

*This is an excerpt from the OECD Economic Survey of Germany, 2004  
from the section on the framework for fiscal policy, chapter 2*

### **The framework for fiscal policy needs to be improved**

1. As was outlined in the special chapter on public sector spending reform in the 2003 *Economic Survey*, linking fiscal consolidation to public sector reform requires a more rigorous approach to evaluating and prioritizing public sector spending projects. Improving the budgeting process itself and rebalancing inter-governmental fiscal relations are instrumental for progress on these counts. The latter also play an important role in determining the speed of response to policy challenges.

#### ***Towards better prioritization in the budgetary process***

2. Against the background of the various fiscal pressures that are impinging on the general government budget strict prioritization of public sector spending projects is required for the sustainability of public sector finances to be secured. In the past, fiscal adjustment on all levels of government was largely made *via* cutting back public investment. While this is much easier to accomplish than reforming entitlement spending, the savings associated with curbing investment are relatively limited in the medium term and might be counter-productive (see **Figure 1.8 in Chapter 1**). Hence, such action needs to be evaluated against alternative spending strategies. Cuts in government employment were another major source of savings over the last decade or so. For these to be efficient choices on government tasks need to be made.

3. The present German budgeting system places little emphasis on policy outcomes. Legislation focuses on parliamentary control of inputs as opposed to budgetary appropriations on a programme or activity basis.<sup>1</sup> In contrast, since the 1980s, many OECD countries, such as Britain, Northern European countries, New Zealand and the US, have relaxed input controls and reoriented budget systems to focus on results.<sup>2</sup> In exchange for greater flexibility in budget management, in this approach decentralized managers are now more responsible for achieving results from a relatively small number of government programs. Accordingly, budget laws have been changed to simplify the structures of budget appropriations approved by Parliament. For example, in France full introduction of a programme-oriented budget is scheduled for 2006, with only about 150 programmes ("budget lines") to be approved by Parliament. Accrual accounting is supplementary to an outcome-based budgeting approach in that it makes the full cost of government activities more transparent, thereby improving decision making by using this enhanced information.<sup>3</sup> German legislation requires that budgeting is based on the cash rather than the accruals principle. While some moves were made by states and communities to introduce elements of accruals accounting, against the standard required by legislation these efforts are supplementary accounting practices and therefore unlikely to be adopted on a general scale within the present legal system.

4. Hence, facilitating the setting of spending priorities by policy makers suggests significant revisions of the input-oriented budget codes at the levels of the federal government and the states so as to adopt output oriented budgeting. This should entail basing budgetary appropriations around programmes, within a simplified budgetary framework, associated with the requirement to supply to parliament analysis of the costs and the benefits of such programmes. Within this setting, ministries would be held responsible for the programme management. This move might as well imply a re-orientation of the qualification structure within ministries with more emphasis on economic rather than legal issues as is presently the case.

#### *Federal fiscal relations need to be untangled to reinvigorate decision making*

5. With the receipts of almost all major taxes being shared between the different layers of government, modifications in the tax regime, including cuts in tax expenditures, require the approval of the second chamber of Parliament. Moreover, both the high degree of tax sharing and the significant degree of co-financing across government levels allows regional governments in principal to condition their approval to federal fiscal legislation on concessions in federal legislation that does not require the approval of the *Bundesrat*, as experienced in the recent legislative process. Key elements of the government's recent legislative proposals that were scheduled to become effective in January 2004 were only decided in mid December 2003. This concerns legislation to bring forward income tax reductions into 2004 and to cut subsidies and tax expenditures. In each case, legislation was delayed by a complicated mediation process between the Bundestag and the *Länder* chamber of Parliament (*Bundesrat*), which involved other draft legislation as well, such as deregulation in the handicraft sector and the combination of social assistance benefits and unemployment assistance benefits into one single means-tested income support scheme. In some instances the outcome of the mediation process proved hard to predict. For example, while some states questioned the appropriateness of bringing forward income tax reductions into 2004, given the need for fiscal consolidation, the volume of tax expenditures to be cut according to the legislative compromise is smaller than originally proposed by the federal government.

6. The organisational reform of the Federal Employment Agency (*Bundesagentur für Arbeit*), which commenced in spring 2003, stands as another example. The design of reorganisation is closely linked to the decision whether the responsibility for the provision of social assistance benefits would continue to rest with the communities or shift to the FEA as originally envisaged by the federal government. However, as with other legislation, the pertinent legislation passed the second chamber of Parliament only in December 2003, without a workable clarification of the issue. Instead, the new legislation introduced a new element of split responsibilities between the FEA and regional governments, which is likely to constitute a serious hurdle for efficient income replacement for long-term unemployed (see **Chapter 3** below), and whose implementation arguably raised difficult legal questions. By spring 2004 follow-up legislation on the issue was still outstanding.

7. Hence, untangling the responsibilities of the federal government and the states and communities is one of the most pressing tasks in order to make meaningful progress on budget and structural reform. Reducing the degree of co-financing between the different levels of government and introducing a higher degree of tax autonomy for the *Länder* and communities, as has been proposed in earlier *Economic Surveys*, would go some way in this direction.<sup>4</sup> In October 2003 both chambers of Parliament commissioned an expert commission to make reform proposals, within a year, designed to improve the allocation of responsibilities within the federal system and to foster the efficiency of public sector actions. Federal fiscal relations, in particular issues of co-funding and taxation should be set on the commission's agenda. Moreover, constitutional reform, limiting the power of the *Bundesrat* to block federal legislation should be considered.

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## NOTES

1. Details on proposed changes in the number of civil servants and salaries are contained in the budget. The input orientation of the budgeting process is illustrated by the fact that the parliament's discussions on resources relative to staffing are often the most contentious part of the budget debate.
2. See Blöndel (2003); Kristensen *et al.* (2002). See also: Lienert and Jung (2004).
3. See: Lüder (2002); Blöndal (2002).
4. See OECD (1997 and 2003a).