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FEDERALISM COMMISSION II – RECENT REFORMS OF FEDERAL-LÄNDER FINANCIAL RELATIONSHIPS IN GERMANY

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ABSTRACT

In 2009, the second stage of reform of Germany's fiscal federalism passed both chambers of parliament by two thirds majorities enacting new debt restrictions in the Grundgesetz and in federal legislation. In this paper, this reform is evaluated regarding the problems of German fiscal federalism and the possible solutions discussed in constitutional economics. The reform is an important step to remedy the shortcomings of German fiscal federalism, but it needs to be complemented by tax autonomy of the German Länder (states).

INTRODUCTION

The second stage of the reform of Germany's fiscal federalism was completed by both chambers of parliament in 2009. Whereas the first stage was primarily concerned with readjustments of responsibilities between state governments and the federal level, the second stage has been supposed to address the system of intergovernmental finances. However, a comprehensive restructuring of the system of fiscal federalism did not take place in this stage either. Instead, federal and state governments agreed to leave the existing intergovernmental transfer scheme in place until 2019. In that year, the so called *Solidarpakt II* will phase out, as will the existing system of horizontal fiscal equalization. The main issue in which the Federalism Commission II made progress was how to deal with increasing public debt in Germany. The changes in the regulations governing sub-national and federal borrowing are therefore the main innovation of this set of constitutional changes.

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Both the federal level and the Länder in Germany have accumulated remarkably high levels of debt since the early seventies. Even though the fiscal stance of the federal and most state governments has improved during the last few years due to favorable economic conditions, the recent financial and economic crisis will undo these successful fiscal adjustments. The Federal Finance Ministry expects a deficit for Germany of about 3 % of GDP in 2009 and about 6 % in 2010 because of lower revenue from income, corporate and value added taxes, and higher expenditures for macroeconomic stabilization programs (among others).

High levels of public debt are not only a problem of the federal, but also of the state governments. Some state governments have even claimed in the recent past that they faced unsustainable levels of debt and therefore required a federal bailout. In doing so, they followed an established pattern. Already in 1992, the Federal Constitutional Court ruled that *Saarland* and *Bremen* could not overcome their fiscal problems on their own and consequently were eligible for a federal bailout (BVerfGE 86, 148, 358 ff.). The federal government paid bailout transfers to both states between 1994 and 2004. Recently, *Berlin* sued on its part the federal government and demanded bailout transfers. *Saarland* and *Bremen* followed suit, arguing that the first batch of transfers had been insufficient to solve their fiscal problems. In October 2006, the Constitutional Court refused to acknowledge that *Berlin* was facing an extreme fiscal crisis, i.e. one that could not be resolved without additional federal transfers. While the court argued that *Berlin* was capable to solve its problems on its own, it demanded that German policy makers formulate effective borrowing restrictions in order to avoid the need for bailouts in future.[1]

The second stage of the reform of Germany's fiscal federalism addresses the concerns of the Constitutional Court. At its core, this stage of the reform establishes a new borrowing rule, called the *debt brake.* This borrowing rule will fully come into effect in 2016 at the federal level and in 2020 at the state level, and thus replaces the old restrictions based on Art. 115 and Art. 109 GG (Basic

[1]For a discussion of excessive indebtedness and the bail-out problem in German fiscal federalism see Homburg (1994), Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (2005), Rodden (2006), Feld (2006, 2007a), Fink and Stratmann (2009).

Law, i.e. the German constitution). At the same time, the reform also establishes a preventive system designed to avoid excessive fiscal indebtedness in the future. This preventive system empowers a newly created *stability council,* which consists of the federal finance minister, the finance ministers of the state governments, and the federal economy minister, to continuously control the fiscal polices of the federal and Länder governments. A third feature of the reform is that additional transfers will be granted to the states of *Berlin*, *Bremen*, *Saarland*, *Sachsen-Anhalt*, and *Schleswig-Holstein* to help them cope with some of the more stringent requirements of the debt brake.

In this contribution, I explore whether the second stage of the reform will solve the problems of German fiscal federalism.[2] In *Section 2*, the German debt problem is illustrated and discussed. In *Section 3*, I explore the reasons for the increase in public indebtedness in recent years. Thereafter, different potential remedies are analyzed with which this trend can be slowed down and possibly reversed (*Section 4*). Because of the particular interest in the debt problem at the sub-national tier, I discuss whether market based restrictions on sub-national borrowing, tax decentralization or formal fiscal restraints (debt or spending restrictions) can be means to ensure that state governments implement sound fiscal policies. On the basis of this analysis, I evaluate the second stage of the reform of Germany's fiscal federalism in *Section 5*. *Section 6* offers a brief outlook on a possible third reform stage.

THE GERMAN DEBT PROBLEM

The inability of Germany's prevailing fiscal constitution to prevent unsustainable fiscal policies is exemplified by the high level of debt accumulated by all tiers of government. *Table 1* presents data on the evolution of public debt at the three tiers from 1960 onwards. At all tiers, increasing levels of indebtedness can be observed at least since the early seventies. In 2007, the aggregate debt to GDP

[2] I have accompanied this reform in its several stages starting already early on when the Federal Finance Ministry did not yet subscribe to a particular model of a debt brake. See Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (2007), Feld (2007b, 2008a, 2008b, 2008c, 2009), Feld and Baskaran (2007, 2009) and Feld and von Hagen (2006, 2007). For the proposal of the Federal Finance Ministry see Kastrop and Snelting (2008). I will draw on these contributions to provide for an evaluation of the reform ex post.

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ratio was about 65% of GDP and thus 3.5 times as high as in 1970, when the ratio was at 18.6% of GDP. This remarkable increase cannot be explained solely by the reunification of Germany. Already in 1989, the debt to GDP ratio was about 41.8% of GDP in Western-Germany and hence more than double than in 1970.

Table 1: Public indebtedness in Germany

End of the period	Aggregate debt	Federal	State	Local	Debt to GDP ratio
	Mio. DM West Germany				
1960	52,759	26,895	14,695	11,169	X
1965	83,667	40,422	17,401	25,844	X
1970	125,890	57,808	27,786	40,295	18.6
1975	256,389	114,977	67,001	74,411	24.8
1980	468,612	235,600	137,804	95,208	31.7
1985	760,192	399,043	247,411	113,738	41.7
1989	928,837	497,604	309,860	121,374	41.8
	Mio. DM Germany				
1990	1,053,490	599,101	328,787	125,602	X
1995	1,993,476	878,180	511,687	194,101	55.6
1998	2,280,154	1,071,576	623,571	198,833	60.3
	Mio. Euro Germany				
1999	1,199,987	770,342	327,407	102,237	60.9
2000	1,211,455	774,840	338,143	98,462	59.7
2001	1,223,966	760,199	364,559	99,209	58.8
2002	1,277,667	784,653	392,172	100,842	60.3
2003	1,358,137	826,542	423,737	107,857	63.8
2004	1,430,582	869,373	448,672	112,538	65.6
2005	1,489,029	901,620	471,375	116,033	67.8
2006	1,533,697	933,467	481,850	118,380	67.6
2007	1,540,381	940,088	484,373	115,920	65.1
2008	1,541,759	950,431	477,396	113,932	65.9

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Source: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2009), Table 22*, Statistical Appendix, p. 373. – Reported values for aggregated debt are not adjusted for borrowing between different government branches. Data for the federal government do not take special purpose funds into account. Figures for the local tier include borrowing by special purpose funds and community hospitals. From 1991 onwards, certain types of hospitals are not considered any more. The debt to GDP ratio is calculated as the ratio of aggregated debt of all tiers of government to nominal GDP.

According to *Table 1*, the debt to GDP ratio has declined slightly from 2005 onwards until 2007. Some commentators interpreted this small consolidation as a reversal of the general trend of ever increasing levels of debt. The recent financial meltdown, however, casts severe doubts as to the validity of this interpretation. According to the German Council of Economic Advisers ("*Sachverständigenrat*") the debt to GDP ratio will increase to 71.8% in 2009. For 2010, the forecast is 79.0%, for 2011 it is 81.0%, and for 2012 and 2013 it is 82.0%.

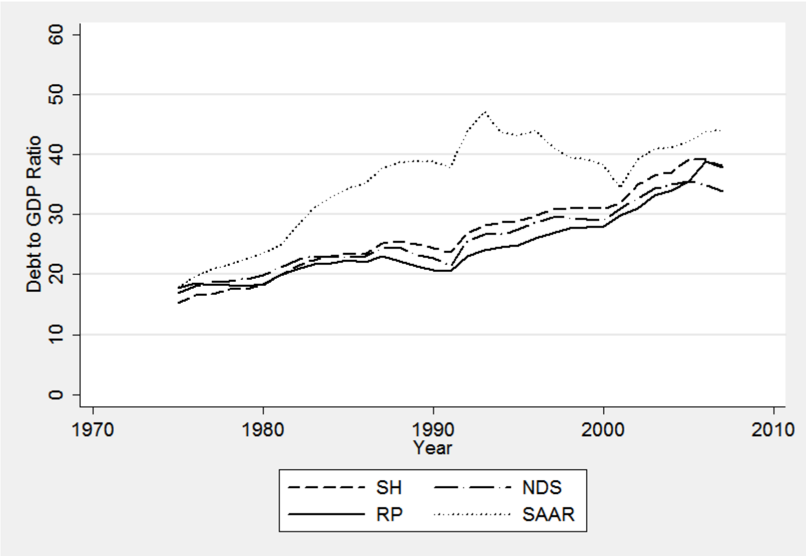

Figure 1a: Debt to GDP ratio (in % of GDP) of fiscally weak West-German states (including communities), 1975 – 2007

Source: Statistisches Bundesamt (2008a, 2008c); Arbeitskreis VGR der Länder (2008)

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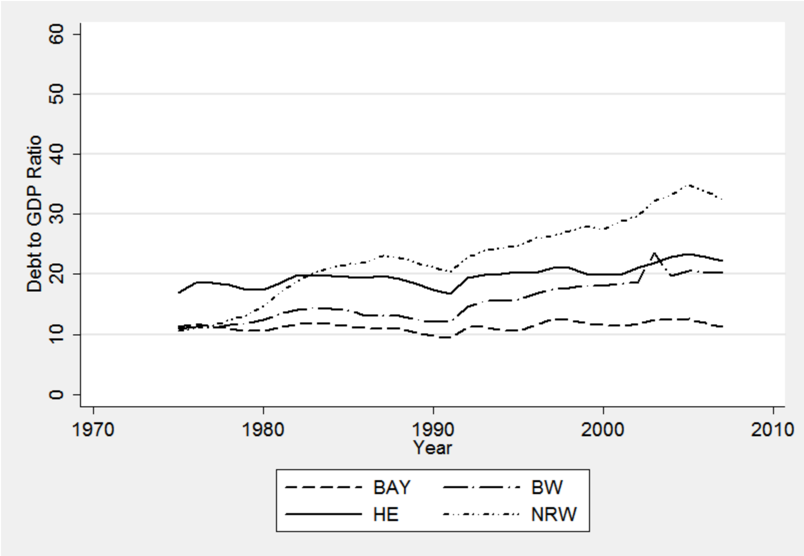

Figure 1b: Debt to GDP ratio (in % of GDP) of fiscally strong West-German states (including communities), 1975 – 2007

Source: Statistisches Bundesamt (2008a, 2008c); Arbeitskreis VGR der Länder (2008)

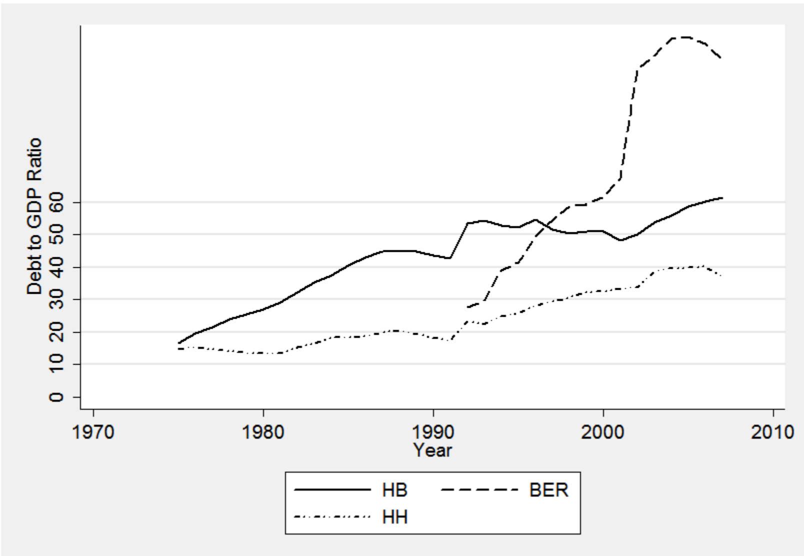

Figure 1c: Debt to GDP ratio (in % of GDP) of city-states, 1975 – 2007

Source: Statistisches Bundesamt (2008a, 2008c); Arbeitskreis VGR der Länder (2008)

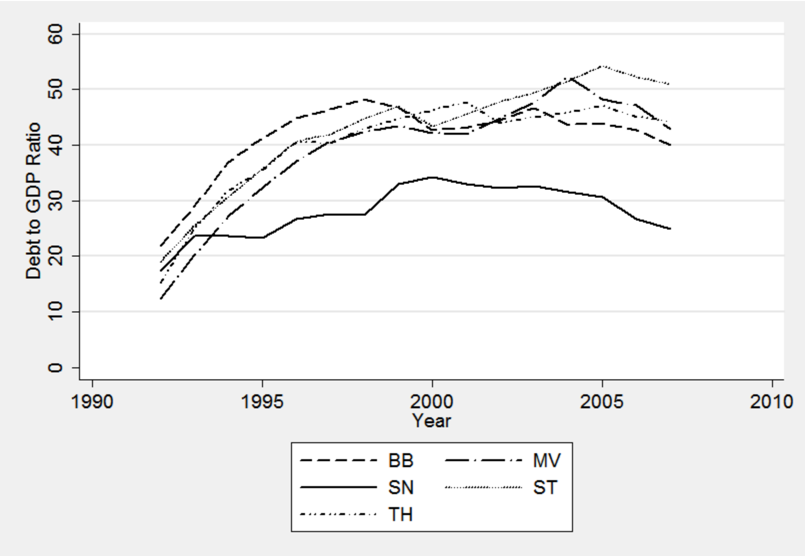

Figure 1b: Debt to GDP ratio (in % of GDP) of East-German states (including communities), 1992 – 2007

Source: Statistisches Bundesamt (2008a, 2008c); Arbeitskreis VGR der Länder (2008)

The federal government is primarily responsible for the rise in aggregate public debt. The federal share in aggregate debt was 53.6% in 1989. In 2007, it had increased to 60.8%. Nonetheless, state governments are not innocent either, even though their relative share in aggregated debt has declined from 33.4% in 1989 to 31.4% in 2007. The situation is particularly dire in the case of some highly indebted Länder, like, e.g., Saarland or Bremen. As can be observed from *Figures 1a* to *1d*, their debt to GDP ratios had risen steeply from the mid seventies to the early nineties in both states. Only the communities offer fewer grounds to worry. Even though their current debt to GDP ratio is higher than in 1989 or in 1960, they have experienced several periods of real fiscal consolidation. Furthermore, the local share in aggregated debt has declined from 13.1% in 1989 to 7.5% in 2007.

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Hence, the developments at the federal, state and local levels are worrisome.[3] Because of increasing levels of debt, an ever increasing share of the budget has to be earmarked for interest payments. This reduces the ability of the government to implement discretionary policies and constrains future generations. This problem is more severe than commonly perceived because interest rates have been rather low in the immediate past. If they should start to rise, the necessity of fiscal consolidation will become even more urgent. Therefore, the need for fiscal reforms in Germany cannot be denied. According to Domar (1944) the debt to GDP ratio needs to be stabilized at some point through the accumulation of primary surpluses when the nominal interest rate is higher than the growth rate of nominal GDP. The debt to GDP ratio will increase in such a situation if a country does not generate primary surpluses, and eventually lead to increased costs for refinancing the debt. This basic relationship has been the starting point for many analyses on the stability of fiscal policy (Blanchard et al. 1990, Seitz et al. 2006).

Such consequences of the rising debt to GDP ratios for the fiscal flexibility of state governments can be illustrated with the help of interest-to-tax ratios. The interest-to-tax ratios are calculated as the ratio of interest payments to tax revenues. The development of these ratios in all Germans states from 1975 to 2005 is presented in *Figures 2a* to *2d*. Note that the definition of "taxes" in these figures also includes "tax-like" revenues such as receipts from the horizontal equalization scheme and vertical transfers, in particular the receipts from so called "*Sonder-BEZ*", "*Übergangs-BEZ*, and "*Sanierungs-BEZ*". It is obvious that the interest-to-tax ratios have increased considerably in Saarland and Bremen from 1975 to 1992. In Saarland, the ratio rose from about 10% to over 25%; in Bremen, the ratio rose from under 10% to about 30%.

The increasing trend in the debt-to-GDP and interest-to-tax ratios in 1975-1990, while particularly pronounced in Saarland and Bremen, was not confined to these two states. Rather, the debt to GDP ratios of all West-German states with the exception of Bavaria have exhibited this trend, even though the increases

[3]Please note that the local level offers a large variety of debt performance. On average, local indebtedness is less worrisome, but many cities and municipalities are highly indebted such that they must finance their current spending by issuing debt. See Heinemann et al. (2009).

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were more moderate in the fiscally strong than in the fiscally weak states. Despite some efforts for fiscal consolidation, debt-to-GDP ratios have generally continued to increase after reunification, with the exception of Bavaria and Saxony.

The rise in sub-national indebtedness presents a twofold problem for the federation: First, because almost all states are responsible for the increasing levels of public debt at the Länder level; and second, because the costs of over-borrowing by one sub-national jurisdiction can be shifted to all members of the federation through federal bailouts. It is thus imperative to understand the causes for the rising levels of public debt.

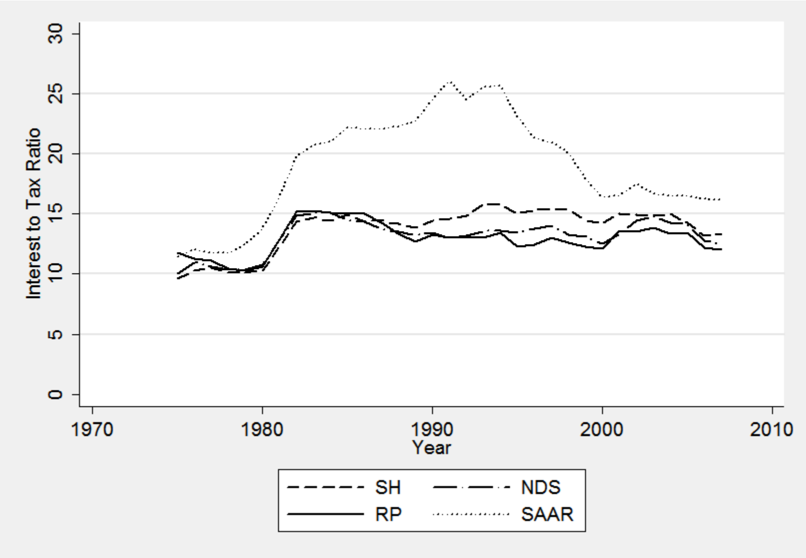

Figure 2a: Interest to Tax ratio (in %) of fiscally weak West-German states (including communities), 1975 – 2007

Source: Statistisches Bundesamt (2008b, 2008c)

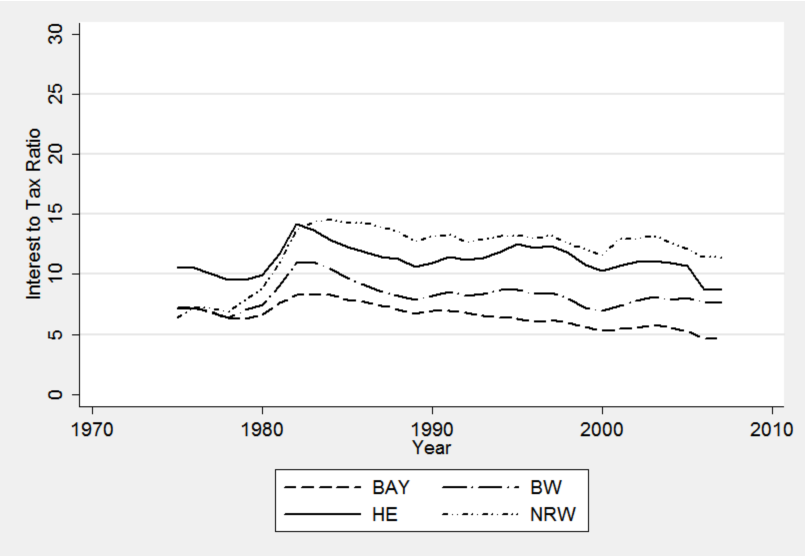

Figure 2b: Interest to Tax ratio (in %) of fiscally strong West-German states (including communities), 1975 – 2007

Source: Statistisches Bundesamt (2008b, 2008c)

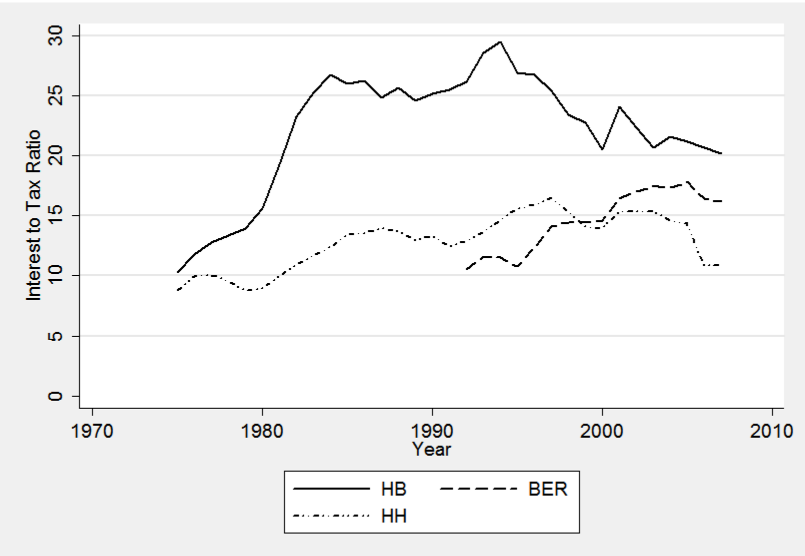

Figure 2c: Interest to Tax ratio (in %) of city-states, 1975 – 2007

Source: Statistisches Bundesamt (2008b, 2008c)

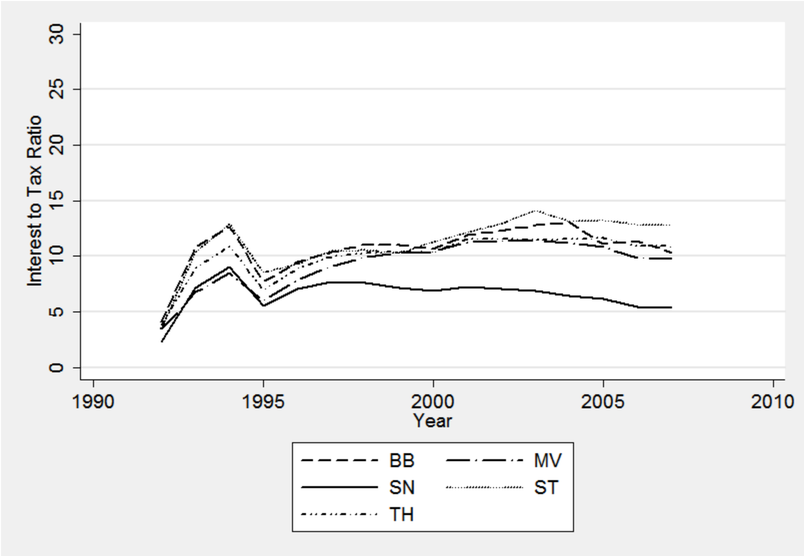

Figure 2d: Interest to Tax ratio (in %) of East-German states (including communities), 1992 – 2007

Source: Statistisches Bundesamt (2008b, 2008c)

THE PROBLEMS OF GERMAN FISCAL FEDERALISM

Most scholars in economics acknowledge that the rise in levels of public debt in almost all OECD countries from 1970 onwards has been primarily due to political factors (Alesina and Perotti 1995, Feld 2008a). Even though economic factors have not been irrelevant, recessions have been too short-lived to explain completely the constant growth in public debt.

Two political mechanisms stand out. First, public indebtedness is likely to increase if governments use debt strategically. A high stock of public debt reduces the fiscal leeway of future governments because they will have to consolidate at some point. If the current government believes that it will not be re-elected, it has an incentive to constrain the ability of subsequent governments, formed by the current opposition, to implement their favored fiscal policy.

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Second, when different interest groups attempt to tap into the common fiscal pool, over-borrowing will be the likely outcome (Buchanan and Tullock 1962, Weingast, Shepsle and Johnsen 1981, Schaltegger and Feld 2009). The benefits of "targeted" public expenditures are experienced by only one or very few interest groups, whereas the costs are usually spread over the whole population. Therefore, any given interest group has an incentive to demand more public expenditures than would be warranted given the true social costs of these expenditures. Even though this argument only addresses public expenditures, it is related to over-borrowing. Through public borrowing, the size of the common pool can be further expanded by including future taxpayers. This results in an additional increase in the demand of interest groups for public expenditures, and rising levels of public debt.

These arguments hold for all government levels in Germany and they are particularly important for the understanding of federal indebtedness. However, there is evidence that the fiscal constitution in Germany exacerbates common pool problems because of the way the federal and state finances become interrelated. The current fiscal constitution is characterized, inter alia, by i) a relatively low level of sub-national tax autonomy, ii) a strong horizontal and vertical interdependence in intergovernmental finances, and iii) the constitutional guarantee of "comparable" living conditions throughout the federation. While each of these characteristics on its own does not necessarily lead to public over-borrowing, their interaction is bound to diminish incentives for sound fiscal policies.

First, the constitutional guarantee of comparable living conditions – formerly even equal living conditions – was interpreted to imply before *Föderalismusreform I* (first stage of the federalism reform) in 2006 that all sub-national jurisdictions had to exhibit identical or at least very similar policies in the most important policy areas. In particular, all sub-national governments were subject to federal regulations with respect to social policy, and employment in the public sector was regulated at the federal level. While the leeway of sub-national governments in the area of public employment has increased considerably after the *Föderalismusreform I*, social policy continues

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to be tightly regulated. The achievement of comparable living conditions thus continues to be one of the main goals of German federalism.

Second, since sub-national governments have little tax autonomy, they are forced to finance public expenditures primarily through the receipts from shared taxes (income tax, corporation tax, and value added tax) for which they cannot determine rates nor define bases, or they must finance spending through transfers from the federal or other sub-national governments. If both sources of revenue do not suffice, the Länder may borrow. Both features of the German fiscal constitution as such lend towards higher indebtedness. In order to achieve similar living conditions across Länder, each has to spend a minimum amount in the different policy areas. In order to finance these spending requirements taxes cannot be increased individually, new transfers must be agreed upon at the federal level also such that borrowing becomes the easiest way to obtain a formally closed budget balance.

The third element of German fiscal federalism exacerbates these problems. The federal and sub-national governments are interlinked in a complex intergovernmental transfer scheme (Feld and von Hagen 2007). This transfer scheme consists of three stages. In the first stage, the revenues from the shared taxes are distributed to the state governments. The receipts from the income and corporation taxes are allocated according to where they were collected; 75% of the receipts from the value added tax are allocated according to population shares. Given that the level of economic activity and thus receipts from value added taxes vary between states, this particular distribution of receipts already implies an equalization of fiscal resources. The remaining 25% are used to raise the available revenues in fiscally weak states closer to the federal average.

The first stage typically fails to achieve a complete equalization of fiscal revenues. Therefore, remaining differences in the fiscal capacity of sub-national governments are further equalized through transfers from fiscally strong to fiscally weak states. Since the federal government does not participate during this second stage of the intergovernmental transfer scheme, this is called horizontal equalization. Even though a recent reform has introduced more

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competitive elements into the system, the intensity of horizontal equalization remains high. After the second stage, the fiscal capacity of fiscally weak states raises to about 95% of the federal average.

During the third stage of the transfer scheme, the federal government grants vertical transfers to the fiscally weak states. These transfers are paid either in the form of general or special needs ("*Bundesergänzungszuweisungen*"). For example, East-German states receive special-needs transfers to compensate them for infrastructure expenditures associated with "Reconstruction East". Overall, these federal transfers continue to reduce the differences in states' fiscal capacity.

This leveling of fiscal capacities implies that every additional Euro collected by a state on its own leads to a reduction of receipts from transfers by an almost equal amount. Thus, states lack incentives to generate additional revenue by fostering economic growth or policing tax fraud (Baretti et al. 2002, Rodden 2006). A state would have to incur the full costs of additional revenue collection while only receiving a fraction of the benefits. If a state wants to increase expenditures, it is, from its own perspective, more reasonable to finance these with public debt. Although the state has to pay the principal and interest in the future, the costs of borrowing are only partly internalized by the current government since the opposition will win the next election with a certain probability. This argument could be an explanation for the relatively low levels of public indebtedness in Bavaria and Saxony.

The incentives to finance expenditures with debt are further increased by additional features of the German constitution. The Constitutional Court emphasized in its ruling on Saarland and Bremen in 1992 that it is the duty of all constituent members of the federation to display "intergovernmental solidarity" toward a state experiencing a budgetary crisis. The solidarity principle was again emphasized in 2006 by another ruling of the Constitutional Court on a similar case that dealt with Berlin. As a consequence, states can expect to shift the costs of borrowing once they lose the ability to finance a minimum level of public goods. It is a reasonable conjecture that this reduction in the expected costs of borrowing leads to inefficiently high levels of public debt (Homburg

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1994, Goodspeed 2002). That is, the constitutional guarantee of a bailout by the federation reduces incentives for fiscal prudence (Wissenschaftlicher Beirat beim BMF 2005).

The solidarity principle, besides its direct consequences on the fiscal incentives of sub-national governments, also reduces the incentives of capital markets to evaluate the soundness of sub-national budgets and to adjust the costs for public debt accordingly. This is exemplified by the different interest rates that different states face. That is, despite significant difference in public indebtedness, rating agencies rate all state bonds equally, and only small risk premiums are charged on the bonds from highly indebted states. Apparently, the possibility of a federal bailout is perceived to imply that the probability of default is equally low in all states.

Overall, the properties of the German fiscal constitution induce the states to be fiscally irresponsible. The fiscally weak states in particular can expect to socialize their expenditures due to the existence of the horizontal equalization scheme and the constitutional guarantee of comparable living conditions. The underlying reason for such incentives is that Germany's fiscal constitution treats tax revenues as a common pool. Therefore, an increase in sub-national fiscal autonomy and a reduction in the "common pool" properties of the tax system will increase sub-national incentives for sound fiscal policies.

The federal government, too, faces common pool problems, but they are of a different nature. As in other OECD countries with parliamentary systems and a proportional electoral rule, different interest groups attempt to obtain economic rents through targeted spending. These attempts already commence when the various federal ministries prepare the next budget. The benefits of the expenditures by one particular bureaucracy are focused on one interest group whereas the costs are distributed over all societal groups, thus generating a different type of common pool problem than that at the sub-national level.

We are thus facing three components of the common pool problem in Germany: first, at the federal level different constituent groups have access to the federal fiscal commons and tend to overuse it. In each Land, constituent groups similarly induce overspending due to a fiscal commons problem. In addition, the states could aim at getting additional funds from the federal government or from the other Länder inducing the third fiscal commons problem due to the interaction in the German fiscal equalization system. Each of these problems needs to be coped with by an effective institutional framework.

WHAT COULD BE THE REMEDIES?

Several institutional solutions are discussed in the literature to reduce common pool problems and strategic public debt, and thus to contribute to sound public finances (Kirchgässner 2002). Each one has its particular advantages, but needs to be adapted to existing constitutional environments in different countries. This holds particularly for a federation like Germany in which, as argued before, the interaction between the state and the federal level poses an additional challenge for sound fiscal policies. Institutional solutions that have been considered for the German case are the following: (1) Activating the control task of financial markets for the Länder level, (2) introducing tax autonomy for the Länder, (3) imposing more restrictive constitutional constraints on public debt than the old version of Art. 115 in connection with Art. 109 GG provides.

Activating the control task of *financial markets* means that every sub-national unit is solely responsible for the costs that result from its borrowing decisions (Konrad 2007). As we have seen, the Länder benefit from the good ratings of the federal government and are able to refinance themselves on relatively preferable conditions. The federal and state governments re-insure their debts mutually ("*Haftungsverbund*" or common liability), which complements the fiscal linkages already established in the fiscal constitution. Moreover, the decisions by the Federal Constitutional Court which establish a final bail-out obligation for excessive debt jurisdictions ensure that financial markets perceive the federal level and the other Länder to step in and thus offer almost uniform conditions for borrowing across Germany. If the common liability for federal and Länder debt were cut, those with higher debt would be required to pay higher interest rates because the risk premium would be higher. With a higher interest rate on new bonds, Länder would have an incentive to reduce their debt. Moreover, the

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creditors would participate in debt restructuring of highly indebted jurisdictions by taking their share of the burden, such that the solidarity between the Länder and the federal level would be less strained.

Other federations like Switzerland or the U.S. emphasize the fiscal autonomy of its sub-federal jurisdictions in their relation to capital markets. As the U.S. has a special regime which cannot be easily transposed to the German case, the Swiss experience appears to be more interesting. The question of debt liability of sub-federal jurisdictions remained almost dormant in Switzerland until the small community of Leukerbad had to concede that it is unable to service its debt. Its creditors and the community itself then sued the canton of Valais for bail-out. The Swiss federal court ruled in favor of the canton of Valais and against bail-out. This led to the consequence that creditors have subsequently been forced to evaluate the creditworthiness of public debtors (Blankart and Klaiber 2006). The Swiss banks therefore reacted to the ruling by adjusting their procedures to evaluate the fiscal position of sub-national jurisdictions (Daldoss and Foreita 2003).

Even before the ruling, the majority of Swiss cantons were associated with different risks of default. According to a study by Küttel and Kugler (2002), the risk-premium on the cantonal in comparison to the federal debt has varied in the 1990-1998 period between -0.14% in Graubünden and 0.86% in Tessin. Given that Euro-bonds in this period had interest rates between one and eight percent these are significant risk premiums (Kirchgässner 2003). Küttel and Kugler (2002) find in their empirical study that the existence of fiscal referendums is the most important determinant of the interest rate differential. Cantons with mandatory fiscal referendums pay – *ceteris paribus* – significantly lower risk premiums. Apparently, financial markets take the expenditure-reducing effects of fiscal referendums into account (Feld and Matsusaka 2003). Overall, the Swiss experience shows that individual liability for sub-federal debt is feasible without major disruptions.

It must be noted however that this institutional solution has never been seriously considered in the deliberations of the Federalism Commission II. One problem of the switch from a common debt liability regime as it currently holds to an

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individual debt liability regime consists in the high volatility of financial markets. Indeed, comparing different states of a common and an individual liability regime empirically may not suffice to obtain insights into the working of each because the transition from one stage to the other also matters. Over-shooting phenomena might occur in the short run such that highly indebted states would have to pay higher risk premia than warranted given their fundamentals. Over-shooting could also transitorily increase refinancing costs at the federal level such that the federal government has been quite skeptical of this solution. Needless to say, individual financial liability of each state could provide a solution for the sub-federal common pool problems in Germany, but would not contribute to a reduction of federal debt beyond the extent of the additional debt that is induced by the Länder due to the incentives provided by the fiscal constitution.

The second solution discussed to cope with excessive debt in Germany is the introduction of *tax autonomy* at the Länder level. In several studies, this remedy has been discussed.[4] As a starter it is obvious that tax autonomy works against indebtedness simply because of the higher flexibility in budgetary terms. Whenever spending is difficult to cut, the Länder governments would not only need to refer to debt as a short term solution to close the budget, but could also raise taxes. Regarding the sub-federal common pool problems, tax autonomy at the Länder level promises to considerably help against excessive spending and indebtedness. Tax autonomy at the Länder level would align spending and taxing decisions following the principle of fiscal equivalence. Those who benefit from public spending programs by the Länder would more probably, though not fully face the costs. With tax autonomy this common pool problem is however only confined to the Länder budgets. To a lesser extent the financing of public spending could be externalized to other Länder or to the federal level. At a conference of the Forum of Federations in 2005, John Kincaid brought this reasoning to the point: “He who has the nice task to spend the money should have the nasty task to collect it.”

[4]See, e.g., Feld (2004), Kirchgässner (2006), Feld and Baskaran (2007).

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In addition, tax autonomy of the Länder would induce tax competition as long as important tax sources would be given to the responsibility of the Länder. The most useful candidates would be personal and corporate income taxes in the sense that the Länder could raise surcharges on personal and corporate income tax liabilities. The subsequently emerging tax competition would most probably be beneficial for Germany overall. The Swiss experience suggests that tax competition between the Länder would induce more efficient provision of public services without providing a real threat to income redistribution.[5]

While tax autonomy was discussed by Federalism Commission II, it has not had a real political chance. This is mainly due to the fact that most of the Länder which are recipients in the fiscal equalization scheme cannot imagine how they should be able to compete with taxes against the fiscally strong Länder. In addition, the city states have fears in tax competition. Drawing on Swiss experience, it should be expected that tax policy provides for a particularly valuable instrument for structurally weak Länder to compensate for the disadvantages they might otherwise have. If this insight is gaining ground, there might be a chance for a reform towards tax autonomy when the current fiscal equalization has to be renewed in 2019.

Thus, the final remedy has been taken to reform German federalism: *Formal fiscal restraints* provides for another solution against excessive debt. The basic idea is simple putting a numerical constraint on budget deficits and/or public debt like the EU Stability and Growth Pact (SGP) does. Supposedly such a rule restrains the fiscal commons problem to fiscal reality. Art. 115 in connection with Art. 109 GG old version took a different route than the SGP by linking budget deficits to (gross) investment spending. Most Länder constitutions had similar stipulations. Unfortunately, this restriction was blurred by the possibility to incur higher debt whenever the economy was in disequilibrium. This clause was unfortunately not specified in more detail by the old constitutional

[5]For the working of tax competition in Switzerland, see Kirchgässner and Pommerehne (1996), Feld (2000), Feld and Kirchgässner (2001, 2003), Liebig and Sousa-Poza (2006), Schmidheiny (2006), Liebig, Puhani and Sousa-Poza (2007), and Feld and Reulier (2009); for its effect on the provision of public goods and the size of government see Kirchgässner and Feld (2004), Feld, Kirchgässner and Schaltegger (2004, 2010), and for the effects of tax competition on income distribution see Feld, Fischer and Kirchgässner (2010).

restrictions such that it was easy to circumvent the restriction to public investment. As the international evidence shows (Bohn and Inman 1996, Kirchgässner 2002, Sutherland, Price and Joumard 2005), the success of formal fiscal restraints depends on the details of the provisions. The Swiss debt brake(s) is deemed to be more successful than the old German restrictions (Feld and Kirchgässner 2008). Thus, it is no surprise that two proposals by Sachverständigenrat (2007) and Wissenschaftlicher Beirat beim BMF (2007) draw on Swiss experience when suggesting a debt brake for Germany. Both proposals differ in one crucial respect that is the role of investment spending. While Sachverständigenrat wants to keep it, Wissenschaftlicher Beirat suggests switching to a close to balance provision. The latter suggestion has been taken up in the new debt rule for Germany (Kastrop and Snelting 2008).

THE LEGISLATIVE CHANGES DURING THE SECOND STAGE OF THE REFORM OF GERMAN FEDERALISM

The changes of the constitution and the accompanying laws for the reform of Germany's system of federalism have to be evaluated in view of the German situation. The reform only attempts to improve the existing borrowing restrictions. The borrowing restriction for the federal government is, on the one hand, structured in view of EU provisions; on the other hand, it also encompasses elements that are known from the regulation in Switzerland.

The new debt rule requires a close to balanced budget. Governments are therefore not allowed any more to incur debt to finance investments. The *federal government* is allowed in "normal" economic times at most a deficit of 0.35% of GDP. Given a normal rate of economic growth, this implies in the long run a decline of the debt to GDP ratio. In order to account for business cycle fluctuations, a macro-economic model is used that is also applied at the EU level. In addition, as in Switzerland, a special account has been established. It synchronizes budget planning and implementation. The unplanned deficits and surpluses are booked to the special account and covered over several years. The debt rule also allows for extraordinary deficits in special circumstances, for example when natural disasters occur, or in times of extreme macroeconomic crises like the current financial meltdown. To approve such extraordinary deficits, a qualified majority is required.

The *states* are restricted to *balanced budgets* in the planning phase, but will have some flexibility over the business cycle in budget implementation. In addition, the new debt rule stipulates a procedure to prevent extreme fiscal crisis; they also upgrade the "*Finanzplanungsrat*" (Finance Council) to a "*Stabilitätsrat*" (Stability Council). Finally, the states of Berlin, Bremen, Saarland, Sachsen-Anhalt, and Schleswig-Holstein will receive additional transfers. The new debt rules will take effect after a transitory period in 2016 for the federal and in 2020 for state governments.

The new rules will in all likelihood have positive consequences for the evolution of public debt in Germany. They are more capable to limit the growth of debt than the existing regulations. If one considers the details of the debt brake, the diligence that was deployed to make it conform to European regulations will become obvious. The federal and state governments are now embedded in a vertical network of debt limitation and are required to put forward valid reasons when they want to expand their debt in the future. At the same time, the debt brake allows for some amount of flexibility. Therefore, the new rule will be both balanced and effective.

There are some criticisms, however. The first is related to the length of the transitory period. Obviously, such periods are necessary in order to give jurisdictions some time for adjustments. The current debate in Germany shows that when the recession is over, consolidation of the federal budget must start at the latest in 2011 if the debt rule should be met in 2016. This indicates that the transition is sufficiently ambitious. Nonetheless, the states could have been more ambitious and commit themselves, as the federal government has done, to implement the new borrowing rule in 2016 and not only in 2020. That the "*Solidarpakt II*" will be discontinued in 2019 is not a sufficient argument for the implementation of the new borrowing rule and has, at most, only symbolic relevance.

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The second criticism is related to the exceptions under which jurisdictions are allowed to borrow. Explicitly mentioned are natural catastrophes and severe macroeconomic crises. Their existence can be stated by parliament with a qualified majority. While this is an improvement compared to existing regulations, it is not a big barrier either. The qualified majority simply requires that more than 50% of all members of parliament (with all MPs present) vote in favor of an expansion of debt. It would have been more effective if the law would have required that any expansion of debt has to be approved by the second chamber of parliament as well.

A third criticism is the definition of what constitutes the public sector. A debt rule should indeed cover the federal and state governments, but also the municipalities, social security, and off-budget items. Currently, however, it only pertains to the federal and state governments. The neglect of the remaining branches of the public sector has been justified on the grounds that their inclusion would cause informational difficulties. This argument is not convincing. The municipalities and the institutions of social security publish forecasts about their budgetary situation over the next few years. The federal and state governments are aware of these forecasts. Therefore, it is questionable why their inclusion into the debt rule would require additional information. It should also be noted that lending between jurisdictions or social security is providing for another loophole in the provisions.

The treatment of off-budget funds has been solved better, even though it is not completely satisfactory. From 2011, new off-budget funds are not allowed anymore by the new debt rule. However, this regulation does not apply to existing off-budget funds. This is particularly relevant for the newly created fund for the rescue of banks, Soffin, and another fund through which the recovery package II is financed. The current discussion on the further development of the debt brake in Switzerland shows how such off-budget funds can be integrated into existing borrowing rules (economiesuisse 2008).

The fourth criticism pertains to the new preventive system. It would have been preferable if the stability council were to formulate the budgetary figures according to which the fiscal stability of jurisdictions is evaluated before the

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actual decisions. This would make the criteria more transparent. The scientific advisory board of the Ministry of Finance (2005) has proposed several indicators and critical values. That they are not inflexible and depend on the state of research can be seen in the contributions by Feld (2006, 2007) and Feld, Baskaran and Schnellenbach (2007). But transparency ex ante is as important as comprehensibility ex post. Also, the social security payments should be explicitly considered in evaluating the fiscal stability of state governments. Finally, the most important problem is that the stability council cannot impose sanctions.

The fifth criticism pertains to the transfers to Berlin, Bremen, Saarland, Saxony-Anhalt, and Saarland. These transfers have been necessary to foster a compromise on the debt brake, even though they have probably more to do with political consideration than with the fiscal situation of these states. Furthermore, the volume of the necessary transfers cannot be determined scientifically, it is a result of a political compromise. More important are the obligations of the recipient states that accompany these transfers. A pre-condition for granting them is that these receiving states agree to dismantle any structural deficits until 2020. The draft has a pre-specified plan for this dismantling. If the stability council spells out a warning to a state because it has failed to implement the plan, the transfers for this year will not be paid. However, the stability council can also determine that a transgression of the debt limit is unproblematic. In this case, there will be no warning and no sanctions. By abolishing the possibility for such a ruling, the hand of the stability council should be strengthened.

The most significant criticism is, however, that the degree of sub-national tax autonomy has not been expanded. When the states are prohibited from borrowing after the introduction of the borrowing rule, they have almost no flexibility to react to unforeseen developments at the revenue side of the budget. While they still have some amount of flexibility at the expenditure side of the budget, the absence of tax autonomy is problematic and could lead to conflicts. Granting sub-national governments more tax autonomy would have resulted in a more effective reform.

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CONCLUSION

Considering the previous analysis, we conclude that the regulations for the introduction of a reformed borrowing rule go a long way in solving the public debt problem in Germany. The main features of these regulations are sound and will lead to more sustainable fiscal policies (Feld 2008a, 2008b, 2008c). There are only few criticisms. First, it should have been more difficult for policy makers to claim an extraordinary economic situation in order to raise more debt than normally allowed. The qualified majority that is required to break the debt rule is too easy to achieve. Second, the communities, social security systems, and special purpose funds are not sufficiently covered by the debt brake. Jurisdictions could lend each other and thus incur higher debt. Finally, more restrictive regulations with respect to the stability council, the transition period, and the consolidation transfers to the fiscally poor states would have been preferable.

The most important flaw of the regulations is that sub-national governments have not been granted more tax autonomy. The chance for a fundamental reform of the fiscal constitution has thus been missed. The experiences in Switzerland show that fiscal competition at the sub-national level leads to preferable economic and fiscal outcomes. Switzerland avoids both a bailout guarantee for sub-national jurisdictions, and the negative incentive effects of an intense equalization scheme.

The habit to impose the costs of one's own fiscal profligacy onto other jurisdictions is less common in Switzerland. The reason for this is probably the high tax autonomy of sub-national governments. Tax autonomy ensures that citizens within a particular locality pay with their own money for the benefits of local public services. In view of the restrictions that the second stage of the federalism reform has had to face, one could not have expected that the fiscal constitution would be significantly reformed. Thus, the only avenue for change is the ability of states to impose surcharges on the income and corporate tax. The apprehensions of many states with respect to the introduction of more fiscal competition are not justified. More autonomy means more responsibility. Without autonomy, the systematic irresponsibility incorporated in the German fiscal constitution will only be prolonged.

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