Dr. Jürgen Hamker: Temporary measures and off-budget activities – developments in Germany¹

Over the first years of this century, Germany's public finances developed very unfavourably. Significant pressures to reduce the overall budget deficit emerged. However, not least given the budgetary autonomy of the individual federal states and their influence on federal legislation, for several years central government failed to bring the German deficit ratio back below the Maastricht threshold by means of consolidation measures. Recourse to temporary measures remained limited, while Eurostat was reluc-tant to accept deficit-decreasing entries in the national accounts. With regard to national fiscal rules, asset sales and securitisations were used to avoid too obvious conflicts. Following the significant decrease in budget deficits experienced since the end of 2005, current European and national fiscal rules are now respected without circumventions. However, a planned tightening of national borrowing limits as well as the European aim to have a structurally balanced budgetary position might lead to a search for new sidestepping measures. Public-private partnerships – despite possible cost advantages – seem to be a part of such efforts. At the local government level, outsourcing seems to distort budgetary data, but the net effect on deficits should be negligible.

JEL-codes: H62, H72, H74

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1. INTRODUCTION

The German constitution stresses the importance of legislation below central government level. A substantial proportion of federal laws - especially those affecting revenues from joint central (Bund) and state (Länder) government taxes - requires the approval of the second legislative chamber, the Bundesrat, where state governments are represented. In addition, budgetary autonomy is also assigned to the individual federal states. They are also responsible for their borrowing rules and for the finances of the local governments (Gemeinden) within their jurisdiction. As a large number of tasks must be fulfilled by state governments and local authorities, the sum of their budgets clearly exceeds central government expenditure. With regard to capital formation, local authorities contribute about 60% to general government expenditure, while the remainder is accounted for in almost equal parts by state and central government. However, since the late 1960s, regular borrowing limits as laid down in the federal and state constitutions refer to the sum of investment expenditure in budgetary terms. Therefore, not only capital formation but also acquisitions of financial assets and investment grants to other parts of general government or enterprises may be used to justify borrowing. Asset sales and depreciation allowances are not taken into account. Consequently, deficit financing is

not restricted to the net increase in government assets but may also be chosen for replacements and subsidies for the private sector. At the local government level, however, stricter rules apply. In most federal states, long-term borrowing may only be used by local authorities to finance investment expenditure if the respective municipality can prove its ability to bear additional debt burdens. As regular redemptions have to be financed from current revenue, such borrowing is restricted in principle to net investments.

In general, borrowing limits in Germany do not seem to be very demanding for central and state government budgets. While the largest parts of the deficits throughout the last decades were incurred at the central level, state governments also significantly contrib-uted to the Maastricht deficit. The maximum level reached almost 1 ½% of GDP in 2003. On the other hand, local governments recorded limited borrowing requirements of less than ½% of GDP.

2. CONTINUED BREACHES OF THE MAASTRICHT DEFICIT LIMIT AND TEMPORARY MEASURES

Between 2002 and 2004, Germany had exceeded the 3% deficit limit set by the Maastricht treaty three times in a row – thus not following the initial Ecofin-Council instruction to

 $^{^{\}scriptscriptstyle 1}$ The views expressed are those of the author. They do not necessarily reflect those of the Bundesbank.

eliminate the excessive deficit in 2004 at the latest. Despite being the main contributor to the high deficit level, the central government faced severe problems in bringing the German figures in line with European rules. On the expenditure side, the most important items, accounting for 2/3 of total central government expenditure, are grants for the statutory old-age pension scheme, interest payments, costs arising from long-term unemployment and defence. Treaties and constitutional commitments leave only moderate room for expenditure cuts in these areas. With regard to staff levels, the budgets contained reductions of about 1 1/2% per year. However, given the relatively low share of compensation of employees in the federal budget (7%), the effects remained limited. Planned revenueincreasing measures affecting joint taxes, which yield about three quarters of German tax receipts, were not given the necessary approval by the Bundesrat, which was dominated by governments led by the big opposition party in the Bundestag (the Christian Democrats). Reaching agreements with the second chamber often involved additional burdens being placed on the central government budget. For example, in order to gain approval for the labour market reform in 2005, the central government had to promise to safeguard relief of € 2.5 bn per year for local authorities, which was ultimately taken from the federal budget. Such approval was not needed in order to raise consumption taxes as revenues accrue only to the central government budget. Following several increases made between 1999 and 2003 in order to finance additional grants for the statutory old-age pension scheme, growth in revenues from mineral oil taxes had come to a halt. Tobacco taxes had already been raised in order to finance measures for combatting international terrorism. Further increases from 2004 onwards were expected to generate about 0.2% of GDP for grants for the statutory health insurance scheme aimed at lowering contribution rates in order to promote employment. However, almost no additional revenues were observed, thus putting additional strains on central government deficit figures. Consequently, there seemed to be only limited scope for budgetary improvements by means of consolidation measures taken by central government.

Budgetary problems in 2005 – which by the end of 2004 was believed to be the decisive year for bringing the deficit in line with European rules – were augmented by the last step of the significant income tax rate reductions between 2001 and 2005. These were approved during the last boom period, when higher GDP trend growth was expected that would have enabled German general government to compensate for the tax cuts. However, several years of near-stagnation had followed and tax revenues had developed even worse than what might have been deducted from the macroeconomic figures and legislative changes.

Following the official tax estimate in November 2004, a further drop in revenue expectations had to be compensated for in order to reach a deficit ratio of slightly less than 3%. Opportunities for sizeable consolidation measures were limited as tax revenues were impaired by the last step of rate cuts as well as by expected ongoing decoupling from the development of the macroeconomic tax bases; therefore, temporary measures similar to those used in other European countries seemed to offer an escape. Between 1997 and 2004, some central governments had taken over old-age pension obligations from enterprises in exchange for substantial one-off payments. As national accounts on the basis of ESA 1995 do not record unfunded pension obligations which are to be paid by general government, such payments were treated as unrequited transfers with a positive effect on the Maastricht deficit. In Germany, the successor companies of the Bundespost had to bear pension obligations for their civil servants. In the nineties, Deutsche Telekom, Deutsche Post and Deutsche Postbank were obliged to pay old-age pension contributions of 33% of the wage sum of the civil servants still employed. Annual amounts of just over € 1 ½ bn were just sufficient to finance a quarter of total pension payments for retired civil servants. Since 1999, about € 5 bn (1/4% of GDP) had to be added from the central government budget every year in order to avoid deficits and an accumulation of debt within this pension scheme. Copying similar cases in Europe would have required the successor companies to be released from their pension obligations. The net present value of the comparable contribution duties amounted to 3/4% of GDP. This would have generated sufficient revenue for central government to avoid another breach of the Maastricht deficit ceiling in 2005. However, the companies did not want to incur this amount of additional debt. Another approach therefore had to be found. Finally, an agreement was reached to securitise the contribution claims. In 2005 and 2006, two transactions took place, yielding € 15 ½ bn for the pension scheme. Consequently, the central government did not have to make any payments in those two years and only minor funding was planned for 2007. If the pension scheme had been booked outside the government sector, this would have reduced the Maastricht deficit. As the securitisation was a sale of future revenue, the ESA 1995 accounting rules made it necessary to treat it as borrowing of the respective sector. However, Eurostat resisted to classify the pension scheme as part of the enterprise sector given the very strong influence exerted by central government on the pension scheme. In the end, it was reclassified within the government sector. Hence, no deficit-reducing effect was recorded and the excessive deficit could not be eliminated. After the reform of the Stability and Growth Pact in 2005, however, no further steps were taken within the excessive deficit procedure and no fine had to be paid. Instead, as

GDP growth had been weak for several years, the German central government was granted another two years to bring the deficit ratio back below the 3% limit.

At the state government level, some temporary measures had repercussions on the Maastricht deficit. However, these transactions were mainly aimed at avoiding breaches of constitutional borrowing limits. These limits, which are based on investment expenditure, are not corrected for sales of assets. Hence, such transactions were chosen as an easy way of alleviating short-term budgetary pressures. State governments, in most cases, do not possess large enterprises that could be privatised as easily as Deutsche Post and Deutsche Telekom. Instead, subcentral governments have many administrative tasks and consequently need numerous buildings. Given the substantial increases in real asset prices in the United States and most European countries government buildings could be sold at reasonable prices and were rented back. In particular, the state governments of Hamburg and Hesse used this opportunity in 2005 (and to a lesser extent in 2006) to sell government buildings for almost € 2 bn. These transactions were classified as sales of non-financial assets and hence reduced the German Maastricht deficit ratio by slightly below 0.1 percentage point. Other state governments took similar measures, but they had reorganised the ownership structure of the buildings in order to enhance the efficiency of their asset management. After the outsourcing of the assets into public corporations, only financial transactions with no direct effect on the Maastricht deficit were recorded. However, this was not considered to be important as the money received prevented the constitutional borrowing limits of the respective states from being exceeded.

Other temporary measures taken by state governments referred to interest claims. Owing to loans mainly granted to home construction companies and Landesbanken, state governments regularly receive interest payments. In order to alleviate budgetary pressures, sales of interest claims were discussed in several states. The biggest transaction occurred in Baden-Württemberg, reaching almost € ¾ bn over two years (slightly less than 0.02% of GDP in each year). However, the budget flagged these revenues as privatisation proceeds without any direct effect on the Maastricht deficit. In other states, smaller transactions may have been treated differently, but the overall effect on the general government deficit ratio should have remained small.

3. BUDGETARY RELIEF DUE TO POLITICAL CHANGES AND MACROECONOMIC DEVELOPMENT

Besides the changes to the European Stability and Growth Pact in 2005, which reduced the time pressure for bringing the deficit ratio in line with the Maastricht limit, a political change occurred. The coalition between the Social Democrats and the Green Party had lost a series of elections in the German states and opposition parties were close to a 2/3 majority in the Bundesrat that would have enabled them to block federal legislation almost completely. The central government wanted to hold early elections in order to receive a renewed mandate from the voters. However, neither the government nor the conservative-liberal opposition parties gained a majority. In the end, the two major parties - the Christian Democrats and the Social Democrats - formed a coalition. This government has a very large majority in the Bundestag as well as in the Bundesrat. As most state governments were facing severe budgetary problems in 2005 - only two of the sixteen states did not require asset sales or misuse of federal infrastructure development grants for Eastern Germany in order to avoid breaching the constitutional borrowing limits - even unpopular tax hikes found support in the Bundesrat given the lack of a major opposition party.

Notwithstanding this, no additional consolidation measures were implemented for 2006 as a whole, while expenditure growth remained subdued. However, strong GDP growth and - to an even greater extent - an unexpected additional increase in revenues from profit-related taxes helped to eliminate the excessive deficit in that year already. Budgetary problems, especially at the central government level, could not be completely solved by that. The budget had envisaged a borrowing requirement of € 38 bn, which exceeded the investment-expenditure-related constitutional limit by € 15 bn. The deficit outcome of € 28 bn was much more favourable, but still clearly above the regular limit in the German constitution. The fundamental position - calculated by just excluding budgetary relief from asset sales or securitisations - was actually far worse as such transactions amounted to about € 15 bn in 2006. Thus, despite the significant improvement in the general government Maastricht deficit figures, a fundamental gap of about € 20 bn with regard to the constitutional borrowing limit had to be closed. For that reason, the 2007 tax hikes announced after the 2005 general election could not be revoked despite the significant improvement of the overall budgetary situation.

As a consequence of these consolidation measures and the aforementioned additional positive developments, most states and the central government have been able to keep their deficits in line with the current constitutional borrowing limits in 2007. It is possible that nine out of sixteen states might even have at least a balanced budget in 2007, while the central government in particular is still facing a borrowing requirement of slightly above € 20 bn excluding one-off

revenues from asset sales and securitisations. However, its latest medium-term financial plan foresees a balanced budget in 2011.² This was considered as being in line with the European agreement concerning objectives for 2010 as other government sectors were expected to have sufficient surpluses by then. In order to prevent a return to high deficits and increasing debt ratios a change of the constitutional borrowing rules is planned. This is expected to be part of the second stage of the reform of the German federal system to be agreed upon by the major parties and state governments before the next general election, which is scheduled for 2009. With regard to transparency and simplicity, following the rules laid down in the European Stability and Growth Pact seems to be a promising approach also for constitutional borrowing limits.³

4. PPPS AS A SIGNIFICANT LOOPHOLE UNDER BALANCED BUDGET RULES

As investment expenditures are expected to generate utility in the future, present taxpayers may want to pass on at least part of the financing burdens. The current budgetary borrowing restrictions do not set any limits on this. However, if in future structural net borrowing is no longer allowed, other ways to shift burdens may be sought. Public private partnerships (PPPs) might be a particularly attractive option. Private companies commit themselves to build, operate and maintain public infrastructure for several years or even decades. According to a Eurostat decision clarifying ESA 1995 accounting rules for PPPs, the respective capital formation expenditures do not have a direct impact on the Maastricht deficit if the private partner takes over at least the financial risks involved in construction and the availability of the respective asset or demand fluctuations. 4 The government partner does not have to pay bills according to the progress of construction works. Instead, regular service fees are charged over a long-term period. Besides interest on invested capital also redemption payments may be included in the fees if the government finally becomes the owner of the assets. Such treaties come very close to credit contracts. Hence, from the perspective of budgetary accounts, PPPs could be used to circumvent balanced budget rules. Under such circumstances, efforts to promote the use of PPP models in Germany have to be observed carefully. Reported cost savings of up to 20% of total costs incurred over the lifecycle of a project might be another good reason for using such

models. However, in practice it will be difficult to judge whether the circumvention of budgetary rules might also be important.

While central government accounts for only a minor part of government capital formation, it has major responsibilities in the field of long-distance road construction. At present, two different types of treaties for cooperation with private partners are available. The first ("A-model") consists of treaties assigning investment expenditure needed for the sixlane development of existing motorway sections to a private partner who will subsequently receive federal truck tolls collected for the respective sections. In spring 2007, the first respective construction works were started.⁵ Treaties for four additional motorway extensions are expected to be signed soon or have already been agreed upon. Total respective capital formation expenditure is estimated to reach € 1.2 bn overall (0.05% of current GDP).6 The other way of integrating private partners was already created in the nineties, but its use is still limited. Specific road construction projects like bridges, tunnels and new motorway sections on mountain slopes may be financed using fees collected outside the federal truck toll system ("F-model"). The lack of profitability of the first projects - the two streets can be circumvented by using somewhat longer toll-free roads seem to impair the prospects of this model. The Fehmarnbelt bridge project would have been an opportunity to revitalise this model, but the responsibility for the main capital formation expenditure of about € 4 bn was taken over by the Danish government.

5. OFF-BUDGET ACTIVITIES BY LOCAL AUTHORITIES

As mentioned above, borrowing limits for local governments are much stricter. Those municipalities still using cash accounting are in principle only allowed to take up a regular loan if their current revenues exceed total current expenditures plus redemption payments due. After the changeover to business accounting, which in early-acting states has to be finished by 2009, the sum of yields has to be at least equal to the total costs including depreciation allowances – a requirement which may be even stricter. In most states, local government borrowing envisaged in the budget has to be approved by a supervisory institution. For larger municipalities, this task is designated to state

² Only three state governments are expected to need more time to balance their budgets.

³ See for example Deutsche Bundesbank (2007b), p. 47 ff.

⁴ See Eurostat (2004).

⁵ See Federal Ministry of Transport, Building and Urban Affairs (2007b).

 $^{^{\}rm 6}$ See Federal Ministry of Transport, Building and Urban Affairs (2007a), p. 14.

⁷ See Deutsche Bundesbank (2000), p. 45.

⁸ See Deutsche Bundesbank (2007a), p. 42 f.

government, which ultimately might have to assume responsibility. However, owing to revenue shortfalls and significant social expenditure increases, many municipalities were not able to balance their budgets as prescribed and financed even current expenditure via short-term cash advances which were not to be included in the budgets. In 2007, cash advances have reached a level of almost € 30 bn (just over 25% of local governments' debt stock).

Problems with keeping borrowing in line with the budgetary rules and the large responsibility in the field of government capital formation expenditure made PPP projects especially attractive for local governments. However, PPPs might be judged as contracts that are similar to borrowing. In that case, approval of supervisory institutions will also be needed. Hence, an extension of leeway for local politicians cannot be directly derived from such agreements. Nevertheless, as part of the government system and thus dependent on electoral support, supervisory institutions in practice have only limited possibility to forbid projects deemed politically important. Urgently needed school building maintenance works, for example, seem to be hard to stop by claiming budgetary problems. By limiting current budgetary pressures, PPPs might be more easily approved than investment projects which would have to be financed immediately from the budget. Given the current borrowing limits for central and state governments, which are based on investment expenditure, PPP projects were mainly a feature for local governments over the past few years. According to a survey, they were in charge of 38 out of all 46 PPP projects (excluding road construction) agreed upon between 2003 and 2005. The total multi-year capital formation expenditure involved was still limited and amounted to just € 1.4 bn (0.06% of overall annual GDP). Compared with the total ESA 1995 government investment of € 31 bn in 2005, the share seems to have still remained below 2%, while figures for the UK, which is considered to be the PPP-benchmark in Germany, reached almost 15%. Although 120 planned additional projects were estimated as including multi-year capital formation expenditure of about € 6 bn, 10 the difference in shares between the UK and Germany will still remain significant.

The limited use of PPPs in Germany is not only to be explained by the budgetary rules. In addition, some legal disadvantages with respect to taxes must also be taken into account. Until the PPP acceleration law came into force in

2005, local taxes on immovable property were charged for each project, while governments were granted exemptions. Similarly to taxes on immovable property, real property transfer tax is still levied unless PPPs are used for government activities and the government partner regains ownership later. Furthermore, services offered by PPP companies are subject to turnover tax, raising prices substantially. Finally, investment grants often play an important role, especially for local government projects. While financing investment expenditure directly from the budget does not pose any problems in that context, PPPs may be judged differently – particularly if the private partner is the legal owner of the respective assets. Altogether, an extended use of PPPs in Germany still seems to depend partly on changes in the legal conditions.

But even if conditions for PPPs were to improve further and the number of such projects were to increase significantly, public finance analysis need not face major problems. When calculating the deficit figures for the Maastricht notification, the national statistical authority takes a prudential approach, classifying assets according to counterpart information from construction enterprises. Consequently, PPPs are expected to be labelled as government investment expenditure with a direct effect on the deficit. Given the common structure of limited transfer of risks and ownership to private partners, this seems adequate.

However, until now PPPs have seemed to be only a minor off-budget item compared with the outsourcing of public entities that has taken place since the 1990s. 12 One important reason for this type of restructuring of local government activities were the restrictions resulting from special rules for public employees and their compensation, government accounting and procurement. In order to gain more flexibility, entities were separated from the administration. Enterprises with limited autonomy and/or public enterprises with legal independence were founded and no longer included in the local government budgets as those institutions have a separate accounting system. Only payments between the administration and the enterprises have to be recorded within the framework of government budgetary statistics. With regard to the national accounts, the enterprises tend to be considered as institutional units outside the government sector. Besides having their own accounting systems, they generally cover most of their costs using fees collected from users and are also deemed to have sufficient autonomy

⁹ Notwithstanding, this type of borrowing is included in ex-post budgetary as well as national accounts deficit figures. The stock of cash advances is also included in the Maastricht debt.

¹⁰ For the data see Federal Ministry of Transport, Building and Urban Affairs (2007a), p. 12.

¹¹ See Eurostat (2007).

¹² For an estimate of the effects since 2000 see Deutsche Bundesbank (2007a), p. 33 ff. A more detailed analysis of the effects of outsourcing on budgetary data can be found in Deutsche Bundesbank (2000), p. 50-53.

concerning their main activities. While, in particular, budget figures for the compensation of employees and capital formation expenditures are lower than without outsourcing, this should on balance be practically offset by lower fee revenues and increased other operating expenditure. The net effect on the deficit should thus – if at all – be relatively small. As public utilities are also expected to cover their depreciation allowances, outsourcing of such enterprises might sometimes even lead to slightly higher deficits. However, disaggregated analyses of local government budget developments and comparisons between different municipalities are significantly impeded. Nevertheless, as most local governments will switch over to business accounting within a few years, they will have to integrate outsourced amenities into their accounting system again and such distortions may disappear.

6. CONCLUSIONS

Temporary measures played an important role in Germany in the first years of this century. However, most of them were intended to keep net borrowing within the constitutional limits and had no effect on the Maastricht deficit. Following the significant reduction of budget deficits since the end of 2005, achieving balanced budgets as prescribed by the European Stability and Growth Pact gained importance. Under such circumstances, budgetary leeway can be extended by using PPPs instead of government capital formation expenditure. Therefore, in order to avoid simple circumventions of borrowing limits, it could become necessary to establish a safeguard. This could be achieved by restricting the use of PPPs to cases in which significant cost advantages can be expected while also fixing a maximum level for capital formation expenditure involved in such contracts. The extension of offbudget activities through the outsourcing of public services observed over the past few years, mainly at the local and to

some extent also at state government level, seems to have had only limited repercussions on the deficit figures. Structural breaks in specific revenue and expenditure categories caused by outsourcing may be corrected after a changeover to business accounting which is expected, at least for local governments, within the next years.

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