increased by about 1800 per cent. Note the uneven distribution over the whole period: while debt at the federal and at the state level increased by 2552 per cent and 2452 per cent, respectively, the municipalities increased their debt only by about 340 per cent.

From 1970 on, one can observe a steady increase in public debt at all levels of the federal state, while it is noteworthy that until 1976 the municipalities had a

Figure 1

Accumulated Debt at the Different Levels of Government
(billions of euros)



higher level of debt than the states. The increase of public debt in the Seventies basically was made possible by a softening of the legal-debt boundaries at the end of the Sixties on the one hand – the introduction of the comparatively soft "Golden Rule" into the constitution (Article 115 GG) –, on the other hand the passing of the new "Stability Law", which allowed the government to exceed the debt limit laid down by the constitution in the case of a disruption of the overall economic balance. As a consequence of active stabilisation policy, but also through an expansion of debt-financed social expenditure programs, in the Seventies the expenditure ratio as well as overall debt increased considerably. At the beginning of the Eighties, the general government debt ratio reached the level of 30 per cent GDP (see Table 1). During the following years, in particular, the federal government and the states increased their indebtness, while somewhat slowing the growth rate of debt compared to the Seventies.

German unification in 1990 constituted a substantial structural break in the overall course of economic policy in Germany. Some initial overoptimistic forecasts claimed that unification only needed an initial "knock-on financing" which could be refinanced by increased tax revenues of the following expected unification boom. However, after it became clear that an independent and self-financing upswing of the eastern economy was not within reach, public finances had to fill the gap by infusing a massive amount of public transfers to the east. The overall tax and social contribution ratio, as a consequence, rose to a record level of 44 per cent of GDP during the first half of the Nineties, the expenditure ratio increased again to almost 50 per cent and public debt approached the level of 60 per cent. Note that a significant part of the rise in the expenditure ratio was due to the increased claims on the German social security system. Between 1991 and 1995, around 70 per cent of total transfers were used for financing the deficits of the public social security system as well as for supporting the development of public administration and bureaucracy in the east of the federal republic. Around 30 per cent on the other hand were used for public investment and the financing of the "Treuhandanstalt", a trust agency that was in charge of the privatisation and restructuring of the east German economy. Until today, the fiscal consequences of unification are not cured, which is indicated by the comparatively high level of above 60 per cent of GDP at which public debt is remaining.

The debt level of the federal state, including the special funds, reached 778.6 billion € (59.02 per cent of GDP) at the end of 2002, where the special funds had a share of 59.2 billion €. Net new debt was at 32.7 billion € in 2002. Interest payments in that year amounted to 37.1 billion €, which was 14.9 per cent of total federal expenditure, coming down from a high of 16.6 per cent in 1999. In 2002, interest payments amounted to around 1.8 per cent of GDP. In addition to the federal level, in 2002 states and municipalities had reached a level of debt of 384.8 billion € and 82.7 billion € respectively (in 2002, net borrowing amounted to 29.3 billion € and 4.6 billion € respectively). Consolidation of the different levels into the general government gives a total amount of debt of 1,253.2 billion € at the end of 2002.

Table 1

Public Debt
(percent of GDP)

	General Government	Federal Level	Special Funds	States	Municipalities
1960	18.74	8.66	1.2	5.03	3.81
1965	18.38	7.63	1.5	3.70	5.57
1970	17.88	6.94	1.2	3.98	5.79
1975	24.11	10.22	0.6	6.32	6.96
1980	30.87	15.34	0.2	9.07	6.25
1985	40.49	21.00	0.3	13.18	5.98
1990	42.06	21.74	2.3	13.09	4.95
1995	56.03	21.41	15.1	14.29	5.27
2000	59.02	35.25	2.9	16.41	4.49
2001	58.06	33.63	2.8	17.25	4.33
2002	59.38	34.09	2.8	18.23	4.26
2003	62.26	35.72	2.8	19.49	4.30

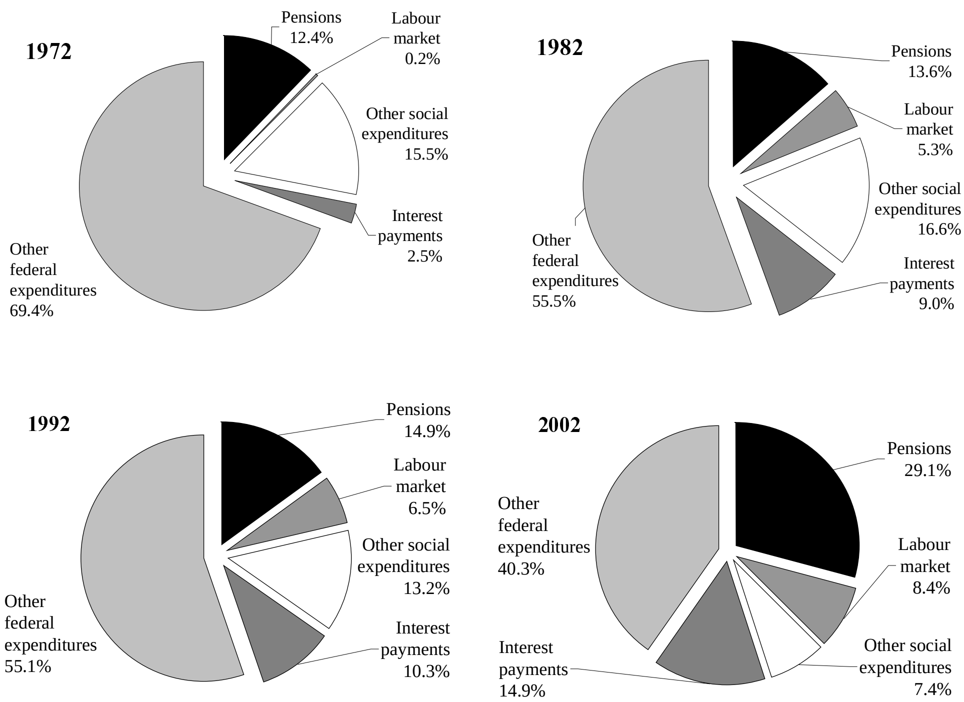
Source: Federal Statistical Office, own calculations.

1.2 Structure of the federal budget: increasing share of "tied" expenditures

To illustrate the diminishing room for manoeuvre for fiscal policy in Germany over time, Figure 2 presents the expenditure structure of the federal budget for selected expenditure categories for the years 1972/82/92/02. The figure suggests that the federal budget is getting more and more "past-oriented". An increasing share of public expenditure is spent for debts incurred in the past and for the social security system. Whereas, in 1972, 14.9 per cent of public federal expenditure went to interest payments and as federal subsidies to the public pension scheme, in 2002 this share already amounted to 44 per cent. Federal expenditure for pensions, labour market, other social expenses (child, parenting and living benefits, family policy among others) and interest payments, taken together, even amounted to 60 per cent of total expenditure in 2002, compared to 33 per cent in 1962. One key problem of this development is that an increasing amount of expenditure in the yearly federal budget is "tied", due to legal obligations of the state, the consequence being that it is almost impossible for the government to reduce this expenditures in the short run. Other expenditure categories that are more "future-oriented" are hence squeezed out and the government, as a consequence, is increasingly losing control over a significant part of its main fiscal policy instrument. It is self-evident that unless the

Figure 2

Structure of Expenditure of the Federal Budget
(shares in total expenditure)



government takes more countermeasures, the ageing of the society that lays ahead as the key challenge for fiscal sustainability in the future may easily worsen this process (see also below in section 1.3).[1]

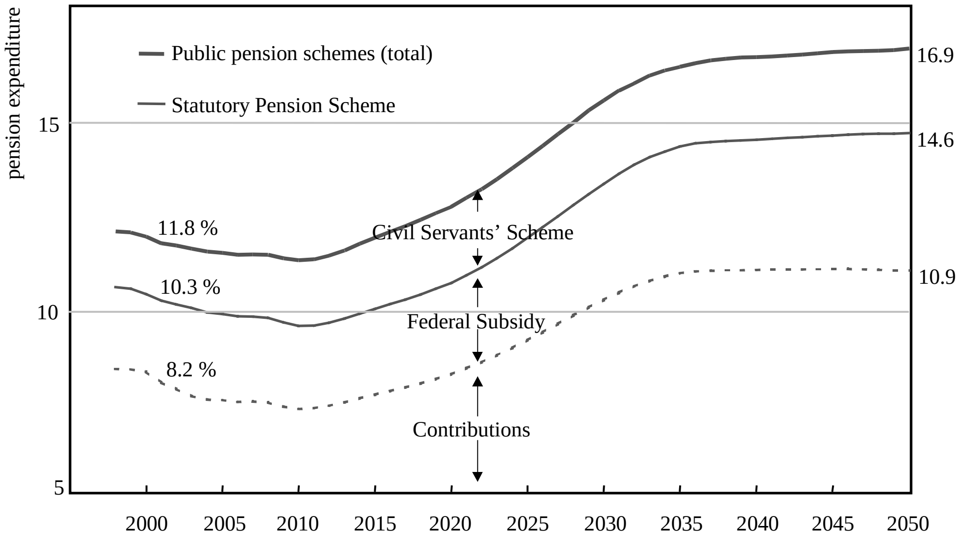
1.3 *The look ahead: challenges to sustainability due to demographic factors*

Germany is a country that will be strongly affected by the demographic challenges that lay ahead. All demographic projections available indicate the

[1] It has to be stressed that one can read only raw tendencies and trends from these kind of figures, as, due to changes in the laws and in the budget system itself, figures on the federal budget are not always consistent and directly comparable over time. For example, from 1996 on, the child benefit – until then part of the category "other social expenditures" – is no longer a direct government expenditure, but is instead reimbursed via the tax system. This is one reason for the decrease of this category from 1992 to 2002, while qualitatively there has been no change. Note, however, that the trend visible in Figure 2 is also existent if one looks at the change over time in the different expenditure categories as a share of GDP.

Figure 3

Public Pension Expenditure per GDP up to 2050
(percent of GDP)



Source: IFO (2000), simulations for the "standardised scenario" of the EPC.

continued ageing of the population, this process reaching its peak in the 2030s and 2040s. The main causes for this development are an increasing life expectancy and low birth rates since the Seventies, while the baby-boom generation of the Fifties and Sixties now begins to enter the age of retirement.

There are many studies available that analyse the potential effects of ageing on public finances, see, e.g., EPC (2001) or Banca d'Italia (2000) and the references therein. It is beyond the scope of this paper to give an overview over this literature and especially the methodological problems connected to projections in the long-term future. Nevertheless, we want to present one example that gives an idea of the challenges that lay ahead. One of the key pillar of the German social security system that will be impacted severely by the demographic trends is the public pension scheme. In 2000, the IFO (Institute for Economic Research) in Munich was commissioned by the Federal Ministry of Finance to analyse the financial development of the Statutory Pension Scheme and the spending on the Civil Servants' Scheme up to the year 2050, see Werding and Blau (2002) for details. As this study was the national input to the first round of sustainability analyses by the EPC in 2001,[2] the projections are based on the standardised assumptions agreed

[2] See EPC (2001) for more details and a comparison of all EU member states. A second round of harmonised EU-wide sustainability analyses is due in 2005.

upon in the EPC beforehand, see Werding and Blau (2002) and EPC (2001) for a detailed description of the assumptions and the different scenarios projected. The model used (CESifo pension-model) is based on a partial equilibrium approach to forecast the pension budgets and the retirement benefits for civil servants. In its calculations, the legal framework is that of the end of 1999, recent changes in pension legislation will be considered in a new study of the IFO Institute due in autumn 2004.

The main result of the model projections can be seen in Figure 3, which plots the projected development of public pension expenditure per GDP for the years up to 2050. It can be seen from the figure that until 2015 there will be some relief in the Statutory Pension Scheme mainly due to the pension reform implemented in 1999. Total expenditures (including contributions to the Statutory Pension Scheme, the federal subsidy as well as the civil servants scheme) will decrease from 11.8 per cent in 2000 to around 11.2 per cent in 2010, being back at the initial level at 2015. However, after 2015 total expenditures increase steady until 2035 and reach a level of 16.9 per cent in 2050, given that there will be no more adjustments to the system. With respect to the contribution rate, the projections of the IFO show that, without any additional measures, it decreases from 19.3 per cent in 2000 to about 17.3 per cent in 2015, while it afterwards increases sharply and remains at a level of 26.4 per cent up to 2050.

2. The role of fiscal institutions in securing long-term sustainability of public debt in Germany

With respect to sustainability-oriented fiscal policies, one hugely important issue is to look at the existing system of laws and regulation that form the social insurance system and that bring about concrete and legally-binding expenditure duties for the state. The key point here is that laws and regulations that make up the social welfare state have direct fiscal consequences either directly via higher expenses or, indirectly, via negative impact on growth and employment and probable reduced tax revenues.

In the present paper, however, we do not want to focus on the issue of social reform, although it is certainly of paramount importance for the ongoing viability of the system. Rather, here we try to shed some light on the more “fiscalist” aspects of safeguarding sound public finances and on the contribution of fiscal institutions to sustainability in a broad sense, which is a problem of the right policy and of the proper functioning of the institutions. An extensive and still growing political economy literature has highlighted the importance of proper fiscal institutions for sound public finances. Fiscal institutions in this context are understood as the entirety of institutions that govern the decision making process over public spending and revenues of a country. These institutions include the formal and informal decision-making rules that distribute authority and control over public finances, determine who does what and when in the decision-making process, and channel the flow of information among the relevant actors (Perotti *et al*., 1998).[3]

In the present paper we intend to approach this rather broad topic from an applied perspective. We discuss existing institutions that support a medium- to long-term perspective on the budgeting process in Germany and develop approaches aimed at improving the existing fiscal institutions.

2.1 Medium-term financial planning

The federal budget in Germany is planned and executed on a yearly basis. Nevertheless, in 1967 medium-term financial planning was introduced into the German budget system to have some sort of forward-looking element in the budget process:

- to take into account likely developments in public finances in the medium term when making the decision incorporated in the yearly budget;
- to identify at an early stage the full impact of new measures, reform projects, etc.;
- to assess the scope for fiscal policy action in future years;
- to identify in good time undesirable fiscal policy trends with longer-term impact and to enable policy decisions to counteract them at an early stage.

The German system is based on a five-year period. The first year in the period is the current fiscal year. The second year is covered by the draft budget for the next fiscal year, and this is followed by three genuine planning years. The whole financial plan is "rolled forward" every year, to be able to respond flexibly to recent political decisions and potentially changing economic conditions.

The medium-term financial plan in Germany includes the expenditure as well as the revenue side of the budget. For this reason, a system of advance tax estimation is installed to ascertain what the tax revenues will be in the medium term. In particular, for the revenue forecast, but also for the forecast of certain expenditure categories, a sound medium-term projection of key macroeconomic data is necessary. This is provided in the bi-annual macroeconomic forecast of the federal government.

In the German system of financial planning, a forecast of aggregate economic development is made for the first two years of the planning period, taking account of discernible trends in economic activity. In contrast, the medium-term projection of the envisaged development of the economy in the last three years of the planning period deliberately makes no allowance for fluctuations in the level of economic

[3] Note that of course there is a direct connection between the issue of social reform and the existence of proper fiscal institutions. Particularly relevant are "tied expenditure" in the budget due to legal entitlements in the social security sector that may lead to a loss of control over a significant and increasing part of the budget, see section 1.2 and, among others, the discussion in Strauch and von Hagen (2001).

activity. This cyclically-neutral projection is intended to have a stabilising effect on private-sector decision-makers, and serves at the same time to ensure a balanced fiscal policy.

All states and municipalities in the federation are obliged to draw up a financial plan. The necessary coordination of the budgets and financial plans of the different levels of government is undertaken by the Financial Planning Council. This is a coordinating body at ministerial level with the federal minister of finance in the lead, comprising in particular the finance ministers of the states and representatives of the associations of the municipalities.

Overall, the financial plan has indeed become a useful tool for fending off excessive demands on the budget. Moreover, the obligation to draw up a financial plan each year reinforces awareness within the federal government of the need for financial discipline and responsible budgetary policy. However, while financial planning is a valuable instrument, it cannot guarantee the implementation of a sound budgetary policy. One key problem in this context is the non-binding nature of the medium-term financial plan. In particular, it may be adjusted every year in the course of the budgeting process without the need to explain the changes. Medium-term financial planning, therefore, while being a useful tool to support a forward-looking budgetary policy, has to be supplemented by other mechanisms and procedures that frame the conduct of fiscal policy to support its long-run sustainability.

2.2 Transparency and information

One key aspect of sound budgeting institutions is to ensure the transparency of the budget and of the budgeting process. The more detailed and disaggregate information about the budget is freely available, the easier it is for the parliament to exercise its control function and for the public, more in general, to form an objective opinion on the fiscal policy of its government. This, in turn, increases pressure on the government to implement sound fiscal policies that reflect the view of the majority of the population. Transparency and information, thus are a key "institution" that supports sound public finances in a democracy.

In general, the German budget process is judged as being very transparent – recently confirmed by the IMF in the 2003 Report on the Observance of Standard and Codes in Germany – and the constitution and several additional budget laws (Law on Budget Principles, Federal Budget Code and the annual Budget Statute with the budget itself in the annex) establish a number of provisions that are essential for an orderly and efficient budget management (see, for instance, Federal Ministry of Finance, 2000).

However, one aspect that is criticised quite often in the current debate on the sustainability of public finances is the fact that the consequences of ageing – in particular, increasing liabilities resulting from the public pension system – are not explicitly taken account of in the official budget process. To increase transparency and especially information in this area, the first step is to increase public awareness of the dimension of the upcoming problems. Although there are a lot of academic studies around that demonstrate the fiscal consequences of ageing, it seems likely that the broader public does not really take notice of these studies und therefore is relatively uninformed about potential future developments. Furthermore, one key challenge for policy makers today is that the consequences of ageing will in its full dimension only be felt in the future, while significant and political adjustments, to some extent “painful” for the public, are necessary already today.

Therefore, increased efforts have to be undertaken to inform the public about the coming developments and challenges, not least to gain political support for necessary political measures today. The Federal Ministry of Finance, therefore, plans to inform the public about the consequences of the ageing of the population with a new *Sustainability Report* which will be published in 2004 for the first time. The report will present a sustainability analysis of the sort presented in section 1.3 of this paper. In addition, the report will try to spell out a fiscal, economic and social policy strategy of the government which embeds the different political reform options in a concrete political program. It thereby intends to fill a still existing gap in the political discussion on public finances in Germany.[4]

2.3 The “optimal” structure of the budget to achieve long-term sustainability

The public debate on public finances has devoted increasing attention to the concept of quality of public finances during recent years. This is due to the fact that a long-term consolidation strategy has to focus not only on the quantitative aspects of the consolidation but also on qualitative or structural issues. The growth-enhancing restructuring and the efficiency-improving design and management of public expenditure (and revenues) can quite clearly be described as one major policy challenge with evident macro- and micro-economic implications.

2.3.1 The PEGS-budget concept

Background

The aim of structural consolidation is to strengthen future-oriented public expenditures, *i.e*. those public expenditures that are of high quality, in the sense that they improve economic growth, employment and sustainable development.

As a first step towards improving the quality of the budget, information about the budget quality has to be gained. In the following, a new indicator of the quality of the budget is presented that is based on a study of the Cologne Center for Public

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4 While consistency with the medium-term financial planning certainly has to be secured, it has to be stressed that it seems not to be useful to directly connect a sustainability analysis with the yearly budget process, especially as a yearly update of the sustainability analysis doesn’t seem to be sensible and necessary.

Finances, commissioned by the Federal Ministry of Finance (see Thöne, 2004, for details). The focus of this indicator lies on exposing expenditure categories that encourage economic growth, employment, and sustainable development (PEGS = Public Expenditure for Growth and Sustainable Development). It should be viewed as complementary to other indicators and, therefore, assist the broader analysis of the quality of public finances. It thereby may serve as one input to a broad strategy of qualitative consolidation.

Traditionally, public investment expenditure is treated as a synonym for precautionary policy with major merits for future generations. Consumptive expenditure, in contrast, has the reputation of being unproductive. This distinction is the basis for the German "Golden Rule" of article 115 of the federal constitution that restricts the scope of deficit-financing to the amount of public investment. Yet, recent empirical research doubts the old dualism investment and consumption-spending for two reasons.

Public investment is often assumed to generally exert a positive influence on economic growth. This assumption stems from large network-infrastructures in transport, communication and public utilities. For example, roads, railways and harbours are intermediate public goods that generate benefits as inputs in the production process and thereby increase the efficiency of the private sector investments. Where public investment expenditure significantly contributes to the production of indispensable public goods, economic theory expects positive impacts on economic growth. Yet, this kind of expenditure accounts only for the minor part of official public investment expenditure in Germany. Additionally, empirical findings hint at saturation effects and a low marginal utility of new public investment in highly-developed economies.

Even though network-infrastructures are very capital-intensive public goods, it is still the provision of infrastructures services that count for economic growth. Infrastructures without the complementary operating services rapidly lose their productive potential for the economy. A survey of the empirical literature shows that many categories of consumptive government-spending may indeed produce positive growth effects, see Thöne (2004) for details:

- one important example is investment in human capital, although many studies are based on output (e.g., schooling quality) of public activity in this area, not public expenditure *per se*,
- another important example is research and development that in general ranks high among the major causes for long and sustained economic growth in industrialised countries. Yet, the question whether this qualification holds for public R&D-activities (and R&D-expenses) is highly controversial. The crucial issue is whether public and private R&D are substitutes or complements. Only in the latter case, public R&D expenditures may have a positive impact on growth. The empirical findings on this question are heterogeneous, while many studies find evidence for a complementary relationship.

Differences in labour utilisation are considered to be another important cause of growth disparities between the United States, Australia, Canada and Ireland on the one hand and continental Europe and Japan on the other hand. Low labour utilisation in Europe results from (a) fewer hours worked annually and (b) low participation rate in the labour market. In continental Europe, early retirement is customary, and in many European countries women still have insufficient chances and incentives to combine family life with a long-term professional career. Thus, active labour market policy to increase participation in the labour market can be viewed as a helpful additional measure to enhance growth potentials.

Finally, the government's health policy is traditionally seen as one key government activity that increases the quality of human capital in the economy. Recent empirical research, however, questions the direction of causality in the relationship between growth and health, especially in rich countries.

Based on these considerations, an alternative "quality" indicator, Public Expenditure for Growth and Sustainable development (PEGS), is introduced. The PEGS-budget consists of expenditures in the following policy fields: schools and nursery schools (including overseas schools); colleges, universities and other education (including financial assistance to students); science and R&D outside universities; family policy (family allowances, maternity protection, early childcare, etc.); active labour market policy; public health service; environmental and nature protection (incl. nuclear safety and community amenities); promotion of renewable energies and infrastructure-services in transport and communication.

The PEGS-budget: an application to Germany

Figure 4 shows the PEGS-expenditures of the German federal government as a share of GDP, Figure 5 as a share of total expenditures from 1975 onwards. In a similar manner, it is possible to identify the PEGS-budget for the general government. Due to the specific division of functions within the German federal state, the share of PEGS is slightly larger at the state level (almost all education expenditures are done at the state level) and even higher at the municipal level (the majority of infrastructure investment is done at the municipalities level) than on the level of the federal government.

Overall, the PEGS-budget as share of total expenditure displays the same trend as investment expenditure: coming from a high level in the Seventies, the PEGS decreased and stagnated during the Eighties. With German unification, the PEGS-budget jumped upwards to a new level in the early Nineties. In 1995, the federal PEGS-budget amounted to 19 per cent of federal expenditure (and 20.6 per cent of total government expenditure). Note the following: in 1996 a rearrangement of the way child benefits are paid out caused a structural break and hampered the intertemporal examination of the data. With the beginning of 1996, the child benefit is no longer an expenditure but instead is reimbursed via the tax system. Thus, a "sustainability-relevant" expenditure was succeeded by a tax exemption which is equally "sustainability-relevant", but nevertheless not part of the PEGS-budget.

Figure 4

PEGS Expenditures applied to Germany
(percent of GDP)

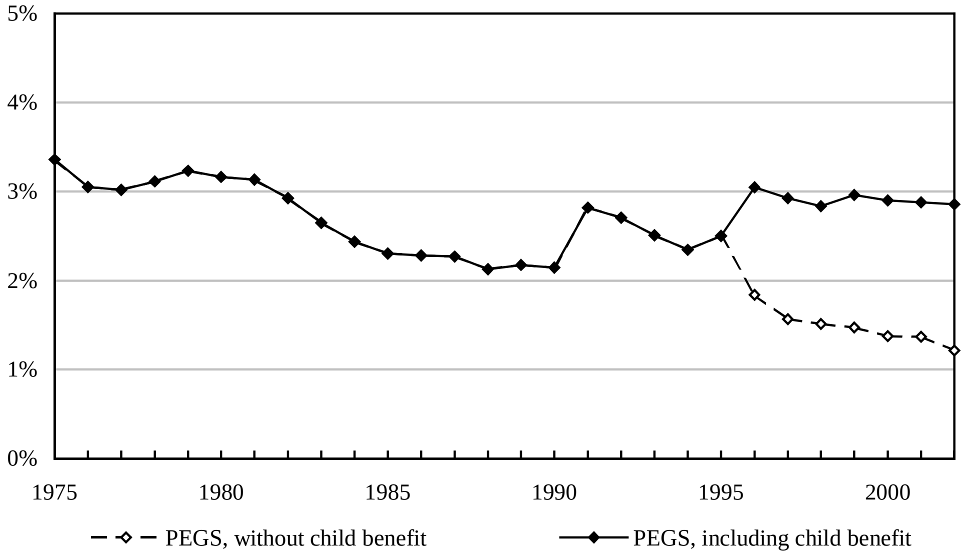
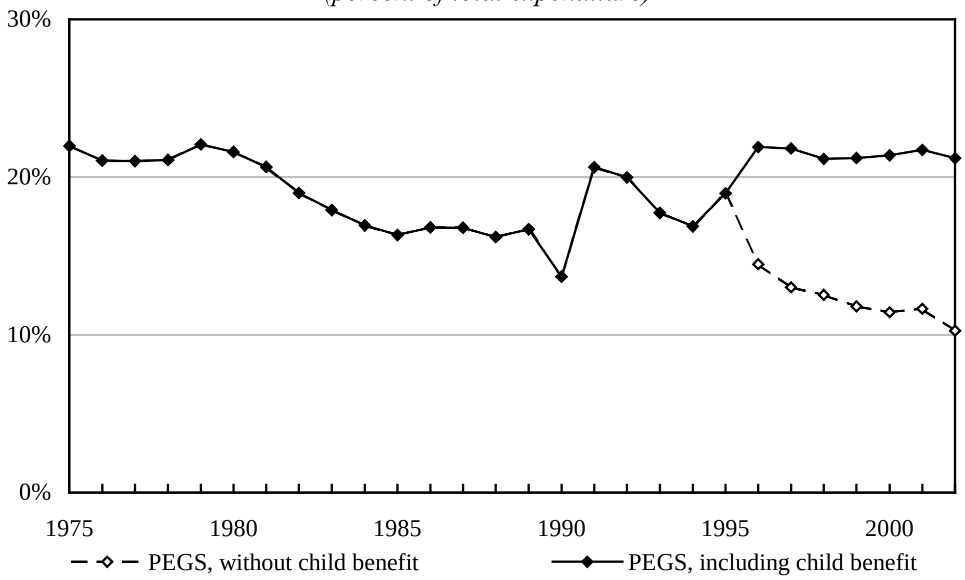


Figure 5

PEGS Expenditures applied to Germany
(percent of total expenditure)



Figures 4 and 5 show the huge difference between the PEGS-budget without the family allowance and a hypothetical PEGS-budget that includes this tax expenditure. Taking the tax allowances into account, the PEGS-budget rises to a level comparable to the Seventies, otherwise the share declines continuously.

Methodological shortcomings of PEGS

The PEGS-budget is thought to serve as a first starting point to measure the quality of public expenditure. The PEGS-budget in its actual form certainly has shortcomings. The most important of them are:

- no provision for tax expenditures. The case of the child benefit immediately shows one of the main shortcomings of the indicator: since tax expenditure and direct expenditure are substitutes, the PEGS-budget and the overall government budget remain incomplete as long as tax expenditures are not taken into account systematically,
- pure input orientation. From an economic point of view, the actual positive effects of expenditures stem primarily from government activities, not from the expenditures *per se*. Consequently, input data, *i.e.* public expenditure in a PEGS-activity, should be interpreted with great care when one is actually interested in the output effects, like, for instance, schooling quality.

Both criticisms show that the PEGS-concept warrants further work to be more utilisable for practical purposes. In general, the Federal Ministry of Finance considers to take this new indicator into account for its consolidation strategy, while it is still unsettled how to proceed from the first step of a general quality analysis to the second step of incorporating these concepts concretely into the budget process.

2.3.2 Subsidy control

There is the widespread belief – partly theoretical, partly ideological – that granting subsidies always violates the principle of "good allocation". As a consequence, one can observe some public support for radical cures, such as prohibition or linear reductions of all subsidies ("lawnmower method"). However, the starting point of our discussion of subsidy control is the observation that subsidies *per se* are neither good or bad, neither necessary in general, nor indispensable on the whole. Consequently, like any other policy instrument, they must be judged on their merits: can they be implemented successfully? Do they enhance the incentive structures? Do they reach their addressees, thus promising to accomplish their political purpose? Finally, are subsidies cost-efficient instruments? The acknowledgment of potential justifications for subsidies implies the necessity of a critical review and control of subsidies instead of, for instance, the proposed linear reduction of all subsidies.

A key challenge to subsidy control already arises at the first level of the control process, namely the questioning of a subsidy's objectives. Before asking how the aim may best be reached on the operational level, the justification of a subsidy has to be critically assessed. In doing so, usually not only the rationale of the subsidy itself will be under investigation, but the justification of a public intervention in general must be questioned regardless of the particular instrument employed (potential justifications include the existence of externalities, economies of scale, imperfect information and the like). Obviously all potential justifications cannot completely rule out subsidies that distort markets or violate the principles of allocation. Consequently, systematic subsidy control must review the objectives of a public intervention on a regular basis in order to assess whether the original justifications can still be sustained. Of course, the review of subsidy objectives must also take potentially negative effects of public aid measures into account. In a second step, the success or failure of the single measure in achieving the objectives has to be evaluated. In this context, the significant problem of how to measure the effectiveness and efficiency of the measures arise, see the extensive discussion in Thöne (2003) for details.

As a first step in the direction of a systematic subsidy control, in 2002 the Federal Ministry of Finance developed a questionnaire for the control of the efficiency of all granted expenditure subsidies. This was the basis for the first step of a systematic controlling of subsidies that was introduced in the preparation of the federal budget for the year 2004 and of the federal financial plan 2003-07. Every subsidy that is part of the federal report on subsidies was reviewed on the basis of the control scheme. Questions that had to be answered by the relevant ministries responsible for the respective subsidies included the following: what are the legal obligations within the medium-term financial planning horizon? Is the aim of the subsidy clearly defined and justified? Is the subsidy in this form the suitable instrument to reach the defined aim? Is it effective and efficient? Is it possible to grant the subsidy in a degressive manner?

It is planned to establish this inquiry as a regular instrument in connection with the budget preparation procedure. Furthermore, to put the attempt for a sustainable reduction of subsidies in a more systematic and binding framework, on the occasion of passing the 19th Federal Report on Subsidies, the federal cabinet agreed on the following principles for the future subsidy policy of the government:

- in the future, new subsidies are granted only, if at all, as expenditure subsidies and not as tax benefits;
- new subsidies are granted only temporarily and in a degressive manner;
- aims of new subsidies are defined in a manner that allows a success control;
- the above-mentioned aims are to be applied to all existing subsidies. Thereby it has to be examined to what extent existing tax subsidies can be transferred into expenditure subsidies.

Based on these policy principles and utilising the above-mentioned control scheme, the Federal Ministry of Finance plans a systematic stocktaking of all existing subsidies with precise information about time restrictions, degression and success control during the course of 2004. In a next step it is planned to work out concrete needs for action for the future subsidy policy.

2.4 The role of national fiscal rules

2.4.1 National institutional boundaries to debt

Budgetary rules may be one building block to restore or safeguard sustainable public finances. Indeed, many OECD countries have installed fiscal rules at the national level, for an overview see, e.g., OECD (2002). In Germany, the constitution (Article 115 GG) provides for a "Golden Rule" at the federal level, according to which the federal deficit must not exceed federal investment spending. This rule, however, may be breached when the national economic equilibrium has been disrupted. Notably, most state constitutions also provide for a Golden Rule in their constitutions or budget rules. A more strict solution is provided for at the level of the municipalities, who are allowed to resort to public borrowing only when other means of financing are not possible or appropriate. Moreover, borrowing by the municipalities has to be approved by the states.

Yet, there are many critical voices that claim that these regulations are not sufficient to ensure a sustainable limitation of public debt in Germany. The main reasons put forward in the debate are that public investment is defined in a rather broad sense, that the rules apply only to the Federal budget and therefore may be circumvented by debt issuing of special funds, and finally that there is no powerful enforcement mechanism when the limits on borrowing are breached.

A full critical appraisal of these arguments is clearly beyond the scope of this paper. Yet, only when looking at the debt figures (compare to section 1) it is apparent that the statutory regulations have not been able to prevent a sizeable increase in the stock of public debt. Moreover, the much stricter deficit and debt limits provided by the Maastricht Treaty increasingly dominate the debate on public debt and represent an even bigger challenge to the existing fiscal policy institutions in Germany.

Historical experience shows that the federal structure of the state makes a unitary systematic fiscal policy strategy very difficult. Many areas of responsibility remain at the state level and the states exercise quite significant influence on the decision-making process through the upper house of the parliament. Coordination of the different levels to find a coherent fiscal strategy is quite loose and so far the states have resisted initiatives to find some sort a stronger form of coordination between the different levels of government.[5]

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[5] Non-binding coordination of public finances across different levels of government is done within the Financial Planning Council, which is composed of the Federal and the state finance ministers and other local authority officials.

2.4.2 A "national stability pact"?

The Stability and Growth Pact demands the member states of the EU to build up effective national mechanisms to ensure that the deficit and debt levels prescribed by the Treaty are met. Against the background of Germany's federal structure and the considerable degree of budget autonomy granted to the states by the constitution, some sort of a "coordinative" deficit and/or debt restriction is certainly necessary. During the Nineties there was a considerable political and academic debate on the optimal shape of a national stability in Germany, see Wendorff (2001) for an overview. Although the Federal Ministry of Finance and some states came up with reform proposals, in the end no agreement could be reached due to strongly divergent interests of the parties involved. This is remarkable, as the general need for some sort of national regulation that safeguards the proper functioning of the Stability and Growth Pact was not denied. But it is important to mention here that the Federal Government had no legal or specific political powers to force the states in such a pact against their will. Germany, hence, cannot be directly compared with other federal states like, for instance, Austria.

It was in the context of the imminent *Early Warning* of the Ecofin Council in 2002 that the issue of a national stability pact regained interest. While during the Nineties the possibility of Germany's general government deficit breaching the 3 per cent limit of the Treaty looked rather theoretical, it became concrete in 2002. For this reason, the Financial Planning Council decided, at a special meeting on 21 March 200,2 to bring forward to the year 2002 an amendment of the Law on Budgetary Principles (HGrG) which had already been agreed in the Law to continue the Solidarity Pact but was originally to have effect only from 2005 onwards. The new Section 51a of the HGrG is concerned with a procedure to implement at national level the commitments entered into by Germany at European level in the Maastricht Treaty and the Stability and Growth Pact.

Section 51a of the HGrG stresses the common responsibility of the Federation and the states to comply with the budgetary discipline within the framework of the European economic and monetary union. Federation and states are enjoined to reduce net borrowing with the aim of achieving budget balance. The Financial Planning Council plays a central part in the procedure to ensure compliance with budgetary discipline by issuing appropriate recommendations especially on a common expenditure line as a yardstick for the budgets of the federal and state governments (including local authorities). The Council also assesses whether trends in the budgets of the federal, state and local governments are in line with the provisions of Article 104 of the EC Treaty and the European Stability and Growth Pact. If necessary, the Council makes recommendations on measures to be taken to restore compliance with budgetary discipline. The amendment to the law took effect in July 2002.

This strengthening of the role of the Financial Planning Council places greater weight on the effect of decisions reached in a cooperative procedure by equal partners, thus refraining from restricting budget autonomy by way of a law, which would run up against constitutional problems.

However, while the now existing "national stability pact" is the best that could be reached within the binding legal and political restrictions, it is still not optimal, as it does not lay down clear and binding responsibilities and furthermore does not allow for any sort of enforcement mechanism. In the context of the existing structure of the national stability pact, one could think of giving the Financial Planning Council the competence of formulating concrete recommendations to the states with the possibility of imposing sanctions when the recommendations are not met. Moreover, binding rules should be established for the participation of the states in potential sanctions in the context of the EDP.

A more comprehensive national stability pact, however, can only be implemented in line with a general reform of fiscal federalism in Germany, which is currently discussed in the Constitutional Commission set up jointly by the Bundestag and the Bundesrat. The task of the Commission is to look into the modernisation of the federal system and to try to reach the necessary consensus on appropriate reform measures and to put them into effect before the end of the current parliamentary term.

3. Conclusions

The first part of the paper presented past debt developments as well as future challenges to fiscal sustainability due to the ageing of the population in Germany. The second part discussed, from an applied perspective, selected approaches to improve fiscal institutions that support the long-run sustainability of public finances in Germany.

With respect to some of these approaches, we discussed only first ideas that have to be developed further and that have to be implemented in a complex political environment. Fundamentally, to make the discussed projects work and exploit all potential benefits, a reform of the federal system is indispensable. To reach this aim, however, a change of the constitution is necessary which in turn requires a consensus of all levels of the state as well as all political powers. The difficulty is to get the parties involved to focus on the advantages of cooperation in this strategic game.

For the federal level there is, not only due to the Stability and Growth Pact, no money to "buy a consensus", so arguments have to do the job, in particular long-term arguments that reach beyond the legislation period of four years and, accordingly, have no high priority on any political agenda seeking power within the next four years.

Another easily underestimated challenge is the implementation of such a strategy in economically difficult times. During the last four years a considerable reform package has been implemented in Germany, in particular in the area of labour markets, in the social security system and in the tax system. Of course, more reforms are necessary, Germany still lags somewhat behind compared to other major economies. However, also due to the unfavourable macroeconomic environment, these reforms have not yet delivered all of their potential benefits. As a consequence, many people, being generally in favour of reforms, are discontented with the concrete reforms implemented. This strategic deadlock makes further reforms difficult to implement and may require a big political coalition at least for some time.

Finally, any strategic policy discussion at the national level has to be seen also in the European context. With respect to a reform of fiscal and economic surveillance and coordination in Europe a window of opportunity opened after the argument in the Ecofin-Council in November 2003 and the recent ruling of the European court of Justice. Sustainability and quality will probably play an important role in any possible reform of "economic governance" in the EU. A discussion of this aspects is beyond the scope of this paper but remains an interesting area for future research.

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