

Chapter 6:

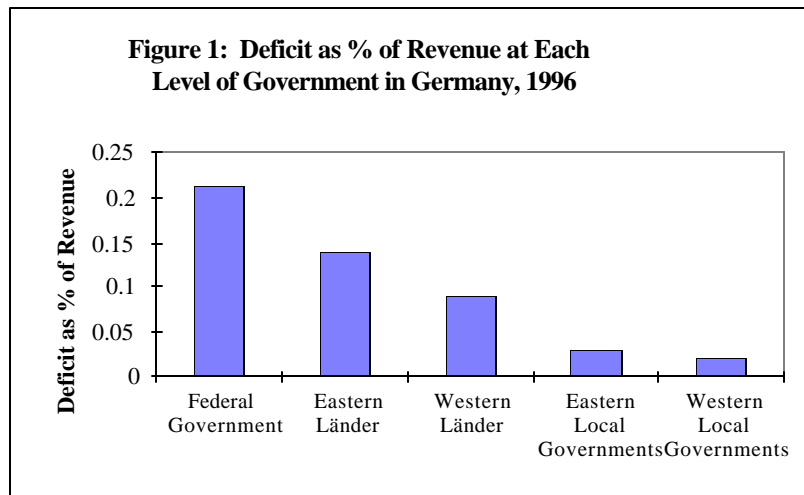
Soft Budget Constraints and German Federalism

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At first glance, the Federal Republic of Germany appears to have one of the most decentralized public sectors in the world. Together, the *Länder* (federal states) and the *Gemeinden* (local communities) are responsible for over sixty percent of total public sector spending. Yet the German public sector displays few of the well-known virtues of fiscal decentralization. On the contrary, the rising costs of German-style fiscal federalism are among the most important barriers to improved efficiency in the German public sector. Although the German federal government is famous for its prudent monetary and fiscal policies, the fiscal performance of the subnational sector is far less admirable. Some of the costs of fiscal decentralization in Germany have been understood by scholars for some time,¹ but now that they have been exaggerated by the process of German unification and by recent decisions of the Constitutional Court, the costs of federalism are an important subject of scholarly and political debate in Germany. Even though scholars and politicians alike seem to agree that the intergovernmental fiscal system is badly in need of reform, and public awareness of the problem has increased, the renegotiation of the basic federal contract will be one of the most daunting and divisive challenges facing Germany in the years ahead.

Among the most important manifestations of the crisis of fiscal federalism in Germany is the softening of subnational budget constraints and the problem of persistent subnational deficits

(See Figure 1) and public debt (See Figure 3). This chapter pays special attention to the problem of soft budget constraints in the German *Länder* in the 1990s. The most obvious problems have been in the *Länder* of Saarland and Bremen, where governments have consistently run large deficits in recent decades-- refusing to cut spending despite unsustainable debt levels (See Figures 2 and 3). Following a controversial court decision, the federal government may have exacerbated the moral hazard problem for other jurisdictions by extending large debt relief bail-outs to Bremen and Saarland. The problems of bad incentives, soft budget constraints, and persistently high deficits are serious in the new Eastern *Länder* as well.²



Source: Sachverständigenrat (1997: 120) and author's calculations.

Starting from zero debt in 1990, by 1995 the eastern *Länder* reached 70 percent of the per capita debt of their western counterparts (Spahn & Föttinger, 1997: 243). Soft budget constraints at the *Land* level could threaten Germany's ability to stay within the general government deficit limit imposed under the terms of the Stability and Growth Pact of EMU. If

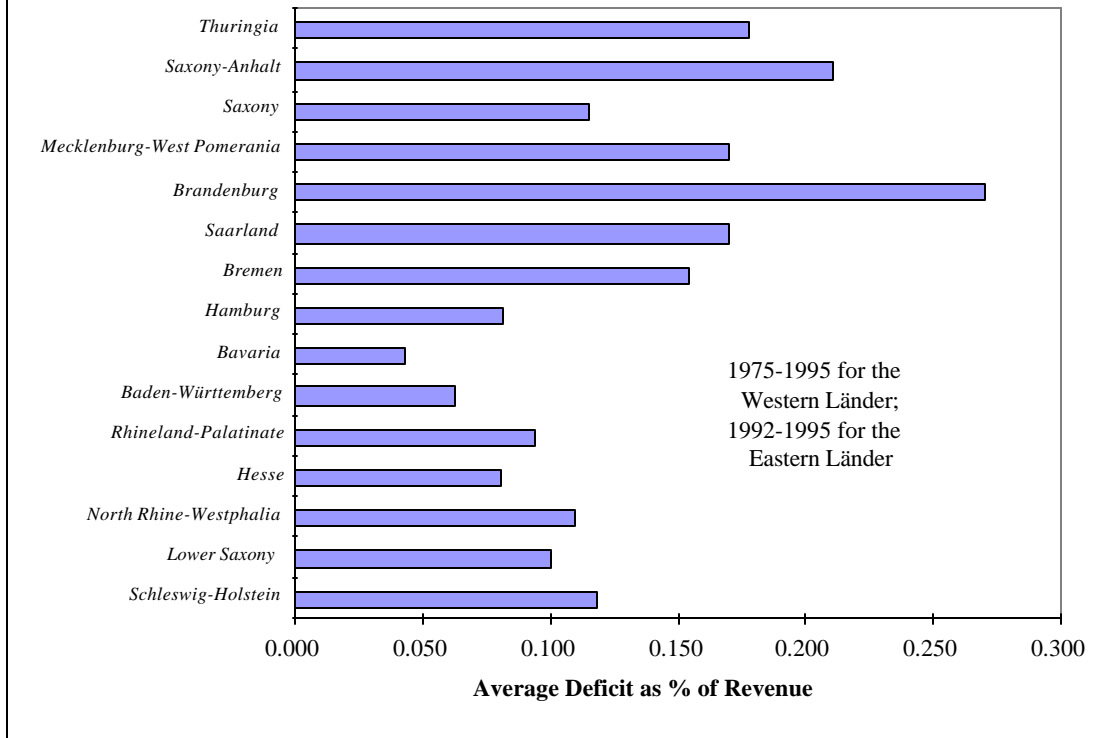
¹ See, e.g. Scharpf, et al. (1976).

the *Länder* run excessive deficits under present conditions, the *Bund* (federal government) would have to bear the fines for non-compliance under EU regulations (OECD, 1998: 88).

Undoubtedly some of the fiscal problems of Saarland and Bremen are related to the challenges of governing small states with high personnel costs and high levels of unemployment, and deficits in the Eastern *Länder* reflect to some extent the need to combat massive unemployment and invest heavily in infrastructure. Nevertheless, this chapter argues that the recent crisis of fiscal federalism in Germany is best understood as a manifestation of underlying structural weaknesses in the German federal system that have been present throughout the post-war period. Specifically, the collaborative intergovernmental system of revenue legislation, collection, and distribution breaks the link between taxing and spending decisions that is critical for effective government provision of goods and services. While the *Länder* have wide-ranging expenditure responsibilities, they possess very little autonomous authority to raise their own revenue. While most spending and policy implementation occurs at the *Land* or *Gemeinde* level, most revenue decisions are made at the *Bund* level. As a result, voters cannot identify which level of government taxes or spends for which goods and services, and they have neither the ability nor the incentives to monitor or discipline the fiscal decisions of state or local governments. Perhaps the most important leitmotiv of this chapter is that Germany's complex, interdependent, collaborative style of federalism tends to dilute fiscal accountability and soften budget constraints.

² See Figures 2 and 3. The new *Länder* include Berlin, Brandenburg, Saxony, Saxony-Anhalt, and Thuringia.

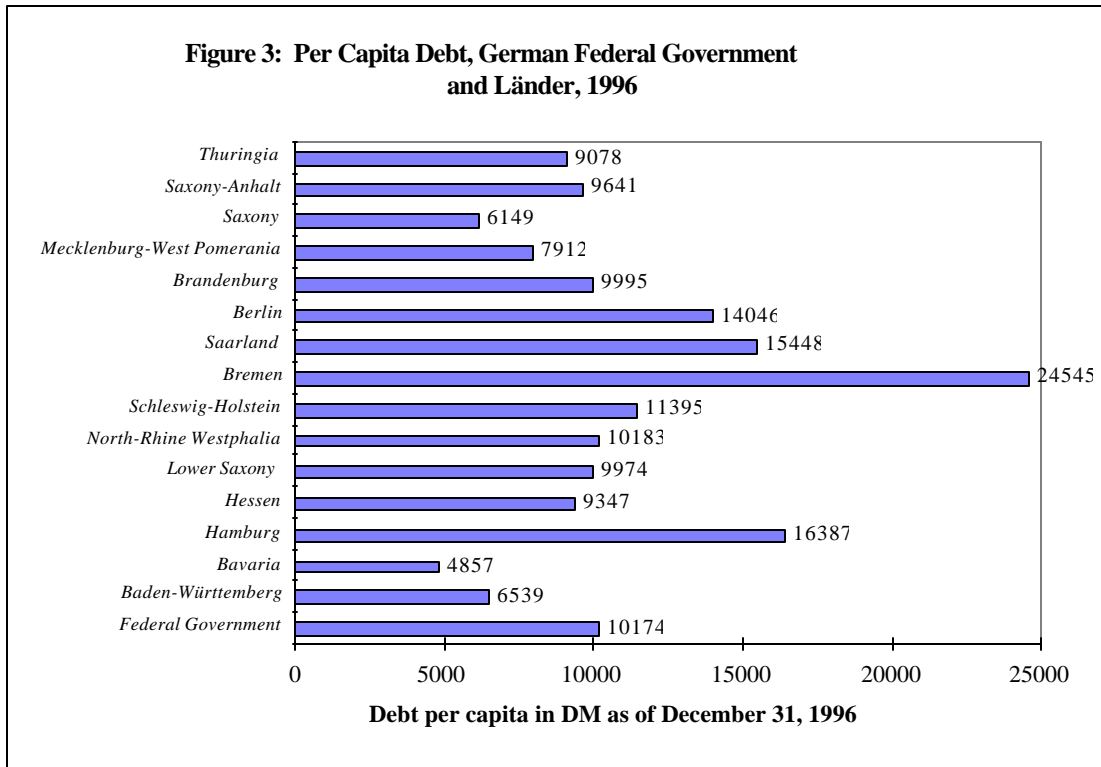
Figure 2: Average Deficit as % of Revenue in the German Länder, Selected Years



Source: Statistisches Bundesamt (<http://www.statistik-bund.de>) and author's calculations.

Even if local voters do not impose hard budget constraints, fiscal restraint would still be possible if the central government possessed the authority to impose hierarchical constraints on the fiscal activities of the *Länder*, as in Norway (Rattso, this volume). Yet the basic constitutional structure of German federalism undermines the hierarchical oversight mechanism as well. Often called "administrative federalism," the German system is characterized in most policy areas by central legislation and state implementation. The *Grundgesetz* (Constitution) requires that the "equivalence of living conditions" be maintained throughout the federation. As interpreted by the Constitutional Court, the Constitution requires a complex system of fiscal equalization. As explained below, this fiscal equalization system creates perverse incentives in some of the states by rewarding fiscal profligacy. Most recently, in response to debt servicing

crises in Bremen and Saarland, the Federal Constitutional Court has ruled that the "equivalence of living conditions" clause obligates the federal government to provide these *Länder* with an explicit bail-out package that features special yearly transfers until 2003. This interpretation will likely undermine the credibility of the central government's commitment not to bail out other troubled *Länder* in the future.



Source: Sachverständigenrat (1997: 195)

This chapter expands on these arguments by examining the strengths and weaknesses of the German *Länder* in maintaining fiscal discipline through each of the channels discussed in chapter one. Section one discusses in greater detail the basic architecture of the German federal system, and assesses the institutional incentive structures faced by *Land*-level politicians. Section two then considers additional *political* incentive structures. Section three lays out the role of the capital market and its regulation. Section four addresses in greater detail the way

these incentive structures have undermined fiscal discipline in certain *Länder*. Special attention is given to Bremen, Saarland, and the new *Länder*. The final section concludes and discusses the prospects for reform.

I. Hierarchical Structure and Intergovernmental Fiscal Relations

Most of the theoretical literature on federalism in economics and political science assumes that central and subnational governments are responsible for the provision of distinct, non-overlapping goods and services. According to these theories, the central and subnational governments should raise their own revenue, and transfers from the central government to the subnational units should be used primarily to internalize externalities produced by the subunits. The German system of federalism is deeply at odds with this vision of "dual" federalism. Although some tasks, like national defense, are clearly allocated to the *Bund* alone, legislation and implementation in Germany is in most policy areas a complex, cooperative process between the highly interdependent *Bund* and *Länder*. Unlike the states in most other modern federations, the German *Länder* have few exclusive areas of legislative competence, and federal law generally overrides state law.

The *Länder* are nevertheless important players in the German policy process. This is not because they possess an autonomous role in legislation within a constitutionally protected set of responsibilities, but rather, because they are key players in the formulation of policy at the federal level, and in its implementation at the *Land* level. Unlike the states in most other federal systems, the governments (as opposed to the citizens) of the *Länder* are directly represented in the *Bundesrat*-- the federal upper house of parliament. Every law that effects the interests of

the states must be approved by the *Bundesrat*, which gives the states a very important role as veto players in the federal policy-making process. Additionally, in contrast to most other federations, the German central government has a very limited bureaucratic apparatus under its own control-- it relies on the *Länder* and *Gemeinden* to implement most federal policy. Given this structural interdependence of *Bund* and *Länder*, it is very difficult for either level of government to achieve its goals without bargaining, cajoling, or cooperating with the other level.

Multilateral bargaining between the interdependent *Bund* and *Länder* is also the modus operandi in the collection and distribution of revenue. All of the most important taxes accrue to the federal and state governments jointly. Most decisions about tax base and rates are made by the federal government (subject to the approval of the *Bundesrat*). While some taxes are collected by the *Bund*, most are administered by the revenue authorities of the *Länder*, which act as agents of the federation. The fiscal equalization system goes to great lengths to redistribute revenue from the wealthy to the poor *Länder*, and the parameters of this system are renegotiated periodically between the *Länder* and the central government.

Expenditures

The constitution explicitly assigns a number of responsibilities to the federal government. These include foreign affairs, defense, monetary policy, citizenship, customs, rail and air transport, the postal system, and telecommunications. The states are responsible for such areas as culture, education, law and order, health, environmental protection, and regional economic policy. The municipalities are responsible for local health facilities, sports and recreation, the construction of schools, roads, and public housing, and other community services (Laufer, 1994: 57-58). Despite the constitution's attempt to divide authority between the governmental units,

however, it is difficult to identify a policy area in which only one level of government is involved. As mentioned above, the *Länder* are responsible for implementing the vast majority of the federal government's policies, and likewise, the *Länder* delegate a variety of tasks to the *Gemeinden*. As a result, neither the constitution nor outlays by level of government reflect very accurately the actual distribution of authority or spending.

Even in policy areas that had previously been the exclusive competence of the *Länder*, the activities and finances of the *Bund* and *Länder* have gradually become intertwined. The most important step away from "dual" federalism was the 1969 renegotiation of the Basic Law, which established the so-called "joint tasks." The *Länder* agreed to give up their exclusive authority in several policy fields in exchange for complex forms of multi-level cooperation in policy-making and funding. These policy fields include university construction, regional industrial policy, and agricultural structural policy (Article 91a, Basic Law); housing, urban renewal, urban transportation, and hospitals (Article 104a IV, Basic Law); and secondary education and research financing (Article 91b, Basic Law).³ Since the introduction of the joint tasks in 1969, the importance of intergovernmental planning and co-financing of public activities has grown. Between the end of the 1970s and unification, federal outlays devoted to the joint tasks increased by 15 percent in real terms (OECD, 1998: 74).

The discretion of the *Länder* in spending is limited in most areas by uniform federal law. Nevertheless, the *Länder* enjoy relatively wide autonomy in practice. Strict specific-purpose grants play only a very limited role-- most transfers are general-purpose in nature (see below). The federal government does not give specific instructions to the *Länder* in the execution of federal law, and it has no powers of supervision or specific approval of administrative practices.

The *Länder* enjoy budgetary autonomy, and in many fields, they can vary the amount of support they give to programs required by federal law, and they remain free to supplement services prescribed by federal statute. The *Länder* are the largest public sector employers in Germany. In this capacity they also enjoy a good deal of discretion, again within federally-imposed legal constraints. *Länder* make their own personnel decisions, but they must abide by national public service laws, which rigorously define the qualifications necessary for each position. The result is a very homogeneous bureaucracy in each sector across the *Länder*. Public sector wages are determined by a coordinated bargaining process involving the major public sector unions and representatives of the federal government, the *Länder*, and the *Gemeinden*.

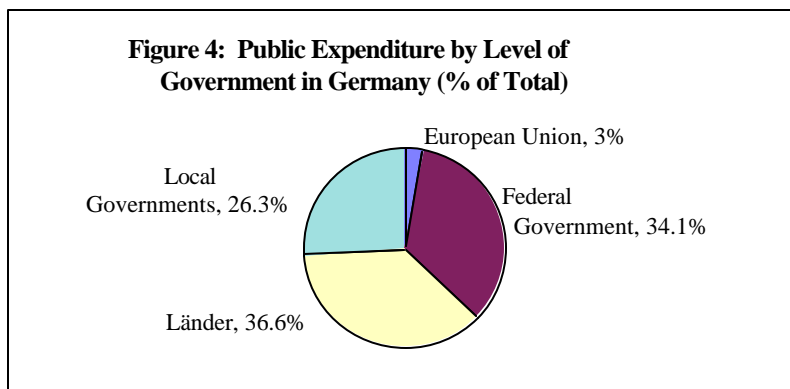
B. Revenue

Like expenditure decisions, the responsibility for revenue legislation and administration is also intertwined between the *Bund* and the *Länder*. The constitution specifies in great detail the assignment of revenue to the *Bund* and *Länder*, and major revisions in federal financial arrangements can only be made by amending the Constitution, which requires a two-thirds majority in both the *Bundestag* and the *Bundesrat*. The flow of revenue laid out in the German Constitution is far removed from the principles laid out in fiscal federalism textbooks. Instead of assigning specific taxes to the layers of government and matching them with specific expenditure responsibilities, the provisions of the German constitution stipulates that all of the most important revenue sources are shared in Germany. The significance of taxes assigned *directly* to the layers of government is low. The income tax, corporation tax, and VAT, which yield almost

³ For critical analysis of the joint tasks, see Scharpf (1976, 1988).

three quarters of total tax revenue, are each jointly appropriated.⁴ Legislation regarding tax base and rates for each of these is the domain of the federal government, although these taxes are administered by the revenue authorities of the *Länder*. In the administration of the shared taxes, the state authorities act as agents of the federation, and are subject to uniform federal administrative guidelines.

The vertical distribution of the shared taxes between *Bund* and *Länder* is very stable over time because the actual percentage shares are laid out in the Constitution, and can only be changed by amendment. In order to ensure that the *Länder* receive sufficient funds to fulfill their federally-mandated responsibilities in the face of changing fiscal circumstances, the vertical distribution of the VAT is frequently renegotiated between the *Bund* and the *Länder*. The resulting bargain must be approved by the *Länder* in the *Bundesrat*. The VAT is the only aspect of the vertical distribution of resources that is flexible, and although the renegotiation is often contentious, it can be used to make adjustments in the vertical allocation of funds when made necessary by new policy programs or exogenous shocks.

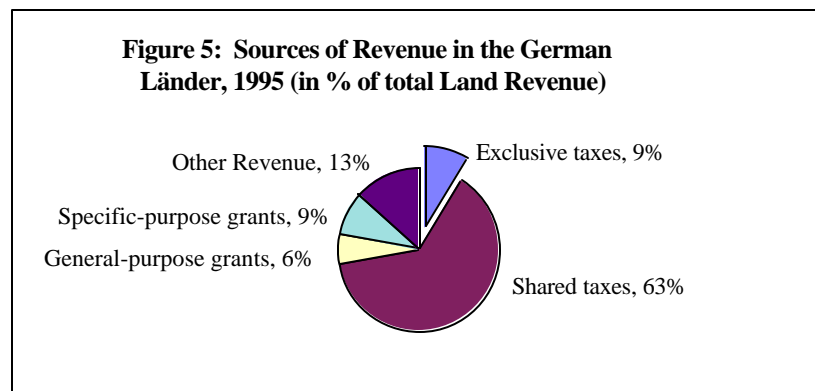


Sources: Federal Ministry of Finance (1996: 328); Spahn & Föttinger (1997: 228).

C. Transfers and Equalization

⁴ For additional details, see Spahn & Föttinger (1997: 229).

The German *Länder* spend more money than the federal government (see figure 4 above), but they have very little authority to raise their own revenue. By far the most important sources of funding for the *Länder* are the shared taxes discussed above (see figure 5 below). Since these taxes are legislated at the federal level, and collected and distributed according to federally determined rules and criteria, they are difficult to distinguish from intergovernmental transfers. In addition, an important portion of *Land* funding comes from more explicit intergovernmental transfers. As shown in figure 5, only nine percent of *Land* revenue comes from own-source taxes.



Sources: Federal Ministry of Finance (1996); Spahn & Föttinger (1997: 321).

First of all, the *Bund* funds specific activities and capital investments in the *Länder* through the mechanisms laid out in the 1969 renegotiation of the Basic Law. Policy-making on the so-called joint tasks is made by a plethora of sector-specific administrative planning committees in which the federal government and the states are represented. In order for a project to be funded, it must be approved by the federal government and a majority of the states. The central government plays an important role in determining priorities in these areas,

not only because it is represented on the planning committee, but because it can threaten to withdraw federal cofinancing.

For the purposes of this study, the most important aspect of intergovernmental transfers in Germany is the fiscal equalization system mandated by the "equivalence of living conditions" clause in the Basic Law. First of all, the primary system of tax sharing distributes the proceeds of the major shared taxes to the states as follows: income tax revenue is apportioned to the states according to the derivation principle, corporate tax revenue is divided according to a formula based on plant location, and a portion of the VAT is distributed to the states on a per capita basis. Next, the secondary system of revenue equalization proceeds in three stages. The first two stages are horizontal, while the third involves vertical transfers from the Bund.

In the first stage (*Umsatzsteuervorwegausgleich*), up to 25 percent of the VAT is redistributed to the *Länder* with the lowest revenue after the primary tax sharing receipts are calculated. At present, this part of the equalization process benefits only the new *Länder*. After this stage of redistribution, the financial endowment (*Finanzkraft*) of each state is calculated and compared with its financial needs (*Finanzbedarf*). Then at the second stage of equalization (*Länderfinanzausgleich im engeren Sinne*), revenue is redistributed from states whose endowments exceed their needs, to those for whom the opposite is true. The concept of "need" is based on the per capita tax income for the entire country. At this stage, the weaker (*Finanzschwach*) states reach 95 of their financial "needs."

In the third stage of the equalization system, the federal government steps in to lift the recipient states up to at least 99.5 percent of their "needs." It does this with supplementary grants (*Bundesergänzungszuweisungen*). At this stage, the *Bund* also bestows additional supplementary grants on some states to compensate them for special burdens. Presently, these

grants are most beneficial to the new *Länder*. Special supplementary grants are also received by smaller *Länder* to compensate them for higher administrative costs, and by some of the "old" *Länder* to compensate them for the higher fiscal burden they must bear because of reunification. As I will discuss in greater detail below, the *Bundesergänzungszuweisungen* are also being used to provide bail-outs to Bremen and Saarland because of their debt servicing obligations.

D. Intergovernmental Budgeting System

The budgeting and fiscal management processes of the *Bund* and the *Länder* are constitutionally autonomous and independent. Nevertheless, the *Länder* are obliged by the Constitution and federal legislation to follow uniform principals that apply to all public sector bodies. The *Länder* must follow a variety of general provisions and specific rules regarding the preparation of the budget, accounting, auditing, transparency, etc. The *Länder* are also required to engage in multi-year financial planning and exchange budget-related information.⁵ The *Bund*, *Länder*, and *Gemeinden* participate in the Financial Planning Council, which meets periodically to coordinate general budgetary policy and provide the central government with the information it needs to ensure macroeconomic stability. Although it helps coordinate long-term budgetary planning between the levels of government, the Financial Planning Council does not make binding decisions. Despite the high level of coordination and information-sharing between the *Bund* and *Länder*, in the end neither can force the other to do anything, and when difficult sacrifices must be made in order to improve overall public sector fiscal balance, compromise can be very difficult to achieve.

E. Borrowing

The Financial Planning Council is complemented by the Committee on Public Borrowing, which attempts to coordinate public borrowing between the *Bund*, *Länder*, and *Gemeinden*. Its decisions are also non-binding, however, and the central government has no power to place numeric restrictions on the borrowing activities of the *Länder*. Nor must the borrowing decisions of the *Länder* be approved or reviewed by the *Bund*. Like the federal government, however, the *Länder* have their own constitutional and statutory provisions that restrict them from borrowing more than the outlays for investment purposes projected in the budget. These so-called golden rule provisions at the *Land* level, however, have a number of well-known loopholes. First of all, "investment purposes" is an extremely slippery concept, and it is not difficult to recast a variety of expenditures as investment outlays. Second, financing arrangements associated with the contracting out of local public infrastructure projects provides an additional way around the "golden rule" provisions. Private investors are given guarantees and asked to build and prefinance infrastructure projects. Upon completion of the work, the government redeems the building costs over a certain period (Spahn & Föttinger, 1997: 237). In addition to the problem of loopholes, some states have chosen to simply ignore their constitutions, as we shall see in section five below on Saarland and Bremen.

It is important to note that while most of the federal government's debt is in the form of bonds, the *Länder* and *Gemeinden* rely primarily on direct bank loans to finance their deficits. The *Länder* indirectly control a network of commercial banks-- the *Landesbanken*, which make loans (*Schuldscheine*) to the municipalities and the *Länder*. The officials of the Landesbanks generally have excellent political connections at the *Land* level. *Land* politicians

⁵ For additional details, see Spahn & Föttinger (1997: 240).

frequently accept lucrative stints on their Landesbank's supervisory board, and some suggest that the Landesbanks are used to channel cheap credit to politically favored businesses.⁶ At the municipal level, the mayor of a commune is often also chairman of the supervisory board of the local savings bank (Spahn & Föttinger, 1997: 238).

In short, the central government is unable to place restrictions on the borrowing behavior of the *Länder*, yet they are also not disciplined by the competition for investment capital. The lack of credit market discipline in Germany will be addressed in greater detail in section four below.

F. Implications for Soft Budget Constraints in the Länder

In many respects the unique structure of German administrative federalism has served it well throughout the post-war period. The German inter-jurisdictional market is perhaps more complete than that of any other federation. German-style cooperative federalism has facilitated mutual recognition and other agreements that facilitate the free flow of goods and services across jurisdictional boundaries (Rodden, 1999b). Since the *Länder* have a good deal of discretion in implementing federal law, they may be able to tailor implementation to suit local conditions. Yet the system also insures a good deal of uniformity of service provision throughout the federation, and federal standards ensure that the *Land* bureaucracies are highly competent.

The disadvantage of German-style cooperative federalism is that it destroys the link between taxes and benefits and distorts accountability. The system creates a variety of bad incentives at the *Land* level, which have recently created a problem of soft budget constraints.

⁶ "German Banking: Can Dachshunds be Whippets?", *The Economist*, January 4, 1997, page 70.

First of all, the expenditure responsibilities of the *Bund* and *Länder* overlap in almost every policy area, and they have only become more intertwined since the introduction of the joint tasks in 1969. As a result, it is almost impossible for voters to know whom to hold responsible for which activities. Second, the *Länder* rely heavily on tax sharing and grants, and their tax autonomy has only declined over time. They have no direct control over tax base or rates, so one of the basic principle of public finance in federal systems-- that each layer of government should bear the costs for the fulfillment of its public tasks-- is violated by the basic structure of the German federal system.

This principle is destroyed most completely by the equalization system in particular, and the constitutional objective to equalize living conditions more generally. The equalization system provides few incentives for the *Länder* to raise their own economic performance and tax base. For individual states, an additional DM 1 million in income tax receipts-- either personal or corporate-- generates only between DM 80,000 and DM 290,000 in extra tax income (OECD, 1998; Huber & Lichtblau, 1998). After equalization, the *Länder* with the lowest initial per capita fiscal capacity-- Bremen, Saarland, and the eastern *Länder*-- end up with the highest fiscal capacity per capita. Meanwhile, the *Länder* with the highest initial fiscal capacity-- Hamburg, Hesse, and Baden-Württemberg-- end up with the lowest capacity after transfers.

As a result, the *Länder* have relatively weak incentives to be concerned with low rates of revenue collection or deficits. This incentive structure contributes to what the German Council of Economic Advisors has identified as one of the most important problems in German public finance-- falling rates of revenue collection despite increasing tax burdens (Sachverständigenrat, 1998: 114-118). Since the *Länder* bear most of the costs of tax administration, and only a small fraction of additional tax revenues accrue to them, they face

weak incentives to strengthen audits and improve revenue collection. This problem is especially severe in the most dependent *Länder*, who receive almost no benefit from increasing tax collection efforts (OECD, 1998: 84-85). A recent report estimates that the cost of lost revenue resulting from tax evasion and avoidance is around DM 125 billion-- around 15 percent of GDP.⁷

While all of these features of Germany's complex, intertwined federalism conspire to weaken the incentives of *Land* leaders to be fiscally responsible, one feature of the equalization system may explicitly encourage irresponsibility-- the "supplementary transfers" (*Bundesergänzungszuweisungen*). These transfers explicitly reward states whose fiscal performance has been poor in the past. As discussed in greater detail below, these transfers have recently been used as explicit bail-outs for Saarland and Bremen. Econometric analysis has shown that the states that are most dependent on such transfers are slower in adjusting to negative revenue shocks (Rodden, 2000) and run larger deficits in the long run (Rodden, 1999a).

The Basic Law and its interpretation by the courts require far-reaching efforts to achieve inter-state equality, but at the same time, they impose important restraints on the hierarchical oversight and control mechanisms available to the central government. Despite the bad incentives introduced by the equalization process, the problem of soft budget constraints would disappear if the central government were able to control the access of the *Länder* to credit, or at least punish them for excessive deficits. The current structure provides the central government with no such tools. Significant changes to the incentive structure would require the

⁷ Report of the *Institut der deutschen Wirtschaft (IW)*, cited in Peter Norman, "The Taxpayers are Revolting," *Financial Times*, Nov. 3, 1997.

consent of the *Länder*, however, and since many of them benefit from the current set-up, they are reluctant to agree.

Given the inherent weakness of hierarchical mechanisms for controlling *Land*-level fiscal behavior, it is useful to examine the role of voters and capital markets in constraining the fiscal activities of the *Länder*. The next two sections examine each of these in turn.

II. The Political Mechanism

The main task of this section is to assess whether citizens have the necessary authority, incentives, and information to successfully monitor the fiscal activities of *Land*-level officials and enforce hard budget constraints. It argues that some of the structural weaknesses of German federalism outlined in section one above extend to the principal-agent relationship between voters and public officials at the *Land* level and undermine the electoral oversight mechanism. Voters at the *Land* level have the authority to vote fiscally irresponsible officials out of office, but they have neither the information nor the incentives to do so.

Most German pundits believe that *Land*-level elections are primarily referenda on the popularity of the federal chancellor and his government rather than independent assessments of the performance of *Land*-level politicians. This supposition is borne out by empirical analysis of election returns. Rodden (1999b) shows that the reelection chances of *Land*-level politicians are strongly affected the success of their partisan colleagues at the *Bund* level.⁸ This is not surprising, since the *Bundesrat* possesses the power either to veto, delay, or rewrite most federal legislation, and *Land* elections determine the make-up of the *Bundesrat*. As a result,

the media, voters, and *Land* politicians themselves have come to interpret *Land* elections as federal by-elections (Abromeit, 1982).

Second, given the complex interdependence of the German federal system, it is very difficult for citizens to obtain and interpret information about the competence and performance of their representatives at the *Land* level. Since they have no autonomous control over local tax rates, most policy decisions are made through cooperative intergovernmental processes, and most of their expenditures are for the implementation of federal programs, *Land*-level officials can always credibly claim that the blame for local policy failures or revenue shortfalls lies elsewhere, even though this is not always true. Voters simply have no way of accurately sorting out credit and blame for outcomes. Thus it makes sense for information-economizing voters to simply assess the performance of the governing coalition in Bonn and punish or reward the same parties at each level of government (Rodden, 1999b).

As a result, electoral incentives for sound fiscal policy at the *Land* level are weak; it is easy for *Land*-level officials to escape electoral sanction for imprudent fiscal policies. Such blame avoidance might be even easier in *Länder* that are controlled by the opposition party.⁹ Moreover, under some conditions *Land*-level leaders may actually face electoral incentives to spend beyond their means and run deficits. The equalization system ensures that the costs of public goods in several of the recipient *Länder* are externalized onto the paying *Länder*. Recent events have made it clear that excessive deficits might be rewarded with bail-outs, so voters may face incentives to reward fiscal irresponsibility if they think it will lead to larger

⁸ See also Fabritius (1978), Lohmann, Brady, & Rivers (1997).

⁹ For instance, federal finance minister Oskar Lafontaine clearly did not have to pay an electoral price for repeatedly running massive deficits while serving as Minister-President of Saarland during the Kohl era. Likewise, Gerhard Schröder's legacy of budget problems and massive debt in Lower Saxony was no

transfers in the future. If the state's debt burden becomes unbearable, voters are more likely to lobby the central government for a bail-out than to put political pressure on *Land*-level representatives to make costly spending cuts.

III. The Capital Market and its Regulation

This section turns attention to the role of the credit market in enforcing fiscal discipline in the German *Länder*. As explained in chapter one, the need to borrow in well-functioning capital markets might force subnational leaders to make prudent fiscal decisions. Above all, credit ratings and interest rates can provide voters with important signals of government performance. If the costs of high interest rates resulting from imprudent fiscal decisions must be paid by local citizens in the form of increased taxes or lower property values, they are more likely to vote incumbents out of office. Such incentives have not been present at the *Land* level in Germany. For the most part, *Länder* need not worry about credit ratings, and the cost of capital has traditionally been roughly the same for all *Länder*. This system may be changing, though, as some of the *Länder* and their *Landesbanken* seek new forms of credit. This section first provides an overview of *Land*-level "connected borrowing" throughout the post-war period, and then second, assesses recent developments that may enhance credit market discipline in the future.

The *Länder* have fulfilled their borrowing needs throughout the post-war period in the domestic bond and *Schuldschein* markets. The *Länder* are barred from issuing debt in

impediment to his ascent in federal politics. Instead, he was able to use his state's economic and public finance difficulties as the basis for attacks on the Kohl government.

currencies other than the Deutschmark. The *Länder* occasionally issue DM bonds, *Länderanleihen*, which are typically managed by the state's *Landesbank*. Bonds have been an insignificant part of *Land*-level borrowing, however, because of the attractiveness of the *Schuldschein* market. *Schuldscheine* are not securities. *Schuldscheindarlehen* are credits which are documented by negotiable promissory notes called *Schuldscheine*. They are not quoted on any exchange but can be transferred to third parties by way of a written assignment. This issue method is popular because of its low cost, flexibility and discretion with which the terms can be agreed.¹⁰ In most cases these are negotiated with the state's *Landesbank*. Most state and municipal borrowing is made up of *Schuldscheine*. In 1993, for example, state *Schuldschein* issues amounted to DM 489.2 billion, while state bond issues totaled only DM 104.1 billion.¹¹ A disadvantage of this method is that the *Länder* have not been forced to use credit ratings and respond to the rigors of more competitive, transparent international bond markets.

In the mid-1990s, some of the *Länder* have started to make use of a wider range of instruments as their overall debt requirements grow and as barriers between domestic and offshore markets come down. Although the *Länder* are only allowed to make Deutschmark issues, there are no restrictions that prevent the *Länder* from borrowing in international markets. Some *Länder* have recently structured new forms of debt securities to attract international investors. In late 1993 there was a spate of long-dated DM issues by several of the *Länder*, led by foreign investment banks. Although these deals have not performed well, it seems likely that the *Länder* will continue to seek international investors in the future. If this trend continues,

¹⁰ "Germany: Euroweek Supplement on Top Credits-- Länder Look to New Horizons," *Euroweek*, Nov. 30, 1994.

the *Länder* will eventually be forced to go through a rigorous rating process. According to Standard and Poor's, "As volume mounts, investors will be less prepared to accept these issues solely on the basis of the German 'Land' label. They will seek different yields based on differences in credit quality."¹²

Another source of burgeoning credit market discipline may come from the Landesbankens. Not only are the *Länder* starting to raise funds outside of domestic markets-- the Landesbanks are beginning to look to international sources of capital as well. Some of the larger Landesbanks are beginning to issue Eurobonds and hold substantial capital in foreign currencies. The Landesbanks are considered semi-sovereign debtors, and investors are attracted to them because they are guaranteed by their respective *Länder*. For this reason, each Landesbank has at least one triple A rating-- from Ibca (London)-- and several have the same from Moody's and Standard & Poor's. (See Table 1). Note that there is very little variation across *Länder*-- no Landesbank is rated below Aa1 by Moody's, or below AA+ by Standard & Poor's. This is in spite of the fact that the Landesbanks clearly do not perform as well as conventional triple-A rated institutions, and in spite of the fact that there are large variations from one Landesbank to another.

Table 1: Landesbank Credit Ratings, 1997

Landesbank	Moody's	Standard & Poor's	Ibca	Moody's Bank Financial Strength Rating
<i>Bayerische LB</i>	Aaa	AAA	AAA	C+
<i>Bremer LB*</i>	Aa1	---	AAA	C
<i>DSL-Bank</i>	Aaa	---	AAA	D+
<i>Helaba</i>	Aaa	AAA	AAA	C+
<i>L-Bank Berlin</i>	Aaa	---	AAA	B

¹¹ Ibid.

¹² Quotation in "Germany: Euroweek...", note 9 above.

<i>LB Rheinland-Pfalz</i> **	Aa1	AA+	AAA	C+
<i>LB Schleswig-Holstein</i> **	Aa1	---	AAA	C
<i>LKB</i>	Aaa	AAA	AAA	C+
<i>NordLB</i>	Aa1	---	AAA	C+
<i>SudwestLB</i>	Aaa	AAA	AAA	C+
<i>WestLB</i>	Aa1	AA+	AAA	C

* Supported by NordLB and therefore indirectly guaranteed by Lower Saxony

** Supported by WestLB and therefore indirectly guaranteed by North Rhine-Westphalia

The logic behind Ibca's uniform triple-A rating is the argument that if any Landesbank gets into trouble, the *Land* government would support it, and if this support would lead to a financial crisis in the *Land*, the federal government would step in. Standard & Poor's, on the other hand, has been less convinced that federal bail-outs would be forthcoming, and thus does not automatically award triple-A ratings. According to Standard & Poor's, a rating is concerned with the timely payment of interest and capital, and even if the federal bailouts are forthcoming in the event of a crisis, the time lag between crisis and bail-out could prove costly.¹³ Thus Standard & Poor's considers the economy and fiscal performance of the *Land* when deciding on ratings. The credit rating of West LB, the largest of the Landesbanks, has recently been threatened with downgrade by Standard & Poor's because of the public finances of Nordrhein Westfalen. Nord LB has had a difficult time achieving triple-A status because of the finances of Niedersachsen. In such cases, the *Land* governments may indeed feel indirect pressure, via the Landesbanks, to improve their public finances. Moody's has recently responded to pressure from international investors to create a more realistic rating system for the *Länder*. This "Bank Financial Strength Rating" shows more variation than previous ratings systems, ranging from B to D+ (See Table 1). As Landesbanks continue to diversify and

¹³ Laura Covill, "Germany: When the Bankers Go Cap-in-hand," *Euromoney*, Dec. 28, 1994.

attempt to attract global capital, credit ratings will continue to become more important to the Landesbanks, and the pressure on *Land* governments to improve their finances will increase.

Finally, the entire system of "connected borrowing" from the Landesbanks may not last much longer. Not only are credit-rating agencies beginning to pressure the Landesbanks with more realistic credit ratings, but the key pillar of their strength-- public guarantee of debts-- is being threatened by the European Commission. In addition, some cash-strapped *Länder* have started to sell off stakes in their Landesbanks. For example, Bremen now owns only 7.5% of Bremer Landesbank. Landesbank Berlin has been partially privatized through a transfer of 75% of its shares to the publicly-listed Bankgesellschaft Berlin (BGB), while the *Land* government, as the majority shareholder in BGB, maintains its explicit guarantee. Most analysts agree that the pressure for privatization of the Landesbanks is likely to grow stronger. In any case, the introduction of the Euro and increasing international competition have the potential to push the *Länder* further in the direction of credit market discipline.

IV. Deficits and Bail-outs in Saarland and Bremen

The previous sections have argued that while German federalism may have a number of strengths, its most important weakness lies in the fact that it may facilitate fiscal indiscipline and soft budget constraints in the *Länder*. Many of the problems described above have been visible in the recent crises and responses in Bremen and Saarland. Although Saarland has always been a receiving *Land* in the equalization process, Bremen was a contributor prior to the 1970s. Both *Länder* have faced major economic downturns and had to deal with vexing unemployment problems in recent decades. Thus it is not surprising that these *Länder* have faced significant

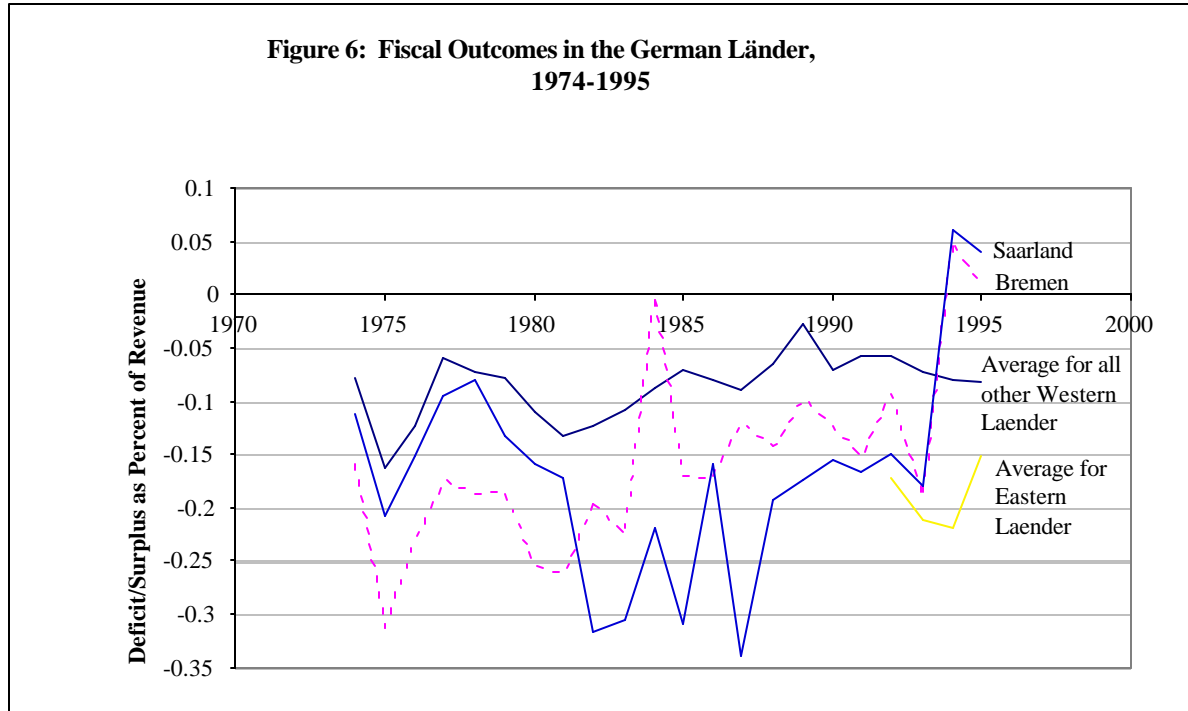
pressure on their public finances. Given their lack of revenue autonomy and small size, they were poorly situated to bear the costs of adjustment alone.

In fact they have not been forced to bear the costs of adjustment alone-- prior to unification, they became the largest beneficiaries of the equalization process. In recent years, Saarland and Bremen have generally been ranked number one and two among all the *Länder* in fiscal capacity per capita after equalization. Despite constantly increasing dependence on equalization payments and associated transfers, both *Länder* continued to increase spending, run large deficits, and rely heavily on debt to fund current expenditures throughout the 1980s and 90s (See Figure 6).

The *Land* governments simply had no hierarchical, political, or market incentives to cut spending. The *Bund* and the other *Länder* grew frustrated with their refusal to cut spending and balance their budgets, but they had no mechanisms with which to influence the decisions of Bremen and Saarland. Given their high level of fiscal dependence on other *Länder* and the *Bund*, the governments of Bremen and Saarland were able to simply explain to their voters that they were not responsible for growing deficits and debt burdens-- on the contrary, they argued that the rest of the federation was not adequately fulfilling its constitutional obligation to support them during their time of need. Despite growing debt levels, the governments of Saarland and Bremen had no trouble securing credit from their Landesbanks.

Saarland's constitution contains a "golden rule" provision that public debt must not exceed investment spending. The government of Saarland simply ignored this provision, despite the fact that the highest court in the state repeatedly declared that its budgets contradicted the state's constitution. Rather than suffering public embarrassment, the government of Saarland

used the "unconstitutional" nature of its deficits as further proof that the rest of the federation was not fulfilling its obligations.



Source: Statistisches Bundesamt (<http://www.statistik-bund.de>) and author's calculations.

In the mid-1980s it became clear that the accumulated debt levels in Bremen and Saarland were unsustainable, and both *Länder* declared that they faced fiscal "emergencies," calling on the federation and the other *Länder* to provide special funds to pay down some of their debt. Bremen eventually requested that the *Bund* explicitly take over its obligations. The 1980s saw a variety of complaints by the *Länder* to the Constitutional Court over the details of the fiscal constitution, and Saarland and Bremen took their case for bailouts to the courts. A 1986 decision found that the federal supplementary transfers can be used to bail out fiscally troubled *Länder*. This gave the governments of Bremen and Saarland hope that they would eventually receive special federal funds, and through the rest of the 1980s they had no incentives to improve their finances. They continued to bring complaints to the Constitutional Court in

order to secure these funds, and in May of 1992, the Court declared that the "solidarity" obligation contained in the *Grundgesetz* required that the *Bund*, as part of the renegotiation of the equalization system in 1993, begin using the supplementary transfers to provide Bremen and Saarland with bail-outs amounting to 17 billion DM.¹⁴

Bremen and Saarland started receiving the special funds in 1994. Bremen has been receiving an extra 1.8 billion DM per year, and Saarland an extra 1.6 billion DM. These have been sufficient to balance current budgets (note the sharp improvement in Figure 6). Nevertheless, the *Bund* still has no carrots or sticks with which to punish or reward changes in spending or progress in reducing debt, and the progress of both *Länder* in reducing debt has fallen far short of expectations. In fact, both *Länder* are now arguing that the bail-outs are insufficient, and they explain their inability to reduce debt by pointing out that they have experienced unexpected revenue shortfalls.¹⁵

Although the bail-out episodes in Bremen and Saarland have been costly, and may even become more costly over time, the most dangerous aspect of the crises is the demonstration effect for other fiscally troubled *Länder*. The governments of Bremen and Saarland were able to use their status as small, transfer-dependent subnational units to their advantage. The nature of the federal system led them to believe that it was unlikely in the long term that the costs for their spending and borrowing decisions would be borne locally. They believed that the constitution necessitated an eventual bailout, and now the Constitutional Court has affirmed this, other highly transfer-dependent *Länder* will have few incentives to worry about deficits and

¹⁴ "Bund fordert Länder zur Mitfinanzierung auf," *Handelsblatt*, March 3, 1998.

¹⁵ "Streit um Hilfen für das Saarland und Bremen," *Frankfurter Allgemeine Zeitung*, Feb. 25, 1998.

debt burdens in the future. Given the level of transfer-dependence in the Eastern *Länder*, the moral hazard problem may loom large.

V. Conclusions and Prospects for Reform

Perhaps the most important source of soft *Land*-level budget constraints in Germany is the Constitution itself. By simultaneously creating wide-ranging *Land*-level administrative autonomy, guaranteeing the equivalence of living conditions, and entrenching strong representation of the *Länder* in the federal policy-making process, the Constitution creates hurdles for the proper functioning of several local fiscal discipline mechanisms. The constitutional structure divides taxing and spending decisions, carving out a good deal of spending autonomy for the *Länder* while giving them very little revenue autonomy. Because of the equalization system, the *Land* governments face weak incentives to make prudent fiscal decisions. Because of blurred accountability and the possibility of bailouts, local citizens have neither the information nor the incentives to punish and reward *Land* representatives based on their fiscal decisions.

The Constitution provides the federal government and the wealthier *Länder* with no hierarchical mechanisms with which to constrain the spending or borrowing decisions of the dependent *Länder*. The lack of any such mechanism has always been an annoyance in the cases of Saarland, Bremen, and occasionally a few other western *Länder*, but recently, the costs of fiscal indiscipline that must be borne by the *Bund* and the wealthier *Länder* are becoming a serious source of frustration that is beginning to undermine the solidarity and cooperation that have characterized the operation of the German federal system. Bavaria and

Baden-Württemberg, two of the wealthiest *Länder*, are aggressively challenging the equalization system in the courts and in the political process. The *Bund* has had to shoulder most of the costs of unification, and has been forced to fund the bail-outs of Bremen and Saarland as well, and it is demanding that the *Länder* take on a larger share of the burden. The problem is only likely to get worse now that the Constitutional Court has transformed the equivalence of living conditions requirement into an explicit bailout guarantee for profligate states.

As various *Länder* continue to bring complaints to the Constitutional Court and the wealthy *Länder* step up their threats to withdraw from the equalization system, it has become increasingly clear that the system is in crisis. A *Bund-Länder* working group has been formed to begin discussions about a major overhaul of the system. The wealthier *Länder* are demanding greater tax autonomy and a complete overhaul of the equalization system.¹⁶ The *Bund* is especially interested in reforming the system, since it is obliged under the terms of the Stability and Growth Pact to observe a general government deficit limit and to accept sanctions including fines in the event of non-compliance. The federal government argues that despite the fact that it presently has no mechanism to control the borrowing of the *Länder*, irresponsible *Land*-level borrowing decisions could cause the German public sector to run afoul of the Maastricht deficit limit, and the federal government would be forced to pay the fines.

As a result, the federal government is seeking to establish an internal equivalent of the Stability and Growth Pact (OECD, 1998: 87-91; Sachverständigenrat, 1996: 191-194). The government has proposed to determine legally binding allocations of the Maastricht deficit limit

¹⁶ Baden-Württemberg's Minister-President, Erwin Teufel, has been leading the charge. He proposes a complete overhaul of the system that would drastically reduce vertical and horizontal imbalance. See "Eigene Steuern für die Länder," *Focus*, Feb. 23, 1998, and "Attacke der Reichen," *Focus*, Feb. 23, 1998. See also "Letzter Einigungsversuch zum Finanzausgleich," *Frankfurter Allgemeine Zeitung*, March 2, 1998. For overviews of academic reform proposals, see OECD (1998), Rensch (1999a, 1999b).

both vertically between the *Bund* and the *Länder*, and horizontally across the *Länder*. These caps would only come into play in the event of an excessive deficit for Germany as defined by the Maastricht criteria. The idea is to allocate the EU fines among the *Bund* and *Länder*. Of course this has led to a good deal of conflict over the fraction of the overall deficit that should be allocated to the *Bund* and *Länder*, and how fines should be allocated horizontally across the *Länder*. However, it is not clear how the idea of penalizing particular *Länder* for deficits squares with the equalization system, or with the Constitutional Court's interpretation of the "equivalence of living conditions" clause.

In order for the German Domestic Stability and Growth pact or any of the other proposed reforms to be successful, the architecture of tax-sharing and equalization arrangements-- in essence the basic structure of the federal system-- will have to change, which means the underlying constitutional contract between the *Bund* and *Länder* will have to be renegotiated. This may prove very difficult. A constitutional change would require the approval of two thirds of the *Länder*, which means some of the *Länder* that benefit from the current system would have to approve of the changes. The wealthy and poor *Länder* have coalesced into distinct groups with clear objectives, and it may be very difficult to bring them to a compromise. The *Länder* have also shown that they are able to coalesce against the *Bund* to protect their interests.¹⁷

In the past, renegotiations of the system of fiscal federalism have been possible in spite of the entrenched interests of certain *Länder* because of cross-cutting partisan cleavages

¹⁷ Most of the fiscal burden associated with unification, the inclusion of the new *Länder* in the federal fiscal system, and the bail-outs of Saarland and Bremen have fallen on the *Bund* because the *Länder* were able to cooperate against the federal government in the negotiations leading up to the 1993 "solidarity pact."

(Renzsch, 1995; Rodden, 1999b). Unfortunately, however, partisan cleavages are beginning to match up with the cleavages of fiscal federalism-- the Social Democrats are strongest in the weaker, more dependent *Länder*, and the Christian Democrats are strongest in the wealthiest *Länder*. In addition, the PDS (the former communist party in East Germany) has become a regional party that very effectively represents the interests of the Eastern *Länder*. Attempts to improve the efficiency of the public sector in Germany often fail because of the difficulty of bringing together a reform coalition in a system with so many effective veto players. The proposed National Stability and Growth pact would be an important step in the right direction, but it remains to be seen whether the weaker states will be willing to agree to firm, non-negotiable deficit limits.

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